Five Tips for Policyholders Arbitrating R&W Insurance Claims

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PRACTICES Insurance Recovery, Litigation, International Arbitration

Although 2023 saw a drop in deal volume overall, claims made under representations and warranties insurance (RWI) increased substantially within the past year.[1] Not surprisingly, with an increase in claims also comes an increase in disputed claims by RWI insurers. Most RWI policies are buyer-side policies requiring arbitration of disputed claims. Here are five (5) tips for policyholders facing arbitration with an RWI insurer in 2024.

1. Conflicts & Communication with Transactional Counsel

"Buyer-side" RWI policies protect the acquiring insured against loss resulting from the seller's breach of a representation or warranty relating to the target. When the seller's breach is material, and a claim is made under the RWI policy, the knowledge of the insured, including what information might be imputed to the policyholder through its counsel, may be put at issue. The knowledge of a buyer (or seller) may be relevant to a specific policy exclusion, or knowledge may be implicated in issues of materiality or damages or otherwise. RWI policies may include an appendix identifying the "deal team members," whose knowledge is relevant for purposes of knowledge-based exclusions or declarations. These deal team members may, either expressly or implicitly, include counsel participating in the negotiation of the underlying purchase and sale agreement. The role of in-house or outside counsel in an insured transaction and the potential relevance of counsel's knowledge in an RWI claim has at least two strategic implications for potential arbitration of an RWI claim.

First, the policyholder will need to determine whether the firm(s) involved in the underlying transaction can or should also represent the policyholder in a dispute with the RWI underwriters. While the institutional knowledge transactional counsel may bring to an RWI claim may have some visceral appeal, transactional counsel may be conflicted from representing a client engaged in a dispute over what the deal makers, including counsel, knew and when. When an RWI claim is disputed, policyholders and counsel alike should give careful consideration to these issues in order to avoid potential disqualification or other complications that could affect the prosecution of the RWI claim.

Second, by the same token, where the knowledge of the deal makers is the focus of a disputed RWI claim, related disputes may arise over what communications between the policyholder client and its counsel are privileged and what documents are subject to discovery. In such disputes, the policyholder will need to carefully examine not only what communications qualify for protection as confidential attorney-client communications, but also what documents are entitled to protection as "work product" prepared in anticipation of litigation, which designation may have important implications for knowledge-based provisions in the RWI policy.

2. First-Line, First-Party Coverage, Not A Last Resort

RWI, also known as warranty and indemnity insurance, is intended to take the place of a traditional escrow and protect either the buyer or seller against its own "loss" resulting from a counterparty's breach of warranty. In the context of an insured transaction, when a representation or warranty in a purchase and sale agreement is materially breached, the non-breaching party has the choice to pursue the breaching counterparty for damages, or to seek recovery for the loss resulting from the breached rep/warranty from the RWI insurer. The insured buyer or seller should not have to establish the merits and veracity of its breach claim against the counterparty as a condition of obtaining insurance coverage. Otherwise, RWI would be meaningless and illusory if the insured is required to first pursue the only recourse that would exist in the absence of insurance. Insured beneficiaries of RWI should not only ensure that policies placed to cover corporate transactions do not require pursuit and exhaustion of claims against a breaching counterparty as a condition of coverage, but should also not accept an insurer's attempt to compel such pursuit in the event of a claim.

This was the holding in *UDP Holdings Pty Ltd. v. Ironshore Corporate Capital Ltd*, [2019] VSC 645, where a buyer (UDP) sought coverage under a warranty and indemnity policy after the company (5 Star Foods) UDP acquired from seller (Esposito) was found to have overcharged a key customer by millions of dollars and had otherwise misrepresented the profitability of 5 Star Foods's milk business. Initially, Esposito and UDP arbitrated, respectively, claims to receive the unpaid purchase price for 5 Star Foods and a counterclaim for damages resulting from Esposito's breach of warranties relating to 5 Star Foods's business. UDP also commenced a contemporaneous arbitration against the underwriters of the subject W&I policy to recover the loss sustained from Esposito's breach of warranty. Underwriters were at first successful in staying the coverage arbitration pending the outcome of UDP's claims against Esposito. Once the coverage arbitration resumed, underwriters again urged that (1) UDP's mere contractual right to recover from Esposito did not represent a "loss" triggering coverage under the operative policy; and (2) "loss" could not be determined under the policy without also establishing the "recovered amounts," *i.e.*, amounts paid to an insured from sources other than underwriters. The Supreme Court of Victoria rejected these arguments as contrary to the commercial purpose of the policy. Specifically, "[i]f the underwriters could avoid making payment on claims merely because there were actual or possible claims by the insured against third parties, payment of a claim under a policy might be delayed for a very long period, potentially for years," *see* ¶ 339, which the Court characterized as an "uncertain, uncommercial and unworkable situation." *Id.* at ¶ 340.

