AKO POLICYHOLDER ADVISOR
The Policyholder Law Firm
Volume 12 Number 1 www.andersonkill.com March 2003

# Buyers Beware! California Confounds Corporate Policyholders

Cathleen Cinella Tylis William G. Passanante

Are you a corporate risk manager or corporate counsel for a company with any connection to California? Might your company buy or sell another entity in California? If so, you should "beware" of the California Supreme Court's recent decision in *Henkel Corporation v. Hartford Accident & Indemnity Co., et al.*, 129 Cal. Rptr. 2d 828 (Cal. 2003). *Henkel* represents an extreme departure from California law with respect to insurance rights for pre-transaction liabilities. Under *Henkel*, insurance companies will argue that bought and paid for occurrence-based liability insurance may be eliminated by common changes in corporate form even without *any* change in risk.

On February 3, 2003, the California Supreme Court reversed a favorable policyholder decision from the Court of Appeal, which had held that the right to indemnity for pre-transaction liabilities transferred by "operation of law" to a successor corporation, even though the insurance policies were not assigned in the purchase transaction. *Henkel* rejected the well-established "operation of law" theory and concluded that the successor corporation was not entitled to a defense or indemnity from the predecessor's insurance companies for lawsuits alleging bodily injury as a result of exposure to the predecessor's chemical products. *Henkel's* extreme decision was based on two findings: (1) the successor corporation's liabilities for pre-sale injuries were assumed voluntarily by contract rather than imposed by law; and (2) an assignment of insurance benefits without the insurance companies' consent violates the "no-assignment" clause in the policies.

The "no-assignment" argument set forth in *Henkel* has been rejected by courts nationwide. The near-universal rule across the country is that the right to recover for pre-transaction liabilities may be freely assigned without the insurance company's consent notwithstanding the supposed "no-assignment" clause in the policy. Such an assignment does not interfere with the insurance company's right to choose its own indemnitee but merely involves the payment of a claim which has already accrued. Courts have concluded that because the alleged injury took place *prior* to the transfer of assets, the insurance company is not exposed to any greater or lesser risk than the one bargained for when it initially evaluated the risk. Accordingly, the benefits of the insurance policies are transferred by operation of law irrespective of whether the *physical* policies themselves were actually transferred. In other words, the right to indemnity follows the alleged liability rather than the policy itself. This is simply how liability insurance works.

***"The 'no-assignment' clause in the policy should not prohibit assignment after a loss has taken place."***

Insurance companies will argue that *Henkel* narrows this long-standing rule by finding that an assignment is valid only when: (1) a claim against the policy has been "reduced to a claim for money due or to become due;" or (2) the insurance company has breached a duty to the policyholder and the assignment constitutes a cause of action to recover damages for that breach. Insurance companies will use *Henkel* to incorrectly equate a "chose in action" with a claim that has been "reduced to a sum of money due or to become due." Under this flawed argument, a chose in action is very narrowly defined as a claim resulting in a legal finding of liability. Yet, a chose in action is much broader. Black's Law Dictionary defines a chose in action as "the *right* to bring an action to recover a debt, money, or thing." To establish a chose

*"Buyers Beware!..." continued page 2*

## RECENT DEVELOPMENTS

**Negligence Causing Damage To Other Property Is An Accident, Iowa Judge Rules.** *General Casualty Insurance Cos. v. Exterior Sheet Metal, Inc.* General Casualty Insurance Company ("General Casualty") sought a declaratory judgment denying its duty to defend Exterior Sheet Metal ("ESM") under CGL and umbrella policies in effect from 1998 to 2002. ESM had constructed a new roof for an athletic facility at the University of Northern Iowa. After ESM left the project, the roof began to leak. ESM argued that the roof began to leak after a snow and ice storm, that this constituted an "accident," and that a continuous exposure to harmful conditions constituted an "occurrence." ESM also contended that the damage to the interior of the athletic facility constituted "property damage" caused by continuous and repeated exposure to the leaking roof. General Casualty asserted that ESM knew it was doing defective work on the roof, therefore, damages to the interior were expected. General Casualty further argued that there cannot be an "accident" if a defect exists. U.S. Magistrate Judge John A. Jarvey of the Northern District of Iowa agreed with ESM, finding that the matter fit within the policy's definition of occurrence, involving continuous or repeated exposure to harmful conditions causing property damage.

