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Time for a Change? California Revisits *Henkel* on Coverage for Contractually Acquired Liabilities

By Celia M. Jackson

The California Supreme Court's unexpected decision earlier this year to accept review of *Fluor Corp. v. Superior Court*, 208 Cal. App. 4th 1506 (2012), *rev. granted*, has both policyholders and insurers speculating about whether the court will overturn its controversial decade-old decision in *Henkel Corp. v. Hartford Accident & Indem. Co.*, 29 Cal. 4th 934 (2003). In *Henkel*, the court disapproved the transfer of insurance rights by operation of law in connection with a corporate transaction. *Henkel* held that where liability is acquired by contract, and not by operation of law, insurance coverage likewise does not transfer by operation of law. The policies in *Henkel* contained a "no assignment" clause, which prohibited the assignment of an "interest" under the policies without the consent of the insurer. Because Henkel had not obtained the insurer's consent, the court held under California law that the attempted contractual assignment was ineffective. Consequently, when Henkel was sued for injuries caused by defective products manufactured by the predecessor, it was not entitled to either a defense or indemnity with respect to such claims.

The *Henkel* Decision

Henkel involved a complex series of corporate transactions, briefly summarized here. "Amchem No. 1" had two distinct product lines: agricultural chemicals and metallic chemicals. Its insurance policies insured both product lines. In 1977, Union Carbide Corporation acquired Amchem No. 1 by stock purchase and merger; Amchem No. 1, now a Union Carbide subsidiary, created a new subsidiary, "Amchem No. 2," and transferred its assets and liabilities related to the metallic chemical products to the newly formed subsidiary. In 1980, Union Carbide sold all the stock of Amchem No. 2 to Henkel. Amchem No. 1 was later sold to a Rhone Poulenc subsidiary.

In 1989, Henkel was sued by a group of plaintiffs who claimed that they had been injured by exposure to the metallic chemicals at their workplace. The alleged exposure had occurred before the creation of Amchem No. 2, when Amchem No. 1 was still selling both agricultural and metallic chemicals. Thus, Henkel tendered the defense of these claims to the insurers who had insured Amchem No. 1. The insurers refused to defend or indemnify Henkel. Henkel settled the lawsuit and filed an action for a declaratory judgment against the insurers.

Henkel brought a motion for summary judgment. Henkel argued that even though it was not the corporate successor to Amchem No. 1 (Rhone Poulenc was), it nevertheless was entitled to the benefits of Amchem

No. 1's insurance policies because Amchem No. 2 had inherited Amchem No. 1's liabilities related to metallic chemicals by operation of law when the assets and liabilities of Amchem No. 1 were transferred to Amchem No. 2. The trial court rejected Henkel's argument, finding that Henkel had voluntarily assumed liability for Amchem No. 1's torts by contract. The trial court also found that any assignment of the insurance policies was void without the insurers' consent.

California's intermediate appellate court, the Court of Appeal, reversed the trial court ruling. It found that the policies had transferred by operation of law when the successor acquired the predecessor's liability.

The insurers appealed to the California Supreme Court, which reversed the Court of Appeal's decision and found that Henkel had no rights to coverage under Amchem No. 1's insurance policies.

Before *Henkel*, the few courts that had addressed the issue of a corporate successor's right to a predecessor's insurance coverage had generally found that where liability transferred to the successor, regardless of how that transfer occurred, the insurance rights followed. *Henkel* was one of the first cases expressly to limit coverage based upon the nature of the corporate transactional documents and the presence of an anti-assignment provision, even where the liability causing acts had taken place before the corporate transaction. Not surprisingly, the case has been the subject of numerous law review articles and professional commentaries and has been cited in numerous jurisdictions outside of California that have decided similar issues.

