

# COVID-19 and Representation and Warranty Insurance on US M&A Deals: Considerations for Buyers and Sellers

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The COVID-19 outbreak has caused major disruptions in global economies, including merger and acquisition activity. In response to the pandemic, we are seeing changes to the representation and warranty insurance (“RWI”) market. Specifically, RWI insurers are currently proposing certain exclusions from coverage with respect to COVID-19 risk and are requiring buyers to conduct focused diligence regarding the impact of COVID-19 on the target’s business. Market dynamics are fluid and changing on a daily basis, and it remains to be seen (i) whether coverage limitations regarding COVID-19 or broader pandemic risk reflect a temporary change in the market or a long-term trend and (ii) how the current market dynamics will affect short- and long-term utilization of RWI in both distressed and non-distressed M&A transactions.

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## Areas of Heightened Risk and Policy Exceptions

At the front-end of every transaction involving RWI, the insurer will identify certain “heightened” diligence areas that are driven by specific concerns regarding the target or the industry in which it operates. While the insurer will expect the buyer to conduct a customary, thorough diligence process on the target as a whole, it will pay particular attention in its underwriting process to those heightened diligence areas. To the extent that the buyer is unable to diligence those particular areas to the insurer’s satisfaction, the RWI policy will exclude coverage for some or all of the relevant subject areas. Further, any known issues identified in the course of the buyer’s pre-signing diligence, or that arise and are identified between signing and closing, will be excluded from coverage under the RWI policy as a matter of course.

For RWI policies that are being underwritten in today’s environment, insurers are universally flagging the impact of COVID-19 on the target’s business as a heightened area of diligence. The rigor by which RWI insurers will stress-test buyers’ COVID-19 diligence will differ greatly across industries, with those that rely on strained supply chains or that are hampered by “social distancing” efforts receiving a more strenuous review. In addition, insurers are focused on understanding the effects of the pandemic on the target’s customers and employees, as well as the target’s and its counterparties’ ability to perform under existing contracts in light of the current pandemic. For example, insurers may focus on whether “material adverse effect,” force majeure and termination provisions in customer and supplier contracts could potentially excuse performance by the target’s counterparties. Additionally, we expect that insurers will be particularly focused on certain representations in acquisition agreements (and the related disclosure schedules) that are more likely to be impacted by the pandemic—such as representations regarding customer and supplier relationships, accounts receivable, absence of changes to the target’s business, undisclosed liabilities, financial statements adequately presenting the target’s financial condition, employees, compliance with laws and adequacy of insurance—and insurers will expect to see that buyers have tailored their diligence to confirm the accuracy of those representations. Insurers have also focused on how the parties have allocated COVID-19 related risks in the acquisition agreement (either explicitly or implicitly) between

signing and closing and the related closing conditions. Prior to the pandemic, buyers had largely accepted very narrow closing conditions under which they could only terminate in the event of a “Material Adverse Effect” (which itself was narrowly defined). Insurers are particularly sensitive to efforts of the parties to shift this deal risk to the insurers and generally prefer to see the issue explicitly addressed.

In addition to the focus on diligence, we are generally seeing proposed exclusions for coverage for certain COVID-19 related risks even if specific issues arising from COVID-19 are not identified in the buyer's diligence at the time of signing. The breadth of the proposed exclusions is currently changing on a daily basis and varies from insurer to insurer, and we expect to see continued movement in coverage terms as the impact of the pandemic is better understood and there is more deal volume. Currently, some insurers are fully excluding all losses arising from or related to the pandemic, whereas other insurers are willing to consider narrowing (although not necessarily eliminating) the exclusion under certain circumstances based on the nature of the target's business and the results of diligence.

For the most part, these changes have appeared in newly submitted indications of interests, and insurers have not broadly sought to renegotiate their non-binding commitments on existing transactions, perhaps because the insurers recognize the reputational damage that could result.

## **Re-Evaluating the Benefits of RWI Policies in Current Environment**

Prior to the pandemic, in the United States, we had seen a maturation of the RWI market. Specifically, competitive forces driven, in part, by an ever-growing number of RWI insurers led to a vast increase in the use of RWI on private-company transactions, with insured-friendly policy terms, including lower policy retentions (i.e., deductibles) and limited coverage exclusions. With a robust seller-friendly M&A market, buyers became more comfortable relying primarily or exclusively on RWI, which allowed sellers to limit or even eliminate the traditional seller indemnity structure entirely on private company deals.

