

CORPORATE INSURANCE LAW

Expert Analysis

Representations and Warranties Insurance: A Real World Claims Discussion

Over the last approximately 20 years, more and more deal practitioners have begun to routinely use Representations and Warranties (R&W) insurance to help clients mitigate risks associated with the purchase and sale of both private and public companies. When R&W insurance products were first introduced into the marketplace and as the use of these policies initially started to increase, many noted that the real staying power of the products would be impacted by actual claims experience. Fast forward to today and that claims information is now available and product use continues to increase.

R&W insurance claims can arise, subject to policy-specific terms and exclusions, out of the breach of any representation made in a purchase agreement. Based on available data, the most frequent claims appear to arise out of breaches of representations concerning financial statements, tax, compliance with laws and material contracts. We thought it would be useful to our readers to describe some real-world R&W insurance claims and so we consulted with the experts at Euclid Transactional, who assisted us



By
**Howard B.
Epstein**



And
**Theodore A.
Keyes**

in preparing this column.

Euclid Claims Experience

Over the course of the last three years, Euclid has written over 1,300 policies and received over 175 claims. These claims have resulted in the payment of tens of millions of dollars to insureds for claims that generally fall into two categories: (1) first-party claims, where the buyer claims loss resulting from the acquired business not being in the condition represented by the seller; and (2) third-party claims, where the buyer claims loss related to a liability or obligation owed by the acquired business to a third party. Simple examples of first-party claims include where a target business is missing inventory or has assets in worse condition than represented to the buyer. Examples of third-party claims include litigation against an acquired business or claims from customers that the acquired company has breached a contract. For both types of claims, Euclid will carefully sort through the

facts and circumstances to determine what transpired and experience has taught that claims arise from two main sources, people's mistakes and people's lies. Below we discuss some noteworthy situations involving both first- and third-party claims and innocent and bad actors. Names and facts have been changed to protect the confidentiality of parties and the examples should not be viewed as legal advice or guidance on how Euclid will handle future claims.

Based on available data, the most frequent claims appear to arise out of breaches of representations concerning financial statements, tax, compliance with laws and material contracts.

Third-Party Claims

Approximately 60% of Euclid's claims involve outside parties alleging that the acquired business owes them money. In these cases, the claims process must often move quickly to work within litigation or other business critical deadlines imposed on the acquired business.

The Customer Is Always Right. Buyer's due diligence process typically involves a review of key contracts with

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

customers and suppliers. In a number of Euclid's claims, the target did not comply with the terms of a contract with a key customer. In one case, a company providing technology-related services to its customers had for some period of time been overcharging the customer. In another case, a company providing services to the U.S. government had not complied with a contractual obligation to give the government the most favorable terms of any of its customers. Each of these cases resulted in multi-million dollar payments to the customers on behalf of the insureds. In both cases, Euclid verified that the terms and conditions of the contracts were not followed and assessed the amount of loss. Euclid then reviewed whether there was any basis to reduce or mitigate the amount payable to the third party before either making payment to the third party or reimbursing the target for amounts paid.

We Owe Them What? Some third-party claims may not arise from accidental misinterpretation of contractual clauses or other oversights. In some cases, Euclid has questioned whether the seller was hiding an existing liability to receive a higher sales price. In one claim, buyer discovered after closing that the target business owed millions of dollars of debt which was not previously disclosed. This led to a multi-million dollar claim payment and an investigation into the reasons why the debt was not identified during the sales process. Ultimately, after an investigation into fraud and misconduct, it was determined that poor record-keeping and lack of management continuity were the primary causes of the non-disclosure.

First-Party Claims

The other 40% of Euclid's claims are first-party claims where the seller did

not hold up its end of the bargain and delivered a business in a condition different than represented to the buyer. These claims have proven to be costlier on average than third-party claims.

I'll Blow Your House Down. First-party claims under R&W policies often involve situations where a buyer believed that, like the little pigs in the story, the business they purchased was stronger than they thought. For example, Euclid facilitated payment of a multi-million dollar claim for an insured who purchased a building thinking it was in good operating condition after an initial inspection and based on representations from the seller. However, upon further inspection and review by engineers after the sale was complete, it was determined to be a dangerous place to conduct business. In fact, after Euclid sent its own engineer to inspect the site, he stated that he would never be willing to walk into the unsafe facility again.

Beyond the physical strength of the buildings in an acquired business, a buyer may be surprised to learn that the revenue of the business is weaker than expected. Euclid's experience has included claims where financial system issues or errors in calculations caused revenues to be overstated in the financial statements of businesses. In other claims, sellers changed accounting practices, such as how they reserve for uncollected receivables or contingent liabilities, without informing the buyer, and this resulted in financial statements that did not properly reflect the financial situation at the target business.

Fraudulent Claims. Unfortunately, not all claims arise from innocent or inadvertent errors or omissions. Some claims have involved businesses that were inflating sales numbers, falsifying contracts and, in one case, even

inventing fictitious people as part of an elaborate ruse. Lies can seriously damage the value of a business and buyers can be rightfully angry and frustrated when they learn that intentional misrepresentations have been made by a seller. In those cases, insurers and insureds will carefully consider whether the insured will directly pursue the bad actor who caused the loss or allow the insurers to subrogate against those bad actors for loss paid under the policy. In some situations, the insureds and insurers are in the unenviable position of relying on the bad actor to confess and explain the full extent of the skullduggery to assist with mitigation efforts.

Looking Forward

In each of the claim scenarios discussed above, the buyer did not get the benefit of the bargain negotiated with the seller, and Euclid's insurance policy helped put the insured in the position it would have been had the breach not occurred.

These scenarios only provide examples of some of the R&W insurance claims that arise. Of course, the claims that practitioners care most about will continue to be their own client's claims. As with all insurance claims, these will be addressed on a case-by-case basis according to their own unique set of facts.

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