Representations and Warranties Insurance: Fundamentals

A Practical Guidance® Practice Note by
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This practice note addresses the fundamental aspects of representations and warranties insurance. It provides an overview of representations and warranties insurance and the underwriting of representations and warranties policies. The practice note also delves into the various aspects of representations and warranties insurance claims, coverage, and dispute resolution.

In any commercial transaction involving the sale of a company, the buyer and the seller execute an agreement containing the terms of the transaction. The agreement can go by a variety of names (e.g., an acquisition agreement or a purchase agreement) but this practice note will refer to the document as a "transaction agreement." The transaction agreement typically includes, among other things, representations and warranties made by the seller and the company being sold (the "target" company) regarding important attributes of the target. For example, the seller and the target typically represent that the target's financial statements were prepared in accordance with generally accepted accounting principles (GAAP) and that they otherwise fairly represent the financial condition of the target. This representation is important to the buyer because it will often rely on those financial statements in evaluating the value of the target and, to do so with any confidence, it must understand how they were prepared. The use of representations and warranties (R&W) insurance is not limited to commercial transactions involving the sale of a company; however, the use of R&W insurance for such transactions is most common.

For additional information about R&W insurance, see Representations and Warranties Insurance Policy Selection, Representations and Warranties Insurance Policies Strategic Uses, and Representations and Warranties Insurance: A Closer Look at Claims.

Overview

In the event a representation or warranty proves to be inaccurate, the seller/target is considered to have breached that representation/warranty. The transaction agreement specifies the buyer's recourse in the event it suffers a "loss" because of the breach. As discussed below, loss generally means the economic harm resulting from a breach. Before representations and warranties (R&W) insurance, and in deals without R&W insurance, the buyer would typically recover the amount of its loss from an escrow account established by the parties, usually funded with some percentage (e.g., 10%–15%) of the purchase price (i.e., the seller does not receive the entire purchase price at closing). The escrow account could be the exclusive source of recovery

for a buyer in the case of a breach and a loss, but the transaction agreement could also provide for direct recovery from the sellers for amounts more than the escrow – if, for example, a representation was breached due to seller fraud. The escrow account would exist for a certain period specified in the transaction agreement, known as the survival period. Any funds left over when the survival period expired reverted to the seller. Of course, these funds could not be used by either party for other purposes during this time.

In transactions involving R&W insurance, the buyer may seek recoveries from the R&W insurer for any loss (above the policy's retention) resulting from the breach of a representation or warranty instead of seeking recovery from an escrow or the seller. In other words, instead of the seller leaving a portion of the purchase price in an escrow account, the buyer purchases an R&W insurance policy, which serves much the same function as the escrow fund and, in some cases, completely supplants it. If an escrow is required, it can often be capped at an extremely low percentage of the purchase price (e.g., less than 1%). As a result, the seller receives all or substantially all of the purchase price at closing. (In addition, transaction agreements may provide that no indemnity may be obtained from the seller absent fraud.) This result—freeing up capital that would otherwise be tied up in an escrow account—is one of the drivers behind the explosive growth of R&W insurance over the last decade. Indeed, repeat buyers and sellers of companies, most often private equity funds, commonly value the ability to take that capital and reinvest it in more profitable ways over the cost associated with purchasing R&W insurance.

Note that the seller can procure R&W insurance instead of the buyer, and it serves the same function of replacing the escrow account. There are significant differences between sell-side policies and buy-side policies; however, buy-side policies make up the vast majority of policies procured. Thus, this practice note focuses on buy-side policies only.

R&W insurance can provide other benefits over the traditional arrangement between the buyers and sellers as well. For example, the buyer is often able to obtain more coverage from an R&W insurance policy than would otherwise be available by a seller-funded escrow account (i.e., the buyer can get limits higher than 10%–15% of the purchase price). In addition, the survival period for the representations and warranties is often longer under an R&W insurance policy, so the buyer has more time to determine if there was a breach. The R&W insurance policy also enables sellers to simply "move on" from a sale and minimize (if not eliminate) the prospect of post-close disputes regarding breaches of representations. This latter benefit can be particularly helpful when the seller remains involved in the business after closing.

