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RESOLVING POST-ACQUISITION DISPUTES: REPRESENTATIONS AND WARRANTIES (R&W) CLAIMS

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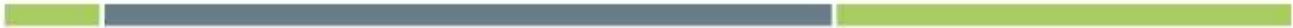


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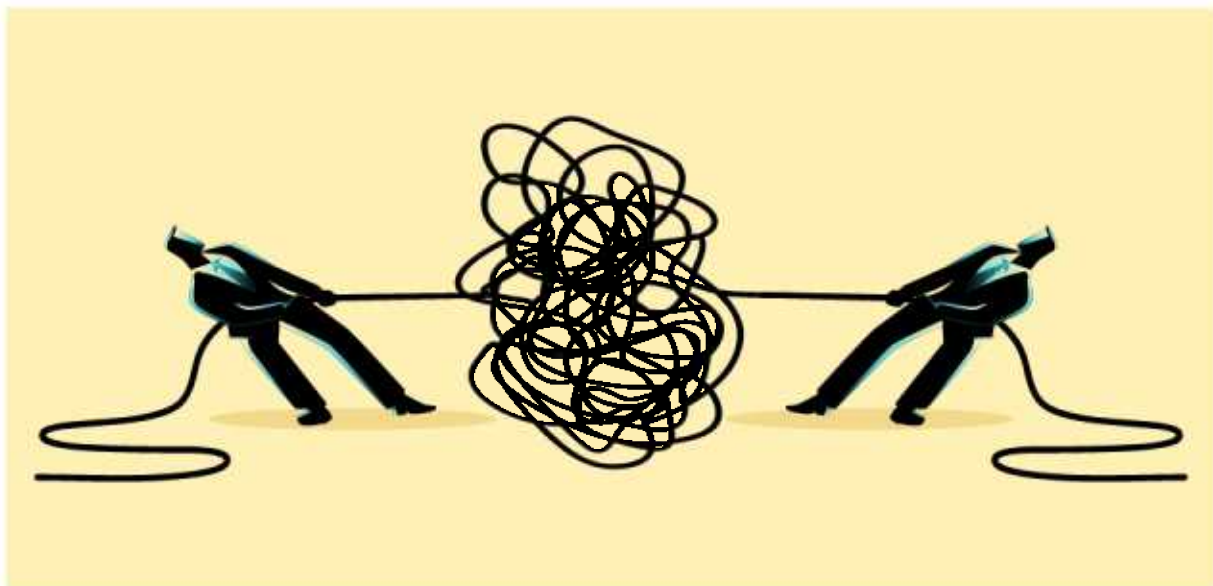


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MINI-ROUNDTABLE

RESOLVING POST- ACQUISITION DISPUTES: REPRESENTATIONS AND WARRANTIES (R&W) CLAIMS



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Diane DiBlasio practices in the litigation department, concentrating in insurance coverage litigation, property insurance law, related first-party insurance matters and commercial litigation. Her experience includes litigation in various first-party areas, including coverage disputes, and third-party insurance defence matters. She represents a significant number of syndicates in the world's leading specialist insurance market: Lloyd's of London.

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CD: There is a lot of focus on the interplay between representations and warranties insurance (RWI) and M&A. On the claims side, how does claims processing for RWI differ from that of other types of insurance?

Wothers: One of the fundamental differences is that there are multiple business relationships to manage. Two significant things have occurred before the claim is ever made under an RWI policy. First, an M&A deal has been negotiated and second the RWI policy has been underwritten, taking into account key facets of this deal. Many business relationships are involved in both aspects that need to be managed in the claims process. Another difference that makes the claims different from other policies is that RWI policies are written specifically for a particular deal. Each transaction is unique, therefore each claim is unique. The specific risks transferred and not transferred are normally extensively negotiated in the underwriting process. Therefore, in order to understand the context of such issues it is particularly important to talk to the underwriters.

Evans: Another way that the RWI claims process is different is that the coverage assessment is not what it sometimes initially may seem. For example, there may be minor issues that may result in a breach of an acquisition agreement's representations; however, RWI policies frequently contain materiality

scrapes. This means that the misrepresentation may not need to be material in order for there to be a breach. In fact, part of the evolution over the last several years broadening risks to insurers has included the use of materiality scrapes.

