INSURANCE COVERAGE
SECTION OF LITIGATION
Spring 2018, Vol. 28 No. 2

Improving Corporate Matchmaking: The Rise of Transactional Liability Insurance

William G. Passannante, Carrie Maylor DiCanio, and John M. Leonard[1] – June 18, 2018

Private equity firms and companies use transaction liability insurance to manage the risk inherent in mergers and acquisitions. Most common among these types of insurance is representation and warranty (R&W) insurance, which covers the risk of a target company's seller breaching representations and warranties in a purchase agreement. R&W insurance was first created decades ago but has become increasingly popular in the past few years, particularly among private equity firms, which use it to facilitate the purchase and sale of portfolio companies.

This article discusses the history of transactional liability insurance, reviews existing case law addressing coverage issues that can arise under transactional liability policies, and offers strategies for policyholders with claims under these types of policies.

History and Types of Transactional Liability Insurance
As with any insurance, transactional liability insurance transfers a potential risk from the policyholder to an insurance company for a substantial premium.[2] Numerous products fall under this umbrella, including R&W insurance, loss mitigation underwriting insurance, and liability tax insurance.[3]

Representation and warranty insurance. R&W insurance developed relatively recently in the historical arc of insurance coverage. It did not reach widespread availability in the United States until the 1990s.[4] Similar insurance policies, known as warranty and indemnity insurance, were sold in the United Kingdom roughly a decade earlier.[5]

Purchase agreement representations and warranties ensure the accuracy of the target company's statement concerning, among other things, accounting compliance and the value of inventory and accounts receivable. Misrepresentations concerning these assets could have substantial impact on the value of the acquired company and result in significant damages to the buyer. R&W insurance is intended to reimburse the buyer for the damages resulting from seller's potential misrepresentations.

Typically, R&W insurance indemnifies losses incurred on account of a breach of a seller's representations and warranties during a merger and acquisition transaction.[6] Either the buyer or the seller can purchase the insurance and do so for differing reasons. Buyer-side insurance allows the buyer to recoup losses suffered in a transaction from the insurance company that sold that policy, rather than pursuing the seller for recovery.[7] Limiting the seller's liability to indemnify the buyer for a potential breach can entice the seller to accept a lower purchase price because it caps the amount of escrow required for the transaction and facilitates distribution of proceeds. On the other hand, seller-side insurance indemnifies the seller for financial losses suffered by the buyer.[8] These separate policies can work in tandem to cover almost any loss incurred through a seller's breach of representations or warranties in a transaction.

R&W policies may provide first-party coverage as well as liability coverage against third-party claims related to the transaction. R&W policies also extend the time period for discovery of breaches of representations and warranties by providing for a policy period of up to seven years in which to discover and notice a claim.[9] Generally, an R&W policy will have a retention and may contemplate seller's liability for a portion of the loss in the amount of the indemnification cap under the purchase agreement.[10]

Loss mitigation underwriting. Another type of transaction liability insurance is loss mitigation underwriting (LMU) insurance, which provides "insurance coverage for existing litigation or for litigation that is imminent."[11] LMU insurance was born after a fire at the MGM Grand Hotel in Las Vegas in the early 1980s exhausted the hotel's policy limits with future litigation still pending.[12] Insurance companies designed and sold new policies to the hotel to insure against these future losses that were sure to arise from the fire-related litigation.[13]

Because LMU insurance is meant to provide coverage for litigation stemming from a loss that already has taken place, generally an LMU policy is written for the specific situation that it is meant to insure.[14] Thus, a typical LMU policy features few exclusions to coverage.[15] At the time an insurance company sells the LMU policy, the risk is already known, and the extent of the risk is yet to be determined. With the shared knowledge regarding litigation expenses, a policyholder and an insurance company can design a policy to insure the amount of risk for which coverage is necessary.

