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Confusion Reigns: Applying the Multiplied Damages Exception in Representations and Warranties Insurance Policies

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The definition of covered ''Loss'' in many representations and warranties insurance (R&W Insurance) policies is derived from the definition historically used in directors and officers insurance (D&O Insurance) policies. This includes the exceptions for civil and criminal penalties, punitive or exemplary damages, and the multiplied portion of multiplied damages (the Multiplied Damages Exception). When courts have applied the Multiplied Damages Exception to D&O Insurance claims, it has been to bar coverage for multiplied damages awarded for violations of antitrust or antifraud legislation, where the multiplied damages result from intentional wrongdoing by the insured.[1]

These exceptions bar coverage for the types of loss that arise from intentional bad acts of the insured. Courts have referred to these as the ''moral hazard'' exceptions.[2] The reason for including the moral hazard exceptions in D&O Insurance policies is to prevent insureds from avoiding the consequences of their intentional wrongdoing.

However, in R&W Insurance policies the Multiplied Damages Exception is sometimes being used for an en-

[1] Carolina Casualty Ins. v. Merge Healthcare Solutions, Inc., 728 F.3d 615, 617 (7th Cir. 2013).
[2] *Id.* at 618.

tirely different purpose; parties are claiming that this exception can limit an insured buyer's coverage for damages calculated as a multiple of some financial performance metric (generally related to earnings) that result from a breach of a representation or warranty in the purchase and sale agreement. Repurposing the Multiplied Damages Exception has led to confusion concerning the scope of coverage provided by R&W Insurance policies.

Pricing Based on a Multiple of Earnings

R&W Insurance policies provide coverage for damages resulting from breaches of contractual representations and warranties made by the seller in a merger and acquisition (M&A) transaction. Purchase and sales agreements in M&A transactions frequently contain representations and warranties concerning matters that may affect the buyer's decision whether to purchase a company and how much to pay, such as representations and warranties as to specific accounting matters, liabilities, salable inventory and customer contracts (Financial Representations and Warranties). A breach by the seller of such Financial Representations and Warranties can impact the buyer's ability to fairly value the target company.

One of the most common methods a buyer uses in determining the price it is willing to pay for a company is a multiple of the target's earnings.[3] The specific measure of earnings used can vary based on the type of company being acquired or the industry it operates in, but generally will be based on a measure of net operating earnings such as Earnings Before Interest and Taxes (EBIT) or Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA). While there are a variety of assumptions imbedded in the multiple selected by a buyer, using a multiple allows a buyer to estimate the market value of a company based on an expectation of future earnings or cash flows.

The measure of value a buyer applies by using a multiple to determine the purchase price will likely be based on the latest financial information available to the buyer. Because a seller typically has significantly more information about its own operations, a buyer must rely on the seller's Financial Representations and Warranties in deciding whether to make the acquisition and how much to pay. If the seller has breached a Financial Representation or Warranty affecting a key metric used by the buyer to estimate the target's market value and determine the price it was willing to pay, the buyer may have been damaged to the extent the breach caused the buyer to pay more for the company than it otherwise would have paid.

The Coverage Disconnect

In such a circumstance, a buyer may bring a claim under its R&W Insurance policy for breaches of seller's Financial Representations and Warranties, and assert its loss should be measured as a multiple of the negative change in the financial performance metric impacted by the breach. But the insurer may contend that the multiplied portion of multiplied damages is not recoverable when an R&W Insurance policy includes a Multiplied Damages Exception. The insurer's position is strengthened when the definition of ''Loss'' in an R&W Insurance policy expressly states that the Multiplied Damages Exception applies to pricing multiples for financial performance metrics like EBIT or EBITDA.

There is, of course, no reason that the insured and insurer cannot agree to bar recovery of damages measured as a multiple of a financial performance metric. But this is not the type of loss the Multiplied Damages Exception was originally intended to bar when it was used in D&O Insurance policies—raising the question as to how the Multiplied Damages Exception should be interpreted in the context of R&W Insurance.

Measuring Damages for Misrepresentations Affecting Earnings

While it may be possible to calculate the exact dollar amount of the misstatement causing a misrepresentation of a Financial Representation and Warranty, the buyer may contend that the impact of the misrepresentation on the estimated market value exceeds the dollar amount of the misstatement causing the misrepresentation. For example, if the misstatement causing the misrepresentation results in an overstatement of current period earnings and the buyer used a multiple of earnings to determine the purchase price, the buyer may contend the overstatement is likely to similarly impact future earnings. If the buyer based its purchase price on a multiple of earnings, and can prove that it did, a dollar-for-dollar adjustment to the purchase price in the amount of the current period accounting adjustment necessary to properly state the seller's financial statements might not, from the buyer's perspective, make the buyer whole. The buyer will likely claim it has been damaged by at least the same multiple of the misstatement causing the breach.

