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APRIL 2018

# REPRESENTATION AND WARRANTY INSURANCE IN ENERGY M&A: AN OLD PRODUCT GETS A NEW LOOK

*Energy Series*

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## ENERGY SERIES

Seminars & Continuing Legal Education Programs

**#MeToo in the Energy Industry**

**Thursday, April 26, 2018**

Speakers: Christopher Bacon; S. Grace Ho

**Simplifications, Roll-Ups and Corporate Conversions**

**Wednesday, June 13, 2018**

Speakers: Ryan Carney; Ramey Layne; David Oelman

# TODAY'S PANEL



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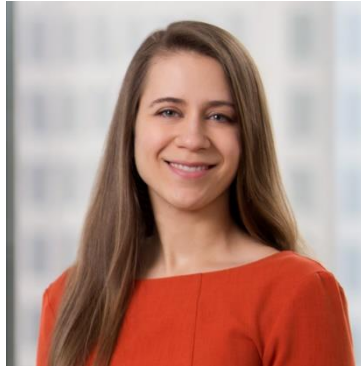


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# DISCUSSION OUTLINE

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I. Basics of R&W Insurance

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II. Increasing Use of R&W Insurance in Deals

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III. Underwriting and Due Diligence Process

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IV. Drafting Considerations in M&A Agreements

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V. Anatomy of a R&W Claim

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# **BASICS OF R&W INSURANCE**

## R&W INSURANCE 101

### WHAT IS R&W INSURANCE?

- Provides insurance coverage for claims a buyer may have for losses resulting from a breach of a representation and warranty made by a seller in an acquisition agreement
- Use has increased substantially in the past several years:
  - Product is more familiar in the marketplace
  - Premiums have become lower
  - Terms have become more friendly to the parties making claims
  - Underwriting process has become more efficient
- Use in midstream/OFS transactions has increased significantly in the past 24 months
- Insurers may begin to offer R&W insurance for upstream transactions

## R&W INSURANCE 101

### WHY DO SELLERS LIKE IT?

- Lowers the cap on a seller's post-closing exposure
- Allows more sale proceeds to be distributed rather than placed into escrow or held to secure buyer claims
- Facilitates a “cleaner” break post-closing
- Expedites the sale process by minimizing negotiations of acquisition agreement

