Coronavirus (COVID-19): Implications for Representations and Warranties Insurance

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The novel coronavirus (COVID-19) has swept across the globe in historic fashion, prompting unprecedented turbulence in the markets and the closure and disruption of numerous businesses in virtually every industry. The ripple effects of the pandemic have already had a considerable impact on ongoing and future mergers and acquisitions as dealmakers scramble to grapple with the new uncertain landscape. In recent years, representations and warranties insurance (RWI) has become an increasingly popular risk allocation tool for M&A transactions, and so buyers and sellers are understandably anxious to get a better grasp of how insurers are responding to the current environment, especially with respect to the possibility of enhanced underwriting scrutiny and new policy exclusions, which may severely limit the desired scope of coverage.

Due Diligence

Buyers should be aware that underwriters are taking a much closer examination of the due diligence reports and memos prepared by the buyer's financial, legal, and other advisors regarding a target company's performance and operations to ensure that any COVID-19-related concerns are satisfactorily addressed. The level of scrutiny will of course depend on the nature of the target's business profile and industry, but underwriters will be particularly concerned about any potential disruptions to a target's supply chain due to the COVID-19 pandemic. Insurers may also focus on the possibility of disruption to the target's workforce (e.g., as a result of any government-mandated closing of the target's facilities or any COVID-19-related effects on employee's health and productivity).

Moreover, insurers will likely be interested to know if COVID-19 has adversely affected the buyer's ability to rigorously conduct its due diligence investigation; for instance, perhaps the buyer is unable to conduct face-to-face meetings with senior management or is unable to visit key operational sites due to restrictions caused by the pandemic. During the course of its underwriting, the insurer will request one or more conference calls with the buyer and its advisors which typically involve discussion and follow-up regarding the business overview of the target, transaction background, due diligence process, and insurance objectives. Buyers should expect to encounter additional detailed questions during such calls, including how the target company has responded to any impact of the COVID-19 pandemic and whether any business interruptions have occurred or are anticipated.

Policy Exclusions

Not surprisingly, insurers have been proposing new policy exclusions related to COVID-19. Such exclusions have varied in scope; in any case, policyholders should always work with their counsel and broker to try to narrow any overly broad language contained in such exclusions as underwriters have shown willingness to accept certain limitations (although they may not be inclined to remove the exclusion entirely). For example, an insurer may propose a COVID-19 exclusion as follows: "Losses relating to business interruption to the extent such interruption relates to the COVID-19 epidemic." A policyholder may attempt to tailor such an exclusion to reflect tighter causal relationship to COVID-19: "Losses resulting from business interruption solely to the extent such interruption results from the COVID-19 epidemic."

Moving forward, buyers and sellers should expect proposed COVID-19-related policy exclusions to become commonplace in the nonbinding indication letters (i.e., term sheets) provided by insurers for new transactions. If the parties in a potential transaction are uncomfortable with any such form of exclusion and thus do not ultimately pursue an RWI policy, we may again see the emergence of more traditional risk allocation mechanisms such as a larger indemnity escrow, an earnout, or a special indemnity to handle such concerns.

The ultimate ramifications of the COVID-19 for the M&A world are still yet to be assessed as it seems the pandemic and its aftermath will play out for at least several more months. For instance, if M&A transaction pace slows or interest in RWI dampens, we may see insurers (at least in the short-term) offering more favorable terms in coverage or perhaps a further decrease in premiums. Finally, dealmakers may also begin to consider other forms of insurance such as business interruption to address COVID-19 (or other future pandemics) as the true intent of RWI is to cover unknown breaches of representations and warranties in transaction agreements.

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