Hayes: Another distinction is that a literal reading of some representations may result in breaches from the moment they are made. These may include the 'no undisclosed liability' representation and the 'true and accurate financial statement' representation. Neither is truly capable of being underwritten if read literally. Even audited financial statements under generally accepted accounting principles (GAAP) do not reflect that financial statements are true and accurate. Therefore, we must rely on relationships to read these provisions in a commercially reasonable way and work to achieve a commercially reasonable resolution.

DiBlasio: Unlike other types of claims under other types of policies, a key to expediting the claims process in RWI claims is the continued involvement of the insurance underwriter in the claim. He or she has the transaction background that can be incorporated readily into the claim review process. We also recognise that how the claim is handled can be a key differentiator in the insurer's selection by the insured and its team.

McGrath: Escalation of the claim to litigation or arbitration in any commercial claim risks damaging business relationships. This is particularly true in RWI claims. Therefore, consideration of damage to key relationships reflects potentially significant costs in escalating RWI claims. One way RWI claims do not differ from other first party claims is that they require compliance with the Unfair Claims Settlement Practices Act. A version of this uniform act has been adopted by most states and it sets out communication and other reporting requirements from the carrier to the insured. A conflicts of laws analysis is sometimes necessary to determine which state's law will govern with respect to the Unfair Claims Act. Given that RWI claims involve commercial disputes, it is not uncommon for the insured to face competitive or financial pressures as a result of the facts or circumstances underlying the claim. Therefore, it is important to recognise those circumstances as swift and efficient claims processing is critically important. Sometimes the survival of the affected business is implicated or put at risk. An insurer, or their counsel and their consultants, that have seen numerous claims can leverage that experience to expedite the fact-intensive work of assessing losses. Where a third-party claim is filed against an insured, an experienced team can help the insured to mitigate losses. This is particularly true where litigation has been filed against the insured or the claim arises out of a tax audit.

CD: Are there differences in the way a claim is handled depending on its type? For example, in what ways is a financial representation claim handled differently from a tax representation claim?

Evans: The type of consultants needed is different and who and how they communicate is different. For example, for a financial statement claim, it may be best for the insurer's consumer protection association (CPA) to speak directly with the insured's CPA and leave the lawyers out of it. In these types of claims, loss is often calculated by way of a multiple applied to a target's earnings before interest, taxes, depreciation and amortisation (EBITDA) or related measure. As a result, the claims attorney becomes conversant in basic accounting principles in order to make a coverage recommendation. In other types of claims, it may be best for the insurance company's lawyer to speak directly with the insured's lawyer.

Wothers: It is important to understand that the diligence process in the underlying deal or in underwriting the policy may have been different depending on the type of deal and claim. This means the sources of information for a claim evaluation will likewise be different. For example, if a tax claim is presented, audits by state or federal tax authorities may be ongoing, thereby resulting in a longer claims process. A tax claim may involve voluntary disclosures or delinquencies with fines

and penalties. The types of consultants and the information requested could be very different depending on which circumstance is presented in the claim. Conversely, if a material contract claim is made, industry consultants and logistics specialists may be necessary, and the types of information requested and from whom would be dramatically different. Therefore, understanding the nature of a claim, the nature of the underlying deal and the industry are very important in developing claims investigations, the timelines involved and, of course, the coverages implicated. All of these things would also likely affect how any disputes are resolved.

McGrath: RWI policies contain both first- and third-party coverages. Obviously, first party claims involve different types of issues from third party claims even under the same RWI policy. With third party claims, issues frequently arise concerning whether the underlying dispute invokes coverage and the amount of litigation costs covered, which comes into play when an underlying dispute is determined to only be partially covered. The carrier can exercise its right to associate with the insured and their counsel in the underlying case to help to direct the course of the litigation and look for opportunities for settlement. However, given that litigation costs effectively erode the policy

limits, many of these issues affecting litigation management and settlement are similar to those presented in professional liability cases.

“Escalation of the claim to litigation or arbitration in any commercial claim risks damaging business relationships. This is particularly true in RWI claims.”

*Melody McGrath,
Niles, Barton & Wilmer LLP*

CD: What advice would you offer to an RWI insured when submitting a claim under a policy?

Hayes: Primarily, the insured must understand that this is an insurance claim as opposed to a more traditional representations and warranties dispute under an escrow agreement. The carrier is required to validate the claim. It is a process. Understanding these things is important to developing reasonable expectations. Seeking to shortcut this process usually results in the claim assessment being slowed down or becoming more disjointed.