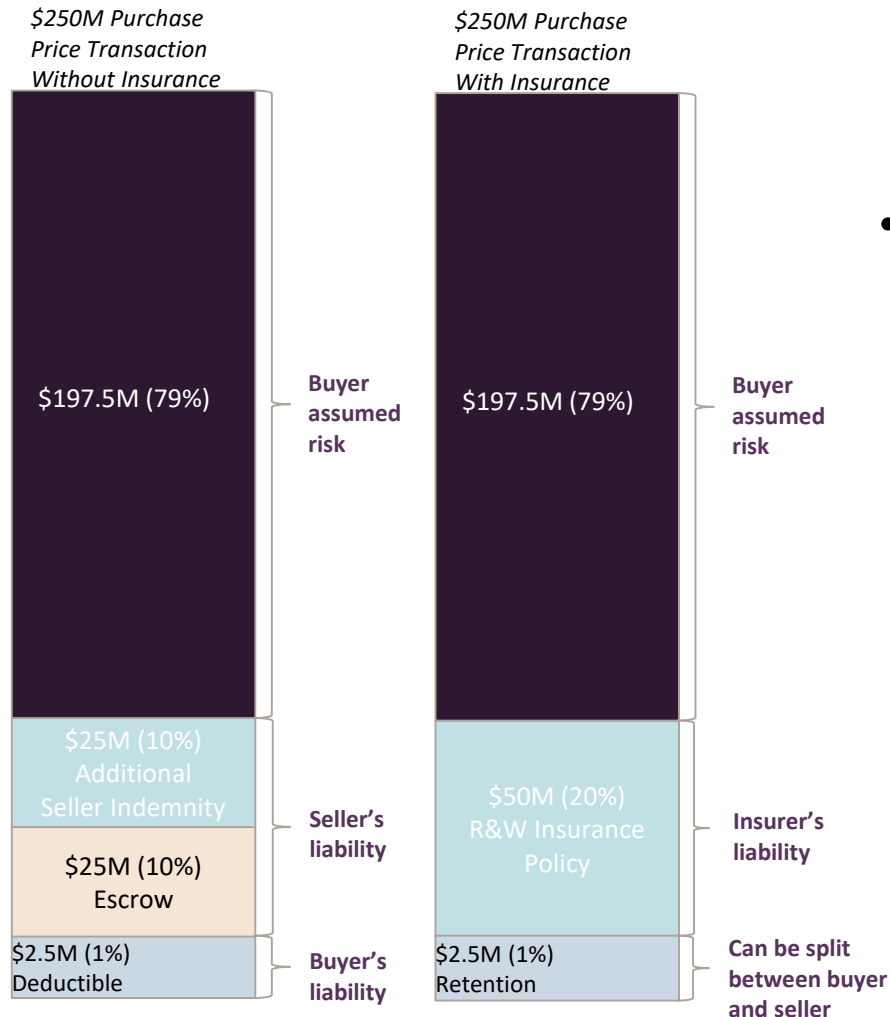
## R&W INSURANCE 101

### WHY DO BUYERS LIKE IT?

- Makes an offer more attractive and/or distinguishes a bid in a competitive auction by permitting a more limited indemnification package to be offered
- Increases the scope of indemnification that may be available under the acquisition agreement
- Extends the duration of the representation and warranty survival periods
- May provide a more secure or reliable source of recovery post-closing
- Avoids challenging dynamics when the seller and buyer need to maintain a positive relationship post-closing

# R&W INSURANCE 101

## INDEMNIFICATION BEFORE AND AFTER USE OF R&W INSURANCE



- **Hypothetical M&A deal**
  - PE seller
  - \$250 million purchase price
  - Buyer-side R&W policy
  - \$1.5 million premium cost (3%)
  - \$50 million coverage (20%)
  - 3 year term / 6 year term for fundamental representations and tax

# R&W INSURANCE 101

## COSTS OF POLICY AND KEY MARKET CONSIDERATIONS

### Coverage Limits

Buyers generally purchase limits representing 10-20% of unadjusted purchase price; sometimes Buyers place primary and excess policies

### Cost of Coverage

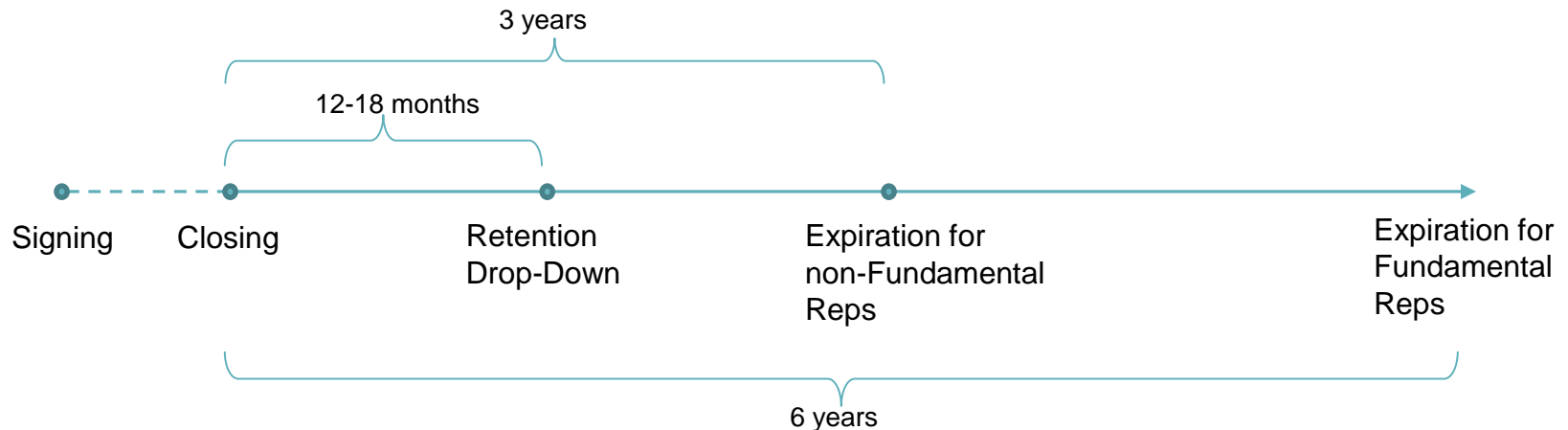
Premium is usually 2.5% to 4% of the policy limit; total costs will include additional underwriting fee (usually \$25,000 - \$60,000), taxes, and broker placement fee