R&W insurance does not cover everything that could go wrong in a deal and there are certain representations and warranties that are excluded. For example, a breach of a representation that occurs after signing but before closing (known as "interim" breach) is usually not covered. At times, there can be an increased appetite to insure these breaches. A breach of a "covenant," which typically concerns promises of future acts or omissions, also is usually not covered. Representations that certain deal team members know to be false at the time of the representation are not covered as well. While this exception is intuitive, whether a representation was "known" to be breached can be hotly contested. In addition, insurers may seek to exclude loss associated with particularly difficult to underwrite risks, such as environmental exposures in certain industries, asbestos, and underfunding of pensions. The allocation of the risk associated with non-covered events is left to the parties and can be addressed in the transaction agreement.

Underwriting R&W Policies

Under an R&W policy, the insurer is essentially stepping into the shoes of the seller/escrow and insuring loss arising out of inaccurate representations and warranties being made about a company (i.e., the target) it knows nothing about. But the insurer usually only has a relatively short window (often a few days) to evaluate the deal and issue the policy. The insurer does not have the time to independently diligence the representations and warranties, which, even if it were possible, would be a costly endeavor that would likely make the policy cost prohibitive. Instead, the insurer relies on the diligence performed by the buyer and its advisors to evaluate the risk. Thus, the underwriting process for R&W insurance is aptly described as "diligencing the diligence."

Typically, the insurer is provided with some initial information regarding the deal, such as a draft of the transaction agreement, letter of intent, the confidential information memorandum, or some other information about the target (e.g., its website), and the target's recent financial statements. The insurer uses the preliminary information to prepare a nonbinding indication letter (often referred to as an NBIL). This letter provides a preview of certain policy information that would apply if the policy were issued, such as general policy terms, premium estimate, the deductible amount, and representations/warranties that will not be insured. The NBIL will also identify the "underwriting fee," which is the amount charged by the insurer to underwrite the policy that is paid even if the policy is not issued. In addition, the nonbinding indication often includes a request for a variety of required information (including access to the buyer's diligence reports).

Once the buyer pays the underwriting fee and provides the required information, the underwriting process gets underway. The insurer often hires outside counsel to review the buyer's

diligence by analyzing the information in the data room (the electronic files about the target available to the buyer). The insurer and its lawyers then have a call with the buyer (and its team) to ask questions about the diligence performed. The insurer can be looking for any indication that there is a "known" or "identified" exposure not scheduled against the representations (e.g., a known tax exposure) or a particular representation that buyer did not diligence. For example, if the target is a manufacturer and represents that the equipment in its main factory is in good working order, but the buyer did not inspect that factory, the underwriter may want to understand why more diligence was not conducted. If the insurer is not comfortable with the explanation, it may exclude loss resulting from a breach of that representation unless additional diligence is performed. Following the call, the insurer typically proceeds to offer the policy (subject to the condition that outstanding requests for information are resolved).

R&W Claims

As noted above, a buyer may file a claim to recover its damages under an R&W policy when it suffers a loss due to a breach of a representation or warranty. Thus, to recover, the insurer will require that the buyer establish two things:

- Breach of a representation or warranty –and–
- A resulting loss

The insurer will also evaluate whether any exclusion applies and whether the policy conditions have been complied with.

Breach is usually defined in the R&W policy as any breach of or inaccuracy in any representation or warranty in the transaction agreement. In general, an R&W policy will define the term loss as the amount the policyholder is entitled due to a breach under the transaction agreement. In turn, the transaction agreement typically defines loss broadly as encompassing all actual damages, liabilities, deficiencies, judgments, fines, fees, costs, etc. For instance, loss occurs when the buyer suffers financial harm because of a breach. The concept of loss is seemingly straightforward; however, its application and quantification of damages can be, and often is, complex, and tends to be a hotly disputed issue, as discussed below.

Claim Frequency and Severity

Claim frequency (noticed claims) under R&W insurance policies typically hovers around 20%, meaning roughly one in five policies receive notice of a claim—though many claims will not exceed the policy's retention. Claim frequency can vary slightly depending on the size of the deal and generally trends upward for larger deals. For example, according to AIG's 2021 M&A (Mergers & Acquisitions) Claims report, deals valued at less than $100 million had a 17% claim frequency, whereas deals valued at between $500 million and $1 billion had a 23% claim frequency.