Using a multiple to determine an offering price, and ultimately the purchase price, does not automatically mean a multiple or the same multiple should be used to determine a purchase price adjustment or damages when a seller has breached a Financial Representation or Warranty. Applying the multiple used by the buyer could either overstate or understate damages, depending on the specific misstatement causing the breach of a Financial Representation and Warranty.

In certain instances, a dollar-for-dollar adjustment may be more appropriate. For example, sellers often warrant that no undisclosed liabilities exist or that all inventory is saleable as of the closing balance sheet date. If these representations are false and the adjustment needed to properly account for the undisclosed liabilities or obsolete inventory is a one-time charge to current earnings, a dollar-for-dollar adjustment equal to the misstatement may be appropriate.[4]

In other circumstances, simply applying the multiple the buyer used to determine its purchase price to the misstatement causing the misrepresentation may be insufficient to measure the damages. A key question in this circumstance is, what would the buyer have done had it known about the misrepresentation prior to

[3] Multiples of other financial metrics such as revenues listed on the income statement or assets on the balance sheet could also be used.

[4] Assuming no indemnity basket or cap that establishes the buyer's maximum loss before the seller's liability begins.

closing? It may have, for instance, utilized a smaller multiple or decided not to proceed with the transaction. In such a situation, applying the actual multiple used by the buyer is arguably an insufficient measure of the buyer's total losses.

For example, assume the target's current period EBITDA was $1 million and the buyer used a multiple of 5x to arrive at a $5 million purchase price; however, the target's revenue was overstated and the actual EBITDA was only $900,000. Simply applying the multiple of 5x to the EBITDA overstatement of $100,000 results in damages of $500,000. However, the buyer may have only used a 4x multiple to value the target had it known about the issue prior to closing. In this scenario, the buyer would have only paid $3.6 million for the target resulting in $1.4 million of damages ($5 million actual purchase price minus $3.6 million ''but for'' purchase price).

Addressing Coverage for Decrease in Market Value in an R&W Insurance Policy

In M&A transactions, sellers and buyers often do not address in detail the scope of a seller's indemnity obligation for breaches of Financial Representations and Warranties (apart from whatever indemnity baskets or caps may be established). While M&A agreements often provide that a seller's indemnification obligation does not extend to special and consequential damages, such a provision begs the question of whether a buyer's claim that it overpaid by a multiple of an earnings adjustment constitutes direct or special/consequential damages. M&A agreements may also bar indemnity for lost profits, but again the question this raises is whether a claim for the decrease in market value measured as a multiple of a decrease in future estimated earnings constitutes a claim for lost profits. For the parties to an M&A transaction, having some uncertainty as to the scope of potential indemnity exposure may be a tolerable risk since the critical economics driving the deal relate to consideration for the purchase and sale.

But for an R&W Insurance policy, the scope of the indemnity being provided is the critical economic consideration from the perspective of both the insurer and insured; it is what the insurer is selling and the insured is buying. Accordingly, an important initial question to address is whether the R&W Insurance policy is intended to cover decreases in market value resulting from misrepresentations by the seller concerning Financial Representations and Warranties. The parties may reasonably decide that the policy is not intended to cover such loss as this will likely reduce the policy premium. And if it is the parties' intention that the policy indemnify for the decrease in market value caused by breach of Financial Representations and Warranties, then the policy can be priced accordingly.

Once the parties agree on whether the R&W Insurance policy will cover a decrease in market value tied to breaches of Financial Representations and Warranties, the question becomes how that agreement should be reflected in the policy. Repurposing the Multiplied Damages Exception is not the cleanest and best way to accomplish this. Certainly if the parties agree that such damages are to be covered by the R&W Insurance policy, there is no reason that the insured should be foreclosed from arguing, in appropriate circumstances as discussed above, that applying the multiple it used to price the company is a fair way to measure the decrease in the company's market value.[5] Courts have recognized that, under certain circumstances, applying a multiple of earnings can be a fair measure of damages to a buyer for breach of representations and warranties concerning a company's financial performance.[6]

On the other hand, if the parties agree that the policy will not cover as loss a decrease in market value resulting from breaches of Financial Representations and Warranties, reliance on the Multiplied Damages Exception may not fully capture the parties' agreement. Even if language is added to make clear that the Multiplied Damages Exception applies to pricing multiples for financial performance metrics, the exception does not necessarily prevent the insured from arguing that it is entitled to a decrease in market value calculated in another fashion. The more straightforward approach is to include language expressly providing that the policy does not cover loss resulting from diminution of market value caused by breaches of representations and warranties, and leave the Multiplied Damages Exception to fulfill its originally intended purpose of preventing recovery of moral hazard type damages.

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[5] If the parties agree that the policy will cover a decrease in market value, the insurer may want to inquire concerning the insured's pricing assumptions as part of the underwriting process.

[6] *See e.g.*, Cobalt Operating, LLC v. James Crystal Enterprises, LLC, 2007 BL 257367 at 31 (Del. Ch. July 20, 2007), *aff'd*, 945 A2d 594 (Del. 2008).