

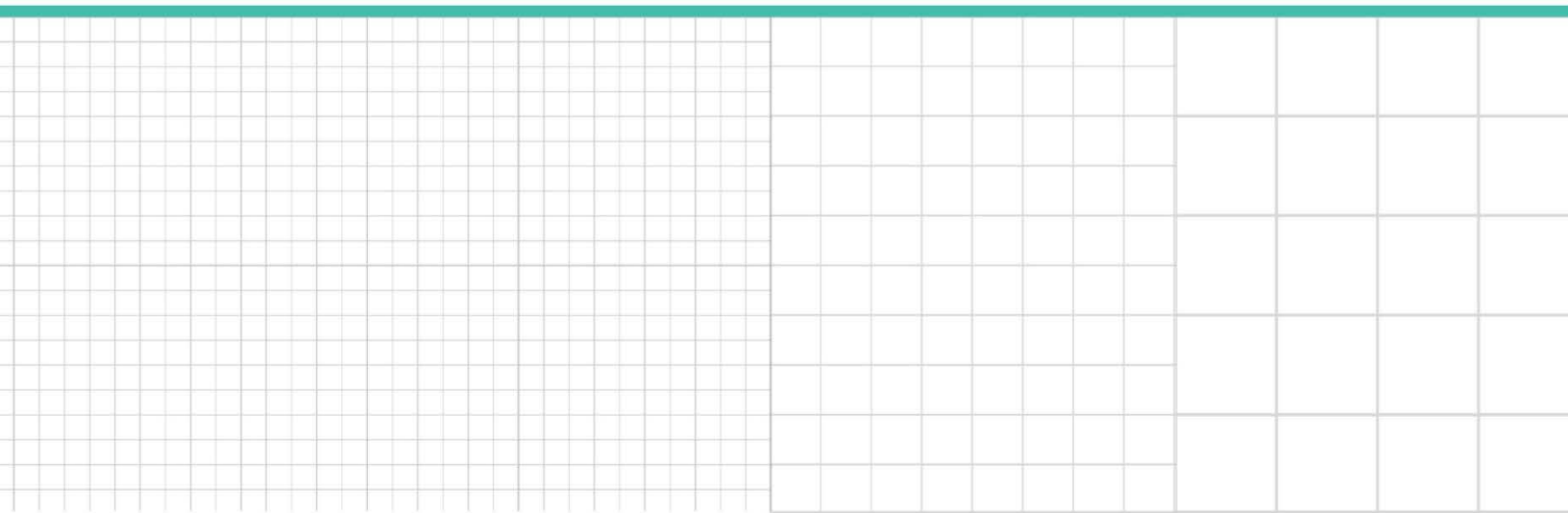


Professional Perspective

RWI Policies in the Coronavirus Era

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RWI Policies in the Coronavirus Era

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The coronavirus pandemic has stressed the deal market in ways not seen since the Great Recession. Seasoned deal professionals who weathered the last economic downturn know the pressure points to consider. However, representation and warranty insurance policies only exploded onto the scene relatively recently. This is the first time practitioners need to consider an economic shock and its interplay with RWI. Deal professionals should consider the current market environment and how it impacts transactions.

When the economic environment is rapidly evolving, it can produce daily, and sometimes hourly, movements in how insurers are thinking about the driving factor, such as the coronavirus pandemic. In this case, deal professionals should maintain close contact with trusted RWI brokers to stay apprised of market evolutions.

Creditworthiness of Insurers

A creditworthy insurer that backstops the representations is fundamental to the value of RWI. It reduces the need for a sizeable escrow or other indemnity collateral. It undermines RWI if insurer creditworthiness is in jeopardy.

During the Great Recession, insurers' exposure to exotic products resulted in concerns about their creditworthiness. Current economic conditions coupled with uncertain claim activity relating to the coronavirus require greater attention to be paid to creditworthiness considerations.

Apart from offshore insurers, insurer creditworthiness has not been a major factor when selecting an RWI insurer. But during unusual times, evaluations of insurer creditworthiness need to be consciously incorporated into the selection process. It is useful to work with an RWI broker who has a deep understanding of the insurance industry and consult with litigators who are monitoring insurance litigation closely. Collectively, deal professionals should consider whether there are developments that might negatively affect one or more of the insurers.

They should stay in contact with the broker and the litigator even when the deal is over. Lawyers understand legislation and litigation; brokers understand insurance and the insurance industry. A collaborative partnership should leverage and pool specialized skills. This will enhance the caliber of knowledge and advice each member of the partnership can offer to clients.

Potential areas that could impact insurer creditworthiness, and which the working group should monitor, include:

Legislative Changes. For instance, there has been discussion about legislation to compel insurers to pay out on business interruption policies, regardless of policy terms.

Claims Activity Related to the Coronavirus. Deal professionals should actively monitor claims activity and potential exposure for insurance companies under a variety of lines of coverage, including with respect to event cancellation, business interruption, workers compensation, and general liability.

Other Exposures. Apart from any exposures insurers may have to COVID-19, practitioners should also keep a watchful eye on other unexpected exposures insurers may have that only come to light in the context of a rapid economic decline (as was the case in the Great Recession).

