

Transaction Liability Insurance: Where Corporate Deals, Insurance Claims-Handling Intersect

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Transactional attorneys and those in private equity have seen and worked with representations and warranties (R&W) insurance. Usually, the buyer in a securities transaction purchases R&W insurance to facilitate a deal by limiting the seller's liability for potential breaches of the representations and warranties in a purchase agreement.

R&W insurance establishes a mechanism by which the insurance company will pay the buyer for loss caused by the seller's breach of a representation or warranty. R&W insurance also potentially extends the survival period for seller's representations and warranties by allowing the buyer more time to discover and report a breach.

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Dealmakers may view R&W insurance as a tool to replace or limit the amount of escrow required from sellers, but R&W insurance is, first and foremost, insurance. The policyholder's claim for coverage of loss arising from seller's breach, like any other insurance claim, should be presented to the insurance company to recover all available coverage.

Policyholders expect the insurance company to pay their

damages in full in the event of breach of a representation in the purchase agreement, and there is little public data regarding how claims disputes are resolved because claim disputes are resolved in confidential arbitrations. So what should the policyholder do when an insurance company refuses to pay a claim for breach or disputes the amount of loss at issue? Some strategies to obtain the coverage purchased

and facilitate efficient resolution of R&W insurance disputes follow.

Proving the Breach

Typically, insurance coverage under R&W policies is triggered by seller's breach of a representation and warranty in the purchase agreement. The policies generally contain broad grants of coverage. One part of the policyholder's claim is showing that the sellers breached the agreement. Often coverage under the policy obviously has been triggered, and showing the amount of loss is the next step. For example, if the breach involves a representation in the purchase agreement as to the accuracy of the company's financial statements or whether they comply with generally accepted accounting principles (GAAP), the policyholder may include an accountant's view as to amount, and as to GAAP requirements and the seller's noncompliance as part of its showing that seller breached that representation in the purchase agreement.

Hiring a Team of Experts

Securing a complete recovery for a R&W insurance loss requires analysis of the insurance policy and the claim. Take the above example, where the policyholder's claim involves the financial statements representation and seller is alleged to have misstated the acquired company's financials. If

the purchase price paid for the company was based on a multiple of the company's earnings, such misstatements may have impacted the company's earnings and thus the price paid for the acquired company. In this case, the amount of loss resulting from seller's breach should be calculated using the multiple that was used to determine the purchase price.

The insurance company may argue, however, that no multiple should apply, or that a different multiple should apply than that

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used to determine the purchase price. There are several arguments against this position. For one, where the premium paid contemplated the omission of any exclusion for multiplied damages, it can be argued that the insurance policy intended to cover loss at the multiple. Even if the policy at issue contains an exclusion for multiplied damages, there is a good argument that a multiplied damages exclusion is only intended to apply to limit coverage for loss resulting from intentional statutory violations, such those regulating antitrust or securities. Such an exclusion

is not intended to limit recovery on a loss caused by exactly the type of representation and warranty breach that the policy was purchased to cover.

Coverage counsel and financial experts can address coverage and valuation disputes upfront, properly valuing the potential claim for the policyholder. The insurance company will hire experts to evaluate the claim on its behalf and those experts will take positions that limit the policyholder's recovery. As in most insurance claims processes, preparation and determination can overcome the default impecunious approach of the insurance claims department.

Documenting the Loss

Facilitating the payment of a R&W claim usually involves providing the insurance company with information to support the claim and providing information in response to questions about the claim. Support for the quantity of damages arising from the breach, which may involve complex financial calculations, also are often provided.

Most insurance policies contain a cooperation clause, which insurance companies often attempt to misuse in an attempt to manufacture a breach by the policyholder. Usually the policyholder's best interests include responding to information requests from the insurance company. Policyholders should keep a

record of the information provided in order to respond to arguments made by their insurance company

Satisfy Potentially Applicable Policy Requirements

Comply with notice provisions. Although a R&W insurance policy may provide a window of several years for the policyholder to discover and provide notice of a representation and warranty breach, policyholders should take note of any potentially applicable time limitations in the policy—both with respect to notice and litigation or arbitration against the insurance company—and make sure to comply with policy provisions. Notice of a claim is often provided via the insurance broker, but delay in giving notice should not impact coverage where the insurance company is not prejudiced by the delay. Still, work with the broker to ensure timely notice.

Attention should also be paid to any choice of law and choice of venue provisions in the event that a coverage dispute results in litigation or arbitration. The policyholder may initiate litigation against the seller to recover the seller's portion of indemnity for the breach while their insurance claim remains pending. The insurance company should pay the policyholder's claim regardless of whether any amounts have been recovered from the seller. Otherwise, to the extent

that amounts due from sellers are uncollectable, coverage would be illusory. Indeed, this collection risk is a significant reason buyers purchase R&W insurance.

Initiating Arbitration Or Litigation

If the insurance company delays in paying the claim, or a dispute arises during the claim process, the policyholder should consider setting a deadline to resolve the claim. If that deadline is not met, the policyholder should consider dispute resolution options. Most R&W policies provide for confidential arbitration of claim disputes, which will require the policyholder to forgo, in-court litigation. But there may be potential benefits to arbitrating a coverage dispute, including the ability to select an arbitrator with subject matter expertise, potential lower overall costs, and the possibility of a faster resolution.

During arbitration or litigation against the insurance company, discovery of the underwriting file and communications between the insurance company and the insurance broker may show the insurance company's intent to insure the seller's representations and warranties in the purchase agreement, and potential damages arising out of a breach thereof, at the purchase price and multiple contemplated by the buyer when it entered into the transaction.

Discovery of the claims file also often takes place. Although many R&W insurance claim handlers, brokers, and underwriters are attorneys, as a rule, the claim file is not privileged as between the policyholder and the insurance company even if the claim handler is a lawyer.

Policyholders may also consider claims against the seller as many purchase agreements and R&W policies contemplate the seller being liable for some capped amount of indemnification.

Conclusion

Policyholders must be prepared to advocate for their R&W insurance claims. We have presented here various ways that the policyholder can best position itself for full recovery, including analyzing the breach and loss, assembling a team of experts to prepare and negotiate the claim, assessing dispute resolution options and strategies. Following these steps will help minimize disputes as to coverage and the scope of damages and permit full recovery of your R&W insurance claim.