

Lawyer Insights

Representations and Warranties Insurance Claims & COVID-19

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Much has been written about COVID-19 and business interruption coverage under property insurance policies. COVID-related issues will likely arise for other insurance policies too, including representations and warranties (R&W) coverage. In particular, R&W insurers may rely on COVID to try to diminish policyholders' damages.

Generally speaking, R&W insurance covers a policyholder's damages arising out of a breach of a representation or warranty made in a corporate transaction. One potential area for disagreement between insurers and policyholders is whether and to what extent the claimed damages actually arose out of the breach. Insurers may attempt to introduce an additional wrinkle into that kind of dispute to avoid or reduce coverage by arguing that the damages resulted from COVID's impact on the business, not the breach.

Take, for example, a deal that closed in early 2020. Assume that in the following months, the buyer discovers that the seller breached a representation related to the acquired company's agreements with a key employee responsible for a large customer contract. Such a breach could lend itself to damages based on the post-deal downturn in the company's performance. For instance, if the employee left the company, joined a rival company, and convinced the large customer to contract with the rival company, a policyholder could claim damages in the amount of business it would have gotten from that now ex-customer.

When a buyer turns to its R&W insurer, that insurer may challenge these kinds of damages by claiming that most or all of the buyer's damages resulted from a COVID-caused economic downturn. That is, the insurer might argue that the reduced sales caused by the loss of a crucial customer would have been the same or similar in light of effects of COVID on the economy generally. Insurers may make similar claims for any breach of a representation related to the company's ongoing performance, like representations related to customer contracts to buy products, the condition of a key asset, or the status of inventory. Policyholders should have a few responses available to rebut those sorts of arguments.

First, policyholders can explore establishing their damages by determining the value of the company acquired versus what was paid. After all, the representation or warranty generally reflects the selling company's promises about the company as of the day of the closing. In other words, a representation is usually a snapshot in time on the day of the closing; if a representation has been breached and the buyer damaged as a result, damage happens on that day.

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For instance, if the buyer valued the acquired business based on a multiple of EBITDA, it can recalculate EBITDA had it known about the true state of affairs and then determine how much the business was actually worth based on the same multiple. (In some instances, it may also be appropriate to change the multiple used if the multiple depended on the misrepresented information.) Calculating damages this way should eliminate disputes related to how the business would have performed after the corporate transaction. And thus, it would eliminate any reliance on alleged post-transaction effects of COVID on the business.

Second, if a policyholder does not quantify damages in the manner above, they should, as always, closely study the relevant provisions in the deal document and the insurance policy. Those provisions may not allow for insurers to try to avoid damages based on COVID-related arguments. For example, the R&W policy or the corporate agreement (which can be incorporated into the policy) may contain provisions that support that external issues—like any general economic downturn caused by a pandemic—should not be considered in calculating damages resulting from a breach.

Third, policyholders should not concede that an alternative, hypothetical explanation for damages would bar coverage. Other insurance policies—like property coverage—contain explicit provisions addressing similar causation issues that identify when coverage is and is not available when there is more than one potential cause of the damage and one cause is not covered. One example is “We do not insure for loss caused directly or indirectly by any of the following. Such loss is excluded regardless of any other cause or event contributing concurrently or in any sequence to the loss.” The absence of any such provisions in an R&W policy should benefit the policyholder.

Finally, businesses should keep these potential issues in mind when negotiating their corporate deals and R&W policies. Considering and addressing these issues when the contracts are formed can help minimize disputes if a claim later arises.

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