The *Fluor* Decision

In *Fluor*, the successor corporation (referred to in the opinion as "Fluor-2") was formed as a result of a "reverse spinoff." The predecessor, "Fluor-1," retained certain operations, but others were transferred to the newly created Fluor-2. Hartford Accident & Indemnity Company (which incidentally was also an insurer in the *Henkel* case) had issued a number of insurance policies to Fluor-1 but for many years after the formation of Fluor-2, had paid defense and indemnity to both entities in connection with asbestos claims arising from locations where Fluor-1 had operated. In 2006, Fluor-2 initiated litigation against Hartford to resolve certain coverage disputes. Hartford alleged in a cross-complaint that only Fluor-1 was covered under the policies and that, pursuant to *Henkel,* it did not have any obligation to provide coverage to Fluor-2 because the policies had not been assigned to Fluor-2 with Hartford's consent.

On a motion for summary adjudication, Fluor-2 argued that *Henkel* did not apply and instead the case was governed by a statute enacted in 1872 and codified at California Insurance Code section 520 ("Section 520") that had not been considered by the California Supreme Court in deciding *Henkel*. Section 520 states in relevant part: "An agreement not to transfer the claim of the insured against the insurer after a loss has happened, is void if made before the loss . . . ." According to Fluor-2, Section 520 must be interpreted as invalidating consent-to-assignment clauses in liability policies after an insured "occurrence" has taken place. Fluor-2 contended that, under California law, where there is a conflict between a statute and a common law decision, such as *Henkel,* the statute controls.

The trial court denied Fluor-2's summary judgment motion. Fluor-2 filed a writ of mandate, which the Court of Appeal initially denied. The California Supreme Court, however, vacated the denial order, and the Court of Appeal proceeded to decide the applicability of Section 520. The appellate court found that *Henkel* was "on point", not distinguishable, and that Section 520 did not apply to occurrence-based liability insurance—which did not exist at the time the statute was enacted—but applied only to losses under first-party policies. Fluor-2 filed a petition for review by the California Supreme Court, which the court granted.

Fluor May Address Policyholders' Criticism of *Henkel*

Henkel was widely criticized by policyholders when it was decided. Notably, policyholders' counsel commonly argue that *Henkel* conflates two distinct bases upon which one may acquire rights to insurance coverage: (1) by contractual assignment and (2) by operation of law. Indeed, *Henkel* represents a minority view in jurisdictions that have considered the issue of assignment of insurance rights. Most courts—including courts in New York, Delaware, Illinois, Connecticut, and New Jersey[1] —have found that a no-assignment clause in a liability insurance policy does not prevent the assignment (even without insurer consent) of the right to recover under the policy ***after*** the loss or occurrence at issue has taken place, *i.e.*, a "post-loss assignment." These courts follow the principle that "insurance follows the liability." If a successor is saddled with a predecessor's liability, it should be able to obtain the benefits of the predecessor's insurance to cover claims arising from that liability. These courts also acknowledge that a post-loss assignment—which simply permits someone other than the policyholder to collect insurance proceeds that the insurer agreed and accepted premiums to provide—does not increase the insurer's agreed-to risk.

Indeed, this was the position taken by the lone dissenter in *Henkel*. Justice Carlos Moreno, now retired, argued that when a loss occurs before the asset transfer, the policyholder can freely assign the right to recover under its liability insurance, the no-assignment provision notwithstanding. A post-loss assignment of policy benefits is a chose in action—a right to recover under the insurance contract—that is freely assignable. The dissent's position was not new. Courts have recognized for more than 100 years that once a loss has occurred, a right to payment under an insurance policy for the loss is not a transfer of the policy itself, but rather an intangible chose in action with an existence separate from that of the policy.[2] Not allowing the assignment, the dissent argued, would "secure an unfair windfall" to the insurer.

The majority in *Henkel*, however, found that at the time the successor assumed the liabilities of the predecessor, no chose in action to assign existed. According to the majority, a chose in action exists only after the claims have been reduced to a sum of money due under the insurance contract—a narrow understanding of the term fundamentally different from that of the dissent and other states' courts. Under *Henkel,* only claims that have been reduced to a sum certain can be assigned. In the case of long-tail claims arising from the predecessor's operations—in which injury may not manifest until many years after the predecessor has transferred liability to the successor—the later-created corporation is left out in the cold and cannot access the prior insurance.

