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**Shifting Pricing and Coverage
The Current Landscape of R&W Insurance (Part 1)**

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The COVID-19 pandemic has impacted the economy to a significant extent. With respect to the representations and warranties insurance ("RWI") market, the pandemic presents two specific challenges: (1) a reduction in M&A activity, and the resultant decline in RWI premium spend, has caused insurers to fall behind on their annual revenue targets; and (2) many transactions submitted for insurance during this period have relatively unfavorable risk profiles. Fortunately, M&A activity seems to be picking back up, with an emphasis on transactions involving distressed entities and tech and health IT companies. This update discusses how the RWI market is responding to the COVID-19 pandemic and this new normal, but with a view to providing you with guidance as to what you should expect when placing an RWI policy.

Background: The increased risk profiles of deals in the current environment.

From a buyer's perspective, the primary purpose of the M&A due diligence process and representation and warranty package is to understand and eliminate risks existing in the target company. The COVID-19 pandemic has increased the challenge of identifying and quantifying these risks because of the myriad and far reaching potential effects of COVID-19 on any given target company. Indeed, nearly any representation or warranty in an acquisition agreement theoretically later could be argued to have been inaccurate due to COVID-19. Just to take a few examples: (i) a financial statements representation (which typically includes a statement that the financials "fairly represent" the financial condition of the business) arguably could be inaccurate if the impact of the COVID-19 economic downturn is not reflected in those statements; (ii) a compliance with laws representation arguably could be inaccurate if the target had been operating in "survival mode" in response to the COVID-19 pandemic and failed to dedicate sufficient resources to its compliance function (including monitoring and complying with the bevy of new laws or regulations enacted in response to COVID-19); or (iii) a customer or supplier representation arguably could be breached if the disclosure schedules did not reflect that certain customers or suppliers had ceased operations due to COVID-19 or expressed an intention to reduce their relationships with the target. Even if such representations are qualified by "seller's knowledge", such knowledge qualifiers often carry a "due inquiry" standard or similar concept of constructive knowledge that imposes a burden on the target to affirmatively verify the accuracy of its representations.

These risks are compounded for target companies with international operations. The challenges of complying with the rapidly evolving laws of any one jurisdiction are magnified when the target operates across multiple jurisdictions.

How is the RWI market managing these risks?

Fortunately, no R&W insurer to date has exited the market in response to the current climate. Moreover, with one exception, the R&W insurers have not moved significantly on pricing or terms since the onset of the COVID-19 pandemic, although nearly all insurers have adopted some form of an exclusion for losses resulting from the COVID-19 pandemic.

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Depending on the insurer (and the target industry), the wording of the COVID-19 exclusions vary widely in their breadth. Certain exclusions are narrowly tailored to identified risks (for example, breakdowns in the target's supply chain). Others broadly exclude any losses that relate to the COVID-19 pandemic (or the government's response thereto), making it difficult to adequately assess the usefulness of a policy to the buyer (or a seller, if the seller has agreed to indemnify buyer for exclusions to the policy). Additionally, certain insurers propose language in their initial quotes (known as a non-binding indication letter or "NBIL") on a "take it or leave it" basis, whereas others are amenable to negotiating the wording of the exclusion following underwriting. In all events, it is critically important to focus attention on the COVID-19 exclusion. **In light of the potentially wide-ranging (and still unknown) impact of COVID-19 on any given target company, a broadly worded and aggressively applied COVID-19 exclusion theoretically could exclude the coverage for many breaches the insured would generally expect to be covered**.

It may be helpful to discuss some broad concepts included in many of the different versions of COVID-19 exclusions:

The "lead-in" language. The lead-in language to an exclusion specifies the necessary causal relationship between the loss suffered and the subject of the exclusion. It is in the policyholder's interests to have a direct or proximate causal requirement as opposed to an exclusion that can be triggered by an indirect causal relationship. A common lead-in to the COVID-19 exclusion provides that the policy will not cover loss "arising out of, related to or to the extent increased by" COVID-19, whereas other exclusions apply only to loss "directly caused by" COVID-19. Let's take a practical example: imagine that a target company's CFO committed accounting fraud and intentionally falsified the target's financial statements to hide the negative impact of COVID-19 on the target's financial results. An aggressive insurer could argue that the breach of the financial statements representation "arose out of" or "related to" COVID-19's negative impact on the target company's financial results. The insurer could also argue that the loss was, at a minimum, "increased by" COVID-19 (and thus, the policy should exclude such increased damages). On the other hand, if the policyholder has the benefit of the narrower "directly caused by" language, then the insurer will be hard pressed to argue that the direct cause of the loss was anything other than the CFO's misconduct.

