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Novolex Holdings: A Rare Look at an RWI Claim Dispute

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Over the past decade, representations and warranties insurance (RWI) has emerged as a critical tool to mitigate risk in merger and acquisition (M&A) transactions. In fact, while RWI may initially have been seen as a novelty, it is now viewed as a relatively standard requirement in M&A transactions.

RWI policies reduce a policyholder's risk by providing coverage for losses incurred due to a seller's breach of representations and warranties in the purchase agreement. These policies can be either seller-side, where an insurer indemnifies the seller for losses stemming from a breach of the seller's own representations and warranties or, more commonly, buyer-side, where the RWI policy covers the buyer for losses due to the seller's breach. RWI can be used to partially reduce a seller's indemnity obligations in the event of post-closing losses (*i.e.*, by reducing the cap on a seller-funded indemnity or escrow), but the policies are now often used as a complete substitute for seller indemnities.

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While RWI policies are manuscripted policies separately negotiated for each transaction, the vast majority of RWI policies contain arbitration clauses, meaning that claim disputes are resolved privately without published court rulings. That leaves policyholders and practitioners without much in the way of specific legal precedent to inform their policy negotiations and their own approach to RWI claims handling.

However, a recent ruling in a case involving RWI that is being litigated in New York, *Novolex Holdings v. Illinois Union Insurance*, Index No. 655514/2019, 2024 WL 144990 (N.Y. Sup. Ct. Jan. 12, 2024), sheds some light

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on one of these claim disputes, while also providing important lessons for insurers and M&A practitioners.

Novolex

Novolex Holdings LLC (Novolex) purchased primary and excess RWI policies in connection with its $2.275 billion acquisition of The Waddington Group (TWG), a manufacturer and distributor of disposable kitchenware. The equity purchase agreement governing the acquisition contained standard seller representations and warranties, including with respect to TWG's top customers and business operations prior to the transaction. At the time the purchase agreement was executed, Costco Wholesale Corporation (Costco) was TWG's third largest customer based on purchase volume.

Novolex alleged that Newell's failure to disclose Costco's pre-closing statements suggesting that Costco intended to take its business elsewhere constituted a breach of the material contract representation.

After the transaction closed, Novolex submitted a claim to its RWI insurers, contending that it had incurred in excess of $250 million in losses due to misrepresentations made by TWG and its parent company, Newell Brands Inc. (Newell), regarding TWG and Newell's relationship with Costco. In particular, Novolex pointed to pre-closing communications from Costco, which Novolex claimed had informed TWG of Costco's "intent to take substantially all of its business elsewhere, following a lengthy period of repeated failures by TWG to live up to its side of the bargain." *Novolex Holdings v. Illinois. Union Insurance*, 2024 WL 144990, at *2.

Novolex sued its insurers after they denied coverage, claiming a right to recover loss incurred due to, among other things: (1) breach of Newell's material contract representation, (2) breach of Newell's material adverse effect representation, (3) breach of underlying contracts with Costco and (4) breaches of warranties related to goods and services provided to Costco.

In its Jan. 12, 2024, ruling on the parties' summary judgment motions, the New York County Supreme Court addressed each of the above claims, the two most significant of which we discuss below.

Alleged Breach of the Material Contract Representation

Newell listed Costco as one of its "material relationships" in the disclosure schedules to the purchase agreement, which set forth the 10 largest customers and 10 largest suppliers of the purchased companies. In the purchase agreement, Newell represented that "[s]ince Dec. 31, 2017, there has not been any written notice or, to the Knowledge of Parent, any oral notice, from any such material relationship that such material relationship has terminated, canceled or adversely and materially modified or intends to terminate, cancel or adversely and materially modify any contract between a purchased company and any such material relationship." The parties agreed that TWG's vendor agreements with Costco were "material contracts" under the purchase agreement.

Novolex alleged that Newell's failure to disclose Costco's pre-closing statements

suggesting that Costco intended to take its business elsewhere constituted a breach of the material contract representation. The court rejected this argument, first explaining that the material contract representation unambiguously applies to "termination, cancellation, and modification of contracts…" Thus, a mere change in TWG's "general business relationship" with Costco would not constitute a breach in the absence of actual termination, cancellation or modification of a contract.