Henkel also found that an assignment before claims were reduced to sum certain could subject the insurer to increased risk if both the predecessor and successor company claimed a right to defense under the same insurance policies. In that case, the insurer would have the "burden" to defend both entities, rather than only one of them. In fact, that is what happened in *Fluor*: Hartford defended both Fluor-1 and Fluor-2. The dissent in *Henkel* countered that if the right to recover under the policies were assigned, the insurer would have an obligation to defend only the successor and that any dispute regarding the assignment could be resolved in a separate declaratory judgment proceeding. In fact, courts have rejected the idea that a potential increase in the costs of defense to the insurer justifies withholding coverage to the successor. These cases have correctly found that an insurer's concern with no-assignment clauses has nothing to do with its defense obligation, but rather that the assignment could materially alter the insurer's risk.

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[1] *See, e.g., Arrowood Indem. Co. v. Atlantic Mut. Ins. Co.*, 96 A.D.3d 693, 948 N.Y.S.2d 581 (N.Y. App. Div. 2012) (New York law); *Int'l Rediscount Corp. v. Hartford Acc. & Indem. Co.*, 425 F. Supp. 669 (D. Del. 1977) (Delaware law); *Illinois Tool Works, Inc. v. Commerce & Indus. Ins. Co,*, 962 N.E.2d 1042 (Ill. App. 2011) (Illinois law); *Peck v. Public Svs. Mut. Ins. Co.,* 114 F. Supp. 2d 51 (D. Conn. 2000) (Connecticut law); *Elat, Inc. v. Aetna Cas. & Sur. Co.*, 654 A.2d 503 (N.J. App. 1995) (New Jersey law).

[2] *See Aultman v. McConnell*, 34 F.2d 724, 726 (C.C. Iowa 1888).

Thus, from the policyholder perspective, the review of *Fluor* represents an opportunity for California to adopt the more mainstream view of the transfer of insurance coverage for successor corporations. *Fluor* has generated considerable interest, with amicus briefs being filed by insurers, the California Insurance Commissioner, and industry groups on both sides of the issue. While the California Supreme Court would not lightly and without good reason overturn a previous decision—and therefore could issue a narrow ruling related to the construction of Section 520 and issues of legislative intent—notably, a majority of justices who currently serve on the California Supreme Court were not on the court when *Henkel* was decided.

Avoiding *Henkel* in Corporate Transactions

Henkel represents a minority rule that may be overturned in *Fluor*. But until the California Supreme Court issues its decision in *Fluor*—which is likely to happen next year—corporations considering an asset sale or purchase governed by California law should carefully examine the insurance ramifications and consider ways to structure transactions to avoid running afoul of *Henkel*. Because the situations under which liability transfers by operation of law vary, it is advisable that a policyholder seek legal advice as to whether a corporate transaction will raise *Henkel* issues.

Other Policy Provisions Applicable to a Merger or Sale

Aside from the no-assignment provision at issue in *Henkel,* it is also important to consider other policy provisions that may apply in the event of a merger, sale or acquisition involving the policyholder. Many types of liability policies, including general liability and D&O (directors and officers) policies, contain "change in control" provisions. These provisions vary considerably. For example, some policies may terminate upon a merger or change in control, although they should still provide coverage for claims arising from actions that occurred before the transaction. Interestingly, there is very little litigation involving the interpretation of these types of policy provisions, and it is therefore unclear whether they would be strictly enforced. Nevertheless, it is important that a policyholder contemplating a change in ownership look carefully at its insurance policies to consider the effect the change may have on existing coverage and, if the policyholder will be the successor, to examine the predecessor's coverage and potential liabilities.

Given the pitfalls of *Henkel* and the uncertainty created by the California Supreme Court's acceptance of the review of *Fluor*, a policyholder may want to consult an experienced coverage attorney when contemplating an asset sale, merger or other change in corporate control.