

THE POLICYHOLDER ADVOCATE/IP COUNSELOR

NEWSLETTER

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NEW CHALLENGES FOR MERGER AND ACQUISITION SPECIALISTS:

Avoiding Legal Malpractice Exposure



I. INTRODUCTION

Knowledge of insurance law, previously considered arcane by some business attorneys, has become increasingly relevant in assessing whether policy forms possessed by clients may respond to a variety of intellectual property/antitrust and other business torts. Heightened awareness of these connections will lessen the potential for malpractice claims against business litigators who fail to consider insurance opportunities when representing defendant/counterdefendants, or even claimant/plaintiff/counterclaimants, in business litigation. In a series of

three decisions, first issuing from the California Supreme Court, a serious potential exists that policies issued to an acquired company may not be assignable freely to the acquiring company without the insurer's express written consent. *See Henkel Corp. v. Hartford Acc. & Indem. Co.*, 62 P.3d 69 (Cal. 2003); *Century Indem. Co. v. Aero-Motive Co.*, No. 1:02-CV-108, 2003 U.S. Dist. LEXIS 24565 (W.D. Mich. Dec. 17, 2003); and *Associated Aviation Underwriters, Inc. v. Purex Indus.*, No. B149365, 2003 Cal. App. Unpub. LEXIS 7501 (Cal. Ct. App. Aug. 4, 2003). Thus, merger and acquisition corporate counsel also need to be sensitive to the insurance implications of their deal-making.

II. HENKEL AND PROGENY: INSURER CONSENT REQUIRED TO ASSIGN INSURANCE BENEFITS

Henkel Corp. v. Hartford Acc. & Indem. Co., 62 P.3d 69 (Cal. 2003) dashed the blithe assumption

that the transfer of certain assets and liabilities from one company to another will include an assumption by the acquiring company of the acquired company's liability

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If you have a topic you would like to see addressed in future issues, please feel free to contact us with your suggestions.

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insurance, whether or not a claim or lawsuit is pending as of the date of the acquisition. Prior to *Henkel*, the majority of courts to address this issue held that insurance will follow the liabilities against which it insures for events that arose or liabilities that arose before the transfer as insurance coverage follows the liabilities. The nonassignment clause in the policy did not impact this result.

This is the most logical solution to the problem: Transferring liability once an insured event occurs or liability arises does not change the insurer's risk. This follows because ownership of the assets and the identity of the acquiring company to which risks are transferred is of no moment.

The acquiring company cannot influence the risk of exposure for such events. Absent such a rule, liability insurers might receive a windfall from what would otherwise be a covered set of claims merely because of a change in the ownership of assets.

Henkel, applying California law, relying on a literal interpretation of the nonassignment clause, changed this result. Thus, any company whose operations potentially subject it to California jurisdiction risks the application of California law under its broad governmental interest choice-of-law rules. Nor are there any published decisions in most jurisdictions addressing this issue, including New York and Delaware, leading to the argument that, in the absence of a conflict of law, California choice-of-law rules require the application of California law.

In *Henkel*, liability was not imposed involuntarily by law, but

assumed voluntarily by contract, according to the Court. Since the insurance rights were assumed by contract, the rights obtained were "defined and limited by that contract." *Id.* at 74. The Court did not address whether insurer consent was required when successor liability was imposed by operation of law, and the trial court had found that the corporate restructuring agreement did not assign liability insurance benefits to accompany the liabilities that were expressly transferred. *See id.* at 72. Had the Court desired, therefore, in *Henkel*, the case could have stood only for the proposition that, in an asset purchase transaction, when the liabilities do not transfer by operation of law, and the insurance rights were not transferred by contract, those rights would not be deemed transferred by operation of law.

