

# THE ROLE OF INSURANCE ASSETS IN BUSINESS TRANSACTIONS

By Eric Rothenberg and Tom Freeman\*

## INTRODUCTION

In recent decades, companies have faced increasingly large and sometimes particularly catastrophic losses from largely unanticipated private and governmental claims, including those arising from environmental matters. At the same time, companies are consolidating or experiencing fundamental corporate change at an unprecedented pace. It has, accordingly, become critical to understand the dimension of these claims and how they impact the business deal, including what insurance assets may be available. We begin by providing a context for the kinds of insurance that are relevant in business and financial transactions. Next, we discuss techniques used by legal and other professionals in finding policies and developing a picture of what the insurance asset looks like. We discuss legal issues inherent in documenting deals successfully. Finally we will discuss methods to protect and enhance the existing insurance assets.

Insurance assets are relevant in deals of all kinds. In stock deals, generally speaking, the insurance assets will be acquired without need for special documentation, since the policyholder remains the same. In asset acquisitions, by contrast, there may be legal impediments to acquiring the insurance. The same is true as to financings, where there may be actions that need to be taken if the insurance assets are to redound to the benefit of the lenders as well. In the context of reorganizations and workouts, it typically takes the action of the bankruptcy or the reorganization court to allocate the insurance assets and specify their disposition.

## TYPES OF INSURANCE

### *Comprehensive General Liability Coverage*

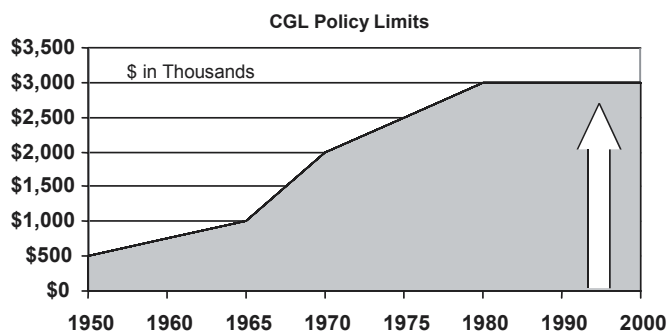
The kind of insurance that typically is of most interest in these transactions is historic comprehensive general liability (CGL) coverage that is written on an occurrence basis; under an occurrence policy a claim can be made today with respect to an event that occurred many years ago. Hence, under an occurrence policy, a company could seek coverage for a superfund action filed against it today with respect to contamination that occurred at a facility during World War II. This is distinct from the way most insurance is written today, which is on a claims-made basis; both the event giving rise to the insurable event and also the claim have to be made within the policy period.

CGL policies provide coverage for property damage and bodily injury or personal injury, broadly defined, and these policies are usually written with policy forms or form endorsements that cover business interruption, advertising injury, products liability and the like.

The classic illustration of the importance of occurrence-based insurance in a business transaction is asbestos claims. It has been estimated that there could ultimately be \$280 billion paid out in asbestos defense and indemnity, as against estimated insurance reserves of \$40 billion. This disparity in insurance resources has already been a central factor in over sixty major bankruptcies. This has been very much in the news, what with the Congressional debate over the FAIR Act, which would provide compensation for all the remaining asbestos claims<sup>1</sup>.

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The chart illustrates what the historic occurrence-based insurance assets might look like in the asbestos context. Limits of liability, as might be expected, increased dramatically over time from the 1950s to the present. This also demonstrates why it is important to locate and seek coverage over the entire period. While the limits of liability were typically smaller in the early days, there were also fewer applicable exclusions to coverage. In the later years, the limits are increased, but there are more potential problems with exclusions and other limitations in the policies.

Typically, policies were written each year for single and aggregate claims on an occurrence basis. Presupposing that we are looking at a claim by an asbestos pipe fitter who was first exposed to asbestos in 1950, became symptomatic in 1970, and was diagnosed as having asbestos-related mesothelioma in 1980, there are potentially as many as 30 years of coverage that could be used to cover the claim. How much of that coverage is available will depend on the law in the state that might apply; the swing issues being “trigger of coverage” (which of the policies applies?) and “scope of coverage” (how much of the liability does each triggered policy pay?).

