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Expert Analysis

Court Denies Coverage Under Reps and Warranties Policy

By **Howard B. Epstein**

And **Theodore A. Keyes**

The Representations and Warranties Insurance market continues to grow and evolve, as buyers and sellers of businesses and their counsel become more comfortable using insurance products to mitigate risks arising out of mergers and acquisitions. We covered Reps and Warranties Insurance 101 and the growth of the market in two prior columns. Howard B. Epstein and Theodore A. Keyes, "Representation and Warranty Insurance Comes of Age," N.Y.L.J. Vol. 255, No. 61, March 31, 2016; "Representation and Warranties Insurance as Deal Making Tool," N.Y.L.J. Vol. 248, No. 59, Sept. 24, 2012. As we discussed, because this is a relatively new product, there is limited information available concerning claims experience under these policies. In addition, because most Reps and Warranties policies include arbitration clauses or other alternate dispute resolution provisions, courts have had limited opportunities to interpret the terms of the policies. Recently, however, the U.S. District Court for the Eastern District of Wisconsin and the Court of Appeals for the Seventh Circuit issued opinions that addressed the terms of a Reps and Warranties policy governed, according to the policy terms, by New York law.

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Sale of Packerland

In 2012, Packerland Whey Products was a manufacturer of high protein ingredients most often used for dairy and beef cattle feed. Not surprisingly, given the name, the company was located in Green Bay, Wisc. In May 2012, the Ratajczak brothers, owners of Packerland, sold 100 percent of the stock of Packerland to an affiliate of Granite Street Partners (buyer) pursuant to the terms of a Stock Purchase Agreement (SPA). As part of the sale agreement, the Ratajczak brothers remained employees of Packerland and invested in the parent company of the purchaser.

Pursuant to the SPA, the Ratajczaks made certain representations and warranties to the buyer. Under the terms of the SPA, in the event of a breach, the sellers' liability was capped at $1.5 million unless they breached one of the representations designated as a Fundamental

HOWARD B. EPSTEIN *is a partner at Schulte Roth & Zabel, and* THEODORE A. KEYES *is special counsel at the firm.*

Representation or a specific trade secret warranty. *Ratajczak v. Beazley Solutions Limited*, 2016 WL 8117956 (E.D. Wisc. Aug. 17, 2016).

Reps and Warranties Policy

In order to mitigate the risk associated with the transaction, and pursuant to the requirements of the SPA, the Ratajczaks purchased a seller-side Reps and Warranties policy from Beazley Solutions Limited. The policy insured the Ratajczaks against claims for breach of certain representations and warranties made in the SPA up to a limit of $10 million and subject to a $1.5 million retention. Since the retention matched the SPA cap on liability for breach of general representations, it appears that the policy was purchased for the purpose of insuring liability associated with breaches related to Fundamental Representations and trade secret warranties.

The insuring agreement of the policy provided that Beazley will "indemnify the Insured for, or pay on its behalf, Loss, in excess of the Retention but not in excess of the Limit of Liability, on account of a Breach or Third Party Demand, provided that each Breach or Third Party Demand is first reported to the Underwriters in accordance with the terms of this Policy." A Breach was defined in the policy as any breach of the insured representations and warranties and a Third Party Demand was defined to include any legal action or demand against the Ratajczaks that resulted from "an actual or alleged breach." Id. at *2.

Buyer's Claims

At the time of the sale, Packerland's most important product was a whey protein concentrate known as WPC-34. In November 2012, buyer allegedly discovered that the Ratajczaks had been directing Packerland employees to add urea, a source of non-protein nitrogen, to the manufacturing process for WPC-34. Adding urea to the product boosts the nitrogen levels, which are used to measure the amount of protein, making the product appear to contain more protein that it actually does. Since the product's value is tied to its protein levels, adding urea made WPC-34 appear more valuable than it actually was.

