Good News for California Asset Transfers: Insurance Now Follows the Assets

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Insurance

In *Fluor Corp. v. Superior Court*, No. S205889 (Cal. Aug. 20, 2015), the California Supreme Court overruled its own 12-year-old decision in *Henkel Corp. v. Hartford Accident & Indemnity Co.*, 29 Cal. 4th 934 (2003), and returned California law to the mainstream by once more allowing policyholders to assign rights to insurance coverage without obtaining insurance company consent. This removes a significant and widely-criticized legal impediment to mergers and acquisitions that implicate business operations and liability exposures in California.

Background and *Henkel*

Henkel involved a common transaction in which a company transfers assets to another entity along with rights to insurance coverage for the accompanying liabilities. The assignment of insurance policy rights for such liabilities is a key part of many asset transfer deals: the acquiring company may be unwilling to take on liabilities unless it also inherits the predecessor's related insurance rights.

To the surprise of many, and bucking a decades-long national trend as well as earlier California law, the California Supreme Court in *Henkel* ruled that these routine transfers violated the "consent to assignment" provisions found in many insurance policies. These provisions say that the policyholder cannot transfer its coverage rights to another entity without the insurance company's prior consent. Such provisions are supposed to protect the insurance company from having to cover new entities that may have different risk profiles than the entity it originally underwrote. But American common law has long recognized that the rationale for enforcing anti-assignment clauses is no longer relevant *once a covered loss has occurred*. The insurer's coverage duties are fixed at that point, and what is being assigned then is not the policy as such but the contractual right to be indemnified for a particular liability the insurer already is obligated to cover.

The *Henkel* court however held that such an assignment was not valid without the insurer's consent, at least not until the loss had been "liquidated" (through a judgment, for example). This ruling represented a major barrier to asset transfer deals, which often require insurance rights to be transferred in order to protect the successor from future claims that might arise out of past business operations, such as legacy "long tail" liabilities for asbestos and environmental injury or damage. Insurance companies have little or no incentive to agree to assignments after they have collected premiums, and before *Henkel* many corporate insureds did not seek consent because the law seemed clear that they did not need to. *Henkel* created an unexpected legal impediment to asset transfers involving operations in California, and it cast into doubt an important aspect of many corporate transactions that already had been consummated. Even where Delaware law governed a transaction, a California court might have found California law

applicable to a dispute over coverage for assumed liabilities originating in California, and determined there was no coverage if the insurer withheld consent.

In *Henkel*'s wake, corporations and practitioners were forced to consider these insurance repercussions in addition to the usual considerations to structuring a deal. Various work-around strategies arose. The most obvious was for potential buyers and sellers to seek the insurers' consent to transfer the insurance rights. The insurers had considerable leverage in this scenario, and often companies were advised to be prepared to pay an additional premium in exchange for consent. Because many of the liabilities involved would have been covered under "old" insurance policies (which are triggered when the original injury or damage occurred), companies had little ability to weaken or delete any "consent to assignment" provisions or to influence any choice of law clauses to steer clear of states that followed the *Henkel* rule.

An alternative strategy was for the buyer to try to assume the liabilities "net of insurance." A so-called net-of-insurance indemnity technically leaves the liabilities with the seller (meaning that insurance policy anti-assignment provisions would not apply since the liabilities and the policy had not actually been assigned). The seller then warrants that it will manage any claims and communicate with the insurers. Though mostly effective, disadvantages of this strategy included potential balance sheet problems for the buyer, the need to rely on the seller to defend future claims and suits (and to negotiate defense arrangements), and solvency concerns about the seller.

Companies were also advised to reconsider the structure of transactions to avoid the *Henkel* asset purchase problem altogether. Since stock purchase transactions and mergers were generally assumed to be free from *Henkel*'s limitations (especially in situations where the original corporation survives and is able to pursue insurance coverage, such as an equity acquisition or reverse triangular merger), companies considered these structures as alternatives to purchasing assets in California. But in many situations, such as purchasing a spun-off division or unit of a larger business, such structures often were difficult or impracticable to accomplish.

