

Professional Perspective

Maximizing R&W Insurance Claims

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Maximizing R&W Insurance Claims

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Representation and warranty insurance has changed the M&A market. The popularity of reps and warranties (R&W) insurance—which provides indemnity to buyers for breaches stemming from seller misrepresentations in acquisition agreements—skyrocketed in the past decade alongside a bustling M&A market. Sellers realized that R&W insurance was a useful tool that would enable them to offload risks associated with R&W breaches and avoid having to provide escrows and/or indemnifications as part of the deal. As a result, buyers are increasingly required to include R&W insurance as a deal term in order to remain competitive in the bidding process.

But a crucial question has largely gone unanswered: are insurers actually paying R&W claims?

Lowenstein Sandler's 2020 [survey](#) of 149 executives involved in the R&W market sought to answer this question. While 87 percent of respondents say they received at least a partial payment for R&W claims that exceeded the self-insured retention (SIR), respondents also reported that some degree of negotiation was required. Meanwhile, more than 70% of claims did not result in payment because the claimed losses remained entirely within the SIR.

In other words, insurers are paying claims—but securing maximum value is often no easy task. This article provides some best practices for policyholders looking to obtain maximum value from R&W claims and discusses some evolving market conditions that may shape the R&W landscape in years to come.

Move Ahead Early with Claims

In 45% of reported cases it takes more than six months for a policyholder to submit a claim. There are several reasons policyholders delay, even if doing so is a mistake.

For instance, some may not file a claim if negotiations with the seller about indemnity issues are ongoing. But this could be a trap for the unwary, particularly if the seller engaged in fraud and demands a broad release to resolve an indemnity claim. Because all R&W policies require policyholders to preserve the insurer's subrogation rights in the event the seller committed fraud, a premature and broad release of the seller may unwittingly impair—or eliminate—the buyer's rights under the R&W policy.

Others wait in fear of the perceived cost associated with pursuing a claim. Yet while third-party advisers may require a meaningful upfront investment in the claim, more often than not the money is well-spent: our survey shows that costly litigation is only required to secure coverage in a fifth of cases.

Waiting can cause damage in the long run. Over time, key executives may depart, and institutional knowledge may be lost, making it more difficult for a buyer to articulate the breach and value the loss.

Further, even though policy provisions require insurers to show they were actually and materially prejudiced by delayed notice, insurers often still attempt to deny coverage for claims based on a late-notice defense. Notwithstanding that the defense is hard to prove, our survey shows insurers will still assert late notice so they can leverage it for a reduction of coverage. By way of example, insurers may withhold “credit” against the SIR or otherwise refuse to cover costs incurred without their knowledge or consent.

The bottom line? Don't delay the payday. Provide notice of claims early and follow up to press for payment often.

Negotiate, Negotiate, Negotiate

Our survey data show that while R&W insurers initially deny claims when they are presented, that denial does not end the process. Instead, buyers can usually secure some form of payment for their claims—if they are willing and able to pursue them.

For instance, the vast majority of policyholders (86%) and insurers and brokers (89%) agree that at least some recovery results from a challenge of the initial claim denial and further negotiation of the claim. In fact, survey respondents report meaningful recoveries in these cases: more than 75% of respondents report claim payments that exceed 50% of the claimed loss.

To effectively negotiate R&W claims, policyholders should consider the following best practices:

Come to the table well-armed. Our data show that R&W insurers will assemble a team of professionals to evaluate the claim with the goal of avoiding, or minimizing, payment. That means policyholders need a team of their own: brokers to manage the business relationship, coverage counsel to articulate the legal basis for coverage and negotiate the resolution—or litigate or arbitrate if needed—and accounting experts to credibly value the loss.

Keep the claims process moving. Again, delay of any kind typically disadvantages the policyholder. That's why they should negotiate policy terms that require insurers to provide coverage determinations and claim payments within strict deadlines. They also should work closely with their claim advocacy teams to provide well-documented damages or losses, along with documents that substantiate the breach, to reduce follow-up information requests from insurers.

Prepare to rebut common coverage defenses, like “actual knowledge” exclusions and “no breach or loss” defenses. Policyholders report that insurers typically first take the position that no breach has occurred or no loss has been suffered, or they cite the actual knowledge exclusion in the policy. When it comes to the “actual knowledge” exclusion, buyers can start by limiting the number of deal team members who are subject to the exclusion at the policy placement stage. Regarding the “no breach or loss” coverage defenses, skilled coverage counsel can often foreclose such defenses by citing applicable case law and advocating the policyholder's position.

Be proactive. Policyholders should be proactive in providing prompt notice of all actual and potential breaches. They should inform insurers of all ongoing negotiations with the seller and/or any other third parties who may be held responsible for the loss, as involving insurers in these discussions could go a long way in blunting or eliminating the impact of a lack-of-consent defense later on. Finally, policyholders should avoid providing a broad release to sellers—or any other responsible party—without first discussing it with their insurers; even better if policyholders are able to secure the insurers' written consent to any settlement involving the aforementioned parties.

Document the claim. Buyers need to remember—and clearly document—how they got to the point of filing a claim. A well-prepared proof of claim paves the way to getting the insurer meaningfully engaged in the negotiation process so that full-blown litigation or arbitration will not be necessary to secure payment for the claim.

Changing Market Conditions: SIRs and Covid-19

A central issue in the current R&W market is that, according to the survey data, only 29% of claims exceeded the SIR—this, despite the fact that insurers have generally been lowering SIRs over the past few years. This creates an imbalance by which insurers collect significant premiums, impose substantial SIRs, and often end up paying claims at a reduced percentage of the claim's full value during the negotiation process.

How to correct this imbalance? A few options to consider:

Shift SIRs to a more traditional model. Instead of basing SIRs on a percentage of enterprise value—as is currently the standard—R&W insurers could set such retentions based on perceived risks and claims experience, as in D&O and cyber insurance. Under this model, insurers could offer buyers different SIR options at different premium price points.

Accelerate the step-down process. Currently, the reduction of SIR does not begin until 12 to 18 months after deal closing. This could be accelerated to right-size the risk-reward tradeoff involved in deciding whether to put these policies in place.

Reduce upfront premiums. This approach provides another solution that makes these policies more attractive, if SIRs do not change.

Creative credit approaches. Insurers could provide credit against the SIR for costs incurred to address some or all otherwise uncovered or excluded breaches, such as deal-specific exclusions—even if the exclusion might remain in place to evaluate the insurer's coverage obligation above the SIR. Credit could also be provided against the SIR when losses, or portions of losses, are covered by a traditional insurance policy—an approach already used in other insurance contexts.

It is also worth considering that Covid-19 will place additional pressure on the R&W market. Policyholders should expect Covid-19 and pandemic-related exclusions, as well as heightened diligence of areas that now carry increased risk, such as material contracts, suppliers, and remote-work preparedness and capabilities.

In an effort to preserve cash amid declining deal flow, insurers will likely extend the claims process even further. But our data also indicate that once deal flow resumes, insurers will need to become more competitive than before—which they can do by continuing to pay claims, lowering SIRS and premiums, and reducing deal-specific exclusions.

These conditions should lead to a right-sizing of the R&W market in the long term. And this correction, combined with thoughtful negotiation tactics and claims preparation, should set the stage for policyholders to get the most out of their R&W policies.