### Retention / Deductible

Retentions on R&W policies are typically between 1% and 1.5% of unadjusted purchase price and normally drop down to 0.5% of unadjusted purchase price at 12- or 18-month anniversary of closing; typically split 50/50 between buyer and seller, but NSI (No Seller Indemnity) deals are becoming more common

## R&W INSURANCE 101

### “LOSS REPORTED” FORM WITH AN AGGREGATE LIMIT AND RETENTION



- Trigger of coverage: “Loss” in excess of the applicable retention reported during the policy period (or grace period)
- Retention usually drops 50% 12-18 months following Closing
- Policy period is usually 3 years for non-Fundamental Reps and 6 years for Fundamental Reps

## Examples of “Loss” Definitions in R&W Policies

- “Loss” means the amount to which the Insureds are contractually entitled in respect of a Breach pursuant to the terms of the Acquisition Agreement . . .
- “Loss” means the aggregate amount of any losses, liabilities, claims, damages, penalties, fines, judgments, awards, settlements, costs, fees and expenses incurred by any Insured for or in respect of (A) a Breach, or (B) a Third Party Demand based upon, arising from, or attributable to an actual or alleged Breach . . .

Some R&W policies are tied to the indemnification provisions of the acquisition agreement (i.e., buyer must be contractually entitled to recovery due to a breach), but some are not – these are tied only to a “Breach,” without regard to the acquisition agreement’s indemnification provisions.

## R&W INSURANCE 101

### FIRST PARTY AND THIRD PARTY COVERAGE

#### First Party Coverage

- Covers the insured for its own losses directly
- Example: financial statement rep breach is discovered post-closing; buyer determines that it overpaid for the target and makes a claim on the R&W policy for “Loss” due to the breach of the financial statement rep

#### Third Party Coverage

- Covers the insured (including the target, post-closing) for third party claims against it
- Example: post-closing, target is sued by numerous plaintiffs alleging violations of law pre-closing; buyer makes a claim on the R&W policy for “Loss” due to a “Third Party Demand” arising from, if the allegations are true, a breach of the compliance with laws rep

## R&W INSURANCE 101

### OTHER KEY POLICY PROVISIONS

- Exclusions
  - Generally excludes known issues, pension underfunding, including withdrawal liability, asbestos/PCBs, uninsurable fines and penalties, net operating losses and other deferred tax assets
- Subrogation
  - Limited to fraud
- Interim Breaches
  - Some carriers may provide limited coverage for policies bound at signing – but will exclude matters that become known to the buyer during the interim period and relate to events first arising during the interim period

## R&W INSURANCE 101

### ENERGY M&A CONCERNS

- Environmental reps
  - Deal by deal basis, but can be covered in energy deals
  - If covered, heightened area of diligence focus
  - Coverage sometimes specifically excess of existing environmental policies
- Tax reps and pre-closing tax indemnity
  - Coverage for 6 years except for (i) any matters disclosed in the disclosure schedules (ii) any item which was accounted or reserved for in the books and records of the Company and its Subsidiaries or pursuant to the working capital adjustment mechanism and (iii) transfer taxes.
- Title reps
  - Challenges in upstream deals