The growth in usage of RWI policies can be attributed to, among other things, the numerous benefits that accrue to the buyer policyholder, including the following:

- the ability to obtain a larger indemnity (clients can purchase as much insurance as they feel necessary) and a longer survival period than the buyer would otherwise obtain in a traditional seller indemnity construct;
- the elimination of seller post-closing credit/collection risk (e.g., in transactions involving multiple sellers, foreign sellers or insolvent sellers);
- the availability of certain coverage enhancements such as a full materiality scrape and the potential recovery of consequential damages and diminution of value;
- the elimination of the need to consider bringing claims against management sellers; and
- the ability to obtain recourse when no seller indemnity is otherwise possible (e.g., in public company sales, bankruptcy or distressed situations).

Moreover, where the seller's liability for breaches of representations and warranties is limited or eliminated, buyers are often able to negotiate a more comprehensive suite of representations and warranties as compared to a traditional seller indemnity transaction.

With the expected near-term increase in restructuring activity, RWI may continue to increase in popularity in distressed sales as it provides a source of recovery where one may not otherwise be available, particularly in the bankruptcy context where seller indemnities are generally not an option. In distressed transactions outside of a formal bankruptcy process, buyers may understandably be concerned about a seller's ability to stand behind its indemnity obligations, and the use of an RWI policy can serve as a tool to

mitigate credit/collection risk (especially with respect to larger indemnity obligations that may be necessitated by the crisis), notwithstanding any additional uncertainty in coverage terms that COVID-19 related exceptions may introduce.

It remains to be seen how the current market dynamics will affect short- and long-term utilization of RWI in non-distressed M&A transactions. Undoubtedly, RWI will continue to provide the benefits outlined above, which we expect will continue to attract many buyers to use the product as the primary or exclusive source of post-closing indemnity coverage. Nevertheless, the competitive forces driven by a seller-friendly market (where sellers could dictate terms) were also a meaningful factor in certain buyers' using RWI out of necessity. For example, with respect to companies sold in auction processes, bid instruction letters routinely required potential bidders to agree to look solely to a RWI policy for post-closing recourse. To the extent that buyers' leverage increases in the near term, the buyers that reluctantly agreed to use RWI in prior deals may push for a traditional seller indemnity structure backed by a fulsome escrow in future deals, particularly in an environment where broad COVID-19 exclusions and the lack of visibility regarding what may occur between signing and closing may render the buyer's prospects of successful recovery under a RWI policy uncertain. We expect to see more clients conducting a thoughtful analysis to determine whether the numerous benefits of RWI outweigh the enhanced risks of using the product in this market.

## **Necessity of Assessing the RWI Insurer**

We expect that current market conditions may result in an increased number of claims being made under outstanding RWI policies. Anecdotally, we know that certain RWI insurers experienced sizable claims in 2019 that have caused the underwriters (and their investors) to scrutinize their underwriting process, policy pricing and certain of their coverage positions. A meaningful increase in the number of claims may lead to an increased scrutiny of those positions and cause additional stress on the insurers. Some insurers may even exit the market, and unburdened by reputational constraints, focus on limiting the payment of claims. At a minimum, buyers should look to counsel and brokers to help assess creditworthiness and claims history when selecting their insurer.

## **Looking Forward – Post-Pandemic**

With the current state of the US economy and the uncertainty of deal-making in the immediate future, it is impossible to gauge at this early stage what the post-pandemic RWI market will look like, but we have some initial data that is encouraging. Most importantly, RWI insurers are generally well-funded and the RWI market remains competitive, so we expect, post-pandemic, for the RWI coverage to revert to pre-pandemic terms. It is possible that COVID-19 (or more generally pandemic-type concerns) may become a standard stand-alone exclusion, at least under the basic policy terms and perhaps with some layer of protection available for additional premium with risk-sharing between the insurer and insured.

## **Conclusion**

The crisis presented by the COVID-19 pandemic is unprecedented, and we expect continued evolution in the means by which insurers will treat the pandemic through the use of virus-related policy exclusions in the coming weeks. Counsel should ensure that potential policyholders closely scrutinize the impact of COVID-19 on the target's business in their diligence so that they are prepared to negotiate virus-related policy exclusions with their insurers. Further, while we expect that RWI will continue to remain a viable and valuable tool for buyers to utilize in the right circumstances, buyers should critically evaluate the appropriate post-closing recourse structure on a deal-by-deal basis.

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Gibson Dunn's lawyers are available to assist with any questions you may have regarding developments related to the COVID-19 outbreak. For additional information, please contact any member of the firm's Coronavirus (COVID-19) Response Team.

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