Tailored scope. Certain COVID-19 exclusions apply to every representation and warranty in the acquisition agreement, while others apply only to identified representations, such as the customer or supplier representations. In the latter type of exclusion, coverage is not excluded for breaches of any representations that are not identified. As an example, if the exclusion applies only to employment representations, and there was a breach of a tax representation that had a causal connection with COVID-19 (for example, the company obtained forgiveness of a portion of its debt because of economic hardship caused by COVID-19, but failed to pay income taxes on this cancellation of debt income), the exclusion would not apply to a breach of the tax representations.

Hidden Exclusions. Sometimes the COVID-19 exclusion is not so obvious. Some carriers "exclude" COVID-19 damages in the Definitions section of the policies, particularly in the definition of Loss. This is one way for the insurer to make sure that the "exclusion" applies across the board. Policyholders should carefully review the Definitions sections of proposed policies with their brokers and counsel to understand the full scope of proposed limitations to coverage.

What triggers the exclusion? The exclusion may specify what types of losses are excluded. Certain COVID-19 exclusions are broadly tied to any "loss" or "financial impact" arising out of COVID-19, but other COVID-19 exclusions apply only to "bodily injury" or "business interruption." These limitations can be beneficial to insureds. For example, the bodily injury formulations would appear to be inapplicable to the

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financial impact of a customer that went out of business. Similarly, the "business interruption" formulation would appear inapplicable to a breach of the financial statements rep.

Subject to Negotiation. While insureds should expect that some kind of COVID-19 exclusion will find its way into most policies, the scope and wording of the exclusions can be negotiated. Because the exclusion is ubiquitous, your counsel and insurance broker should be able to adjust the scope of the exclusion in most cases. Fortunately, on this issue, time is on the insured's side – the general trend is that as the effects of COVID-19 are becoming better understood, insurers have been moving towards narrower exclusions and even in some cases omitting an exclusion altogether.

Insurance coverage for PPP loans?

Under the Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act"), many businesses obtained Paycheck Protection Program ("PPP") loans with the expectation that these loans ultimately will be forgiven by the U.S. Small Business Administration (the "SBA"). In the context of an M&A transaction, sellers may push to exclude PPP loans from the typical definition of "Indebtedness" that is often associated with a purchase price reduction (assuming the price is being paid on a cash-free, debt-free basis). The buyer, however, may require the seller to represent that the PPP loan is eligible for forgiveness (or makes representations relating to the target's forgiveness eligibility), and there may be a breach of those representations if the SBA subsequently determines that the loan must be repaid. The buyer's loss in that scenario would include the amount that must be repaid and could also include additional elements, including: (a) unpaid interest on the loan, (b) legal fees that the buyer/target incurs in opposing the government's demand for repayment; (c) civil fines and criminal charges assessed by the SBA or Department of Justice (including punitive or treble damages, or claims under the False Claims Act); or (d) reputational harm the buyer/target suffers relating to the PPP loan (such as critical media coverage or congressional investigations relating to the loan).

Most R&W insurers are taking the position that an RWI policy is not the appropriate vehicle for covering the risk of reimbursement, although certain insurers will cover this loss if the buyer (and insurer) have adequately diligenced the target company's eligibility for loan forgiveness. Certain insurers are offering separate contingent risk insurance policies, which are insurance policies that cover a single risk – in this case, the risk of loss related to the PPP loan. This coverage is developing in real time and there are a number of open questions about the coverage, including whether the coverage will be limited to the amount that is reimbursed or whether it could also include additional losses. Additionally, contingent risk policies currently are covering risks related to eligibility, but not risks related to forgiveness. Eligibility relates to whether the applicant was eligible at the time it applied for the loan; forgiveness relates to how the recipient spent the PPP loan funds. Denial of forgiveness would be covered only if the denial is due to a lack of eligibility. In M&A transactions in which a PPP loan is involved, the deal documents should specifically include a representation regarding the loans. In that way, the subject of the loans can be negotiated either as a part of the R&W policy or as a stand-alone policy within a single negotiation.

