

The Sins of the Corporate Grandfather

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You are a risk manager for Grandson, a company with the usual convoluted genealogy of mergers, acquisitions, spin-offs, and other reorganizations. One day the EPA announces that one of your corporate predecessors, Grandpa Corporation (long deceased), released chemicals into the environment that now, generations later, have been determined to be toxic. Grandson is found liable for millions of dollars in remediation and cleanup costs, and faces private suits for bodily injury and property damages as well. Grandson's insurance policies are no help, but you do not despair. Digging through musty archives in off-site storage, you locate an occurrence-based comprehensive general liability ("CGL") insurance policy issued to Grandpa for the period when the chemicals were released. You are overjoyed to find that the policy contains no pollution exclusion. Even better, there is no deductible, and defense costs do not erode the policy limits. You begin to daydream about bonuses and promotions.

You note that the policy prohibits assignment by the policyholder (Grandpa) without the consent of the insurer. Until recently, that non-assignment clause was unlikely to prevent Grandson from obtaining coverage under the policy. Loathe to hand a windfall to an insurer that pocketed premiums merely because of a change in corporate ownership or structure that had little or no effect on the insurer's risk, courts in most jurisdictions have developed a number of reasons for reading non-assignment clauses narrowly or not enforcing them at all. For example, an assignment of policy proceeds after the loss has occurred is often considered an assignment of benefits and not of the policy itself, and therefore not a violation of the non-assignment clause. Similarly, non-assignment clauses have been held not to prohibit the transfer of insurance benefits by operation of law, such as statutory mergers where the surviving corporation succeeds to the merged entity's liabilities and assets. Many courts have also permitted assignment of insurance where successor liability is imposed as a matter of law, in effect allowing the insurance to follow the risk.

This trend of reading non-assignment clauses narrowly was a natural result of the increasing tendency of courts to impose liability upon corporate successors, for public policy or equitable reasons, in contravention of the parties' contractual allocation of liabilities. If public policy or equity could deposit unexpected liability, courts reasoned that they could also invalidate insurance policy provisions that forfeited the coverage intended to protect against those liabilities. After all, the insurer had already bargained and collected premiums for this risk and, in theory at least, assignment of policy benefits does not increase the insurer's risk.

Unfortunately, because of a recent decision in California, *Henkel Corporation v. Hartford Accident and Indemnity Co.*, 62 P.3d 69 (Cal. 2003), you may be heading back to the dusty archives instead of to the corner office. This article discusses the *Henkel* decision and its aftermath, and outlines specific measures that successor entities can take to ensure they have not inherited a predecessor's liabilities without the corresponding insurance assets.

Henkel

Last year, the California Supreme Court denied coverage to a successor corporation in a decision that generated much consternation among policyholders around the country. The *Henkel* court held that a complex series of corporate transactions had left one successor entity with all of the liabilities of its predecessor but none of the insurance coverage purchased to cover those liabilities. From 1959 to 1976, Amchem manufactured two product lines: agricultural chemicals and metallic chemicals, both covered under the same insurance program under policies prohibiting assignment without the insurer's consent. In 1977, Union Carbide acquired Amchem by stock purchase and merger, and Amchem became a Union Carbide subsidiary. Two years later, Union Carbide spun off the metallic chemical business as a separate entity, Amchem II, and Amchem II's board of directors agreed to accept a transfer of all "assets and liabilities" of the metallic chemical business, without any specific reference to insurance policies. Amchem retained the agricultural chemical products and changed its name to Union Carbide Agricultural Products. In 1980, Union Carbide sold to Henkel the stock of its subsidiary, Amchem II, again transferring all assets and liabilities apparently without specifying any particular liabilities or insurance policies. Amchem II then merged into Henkel. Union Carbide Agricultural Products was later sold to and merged into Rhone Poulenc.