Wothers: The insured also needs to recognise that the carrier has an information deficit; therefore, the insured can help his claim by understanding this and addressing it when providing information.

The commercial fundamentals of the deal need to be understood to better understand the context in which the coverage was written. Do not treat the insurance claim as a precursor to litigation but instead as a collaborative process. Work to have open lines of communication with the carrier and their consultants to streamline information gathering, as opposed to litigating every request for information.

DiBlasio: Subrogation rights under RWI policies are usually limited to seller fraud. Therefore, we frequently remind the insured that it is important for it to protect the carrier's subrogation rights. This may mean that the insured will have to conduct a fraud investigation. Advising the insured of this early in the claim can be helpful to all parties. Notably, the insured is in a much better position than the carrier to conduct this fraud investigation.

CD: What are the principal causes of disputes in RWI claims?

Wothers: Data show losses are becoming more frequent and more severe. That is the context in which RWI disputes are occurring.

“Insureds will frequently attempt to use a multiple of earnings even though the loss is not permanent. These disputes can evolve into a battle of the experts.”

*Michele Hayes,
Niles, Barton & Wilmer LLP*

Evans: One cause of disputes comes from treating the claim as a precursor to litigation. This is typically seen where an insured challenges nearly every request for information from the carrier and severely restricts those with whom the carrier may speak. In fact, this approach typically results in multiple disputes and greatly delays the claims process. Another area where we see dispute involves issues of allocation, where a claim, typically one involving litigation, is only partially covered by the policy. This can then hinder the ability of the insurer to effectively associate to try to resolve the underlying litigation.

Hayes: Another cause of dispute involves arguments regarding the proper measure of damages and methodologies for calculating them. For example, insureds will frequently attempt to use a multiple of earnings even though the loss is not permanent. These disputes can evolve into a battle of the experts. Even where an insured does not treat the claim process as a precursor to litigation, they still sometimes exert efforts to limit information provided to the carrier and then complain that the claims process is too slow.

CD: In your experience, what are the best ways to avoid disputes in RWI claims?

Wothers: The best way to avoid disputes is to have open communication with the insured, the broker and counsel. This helps to facilitate a clear setting of expectations regarding timing and an understanding of the issues. It is also important to share information and coverage concerns early and often. This may involve giving the insured an opportunity to respond to coverage concerns before a claim decision is made. This avoids a 'rush to judgment' argument and makes identification of key issues easier. This then facilitates problem solving and ultimately resolution.

DiBlasio: RWI claims often involve complex legal, accounting and valuation issues related to breach and loss. Therefore, getting good and experienced consultants to address these issues can be helpful in avoiding disputes.

Evans: From a conflict resolution perspective, some conflicts are harder to resolve than others. For example, a claim involving a material transaction risk that was identified and addressed when the policy