In short, *Henkel* imposed significant complications and transaction costs on companies seeking to acquire or divest business operations or other assets located in California.

Fluor's Reversal

Nearly a decade after *Henkel* was decided, the Court granted review in *Fluor* to consider the effect of Cal. Ins. Code § 520, a statute that had never even been mentioned during the briefing in *Henkel*. It provides that "[a]n agreement not to transfer the claim of the insured against the insurer after a loss has happened, is void if made before the loss." On its face, this statute says that insurance policy anti-assignment provisions are unenforceable if the assignment occurs after the covered loss occurs, and therefore directly contradicts the California Supreme Court's ruling in *Henkel*. The trial court in *Fluor* however concluded that it did not have the authority to second-guess *Henkel*, and the Court of Appeal concluded that § 520 did not require a different result anyway, reasoning that § 520 was first enacted in 1872 – before liability insurance even existed – and so could not have been intended to apply to third-party (as opposed to first-party) insurance claims like the asbestos injury claims at issue in *Fluor*.

The Supreme Court reversed, and in doing so rejected its ruling in *Henkel*. In a unanimous opinion by Chief Justice Cantil-Sakauye, it exhaustively demonstrated that third-party liability insurance was well-known to the Legislature when § 520 was amended and reenacted in 1935 and 1947, and must therefore have been intended to apply to assignments of not only first-party property insurance policy rights, but rights under third-party liability insurance policies too.

As to the critical question of what the Legislature meant by the phrase "after a loss has happened," the Court acknowledged the phrase standing alone was ambiguous. To determine its meaning, the Court surveyed the consent-to-assignment law in effect at the time of the statute's initial and subsequent enactments, which was near-universal in holding that the relevant "loss" occurred *at the time of the covered injury* and *not when the policyholder was later adjudged to be liable for it*.

The Court concluded by adopting the majority rule that insurance policy anti-assignment clauses are not enforceable if the assignment is made after the covered property damage or bodily injury has occurred. It recognized that this is "a venerable rule that arose from experience in the world of commerce" and "has been acknowledged as contributing to the efficiency of business by minimizing transaction costs and facilitating economic activity and wealth enhancement" by allowing the marketplace freely to allocate assets to their most profitable uses.

Fluor's Continuing Lessons

For corporate policyholders involved in California asset transfers, *Fluor* is unquestionably welcome news. The impediments that *Henkel* previously imposed are lifted, and the sometimes cumbersome work-arounds, alternative deal structures, and requests for insurer consent should no longer be necessary. However, the *Fluor* decision makes several additional points clear for corporate policyholders.

First, parties acquiring assets and liabilities in California through an asset transfer should focus diligence efforts on identifying potentially insured losses that have occurred as of the time of the asset transfer – according to *Fluor*, any "loss sustained by a third party that is covered by the insured's policy, and for which the insured may be liable." Such losses may or may not yet be the subject of actual claims or suits against the transferee. For example, public exposure to injurious substances like asbestos may trigger policies long before claims are asserted. Focusing on such losses during diligence and considering coverage for them will permit the acquiror to more quickly and effectively transfer the liabilities to insurers if and when they "ripen."

Second, the acquiror also should make certain that the asset transfer agreement includes an express assignment of insurance rights, and that to the extent possible, the acquiring company's own insurance coverage is adequate to respond to any potential losses that may occur *after* the transaction is complete. If due diligence reveals such potential losses, the parties can account for those exposures by adjusting the purchase price, arranging for the seller to retain some responsibility for the potential liability, or taking other similar measures.

Third, while *Fluor* is a significant decision from an influential court and reflects the majority rule nationwide, its geographic reach is limited to California. As *Fluor* acknowledges, at least some courts have followed and may continue to follow the minority view, including certain courts in Indiana, Hawaii, Louisiana, Oregon, Texas, and Florida. Asset transfers implicating assets and

potential liabilities in those jurisdictions will, for now, still require careful consideration in order to avoid inadvertently jeopardizing insurance coverage.

While *Fluor* has paved the way for greater insurance certainty in California-focused asset transactions, it also serves as a reminder that corporate practitioners should remain focused on whether the insurance will follow the assets.

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