### ***Triggers of Coverage***

There are three basic potential trigger theories: one specifies the period of exposure, meaning beginning in 1950 and continuing throughout the period of exposure<sup>2</sup>; another trigger is the time of manifestation of the disease or discovery of the disease which, depending on the definition used, would be in the 1970s or in the 1980s<sup>3</sup>. The most common trigger, a theory that is adopted in most

jurisdictions, is the continuous trigger, which picks up a combination of exposure through manifestation or discovery, and in the example would deliver 30 years or more of coverage<sup>4</sup>.

The same graphic can be used to think about insurance assets in other contexts. If the company is buying landfill assets that may have been impacted by hazardous substances that entered the landfill beginning at the time of its establishment in 1950, the same graphic and the same basic trigger issues would apply where governmental remediation is required for the first time in 1980. The same is true for products liability; occurrence-based insurance might apply to a product that was introduced into commerce with a defect in 1950, with litigation based on a discovery of its defective character in 1980 and injuries that occurred during those 30 years.

Many courts allow the claimant to “stack” all available coverage over applicable policies. Under this approach, the “full limits” coverage over a 30-year period would be available, illustrated by the entire shaded area in the graphic. There could be, in this instance, hundreds of million of dollars of coverage that could be afforded. On the other hand, some courts will apply rules that limits coverage where some policies have previously been “exhausted.”

### ***Pollution Exclusion Clause***

An important provision in the context of many deals is the pollution exclusion, the question being whether the policies contained such exclusions, and if so based on what form? Frequently, a company involved in a transaction is wrestling with how to handle toxic tort and pollution liabilities. The pollution exclusion clause, which has a lot of case law associated with it, was usually not included in CGL policies until 1970, when it began to be added to policies as an endorsement, or until 1973, when it became part of the standard insurance industry policy form<sup>5</sup>.

When looking at historic coverage, policies in existence prior to the advent of the pollution exclusion are the most valuable, since under such policies it is more difficult for the insurers to resist coverage. Next, during the period between 1970 or 1973 and about 1985 (when a so-called absolute

pollution exclusion clause came into existence), the form of policy excluded coverage for pollution unless it was “sudden and accidental.” Some jurisdictions have, in keeping with the written history of what the insurance company drafters intended, deemed this to mean *unanticipated* from the perspective of the policyholder, and hence there is still a lot of coverage available up until about 1985.

The story does not end in 1985, when the so-called absolute pollution exclusion clause was written. There has been a fair amount of litigation over how far the “absolute” exclusion really goes. For example, there is case law standing for the proposition that coverage remains in place for such things as lead paint associated with structural issues, and also for mold<sup>6</sup>.

### *Defense Obligation*

In dealing with the importance of insurance in deals, it is important to bear in mind that there are two aspects to the protection provided by insurance. One is money for the costs of defense, that is, the cost of litigating and defending a claim. The other is for indemnity or liability payments, that is, the damages or settlement costs of resolving the claim.

It is frequently said that the insurers' obligation to defend is broader than its obligation to indemnify. What is meant is that if the complaint in the underlying action (taken in the light most favorable to the policyholder) establishes a bodily injury or property damage or other form of injury that falls within the coverage, then the presumption is that the insurance carrier has to provide a defense, even if at the end of the day there is no liability or, in the language of the policy, even if the claim is “false, fraudulent or groundless.”

Going back to the asbestos illustration, in many cases the average cost of defending an asbestos claim can be \$10,000 per claim or more, even though the settlement costs may, in some circumstances, be significantly less than that. So when the company is looking at a target company that is in the process of defending 10,000 claims, the defense pool alone can be a very significant number.

There is a trend in some states to incorporate the breadth of the defense obligation into the insurance

regulations of the state. For example, for pre-1970 claims, i.e., claims relating to the period before any pollution exclusion clause became applicable, there is a statutory presumption that there is a defense obligation.