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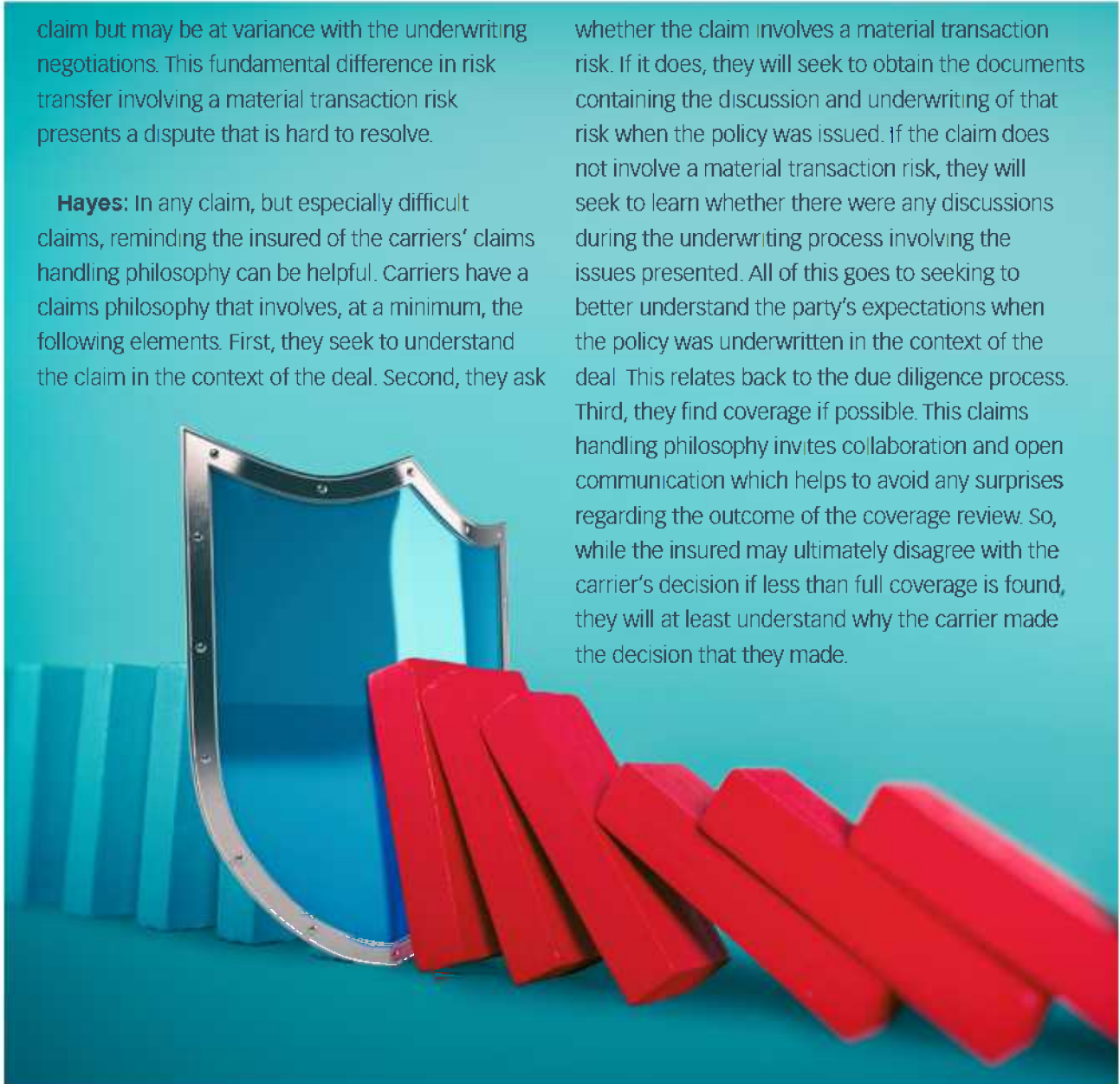
*Diane DiBlasio,
Niles, Barton & Wilmer LLP*

was underwritten is sometimes 'revisited' by way of an RWI claim. Frequently, that portion of a material transaction risk transferred to the carrier is heavily negotiated during the underwriting process. The claim, however, may seek to effectively renegotiate the transfer of risk by seeking to transfer more of it to the carrier. In making this claim, the insured is urging the policy to be read in a way that supports its

claim but may be at variance with the underwriting negotiations. This fundamental difference in risk transfer involving a material transaction risk presents a dispute that is hard to resolve.

Hayes: In any claim, but especially difficult claims, reminding the insured of the carriers' claims handling philosophy can be helpful. Carriers have a claims philosophy that involves, at a minimum, the following elements. First, they seek to understand the claim in the context of the deal. Second, they ask

whether the claim involves a material transaction risk. If it does, they will seek to obtain the documents containing the discussion and underwriting of that risk when the policy was issued. If the claim does not involve a material transaction risk, they will seek to learn whether there were any discussions during the underwriting process involving the issues presented. All of this goes to seeking to better understand the party's expectations when the policy was underwritten in the context of the deal. This relates back to the due diligence process. Third, they find coverage if possible. This claims handling philosophy invites collaboration and open communication which helps to avoid any surprises regarding the outcome of the coverage review. So, while the insured may ultimately disagree with the carrier's decision if less than full coverage is found, they will at least understand why the carrier made the decision that they made.



McGrath: Another way to avoid disputes where coverage is questionable is to ask whether RWI is the right tool for the issue presented in the claim. The buyer can protect itself from known risks in many different ways. For example, the buyer can obtain a specific indemnity from the seller or negotiate an adjustment to the purchase price. If the subject of the claim was addressed by way of a purchase price adjustment, the risk has been addressed and there would appear to be no loss under the RWI policy no matter how broad loss is defined.

CD: When disputes do occur in RWI claims, what are the best ways to resolve those disputes?

