

Breach vs. Loss

February 21, 2020

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Does a seller's breach of representations and warranties in a merger and acquisition (M&A) transaction automatically entitle the buyer to compensation?

Breach of a Representation & Warranty

Representations and warranties (reps & warranties) are typically provided in an M&A transaction by the parties to the agreement. The seller's and target company's (Company) reps & warranties to the buyer contained in the agreement state facts on which the buyer generally intends to rely, finds important to the decision to make the acquisition, and on which the buyer can rely as accurate. Many of those reps & warranties relate to facts about the Company's business, income and expenses, and the assets and liabilities being transferred in the transaction, among others. Reps & warranties can include promises about such things as title to assets, the Company's financial condition, accuracy and elements of the financial statements, litigation matters, customers, and tax matters. Generally, a breach by the seller or the Company of any of the reps & warranties entitles the buyer to indemnification for its losses suffered as a result of that breach. In the event of a breach of the reps & warranties, the buyer is protected by the agreement's indemnification provisions, which generally provide assurances similar to the following:

"From and after closing, the Seller shall indemnify and hold harmless Buyer and its respective officers, directors, employees and agents with respect to any Losses which Buyer suffers as a result of, arising out of or related to the breach by the Company of the representations and warranties set forth in Article 4 of this Agreement."

Under this typical provision, the seller (and/or the Company) indemnifies the buyer for the losses the buyer suffered as a result of a breach, referred to in the indemnification provision as "Losses." The meaning of "Losses" that are indemnified comes from the defined term in the M&A agreement. In the particular agreement from which this indemnification language was taken, a Loss is defined as "all actual damages, deficiencies, liabilities, claims, actions, judgements, fines, fees, costs and expenses." In other words, under the agreement, the buyer must have suffered some actual harm — harm that can be measured by a financial or economic cost to the buyer. This result is no different

than the fundamental legal concept that two things must be proven for a plaintiff in a lawsuit to be successful: liability and damages. Liability, alone, is not enough. So it is with reps & warranties; establishing that a party breached a warranty does not itself entitle someone to money. Once the breach is established, a loss must then be established and quantified — a breach by itself is not enough.

The Role of a Representations & Warranties Insurance Policy

Enter the representations and warranties insurance (RWI) policy, a modern tool that allows a seller to shift the risk of a reps & warranties breach from it to an insurance company. The policies make it clear that they are not generally intended to create any new risks that aren't already part of the buyer/seller representations and warranties. The typical RWI policy starts with a preamble that “the Insureds have entered into an acquisition agreement and desire to purchase insurance to insure them against Loss.” Loss is then typically defined in an RWI policy as “the amount to which the Insureds are contractually entitled in respect of a Breach pursuant to the terms of the acquisition agreement.” In other words, the RWI policy is meant to do no more than shift the risk of a contractual breach under the acquisition agreement and pay the compensation for the Loss sustained as a result of that breach, as envisioned by and provided for under the acquisition agreement. Consequently, for the policy to compensate a buyer for a breach of a rep & warranty by a seller, the buyer must establish a breach by the seller (or Company) under the terms of the acquisition agreement and have sustained a loss as a result of the breach, as defined by the acquisition agreement.

What Kind of Breach Results in a Loss?

Whether a breach of a rep & warranty results in a Loss will depend on the facts of the particular acquisition and the specific representations and warranties made by the seller to the buyer. The same rep & warranty made and breached in two different acquisitions could result in a Loss in one, but not in the other. For example, suppose two acquisition agreements (let's refer to them as A and B) represent and warrant to the respective buyer that through the date of closing there have been no material changes to customer relationships for any of the Company's top 10 customers scheduled in the agreement. And, in both examples, one of those customers notifies the seller a few days prior to closing that they are terminating their business relationship with the Company. Based on these facts, let's assume that in both A and B there is a covered breach of the respective reps & warranties.

Let's assume further that in A, the termination of the customer relationship causes an unavoidable loss of business revenue and earnings. In that case, the breach has resulted in an economic loss that can be quantified and compensated. On the other hand, in B, let's assume that the termination of the customer relationship has resulted in the Company's gaining a new customer that previously would not do business with the Company for competitive reasons because of the existence of the terminating customer. Let's further assume that this new customer replaces all of the business lost

from the previous customer, and the new customer relationship would not have occurred, but for the previous customer's termination. In this scenario B, there is likewise a breach under the reps & warranties (a material change to a customer relationship for one of the Company's top 10 customers) but there has been no economic loss or harm resulting from that breach, and therefore no Loss to be compensated by the insurer.

The Claims Process

The facts of acquisitions A and B seem simple, perhaps because the conclusions are provided here as assumptions. But what if there were no given assumption in acquisition B that "the new customer relationship would not have occurred but for the previous customer's termination?" Suddenly, the conclusion of no loss is not so clear, or even determinable, without a significant investigation and analysis of available data and facts. The answer may be hidden in the historical operating data of the Company. The answer may be influenced by the relative revenue of similar customers. The answer may be informed by the market relative to the Company. The answer may come from analyzing data and patterns from other sources. These various sources of data must be questioned and the data examined to answer the question. In evaluating the existence and amount of a loss stemming from a breach, every circumstance is different, without exception ... and the facts matter.

The claims process initiates the review and consideration of the information that will inform the insurer about whether a breach has occurred and a Loss has been suffered. If the claim is to be properly evaluated and settled with the insured, the insurer must make critical claim evaluation decisions. How is one claim different from another? What facts are important? What related data is needed to understand and validate the claim? And the information that must be considered, and the inquiries that must be made, are not always obvious, and rarely cookie cutter.

There should be no assumption that an insured buyer is entitled to payment simply because there has been a breach of a rep & warranty. Whether a Loss has been suffered by an insured must be determined based on the facts of each specific claim, together with the data that is available, obtained, and analyzed. Similar claims can result in very different Loss amounts, or perhaps no Loss at all with no compensation due, even when similar breaches occur.

About Marc Sherman CPA, JD, and Meghan Cardell CPA: Marc is a managing director, and Meghan is a manager at Alvarez & Marsal. They specialize in reps and warranties policies and claims, in addition to forensic accounting and other business consulting.

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