### *Extensions to CGL Coverage*

There are other kinds of coverages that may be important in the context being discussed. For example, workers' compensation and employer's liability coverage may apply to toxic tort claims. Employer's liability coverage is written so that it often provides continuing coverage for cases and claims that go around the “workers' compensation shield”. The policy in effect as of the date of last exposure typically affords coverage for some of these claims.

Errors & Omissions and Directors & Officers policies can be very important, especially if you're doing acquisitions in an industry subject to close regulatory scrutiny or affected by shareholder claims. Many of these policies have been written, in recent years, on a claims-made basis. However, they are often written with long extended coverage periods or “tails.”

Fidelity & Surety Bonds, including architectural bonds – some of which include coverage for “crimes” – can also be important means of recovery in connection with employee and officer misconduct. There are also industry-specific coverages. For example, there is an aviation GL policy that covers things such as fuel spills and fuel releases.

It is also noteworthy that there are a number of industries that have been active in creating their own captive insurance companies, starting in the 1970s and 1980s. Independent power producers and other energy producers, typically, have captives to cover a large, self-insured retention. That means they buy excess coverage over some high limit like \$50 million, but they actually fund a separate insurance vehicle, which may be available to pay claims.

Another possibility to consider is that insurance issued to another policyholder might cover the target company. For example, if the target is an aviation industry asset, such as a company doing business at an airport, the fuel providers at the airport may have maintained insurance, which names

the tenant airlines, perhaps including the target tenant company, as an additional insured or an additional named insured.

Employment Practices Liability Insurance, or EPLI coverage (which has been written as an adjunct to CGL for over a decade) covers labor claims including “pattern and practice” discrimination actions.

## FINDING THE POLICIES

It is often difficult to locate all historical insurance policies. The company's insurance broker, if still in business, can be the easiest and fastest way to uncover the historical policies. If not, the business records of the policyholder - checks, receipts, and records of payments on other claims by the insurer or any other indicator of insurance - are the next place to look.

There are additional sources outside the company as well. One very fertile source has been government contracts. If the target company contracted with the U.S. Government, the typical U.S. Government contract required not only evidence of insurance, but also a copy of the policy.

Common carriers can also be good sources; copies of policies were often secured as a condition to the use of carriage vessels, railroad sidings, barge-loading facilities, motor carrier transports, inter-modal facilities and the like.

To the extent that an entity being purchased has gone through prior corporate transactions or financings, the prior transactional records should be examined, since they may contain schedules of or copies of insurance. Law firms that did work for the target company sometimes retain policies and can be good sources of information on claims made under those policies.

Loan documentation for the company can also be a good source. Typically there is a loan provision that specifies the types of insurance that must be maintained during the loan term (comprehensive general liability, workers' compensation, motor carriage and the like) with required limits. Often the loan documentation will have a binder or a cover document listing the carriers and sometimes the policy numbers.

Similarly, real estate and leasehold documents may contain provisions requiring certain kinds of insurance and a binder identifying the carriers.

If all else fails, indirect evidence of insurance policies can be used. The legal requirements for proving up the existence of insurance coverage through secondary evidence vary from state to state. In most jurisdictions it is necessary to show a reasonably diligent (but unsuccessful) search for the insurance policies before secondary evidence will be accepted<sup>7</sup>. Under these circumstances, secondary evidence is sufficient to prove the existence and contents of missing insurance policies. For example, oral testimony or a copy of a similar policy can be adequate. Frequently, a company witness might be able to testify: “I don't have my policy for year 1970, but I know we had the same carrier and substantially similar coverage for 1968.” Based on this sort of testimony, the court may be in a position to hold that the 1970 coverage is deemed to be governed by the same provisions as the coverage that was in place for 1968 (unless the insurer can prove otherwise).

It is important to recall that all insurance companies are regulated entities and that the insurance regulations in many states will assist policyholders by requiring that the insurance carrier produce a form policy if one has secondary evidence of the existence of the insurance.