Tax liability insurance. Any merger or acquisition inherently involves risks and issues of taxation. Uncertainty regarding taxation could hinder or forestall a transaction. Tax liability insurance protects against this uncertainty.[16] It can look backward to insure "historical tax positions of the target company" or forward to issues that may arise with the merger or acquisition.[17] Like LMU insurance policies, tax liability insurance policies generally are tailored to cover the specific tax risks associated with a transaction.[18]

Many tax liability insurance policies state that a final determination of the unavailability of the tax benefits bargained for figures in the coverage analysis.[19] For example, a final determination may be a decision by a court or a settlement agreement with the adversary taxing authority.[20] These policies often provide a policyholder with insurance payment for taxes, interest, penalties, costs, and payments to reimburse the policyholder for "additional tax liability associated with receipt of payments under the Policy."[21] Knowledge that this insurance recovery is potentially available should a tax error occur can ease concerns regarding a transaction and move the parties to closing.

Transactional Liability Case Studies

Arbitration provisions in many transaction liability policies largely prevent reported cases concerning R&W coverage disputes. Two reported cases involving R&W insurance (or warranty and indemnity insurance as it's known in the United Kingdom) illustrate two issues central to R&W insurance disputes: valuation of damages and the impact of potentially applicable exclusions. These cases also illustrate the scope of coverage available for first- and third-party policies under R&W policies.

Valuation of damages—*Ageas (UK) Ltd. v. Kwik-Fit (GB) Ltd.* Language in the securities purchase agreement has impact on both the transaction and on insurance, as certain terms in the securities purchase agreement may be incorporated by reference into the insurance policy. *Ageas (UK) Ltd. v. Kwik-Fit (GB) Ltd.*[22] shows how language in the purchase agreement in that case affected the damages recoverable under an R&W policy. The insurance company effectively stepped into the shoes of the seller for purposes of calculating recovery under the policy in that case.

Ageas involved the valuation of loss under a warranty and indemnity policy (a name for an R&W policy in the United Kingdom). Ageas, a personal lines insurance company, purchased a warranty and indemnity policy from Chartis Insurance UK Ltd (now AIG), in connection with its acquisition of a company called Kwik-Fit (GB) Ltd. (KFGB) and its subsidiaries, including Kwik-Fit Insurance Services Ltd. (KFIS), which sold car insurance.

The policy insured Ageas for losses in excess of £5 million resulting from Kwik-Fit's breach of warranties in the securities purchase agreement governing the transaction.[23] One warranty in the purchase agreement in that case stated that

the audited annual accounts of KFIS and its subsidiaries for the calendar years 2007 to 2009 were prepared in accordance with GAAP, gave a true and fair view of the assets, liabilities and financial position of the relevant companies; and that the management accounts for the first five months of 2010 had been prepared on a consistent basis with the annual accounts and did not materially misstate assets or liability or items of income and expenditure or profits or losses for that period.[24]

Ageas alleged that KFIS breached this warranty through its accounting treatment of bad debt, which resulted in the company's revenue and assets being overstated for 2009 by £1,404,639, and for the five months ending May 2010 by £905,157.[25] The monthly calculation of "Time on Cover Bad Debt" (TOCBD), the time for which a customer with an installment contract was insured but had not paid the premium, was at the center of this dispute. According to the opinion, TOCBD was at a "historical peak" at the time of the transaction in July 2010.[26]

After Ageas settled with Kwik-Fit, Ageas and AIG litigated the valuation of damages under the policy. Ageas argued that its damages were £17,635,000 based on the value of TOCBD as of the date of the acquisition, resulting in AIG being liable for £12.635 million under the policy. AIG, on the other hand, asserted that Ageas's damages were only £8,792,000, resulting in AIG being liable for only £3.792 million.[27]

The parties did not dispute that "[t]he measure of loss for breach of warranty in a share sale agreement is the difference between the value of the shares as warranted and the true value of the shares" and that the purchase price of £214.75 million accurately valued the shares.[28] The parties differed, however, as to "whether in valuing KFIS at the date of acquisition, account [was] to be taken of the TOCBD experience of the business *since the date of the acquisition*."[29]

In other words, Aegis argued that the value of TOCBD should be valued as of the date of acquisition, without considering the decrease in TOCBD post-acquisition. AIG, however, asserted that TOCBD should be calculated based on a rate of TOCBD per policy calculated "from the actual TOCBD post acquisition data."[30]

AIG made two arguments in support of its position. First, AIG asserted that assessing Ageas's damages as of the date of the breach would result in a windfall to Aegis. Second, AIG argued "that any benefit Ageas receives by the reduced post acquisition incidence of TOCBD is not one which the parties have conferred on Ageas by the allocation of risk in their contractual bargain."[31] The court disagreed with AIG on both points.