# **INCREASING USE OF R&W INSURANCE IN DEALS**

# INCREASING USE OF R&W INSURANCE IN DEALS

## SIGNIFICANT GROWTH IN NORTH AMERICA IN LAST 7 YEARS

### 2017

- \$8.83 billion in limits / 303 closed deals

### 2016

- \$6.03 billion in limits / 212 closed deals

### 2015

- \$4.26 billion in limits / 159 closed deals

### 2014

- \$2.73 billion in limits / 130 closed deals

### 2013

- \$1.34 billion in limits / 66 closed deals

### 2012

- \$1.43 billion in limits / 51 closed deals

### 2011

- \$767 million in limits / 45 closed deals

### 2010

- \$387 million in limits / 25 closed deals

### North America Market Statistics for Marsh only



# INCREASING USE OF R&W INSURANCE IN DEALS

## GLOBAL STATISTICS

The transactional risk insurance market has continued to evolve in recent years and can provide more innovative insurance solutions than ever.

### Global Market Statistics for 2017 (Marsh only)

The market now offers:

- Broader coverage
- Streamlined process
- Increased limits of liability
- Reduced premium rates and deductible levels

Marsh has an estimated 25% global market share

US\$	AMERICAS	EMEA	ASIA PACIFIC	TOTAL
Limits of insurance placed (\$)	8,830,000,000	8,120,000,000	2,970,000,000	19,920,000,000
No. of policies placed	406	224	105	735
Private equity policies (as % of policies placed)	50%	56%	34%	50%
Corporate policies (as % of policies placed)	50%	44%	66%	50%
Seller-side R&W policies (as % of R&W policies placed)	2%	7%	9%	4%
Buyer-side R&W policies (as % of R&W policies placed)	98%	93%	91%	96%

# **UNDERWRITING & DUE DILIGENCE PROCESS**

# UNDERWRITING PROCESS

## Days 1 – 2

Engage broker (earlier in the process is better)  
Broker and potential underwriters execute NDAs

**Note:** Insurers need to understand exclusivity arrangements on transaction (or lack thereof) – timing / financial impact on process

## Days 3 – 6

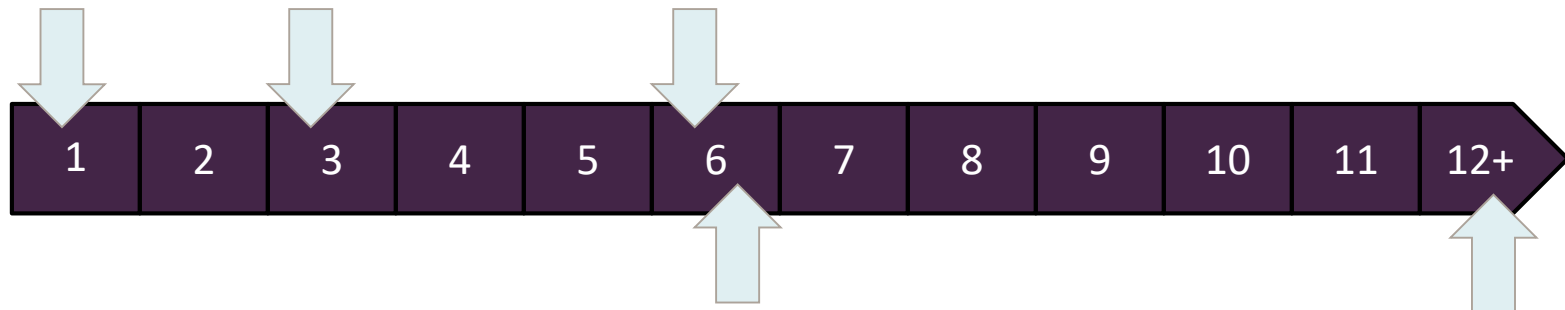
Obtain quotes from underwriters

- In order to get quotes, we'd need recent draft acquisition agreement, information memorandum and target's financials
- No cost to obtain quotes

## Day 6

Select underwriter

- Broker to discuss pros and cons of proposals
- Insurer diligence fee become payable upon entering underwriting (\$25K – \$60K)



## Days 6 to 12+

Underwriting of policy

- Underwriter to gain access to data room and legal, financial, tax and other diligence reports (subject to non-reliance letters)
- Conference call with deal team and advisors