This conclusion holds generally for policyholders seeking to recover under an RWI policy. When confronted with a material breach of warranty, the insured buyer (or seller) should carefully consider what path will be the most efficacious and efficient, but barring the most exceptional circumstances, policyholders should not be bound to exhaust all other avenues of recovery before resorting to claims against the RWI policy.

3. Preserve the Underwriters' Subrogation Rights

Related to the last point, if RWI is to provide a first priority source of recovery for an insured policyholder, there must be a secondary resort to which the underwriter may go to pursue available rights against the breaching party. While RWI policies are manuscripted without prescribed forms, such policies uniformly require the insureds to preserve any indemnification or other rights of subrogation available to offset loss claimed under the policy. One of the perils inherent in choosing to engage a counterparty in litigation or arbitration over a breached warranty or representation is the possibility that a failure to prevail on all points may limit the insured's recovery from both the counterparty and the RWI underwriters, who may second

guess the insured's strategy or otherwise claim that rights of subrogation were not adequately preserved. One of the virtues of proceeding directly against the RWI underwriters in the first instance is the corresponding challenge faced by underwriters, who may be inclined to challenge the existence of a breached warranty, but for the necessity of then taking the opposite position in a future subrogation claim against the breaching seller (or buyer). But that strategic pressure only exists if the rights of subrogation have been adequately maintained in the first place. Accordingly, once a breach becomes known, the insured buyer (or seller) should not only be prompt in providing notice to the RWI underwriters, but also by engaging and communicating regularly with underwriters regarding efforts to preserve and maintain whatever claims may exist against the breaching counterparty or others. Pending a decision from the RWI underwriters on a given claim, the RWI policyholder should act as a prudent uninsured would in mitigating loss, but the more information that is communicated without objection from the insurer, the harder it will be for the insurer to later assert that the insured has neglected its obligation to preserve the insurers' subrogation rights. Relatedly, the insured should avoid negotiating any settlement with a breaching counterparty without the consent of the underwriters. *See, e.g., Ratajczak v. Beazley Sols. Ltd.*, 2016 U.S. Dist. LEXIS 189240, *32 (E.D. Wis. Aug. 17, 2016) (holding that Beazley is entitled to summary judgment because Plaintiffs settled the third-party claim without first obtaining Defendant's written consent).

4. Balancing & Rebalancing Discovery

Because the insured's or the deal makers' knowledge is at the forefront of many RWI claim disputes, there may be a tendency for some RWI claim arbitrations to devolve into a dispute over the insured's disclosure or discovery responses to the RWI underwriters. The 2023 case of *Finsbury Food Group Plc v. Axis Corporate Capital Ltd*, [2023] EWHC 1559, in the English High Court of Justice is illustrative. There, a food manufacturer, Finsbury, sought indemnity under a buyer-side warranty & indemnity policy issued in connection with Finsbury's acquisition of a gluten-free specialty baker, Ultrapharm. Underwriters sought to avoid indemnity, among other things, by reference to a "Knowledge Exclusion" in the subject policy. Before addressing the merits of Finsbury's claim or Underwriters' defenses, the Commercial Court addressed in some detail the "disclosure failures" documented in Underwriters' submission, which may have colored the court's conclusions on the more substantive issues presented in the case. *See, e.g., id.* at ¶¶ 55, 64 (referring to what the insured's "late disclosure" revealed regarding the insured's knowledge).

