MARSH INSIGHTS

Insurer to pay full policy limit on W&I Claim

The recent Victorian Supreme Court ("**Court**") **decision in UDP Holdings Pty Ltd (subject to a deed of company arrangement) (rec and mgr apptd)** v **Ironshore Corporate Capital** (No 2) [2019] VSC 645, provides useful insight into policy interpretation and the scope of coverage offered under a Warranty & Indemnity insurance ("**W&I**") policy.

Ultimately, the Court determined that the plaintiff, UDP Holdings Pty Ltd ("**Insured**") suffered a loss under a buyer's Warranty and Indemnity insurance policy ("**Policy**") underwritten by the defendants, Ironshore Corporate Capital Ltd (No 2) and International Insurance Company of Hannover SE ("**Insurer**").[1] It was held that the Insured was entitled to judgment in the sum of $25 million, being the full Policy limit, plus interest.[2]

Takeaways and Insights

One of the key takeaways, is that the court is inclined to hold W&I insurers to a reasonable response, consistent with the commercial interpretation of a W&I policy. Once the Policy was triggered and the quantum of loss ascertained, the Insurer was obligated to pay. We expect this decision to influence the early assessment and settlement of W&I claims. As Marsh expects W&I claims activity to increase in coming years, the decision bodes well for Insureds' rights under the policy.

There are a number of other key insights to be gained from the decision:

- W&I insurance operates as the first port of call with respect to compensation for a breach of warranty rather than being utilised as compensation of last resort.
- The early submission of supporting evidence to establish a valid claim under the policy, protects the insured's position. In this case, the early submission of accounting evidence allowed the court to find there was unreasonable delay by the Insurer and the Insured was entitled to interest.
- An Insurer cannot unreasonably delay determining its indemnity position by issuing requests for further information.
- A higher policy limit at a marginally higher premium is a significant commercial consideration as the Insured in this case could have been covered for the full amount of the determined loss.
- The high threshold for proving fraud and concerns around insurer reputation might explain why seller fraud was not argued by either the Insured or the Insurer. The Insurer's rights of subrogation under the Policy were limited and did not arise in relation to the litigated claim.
- Underwriters are not bound by an arbitral award for a claim under the sale agreement in the absence of a policy provision to that effect.

[1] UDP Holdings Pty Ltd v Ironshore Corporate Capital Ltd (No 2) [2019] VSC 645, para 1

[2] Ibid, para 441

Background Facts

The transaction

In 2012, Esposito Holdings ("**Seller**") decided to sell 5 Star Foods Pty Ltd and its subsidiaries ("**Target**"), a group which carried on a milk trading and cheese manufacturing business. After negotiations the relevant sale agreement was signed in December 2013 ("**Agreement**") and the deal completed on 31 January 2014, a purchase price of $70 million was agreed, of which $62.5 million was to be paid upfront and the balance was to be paid the following year.

On 17 December 2013, the Insured entered into the Policy with the Insurer, which covered specific warranties and indemnities made by the Seller under the Agreement, for a two-year period with a $25 million Policy limit.

Basis for the claim

Following completion, the Insured was advised that the most significant customer (based on revenue) of the Target, had been overcharged on milk between July 2011 and 31 January 2014, by $9.3million.[3]

The Insured asserted that it was not aware of the overcharging and would not have gone ahead with the purchase, had it known. Additionally, as a result of the overcharging scandal, the Target business found itself in financial difficulty, resulting in managers and receivers being appointed. The Insured sold the Target business for $22.5 million (less than 50% of the purchase price included under the Agreement), which resulted in the Insured suffering a $47.5 million loss.[4]

In October 2014 the Seller referred a claim for the unpaid balance purchase price to arbitration.[4a] Amended pleadings resulted in a claim by the Insured of $47.5million.[4b]

In March 2015, the Insured notified the Insurer of circumstances that may give rise to a claim under the Policy. In May 2015, the Insured made a claim under the Policy for loss arising from insured warranties supported by an expert accounting report.[5] The Insured alleged that the representations and warranties under the Agreement were breached by the Seller and made a claim under the Policy for damages, declaratory relief and interest.[6] The Insurer contested the claim.[7] In February 2016, the Insured commenced proceedings against the Insurer seeking indemnity under the Policy.[8]

In July 2016, the Insurer obtained a Court order to stay the coverage dispute and complete the arbitration first.[9] The arbitration was finalised in the Insured's favour awarding damages of $54.1million.[10] In December 2018 the award was confirmed by the Supreme Court of Victoria. However, no amount awarded by the arbitrator has been recovered to date.[11]

W&I claim assessment and Policy trigger

Breach of warranties

The Court relied upon the arbitration findings that the warranties were breached, as the breach of warranties had not been challenged by either the Insured or the Insurer.[12] These included warranties in relation to the accuracy of the accounts, records and information.