In support of its position, Novolex referred the court to language in the vendor agreements incorporating purchase orders "that have been or will be signed." Novolex argued that Costco's intent to reduce its volume of business with TWG was effectively a modification of the vendor agreements, because it was a modification of future unsigned purchase orders. Consequently, according to Novolex, Newell was required to disclose Costco's statements.

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The court also rejected this argument, explaining that the phrase "will be signed" requires that the parties' intend to enter into a future purchase order. Therefore, future purchase orders that were not actually contemplated by the parties during the period covered by the representation could not be deemed incorporated into the vendor agreement. Since Novolex's complaint stemmed from Costco's general decision to reduce the volume of its business, this could not be deemed a modification of a contemplated purchase order for the purposes of the material contract representation.

In addition, the court highlighted language from Costco's standard terms, which provided that "projections, any past purchasing, prior history and representations about quantities to be purchased are not binding." The court reasoned that, based on this language, Costco's decision to reduce volume in future purchase orders could not be considered a modification of the underlying vendor agreement. Accordingly, the court dismissed the claim entirely.

Alleged Breach of the Material Adverse Effect Representation

The court next addressed Novolex's claim that Newell breached its representation regarding the absence of any material adverse effect. The representation provided that "[d]uring the period beginning on Dec. 31, 2017 and ending on [May 2, 2018], there has not been any effect which has had or would reasonably be expected to have a Material Adverse Effect." Under the purchase agreement, a "material adverse effect" was defined as "any change, effect or event (each, an "effect") that, individually or in the aggregate, has been or is reasonably expected to be materially adverse to the condition (financial or otherwise) or results of operations of the business or the purchased companies, taken as a whole."

Importantly, Novolex's RWI policies contained a provision, known as a materiality scrape, which provided that "[b]oth the existence of any breach and the amount of any losses resulting from such breach shall be determined

without giving effect to any 'material,' 'materiality,' 'material adverse effect,' or similar qualification contained in or otherwise applicable to the representations or warranties contained in Article III" of the purchase agreement.

A materiality scrape is a buyer-friendly provision, in which the term 'material' or similar qualifiers are removed when determining whether a particular representation or warranty was breached, the amount of damages stemming from a breach or both.

Novolex asserted that the materiality scrape altered the definition of "material adverse effect" to include adverse changes, whether material or not, and that the business experienced an adverse change due to the deterioration of the business relationship with Costco. The insurers argued that applying the materiality scrape to the material adverse effect representation would render the representation meaningless, as such an application would remove the defined term entirely.

The court noted that applying the materiality scrape as drafted would create an ambiguity, given that it would be impossible to simultaneously give both the representation and the scrape provision meaning. It went on to explain that ambiguities are construed against the drafter under Delaware law. Since the RWI policies were drafted by the insurers, the court was required to resolve the ambiguity in Novolex's favor.

Ultimately, because it could not determine at this stage whether the business experienced an "adverse effect," it denied both parties' motions for summary judgment on this claim.

Looking Forward

As the use of RWI has increased for both public and private M&A transactions, it has become a routine way to mitigate post-closing losses. The *Novolex* case serves as a reminder that RWI policies are contracts, and therefore disputes regarding RWI claims will be resolved by courts and arbitration tribunals by applying the rules and guidelines applicable to disputes over interpretations of insurance contracts. This should provide deal parties with a degree of confidence over the rules that will govern resolution of claim disputes.

The case also demonstrates that RWI does not provide any broader protection to an insured than the scope of the representations dictate. In order to achieve the broadest protection possible, deal parties are advised to perform diligence and carefully negotiate the representations and warranties in the underlying purchase agreement, as they would in any other transaction not involving RWI.

Further, deal parties should pay close attention to how the RWI policy interacts with the purchase agreement, particularly with respect to definitions that may modify representations or other purchase agreement provisions (for insurance purposes), materiality scrapes and exclusions.