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7th Circuit May Clarify Rep & Warranty Insurer Duties

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On May 23, 2017, the United States Court of Appeals for the Seventh Circuit will hear oral argument in a case involving allegations of bad faith and breach of contract against the issuer of a representation and warranty insurance (RWI) policy. In Ratajczak v. Beazley Solutions Ltd., No. 16-3418, the court will thus have a rare opportunity to address the scope of an RWI insurer's duties to its policyholder, particularly in the context of settlement of an underlying claim.

The RWI market has experienced dramatic growth over the last five years. Not surprisingly, increases in reported claims have followed closely behind the growth in written premiums. Indeed, a recent publication by AIG reported that claims were filed on 18 percent of RWI policies issued between 2011 and 2015. While such claims may have increased, however, most disputes between RWI policyholders and insurers involve policies that include mandatory arbitration provisions. As a result, such disputes lead to the establishment of very few precedential court rulings in the field. Ratajczak promises a potential exception to that rule.

Background

In May 2012, the Ratajczaks (the "sellers") sold their whey product manufacturing company to an affiliate of Granite Creek Partners (the "buyer") pursuant to the terms of a stock purchase agreement (the "SPA"). In connection with the transaction, the sellers purchased a sell-side warranty and indemnity insurance policy (the "RWI policy") from Beazley Solutions Limited.

The RWI Policy

Beazley's RWI policy insured the sellers against "Loss" in excess of an aggregate $1.5 million retention, up to an aggregate $10 million limit of liability. The RWI policy defined "Loss" as "actual damages, including without limitation diminution in value, which the Insured is contractually obligated to pay as the result of a Breach or Third Party Demand and any Defense Costs arising from a Breach or Third Party Demand, in accordance with the [SPA]." Under the terms of the RWI policy, Beazley was required to indemnify the sellers for damage they become obligated to pay as a result of a breach or third-party demand, provided the sellers gave the insurer notice of that breach or third-party demand "as soon as reasonably practicable." The RWI policy also contained a "consent to settle" provision, which stated that

the sellers could not settle any breach or third-party demand "without prior consultation with and the prior written consent of" Beazley.

The Alleged Breach of Warranty

In late November 2012, the buyer accused the sellers of fraud and breach of various warranties contained in the SPA, alleging that the sellers failed to disclose that the acquired company had secretly added urea to its leading whey product. Following a Dec. 6, 2012, in-person meeting between representatives of the buyer and sellers, on Dec. 11, 2012, the buyer sent the sellers a copy of draft complaint that the buyer had prepared — which specified the warranties in the SPA that the buyer believed had been breached — as well as a draft settlement agreement. On Dec. 21, 2012, the sellers sent back to the buyer a revised draft settlement agreement, which varied from the original proposal only by virtue of a reduction of $250,000 in the settlement payment.

Notice to the RWI Insurer

The sellers first provided notice to Beazley of the buyer's third-party demand on Christmas Eve, Dec. 24, 2012, at 7:30 pm local (London) time. The notice to Beazley included the buyer's draft complaint and advised that the sellers intended to settle the "Third Party Demand in accordance with the time frame demanded by the Buyer in order to mitigate damages, if that proves at all possible." The notice did not disclose the proposed settlement terms or ask for Beazley's consent. Following the national holidays of Christmas and Boxing Day (Dec. 26), Beazley's claims adjuster responded on Dec. 27, 2012 by acknowledging the settlement was proceeding quickly, reserving all of its rights to deny coverage and demanding all correspondence that related to the settlement talks. The sellers' counsel began forwarding that "in waves."

On Dec. 28, 2012, the sellers' counsel advised Beazley that a settlement had to be finalized that day, though he again did not ask for Beazley's consent. Just a few hours later, at roughly midnight in London, the sellers settled the threatened litigation with the transfer of $9.77 million to the buyer and subsequently notified Beazley that a settlement had been consummated. Beazley responded a few hours later by indicating that it was not in a position to consent to the settlement, and would advise in due course as to whether coverage existed. Beazley further advised that without its participation and consent as required by the RWI policy, the insured should proceed as a "prudent uninsured." Beazley denied coverage on March 5, 2013.

District Court Proceedings

When Beazley refused to indemnify the sellers for their settlement with the buyer, the sellers filed a federal court action in Wisconsin against Beazley, and included allegations of bad faith and breach of the insurer's duty to indemnify. See Ratajczak v. Beazley Solutions Ltd., No. 13-C-45 (Jan. 17, 2017 E.D. WI). Beazley moved for summary judgment on the sellers' complaint, and the court awarded judgment in favor of Beazley on two alternative grounds.