With respect to AIG's argument that awarding damages as of the date of the breach would result in a windfall, the court found that AIG's analysis

ignore[d] the effects of factors associated with reduction of TOCBD on other aspects of the business. For example, whilst a reduction in TOCBD is desirable as such, if it results from a reduction in number of installment policies written, there will also be a reduction in the financing revenue of the business. The net effect of a reduction in TOCBD and reduction in finance revenue may mean an overall loss rather than a gain to the business, despite the fall in TOCBD. Valuing the company on the basis of a continuation of 2010 levels of bad debt does not involve a windfall if a subsequent reduction in bad debt is part of a trading pattern which as a whole results in a greater reduction than that forecast.[32]

With respect to the second point on allocation of risk, the court found that the risk of the business doing better or worse was calculated into KFIS's purchase price such that Aegis should reap the benefit of that risk because "[t]here was no provision, as there sometimes is in such agreements, for any post acquisition adjustment of the price based on subsequent trading performance."[33] "What happened to TOCBD after the acquisition was therefore part and parcel of the way Ageas chose to run the business following acquisition and the interaction between those business decisions and the effect of the micro and macro economic conditions on the business. Those contingencies are all matters which the parties agreed are for Ageas' risk."[34]

The court further found that it was not relevant why TOCBD was lower in years following the acquisition. "It is sufficient that whatever the reasons, any resultant benefit was to be for Ageas to enjoy, just as Ageas would have to shoulder any resultant burden."[35] The court held in favor of Ageas.

Exclusions and allocation—*Ratajczak v. Beazley Solutions Limited*. Like many insurance policies, transactional liability policies may contain exclusions relating to certain intentional acts, such as fraud. Further, depending on the applicable jurisdiction and whether the policy contains an allocation provision, a dispute may arise over the extent to which the defense and settlement of claims are covered. *Ratajczak v. Beazley Solutions Ltd.*[36] involved both of these issues.

Ratajczak concerned coverage involved a dispute over the extent of coverage for claims brought by a third party and the buyer of a dairy products company called Packerland Whey Products, Inc. The opinion describes the claims as arising from Packerland's altering its whey product to test for falsely high protein levels and thus garner a higher sale price. The opinion states that these actions made the company look artificially profitable.[37]

The dairy company settled with the buyer prior to the complaint being filed and then sought coverage for the settlement under a seller-side R&W policy, which had $10 million limit with a $1.5 million deductible.[38] The R&W policy insured breaches of contract but contained an exclusion related to fraud.[39]

The sale contract contemplated two types of warranty breaches: (1) a false statement in a "Fundamental Representation" (a specific representation on which the buyer relied) and (2) a false statement not included in the Fundamental Representations, damages for which were capped at $1.5 million. The insurance company argued that "if there was a nonfraudulent breach of warranty, the false statement was not among the Fundamental Representations, so contractual damages were capped at $1.5 million. As that matched the deductible, Beazley had no need to indemnify the Ratajczaks."[40]

The buyer's draft complaint alleged that the seller had "fraudulently conceal[ed] the adulteration and the fact that Packerland's profits had been artificially inflated."[41] The seller argued that such allegations could be interpreted as a breach of the sales contract's Fundamental Representation concerning the accuracy of the seller's books and records, and the allegations should be construed liberally as they would under the Federal Rules.[42] However, the court rejected the seller's argument because the complaint was never filed and thus the Federal Rules did not apply. Further, the court found that the draft complaint sounded overwhelmingly in "fraudulent statements and omissions of material facts (such as the adulteration)," which were excluded from coverage.[43] Thus, the court found that the allegations did not involve the breach of a Fundamental Representation, and damages were capped at $1.5 million.[44]