Claim severity also varies depending on the size of the claim. For example, AIG reported that claims for less than $1 million comprised 43% of its claims and averaged approximately $380,000; claims for less than $10 million comprised another 43% and averaged approximately $4 million; and claims for over $10 million comprised 14% but averaged approximately $19 million.

Claims based on breaches of representations or warranties concerning financial statements, undisclosed liabilities, compliance with laws, tax, and material contracts account for the 65% of reported claims, according to Aon's 2021 Claim Study. Insurer payments to Aon's clients based on breaches of representations and warranties related to financial statements and material contracts made up a large share of the total payments—comprising 71% of claim payments.

Adjustment Process

The adjustment process for an R&W claim tends to be more complicated than a typical insurance claim. The subject matter of the claim—whether a statement was inaccurate at the time it was made and the quantum of resulting loss—is more nuanced and complex than traditional insurance policies covering property or general liability, which ask whether property was damaged, or a covered claim was asserted against the insured, respectively.

Given this complexity, both the insurer and policyholder typically engage outside counsel and experts to assist. The type of expert engaged will depend on the nature of the breach and claimed loss. For example, a claim involving a breach of a representation concerning the condition of assets, such as machinery, may require an expert familiar with the type of machinery involved that can opine on its condition. Similarly, many claims will involve a forensic accountant to opine on the financial harm suffered from the breach.

The notice of claim submitted by the policyholder will typically include certain information supporting the claimed breach and loss. The insurer usually responds to the notice by requesting more information it requires to evaluate the claim. Thereafter, the parties may try to work collaboratively to help the insurer understand the breach and resulting loss. Frequent, open, and collaborative communication is important to a successful claim adjustment.

It is worth noting that insurers have recognized billions in loss under R&W insurance policies over the last few years. Indeed, insurers appear to appreciate the importance of following through on R&W claims.

For more guidance on claims under R&W policies, see Representations and Warranties Insurance: A Closer Look at Claims.

Areas of Potential Dispute

R&W claims present fertile ground for dispute given their nuanced nature. Unlike traditional insurance policies that are typically triggered by a discrete event necessarily involving economic harm (e.g., a fire or a lawsuit), R&W claims are triggered by a breach of contract, which is not always straightforward and may not necessarily cause an obvious, easily identifiable economic harm. Of course, R&W claim disputes can come in all shapes and sizes; below we highlight a few areas of dispute that are present during the two thresholds for recovery: breach and loss.

Whether There Is a Breach

As noted above, the definition of breach usually encompasses any breach of or inaccuracy in any representation or warranty. Of the two thresholds to recovery, whether there has been a breach of a representation or warranty is often less complicated. This is because breach can be established based on documents (e.g., email communications) that are less prone to different opinions of interpretation. Nonetheless, the following issues surrounding breach are always examined closely by the insurer and may lead to disputes if not appropriately addressed.

Timing of Breach

A key consideration related to breach is the timing of the breach. The representations and warranties in the transaction agreement are generally only guaranteed true as of the date of the closing. Put differently, the representations and warranties refer to a snapshot in time—the condition and attributes of the company at the time of closing. Thus, if a representation is accurate on the day of the closing, there typically can be no breach of that particular representation. This means post-close events cannot render an otherwise accurate representation inaccurate (but that is not to say that post-close events cannot prove a representation was inaccurate at the time of closing).

For example, the seller and target typically represent that no major client has informed the target of an intent to reduce its business as of the closing date. If the target's biggest customer informs the target it plans to significantly eliminate its business, whether the representation is inaccurate will turn on *when* the target was informed by the client. If the customer informed the target a day before closing, then the representation was inaccurate and there has been a breach. But if the target learns of the customer's plans the day after closing, the representation was accurate and there was no breach.