The judge also found that when negligence causes damage to property other than that upon

"Recent Developments" continued page 3

"Buyers Beware!..." continued from page 1

in action, a party need only show that a right to recovery exists.

In addition to violating fundamental principles of insurance law, *Henkel* allows insurance companies to argue that they should receive a windfall reduction in coverage for the risk they have agreed to insure. For example, suppose an insurance company collects a $2 million premium from Company A for the 2000-2001 policy year. In 2002, Company A sells all of its assets and liabilities to Company B. In 2003, Company B is sued for liabilities arising out of Company A's 2000-2001 operations. Under *Henkel*, the insurance company can argue that unless it consented to the assignment, it has no obligations under the policy even though it collected premiums for this very loss. In this scenario, the insurance company argues that it should pocket the $2 million premium and be released of any responsibility.

Insurance companies are well aware that they may be called upon to defend or indemnify their policyholders for incurred but not yet reported ("IBNR") losses. Insurance companies deal every day with IBNR losses and even deduct IBNR losses from their federal and state income taxes. Standard insurance reference works define and discuss IBNR losses as follows:

> IBNR losses: An estimate of the amount on an insurer's (or self-insurer's) liability for claim-generating events that have taken place but have not yet been reported to the insurer or self-insurer. The sum of IBNR losses plus incurred losses provide an estimate of the insurer's eventual liabilities for losses during a given period.

Given the insurance industry's familiarity with the concept of IBNR losses, insurance companies cannot argue that they did not expect to pay, years after the fact, for injuries which occurred during their policy periods.

The *Henkel* decision essentially eliminates bought and paid for insurance coverage for IBNR losses arising out of pre-transaction operations. Insurance companies will use this decision to deprive their policyholders of already existing insurance coverage for potential IBNR losses. Courts should not act as underwriters after-the-fact, performing post-loss underwriting to undo the promise the insurance companies made when they sold the policies.

### *Conclusion*

Insurance companies will argue that, under *Henkel*, buyers must either obtain new insurance coverage for losses that *have already taken place* or force their predecessor's insurance company to consent to an

"Buyers Beware!..." continued page 3


"In contrast, insureds and insurers share an uneasy, almost adversarial relationship."

Answer on page 3

assignment. Such an argument puts policyholders at a disadvantage when purchasing and selling businesses and allows insurance companies to improperly retain valuable insurance premiums while avoiding their coverage obligations. Although the nationwide impact of this decision remains to be seen, corporations should beware that their rights to coverage may be eviscerated if their predecessor's insurance company asserts these extreme arguments. ■

William G. Passannante is a senior shareholder in the New York office of Anderson Kill & Olick, P.C. and is Co-Chair of the firm's insurance coverage practice group. Cathleen C. Tylis is a junior shareholder in the New York office of Anderson Kill & Olick, P.C. Mr. Passannante and Ms. Tylis regularly represent policyholders in insurance coverage disputes. William G. Passannante can be reached at (212)278-1328 or wpassannante@andersonkill.com. Cathleen C. Tylis can be reached at (212)278-1390 or ctylis@andersonkill.com.

## INDUSTRY NEWS

**New Jersey Court Cuts Off Allocation Period at Time When Insurance Was Unavailable in the Marketplace** Frequently, in states that "allocate" liability for losses among triggered insurance policies, rather than enforcing the standard-form promise in those policies to pay "all sums" of the policyholder's liability, insurance companies seek to extend the allocation period for environmental damages to the present day. Because of the advent of "absolute" and "total" pollution exclusions in 1985, extending the allocation period beyond 1985 can drastically reduce the policyholder's recovery. Recently, however, a New Jersey court rejected such arguments.

In *Champion Dyeing & Finishing Co. v. Centennial Insurance Co.*, the court considered coverage for environmental contamination from a leaking underground storage tank, which took place from 1980 through 1997. The policyholder had purchased occurrence-based general liability coverage, with a "sudden and accidental" pollution exclusion, until 1986; thereafter, its general liability insurance policies contained an "absolute" pollution exclusion. The insurance companies that sold occurrence-based policies from 1980 through 1986, argued that their coverage obligations should be diluted by allocating responsibility to the policyholder for years from 1986 through 1997, on the ground that the policyholder could have purchased environmental impairment liability ("EIL") insurance during that period.

