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Emerging Insurance Disputes

R&W Lessons From Novolex Summary Judgment Decision

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A commentary article reprinted from the May 16, 2024 issue of Mealey's: Emerging Insurance Disputes

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Commentary

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Key Takeaways

Novolex serves as a reminder that while sellers in corporate transactions may ultimately not be liable for breaches of representations (because of Representations and Warranties insurance ("RWI")), insurers may try to rely on the negotiations over and phrasing of those representations. In *Novolex*, the buyer and its R&W insurers have now been litigating for years the meaning of various representations and whether those representations have been breached. While buyers may expect that undisclosed issues like a known reduction in business with a large customer would lead to a breach of one or more representations covered by RWI, insurers may argue it is not so clear, which can lead to buyers getting bogged down in litigation with their R&W insurers. Thus, it is important to consider potential issues that may be the subject of discussions with R&W insurers before deal documents are finalized.

Background

The summary judgment decision in *Novolex Holdings, LLC v. Illinois Union Insurance Company* is noteworthy because many RWI claims are usually resolved before a formal dispute and many policies have arbitration provisions.

The dispute arises from Novolex's $2.275 billion deal with Newell. Novolex acquired The Waddington Group ("TWG"), a manufacturer of food packaging and disposable products under an equity purchase agreement ("EPA"). In connection with the transaction, Novolex procured RWI to protect against the risk that a representation or warranty in the EPA turned out to be inaccurate. Given the size of the deal, Novolex purchased a large amount of coverage: $150 million in limits under four policies in excess of a $17 million retention.

Following the transaction, Novolex alleged that various representations in the EPA had been breached. The breaches related to the overarching allegation that TWG knew that its customer, Costco, intended to significantly reduce business with TWG. Novolex claimed damages of around $267 million. Novolex filed a claim with its R&W insurers seeking to recover

for its loss and was able to resolve its claims with the primary insurer and the first-layer and third-layer excess insurers.

However, coverage was refused under the second-layer excess policy issued by Illinois Union Insurance Co. Novolex filed suit in the New York Supreme Court to recover the insurance proceeds. Illinois Union Insurance Co. filed a motion to dismiss that was ultimately denied by the court, expanded upon in a March 19, 2021, article written by the authors.[1] The case continued and both parties filed motions for summary judgment. The court granted in part the insurer's motion for summary judgment and denied Novolex's motion for partial summary judgment in full. The insurers subsequently moved to reargue and have appealed. Novolex has cross appealed and opposed the motion for reargument.

Cross Motions for Summary Judgment

In their motions, the parties sought summary judgment on whether various representations were breached.

a. Section 3.7 (Material Adverse Effect)

Novolex alleged a breach under Section 3.7(b) of the EPA, which provided that from December 31, 2017 until May 2, 2018, there had "not been any Effect which has had or would reasonably be expected to have a Material Adverse Effect."

The insurers argued that the so-called materiality scrape in the RWI policy did not apply to Section 3.7. That provision, in Section II.D of the RWI policy, stated 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 qualifications contained in or otherwise applicable to the representations or warranties contained in Article III of the Acquisition Agreement."

The insurers claimed that "applying the materiality scrape to Section 3.7(b) would render the representation in that provision meaningless because it would remove the entire phrase 'Material Adverse Effect' from the provision." According to the insurers, applying the materiality scrape literally, Section 3.7(b) would contain a representation that from December 2017 until May 2, 2018, there had "not been any Effect which has had or would reasonably be expected to have a Material Adverse Effect." The insurers contended that meant the materiality scrape should not apply to Section 3.7(b).

The court disagreed and found the policy ambiguous. It explained that if it were to apply the materiality scrape, "the entire phrase 'Material Adverse Effect' would be removed from Section 3.7(b)," making it ambiguous because it would be impossible to give meaning to both Section 3.7(b) of the EPA (the Acquisition Agreement) and the materiality scrape in Section II.D of the RWI policy. The court then construed the ambiguity against the insurers and in Novolex's favor. Thus, to obtain coverage under the RWI policy, Novolex would need to show an "Effect" that "had or would reasonably be expected to have" an Adverse Effect. The court found that presented an issue of fact and thus denied summary judgment to both parties.

b. Section 3.10 (Pricing Provision)

Novolex alleged a breach under Section 3.10 of the EPA, which provided that no "Purchased Company is in breach or default of, or has received any written notice of any breach or default or event that, with notice or lapse of time, or both, would constitute a default by any such Person under any Material Contract . . . ." The parties disputed whether there were any relevant "Material Contracts" on which a breach of Section 3.10 could be based. Novolex relied on three parts of the documentation of the TWG-Costco relationship. The court found that one of those was not a binding contract and thus Novolex could not rely on it to establish a breach of this provision given that the provision was premised on "a default . . . under any Material Contract." For the remaining two, the court found potentially relevant contracts and issues of fact as to whether TWG had breached those parts of the TWG-Costco contracts and consequently, whether representation 3.10 was breached.

c. Section 3.18 (Material Relationship)

Novolex alleged a breach under Section 3.18 of the EPA, which provided that "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."

