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Knowledge Exclusions in W&I Policies: Actual, Imputed and Constructive Knowledge – A Practical Case Study

It is generally accepted that a standard Warranty & Indemnity (W&I) insurance policy only covers so-called "unknown liabilities," i.e. liabilities that could not reasonably be foreseen at the time of executing the SPA.

Equally well established is that risks and liabilities disclosed to the buyer and its advisers during the due diligence process must be addressed in the SPA itself, typically through a specific warranty or a retention from the purchase price. Such liabilities are generally excluded from W&I coverage unless specific risk insurance is arranged.

This principle is often reinforced in buyer-side W&I policies through exclusions where a matter was known to members of the buyer's deal team. The purpose is to exclude from cover any issue the buyer had the opportunity to consider during due diligence.

However, knowledge exclusions are frequently drafted in vague terms, leaving room for divergent interpretations, particularly in relation to so-called "known unknowns."

"Known unknown risks" are identified risks, i.e., uncertain outcomes of future events of which the buyer has general awareness of but cannot fully assess.

A recent example impacting the Italian W&I market arose from the so-called "pay-back" regime. Law No. 125/2015 (the Pay-Back Law) introduced a cooperation mechanism under which, if public healthcare facilities exceed their budgets for the purchase of medical devices, the pharmaceutical companies that supplied those devices must reimburse a portion of the amounts received. Implementation required the public administration to issue annual measures setting expenditure limits and confirming any overspending.

Pending such measures, certain pharmaceutical industry associations circulated handbooks advising members on how to approach potential pay-back obligations – for example, suggesting not to record them in financial statements given the uncertainty around quantum and timing.

In this context, several pharmaceutical companies heavily engaged with the public healthcare sector became M&A targets. The potential pay-back exposure was often overlooked in due diligence: although management was aware of the possible liability, it could neither quantify nor forecast it. The issue was treated as a matter of public knowledge and left unaddressed.

Post-completion, however, certain targets were required to reimburse substantial sums to their public clients.

W&I insurers were asked to respond under undisclosed liability warranties, accuracy of information warranties, and, in some cases, financial statement warranties.

In assessing coverage, insurers examined the knowledge exclusion relating to the buyer's deal team.

While the widespread industry debate around the Pay-Back Law provided strong grounds for imputed knowledge – amounting to circumstantial evidence that "*the buyer must have known*" – many buyers, particularly investment funds with no direct involvement in the pharmaceutical sector, argued they lacked actual knowledge of the issue.

The outcome turned on whether "knowledge" was left undefined in the SPA and the policy, or whether constructive knowledge was expressly excluded.

Constructive knowledge is knowledge attributed by law irrespective of actual awareness. A typical example is knowledge of the law itself, which all parties are presumed to have. Thus, unless the knowledge exclusion carved out constructive knowledge, a buyer could not argue that the seller failed to disclose the Pay-Back Law.

Conversely, if constructive knowledge was expressly excluded, the question became whether the seller had specifically disclosed the potential liability under the Pay-Back regime.

The Pay-Back case highlights the critical importance of how "knowledge" is defined in SPAs and W&I policies. Whether actual, imputed, or constructive, the scope of knowledge attributed to the buyer can decisively shape coverage outcomes – particularly when dealing with systemic or regulatory risks treated as matters of "public knowledge."

We are aware that the market is increasingly moving towards a broad interpretation of "knowledge," requiring not only awareness of the underlying fact but also disclosure of the related issues and risks. In this context, it is important that contractual clauses are aligned with this evolving underwriting approach.

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