Policy negotiations

- Done in parallel with underwriting; outside counsel typically involved

## DUE DILIGENCE

### DUE DILIGENCE PROCESS

- Initial due diligence questionnaire submitted by insurer
- Request to review acquisition agreement and all ancillary agreements
- Request to review due diligence reports prepared by buyer's attorneys, accountants and advisors
  - Non-reliance letters/attorney-client privilege
- Request to review target financial statements
- Supplemental due diligence questions
- Telephone discussions facilitated by broker

# **DRAFTING CONSIDERATIONS IN M&A AGREEMENTS**

## DRAFTING CONSIDERATIONS IN M&A AGREEMENTS

### GENERAL

- No established practice for how to incorporate R&W insurance provisions into the acquisition agreement
- Insurers do not typically provide “standard” language to include but will want to review the acquisition agreement
- Objective is to reflect the R&W insurance as the replacement for the seller as a source of indemnification to the extent negotiated between the seller and the buyer

# DRAFTING CONSIDERATIONS IN M&A AGREEMENTS

## KEY TERMS

- Losses/Damages
  - Consequential damages
- Knowledge
  - Seller/Buyer
- Materiality scrape
- Closing Condition
- Covenants (if not bound at signing)
- Indemnification/Sole Remedy
- Escrow
- Costs

# **ANATOMY OF A R&W CLAIM**

## ANATOMY OF A R&W CLAIM NOTICE

- Notice must be provided within policy period or grace period, if applicable
- Notice may be of:
  - Breach of representation or warranty
  - Third party demand (where allegations, if true, would mean that a breach occurred)
  - Facts or circumstances reasonably likely to result in determination that breach has occurred
- Form of notice may be specified by the policy
- Work with your broker and outside counsel to assure compliance with policy conditions

## ANATOMY OF A R&W CLAIM

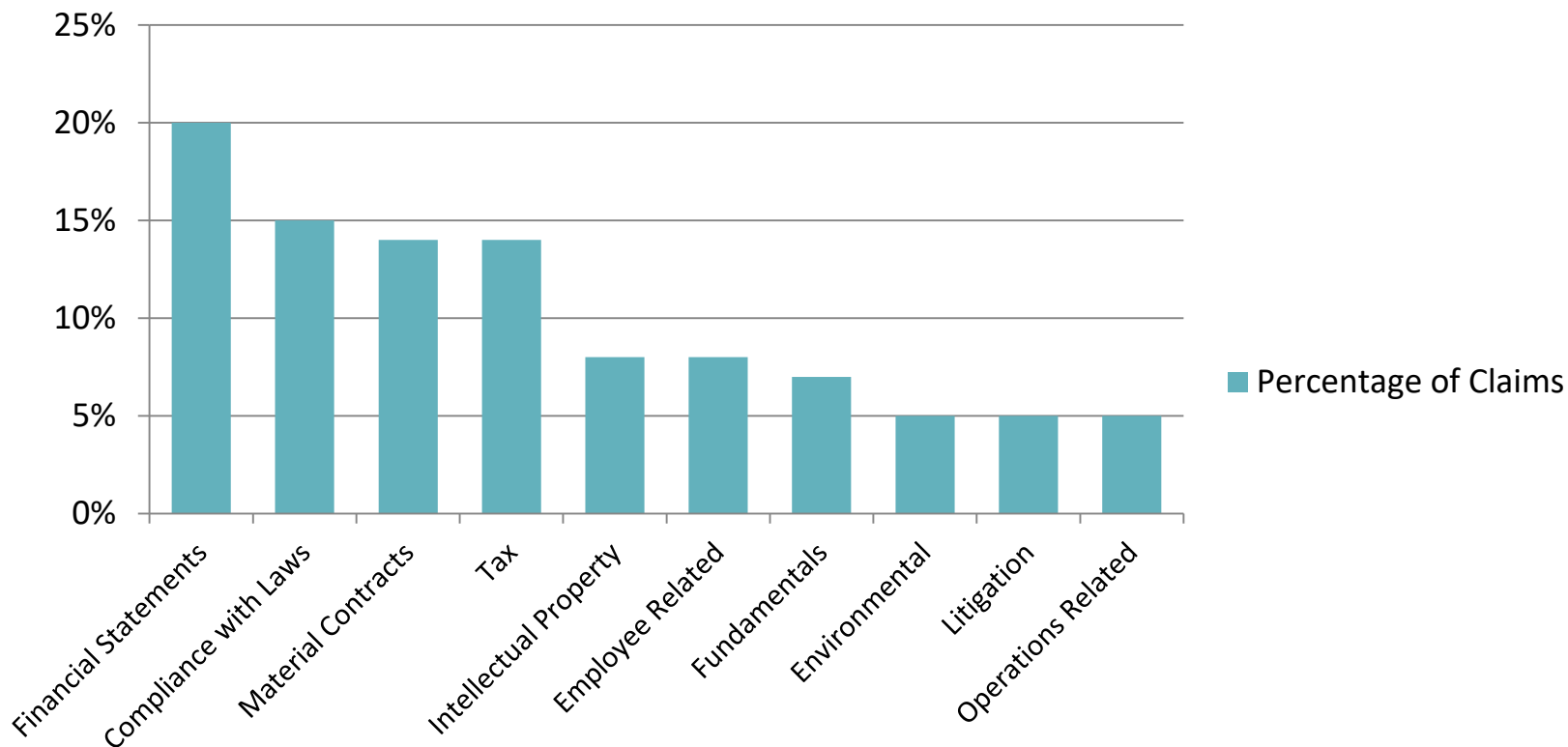
### INITIAL COVERAGE RESPONSE AND NEXT STEPS