In the real world, the facts are rarely so clear. Suppose the client had informed the target months earlier it was unhappy with the relationship and there were a series of conference calls that followed, but there was no written communication from the client informing the target it was reducing its business. Post-close, however, the client stops doing business with the target. What now? Well, the buyer (now the new owners) will typically investigate, which may include interviewing legacy employees and potentially the former client. The result of that investigation will inform whether the buyer believes the target breached the representation as it was written. If a claim is brought, the insurer will undoubtedly test that investigation and if it is not satisfied with the proofs obtained, a dispute will follow.

In sum, the policyholders are well advised to ensure they have adequately established that the representation or warranty at issue was inaccurate as of the closing. Otherwise, the insurer is sure to dispute the claim.

Disclosure Schedules

In most transaction agreements, disclosure schedules will contain transaction-specific details related to the representations and warranties. For example, the seller and target almost always identify specific exceptions to the representation or warranty being made in a disclosure schedule. Thus, if the seller and target identify something as an exception in a disclosure schedule, that issue generally cannot render the corresponding representation or warranty inaccurate. For example, a seller and target will usually represent that they are not aware of any actual or threatened litigation against the target, except for those matters identified in the corresponding disclosure schedule. If the target identifies a threatened lawsuit in the disclosure schedule and that lawsuit is instituted post-close, the buyer highly likely would not have a cognizable claim under its R&W policy. Indeed, the relevant representation was accurate because it explicitly excepted from the representation the threatened litigation.

For this reason, the first place insurers will often look in determining whether there has been a breach is to any exceptions identified in the disclosure schedules. If the alleged breach is based on an exception identified in a disclosure schedule, then there has not been a breach at all.

Disputes often arise in this context due to overly broad, incomplete, or vague descriptions in the disclosure schedules. Suppose the person threatening litigation in the example above demanded $250,000 due to alleged bodily injuries resulting from the use of the target's product, which was identified in the disclosure schedule. If post-close, the person files a class action purportedly on behalf of all consumers of the product seeking $750 million in damages, was the representation accurate? Possibly. But what if there were conversations between the target and the person threatening litigation pre-close where the target became aware that the person was considering a class action? The buyer would certainly argue the representation was inaccurate. The insurer, on the other hand, may point to the disclosure schedule and argue the potential litigation

related to the product was disclosed, so the representation is accurate even though the scope of the disclosure was not accurate.

Whether there has been a breach will depend on the facts and the specific language of the representations and disclosure schedules at issue. For this reason, the representations and disclosure schedules should be scrutinized before filing a claim. The policyholders should be prepared for the insurer to raise any potentially applicable items that would preclude a breach.

GAAP

As noted above, claims based on breaches of representations or warranties concerning financial statements account for a sizable portion of all claims. Many of these claims are premised on the contention that the target's financial statements were not prepared in accordance with GAAP. The problem is, many aspects of GAAP involve judgment calls—i.e., decisions to do or not do something a particular way based on the accountant's judgment. As many accountants will tell you, if you put two accountants in a room, chances are each will have a different view of what GAAP requires and neither will be wrong.

Compounding the problem is that claims based on inaccurate financial statements can be staggering. This is because the buyer usually relies on the financial statements to determine how much the target is worth, which is typically based on using prior financial information to project the revenue or profit the target will generate for years into the future. This issue is discussed in greater length below. In short, certain financial statement errors can result in severe economic harm to the buyer.

For example, suppose a buyer determines that the way the target recorded its receivables was inconsistent with GAAP. Of course, the target's accountants may disagree, but they are often long gone by the time a claim is made under an R&W policy. So, the insurer will typically retain its own accountant to determine whether the target properly recorded the receivables. If the insurer's accountant determines that the target's accounting for receivables was proper under GAAP, then there may be a deadlock.

Illustration

Suppose that pre-close the target receives notification from its biggest customer that it will no longer be issuing purchase orders for merchandise that the target manufactures, which are essentially on-demand orders. And assume the target represented that no material customer had indicated it intended to terminate or modify an existing contract. After the deal closes, the customer drastically reduces its business. Was there a breach? That is the question currently pending before a New York trial court in Novolex Holdings, LLC v. Ill. Union Ins. Co., 2022 NY Slip Op 30552(U) (Sup. Ct.). The answer appears to turn on whether the purchase orders qualify as a contract under Delaware law. The R&W insurers, of course, argue that the purchase orders do not constitute contracts. According to the insurers, because the customer was under no legally binding obligation to make purchases, there can be no contract that the customer intended to terminate or modify. Novolex counters that the overarching contract between the target and the customer contemplated future purchases and, in any case, an objectively reasonable person would view the purchase orders as contracts.