## COVERAGE ANALYSIS

Once policies are secured, an insurance chart is developed, showing what coverage is in place chronologically, both underlying and excess. We then identify what the deductibles and self-insured retentions are with respect to those policies. Some policies may be exhausted in whole or in part through claims. Others may have been extinguished because of insurer insolvency.

The chart can then be used to analyze the claims that might be brought. The business team can then consider a number of potential outcomes as to an insurance claim. Insurers may be willing to “cash out” a given policy or policy year; or to cash out a given type of coverage. The company and the insurer might,

for example, do an environmental buyback: the coverage is still in effect, but the insurance company pays an amount now in exchange for being released from future liability for environmental claims.

Another possibility is an agreement for “coverage in place,” a common practice in the asbestos and toxic tort context. The insurance carrier acknowledges it has coverage obligation but enters into cost-sharing arrangement with the policyholder and other insurers, or settles with the policyholder disputed issues about how the policies will apply going forward.

In the bankruptcy context, courts have sought to resolve disputes over insurance assets by creating funds or “trusts” to handle liabilities. Based on recent decisions under the Bankruptcy Code, the bankruptcy court has very broad jurisdiction over the carriers on such matters<sup>8</sup>.

The bankruptcy courts can marshal insurance assets not only as to existing claims that have come to judgment, but future claims as well.

## DEAL DOCUMENTATION: ACQUIRING THE INSURANCE ASSETS

### *The Henkel Case*

The recent California Supreme Court decision in the *Henkel*<sup>9</sup> case illustrates the sorts of problems that can arise in seeking access to insurance acquired as a result of corporate transactions. In *Henkel*, the court found that, under California law, some policies may require the consent of an insurer before a policy will be considered to have transferred to a corporate acquirer.

The ultimate source of the problem in the *Henkel* case was the anti-assignment clause: “Assignment of interest under this policy shall not bind the [insurance] Company until its consent is endorsed hereon;...”<sup>10</sup>

In *Henkel*, the initial company involved was Amchem (the California Supreme Court, for simplicity, dubbed the original company “Amchem 1.”) Amchem 1 had two lines of business: an agricultural products line and a metallic chemical

line. Union Carbide acquired Amchem 1. No problem so far, since Amchem 1 remained the same company but with different shareholders. Then, Union Carbide created a new subsidiary, which the court called Amchem 2. Union Carbide transferred the metallic chemicals business to Amchem 2 and had Amchem 2 assume by contract the underlying liabilities from the metallic chemicals business.

In this transaction, Union Carbide was trying to split Amchem into its two component parts so that it could sell them separately, and it was trying to have the underlying liabilities associated with the metallic chemicals business reside in the same place where the business itself was, which is why the metallic chemical liabilities were assumed by Amchem 2.

Next, Union Carbide sold off Amchem 2 to Henkel and then Henkel merged with Amchem 2, so that the Amchem Metallic chemical business was now part of the Henkel Company. Then, Union Carbide went through a similar set of transactions with the agricultural products part of the company (still residing in Amchem 1), but without any assumption of liabilities. Union Carbide sold that company off to Rhone-Poulenc and then Rhone-Poulenc merged with Amchem 1.

In reviewing these transactions, the court concluded that, absent contract language to show transfer of insurance rights, these rights did not transfer to Amchem 2, contrary to what had been intended.

Henkel, although it presumably thought that it was acquiring not only the Amchem 2 business and the Amchem 2 liabilities but the right to the insurance for those liabilities, in fact ended up with no coverage for the Amchem 2 liabilities. This, obviously, is a rather serious problem and one that clearly was not anticipated in putting the transaction together.

### ***Law on Transfer of Insurance After Loss Occurs***

While *Henkel* has yet to be broadly applied, it signals the need for caution in the transaction context. It has been the law, for some time, that *after* a loss has occurred, policy rights may be assigned without the consent of the insurance company.<sup>11</sup> The most common situation in which this occurs, familiar to people involved in personal injury litigation, is in the context of a serious personal injury accident. If a defendant is essentially judgment-proof other than its insurance rights, and if there is a coverage defense being asserted, plaintiffs' lawyers will commonly take an assignment from the defendant of the insurance rights, and then go after the insurance rights in the place of the defendant. Although less common, the applicability of this "after loss" assignment rule also applies to corporate insurance situations.