Every case is different, but policyholders engaged in arbitration over a disputed RWI claim should be prepared to anticipate and dispel arguments that informational asymmetries have put the Underwriters at a disadvantage, which must be corrected in some way by the arbitrator(s). Of course, appropriate responses and disclosures are a first step to avoiding discovery disputes, but an equal focus on the insurers' underwriting of the RWI policy is also essential. As a threshold matter, subject to facts and governing law, Underwriters may be precluded from enforcing a "knowledge exclusion" or similar knowledge-based defenses if the Underwriters also had knowledge of the facts allegedly precluding coverage. In any event, what the insurers knew about the breached warranty or representation is at least relevant to the equities of an underwriters' potential disclosure arguments as well as the merits of what an insured should have known from the transactional documentation that in many instances will have been available to both the insured and insurer involved in the deal.

5. Evolving Damages

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Many RWI claim disputes revolve around the valuation of the insured's loss resulting from a counterparty's breach of warranty. In the likely case of a buyer-side policy, the valuation of the insured's loss may involve details relating to the performance of the policyholder's newly acquired business. Sometimes the loss may be circumscribed by a subsequent sale or other circumstances, including contractual terms, that narrowly confine the inquiry regarding loss and its valuation. *See, e.g., UDP Holdings Pty Ltd. v. Ironshore Corporate Capital Ltd*, [2019] VSC 645 (addressing a $47.5 million loss claimed when the insured received $22.5 million for the target it had spent $70 million to acquire). Other cases may involve a more open-ended analysis that accounts for the ongoing status of the target's business operations, including financial disclosures made during the course of the RWI claim. *See, e.g., Ageas (UK) Limited v Kwik-Fit (GB) Ltd and AIG Europe Ltd*, [2014] EWHC 2178 (acknowledging that the financial performance of the target, post-acquisition, may be relevant to the insured's loss). RWI policyholders should carefully prepare and review both the allocation of risk and damages provisions in the underlying purchase and sale agreement, as well as the valuation terms of the RWI policy, to avoid the uncertain impact of unfolding external business developments on a pending arbitration claim. Alternatively, if the contracts do not circumscribe the policyholders' loss, additional care should be given to ensure that otherwise routine business operations and financial disclosures from the target are coordinated with counsel handling the RWI arbitration claims.

On a related issue, the overwhelming majority of buyer- or seller-side RWI policies require satisfaction of a deductible or self-insured retention before the policyholder's loss, including defense costs, will be compensated. However, many of these same policies do not specify or limit the manner in which the deductible or self-insured retention must be satisfied. Without such terms, the insured may arguably exhaust the subject deductible or retention and access the subject policy's coverage by a variety of different means, including through the proceeds of other liability insurance. *See, e.g., Vons Cos. v. United States Fire Ins. Co.*, 92 Cal. Rptr. 2d 597, 605 (Cal. Ct. App. 2000) ("Nowhere does the SIR expressly state that Vons itself, not other insurers, must pay the SIR amount."); *Gen. Star Nat'l Ins. Co. v. World Oil Co.*, 973 F. Supp. 943, 947 (C.D. Cal. 1997) (analyzing a policy requiring the insured to "pay a $100,000 deductible" and concluding that "it does not unambiguously require World Oil to pay the deductible itself"; rather, "[t]he General Star policy nowhere states that the insured cannot purchase coverage for the amount of the deductible"); *Fla. Ins. Guar. Ass'n v. Jacques*, 643 So.2d 101, 102 (Fla. Ct. App. 1994) (finding that the insured's deductible for its general liability policy could be satisfied by payments made under the insured's business automobile insurance policy). Therefore, in the event of an RWI claim, the policyholder should also ensure that notice is provided to all potentially responsive liability carriers, and the proceeds of such insurance applied, where possible, to satisfying any applicable deductible or SIR under the operative RWI policy.

If you have any questions about RWI claims or about insurance recovery in general, please contact one of Haynes Boone's Insurance Recovery Practice Group partners listed below.

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[1] *See* Stacey Hammer, *Reps and Warranties Claim Trends: A 2023 Review*, WOODRUFF SAWYER (Jan. 16, 2024), *available at* https://woodruffsawyer.com/mergers-acquisitions/rw-claims-trends-2023/.

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