In 1989, a group of Lockheed employees sued Henkel and Amchem (which had ceased to exist), alleging bodily injury from exposure to Amchem's metallic chemicals from 1959 to 1976. In 1992, the employees attempted to sue Rhone Poulenc, but later stipulated that they did not intend to assert any claims against Rhone Poulenc because they believed (correctly) that Henkel had succeeded to Amchem's metallic chemicals liabilities. Amchem's insurers refused to defend or cover Henkel in the suit, which Henkel eventually settled for \$7.65 million. Henkel then sued the insurers, arguing that it was entitled to Amchem's insurance coverage relating to the metallic chemical business, particularly because Henkel had inherited the liabilities associated with that business. The trial court rejected Henkel's claim, and the appellate court reversed.

The California Supreme Court reinstated the trial court's verdict, adopting a strict contract-based approach rather than analyzing equitable factors and the purposes of non-assignment clauses. First, the court held that Henkel's liability arose by contract rather than by operation of law, and therefore Henkel was not entitled to the benefit of the corresponding insurance coverage. According to the court, the critical contract was the 1979 board resolution in which Amchem II voluntarily agreed to accept all of Amchem's liabilities relating to the metallic chemical product line. When Henkel merged into Amchem II, Henkel succeeded as a matter of law to the liabilities that Amchem II had voluntarily assumed. "[W]hen liability is assumed by contract, the successor's rights are defined and limited by that contract." In other words, if successor liability comes about because of a voluntary contractual undertaking (in this case a board resolution) followed by liability imposed by operation of law, then the ultimate successor entity may not use the "operation of law" exception to evade the non-assignment clause. Thus, instead of acquiring all assets and liabilities, Henkel acquired all liabilities and no insurance assets.

Second, the *Henkel* court found that, even if there had been an explicit assignment of policy benefits—and there was not—it would have been invalid without the insurers' consent. Henkel argued that, once the event giving rise to the underlying liability has occurred, a policyholder may assign its claim under an occurrence-based liability policy despite lack of insurer consent. The court rejected that argument on the ground that "the claims of the Lockheed plaintiffs had not become an assignable chose in action.

Those claims had not been reduced to a sum of money due or to become due under the policy.” As the dissenting judge pointed out, the *Henkel* majority did not explain how this standard could be reconciled with well-settled California law holding that a loss occurs and coverage under occurrence policies is “triggered by damage or injury occurring during the policy period” and not by the assertion of a claim or its reduction to a sum certain.

Third, the court rejected Henkel's argument that the assignment should be permitted because it involved no additional risk to the insurers beyond what they had already agreed to cover. “Even assuming enforcement of the no consent clause requires a showing of additional burden or risk on the insurer,” the court held, such additional risk existed in the possibility that the insurers might be forced to defend both Rhone Poulenc and Henkel. This possibility was purely hypothetical, because the employees had waived any claims against Rhone Poulenc. Nevertheless, the court noted, rights to insurance benefits “do not rise or fall on the tactical decisions of tort plaintiffs.” The court also suggested in *dictum* that an insurer could face increased risk in the form of the duty to defend two entities rather than one, even if the predecessor entity ceases to exist but “can be revived.” Under this reasoning, a policyholder could seldom if ever show that the assignment of policy benefits involves no additional risk to the insurer.

Whether *Henkel* will have a broad impact on jurisdictions outside California is not clear. Certainly the decision did not have the immediate effect that many commentators expected. Most non-California cases decided after *Henkel* have rejected its strict contract-based approach, either overtly or without mentioning the California decision. For example, in December 2003, a Michigan federal district court followed *Henkel*, but then reversed itself three months later on reconsideration. On the other hand, in July 2004, a New York federal district court did not cite *Henkel* but adopted *Henkel's* strict view of whether an assignment alters the insurer's risk. Regardless of its ultimate impact, *Henkel* illustrates the difficulties inherent in splitting up business operations that once shared a single insurance policy without expressly allocating the benefits of that policy. Risk managers can no longer take for granted the ability of a successor entity to inherit insurance coverage for inherited liabilities.