It is unclear how courts will resolve that kind of issue; however, the Novolex dispute illustrates how an R&W claim can turn on a hyper-technical issue, such as whether a specific type of purchase agreement qualifies as a contract. One of the key takeaways from the Novolex case is to ensure that a seller's representations align with the buyer's objectives, and that the relevant R&W policy applies in the event the representations are breached. For example, Novolex apparently placed value on the target's relationship with this particular customer; however, the representation it claims was breached may not ultimately apply if the court adopts the insurers' argument. In fact, the insurers pointed out in their briefing that there are representations that may have been more appropriate for accomplishing Novolex's goal of ensuring that the relationship between the target and the customer would remain intact post-close.

Whether There Is a Loss (Quantification of Damages)

As noted above, the definition of loss usually encompasses the economic harm suffered by the buyer resulting from a breach. Calculating loss can be and often is a complex exercise rife with areas for potential disagreement. Indeed, two lawsuits filed in 2021 under R&W insurance policies involve disputes over the quantum of covered loss arising out of undisputed breaches of representations. See Huntington Ingalls Indus., Inc. v. Ill. Union Ins. Co., No. N21C-09–007 (Del. Super. Ct. filed Sept. 1, 2021) and pH Beauty Holdings III, Inc. v. Certain Underwriters at Lloyd's, London Subscribing to Policy No. BC-BS-2018–98896-0130, No. 2184cv01586 (Mass. Super. Ct. filed July 13, 2021). However, the number of claims that end up being fully litigated is low. Below are two issues that are often disputed.

The Quantum of Loss Generally

The quantum of loss—the amount of economic harm resulting from breach—is determined by reference to the governing state law. Delaware law is commonly identified in transaction agreements as the governing law, and this practice note will focus on Delaware law.

Under Delaware law, a claim for damages due to a breach of a representation or warranty is generally treated as a breach

of contract claim, see Interim Healthcare, Inc. v. Spherion Corp., 884 A.2d 513, 548–49 (Del. Super. Ct.), aff'd, 886 A.2d 1278 (Del. 2005). The standard remedy for breach of contract requires the breaching party to compensate the nonbreaching party's "reasonable expectation of the value of the breached contract" at the time the agreement was executed, which is what the nonbreaching party lost. Duncan v. Theratx, Inc., 775 A.2d 1019, 1022 (Del. 2001). This type of remedy is commonly known as "expectation damages," Id., or "benefit of the bargain damages." See Zayo Grp., LLC v. Latisys Holdings, LLC, No. 12874-VCS, 2018 Del. Ch. LEXIS 540, at *16 (Ch. Nov. 26, 2018).

An alternative method for calculating the nonbreaching party's damages is "diminution-in-value damages." See Universal Enter. Grp., L.P. v. Duncan Petroleum Corp., No. 4948-VCL, 2013 Del. Ch. LEXIS 162, at *19 (Ch. July 1, 2013). This type of damages requires the breaching party to compensate the nonbreaching party for the difference between the value of the thing promised and the thing delivered. Zayo Grp., LLC, 2018 Del. Ch. LEXIS 540, at *16. The court will depart from the standard remedy of expectation damages where it is either insufficient or would result in a windfall to the nonbreaching party. See Universal Enter. Grp., L.P., 2013 Del. Ch. LEXIS 162, at *19 (Ch. July 1, 2013).