- Initial coverage response (usually due in 60 days):
  - Acceptance (rare first step)
  - Investigation (most common first step)
  - Denial (rare first step, but does happen)
- What to expect during the coverage investigation
  - Insurer may reserve rights on coverage issues
  - Insurer may retain forensic accountants
- What if there are coverage issues?
- Is it better or worse than pursuing a seller for breach of reps and warranties?

## ANATOMY OF A R&W CLAIM

### FREQUENTLY MADE CLAIMS

**Representations relating to financial statements, compliance with laws, material contracts and taxes are the most frequently alleged to have been breached.**



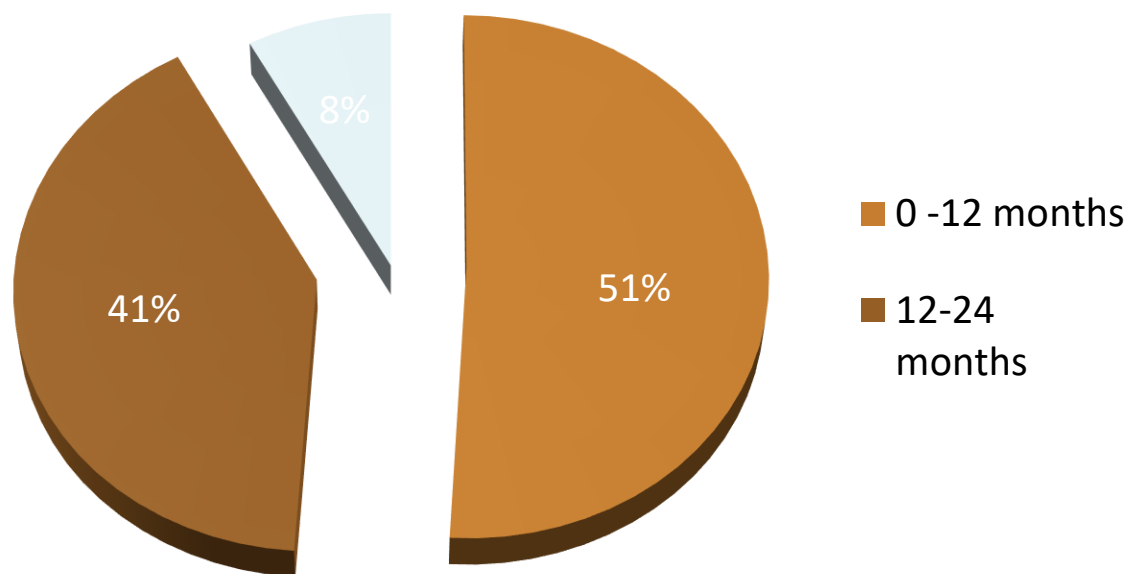
Source: AIG's Representations and Warranties Insurance Global Claims Study Covering 2011 to 2015