Preserving Coverage through Corporate Twists and Turns

As cases like *Henkel* demonstrate, a successor company's entitlement to insurance coverage under a predecessor's policies hinges largely on events that unfolded decades earlier. Nevertheless, certain steps can and should be taken to preserve and maximize insurance coverage.

- **Assemble Key Corporate Documents.** First, if your company has merged or acquired the stock, assets, or operations of another business, you should assemble the key documents evidencing the corporate transactions by which the predecessor's assets, liabilities, or business were acquired. Make sure that, at a minimum, you have every merger, acquisition, or divestiture contract, as well as each bill of sale and assignment or transfer of liabilities, insurance assets, or indemnity agreements.
- **Assemble Historical Insurance Policies.** Second, you should immediately assemble as much information as possible regarding insurance policies of the merged or acquired business. The most valuable of these policies—and the hardest to locate—are likely the older, occurrence-based CGL policies. If you suspect that some of these policies are missing, try to obtain whatever secondary

evidence is available, from both the predecessor's risk management files and those of the predecessor's insurance agents or brokers.

- **Notify Insurers.** Third, notify the predecessor's insurer of the corporate transaction. An insurer that is on notice of a merger or other change in ownership will find it more difficult later to convince a court that the policy's non-assignment clause should be enforced. Although this notice is most effective when given at the time of the transaction, late really is better than never.
- **Consider a Request for Consent.** Fourth, consider asking the predecessor's insurers to consent to assigning the policies to the successor entity, or asking the predecessor company to make such a request. The insurer has little incentive to consent, particularly if the policy is old. These policies typically have limits, deductibles, and defense cost provisions that are quite favorable to the policyholder by today's standards, and most insurers are anxious to rid themselves of these coverage obligations. But if you can demonstrate that such an assignment will not increase the risk originally insured against, and the insurer refuses, a court will be more likely to find that the refusal was unreasonable and contrary to the insurer's duty of good faith and fair dealing.

Demonstrating that an assignment will not increase the insurer's risk is much easier where the predecessor entity no longer exists and there is only one successor entity. If that is not the case, you may need to obtain the agreement of the predecessor or other corporate successor(s) that only one entity will demand coverage under the policy.

- **Document Transactions/Avoid Voluntary Assumption of Predecessor Liabilities.** Besides taking the steps discussed above, you should also insist that future mergers, acquisitions, and spinoffs are properly documented to ensure that your company does not acquire liabilities (expressly or by operation of law) without a corresponding transfer of insurance coverage. Similarly, if your company is divesting assets or stock, the transaction documentation should ensure your company does not retain liabilities without also retaining the applicable insurance coverage. One important caveat: In documenting a merger governed by a statute that automatically transfers all assets and liabilities as a matter of law, be sure not to enter into a contract that could later be construed as a voluntary assumption of predecessor liabilities. That could lead a court to follow *Henkel's* example and find that the contractual assumption trumps the transfer of liability by operation of law.

Special care should be taken in the case of spinoffs of wholly owned subsidiaries. *Henkel* illustrates the difficulties that can arise when a parent spins off a subsidiary and then sells it to an outside entity, particularly where the parent and subsidiary share the same insurance policies covering various liabilities. Where a parent corporation retains most or all of the stock of the spinoff, it is easy to overlook the niceties of who owns which portion of which expired insurance policies, and who has what responsibility for satisfying per-occurrence and aggregate deductibles. This oversight can lead to significant future problems.

Conclusion

As Grandson's risk manager, your job was never simple. Imaginative liability theories are on the rise, including successor liability theories that disregard the parties' contractual allocation of liability. *Henkel* may have made it more difficult in some jurisdictions to tap into a predecessor's insurance coverage, but its principal effect should be a caution. Inheriting insurance along with liabilities is not automatic. Rather, it is the result of a carefully planned and executed strategy. 🗨️

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