The Court concluded that the Sellers were aware the overcharging would negatively affect the value of the Target business and that the accounts and records were misleading and deceptive at the time warranties were given.[13] Notwithstanding these circumstances, there were no allegations of seller fraud nor was a subrogation action pursued by the Insurer.

[3] Ibid, para 11 and 15

[4] Ibid, paras 17-19

a) Ibid, para 20

b) Ibid, para 22

[5] Ibid, para 21 and 23

[6] Ibid, para 2

[7] Ibid, para 3

[8] Ibid, para 26

[9] Ibid, para 27

[10] Ibid, para 30

[11] Ibid, para 33

[12] Ibid, para 133

[13] Ibid, para 113

Establishing and quantifying loss

The contractual entitlement to recover against the Seller under the Agreement for breach of insured warranties was a pre-requisite to establishing 'Loss' under the Policy.[14] The Court was satisfied there was a 'Breach' under the Policy arising from a breach of warranties under the Agreement and consequently, there was a contractual entitlement to recover.[15]

The Court referred to the ruling principle in assessing damages for breach of contractual warranties, which is to place the promisee in a position as if the contract had been performed, and that damages should be assessed at the date of the breach.[16]

It was determined that the loss suffered was the difference between the price paid by the Insured, less the real or fair value, plus the amount of the acquired liabilities. After hearing substantial expert evidence, the Court accepted that the Insured's contractual entitlement was $30.85 million.[17]

Insurer's submissions in denying indemnity

The Insurer did not dispute that the relevant warranties were breached. Instead, the Insurer argued that was it was not possible to determine the amount of "Loss" (as defined in the Policy) suffered because the "Recovered Amounts" (also defined) had not been ascertained.

The judge applied an interpretation to the Policy that had regard for the commercial purpose and the circumstances of the transaction and the policy. On this basis, he considered that the Insurer's position was "uncertain, uncommercial and unworkable".[18]

It was determined that waiting for recovery proceedings to be finalised would leave Insureds financially exposed and in an uncertain position, and was inconsistent with the construction of the Policy. The Court maintained that the scheme of the Policy was for the Insured to have proper recourse though the claim handling procedures set out in the Policy. The Insurer's obligation to indemnify was not dependant on the prior collection of all Recovered Amounts.

Court's findings on the claim assessment process

The Court found it unreasonable that the Insurer elected to withhold payment on or from 14 September 2015 being four months after the claim was made. The Court took into consideration the date of the initial notification (2 March 2015), the benefit of the comprehensive loss accounting report providing a detailed loss assessment and the Insured's responses to multiple requests for information.

Significantly, the Court stated that the Insurer's duty under the Policy to respond to a claim notice 'as soon as reasonably practicable' was not discharged by requesting more documents. Interest was awarded from the date when it was reasonably practicable for the underwriters to respond to the Insured's claim. The Insurer was charged interest under Section 57 of the ICA running from 14 September 2015.[19]

The Court determined that the Insured was entitled to the full limit of indemnity of $25 million plus interest, pursuant to s57 of the Insurance Contract Act.[20]

Concluding views

This decision of the Court is good news for insureds in the current W&I claim landscape, where there is an apparent lack of judicial precedent. It is reassuring to note that the Court upheld the commercial interpretation of a contract of insurance with due regard given to the intent of the policy. W&I policy holders concerns around the claims assessment process should be largely assuaged by the Court's stand on unreasonable delays by the insurer and the award of interest. The Insured successfully derived the full benefit of the W&I policy limit, demonstrating why this form of transaction risk solution is increasingly common and popular in today's M&A environment.

[14] Ibid, paras 126

[15] Ibid, para 134

[16] Ibid, para 138

[17] Ibid, para 278

[18] Ibid, para 340

[19] Ibid, para 435-422

[20] Ibid, para 441

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