COVID-19 Impact on Rep and Warranty Insurance in Private Company M&A

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Over the past 10 years, the use of representations and warranty insurance (RWI) in private company M&A transactions has increased dramatically. From what was originally considered an unusual and quirky option for risk averse parties, to its role as a differentiator for buyers in competitive bidding scenarios for target companies, to its increased usage by strategic (and not just private equity) buyers, and finally through its proliferation into middle market and lower middle market transactions, RWI is seemingly everywhere in private company M&A.

In M&A purchase agreements, a seller makes representations and warranties to the buyer as to the business being acquired, its operations, and its financial position. Those representations and warranties normally survive the closing of the transaction, and have historically been backed by escrowed funds, seller indemnities, offsets against post-closing earnout or other payments, and the like. All of these traditional recourse options reflect direct economic and risk arrangements negotiated between two parties - - the buyer and the seller. And, of course, successful negotiation of those terms has always depended on a number of factors, including market norms and practice and, significantly, a general alignment of risk assessment and allocation acceptance as between buyer and seller.

RWI allows the parties to an M&A transaction to outsource, to a third party, much of the financial risk from the seller's representations and warranties being incorrect. Typically, the buyer procures the policy, but seller side RWI policies are available as well. As the demand for and acceptance of RWI has grown, the market has become increasingly competitive, with top tier insurers and reinsurers entering the space. Premiums have come down (making RWI more cost-effective for lower priced deals), coverage has expanded, and exclusions have narrowed. In this competitive market, policies terms are often subject to negotiation - - within limits.

As a general matter, RWI is intended to insure against unknown events which trigger a breach of a seller's representations and warranties, thereby resulting in financial loss to the buyer. Known risks - - including those disclosed by the seller on disclosure schedules or in due diligence, industry-specific risks, or other risks otherwise identified in the RWI policy - - are usually excluded. The old insurance adage that "you can't insure a burning building" is just as apt when seeking RWI.

As COVID-19 has proliferated throughout the United States, the resulting health-related government actions - - in the form of school and business closures, emergency declarations, shelter in place requirements and the like - - along with "social distancing" and other behavioral adjustments in the consumer population at large continue to have a brutally unprecedented impact on our national economy. Apart from the tragic personal impact the virus has had on families and

their loved ones, there are also, of course, direct financial costs attributable to the public health responses to the outbreak. And there are the wider, more disparate, but clearly growing, economic and social costs which COVID-19 continues to cause, which are not to be underestimated.

Not surprisingly, RWI insurers can be expected to exclude COVID-19-related losses from future RWI coverage as a - - very - - known risk. Similarly, insurers are sharpening their own diligence as to the related risks to the target business from the virus, and are looking carefully at seller reps and warranties which directly or indirectly address COVID-19. As buyers seek greater coverage through seller reps and warranties to cover the virus-related consequences on the target business, and the target's own COVID-19 contingency and other plans, insurers can be expected to resist efforts to have these expanded or new reps included within RWI coverage.

There are a number of different approaches that a RWI insurer may take, within the parameters of a typical M&A agreement, to exclude the consequences of COVID-19 from coverage, including one or more (or potentially all, to get the point across) of the following:

- a broad standalone exclusion from coverage for any losses resulting from or increased by the virus, and its consequences, including government shutdowns and the like;
- an exclusion of any losses resulting from disruptions to the target's supply chain, backlog, customer orders, or other operations attributable to the virus and its effects, including any related force majeure cancellations or performance postponements, labor shortages, etc.;
- exclusions of any seller representations and warranties relating to COVID-19, whether by specific or general reference; and
- "reading in" to the definitional exceptions to material adverse effect or material adverse change, COVID-19 and its consequences, such that they expressly do not trigger a rep breach including a MAE/MAC threshold.

While that general principle - -that COVID-19 is a known situation and as such should be excluded from RWI - - may be logical and acceptable to reasonable minds, as with all things insurance and legal, the devil can be in the details (i.e., the language). Parties looking to use RWI in this environment should, at a minimum, make sure that the exclusionary mechanisms and techniques, including those described above, do not create unintended coverage gaps that would eliminate coverage of risks only tangentially related to the virus and which normally would be considered an unknown risk appropriately covered by RWI.

Policy language should fairly reflect a reasonable nexus between the known risk (COVID-19 and its effects) and the loss borne by the buyer and sought to be excluded by the insurer. Excluding losses "resulting from" or "caused by" (or "directly" caused by) the virus creates a narrower, and more insured-friendly, nexus between loss and exclusion than would result from the use of language such as "arising from," "relating to," "associated with," or of "directly or indirectly" type modifiers. As a related point, parties procuring RWI would benefit by seeking to limit any exclusion to the ***incremental*** losses of requisite nexus, through the use of "to the extent and only to the extent" type qualifiers. In other words, where a loss may be fairly attributable to multiple causes, one of which is COVID-19, the related exclusion should only cover the loss to the extent incrementally caused by the virus, not the entire loss.

Like all businesses, RWI insurers are responding to the impact of COVID-19 and its aftermath on a real-time basis in a fast-moving environment. Ultimately, however, we expect that RWI responses to the virus and its risks will settle into relatively established approaches that will leave insureds with some sense or predictability as well as negotiation room. This is likely to be the case, given the general expectation that the RWI marketplace will remain competitive for private company M&A transactions for the foreseeable future.

[1] Daniel Avery is a Director in the corporate law and M&A practice at Goulston & Storrs, P.C., resident in the firm's D.C. and Boston offices. Gregory Kaden is a Director in the firm's corporate law and M&A practice in Boston.