This "after loss" rule has been expanded in some of the cases in recent years. One of the more interesting cases is the *Westoil Terminals* case<sup>12</sup>. *Westoil Terminals* explains the reason for the "after loss" rule: after the loss has taken place, assignment is permitted because there is no increase in the risk that the insurer is being asked to assume. In effect, the extent of the risk has been "fixed" because the event has already occurred. The insurer is only being asked to respond for the very risk that it set out to cover when the policy was written.

### ***Pre-Loss Transfers***

But what about transfer or assignment of insurance assets *before* a loss has occurred? Is it sufficient, in assigning insurance rights, to simply demonstrate that there has been no increase in risk, even *before* the loss has occurred, or is consent still required in that setting? Certainly in California or in other places where the insurance companies may try to carry the rule in the *Henkel* case, it is not safe to rely on the ability to assign insurance rights without seeking consent.

Most important, what happens if, rather than liabilities assumed by contract, they are imposed by the tort law, for example, in a successorship liability situation where one company is held to be the successor in

interest to another company and therefore inherits the tort liability? The question in that situation is whether the insurance flows to the company that has been held to be the successor. That is an unresolved question in California and, for the most part, elsewhere. There are cases going both ways, but the *Henkel* case specifically declined to decide that question.

While the structure used in the *Henkel* transaction turned out to be problematic, there are other types of transaction as to which a general rule, at least, can be stated:

- Acquisition of the Stock of a Company. This should have no effect on the insurance because the policyholder is the same, both before and after the stock acquisition.
- Merger of Companies. Again, there should be no impact on the insurance rights because the merged entity will retain the insurance right.

The problem is that many times there are non-insurance reasons that drive the structure of the transaction, such as tax benefits. If there is going to be another type of structure, for example, such as what happened in the *Henkel* case, attention has to be paid to the insurance rights. In these circumstances, it is wise to adopt deal language which contemplates *both* an assignment and an undertaking by the seller to help secure insurance assets in the event the assignment is deemed to be unenforceable. Here are two sample provisions that can be used in dealing with insurance assignments in some transactions.

**Insurance Assignment:** Seller shall assign to Buyer all rights, claims and proceeds, actions and causes of action ("Insurance Claims") which the Seller, any Acquired Company or any Subsidiary may have: (i) under any and all historic policies of insurance or settlements with insurers that may provide coverage with respect to any Acquired Company, any Subsidiary, any predecessors thereof and/or any real property currently owned, operated

or leased by any Acquired Company or Subsidiary (the "Historic Insurance Policies"); and (ii) against each and every insurance company that has issued the Historic Insurance Policies

**Insurance Undertaking:** In connection with such assignment, the Seller shall obtain any required consents from insurers in connection with such assignments. Seller further agrees to cooperate with Buyer, including but not limited to: (i) cooperating with the Buyer in the prosecution of any claim under any Historic Insurance Policies and in connection with all reasonable requests of Buyer in prosecuting such claims, including providing sworn testimony at the reasonable request of the Buyer; and (ii) preserving all documents and physical evidence in their possession, custody or control that are necessary or desirable for the prosecution of any such claims by the Buyer, provided that Buyer shall reimburse Seller for any out-of-pocket expenses that Seller incurs in connection with such cooperation and document preservation

## INSURANCE AS A TRANSACTION TOOL

A number of insurance products and tools are available to help cover liabilities in M&A transactions. We simply touch upon these products and tools, which can be used to complement the historic coverage that is found to be available using the analytical methods described above.

### *Loss Portfolio Transfers*

To address balance sheet concerns, a policy is created to cover a pool of self-insured claims. This has been common in toxic tort and workers' compensation, where there might be claims that evolve and trend and develop and are settled out over a period of years into the future.