The court also pointed out that the insurance company would not be liable for the settlement with the buyer because the insurance company never approved the settlement. Many jurisdictions require an insurance company to prove prejudice to be relieved of liability for a settlement under the consent to settle clause.[45]

Claims Strategies

Pre-litigation considerations. R&W policies contain notice and cooperation provisions similar to those of other types of insurance policies. Facilitating the payment of an 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. Most R&W 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 fairly responding to proper information requests from the insurance company. Policyholders should keep a record of the information provided in order to respond to insurance company pretextual arguments. As in most insurance claims processes, proper preparation and perseverance can overcome the usual impecunious approach of some insurance claims departments.

Although an 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 in most venues, delay in giving notice should not have an impact on coverage where the insurance company is not prejudiced by the delay. Still, it is advisable to 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 the policyholder's insurance claim remains pending. Under a buyer-side policy, 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.

Coverage litigation or arbitration considerations. Many R&W policies include arbitration provisions that purport to require confidential arbitration under the rules of an alternative dispute resolution organization, such as the American Arbitration Association or JAMS. Sometimes those clauses are unenforceable and may be avoided in court. Policyholders should consider whether arbitration of insurance claims is acceptable to their organization. Often policyholders prefer to litigate claims before a jury, who are more likely to empathize with the policyholder, and avoid a confidential arbitration in which their fate may be determined by an arbitrator and after which there may be limited opportunities to appeal. Potential benefits to arbitrating a coverage dispute include the ability to select an arbitrator with subject matter expertise, potential lower overall costs, and the possibility of a faster resolution.

To the extent a claim cannot be resolved without arbitration or litigation, an R&W insurance policyholder should bear in mind that, as with other insurance disputes, it is helpful to obtain discovery of the underwriting file, which 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. Discovery of the claims file also may be key to resolution of any coverage issues. Although many R&W insurance claim handlers, brokers, and underwriters often 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.[46]

Conclusion

Transaction liability insurance offers important protection to private equity firms and companies in a global economy with a fast deal-making metabolism. Companies seeking protection against an acquisition's post-sale performance as well as its representations at the time of sale should work with their broker to obtain the right insurance policies. If a claim arises, providing notice and properly documenting the claim process will aid in increasing insurance recovery. Private equity firms and companies rely on transactional liability insurance and should receive full value for their insurance premium payment.

William G. Passannante, Carrie Maylor DiCanio, and John M. Leonard are with Anderson Kill P.C.

---

[1] William G. Passannante and Carrie Maylor DiCanio are shareholders, and John M. Leonard is an attorney, in the New York office of Anderson Kill P.C. Mr. Passannante has represented policyholders in precedent-setting cases argued in trial and appellate courts throughout the country. Ms. DiCanio has recovered insurance proceeds for corporate policyholders in state and federal courts throughout the United States and advised clients on pre-litigation insurance matters. Mr. Leonard focuses his practice on insurance recovery, exclusively on behalf of policyholders.

