Mass. Dispute Highlights R&W Insurance Considerations

By Patrick McDermott, Jae Lynn Huckaba and Syed Ahmad
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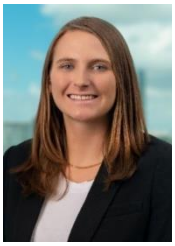
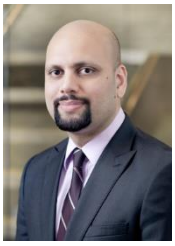

In June, a dispute between a buyer and its representations and warranties insurers reached the summary judgment stage, consistent with an increase in parties resolving representations and warranties, or R&W, coverage disputes through formal proceedings.

Regardless of any increase, litigations involving those disputes remains few and far between.

Thus, the briefing in the litigation in the Massachusetts Superior Court, Suffolk, between pH Beauty Holdings III Inc. and its insurers, Certain Underwriters at Lloyd's London, presents rare public insight into issues that can arise in representations and warranties insurance, or RWI, coverage disputes.

Background

On Sept. 28, 2018, pH Beauty purchased a company known as Paris Presents, a marketer of cosmetic and bath accessories, for $575 million.

As part of the transaction, pH Beauty purchased a buyer's RWI policy to protect against the risk that certain representations or warranties in the purchase agreement turned out to be inaccurate.

The policy provided an aggregate limit of $30 million and covered loss exceeding an initial retention of $4.2 million, which dropped to a lower amount of $2.8 million on the 12-month anniversary of the closing date of the transaction.

In determining the purchase price, pH Beauty contends it relied on Paris Presents' 2018 earnings. Based on its financial records, pH Beauty concluded that Paris Presents was a high-performing company and agreed to purchase the company for a multiple of 13.66 times its reported earnings.

After the purchase, pH Beauty asserts that it learned that the sellers had breached several provisions of the purchase agreement by overstating its profits, leading to an inflated purchase price.

As a result of the alleged breaches, pH Beauty claims it overpaid for Paris Presents by approximately $33 million. pH Beauty filed a claim with its representations and warranties insurers seeking reimbursement for the losses incurred due to the breach of various representations and warranties.

The insurers agreed that a breach occurred and that a covered loss existed, but they refused to pay the full value of pH Beauty's losses.

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Instead, the insurers informed pH Beauty that they would recognize a loss of only $3.6 million and only $373,408 in claim expenses — approximately $26.3 million less than pH Beauty's loss calculation.

Following the insurers' refusal to pay the full amount of loss, pH Beauty filed suit in the Massachusetts Superior Court to recover its losses. In addition to a claim for breach of contract, pH Beauty asserted claims for common law bad faith and violations of Section 11 of Chapter 93A of Massachusetts General Laws.

Two years later, the case has progressed to the summary judgment stage. Each party filed a motion for summary judgment and completed the briefings for both motions by filing their respective replies on June 21. Now, the Massachusetts state court must address three important issues.

The progression of the dispute between pH Beauty and its R&W insurers to the summary judgment stage offers rare insight into coverage disputes that can arise under RWI policies. Thus, there are several takeaways for buyers and sellers looking to procure adequate representations and warranties coverage for future transactions.

Applicable Retention

The first important issue concerns the applicable retention under the policy.

A retention typically refers to the amount of money the policyholder is required to pay before the insurance company will make a payment.

In its motion, pH Beauty says that the $2.8 million dropdown retention applies because more than 12 months had passed since the closing when pH Beauty made its claim against the policy.

The insurers disagree, and instead, argue that the $4.2 million retention applies because Section IV.B. of the policy provides that if the insurer is able to prove that certain persons had knowledge of a "given Claim" prior to the date the retention was set to drop from $4.2 million to $2.8 million, then the $4.2 million retention would continue to apply. The retention was set to dropdown on the one-year anniversary of the deal's closing.

pH Beauty asserts that "Claim" could refer to two types of claims. One is a claim by a third party against pH Beauty or Paris Presents, and the other is a claim for coverage under the policy.

