IN CORPORATE TRANSACTIONS WILL THE INSURANCE FOLLOW THE LIABILITIES?

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Companies buying and selling corporate assets and subsidiaries often transfer corporate liabilities. Some of these liabilities may be covered by insurance. But is the insurance applicable to those liabilities also transferred? *Not necessarily.* Serious complications can arise out of such transactions, often many years later, unless care is taken to structure the transaction so that insurance follows liability. This article illustrates several important potential complications and proposes some ways of avoiding them. In addition, since so much can turn on the validity of anti-assignment clauses in insurance policies, corporate policyholders ought to consider negotiating exceptions to these anti-assignment clauses when they renew their policies.

SELLING A SUBSIDIARY

In 1990, XYZ Corporation ("XYZ"), a diversified manufacturing company, decided to concentrate on its core businesses and sell off the assets it used to manufacture noncore products. One of the noncore products was widgets, manufactured by the unincorporated division known as the Widget Division of XYZ. To effectuate the sale of the Widget Division, XYZ first created and incorporated a subsidiary ("Widget Company" or

"Widget") and transferred the assets and liabilities of the Widget Division to Widget Company. Then, in 1995, XYZ sold Widget Company to a venture capital fund. The venture fund operated Widget Company until 1998, increasing its margins and EBIDTA, and then sold the company to its management.

Fast-forward 11 years to 2009. Widget Company is now an independent corporate entity. It has operated successfully for the 19 years since XYZ took the assets of the Widget Division and created Widget Company. Unfortunately, three weeks ago, a plaintiff filed a lawsuit against Widget Company alleging that a plastic component in the company's main product, the widget, degraded over time and released vinyl chloride into the atmosphere in the vicinity of the widget's installation. The plaintiff alleges that as a result of his many years of working with and around the widget, he had been exposed to vinyl chloride and is now dying of liver cancer. Upon investigation, Widget discovers that vinyl chloride was in fact used in a plastic component in widgets that were manufactured during the time that XYZ owned the Widget Division, but that the division ceased use of vinyl chloride-containing plastic a year before Widget Company was created.

Widget Company does not dispute that XYZ's transfer of the liabilities of the Widget Division to Widget Company included the liabilities arising out of products manufactured by the Widget Division. Widget Company also believes, however, that XYZ's insurance covering the Widget Division should have accompanied the Widget Division's liabilities. Widget's position is that it should therefore be entitled to insurance coverage from the insurers that covered the operations of XYZ during the time that Widget operated as a division of XYZ.

Believing it has coverage, Widget tenders the claim to those insurers for defense and, if necessary, indemnity for the vinyl chloride exposure claim. The insurers deny coverage on the ground that Widget was not their insured and that (as required by their policies) they had not given their consent to the assignment of the insurance policies, if any, to Widget Company.

Who's right?

As with most insurance coverage questions, the answer depends on the jurisdiction whose law controls and what the documents creating and transferring Widget Company provided. For example, in the creation of Widget Company from the assets of the Widget Division, did XYZ expressly transfer insurance rights? If not, the insurance may not follow Widget Company's liabilities. Even if there were an express transfer of insurance, would that transfer be effective, given the anti-assignment clause of standard form insurance policies? In some jurisdictions the transfer is effective, but in some it is not. Do the answers to these questions depend on whether Widget Company continued its independent existence or was merged into a parent company? Again, the answer depends on which state's law applies.

The unavailability of insurance for the type of claim that Widget faces could be devastating to the company. These questions and others related to them therefore require careful analysis. What we know for certain is that in three states—California, Indiana, and Hawaii—insurance coverage does not automatically follow the liabilities that it formerly covered, even if XYZ had expressly transferred rights to coverage when it created Widget Company. In other words, in California, Indiana, or Hawaii, Widget Company would be out of luck.

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HENKEL AND ITS IMPLICATIONS

In *Henkel Corp. v. Hartford Accident & Indemnity Co.*, the California Supreme Court held that where a company's liabilities have been transferred by contract rather than by operation of law (for example, in a statutory merger), the transfer of insurance was "defined and limited" by anti-assignment clauses in the relevant insurance policies. Since these policies prohibited assignment without the insurers' consent, the corporation with the liabilities was left without insurance coverage for those liabilities—even though the alleged bodily injuries occurred before the assignment of assets and liabilities. In other words, in the absence of consent to assignment, the insurer that insured the manufacturer of the actual products that gave rise to the alleged injuries was not required to respond to the tort claims arising from those products. In our example, Widget Company, which received the liabilities by contract (the agreement spinning off the Widget Division), would have no right to the insurance that covered the Widget Division at the time it made the products that subsequently generated tort claims.