### *Alternative Risk Financing*

Alternative risk financing has also been used in the M&A context to create a fund which covers a pool of known risks, i.e., to pay out amounts required for a superfund cleanup where a remedial investigation has been completed and an agency has signed off on a remedy. Hence, the insurance premiums used to fund the account are a pretax expense.

### *Prospective Aggregate Covers*

Prospective aggregate covers are policies created where there is an aggregate limit of insurance that may be impaired because of a claim or a series of claims, and where additional insurance is needed to replenish the aggregate.

### *Integrated Risk*

Integrated risk considers blending all of the above products to cover a broad range of risks faced by a company, not just traditional insurance risks but interest rate and commodity-related risks, political risks – the entire gamut of business risks faced by a company. There is renewed interest in such coverage because of the broad disclosure obligation under Sarbanes-Oxley.

### *Representations and Warranties Insurance*

This is a product that was developed over the course of the last seven years to insure seller's representations and warranties made in a transaction. This initially was designed for sellers, where it was used to back the seller's indemnity obligations. It can also be useful to buyers, however, when there are credit concerns about the seller's ability to back an indemnity.

### *Tax Indemnity Liability Insurance*

This is similar to Representations and Warranties Insurance. It provides a focused ability to cover a tax treatment of a transaction. Tax treatment can of course be fundamental to the transaction. The purpose of this coverage is to indemnify the parties, should the IRS subsequently overrule the underlying tax treatment of the deal.

### ***Loss Mitigation Insurance***

This product provides coverage for active litigation that is known and either uninsured or underinsured (notwithstanding the historic view that one can not insure the “burning building”). The key issue here, in an M&A context, is that there will always be varied opinions between buyer and seller as to the ultimate potential outcome of a litigation. Loss Mitigation Insurance is a third-party solution that establishes coverage at defined limits and therefore helps to bridge the gap between buyer and seller.

## CONCLUSION

All too frequently in the past, transactions have been completed without sufficient attention to the role of insurance. Insurance, or the lack of insurance, can turn a bad deal into a good one, or vice versa. Given the magnitude of potential liabilities in contemporary transactions, especially on environmental matters, attention should *always* be paid to the availability and orderly transfer of insurance assets, and whether insurance products or tools might be used to mitigate some risks.

## ENDNOTES

- 1 The Fairness in Asbestos Injury Resolution Act, S. 1125.
- 2 E.g., *Insurance Co. of North America v. Forty-Eight Insulations*, 633 F.2d 1212 (6th Cir. 1980).
- 3 E.g., *Eagle-Picher Industries, Inc. v. Liberty Mutual Insurance Co.*, 682 F.2d 12 (1st Cir. 1982).
- 4 E.g., *Armstrong World Industries, Inc. v. Aetna Casualty & Surety Co.*, 45 Cal.App.4th 1 (1996).
- 5 The Insurance Services Office, or ISO, and its predecessors, have drafted standard insurance policy forms for use within the industry.
- 6 *Lititz Mutual Insurance Company v. Steely*, 785 A.2d, 975 (Pa. 2001) (Absolute pollution exclusion clause inapplicable to lead paint injury claim) and *California Capital Insurance Co. v. Sacramento Partridge Point et al.*, (Cal. 2002), Mealey's Insurance Litigation Report (Mealey's), Vol. 16 (7/9/02) (Mold does not fall within definition of "pollutant" for purposes of exclusion).
- 7 See, e.g. *Rogers v. Prudential Insurance Co.*, 218 Cal.App.3d 1132 (1990).
- 8 E.g., *Fuller-Austin Insulation v. Fireman's Fund Insurance Co.*, No. BC116835 (Cal. Super. Ct. Feb. 26, 2002).
- 9 *Henkel Corp. v. Hartford Accident & Indemnity Co.*, 29 Cal.App.4th 934 (2003).
- 10 This version of the Assignment Clause is taken from the 1973 ISO Form.
- 11 E.g., *Greco v. Oregon Mutual Fire Insurance Co.*, 191 Cal.App.2d 674 (1961).
- 12 *Westoils Terminals Co. v. Harbor Insurance Co.*, 73 Cal.App.4th 634 (1999).