CARLTON FIELDS

RWI Claims That Keep You Up at Night

February 21, 2020

No One Likes a Bad Deal

Sometimes an acquired company's revenues and earnings decline substantially following an acquisition. The investment is worth less to the new owner and the reputations of the deal team that championed the deal within the private equity fund, or the company officers who made the business case for the acquisition to the strategic buyer's board of directors, are damaged. No one likes having a substantial loss in their portfolio. Private equity firms' senior management, to whom the deal teams report, must show returns superior to competing investment funds. Boards of strategic buyers must show shareholders accretive earnings from merger and acquisition plays. It is human nature to blame the other guy for the loss. Accordingly, the members of the impacted deal teams may have a stake in fixing the blame for the sorry turn of events on others' misconduct. The sellers are no longer around to defend themselves, so they become an appealing target.

When the deal comes to be perceived as a bad one, a close look is taken at the representations and warranties the sellers provided to the remorseful owner. The purchaser of the business now has custody of all business records and may hire experts to sort through them to identify any possible breaches, conduct internal investigations, and take other extraordinary measures to find possible grounds to make a claim. Where the purchaser bought a buyer-side representations and warranties insurance policy in connection with the purchase of the portfolio company, the purchaser may make a claim against its insurer for the breaches it believes were made in the representations in the acquisition agreement.

Diminution in Value Claims and Damages Under Delaware Law

This type of claim, known as a diminution in value claim, is often presented as a violation of one or more representations, along with a description of the large decline in revenues and earnings. A catastrophic loss is claimed. The argument advanced is that, had the purchaser been aware of the breach pre-closing, it would not have completed the purchase. Sometimes the purchaser advances a measure of damages that compares what it paid with the value of the acquired company following the steep decline in the portfolio company's performance. This is known in Delaware case law as "recessory" damages, and the Delaware courts are only rarely inclined to consider them. Typically, in breach of contract claims, Delaware law, which governs the determination of damages under most acquisition agreements, measures the breach's impact on the price paid as of the time of the breach — the time an untrue representation was made.

Where there has been a spirited negotiation of an acquisition agreement by a seller that shares some of the risk of claims by an aggrieved purchaser, the agreement usually contains limitations on the purchaser's recovery of damages. The RWI policy usually provides that claims against the insurer can be made if they are not barred by limitations in the acquisition agreement. For example, "market" terms for an acquisition agreement include the requirement that damages are payable only if they were caused by a breach of the representations, and that special or consequential damages are not recoverable. These limitations mean that if the investment suffered as a result of factors not arising from the breach of the representation, or if they are not "direct" damages, they cannot be recovered under the RWI policy.

How a Violation of a Representation is Positioned as a Catastrophic Loss

Claims that assert that breaches of particular representations resulted in catastrophes include:

- Product Warranty Claims. The company had to repair or replace products for an amount greater than anticipated, in violation of a representation. The insured claims that this widespread failure of goods previously sold by a portfolio company damaged its reputation causing customers to stop buying from the portfolio company.
- Intellectual Property. Failure to obtain or maintain patent filings, in violation of a representation. The insured claims that the lack of intellectual property allowed competitors to steal customers.
- Cost Overruns. A purchaser claims that, had it known about cost overruns, it would have been alerted to problematic operational issues that led to dissatisfied and lost customers.
- Material Contracts. A purchaser claims that one or more of the material contracts about which representations were made were allegedly breached by the portfolio company or by the other party where the acquisition agreement contains a knowledge scrape or the purchaser alleges that one or more of the seller's knowledge parties knew of the other party's breach. Where that contract is alleged to be part of a critical supply chain or customer relationship, purchasers sometimes claim a disruption in the portfolio company's business or customer losses.

- Violation of Law. A purchaser claims that the portfolio company violated laws requiring a change in its operations, and injuring the portfolio company's reputation.
- Contingent Liabilities. A purchaser claims that a contingent liability existed that was not set forth in the disclosure schedule to the related acquisition agreement and such disclosure would have allegedly led the purchaser to discover an operational problem that would have changed the purchaser's perception of the portfolio company.

Handling a Diminution of Value Claim

Diminution claims are first-party in nature. Accordingly, the carrier must independently obtain the information necessary to reach a conclusion as to loss. It will have to retain advisors, and can expect that loss adjusted expenses will be higher than with a claim, like a third-party claim, where the defense of the liability comes from the insured's defense counsel.

Prior to the initial conference with the purchaser of the policy and its representatives, the insurer should retain its economic damages expert and evaluate the story told in the notice of claim and any supporting materials the purchaser submitted. Legal analysis should be provided to the expert concerning the types of damages recoverable under the acquisition and the policy and what breach elements a purchaser must satisfy. At this point, before the initial conference, the adjuster and its advisors should have an understanding of the portfolio company's industry, principal competitors, and key business drivers. This information exists in the due diligence materials contained in the underwriting file, and in publicly available information identified by the advisors.

As the carrier starts its investigation, it should request information that will facilitate an evaluation of whether a breach occurred and pinpoint what loss arose from the breach. In diminution cases, the initial request should also focus on documentation that enables the expert to define the actual drivers for the decline in the business. Internally produced, contemporaneous reports that are extremely helpful to economic damages experts include:

- Monthly Financial Reports. Typically, portfolio companies are required by ownership to provide, not less frequently than monthly, reports that contain monthly financial statements together with commentary concerning any differences between actual and expected results. These reports can help identify key drivers for changes in sales and expenses.
- Investment Committee Presentations and Business Case Presentations. Prior to making a purchase, a purchaser typically provides an assessment of the opportunities and risks associated with a purchase. Sometimes the portfolio company falls subject to the risks and fails to realize opportunities. These documents may contain clues that can be unearthed during the course of the investigation.

- Pre-Closing Expert Reports. Prior to making a purchase, a purchaser may obtain expert advice concerning the market in which the portfolio company competes, a SWOT analysis, or other critical evaluation of the goods sold or services rendered by the portfolio company and risks of execution on company plans or prospects. Some of these reports are not standard fare for an underwriting analysis prior to policies being issued, and may not be in the carrier's underwriting file.

During the investigation, the damages expert should consider whether industry market research can be obtained that exposes changes in competitors' market share, and the reasons for those changes. Depending on the claim amount, it may be valuable to sponsor such research where none exists.

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