Recently, in *Travelers Casualty & Surety Co. v. United States Filter Corp.*, the Indiana Supreme Court held that the anti-assignment clause barred several purported assignments of insurance rights in a series of corporate transactions. The issue the court focused on was whether the policyholder could assign rights to coverage for injuries that had occurred but had not yet been reported as claims, even in the absence of the insurer's consent. The Indiana Supreme Court, following *Henkel*, concluded that it could not.

In the *Travelers* case, the Indiana Supreme Court held that in order to be assignable, the insured loss must be fixed and not speculative. The court further held that the loss must be reported to the insured before it gives rise to a transferable right to coverage and that a chose in action like this can be assigned only at a time when the policyholder could have brought an action against the insurer for coverage.

Taking a slightly different path, but reaching the same result, the Hawaii Supreme Court, in *Del Monte Fresh Produce (Hawaii), Inc. v. Fireman's Fund Insurance Company*, held that Del Monte Corporation's assignment of all of the assets and liabilities of its Hawaiian operations to Del Monte Fresh did not transfer the insurance policies or the rights to defense and indemnity from those policies. The court noted that under Hawaii law:

> it cannot be said, as Del Monte Fresh asserts, that the duties to defend and indemnify are separable from the terms of the insurance policy itself, and are assignable as such notwithstanding the existence of a no assignment provision. … [W]e hold that Del Monte Fresh is not an insured under any of the … insurers' policies, and is therefore not owed duties to defend or indemnify by … insurers.

Thus, under these three cases, whether or not injuries that subsequently give rise to tort claims have already occurred at the time corporate assets are transferred, insurance rights cannot be transferred without the insurer's consent. *Henkel* and *Travelers* at least make an exception to this rule if a tort claim has already been made against the insured at the time corporate assets are transferred. A second important exception applies when assets are transferred by operation of law, such as in a statutory merger or dissolution. In this situation, insurance rights are also transferred, regardless of any anti-assignment clause contained in a relevant insurance policy.

California, Indiana, and Hawaii are the only states that have thus far determined that the assignment of the right to coverage of pre-assignment losses without insurer consent may not be valid. But *Henkel* is a very prominent decision nationwide, and given the fluid nature of insurance law on questions such as this, there is no guarantee that other states will not follow the reasoning of the California, Indiana, and Hawaii courts.

STRUCTURING TRANSACTIONS TO REDUCE THESE RISKS

Whether or not these cases apply, it is clear that the assignment of insurance rights by operation of law is ordinarily valid. A merger is the clearest example of a corporate transaction that effectuates the transfer of insurance rights. Questions arise, however, when more nuanced situations like the hypothetical above are presented. Is the creation of a subsidiary from the assets of a corporation enough like a dissolution or distribution to shareholders that a court outside California, Indiana, or Hawaii would conclude that insurance rights in such a transaction are transferred by operation of law? Similarly, if a corporation purchases the stock of a subsidiary that is one of the insureds under an insurance program, does that subsidiary bring with it the rights to that insurance?

Since the answers to these questions are uncertain, the emphasis should be on finding ways to structure a deal so that, when only assets are purchased, insurance rights are protected for the owner of the liabilities arising from those assets. For example, assume that instead of creating a subsidiary out of the Widget Division, XYZ decides to simply sell the assets of the division to ABC Corporation. Because XYZ wants to be rid of the Widget Division and all of its historic liabilities, known and unknown, XYZ and ABC agree that ABC will assume all liabilities arising from operations of the Widget Division and its products. In order to compensate ABC for its assumption of these liabilities, XYZ agrees to make available to ABC the benefits of XYZ's pre-paid insurance. Is this assignment effective?

Obviously, as discussed above, *Henkel*, *Travelers*, and *Del Monte Fresh* create some questions about this assignment. But assume that the jurisdiction under whose laws coverage is determined has not followed these cases. What other problems may arise? If ABC has assumed the liabilities of the Widget Division, the insurers will argue that since its insured, XYZ, is no longer liable, neither are they. In other words, they will assert, ABC's assumption of liabilities alone may have destroyed the coverage. On the other hand, if ABC's assumption of liabilities does not ultimately protect XYZ from tort plaintiffs, the insurers will argue that they are liable to defend only one of the parties, not both.

What are the alternatives? One would be to leave the liabilities with the seller, XYZ, and provide that ABC will indemnify XYZ to the extent that XYZ's insurance is insufficient to make XYZ whole. This type of arrangement, commonly known as a "net-of-insurance indemnity," has the benefit of not including any purported assignment of insurance rights—the insurance stays with the insured and the liabilities. The anti-assignment clauses of insurance policies therefore do not apply. The parties can then incorporate a claims management provision in the deal documents so that ABC is responsible for defending the underlying claims and submitting claims to the insurers. But this approach has disadvantages. One is that it does not necessarily remove the potential liabilities from XYZ's balance sheet. Another is that the net-of-insurance indemnity is only as reliable as ABC.