Coverage for minority investments

In the current economic climate, it is increasingly common for buyers to limit their investment to a minority position. The process for obtaining an R&W insurance policy in a minority investment is similar to the process employed in a control-position acquisition. The insurer will expect the buyer to conduct reasonably fulsome diligence, although the insurer's view of what the scope of reasonable diligence entails will be informed by the favorable deal dynamics – the buyer's and seller's interests are aligned by virtue of the seller retaining a large financial interest in the target.

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One unique attribute of minority investment deals is that the insurance policy will pay only a pro rata portion of company-level loss, corresponding to the buyer's ownership percentage in the target company. As an example, if the loss related to a defective piece of machinery for which $2 million in repairs would be required and the buyer owns only 25% of the company, the RWI would recognize only $500,000 in covered loss, which corresponds to how much loss the buyer incurred. Note that the policy, however, will pay 100% of the buyer's direct loss, such as a breach of the representation that the company had title to the shares it transferred to the buyer in connection with the investment. Separately, in minority investment deals, the retention is typically tied to the buyer's investment amount, rather than the total investment amount, which is favorable to the buyer.

Finally, it may be challenging to place an R&W insurance policy cost-effectively if the buyer's investment amount (inclusive of the buyer's financing) is less than $20 million. Insurers have minimum premiums which typically exceed $100,000. Also, insurers will require the payment of an additional underwriting fee that is, in most cases, at least $25,000 (and often higher). Finally, many insurers have minimum retentions and, as a result, the retention on a percentage basis could be significantly higher than it would be on a larger deal.

About the Authors:

David Taubenfeld is a partner in the Litigation Practice Group at Haynes and Boone and he represents policyholders in all matters relating to insurance. He frequently works with deal teams to negotiate and secure insurance products to bridge stubborn risks. These types of policies include Representation and Warranty policies; Tax liability policies; environmental policies and other policies created to resolve contingent risks in transactions. He also handles all manner of insurance disputes, finding coverage where others may not look, and he attempts to secure coverage for his clients through negotiation and diplomacy before litigation becomes necessary. When litigation becomes necessary, he litigates aggressively, always with the goal of securing coverage for his clients quickly and economically. He has secured millions of dollars in coverage for his clients through negotiation and litigation.

Tom Harris is a partner at Haynes and Boone and leads the firm's Mergers and Acquisitions Practice Group. He has been advising middle-market clients for more than 30 years, helping them successfully close hundreds of acquisitions, divestitures, and other corporate transactions. He has represented both buyers and sellers in public and private sale-of-business transactions and also has represented independent committees of boards of directors.

Brent Beckert is an associate in the Mergers & Acquisitions Practice Group of Haynes and Boone. He has experience in domestic and international acquisitions, divestitures, and other complex business transactions, and often helps clients navigate the R&W Insurance underwriting process in connection with such transactions. Brent has also advised companies of all types on potential relief available under recent state and federal legislation enacted in the wake of COVID-19, including the Paycheck Protection Program (PPP) and Economic Injury Disaster Loan (EIDL) program available under the Small Business Administration.

Peter de Boisblanc leads HUB's transactional risk practice in the United States. As a broker, Peter draws on his extensive prior experience as an underwriter on AIG's M&A insurance team, where he underwrote more than 150 RWI policies. Prior to joining AIG, Peter practiced law for 11 years, most recently at Ropes & Gray, LLP, where he advised private equity clients with respect to the placement and negotiation of RWI policies for both domestic and international transactions. Peter graduated, *cum laude*, from Fordham Law School in 2004 and from the University of Chicago in 1999.

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Please click here for our previous alert on the impact of COVID-19 on R&W Insurance.

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