Whether using expectation damages or diminution-in-value damages the goal is essentially the same—make the nonbreaching party whole while avoiding a windfall. See Duncan, 775 A.2d at 1022; Universal Enter. Grp., L.P., 2013 Del. Ch. LEXIS 162, at *19. In many cases, there may be little, if any, difference between expectation damages and diminution-in-value damages and thus there will be no need to depart from the standard expectation damages. The court in Universal Enterprise Group, L.P. stated, for example, that diminution-in-value damages may be appropriate where a party defectively performs a construction or engineering contract and the cost of rendering the property compliant (i.e., expectation damages) would be excessive. 2013 Del. Ch. LEXIS 162, at *19. In other words, if the cost of ripping the project down and rebuilding it is excessively high, awarding the difference in value of what was promised and what was delivered may be more appropriate. See id. Because of this, courts and practitioners may (and often do) conflate the methodologies.

A very straight forward (if unlikely) example: the target represents it has $1 million in cash in its bank account, but after closing it turns out that it only has $600,000. That is a breach of a representation. All other things being equal, the buyer received $400,000 less than it expected as a direct result of the target's breach. Thus, the expectation damages amount is $400,000. Likewise, the value of the thing delivered is $400,000 less than what was promised, so the diminution-in-value damages amount is also $400,000. In both cases, the buyer's damages should be recoverable under the R&W policy.

Now take a more extreme example: suppose the target represented that its biggest client had no plan to reduce its business when in fact it had advised it would terminate all business in the event the target was sold. Again, clearly a breach. But suppose further that because of that client leaving, the target gains two new clients that previously would not do business with the target due to the target's relationship with the client that left, and this new business totally replaces all the business that left. Did the buyer get less than expected? Well, it depends on what the buyer expected, but, most likely, yes. That is because damages are generally measured as of the time of the breach, see Comrie v. Enterasys Networks, Inc., 837 A.2d 1, 17 (Del. Ch. 2003), which, in the case of a breach of a representation, is at the time of the closing, as discussed above. And, as of the time of the closing in this hypothetical, the buyer received less than it expected because the target was being delivered without its biggest client.

Another form of damages is rescissory damages, which is the monetary equivalent of rescission. Universal Enter. Grp., L.P., 2013 Del. Ch. LEXIS 162, at *18. "Rescissory damages may be an appropriate remedy for breach of contract in limited circumstances, such as if the breach is evidence of an intention no longer to be bound by the agreed terms of the contract, or if the breach may be said to go to the root of the agreement between the parties." Id. (citation omitted). Rescissory damages are rarely awarded.

External factors impacting the target's business can also play a significant role in determining loss. Suppose the target is in the business of setting up exhibits for tradeshows and it represents that its biggest client has not advised of an intent to reduce business when in reality the biggest client had indicated it would be moving its business to a competitor for one year only. And suppose further that on the day the transaction agreement is signed, a pandemic shuts down the country, which forces all tradeshows to be canceled for one year. Of course, there is a breach, but has the buyer suffered economic harm as a result? One could argue that the buyer is no worse off from the breach because the target would have had no business due to the pandemic anyway.

As apparent from the foregoing discussion, the quantification of loss depends on the facts involved and the terms of the transaction agreement.

Use of Multiple

One of the more controversial aspects in calculating the quantum of loss under an R&W policy is the use of a multiple and when damages are appropriately considered on a multiple. As detailed below, the use of a multiple refers to calculating the buyer's damages based on the multiple

of earnings used in determining the purchase price to achieve the buyer's expectations. Thus, when applicable, it can increase the amount the buyer is owed under the R&W policy by a multiple of the amount by which earnings were misstated. There is little case law on this particular issue and, unsurprisingly, differing views on when it is appropriate. See, e.g., E. Hutchinson Robbins, Jr., M&A Representation and Warranty Damages: The Myth of Lost Revenues into Perpetuity, BUS. L. TODAY (Aug. 19, 2021).

There are many reasons that one business may buy another business. For example, a company may buy a competing business just to remove the competition from the market. Often, however, a business buys another business because it believes it can earn a profit from the target's performance during the period of ownership. In other words, the buyer is not buying a single year of the target's performance, it is buying the target to perform for a period into the future. Buyers (especially M&A firms) often use complex models to assess the value of the target and predict the profit it can earn using the target's financials and various assumptions. This model is often used to determine the purchase price. Thus, where a breach has an adverse impact on the condition of the target into the future, a dollar-for-dollar calculation of damages may not be sufficient to achieve the buyer's expectations (or to compensate the buyer for receiving a target worth less than promised). When that is the case, there is no dispute that the buyer is entitled to the damages that make it whole, but there is no consensus on how precisely to calculate it.