The *Henkel* Court, however, went further, finding that, even if the predecessor contractually assigned benefits under its liability policies to the acquiring company, *Henkel*, "any such assignment would be invalid because it lacked the insurer's consent." *Id.* at 74. The only exceptions are where (1) "at the time of the assignment the benefit has been reduced to a claim for money due or to become due," or (2) "at the time of the assignment the insurer has breached a duty to the insured, and the assignment is of a cause of action to recover damages for that breach." *Id.* at 76. The Court was concerned about the additional burden that would be placed on an insurer from such an assignment without consent by the insurer. Further, that both the party assigning and the assignee could arguably both claim defense rights under the policy

and this would double the burden to the insurer – again, without its consent. This is despite the fact that the plaintiffs had voluntarily dismissed their original suit against the predecessor, seeking only to recover against the successor, *Henkel*, in the facts before the Court. *Id.* at 76.

In *Associated Aviation Underwriters, Inc. v. Purex Indus.*, No. B149365, 2003 Cal. App. Unpub. LEXIS 7501 (Cal. Ct. App. Aug. 4, 2003), the court found that in a suit where CERCLA liability was to be imposed against the successor as a matter of law, there was no transfer of the insurance by operation of law. *See id.* at *6-7. The rationale was, again, derived from *Henkel* based on the reasonableness of enforcing a consent-to-assignment clause based on the potential "additional burdens" on the insurer that may arise. *See id.* at *8.

Century Indem. Co. v. Aero-Motive Co., No. 1:02-CV-108, 2003 U.S. Dist. LEXIS 24565 (W.D. Mich. Dec. 17, 2003), involved the assumption of assets of the predecessor through a series of transactions. Again, an environmental damage suit caused by the predecessor during the period covered by the insurer's CGL policies was at issue. When the successor filed suit against the predecessor's insurance for recovery of cleanup costs, the court rejected the transfer of insurance benefits by operation of law based on the product line successor theory in *Northern Ins. Co. v. Allied Mutual Ins. Co.*, 955 F.2d 1353, 1357 (9th Cir. (Cal.) 1992), which held that the right to indemnity "followed the liability rather than the policy itself," and thus

inured to the successor's benefit through operation of law. *Id.* at 73. The court rejected this argument, relying on *General Accident Ins. Co. of Am. v. Superior Court*, 64 Cal. Rptr. 2d 781 (Cal. Ct. App. 1997) (emphasizing that the "insured-insurer relationship is a matter of contract").

While acknowledging "[s]uccessor liability is a matter of tort duty and liability," the court stated, "It is one thing to deem the successor [] liable for the predecessor's torts; it is quite another to deem the successor [] a party to insurance contracts it never signed, and for which it never paid a premium, and to deem the insurer to be in a contractual relationship with a stranger." *General Accident*, 64 Cal. Rptr. 2d at 785. See *Red Arrow Products Co. v. Employers Ins. of Wausau*, 607 N.W.2d 294, 302 (Wis. Ct. App. 2000) (The court emphasized that the successor liability rule's intent was to protect a person who "cannot otherwise protect himself or herself from an injury arising from a product manufactured by a company that no longer exists." The rule, therefore, in its view had no application to contractual insurance relationships.); *Glidden Co. v. Lumbermens Mut. Cas. Co.*, No. 409039 (Ohio Common Pleas May 8, 2002); and *Millennium Chemicals, Inc. v. Lumbermens Mut. Cas. Co.*, No. 411388 (Ohio Ct. Common Pleas Cuyahoga County May 8, 2002), as reprinted in 16 Mealey's Litigation Report Insurance 27 (May 21, 2002) (holding "[t]he coverage of liability insurance does not automatically fall with the assets purchased by a stranger to the insurance policy." The court rejected the successor

liability doctrine in a transaction where the court found an asset purchase arose.). In the alternative, the *Aero-Motive Co.* court noted that the loss at issue did not occur prior to the assignment of the policies, as the environmental cleanup damage was not evaluated until long after the asset's sale. Since "an insurer's responsibility under a liability policy accrues at the time the complainant suffers damage rather than at the time of the negligent act," there was no ongoing liability at the time of the assignment. The court found *Henkel's* reference to the increased risk to which insurers would be exposed if an insured were permitted to assign policies without the insurer's consent supportive of its analysis.