The Coronavirus Exclusion

While some insurers will require a general coronavirus exclusion, other insurers may approach the issue in a more tailored way. These insurers may exclude coronavirus coverage on specific representations or reject seller attempts to carve coronavirus out of the MAE definition.

At the same time that insurers are excluding coverage for the coronavirus, buyers are evaluating how to protect themselves from coronavirus risk. This may mean pausing transactions. Buyers that are willing to proceed are focusing due diligence on coronavirus-related risks and considering modifications to the transaction documents. Possible coronavirus

modifications to deal terms include tailored closing conditions, detailed representations on coronavirus risks, and greater indemnification protection from sellers.

Before selecting an insurer, buyers need to know whether the insurer is proposing a general coronavirus exclusion, a tailored approach, or no exclusion at all. They should push insurers to provide detailed language and consider it carefully before choosing an insurer.

There is no standard language yet for a general exclusion for all coronavirus-related losses, but the types of coronavirus exclusions we are seeing are problematic. They are often so sweeping that they could give a broad basis for denials of coverage and give rise to disputes. Deal professionals need to identify this problem early in the process. If an insurer with a general coronavirus exclusion is otherwise offering the best policy terms, include a seasoned litigator that handles RWI disputes in the process and take their counsel (this is a good practice generally).

These exclusions are going to create a challenge as insureds try to prove up their damages for a claim. This is because the insured may need to disaggregate damages from a legitimate, covered loss from coronavirus-related losses. Take for example, a common breach of a material customer representation where a seller fails to disclose the loss of a key customer. In that scenario, on what would otherwise be a breach that has nothing to do with the coronavirus, an insurer may be able to rely upon the coronavirus exclusion to argue that the customer's business would have been diminished for coronavirus-related reasons.

If the insurer will take a tailored approach to the coronavirus, deal professionals should understand what the insurer means in detail, focus on whether they will reject a coronavirus carve-out from the MAE definition, and understand the insurer's areas of heightened focus. They should anticipate increased scrutiny on otherwise customary representations, such as the absence-of-changes representation, material contract representations, material customer and suppliers representations, etc. For those representations that have heightened focus, they should be prepared to demonstrate diligence supporting the accuracy of the representations.

Even if the policy is silent on the coronavirus, they should note that an insurer may dispute claims on the basis of buyer knowledge. It is important to carefully focus on this issue and push for policy language that requires actual knowledge of a specific representation breach and places the burden of proof on the insurer if it raises this defense.

If a buyer wants a closing condition related to the coronavirus, deal professionals should consider interactions with RWI. If there is a general exclusion, the buyer should be able to waive COVID-19 closing conditions without needing the insurer's consent. In other situations, waiver of the condition may require insurer consent (or risk the policy).

In general, buy-side advisers need to set client expectations on RWI at an early stage. Both buyers and insurers want protection from coronavirus risks. If post-closing protection from coronavirus risk is critical to the client, buyers should consider negotiating for indemnity and collateral support from the seller.

Pending Transactions

Some pending transactions were signed prior to the coronavirus outbreak (or, in other cases, before the ramifications were better understood). Obviously, these policies do not have coronavirus exclusions. The coronavirus may put pressure on the willingness of buyers and lenders to close into pending transactions, but what behavior should we expect from insurers on these policies?

We have not seen insurers attempt to void bound policies on pending transactions. We do, however, expect the coronavirus to change the nature of the pre-closing bring-down calls with the insurer. These calls will likely include a rigorous discussion on coronavirus impacts to the target business and what work the buyer has done to assess the risk.

Insurers may push buyers to include coronavirus-related disclosures in their no-claims certificates. A buyer should consult with a seasoned M&A litigator before agreeing to include any such language in the no-claims certificate.

If a buyer resists including a disclosure in its no claims certificate, deal professionals should be prepared for insurers to raise the "interim breach" exclusion as a defense to claims (i.e., buyer became aware of a breach between signing, the clean no-claims certificate contained material inaccuracies, and the loss is not covered).

Distressed Transactions

Even with a massive fiscal stimulus, many observers expect an uptick in distressed M&A. Acquisitions out of bankruptcy may once again become commonplace. Even though bankruptcy tends to cut off significant historical liability, this is not analytically different from a traditional asset deal.

RWI is often obtained for asset deals because the representation package provides protection that goes beyond historical liabilities. Distressed investors and bankruptcy lawyers may not have the same experience with RWI as M&A deal professionals. RWI has a use in the bankruptcy M&A context and should be presented as an option to clients.

Conclusion

The stability of the last decade has quickly morphed into volatility and uncertainty. This requires deal professionals to proactively consider how to safeguard their clients. Although it is always important to form collaborative professional relationships that extend beyond a revenue opportunity, it is critical today.

Lawyers and RWI brokers, working together to stay abreast of the evolving landscape, can better serve their clients than when they go it alone. By pooling knowledge, expertise and creativity, deal professionals can help guide the M&A market toward solutions to coronavirus risks and play an important role in returning to economic growth and helping reclaim a bit of normalcy in daily life.