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COVID-19 Exclusions in Representation and Warranty Insurance Policies for M&A Transactions



In response to the rapidly changing and unpredictable business environment resulting from the novel coronavirus (COVID-19) outbreak, underwriters of representation and warranty insurance (RWI) policies are introducing broad exclusions from business interruption or business downturn losses arising out of or relating to COVID-19, and in some cases, any related government or regulatory response.

Although it is unlikely that parties obtaining these policies can avoid COVID-19 exclusions altogether (RWI policies commonly exclude known risks), they are negotiable and should be appropriately tailored to limit the scope of the exclusion. Rather than encompassing any losses that may later be construed to relate in any way to COVID-19 and its far-reaching impacts, the scope of the exclusion should be limited to business interruption and downturn losses solely to the extent resulting from COVID-19 and ideally based on a risk specifically identified prior to binding the policy.

Broad Applicability of Proposed Exclusion

An exclusion for losses "*arising from or relating to any business interruption or business downturn arising out of COVID-19*" could be read as allowing the insurance company to avoid coverage if it can show that the circumstances underlying the breach of an otherwise covered representation and warranty had anything to do with COVID-19. Limiting the exclusion to losses "*resulting from any business interruption or business downturn arising out of COVID-19*" would increase the burden on the insurer to show that the loss was directly caused by COVID-19, but still may not be enough to afford buyers the protection they are looking for under the RWI policy.

Take, for example, a representation by a seller that, to its knowledge, no third party has materially breached a material contract, when in fact the seller's sole supplier of a component necessary to manufacture the seller's product has failed to deliver several shipments of the necessary component. As a result, after the closing, the

seller is unable to fulfill orders for its customers. The supplier did not deliver the shipments because it had to shut down its factory due to COVID-19 concerns. A broad exclusion for losses arising out of or relating to COVID-19 could preclude the buyer from recovering under its RWI policy because the business interruption that the buyer experienced arguably resulted from COVID-19.

Limiting the Scope and Impact of the Exclusion

The COVID-19 exclusion should, like any other RWI exclusion, have limited application to circumstances in which it is a known risk (i.e., representations and warranties for which the seller has disclosed the impact of COVID-19 as an exception), and, in the event not already covered by application to seller disclosure, forward-looking representations and warranties (representations and warranties for which the impact of COVID-19 may not yet be apparent).

That said, these exclusions are new, and the likelihood is that insurers will be unwilling to deviate much from a broad exception until they have a better handle on how COVID-19 claims will play out. At the very least, the COVID-19 exclusion should be limited to losses actually resulting from COVID-19.

In addition, the policyholder should seek express language in the policy that the COVID-19 exclusion (and, indeed, any exclusion) applies only to that portion of the loss that falls within the exclusion, and the remainder of any loss shall remain covered ("solely to the extent such business interruption or other business downturn results from COVID-19").

Takeaways

Even with some narrowing of the exception, buyers may not receive the same protection previously provided under these policies and may find themselves in disputes regarding whether, and the extent to which, a loss was caused by COVID-19. In the absence of insurance protection for COVID-19 losses, parties should consider whether additional representations and warranties, special indemnities, or other risk allocation provisions should be used to address this risk.

Parties to transactions relying on RWI policies are encouraged to seek advice from trusted counsel regarding the scope of policy coverage and exclusions.

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