## ANATOMY OF A R&W CLAIM

### TIMING OF CLAIMS

More than half of all claim notices are received within the first 12 months of the policy's issuance

### Time Lapse Between Closing and Timing of Claim



Source: AIG's Representations and Warranties Insurance Global Claims Study Covering 2011 to 2015

# ANATOMY OF A R&W CLAIM

## CLAIMS PAYING EXPERIENCE

### Asahi

- Related to Asahi's 2011 acquisition of Pacific Equity Partners and Unitas – \$180M paid by insurers

### Lixil

- Related to Lixil's 2013 acquisition of Grohe Group – €360M claim

### Anecdotal

- AIG paid three claims in excess of \$20 million in 2014 for financial statements related breaches and over \$100 million for R&WI related claims around the world
- Concord investigated the magnitude of the damages (including the degree to which future EBITDA would be adversely affected) and amicably resolved a claim using a multiple-based calculation amounting to approximately \$7.5 million above the applicable retention amount, which was then promptly paid

### Ageas v. Kwik-Fit

- Breach of financial statement rep with two aspects of bad debt reserves being inaccurate. There was a coverage dispute over the calculation of covered Loss. Ultimately, consequential damages were covered (i.e., coverage for amount that insured overpaid based upon inaccurate information/breached rep).

# QUESTIONS?



# **SPEAKER BIOGRAPHIES**

# CAROLINE BLITZER PHILLIPS – V&E



**CAROLINE BLITZER PHILLIPS**  
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## Education

- Louisiana State University Law Center, J.D., 1996 (Valedictorian; Order of the Coif; Phi Kappa Phi; Articles Editor, *Louisiana Law Review*)
- Duke University, A.B. *with honors*, 1993
- Admitted to practice: New York; Texas; Louisiana

## Activities

- Board of Trustees: LSU John P. Laborde Energy Law Center

Caroline advises clients in mergers and acquisitions, private equity investments, and general corporate and securities matters. She has substantial experience with clients throughout the energy industry, including oil and gas exploration and production, transportation and midstream, power, oilfield services, coal, and renewables and clean energy.

## Experience Highlights

- Morgan Stanley Energy Partners in its acquisition of Specialized Desanders, an oilfield services company
- Enviva JV Development Company in its acquisition of the Colombo Energy pellet plant
- Enviva Development Holdings in its joint venture with affiliates of The John Hancock Life Insurance Company
- Enviva Wilmington Holdings in various contribution transactions with Enviva Partners, LP
- Penn Virginia Resource Partners in its \$1 billion acquisition of energy pipeline company Chief Gathering
- Buckeye Partners in the \$1.7 billion acquisition of Bahamas Oil Refining Company from First Reserve and Vopak
- Buckeye Partners in its acquisition of the Yabucoa, Puerto Rico refined petroleum products terminal from Shell
- Warburg Pincus in its acquisition and subsequent sale of its interest in APT Generation, a portfolio of three electric generating plants
- Tenaska Capital Management in its acquisition of the New Covert natural gas-fired power generation facility
- Natural Resource Partners in its \$205 million acquisition of VantaCore
- Natural Resource Partners in the \$310 million acquisition, and related debt and equity financing, of interests in OCI Wyoming from Anadarko Petroleum Corporation
- Morgan Stanley Capital Partners in its equity investment in Sterling Investment Holdings, a natural gas gathering and processing company
- Warburg Pincus in its line of equity commitments to domestic and international exploration and production companies (Latigo Petroleum, Laredo Petroleum, Canbriam Energy, Kosmos Energy and Broad Oak Energy), as well as in Competitive Power Ventures Holdings, a power industry development and asset manager
- A private equity fund in the \$343 acquisition of an asphalt terminal and storage company
- Morgan Stanley Private Equity in its acquisition of the Trinity CO2 pipeline and supply companies
- American Infrastructure MLP Fund in its equity investments in United Bridge Holdings and StoneMor Partners

