

Clearing Through the Smoke: Understanding the Short- and Long-Term Impact of COVID-19 on R&W Insurance

March 27, 2020 Jennifer Wisinski, David Taubenfeld, Tom Harris, Brent Beckert

PRACTICES Insurance Recovery, Corporate, Corporate Strategic M&A, Mergers and Acquisitions, Private Equity

The impact of the novel coronavirus (COVID-19) across the globe remains a significant concern in every aspect of business – and the representation and warranty (R&W) insurance market is no different. The following Frequently Asked Questions are designed to address some of the more common questions that have arisen since the outbreak of the pandemic. **As always, advice in this area is fact-sensitive. Particularly given the rapidly evolving insurance and legal landscape, market observations and legal conclusions can evolve on these matters quickly and likely will. If in doubt, seek current advice based on your company's facts and circumstances.**

1. What types of exclusions related to COVID-19 should I expect to encounter in my R&W Policy?

Answer: Insurers have taken several different approaches to the COVID-19 crisis. While some have approached the crisis on an industry-by-industry (or even a company-by-company) basis, others have requested blanket exclusions to coverage.

While the situation remains very fluid, below are some of the explicit exclusions¹ that have appeared in recent transactions since the spread of the COVID-19 virus:

1. Losses arising out of the COVID-19 virus;
2. Losses arising out of or resulting from any pandemic or epidemic disease outbreak relating to the COVID-19 virus (or evolution thereof);
3. Losses arising from or relating to any business interruption or other business downturn solely to the extent such interruption or downturn arises out of the coronavirus (including any resulting COVID-19 sickness) or any government or other regulatory sanctioned response thereto;
4. Loss that represents the portion of Loss that is increased by the COVID-19 virus;
5. Loss arising out of loss of key personnel due to the COVID-19 virus; and
6. Loss arising out of supply chain interruption due to the COVID-19 virus.

We would expect that insured parties will likely object to exclusions #1-4 above because such exclusions introduce significant uncertainty into policy coverage. Insurers could argue that these exclusions apply to many of specific representations in the agreement as well as areas diligenced by the insurer. It is unclear today how damages would be determined under the R&W policy, particularly where it is difficult to reliably measure the impact of the COVID-19 virus on the target company. The uncertainty may incentivize buyers to request an increased seller escrow or broads right to indemnification for matters excluded from the policy (regardless of the subject area) —both of which would undercut the general efficacy of having a policy in the first place, especially in the context of a competitive auction. Further, if insurers are successful in inserting this type of exclusion, it could complicate the claims process with factual disputes about the extent to which the COVID-19 virus has caused or increased the buyer's damages.

While not ideal, exclusions #5 and 6, on the other hand, are more narrowly tailored to certain subject matters (e.g., labor and material supplier representations), and may be more palatable to the deal parties. These targeted exclusions address discrete concerns surrounding tangible and identified exposures. Buyer is much better situated to diligence these areas, understand potential coverage caps, and consider narrowly tailored remedies. For example, in the case of a COVID-19 exclusion that is limited to Losses arising out of supply chain interruptions, buyers could consider (i) pursuing other types of primary insurance policies, such as business interruption coverage, (ii) seek a limited right to indemnification from Seller that is much more narrowly tailored, or (iii) conduct a thorough review of the due diligence (e.g., supplier and customer calls) and make an informed decision to accept the risk of no recourse with respect to such issues.

If the insurer is pushing for a broad exclusion, a buyer can argue that the insurer is already protected by exclusions for “known breaches” (including known liabilities due to COVID-19) by virtue of (i) Buyer’s execution of a “no claims letter” requiring them to certify that they are unaware of any claims at signing, and (ii) explicit subrogation rights in the policy that allow insurers to pursue Sellers in the event of Fraud.

Note that insurers should also take comfort that policies will already exclude coverage for “Interim Breaches”, which is generally defined as a breach in which (i) the facts and circumstances occurred between signing and closing, and (ii) a member of the buyer’s deal team obtained actual knowledge of such breach.

To further guard against COVID-19 exposure, R&W Insurers may expect sellers to have a contractual requirement to notify buyers (and thus the insurers) of any breaches of representations during the interim period (as opposed to allowing buyers to “put their head in the sand”). Buyers and sellers may consider accepting this mechanism in exchange for limited COVID-19 exclusions in the policy.