Novolex asserted that Costco expressed an intent to Newell, the seller of TWG, to modify the Basic Vendor Agreements between TWG and Costco, which put Newell on notice that Costco planned to reduce its volume of business with TWG. Specifically, Novolex argued that the "Vendor Agreement incorporated purchase orders that have been or will be signed," and thus, the representation was breached because there was written notice of a reduction in purchase orders, which was a modification of the Vendor Agreement. The court rejected Novolex's argument, finding that Costco's failure to enter into future purchase orders is not a modification of the Basic Vendor Agreement nor is it a binding contract. The court granted summary judgment to the insurers on this issue.

d. Section 3.20 (Warranty)

Novolex asserted a claim under Section 3.20 of the EPA, which provided that with "respect to any express warranty or guaranty as to goods sold, or services provided . . . there is no pending claim or, to the Knowledge of Parent, threatened claim alleging any [] breach of any Warranty . . . ." Novolex relied on two warranties in the Standard terms of the Costco-TWG contracts, which required all goods be "shipped and sold in compliance with all applicable industry standards" and "without defect." In particular, in Section 9 of the Standard Terms, "Vendor warranties all Merchandise to be . . . packaged . . . shipped and sold in compliance with all applicable industry standards . . . ." In Section 11, "Vendor warranties and represents . . . that the Merchandise is without defects . . . ." The court found there was no evidence that Costco ever filed a claim for breach of those warranties, but concluded that an issue of fact was presented on whether Costco ever *threatened* such a claim. And so the court denied summary judgment on whether TWG breached 3.20.

e. Section 3.7 (a)

Novolex asserted a breach of Section 3.7(a).

3.7(a)(i) provided that "[e]xcept as set forth in Section 3.7 of the Seller Disclosure Letter, during the period beginning on [March 31, 2018] and ending on [May 2, 2018], (i) the Purchased Companies have conducted the Business in the ordinary course, consistent with past practice in all [] respects." Section 3.7(a)(ii) provided that "there has not been any action taken that, if taken during the period of [March 31, 2018] through [May 2, 2018], would require Purchaser's consent . . . ."

Both provisions represented that TWG had conducted its business "in the ordinary course, consistent with past practice" and used "commercially reasonable efforts to preserve" the goodwill associated with the business. The insurers argued that Novolex could not demonstrate that TWG "failed to operate consistent with past practice between March 31, 2018, and May 2, 2018." Novolex argues that insurers mischaracterized the RWI policies, noting that Newell was required to operate TWG "in the ordinary course consistent with past practice in all respects between March 31, 2018, and May 2, 2018." The court found that the issue was "a fact intensive inquiry not suited for summary judgment."

f. Connection Between Breach And Loss

In addition to arguing about breaches, the insurers also attacked Novolex's calculation of loss. Insurers argue that Novolex must prove a proximate relationship between Newell's alleged breach of the EPA representations and Novolex's loss and that the loss must flow from a violation of the contract. However, the RWI Policies provide that "'Loss' means the aggregate of (x) any loss, liability, demand, claim, action, cause of action, cost, damage, fee, deficiency, tax, penalty, fine, assessment, interest or expense arising out of or resulting from a Breach . . . ."

The court rejected the insurers' argument for proximate cause because under Delaware law, "arising out of" only required "some meaningful linkage" between Novolex's loss and the claimed breaches, which was a "much broader standard than proximate cause."

Looking Ahead

The insurers have moved to reargue and have appealed. Novolex has cross appealed and opposed the motion for reargument. Coupled with the fact that this case is now being appealed, it is already noteworthy for the rare litigious route it has taken.

In their reargument motion, insurers argue that the court overlooked Section XII.B of the primary policy which provides that the policy must be construed "without any presumption in favor of either the In-

surers or . . . the Insured's". Furthermore, insurers argue that the court may construe ambiguity in the policy or EPA Section 3.7(b) as a matter of law, and not a question of fact, at summary judgment. The insurers also argue that the court overlooked their argument that Novolex failed to present any probative evidence of causation. In response, Novolex asserts that the court did not misapprehend or overlook any facts regarding the materiality scrape per Section 3.7, warranty claims per Section 3.20, and causation. In addition, Novolex argues that the insurers raised the argument surrounding XII.B of the primary policy for the first time in reargument, and thus, waived their argument.

Endnotes

1. https://www.huntonak.com/images/content/7/4/v2/74810/court-refuses-to-dismiss-claims-in-rwi-lawsuit.pdf ■

MEALEY'S: EMERGING INSURANCE DISPUTES
edited by Jennifer Hans
The Report is produced twice monthly by

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Email: mealeyinfo@lexisnexis.com
Web site: http://www.lexisnexis.com/mealeys
ISSN 1087-139X