The Appellate Court found for the policyholder. First, the court discussed the nature of EIL insurance, in relation to the allocation rule, and specifically, the fact that only one claims-made EIL insurance policy in any continuous period can be triggered by the discovery of pollution because EIL policies are "claims made" and not "occurrence" policies. Second, the court found that, because EIL coverage was written on a claims-made basis, at most one hypothetical EIL policy from the years 1986 to 1997 would have responded, even if the policyholder had purchased EIL coverage in each year. Concluding that the occurrence-based insurance companies had not proved even that the one hypothetical policy would have responded—because no EIL policy would have covered underground tanks as old as those which leaked - the court refused to allocate any of the loss after 1986, and refused to allocate any of the loss to the policyholder. ■

*—Richard P. Lewis*

## RECENT DEVELOPMENTS

which work was performed is an "accident" under the policy, and that it is unlikely that ESM expected damage to the interior of the facility or that loss of use would occur because of faulty workmanship. Judge Jarvey noted that the Iowa Supreme Court has ruled that defective workmanship by itself is not an occurrence under a CGL policy and predicted that the Supreme Court would hold that an "occurrence" exists if a claim seeks coverage for other property consequentially damaged by negligent work. The judge further held that the "business risk" exclusion precludes coverage for the cost to repair the roof due to faulty work, but does not relieve General Casualty of liability for damage to property other than the roof.

Finally, the "intentional acts" exclusion does not apply, because the judge found no evidence that ESM intended or expected damage to the interior of the facility and therefore he denied the insurance company's motion. The judge granted in part and denied in part ESM's motion, finding that a delay in

*"Recent Developments" continued page 4*

**a WHO SAID WHAT?**

**Columbia Casualty Co.**, Columbia Casualty Company's Memorandum of Law in Opposition to North River's Motion for a Protective Order, dated Nov. 1, 1994, *North River Insurance Co. v. Columbia Casualty Co.*, No. 90 Civ. 2518 (S.D.N.Y.).

*"Recent Developments" continued from page 3*

notifying General Casualty of the time the roof first leaked created doubt as to the reasonableness of ESM's notice and whether it complied with the notice provisions.

**Ruined Studies Covered Under Employee Dishonesty Policy Despite Absence of Intent.** *Scirex Corp. v. Federal Ins. Co. Scirex Corp.* ("Scirex"), a firm specializing in clinical testing of new drugs for pharmaceuticals companies, filed suit against Federal Insurance Co. ("Federal") in U.S. District Court for the Eastern District of Pennsylvania, seeking payment under an "employee dishonesty" policy, which covered losses caused by the dishonest acts of Scirex employees. Protocols for four clinical trials required Scirex's nurses to observe patients for eight hours and record their observations every 30 minutes. In many cases, the nurses sent patients home after an hour, while recording and submitting observations covering the full eight hours. Therefore, Scirex had to do the four studies again, costing $1.2 million. Federal refused to cover Scirex's losses, maintaining that the nurses' actions were not dishonest because they acted on their belief that it was unnecessary to strictly follow protocol and they did not intend to harm their employer or enrich themselves when they fabricated drug study paperwork. Federal also stated that even if the nurses' actions were dishonest, its policy covered only "direct" losses and Scirex's losses were business expenses. Finally, Federal contended that even if it were liable for Scirex's losses, it would be liable for $280,000, the policy limit for one occurrence, because the four studies were related. The District Court agreed with Federal on the "employee dishonesty" policy and the policy limit for one occurrence.

On appeal, the U.S. Court of Appeals for the 3d Circuit concluded that the nurses' actions were dishonest as well as negligent, and therefore was covered by Federal's policy. The Court of Appeals agreed with the District Court that the nurses' actions directly caused Scirex's losses. The Court of Appeals also agreed that Federal's liability is limited to $280,000 for the four studies. ■

*—Claudia Ilie*

**AKO Policyholder Advisor** is published every two months by Anderson Kill & Olick, P.C. The Firm has offices in New York, Washington, Chicago, Philadelphia and Newark. The newsletter informs clients, friends, and fellow professionals of developments in insurance coverage law. The newsletter is available free of charge to interested parties. The articles appearing in **AKO Policyholder Advisor** do not constitute legal advice or opinion. Such advice and opinion are provided by the Firm only upon engagement with respect to specific factual situations. For more information, contact our Editorial Board:



Anderson Kill & Olick, P.C.
1251 Avenue of the Americas
New York, NY 10020