Lawyer Insights

Novolex Case Brings Lessons On R&W Insurance

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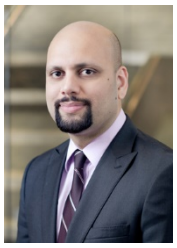


In the world of representations and warranties insurance claims, a dispute playing out in court is a rarity given many claims are resolved before a formal dispute and many policies contain arbitration provisions. Thus, litigation in New York state court between Novolex Holdings LLC and a few of its insurers concerning coverage under an RWI policy for a $267 million loss is particularly noteworthy.

Background

The dispute arises from Novolex's acquisition in 2018 of The Waddington Group, or TWG, a manufacturer of food packaging and disposable products, for $2.275 billion pursuant to an equity purchase agreement. As is common in such transactions today, Novolex procured RWI to protect against the risk that a representation or warranty in the equity purchase agreement 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 alleges that it discovered that various representations in the equity purchase agreement had been breached. Each purported breach relates to the overarching allegation that the seller was aware that TWG's third-largest customer, Costco Wholesale Corp., intended to significantly reduce its business with TWG. Novolex further claims that, as a result of the alleged breaches of representations under the equity purchase agreement, it suffered significant damages, estimated to be approximately $267 million.

Novolex filed a claim with its insurers seeking to recover for its loss. Following a mediation, Novolex resolved its claims with the primary insurer and the first-layer and third-layer excess insurers.

Coverage was refused under the second-layer excess policy, which was issued by Illinois Union Insurance Co. (although multiple insurers in addition to Illinois Union bore the risk of loss under the policy). Novolex filed suit to recover the insurance proceeds, asserting one count for declaratory judgment that the policy was enforceable and six counts related to the alleged breach of various representations in the equity purchase agreement and, consequently, the policy due to Illinois Union's failure to pay.

Illinois Union's Motion to Dismiss

The first matter of judicial business seeks to answer that elementary question that has befuddled law students and some practicing lawyers alike since time immemorial: What is a contract anyway? More

specifically, Illinois Union moved to dismiss two of Novolex's claims related to the allegation that the seller breached a representation that no significant customer had or intended to terminate, cancel or adversely modify a "contract." According to Illinois Union, Novolex fails to identify a contract that was impacted. Novolex opposes that motion arguing there is, in fact, a contract that has been impacted.

The motion to dismiss focuses on a single representation, Section 3.18 of the equity purchase agreement, titled "Significant Customers and Suppliers," which provides, in relevant part, the following:

Since December 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 … intends to terminate, cancel or adversely … modify any Contract between a [TWG] and any such Material Relationship.

The term "contract" in Section 3.18 is defined as "any contract, agreement, license, lease, guaranty, indenture, sales or purchase order or other legally binding commitment in the nature of a contract, whether written or oral."

Illinois Union asserts that Novolex's claims that the representation in Section 3.18 was breached fails to state a claim under Delaware law, which governs the interpretation of the equity purchase agreement. The relationship between TWG and Costco was established by multiple documents, including the basic vendor agreement.

Illinois Union argues that the agreement did not impose on Costco a legally binding commitment to make purchases; rather, it provided for Costco to issue purchase orders based on its needs at a given time, which were issued and fulfilled throughout the year. So, the argument goes, since the basic vendor agreement imposed no obligation on Costco to make purchases, there can be no "contract" that Costco intended to terminate, cancel or adversely modify even if Costco intended to reduce its purchases from TWG.

Illinois Union focuses on the fact that in the complaint Novolex did not cite a specific agreement between TWG and Costco that was purportedly effected. In further support of its argument, Illinois Union contends that, had the parties to the equity purchase agreement intended there to be a representation related to the volume of Costco's purchases, Section 3.18 would have explicitly stated so as other examples of acquisition agreements do.

Novolex's Opposition

Novolex opposes Illinois Union's motion on two grounds. First, Novolex asserts that the purchase orders are contracts under the equity purchase agreement because, according to Novolex, purchase orders, including those that "will be signed" in the future, were incorporated by reference into the basic vendor agreement. And since Costco advised TWG prior to closing that it intended to terminate future business that it placed through purchase orders, the seller's failure to disclose that information was a breach of Section 3.18.

