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Lawyer Insights

Representation and Warranty Insurance and the Collateral Source Rule

The contract between the buyer and the seller, the RWI policy, and common law are important considerations in determining whether any offset rights exist and can be exercised.

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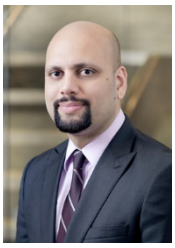

After any merger or acquisition, disputes can arise regarding the accuracy of representations and warranties that the seller made to the buyer. In some deals, the buyer obtains representation and warranty insurance to provide coverage to the buyer in the event that the seller has breached a representation or warranty in the agreement between the buyer and seller. When an RWI policy provides coverage, sellers may attempt to offset their obligations to buyers by amounts paid by the R&W insurers. Likewise, R&W insurers may attempt to do the same for post-contract damages paid by sellers to buyers. But such offsets are far from a foregone conclusion.

To begin with, the contract documents may not even allow for any offsets. The transaction agreement between the buyer and the seller may not include provisions that would allow the seller to offset amounts it owes by amounts paid by an R&W insurer. Likewise, the RWI policy will not necessarily include provisions allowing an insurer to offset amounts it owes by amounts paid by the seller.

Even if the seller or the R&W insurer could assert offset rights, they will need to overcome additional hurdles. In general, an offset is applicable to prevent a party from recovering the same amounts for the same harm. See, e.g., E.E.O.C. v. Waffle House, Inc., 534 U.S. 279, 297 (2002) ("it goes without saying that the courts can and should preclude double recovery by an individual" (quotation omitted)); TMTV, Cpr. v. Mass Productions, Inc., 645 F.3d 464, 475 (1st Cir. 2011) (The "modern view, as already stated, is that an offset is conventional where needed to prevent recovering twice for the same harm."). This is sometimes referred to as the "one satisfaction rule" and its applicability depends on the damages being offset for the same wrong or harm. See, e.g., Chisholm v. UHP Projects, Inc., 205 F.3d 731, 737 (4th Cir. 2000) ("The essential requirement for the 'one satisfaction rule' is that the amounts recovered by settlement and the judgment must represent common damages arising from a single, indivisible harm."); Restivo v. Hessemann, 846 F.3d 547, 595 (2d Cir. 2017)(holding that offset applied because damages were based on "same operative facts and harms); City of San Jose v. Price Waterhouse, No. 91–16489, 1993 WL 83495, at *1 (9th Cir. Mar. 23, 1993) ("An offset is available where the settlement and the jury verdict represent common damages.").

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In the context of corporate transaction disputes and representation and warranty insurance, the damages insurers and sellers often seek to offset may not be for the same harm or injury. For instance, any payment by the seller for breach of contract would likely be limited to the amount of the deductible in the applicable representation and warranty insurance. The insurer's payments for any breach of the deal document would start after that deductible is satisfied. So the seller's and the insurer's payments related to any breach of the deal document would not be for the same harm.

In addition, any other amounts paid by the seller could be for harm caused by fraud, which may not be covered by RWI. In that situation, the damages paid by the seller and those paid by the insurer would not be for the same harm because the damages paid by the insurer are for damages arising out of a breach of the contract between the seller and the buyer and the amounts paid by the seller are for damages related to fraud.

Even if the damages are paid for the same wrong or harm, sellers and insurers still may not be entitled to an offset. Common-law doctrines related to offset—like the one satisfaction rule—may be subject to exceptions, For example, in Delaware, an exception to the one satisfaction rule is the collateral source rule.

Under the collateral source rule, a plaintiff may recover damages against both the alleged tortfeasor and another source for the same injury when the tortfeasor and the source of the other payment are unconnected. See Estate of Farrell ex rel. Bennett v. Gordon, 770 A.2d 517, 520 (Del. 2001) (citing Yarringtonv. Thornburg, 205 A.2d 1, 2 (Del. 1964)). Delaware courts applying the collateral source rule repeatedly have held that there should be no offset of damages in favor of the tortfeasor simply because the plaintiff's insurance carrier previously compensated the plaintiff or the same harm. See, e.g., Yarrington, 205 A.2d at2. Thus, buyers pursuing fraud claims against sellers could argue that the collateral source rule prohibits any offset claims asserted by sellers or R&W insurers.

However, sellers may take advantage of a gloss Delaware courts have placed on the collateral source rule. In Kelly v. Perdue Farms, 123 A.3d 150, 158 (Del. Super. Ct. 2015), the court held that a party was entitled to an offset based on insurance payments because the party had paid part of the premium for the insurance. The court explained that this result was appropriate because the collateral source (i.e. the insurance) would not have existed without the contributions from both parties. Id. Because the party paid 50% of the insurance premium, it was entitled to an offset of 50% of the insurance payment. Based on that ruling, in deals where the seller pays some portion of the RWI premium, sellers may try to argue for a similar offset.

In sum, sellers and R&W insurers face a variety of hurdles to offset amounts they owe by amounts paid by the other. The contract between the buyer and the seller, the RWI policy, and common law are important considerations in determining whether any such offset rights exist and can be exercised.

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