# SARAH H. MITCHELL – V&E



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## Education

- Harvard Law School, J.D., 2008 (Staff, Journal of Law and Gender)
- Vanderbilt University, B.A., Spanish, Honors in the College of Arts and Sciences, *magna cum laude*, 2005 (Phi Beta Kappa)
- Other Language: proficient in Spanish

## Activities

- Member: Dallas Bar Association, Torts and Insurance Practice Section; State Bar of Texas, Insurance Law Section

Sarah is a member of the firm's Litigation group. Her practice focuses primarily on representing policyholders with respect to insurance coverage matters. Sarah represents policyholders on claims under various lines of insurance and routinely advises policyholders on the insurance aspects of corporate transactions and ways to enhance coverage in connection with policy placements and policy renewals.

## Experience Highlights

- Representing energy company in claim under directors and officers liability insurance policies involving "related Wrongful Acts" issues
- Representing an energy company in claims arising from EPA claims and third-party claims under commercial general liability and pollution policies
- Representing an energy company in claims arising from an oil spill under commercial general liability policies
- Represented a chemical manufacturing company in a dispute against a property insurer and an insurance broker seeking recovery for losses from a fire
- Acted for Teva Pharmaceuticals in a suite of 10 ad-hoc arbitrations (London Seat) concerning a denial of coverage in a pharmaceutical-related insurance policy tower
- Advised a communications company regarding insurance coverage under commercial general liability, and directors and officers liability policies, in connection with a business tort, Lanham Act, and antitrust lawsuit
- Advises private equity firms regarding directors and officers liability insurance policies in connection with IPOs of portfolio companies
- Assisted in the representation of a buyer in post-acquisition litigation regarding terms of the acquisition agreement
- Representing multiple clients in connection with claims arising from shareholder activism under directors and officers liability insurance policies
- Representing multiple clients in connection with claims arising from government investigations under directors and officers and errors and omissions liability insurance policies
- Advised a communications company regarding insurance coverage under commercial general liability, and directors and officers liability policies, in connection with a business tort, Lanham Act, and antitrust lawsuit
- Advises private equity firms regarding directors and officers liability insurance policies in connection with IPOs of portfolio companies
- Advised a private equity firm regarding insurance issues in advance of IPO of portfolio company SPAC
- Advised a private equity firm regarding insurance issues in connection with portfolio company's bankruptcy filing
- Represented pharmaceutical company in negotiating transfer of insurance in connection with \$40 billion acquisition
- Representing energy company in SEC investigation relating to disclosures and related party transactions

# CRAIG A. SCHIOPPO -- MARSH



**CRAIG SCHIOPPO**  
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## Education

- BS, Accounting, State University of New York at Albany
- JD, *magna cum laude*, New York Law School

## Current Responsibilities

As leader of Marsh's Transactional Risk Group, Craig is known as an expert in the insurance of financial and transaction risk, regulatory and litigation risks. Craig is constantly involved in the development of dedicated insurance products that facilitate mergers, acquisitions and other corporate transactions. He is also involved in negotiating the terms and conditions of all of the Transactional Risk Solutions.

## Experience

Craig began his career as a Staff Accountant at Anchin Block & Anchin LLP in 1993. After spending two years as an auditor, Craig spent the next five years as a Supervisor in the Tax Department where he was intimately involved in both corporate and individual tax planning and compliance. During his last four years as an accountant, Craig attended New York Law School as an evening student and was a Notes and Comments Editor of the law review.

Upon graduating law school, Craig spent the next four years practicing corporate and securities law at Kramer Levin Naftalis & Frankel LLP. As a corporate attorney, Craig had a diverse transactional-based practice with significant experience in domestic and cross-border mergers and acquisitions, joint ventures, securities and general corporate matters.