There are countless ways a buyer may try to explain the economic harm it suffered from a breach that adversely impacted the target's condition into the future. The buyer will no doubt work with experts in calculating and supporting what it views as the harm.

One common method is to use the multiple of the target's earnings that was used to determine the purchase price. Those involved in the transaction (particularly those involved in valuation) often express the purchase price as a multiple of the target's earnings. For example, if the company's earnings are $10 million a year and the purchase price is $120 million, the purchase price is 12 times the earnings (i.e., a 12x multiple).

Thus, if the buyer calculated the purchase price based on a multiple of earnings, and a breach adversely impacts those earnings, the damages may be calculated using the multiple. Zayo Grp., LLC, 2018 Del. Ch. LEXIS 540, at *16; see also Hutchinson Robbins, Jr., supra note 18. For example, suppose the buyer used a 10x multiple of the target's TTM EBITDA (which means Trailing Twelve Months Earnings Before Interest Tax Depreciation and Amortization) in determining the purchase price, and suppose a breach results in the TTM EBITDA being overstated by $8 million. The buyer expected a business that had $8 million more per year in earnings, and it based the purchase price on 10 times the amount of an inflated earnings figure. Thus, the buyer is made whole by receiving the amount that was overpaid, $80 million.

Now take that same example and assume that the breach resulted in the financial statements overstating depreciation by $8 million. In this example, the buyer's damages may only be $8 million because the breach did not impact the TTM EBITDA (which, as the name implies, is the earnings before factoring in depreciation). Thus, the breach may have resulted in a one-time accounting error that does not adversely impact the financial condition of the target into the future and thus the buyer's expectations might be met by dollar-for-dollar damages.

Suppose the buyer does not rely on a multiple of earnings in determining its purchase price and it buys the target for some other reason, such as removing a competitor from the market as mentioned above. It would be highly unusual, even in this circumstance, for the buyer to have performed no evaluation in understanding the value of the target it was expecting to purchase. Even so, suppose the buyer was unable to establish its expectation value. In this case, the buyer could still calculate the difference between the value of the asset represented and the value of the asset delivered and presumably be entitled to that amount. Here too, the policyholders and insurers would often use experts to support their differing views on what that amount is.

Dispute Resolution

Historically, R&W insurance policies required disputes to be resolved through arbitration. More recently, some R&W insurers are giving the policyholders the option at the time of binding to resolve disputes resolved through traditional litigation in the courts or through private arbitration.

One advantage of litigation is the right to an appeal to an intermediate appellate court. Arbitration, on the other hand, has extremely limited appellate rights, which are generally limited to cases involving undue process, such as an award procured through fraud or other forms of arbitral misconduct. In addition, the cost of litigation can be less than arbitration, depending on who you ask.

One advantage of arbitration is that it is confidential. Courts are public forums that prefer to keep information open to the public. While parties can take steps to try and protect sensitive information from being disclosed, there are no guarantees. In addition, the parties select the arbitrators, so it is possible to have subject matter experts hearing the dispute with the commercial background to fully understand the issues.

Of course, the correct dispute resolution proceeding to select will depend on the transaction and parties involved.

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Checklists

- Representations and Warranties Policy Selection Checklist

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Kevin represents policyholders in complex coverage disputes involving claims under various types of policies, including commercial property, cyber, D&O, E&O, general liability, product liability, and representations and warranties. He also represents clients in connection with professional liability matters, such as insurance broker malpractice.

Kevin is a contributor to the firm's Insurance Recovery Blog.

While in law school, Kevin served as a judicial intern for the Honorable Cathy Waldor, USMJ, in the United States District Court for the District of New Jersey and as a legal intern in the United States Attorney's Office for the District of New Jersey.

Prior to law school, Kevin worked for a leading risk management and insurance broking firm. In that role, he advised Fortune 500 clients on structuring sophisticated risk management programs, brokered the insurance components of such programs and serviced all risk management needs.

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