According to pH Beauty, in other places in the policy, "claim" refers to claims under the policy, and "Claim" refers to a claim against pH Beauty or Paris Presents.

Thus, pH Beauty reasons that a "given Claim" must refer to a third-party claim against pH Beauty or Paris Presents and not to a claim against the policy, and as a result, Section IV.B. — which applies only to a "given Claim" — cannot apply to pH Beauty's claim for coverage.

In addition to relying on the policy language, pH Beauty also cites testimony from the lead insurer to support its argument.

The insurers focus on what they consider the plain meaning of "Claim," which is the stated or specified insurance claim. They also argue that the relevant people were made aware that the financial statements

were understated prior to 12 months after the closing.

To this point, pH Beauty counters that the provision refers only to "Claim" and not to "breach" and if the insurers wanted the policy to refer to knowledge of a "given Claim or breach," as opposed to just a "given Claim," the insurers could have drafted it that way.

Here, the takeaway is that insurers and policyholders should ensure that their insurance policies align with their intent. This is particularly relevant for retention provisions, which can contain unclear language about when the dropdown retention will apply.

For example, the insurers insist that the initial $4.2 million retention applies because "given Claim" refers to a stated claim against the policy. The inconsistent use of "Claim," however, suggests to pH Beauty that "Claim" refers to a claim brought against either pH Beauty or Paris Presents, which would mean the lower $2.8 million retention applies.

The differing interpretations of the retention-related provisions could have been resolved during negotiations or at the time of the policy's procurement.

Therefore, a careful review of the RWI policy at the time of procurement may resolve these issues and prevent costly disputes.

Purchase Price Adjustment Exclusion

The second major issue before the court is whether the insurers wrongfully excluded a portion of pH Beauty's loss under the purchase price adjustment exclusion.

That exclusion bars coverage for any portion of the loss that is accounted for in the purchase price adjustment under the purchase agreement.

Following the transaction, the purchase price was reduced by $5.9 million. The insurers contend, based on an opinion from their expert, that $1.6 million of that purchase price adjustment was attributable to the inaccurate financial statements giving rise to the R&W insurance claim.

Relying on the purchase price adjustment exclusion, the insurers claim that $1.6 million of pH Beauty's claimed loss is not covered under the policy. pH Beauty asserts that the insurers cannot reduce loss due to a net working capital adjustment from the sellers for two reasons.

First, pH Beauty argues, the exclusion applies only to amounts in excess of the applicable retention. That is, even if $1.6 million of the purchase price adjustment could be attributed to the breaches for which pH Beauty seeks insurance coverage, that does not reduce the amount the insurers owe because it is less than the retention — whether the retention is $2.8 million or $4.2 million.

pH Beauty bases that position on the net loss provision. It provides that loss within the retention cannot be reduced based on amounts recovered from the sellers under the purchase agreement.

In addition, pH Beauty claims its position is consistent with the purpose of the purchase price adjustment exclusion, which it says is to prevent pH Beauty from recovering the same loss from both the seller and the insurers.

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In response, the insurers argue that the net loss provision refers to amounts actually recovered, and that the purchase price adjustment does not constitute a recovery because it merely sets the purchase price.

Second, pH Beauty asserts that the only basis for the insurers' position — that $1.6 million of the net working capital adjustment payment made to pH Beauty was related to its loss from the inaccurate financial representations — is an opinion from the insurers' expert. pH Beauty contends that, as the insurers' expert concedes, there are no documents reflecting an agreed allocation of the purchase price adjustment.

As a result, according to pH Beauty, the expert opinion is speculative and does not provide sufficient grounds for avoiding summary judgment. The insurers counter that their expert's opinion was based on her extensive experience and on the parties' competing positions on the purchase price adjustment, including a category for the amounts that had allegedly resulted in the sellers' alleged overstatement of profits.