Upon learning that Packerland was secretly adding urea to WPC-34, buyer threatened to sue and bring criminal charges. Buyer asserted that the use of urea was not disclosed prior to the close of the sale and that "the use of urea in the manufacture of WPC-34 caused the revenues and profits of that business line to be overstated, in turn, impacting the valuation ascribed to the business." Id. at *3.

On Dec. 8, 2012, prior to any litigation, the Ratajczaks' attorneys met with the buyer's attorneys to negotiate a settlement of buyer's claims. Buyer's counsel provided the Ratajczaks with a draft complaint which asserted claims for fraud, negligent misrepresentation, conspiracy to commit fraud, breach of contract, breach of fiduciary duty, injunctive relief, constructive fraud and rescission. In support of the claim for breach of contract, the draft complaint alleged that by using and not disclosing the use of urea, the Ratajczaks had breached the following representations and warranties in the SPA: "that Packerland had no contingent liabilities (SPA §3.11); that Packerland was not in breach of any of its material contracts (SPA §3.14); that there was no basis for a future suit against Packerland (SPA §3.19); that all of Packerland's products conformed to its customers' requirements (SPA §3.32); and that the Ratajczaks had fully disclosed in writing all material facts to [buyer] (SPA §3.39)." Id.

Settlement of the Claims

On Dec. 28, 2012, the parties finalized a settlement that called for the Ratajczaks to pay just under $10 million, surrender their stock in buyer's parent company and waive any claims to additional funds that had been escrowed as part of the sale transaction. As a result, buyer never filed the complaint against the Ratajczaks.

On Dec. 24, 2012, just a few days before finalizing the settlement, the Ratajczaks submitted Notice of a Third Party Demand to Beazley seeking coverage for the buyer's

claims under the Beazley policy and forwarding a copy of the draft complaint. The original notice advised that the Ratajczaks intended to settle the claim but did not disclose the proposed settlement terms.

On Dec. 27, 2012, Beazley acknowledged receipt of the notice and requested information concerning the settlement negotiations. Although the Ratajczaks' counsel began forwarding information to Beazley that afternoon, the Ratajczaks finalized the settlement and wired the settlement payment on Dec. 28, 2012 without first asking for or receiving Beazley's consent to settle. Ultimately, Beazley denied coverage. Id.

District Court Ruling

The Ratajczaks filed suit against Beazley in the district court seeking coverage for the settlement payment made to the buyer. The Ratajczaks alleged, among other things, that Beazley had acted in bad faith and breached its duty to indemnify and that the coverage of the policy was illusory, permitting reformation of certain provisions.

The district court disagreed and granted summary judgment to Beazley on all counts on two alternative bases. First, the district court found that the Ratajczaks failed to demonstrate loss in excess of the policy retention. That alone would have been a sufficient basis to grant summary judgment to Beazley. But the district court also held that the Ratajczaks' claim failed because they did not obtain Beazley's consent before settling buyer's claims.

Covered Loss Did Not Exceed Retention

Under the terms of the policy, coverage was provided excess of a $1.5 million retention, which operates like a deductible. Thus, the Ratajczaks could only recover from Beazley if covered losses exceeded $1.5 million. Under the terms of the SPA, however, the Ratajczaks' liability for a breach was capped at $1.5 million, unless there was a breach of a trade secret warranty or a representation designated as a Fundamental Representation in the SPA. Beazley argued that the buyer's draft complaint only alleged breaches of general warranties, and that therefore the Ratajczaks' potential covered losses were capped at $1.5 million, the same amount as the retention, such that it was impossible for covered loss to exceed the retention.

> The Packerland rulings demonstrate that courts will interpret the terms of Reps and Warranties policies in the same manner that they interpret the terms of other insurance contracts.

The Ratajczaks contended that, even though the draft complaint did not explicitly assert a claim for breach of a Fundamental Representation, a fair reading of the draft complaint, consistent with federal notice pleading standards, would recognize a claim for breach of the Fundamental Representation that Packerland's organizational documents were complete and correct and consistent with sound business practice and accounting policies (SPA §3.3).