2. Will the R&W Insurer cover representations specific to COVID-19?

Answer. Likely not. Insurers will likely be wary about covering representations concerning COVID-19 infection levels in the workforce or supply chain. Further, M&A agreement provisions around issues such as determination of a “Material Adverse Effect”, representations around “Absence of Changes” provisions, and interim period operating covenants will undergo increased scrutiny by R&W insurers.

Buyers may have better luck in obtaining broader coverage for liabilities associated with COVID-19 in a simultaneous sign-and-close transaction (where a seller is not required to provide representations for an interim period after signing). However, insurers are unlikely to explicitly cover COVID-19 liabilities until the full impact of the virus is better understood and market confidence in the economy (including consumer demand and supply chain stability) is restored,

3. What is the Impact of COVID-19 on the Diligence and Underwriting Process?

Answer. We have seen insurers add several issues to the list of “heightened diligence areas” that may be prone to exclusions following the due diligence process. For example, insurers will likely pay close attention to businesses that are heavily reliant on the travel industry, international supply or demand chains, and the impact of COVID-19 on customer and employee relationships.

Further, parties should be prepared to face additional underwriting scrutiny in transactions with longer interim periods between signing and closing. Given the extra complexity related to the

coronavirus, consider building in an extra 5-10 business days of diligence and underwriting in order to avoid last-minute exclusions from insurers.

4. What will be the short-term impact of COVID-19 on buyer's use of the R&W insurance product in competitive auction environments?

Answer. It depends.

If the market settles on allowing broad-based exclusions for COVID-19 related Losses (as described in exclusions #1-4 above), use of R&W insurance may decrease significantly. Even with a policy, a buyer facing broad exclusions may feel compelled to insist on a larger indemnity escrow, broad rights of indemnification, and other concessions from the seller. R&W insurance may provide little competitive advantage in that scenario, causing parties to think twice about the premium costs in light of increased uncertainties around the scope of coverage.

However, if coverage exclusions for COVID-19 become increasingly narrow (or disappear altogether), R&W insurance may become even more essential for buyers to win competitive auction processes. Even before the outbreak of COVID-19, bidders in competitive processes relied on R&W insurance policies to (i) increase sellers' up-front cash at closing (by sharply reducing the size of any required indemnity escrow from 10% to .5% of enterprise value, on average) and (ii) decrease sellers' post-closing exposure to indemnification claims. In light of the market turmoil, we expect that buyers' and sellers' pricing expectations will increasingly diverge in the short-term. In the absence of a R&W insurance policy, this pricing mismatch will be sharply exacerbated by any reduction in sellers' closing purchase price for a substantial indemnity escrow held back for 1-2 years (or longer). A seller facing proposals from bidders that do not use R&W insurance will likely have to weigh not only a price reduction (to either enterprise value, to the amount of cash payable at closing, or perhaps both), but also an increase in post-closing indemnification exposure. If another bidder with a similar valuation is using (and relying on) R&W insurance, the seller's choice should be an easy one. In the absence of a competitive proposal with R&W insurance, other sellers may decide to suspend or cancel a sale process altogether in light of already mismatched expectations on valuations.

5. How will COVID-19 impact the long-term competitiveness of the R&W insurance industry?

Answer. Our expectation is that in the long-term, the R&W insurance market will again become competitively bid (in terms of both pricing and scope of coverage). While uncertainties about the public health impacts of COVID-19 and associated economic disruptions may hinder robust competition from R&W insurers in the near future, we expect the industry to adjust as more information about the virus is known, and once more employees (both in the U.S. and elsewhere) return to the workforce. Additionally, once the virus is under control, insurers will likely rely increasingly on thorough diligence and standard exclusions for "known" liabilities to address past COVID-19 liabilities. This may alleviate the need for broad-based exclusions that may disincentivize buyers from using the R&W insurance product.

Additional Questions? Contact a member of the Haynes Boone [Mergers & Acquisitions](#) or [Insurance Recovery](#) Practice Groups at Haynes Boone, including the following individuals.

¹ Note that COVID-19 carve-outs may not be limited to the "Exclusions" section of the R&W Policy. Insured parties should also pay special attention to the definition of "Breach", "Loss" and related areas of the R&W Policy that may have COVID-19 limitations.