First, the court agreed with Beazley that the allegations in the buyer's draft complaint against the sellers did not assert a claim for breach of a fundamental warranty regarding the company's Organizational Documents: "The Buyer's allegations were not that Plaintiffs organizational documents were wrong or that they violated sound accounting practices; the Buyer's claim was that Plaintiffs failed to disclose the fact that the company was adding urea to [its leading whey product]." Id. at Slip Op. p. 11. The court further rejected the sellers' argument that their alleged misrepresentation may have led to inflated

revenues and profits, resulting in a breach of the fundamental warranty. Instead, the court observed that the sellers' allegations – and the associated settlement – covered only breaches of certain general warranty sections, specifically, section 3.11 (no present or future legal proceedings), 3.19 (no knowledge of any basis for litigation), 3.32 (warranty of products being sold in conformity with contractual requirements), and 3.39 (warranty of disclosure of all facts that could give rise to material adverse effect). Because the SPA capped the sellers' liability for breaches of general warranties at $1.5 million and the RWI Policy included a $1.5 million retention, the court concluded that the sellers had failed to establish a loss in excess of their retention, and granted summary judgment to Beazley on all claims: "Plaintiffs cannot possibly show a loss covered by the Policy in excess of the retention amount unless they can show they also faced liability for breach of one of the fundamental warranties." Slip. Op. at 10.

Second, and in the alternative, the court found that the sellers' claims failed because the sellers had not obtained Beazley's consent before entering into the settlement as required by the RWI Policy. The court rejected the sellers' contention that their general duty to mitigate their damages excused them from complying with the specific policy term requiring written consent prior to settlement. The court held that under New York law – the designated choice under the RWI Policy – Beazley was not required to prove that the sellers' failure to obtain prior written consent before settling caused prejudice. Even assuming prejudice was required, however, the court found that "Beazley was unquestionably prejudiced by Plaintiffs' panicked settlement." Slip. Op. at 15. In particular, the court found that the sellers had known of the buyer's claims for weeks before contacting Beazley, and had essentially resolved the overall settlement terms thirteen days before contacting their insurer. As a result, the court found that the sellers' December 24 notice was "more like an afterthought." Based on this analysis, the court held that Beazley was entitled to summary judgment because the sellers had settled the third-party claim without first consulting with and obtaining Beazley's written consent.

The Appeal

In their briefs on appeal, the sellers again claim that the buyer's threatened lawsuit triggered potential fundamental warranty coverage under Beazley's RWI Policy. The sellers argue that the crux of the buyer's allegations in the draft complaint were that the financial records of the company had not accurately reflected the use of urea in the seller's products, and the company was far less profitable, and worth far less, than the buyer's due diligence review of the books of account and financial records of the company had indicated. The sellers contend that those allegations, if true, would establish breaches of fundamental representations not subject to the $1.5 million cap. In its response brief, Beazley counters that in deciding whether the settlement is covered, the issue is what claims were "actually asserted — not what claims might have been made against the insured had the dispute continued." The Seventh Circuit may thus need to decide whether, in determining what warranties were allegedly breached for RWI coverage purposes, it should look beyond the specific warranties enumerated in the draft complaint.

The sellers also argue in their appellate briefs that the district court incorrectly determined that Beazley could rely on a policy forfeiture provision to disclaim coverage and that the short delay from the timing of the sellers' notice prejudiced Beazley. According to the sellers, Beazley cannot establish prejudice because it admitted it would have denied coverage regardless of whether the notice was timely. Beazley counters that it had no duty to remind the sellers of their obligation under the RWI policy to seek consent for any settlement. Beazley further contends that no showing of prejudice is legally required, but, if such a showing is required, the sellers' failure to comply with the RWI policy's requirements did, as a matter of fact, cause prejudice to Beazley in the form of an unnecessarily inflated settlement payment. Here, the Seventh Circuit may need to consider whether an insurer must show prejudice to

enforce a consent-to-settle provision in an RWI policy. The Court of Appeals may also need to determine whether Beazley had an obligation to expressly state a desire to associate in settlement negotiations during the three-day window between the insured's notice of the claim and the executed settlement, particularly where the sellers had announced unequivocally to Beazley that they intended to consummate that settlement with the buyer.

Conclusion

The pending appeal promises to provide RWI carriers additional clarity with regard to their duties to the policyholder in the context of settling underlying claims. Policyholders, in turn, will gain a better understanding of their duties to seek insurer consent to settlements and the scope of coverage for breaches of warranty in RWI policies.

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