A second alternative would be to transfer both liabilities and insurance rights to accompany them to ABC, but to make these transfers subject to an unwind provision and a net-of-insurance indemnity if the original transfers are found to violate the anti-assignment provisions of the policies. But this also may present balance-sheet issues for the parties.

TRANSACTIONS SUBJECT TO FOREIGN LAW

If a transaction involves divisions or subsidiaries that are outside the U.S. and that have in place local policies governed by the domestic law of the relevant territory, then additional analysis is necessary. For example, the general principle applicable in England is that liability insurance policies are not assignable without the insurer's consent, even in the absence of an anti-assignment clause in the insurance policy. In addition, under English law, a merger will not necessarily effect the assignment of insurance rights by operation of law. Were English law to apply to our hypothetical situation, then a purported assignment effectively substituting Widget Company as insured (in the place of the Widget Division of XYZ), unless it took place with the insurers' consent, would probably be invalid.

Under English law, however, Widget Company would be unlikely to face liability for any product that it did not manufacture. But Widget Company might not be off the hook entirely. The fact that XYZ's Widget Division liabilities had been transferred to Widget Company would not prevent the vinyl chloride plaintiff from suing XYZ. Were he successful, then XYZ would likely have a right of indemnity (under the agreement creating or selling Widget Company) against Widget Company on the ground that Widget Company had taken on the liabilities of the former XYZ Widget Division. Under English law, this kind of voluntarily accepted contractual liability may well fall outside the terms of a standard insuring clause of product liability insurance. Consequently, it would have been advisable for Widget Company to have secured coverage filling this gap from the date of inception of its own stand-alone insurance program.

GUIDELINES

It should be clear by now that, until a court of last resort in the state whose law will definitely govern a transaction has ruled on issues of this sort, there is no foolproof, disadvantage-free method of transferring liabilities and insurance rights, short of a statutory merger. Nonetheless, following some guidelines can help to reduce the risk that a transaction will create problems down the road:

- Mergers are the safest way to ensure the valid transfer of insurance rights.

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Transferring assets into a distressed portfolio can also be accomplished through commutations of financial guaranty insurance policies. Commutations raise preference concerns but may also be at risk for fraudulent transfer analysis. A commutation involves payment to terminate the insurance coverage, which involves estimating the value of the claims that would have arisen under the policy had it not been terminated. A commutation can be vulnerable to fraudulent transfer claims because a receiver can determine, in hindsight, whether the commutation was to the insurer's benefit. If not, *i.e.*, if the commutation amount exceeded the value of claims that would have been made, the receiver has ammunition to argue that the transfer was not supported by fair consideration and thus was a fraudulent transfer. CDOs that commute insurance policies can reduce their risk by documenting the basis for commuting the policy with calculations that demonstrate an exchange of fair consideration.

CONCLUSION

There is no algorithm for minimizing risk when transfers are made from insurance companies to CDOs. Indeed, the countless variations in deal structure, coupled with the variations in state law and the goals of the parties involved, make it impossible to create an instruction manual for protecting assets from an insurance company receiver's clawback powers. The most important task is to identify the risk in advance, and then evaluate the proposed transaction from the standpoint of an insurance receiver with the statutory tools available to challenge transactions of this type.

There are structures that can be devised—once the risks are known. It takes patience, understanding of the rules and the client's objectives, and creativity. What is crucial, however, is that all involved understand the risk and manage it from day one, particularly in those jurisdictions—including New York—in which intent is paramount. A business purpose for the strategy must be articulated and adhered to throughout, in both internal and external communications, and an affirmative case for the deal must be documented at all stages. ■

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- In internal corporate reorganizations, don't forget about insurance. If your client is placing assets in a subsidiary, be specific about insurance rights. If your client is purchasing a subsidiary that was formerly a division, make sure that your due diligence includes a review of transfer-of-insurance issues.
- If possible, keep the liabilities in the same place as the insurance.
- Net-of-insurance indemnities in asset transfers are more likely to pass insurer scrutiny than the assumption of liabilities and the assignment of insurance.
- As the representative of a seller, don't assume that the buyer's assumption of liabilities is sufficient to relieve your client of future liabilities in the event that the buyer is not able to respond. Accordingly, consider retaining insurance rights to the extent of liabilities.
- When insurance policies are renewed, consider negotiating exceptions to anti-assignment clauses so as to avoid the complications that may arise in corporate transactions as a result of these clauses.

All of these questions and structures require careful consideration and contract drafting in consultation with an insurance coverage lawyer. It is far better to consider these insurance issues at the time a deal is being structured than when claims later arise and an insurer denies coverage. ■

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