Lowenstein Sandler's Insurance Recovery Podcast: Don't Take No For An Answer

Episode 94:
3M Must Engage in a "Pointless Formality" to Satisfy Retention: The Importance of Avoiding Non-Market Language in CGL Policies

By Eric Jesse, Alexander B. Corson

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Eric Jesse: All right. Welcome to Don't Take No For An Answer. I'm Eric Jesse from Lowenstein Sandler's Insurance Recovery Group, and I'm pleased to be joined here today by one of our superstar associates, Alex Corson. Welcome to the program.

Alex Corson: Thank you, Eric. It's nice to be here.

Eric Jesse: All right. Alex, and for our listeners today, we're going to be discussing a recent court decision that came out of the Delaware Superior Court that I think really reinforces the importance of regularly and carefully reviewing policy language. As we say here, don't take no for an answer. Our common theme is that the words matter, and this opinion really illustrates the consequences of letting insurers slip non-market language into a policy. I think this decision is also just another reminder for our listeners that insurers are going to look for any which way to avoid their coverage obligations, even if it defies the realities of how parent companies and subsidiaries operate, and even as it defies the reasonable and really, real-world expectations of their insureds.

Ultimately, I think the key takeaway that we'll elaborate on is just how important policy audits are for policyholders, including policyholders that are in acquisition mode and bringing new subs into the corporate tent. With that, Alex, why don't you set the table? We're talking about this 3M case that's happened, Aearo Technologies v. ACE American. Why don't you set the table and tell us what we're talking about here?

Alex Corson: Yeah, so 3M, a large corporation, they acquired this Aearo Technologies in 2008, and Aearo had sold these products that became a part of one of these big mass tort MDLs, with 280,000 lawsuits involved. They ultimately paid $372 million in defense costs in connection with these cases. When they turned to Aearo's CGL policies, their legacy policies that were in effect up

until the time that they were acquired, they ran into a problem with the carriers because these policies, as we know, CGL forms, there's typically the base forms. Then for our larger clients, they typically have a lot of these customized endorsements.

They had a self-insured retention. Even though a lot of CGL forms pay defense costs outside of limits, these ones had a self-insured retention on them, and they had language in there that specifically said that the self-insured retention shall not be reduced by any payment made on your behalf by another. It's almost the exact opposite of the language we like to see in these types of things, where we want the payments paid by someone else, right?

Eric Jesse: Yep.

Alex Corson: Yeah. The insurance carrier said, "Aha, this 372 million that 3M paid out of its bank account doesn't satisfy the SIR. Therefore, we can't have any obligation to pay, because satisfaction of the SIR is a precondition to coverage they denied," and the Court agreed with that argument. They said, "Yeah, maybe it's a pointless formality to transfer the money from the parent to a bank account in the sub's name and it had to be paid that way, but that's what the policy said." They decided in favor of the insurer, and now they remanded it to figure out if there was enough money actually paid from a subsidiary bank account to satisfy those SIRs. A really tough result.

Eric Jesse: Yeah. Yeah, that is. Look, before we talk about how this could have been avoided, I know you as a zealous policyholder advocate. 3M and Aearo, they fought the good fight here, but what are some arguments that were made or could have been made to at least try to convince the Court to see things, I think, more practically and in the reality of how companies operate these days?

Alex Corson: Yeah. I read the opinion closely, and I think that the policyholder attorneys on this case made mostly the right arguments, and there's some practical and logical appeal to the fact that this pointless formality, as the Court kept quoting them, it's just not realistic in this day and age with companies like 3M that have acquired many, many subsidiaries and they bring them on entirely into their corporate structure. They leave that entity, that subsidiary, intact, and they just bring them within their fold, the fold of their corporate hierarchy. Who cares where the check is being written from, which bank account it's coming out of? This is being paid on behalf of Aearo Technologies. I assume, based on the Court's description, that that was really prominently featured.

Also, there are principles of insurance law that need to be emphasized, and I think they probably were, and the Court just didn't find them applicable here. The policies need to be interpreted in a manner that's consistent with the reasonable expectation of the purchaser. You don't buy an insurance policy that you think could be voided based on this kind of hyper technicality, effectively voided here, and the adage is that, like this conditions of coverage through the policies, narrowly, ambiguities need to be resolved in our favor. All these types of arguments I think fit this fact pattern, but particularly the reasonable expectations one here, I just don't think that enforcing that

language in this context would've been something that anybody was thinking about when they bought this policy.

Eric Jesse: Yeah. One point is I think it's important to look to the higher purpose or the main purpose of what a retention is. You don't want some third party, some distant third party, unaffiliated third party, buried in risk. It's the policyholder that should be burying that risk so that they have, quote/unquote, some skin in the game. Here, I'd think when you have an affiliate or a subsidiary ... or apparently, I should say ... of the insured stepping in, I think there's an argument that says there is sufficient skin in the game to satisfy the purpose of the retention.

The other thing I was thinking about too is you often see that courts are willing to be policyholder protective, because these are traps of adhesion. They are drafted by the insurance company, and the policyholder doesn't usually have an opportunity to mark up these endorsements or these forms. That's why we've seen courts in the past say the right to receive policy proceeds can be freely assigned, even though policies have anti-assignment permissions. Some courts have said that late notice under these policies can be excused, despite the policy's notification requirements. Courts come up with these rules to align, to your point, with the reasonable expectations of the insured, and I think that's the direction that the Court should have been going in.