There is much to criticize about *Henkel's* analysis as dissenting Justice Moreno noted at 62 P.3d at 76. Chief among these are: (1) a constricted conception of a chose in action; (2) a clear frustration of the purpose of occurrence-based liability policies; (3) misplaced concerns regarding increased insurer risk; (4) forfeiture for insureds and a windfall for insurers; and (5) public policy concerns based on the restriction of corporate restructuring methods.

Other jurisdictions dispute this result under an asset purchase where the wrongful acts creating insurability had occurred at time of transfer. See, e.g., *Gopher Oil Co. v. American Hardware Mut. Ins. Co.*, 588 N.W.2d 756, 764 (Minn. Ct. App. 1999) (asset purchase); *National Am. Ins. Co. v. Jamison Agency, Inc.*, 501 F.2d 1125, 1128-30 (8th Cir. (S.D.) 1974) (applying Illinois or South Dakota law) (stock

purchase agreement following dissolution and assignment); *Total Waste Management Corp. v. Commercial Union Ins. Co.*, 857 F. Supp. 140, 143, 152 (D. N.H. 1994) (asset purchase agreement); *B.S.B. Diversified Co. v. American Motorists Ins. Co.*, 947 F. Supp. 1476, 1480-81 (W.D. Wash. 1996) (insurance coverage transfers in an asset sale, regardless of nonassignment provision). Courts are split when such liability is based on a statute such as CERCLA, enacted after the asset sale, but the triggering event predates the acquisition. In California, however, the case states the present law, and as the authorities referenced suggest, other courts may find their analysis persuasive. So long as that risk exists, merger & acquisition specialists need to be careful in structuring deals to address insurer assignment issues.

III. DEAL - MAKING SOLUTIONS TO ASSIGNABILITY ISSUES

The reach of *Henkel* can be blunted by recognizing that it addressed only an asset sale, not a forward direct merger or reverse-forward transfer merger, or stock purchase. The key problem in each case is that the acquirer's own insurance is unlikely to cover the acquiree's pre-closing actions or liabilities. Insurance coverage passes with liabilities under *Henkel* in three scenarios. First, the transaction amounts to a consolidation or merger of the two corporations (leaving no survivor). Second, the acquirer is a mere continuation of the seller. Third, the transfer of assets is for the fraudulent purpose of escaping liability of the acquiree that would

otherwise transfer under scenarios one or two. The rationale of this decision was that the nonassignment provision requires insurer consent before any rights under the policies are assigned. The court contended that if the result were otherwise, the insurer would be taking on an additional burden for which it did not bargain. Notably, the *Henkel* court did not address the issue of whether a pending liability claim may be transferred as part of the transaction. The logic of its decision would appear to support a bar on these facts. As a consequence, insurance counsel should be retained to assess what exposure may be in place at time of transfer and how the risks posed may be vitiated.

Most of the merger stock acquisition scenarios should not be adversely impacted by *Henkel* as state merger law would not enforce the nonassignment provision to such deals. *Brunswick Corp. v. St. Paul Fire & Marine Ins. Co.*, 509 F. Supp. 750, 752-53 (E.D. Pa. 1981) (applying either Delaware, Maryland or Pennsylvania law); *Chatham Corp. v. Argonaut Ins. Co.*, 334 N.Y.S.2d 959 (1972) (applying New York law). In a case that did not involve an acquisition of all stock, but rather acquisition of a particular product line of a predecessor and the assumption of related liabilities, critically, the agreements did not explicitly provide for the transfer of insurance benefits between predecessor and successor. See *Henkel* at 71-72. The Supreme Court rejected the Court of Appeals' product line successor rule expounded in *Northern Insurance*.

First, establish a separate subsidiary corporation for each of the product lines. Spin off any product line by selling the subsidiary's stock

to the buyer. Under such circumstances, the liabilities and the insurance rights of that subsidiary would remain unchanged under the corporation's new ownership, and the insurers would have no occasion to assert consent-to-assignment clauses.