Wothers: We hear this over and over again, but it is true: open communication is the best way to resolve disputes. This lets us see if we can agree on what we disagree on. We can discuss whether this agreement is based on a lack of information or a disagreement about facts already provided. We can discuss whether we need more facts and how best to get them. These discussions would likely include whether the additional facts come by way of documents, interviews, consultant or expert reports, or some combination. We can also discuss whether the dispute involves a legal issue. If so, we can seek to agree on a process to brief the legal issue to be

sure it is fully developed and understood. If we can then agree on the basis of a disagreement we can focus only on those issues and meet to discuss a

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Niles, Barton & Wilmer LLP*

path forward. We recognise that RWI claims involve commercial disputes and for commercial disputes there are frequently commercial resolutions if the parties understand the basis of those disputes and are willing to talk to each other about them.

Evans: If the process of distilling the dispute to its essence is unsuccessful, then an early mediation is frequently helpful. The mediation has a much greater chance of success if it immediately follows, because it weeds out many things that do not require time or attention from either party. This helps to make the mediation much more focused and efficient.

DiBlasio: Generally, it is best to take incremental steps in working through claims issues. Seek to avoid unnecessary escalation to arbitration or litigation. This only slows the process down. If arbitration or litigation is necessary, it may be possible to coordinate the filing of the complaint – essentially filing a ‘friendly suit’. This may thereafter allow for stipulations to non-issues so that the arbitration or litigation can focus on the essence of the dispute. This saves time, money and agitation. It also leaves open the possibility for continuing settlement discussions as the process continues.

Hayes: Many carriers are very analytical and able to evaluate claims without the emotion or defensiveness that a seller may have when they are alleged to have made an inaccurate representation.

McGrath: Part of resolving a dispute might involve asking: what is the seller’s position regarding the alleged breach? In finding ways to resolve disputes, parties should not be limited by the processes set out in the policy. For example, if measure of damages is in dispute, parties may seek to utilise a process similar to first party property appraisal. It is not typically contained in RWI policies, but it may be an effective way to resolve a measure of damages issue.

CD: To what extent is the RWI claims process a precursor to litigation?

“If the insured truly believes that the RWI claims process is a precursor to litigation, it frequently makes litigation inevitable.”

*Spencer Evans,
Niles, Barton & Wilmer LLP*

Wothers: An RWI claim is an insurance claim which must be vetted by the carrier. This vetting process is best accomplished through collaboration with the insured. Unfortunately, advisers without experience in RWI claims often take a more litigation-focused approach. They tend to be less communicative, less collaborative and, in some instances, actively adversarial.

Evans: The result of treating a claim as a precursor to litigation is that the claims process is much more expensive and takes dramatically longer. If the insured truly believes that the RWI claims process is a precursor to litigation, it

frequently makes litigation inevitable. It also tends to damage many commercial relationships relating to the underlying deal. For legacy employees now employed by the buyer, this can lead to uncomfortable circumstances. Sometimes, it creates conflicts of interest requiring legacy employees to obtain separate counsel, further inhibiting resolution of the claim and driving up the cost of litigation.

CD: In your opinion, have efforts to artificially speed up the RWI claims process been effective at reducing the time required for insurers to validate and determine coverage for claims?

Wothers: Artificial efforts to speed up the RWI claims process normally have the opposite effect. At its core an RWI claim is an insurance claim. Prior to RWI, these issues were addressed by way of seller indemnity and claims on escrow agreements. Efforts to treat an RWI insurance claim as a seller indemnity dispute will be ineffective. Efforts to artificially speed up an insurance claims process, and treating it as something else, often result in delaying the claim.

Hayes: This sometimes takes the form of a buyer seeking to cut corners, telling the carrier what they think the carrier needs to know, sometimes even bullying the carrier. The carrier has an information deficit compared to other parties of the deal or claim. This simply must be addressed through the carrier's vetting process in order for it to be able to evaluate the insured's claim.

DiBlasio: Having an open line of communication between the insurer and the insured can streamline the carrier's information gathering process.

Evans: Early on, some carriers sought to pay uncovered claims in order to grab market share. This had the added 'benefit' of speeding up the claims process because little or no claims investigation or evaluation was done. Obviously, this is not sustainable. Among other reasons, reinsurers made clear that claims due diligence must be undertaken and only covered claims could be paid, otherwise reinsurers risk directing their capital elsewhere. This has helped to recalibrate the expectations of all participants in the RWI claims process. [CD](#)