The takeaway for this dispute is that policyholders should consider documenting what is included in a purchase price adjustment to try to avoid insurers trying to take advantage of any lack of clarity in future disputes.

Here, the insurers relied on the purchase price adjustment exclusion to withhold a portion of pH Beauty's losses based on a figure that the insurers' expert opined reasonably accounted for the adjustment for the understated financial statements.

Documenting the specific allocation of the purchase price adjustment, where possible, could help avoid disputes like the insurers have raised in this case.

Massachusetts General Laws

The third major issue raised in the summary judgment briefing is whether pH Beauty can maintain a cause of action under Section 11 of Chapter 93A of the Massachusetts General Laws.

This issue is significant because if pH Beauty is able to maintain a cause of action under the statute and prevails, then the company may be entitled to treble damages.

The insurers argue that a cause of action under Chapter 93A is improper because the "center of gravity of the circumstances that give rise to the claim" did not occur "primarily and substantially within the Commonwealth."

The insurers point to several facts and transactions. A few examples include that the insurers are located in England and Sweden, the managing general agent for the insurers is located in New York, the acquired company is a Delaware corporation, pH Beauty's representatives involved in the claim worked outside of Massachusetts, and both the policy and purchase agreement are governed by Delaware law.

The insurers also contend that even if the claim is sufficiently connected to Massachusetts, they did not act egregiously as required for a Chapter 93A claim. The insurers argue that the dispute, at most, is a good faith disagreement over the scope and amount of coverage afforded under the policy.

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They assert that there is no evidence of any conduct that demonstrates an "established conception of unfairness" or conduct that "is immoral, unethical, oppressive, or unscrupulous."

Rather, the insurers argue, they appropriately investigated the claim, made reasonable information requests, and adjusted the claim in a fair and timely manner.

pH Beauty counters that the location of the insurers' wrongful conduct, the location where pH Beauty relied on that conduct, and the location where pH Beauty suffered harm are all primarily and substantially in Massachusetts. pH Beauty is located in Boston, and consequently, it received, relied on, and was affected by the insurers' wrongful conduct in Massachusetts.

Plus, the insurers' claim handling purportedly took place in Boston because they hired a Boston lawyer to handle the claim.

In addition, pH Beauty argues that the insurers' acts were unfair or deceptive. The company asserts that the insurers did not conduct a fair and thorough investigation and looked for ways to deny coverage.

pH Beauty also contends that there is at least a fact issue concerning whether the insurers' conduct rises to the level of commercial extortion, which it says is a well-established concept of unfairness recognized under Massachusetts law. To support its commercial extortion argument, pH Beauty relies on the insurers' conditioning payment of the undisputed covered amount on a full release of pH Beauty's claims.

The company also argues that the insurers strung pH Beauty along, and forced them to file suit before paying the amounts owed under the policy. Each of these facts, according to pH Beauty, are sufficient to rise to the level of conduct required for a 93A claim.

As a final takeaway, it is important to consider how dealing with out-of-state entities and insurers could impact a policyholder's remedies when a breach of a representation occurs and an insurer subsequently denies coverage.

pH Beauty is located in Boston, but many of the other parties involved in the transaction are located outside of Massachusetts. Depending on the applicable case law, the court may decide that pH Beauty is unable to maintain a 93A claim, limiting any remedies to the remaining causes of actions asserted.

Plus, the question of whether Massachusetts is the center of gravity of the circumstances giving rise to the claim under the RWI policy is fact-intensive, which inherently involves additional discovery costs.

Conclusion

Given the associated costs and uncertainty of litigation, it is important for buyers and sellers to evaluate the sufficiency of their RWI policy and how the policy may respond when a breach of a representation occurs. Insurers are often willing to work with policyholders to improve policy language.

As coverage disputes under RWI policies increase and continue to progress further along in litigation, additional issues to consider for future transactions and relevant insurance agreements will arise.

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