The district court disagreed, explaining that buyer claimed that the sellers failed to disclose the practice of adding urea to WPC-34, not that the organizational documents were wrong or violated accounting policies or practices. The "fact that the addition of urea may have inflated revenues and profits does not mean that the books were not properly maintained. There was no allegation that the revenues and profits were misstated; nor was there any allegation that the Company had not maintained its books of account and other records in accordance with sound business practices, and applicable law and accounting policies in violation of Section 3.3 of the SPA." Id. at *6.

Since buyer did not allege a breach of a Fundamental Representation, potentially covered losses were capped at $1.5 million, which did not exceed the policy retention. The district court further emphasized that the policy did not obligate "Beazley to indemnify [the Ratajczaks] for any liability they may have incurred for compensatory and punitive damages for fraudulent misrepresentation,

negligent misrepresentation, conspiracy to commit fraud, and breach of fiduciary duty." Id. at *5.

Failure to Obtain Consent To Settle

In the alternative, the district court held that the Ratajczaks were not entitled to coverage because they failed to obtain Beazley's consent prior to entering into the settlement agreement. The policy expressly provided that the "Insured shall (without limitation): (1) not settle, compromise or discharge any Breach or Third Party Demand without prior consultation with and the prior written consent of the Underwriters (such consent not to be unreasonably withheld, conditioned or delayed)." Id. at *7.

It is undisputed that the Ratajczaks did not seek or obtain prior consent to settle from Beazley. The Ratajczaks argued that the failure to obtain consent was not fatal to their claim because Beazley was not prejudiced by that failure—because Beazley would have, in any event, denied coverage for the claim. In response, Beazley contended that consent-to-settle provisions are enforced under both Wisconsin and New York law without a prejudice requirement.

The district court found that Beazley was prejudiced by the Ratajczaks' failure to obtain consent and, therefore, determined that its decision would be the same under either Wisconsin or New York law. In so ruling, the district court explained that, by failing to provide prior notice and seek consent, the Ratajczaks had deprived Beazley of the opportunity to clarify its potential exposure and the opportunity to attempt to lower the settlement amount or otherwise structure the settlement to protect its interests by clearing apportioning the settlement amount between covered and uncovered claims. The district court emphasized that "the fact that a claim for coverage suffers from more than one defect does not mean that an insurer can't be prejudiced by late notice." Id. at *9.

Seventh Circuit Affirms

The Ratajczaks appealed the district court ruling to the Seventh Circuit, but the Court of Appeals affirmed. The Seventh Circuit agreed that buyer's claims did not allege the breach of a Fundamental Representation and that, therefore, potentially covered losses were capped at $1.5 million, the same as the retention under the Beazley policy. The Court of Appeals explained that "[I]nsurance coverage usually depends on the nature of the victims' claims, and the draft complaint that the buyer showed to the Ratajczaks did not specify a falsehood in one of the Fundamental Representations." *Ratajczak v. Beazley Solutions Limited*, 870 F.3d 650, 655 (7th Cir. 2017). The Court of Appeals rejected the Ratajczaks' argument that the draft complaint should be liberally construed in accordance with federal notice pleading rules, pointing out that the complaint was never filed so that the pleading rules are not applicable. Id.

The Court of Appeals also agreed that the failure to obtain consent to settle provided an alternative ground to grant Beazley's motion for summary judgment. The court held that, in accordance with the choice of law clause in the policy, New York law applies to the dispute. Under New York law, no prejudice is required to enforce a defense based on failure to obtain consent to settle. Id.

Looking Forward

Although most disputes regarding claims under Reps and Warranties policies are likely to be resolved in arbitration or other alternate dispute resolution forums, the Packerland rulings demonstrate that courts will interpret the terms of Reps and Warranties policies in the same manner that they interpret the terms of other insurance contracts. This provides a level of certainty that should increase the confidence of both buyers and sellers of these products.

Schulte Roth&Zabel

Schulte Roth & Zabel LLP
919 Third Avenue, New York, NY 10022
212.756.2000 tel | 212.593.5955 fax | www.srz.com
New York | Washington DC | London