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Advisory

R&W Insurance Claims

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R&W Insurance Policies
Recovering Deserved Damages

The core damages covered under buy-side representation and warranty ("R&W") insurance policies are often misunderstood and underappreciated. This is (in part) because when a buyer discovers a breached R&W, it may initially confuse the harm (or lack thereof) that it suffered post acquisition with the more typically covered direct damage that it sustained ***at the time of the transaction***. As a result of this confusion, buyers are sometimes unnecessarily reticent to submit valid policy claims (or to vigorously pursue those claims in the face of preliminary skepticism from the carrier), if the claims are ever even recognized at all.

Understand Your Measure Of Covered "Direct" Damages For A Breached R&W

R&W policies typically follow the acquisition agreement ("AA") as to the damages that are recoverable under the policy in the event of a breached R&W. The AA, however, may well exclude (through the definition of "loss" or some other similar term) the recovery of consequential damages, lost profits and special damages, rendering the policy inapplicable to these species of damages. Thus, in presenting an R&W policy claim to the carrier (and in pressing the claim), it is often critical to understand the exact measure of the more typically insured "direct" or "general" (*i.e.*, nonconsequential) damages that flow from a breach of many R&Ws.

Under New York law, which commonly governs both AAs and R&W policies, direct damages for a breached R&W are "the difference between the value of [the target] as warranted and its value as delivered." *Merrill Lynch & Co., Inc. v. Allegheny Energy, Inc.*, 500 F.3d 171, 185 (2d Cir. 2007). The target's "as warranted" value is generally the negotiated purchase price. Importantly, the (usually lesser) "as delivered" value is established by proving "how the [target] would have been valued by knowledgeable investors ***at the time of the sale*** were such investors aware of any breaches proved by [buyer]." *Id*. (emphasis added). That is, direct damages are a sum equal to the amount by which the target's value, ***at the time of sale***, would have been diminished if the truth hidden by the false R&Ws had been known.

A Hypothetical (Breached R&W Regarding Accuracy Of Financial Statements)

Suppose, in the AA, a seller warrants the accuracy of its financial statements. After the closing, the buyer discovers that the historical EBITDA flowing from one key customer was substantially overstated in those statements. The R&W was clearly breached. Fortunately for the buyer, however, post-closing market conditions improve, and the EBITDA attributable to that same customer increases in the months after the transaction, eventually matching the overstated historical numbers.

The buyer (or carrier) might wrongly assume that there is no damage resulting from the breach. After all, the target is performing well despite the inaccurate financial statements. Where is the harm? *Merrill*, however, teaches that this line of reasoning is flawed. In quantifying direct damages, "inquiry into [the target's] performance and market conditions in the months ***following*** the acquisition [is] improper because events subsequent to the breach [which occurs when the deal closes], viewed in hindsight, may neither offset nor enhance [the purchaser's] general [*i.e.*, direct] damages." *Id.* Thus, the target's post-acquisition success (at least under New York law) does not necessarily defeat the buyer's ability to claim insured damages.

The buyer, instead, needs to establish (to the carrier's satisfaction) the target's diminished time-of-transaction value had the true EBITDA figures been known at the time. This allows the buyer to calculate the amount by which it overpaid for the target at closing. These direct (non-consequential) damages could be substantial if the EBITDA overstatement in the diligence financials was significant. These are potentially viable damages even if the target performed well post acquisition because that later performance does not change the fact that, when measured as of the time of sale, the buyer overpaid for the target as the direct result of not knowing the truth hidden by the breached R&W.

Another Hypothetical (Breached R&W Regarding Absence Of Customer Termination Threats)

Suppose seller warrants in the AA that none of its key customers has recently threatened to terminate a relationship with the seller. After the transaction, the buyer learns that one key customer had made multiple pre-acquisition threats to terminate its contracts with seller. The customer made the threats because of serious systemic quality issues with seller's service offering. In the months following the closing, buyer spends hundreds of thousands of dollars remedying the quality issues and ultimately (but barely) salvages the customer (which remains disgruntled).

The breach is plain. But, again, the buyer (or carrier) might assume that there is little if any insurable damage resulting from the breach. The customer that threatened termination prior to the closing, though still unhappy, never actually terminated. So, that customer's revenue has not been lost. Meanwhile, the hundreds of thousands of dollars spent to remedy the quality problems (and to retain the customer) may fall below the R&W policy retention threshold, if those expenditures can even be characterized as insurable damages at all.

Under *Merrill*, however, the buyer may be able to effectively demonstrate (through experts and a valuation analysis) that, if the customer termination threats had been known at the time of the transaction, a reasonable investor would have substantially discounted the EBITDA attributable to that customer (given the risk of termination), thus lowering the value of the company as a whole. The buyer could then make a claim, under its R&W policy, to recover the difference between what it paid (believing that no customers were threatening termination) and what the company was really worth (if the termination threats had been disclosed and considered) at the time of the sale.

This type of policy claim would likely need to be carefully and persuasively presented to the carrier, which will often require well-documented proof of loss (and a well-argued theory of legal entitlement to that loss) before paying on a claim. Experts and outside counsel may be a necessary part of the claim presentation process, even if litigation is ultimately unnecessary. But, in a transaction where the original valuation was based on a multiple of earnings formula, the resulting reasonable reduction to the time-of-transaction purchase price (*i.e.*, the direct damage) if a major stream of EBITDA had been discounted at the time of sale could well be significant and easily above any retention threshold.

Don't Miss Deserving Claims

These are but two examples, under only one state's law, of the many possibly nuanced ways in which potentially covered damage claims can materialize. In many cases, outside counsel can be an important resource in helping a buyer navigate the factual nuances and the law of the relevant state to identify and persuasively present deserving claims to the R&W carrier. If a persistent buyer makes a sophisticated claims presentation – supported by credible experts, clear facts and the right legal theory – the carriers can often be persuaded to pay these direct damage claims. It may take time to help the carrier understand the claim. But, it can often be worth the effort.

More information regarding the firm's *Corporate Recovery* and *R&W Insurance* practice areas can be found on the firm's website.