Second, procure a consent to assignment from the insurers whose policies would be implicated by endorsement to all policies likely to be implicated at the time of the assignment; and have any increased premium demanded by the carriers made part of the negotiated deal. This will require an assessment of what coverage exposures may exist that would require access to these policy benefits, typically the task an insurance litigation audit would address.

Third, have the assigning company take the risk that the law to be applied to interpreting the assignability of the policies would be in accord with the previous majority rules, finding consent-to-assignment clauses inapplicable where the covered loss occurs before the transfer or sale of assets. See COUCH ON INSURANCE § 35:7 ("The [consent to assignment] clause by its own terms ordinarily prohibits merely the assignment of the policy, as distinguished from a claim arising thereunder, and the assignment before loss involves a transfer of a contractual relationship, while the assignment after loss is a transfer of a right to a money claim.").

Recent decisions applying the law of Kansas, Georgia, Iowa, Connecticut, Montana, Pennsylvania, Texas, and New York suggest that this is the majority rule. However, most of these decisions predate *Henkel* and progeny. Thus, procuring a representation and

warranty from the assignor which is then secured by an insurance policy issued vis-à-vis that express representation and warranty by a separate carrier will stand behind that risk, charging a premium for that service, but leveraging the risk that (1) no liability would arise that would require access to such policies; (2) if it did, the successor product line theory would control; and (3) that the need to structure the deal in this fashion was driven by business realities, not a fear of any anticipated covered litigation.

IV. ERRORS & OMISSIONS EXPOSURE FOR MERGER & ACQUISITION SPECIALISTS

A merger & acquisition specialist who fails to address assignment of insurance policies in an asset acquisition may be liable for legal malpractice. The clear analogy is to cases pursued against intellectual property litigators who have failed to tender insurance claims for a defense on behalf of insureds they were defending. In both instances an economic benefit, which the lawyer is in a position to recommend to the client, has been lost through failure even to evaluate it. Notice not given cannot be remedied under the law of most jurisdictions. In a minority including significant states like Illinois and New York, (*Steadfast Ins. Co. v. Sentinel Real Estate Corp.*, 283 A.D.2d 44, 50 (N.Y. App. Div. 2001)) a delay of less than a year may preclude any right to policy benefits. *Montgomery Ward & Co. v. Home Ins. Co.*, 324 Ill. App. 3d 441, 448-49 (Ill. App. Ct. 2001). Under the insurance coverage provisions of most states, defense fees incurred pre-tender may be forfeited.

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In *Jordache Enters. v. Brobeck, Phleger & Harrison*, 18 Cal. 4th 739, 764 (1998), the California Supreme Court implicitly found that it was malpractice not to provide notice to the insurer of a pending trade secret lawsuit. Nonetheless, it ruled that the one-year statute of limitations ran from the date new counsel took over the defense of the underlying action. As no notice was provided to the insurer during this period, the statute expired.

Similarly, while finding it was not generally known that trademark lawsuits might trigger coverage at the time notice was not provided, that situation could not attend when the state of the law was more settled. *Darby & Darby, PC v. VSI Int'l, Inc.*, 268 A.D.2d 270, 272 (N.Y. App. Div. 2000). New York's three-year statute of limitations is triggered from notice of conduct which would create liability. There was not a broad duty to inquire into all insurance, but notice to the carrier of the risk as of the date of alleged wrongful acts was incumbent on a prudent practitioner.

V. CONCLUSION

Proactive merger and acquisition specialists should consult with insurance coverage attorneys to assess whether there is realistic exposure for liability claims, likely to arise from any claims that could be asserted against prior coverage, that may not be assignable in light of the applicable law. Long-tail environmental claims, as well as medium-tail antitrust claims and short-tail IP claims, must all be considered in this analysis.

A litigation insurance audit, if previously performed, can be readily accessed for this purpose. However, a simple inquiry on this issue can also include determining whether the

insurance policies are adequate to meet liabilities and impact the perceived value of the transaction. Proactive counsel can minimize the likelihood that an acquiring entity is deprived of insurance on which it intuitively relies in such transactions, or if necessary the deal can be modified to minimize this risk.

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