Second, Novolex relies on the "objective theory of contracts" employed by Delaware courts. That theory provides that a contract is interpreted in a manner that would be understood by an objective, reasonable third party. Thus, Novolex argues, the agreement must be construed in the "commercial context" between the parties.

In doing so, Novolex posits that it plainly has stated a claim. It asserts that in "the commercial context in which manufacturers of food packaging and disposable products like TWG operate, customers are expected to make large and recurring purchases, and suppliers like TWG in fact make capital investments in reliance on those expected purchases so that they have capacity to fill them." Novolex argues that per this "contractual framework" under which Costco made recurring and continuous purchases, which were "part and parcel" of the agreement between them, Costco's decision to reduce its purchases had an adverse effect on the agreement between the parties, resulting in a breach of Section 3.18.

In further support of its position, Novolex claims that Illinois Union's argument — that there must have been a specific past purchase order that was terminated, canceled or adversely modified to breach Section 3.18 — would render the representation valueless. Specifically, Novolex notes that individual purchase orders are simple, one-off orders that, individually, do not meaningfully impact the relationship between Costco and TWG; but, comparatively, changes to the contractual framework between Costco and TWG would have a meaningful impact. Novolex contends that this is why the entire basic vendor agreement was identified as a material contract, as opposed to each purchase order.

Illinois Union's Reply

In its reply, Illinois Union notes that the agreement between TWG and Costco specifically disavowed that any past purchasing history was binding on Costco and further stated that Costco would not be liable for any expenditures made by TWG. Illinois Union also argues that TWG and Costco's prior course of dealings cannot create a legally binding commitment for future orders, and that Costco was under no obligation to make future purchases.

Thus, Illinois Union says, Section 3.18 could not have been breached. Finally, Illinois Union notes that the representation was not meaningless because an individual purchase order, until fulfilled, could have been terminated, canceled or adversely modified.

Takeaways

Although the dispute between Novolex and Illinois Union at this motion-to-dismiss stage boils down to whether there was a contract between TWG and Costco that was impacted by Costco's preclose decision to reduce its purchases, the case reinforces valuable lessons for structuring transaction agreements and procuring RWI. One such lesson is to ensure that a seller's representations align with the buyer's objectives, and that the relevant RWI policy applies in the event that the representations are breached.

For example, Novolex apparently placed value on TWG's relationship with Costco; however, one of the representations in the equity purchase agreement that Novolex relies on related to that relationship is now being challenged by Novolex's insurer and may ultimately be interpreted as not providing the exact type of assurance that Novolex desired. And Illinois Union argues in its papers that there are representations that may have been more appropriate for accomplishing Novolex's goal of ensuring that the relationship between TWG and Costco would remain intact post-close.

Indeed, a representation that no material customer was planning to reduce its purchasing volume during the interim period, as compared to the representation in Section 3.18 involving changes to contracts, may have better served Novolex's objective. We, of course, recognize that such an observation is easy to make with the benefit of hindsight. Nonetheless, it still offers food for thought in the context of the next transaction.

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Interestingly, however, such a representation could cause an insurer to rely on an exclusion found in RWI policies that precludes coverage for breaches of forward-looking statements and projections. While a policyholder could certainly argue that such an exclusion is inapplicable (since it is based on the seller's knowledge during a specific period), an insurer may argue that future purchasing volume is forward-looking and, therefore, subject to the exclusion.

Accordingly, it is important to evaluate the representations and consider how the RWI policy may respond and whether a breach of a representation would potentially trigger any exclusions. In the current RWI market, most insurers are amenable to working with policyholders to design policies that meet the specific needs of the deal, so it is possible to resolve such issues before there is a claim and a dispute over coverage.

As noted above, disputes concerning coverage under RWI policies are uncommon given the prevalence of arbitration clauses. Thus, the Novolex case offers a rare glimpse at how a court would interpret the transaction agreement and policy provisions. And, if the motion to dismiss is any indication of what is to come, the case will provide a wealth of additional issues to consider for future transactions and insurance agreements, so stay tuned.

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