[2] AON Risk Solutions, Risk Intelligence: How to Reliably Mitigate Transaction Risk and Secure Clean Exits.
[3] William E. Knepper & Dan A. Bailey, *Liability of Corporate Officers and Directors* § 28.09 (8th ed. 2017).
[4] 4-32 Jeffrey E. Thomas, *New Appleman on Insurance Law Library Edition* § 32.02 (LexisNexis).
[5] Thomas, *supra* note 4, § 32.02.
[6] Jeff Anderson, *Getting to "Yes": Transactional Insurance Beyond Reps & Warranties* 4–5 (Apr. 2015).
[7] Thomas, *supra* note 4, § 32.01.
[8] Thomas, *supra* note 4, § 32.01.
[9] Olga Sandler, "Representations and Warranties Insurance in M&A Transactions," *Lexology*, Apr. 7, 2015.
[10] Thomas, *supra* note 4, § 32.02
[11] International Risk Management Institute, Inc. (last visited Jan. 17, 2018).
[12] International Risk Management Institute, Inc.
[13] International Risk Management Institute, Inc.
[14] Knepper & Bailey, *supra* note 3, §28.09.
[15] Knepper & Bailey, *supra* note 3, §28.09.
[16] Thomas, *supra* note 4, § 32.01.
[17] Anderson, *supra* note 6, at 6.
[18] Thomas, *supra* note 4, § 32.03.
[19] Knepper & Bailey, *supra* note 3, § 28.09.
[20] Thomas, *supra* note 4, § 32.03.
[21] Knepper & Bailey, *supra* note 3, §28.09.
[22] *Ageas (UK) Ltd. v. Kwik-Fit (GB) Ltd.*, [2014] EWHC(QB) 2178 (Eng.)
[23] *Ageas*, [2014] EWHC(QB) 2178 [1].
[24] *Ageas*, [2014] EWHC(QB) 2178 [10].
[25] *Ageas*, [2014] EWHC(QB) 2178 [11].
[26] *Ageas*, [2014] EWHC(QB) 2178 [16].
[27] *Ageas*, [2014] EWHC(QB) 2178 [2].
[28] *Ageas*, [2014] EWHC(QB) 2178 [14] (citations omitted).
[29] *Ageas*, [2014] EWHC(QB) 2178 [20] (emphasis added).
[30] *Ageas*, [2014] EWHC(QB) 2178 [16].
[31] *Ageas*, [2014] EWHC(QB) 2178 [41].
[32] *Ageas*, [2014] EWHC(QB) 2178 [48].
[33] *Ageas*, [2014] EWHC(QB) 2178 [50].
[34] *Ageas*, [2014] EWHC(QB) 2178 [52].
[35] *Ageas*, [2014] EWHC(QB) 2178 [53].
[36] Ratajczak v. Beazley Sols. Ltd., 870 F.3d 650 (7th Cir. 2017).
[37] Ratajczak, 870 F.3d at 653.
[38] Ratajczak, 870 F.3d at 655.
[39] Ratajczak, 870 F.3d at 655.
[40] Ratajczak, 870 F.3d at 655.
[41] Ratajczak, 870 F.3d at 655.
[42] Ratajczak, 870 F.3d at 655.

[43] Ratajczak, 870 F.3d at 655.
[44] Ratajczak, 870 F.3d at 656.
[45] *See, e.g.*, Kronjaeger v. Buckeye Union Ins. Co., 200 W. Va. 570, 587 (1997); Pub. Util. Dist. No. 1 v. Int'l Ins. Co., 124 Wash. 2d 789, 804 (1994).
[46] *See, e.g.*, Butler v. Am. Heritage Life Ins. Co., No. 4:13-CV-199, 2016 U.S. Dist. LEXIS 10464, at *14 (E.D. Tex. Jan. 29, 2016); Barnard Pipeline, Inc. v. Travelers Prop. Cas. Co. of Am., No. CV 13-07-BU-DLC, 2014 U.S. Dist. LEXIS 53778, at *8 (D. Mont. Apr. 17, 2014); Charter Oak Fire Ins. Co. v. Am. Capital, Ltd., No. DKC 09-100, 2013 U.S. Dist. LEXIS 180523, at *5 (D. Md. July 24, 2013) (investigation during claims handling is done in the ordinary course of business and does not reap benefit of attorney-client privilege); Nat'l Union Fire Ins. Co. of Pittsburgh, Pa. v. TransCanada Energy USA, Inc., 119 A.D.3d 492, 493, 990 N.Y.S.2d 510, 511–12 (N.Y. App. Div. 1st Dep't 2014) ("Documents prepared in the ordinary course of an insurer's investigation of whether to pay or deny a claim are not privileged, and do not become so 'merely because [the] investigation was conducted by an attorney'.") (quoting Brooklyn Union Gas Co. v Am. Home Assurance Co., 23 A.D.3d 190, 191, 803 N.Y.S.2d 532 (N.Y. App. Div. 1st Dep't 2005)).