Alex Corson: Yeah, I couldn't agree more. Also the prejudice rule, right?

Eric Jesse: Yes.

Alex Corson: There are cases that say that for conditions precedent, things like this where this is essentially exhaustion language, right? We see an excess insurer so often try to say, "Oh, well, you didn't pay it in the right way, therefore our policy isn't even implicated. It's a condition precedent of coverage that this is." Many, many jurisdictions have created the rule that the insurer needs to show that they were prejudiced by some noncompliance with a condition precedent, as opposed to exclusions or something like that where that's defining the scope of the coverage.

Something like this, I think this was a good fact pattern to raise that argument that, "Yeah, okay, so how is the insurance company in any worse position if the $250,000 was paid before they were asked to pay a single dime? Who cares who paid it? No prejudice. We're not going to enforce compliance with this technical condition precedent language. We're going to construe that in their favor."

Eric Jesse: Yeah. No, absolutely. Good points. All right, so what could 3M or Aearo have done to avoid this result? Let's go back in hindsight.

Alex Corson: When they bought Aearo in 2008, there was presumably diligence done in the deal, and making sure that you have a knowledgeable and capable insurance part of the team, the diligence team, looking over that language, spotting that. It's easy to just assume that a CGL policy is going to be a CGL policy is going to be a CGL policy, but that's not always the case. All the time,

especially for larger corporate clients, we see these CGL policies where they have the ISO form for the first 60 pages and then they have 150 pages of endorsements and things, and that's where you're going to see these types of SIR deductible endorsements. Even just in my couple of years, I've seen a wide range of language in these types of endorsements, so it should have been flagged.

I think that if the policyholder had known about this issue, even though it was a hyper technical, silly kind of situation, in theory they could have set up a bank account and transferred it through, done the pointless formality that was required by the policy language. Then similarly, conducting regular policy audits, having a knowledgeable professional take a look at the coverage program that you've got in place and identify any gaps and take a look at this, even if it was after the diligence, again, might've spotted this issue and been able to address it in advance, or react to it by setting up the pointless formality.

Eric Jesse: Yeah, exactly, Alex. Those are good points, and I think that while it doesn't necessarily reflect the nature of how parents and subsidiaries operate, just to be going in eyes wide open, understanding this language and understanding how insurance companies tend to operate in these circumstances. I think it would look a lot different to a court if this, quote/unquote, pointless formality had actually been followed, because then you're falling precisely within policy language if the parent is transferring money to the sub to ultimately write the check. It looks a lot different to a court if the check says Aearo Technologies as the payor. What are some other takeaways or key takeaways from this case that we should leave our audience with today?

Alex Corson: I think I just hinted to it, but I think paying close attention when you're placing your policies, not just when you're buying a company but when you're placing your policy. Pay close attention to the language that's being used. As I mentioned, I've seen a number of different ways in which a self-insured retention or deductible structure has been put into a CGL policy. CGL policies typically pay defense costs outside of or in addition to limits, but when the policyholder wants better pricing, they want to take on this self-insured layer before the policy kicks in, there has to be some type of custom language because it's not built into the ISO form.

Reading those deductibles or SIR endorsements carefully, making sure that what the underwriter is telling you they're trying to do there is actually what's reflected in the policy. It's critically important for our clients with these particularly products, so manufacturers, distributors, these types of things, where CGL is a really, really, really important coverage line. Take a look. Spot those ambiguities. Get them addressed before the policy goes into effect, because once it's there, that's what you've got for the next year.

Yeah, I think that this case illustrates particularly the opportunity for a gap or issue potentially in the acquisition phase. There's a lot of moving parts in a deal, as you know, Eric, and it's easy to just skim through and look. "Oh, yeah, we got the coverage we need, no problem." Take a look at those policies. What are you buying? What coverage are you getting, when you're buying a new company, in what's existing? Because it may be that, especially

for occurrence-based policies like these CGLs, you're not going to be able to necessarily put a loss that predates the purchase under your current program.

You're going to have to rely on whatever coverage they had, so take a look. See. If there's a big risk hanging out there or potential risk hanging out there and the company you're buying was insufficiently insured, think about buying some type of supplemental coverage, or think about decreasing the purchase price. Build that into your deal. Don't just assume that they were adequately covered and check the box and move on. Those would be, I think, the biggest takeaways to me.

Eric Jesse: Yeah, and also just being able to go eyes wide open. In many cases, the target's historical insurance program, it will be what it will be, but just making sure you're following the right steps, technical as they may be, as you're defending the claim and moving forward, just so you're falling within these technical requirements in the policy. I think that's a way to really take a lot of arguments away from the carriers. They'll still try and make others, but this can avoid other arguments, so all right. Well, Alex, it was a pleasure having you on the program. Thank you for your informative and useful insight, as always.

Alex Corson: Yeah, thanks for having me. It was a fun one, and yeah, interesting case. A lot of lessons learned there, so thanks, Eric.

Eric Jesse: Absolutely. Great. Take care.

Alex Corson: Bye.

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