

The Emergence of Representations and Warranties Insurance in Oil and Gas M&A Transactions

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When a buyer purchases all, or substantially all, of the assets of a seller, the buyer will typically obtain some form of security for seller's potential post-closing liabilities. Traditionally, when the seller is a special purpose vehicle or is selling a significant portion of its assets and a parent guaranty isn't a viable alternative, a buyer and seller agree to deposit a portion of the purchase price in a third-party indemnity escrow account to secure seller's indemnity obligations to the buyer. However, Representations and Warranties (R&W) insurance is an increasingly popular alternative to the traditional indemnity holdback structure. Although R&W insurance has been available for decades, its usage in the oil and gas industry has grown in recent years.

What is R&W Insurance?

R&W insurance is an insurance policy obtained (typically by the buyer) in M&A transactions pursuant to which the insurance carrier insures against losses resulting from a seller's breach of its representations and warranties in the transaction document. By serving as the primary source of recovery for breaches of representations and warranties made by a seller, R&W insurance shifts the risk of such breach from the buyer and seller to a third-party underwriter. Summarized below are R&W insurance policy features obtained by buyers and sellers in recent oil and gas M&A transactions.

Policy Coverage Limit:	10-15% of transaction purchase price
Policy Cost:	2-4% of Policy Coverage Limit
Survival Period:	3 years for non-fundamental reps; 6 years for fundamental reps

As discussed below, R&W insurance can offer both buyers and sellers with an attractive alternative to the traditional indemnity framework used in M&A transaction documents. However, introducing a third-party to a transaction brings with it certain drawbacks. Fortunately for buyers and sellers, the market for R&W insurance providers is extremely competitive and, accordingly, policy features continue to trend in favor of both parties.

What are the advantages of R&W Insurance?

R&W insurance is attractive to sellers because it can increase the percentage of sales proceeds sellers receive at closing by reducing or, as discussed below, eliminating the amount of sales proceeds seller has to retain, directly or in a third-party escrow account, for potential post-closing liabilities. This attribute of R&W insurance is particularly attractive to private equity-backed sellers because it permits a quicker distribution of sales proceeds to their limited partners and, as a result, maximizes the return on the investment and carried interest compensation. Additionally, R&W insurance can reduce a seller's post-closing contingent liabilities, thereby facilitating a

cleaner exit of the business and winding up of the entity. Finally, R&W insurance can protect passive investor sellers in multiple seller deals from the risk of liability for unintentional breaches of representations and warranties and breaches by other sellers.

R&W insurance can also be an attractive alternative to traditional indemnity escrows for buyers. As noted above, R&W insurance policies often provide for survival periods that extend for 3 to 6 years, as compared to the typical 12-18 month survival period in a transaction purchase agreement. Further, a savvy buyer may use R&W insurance to its strategic advantage during the entire M&A transaction process. First, in a competitive bid process, a buyer may distinguish itself from other potential buyers by including R&W insurance in its proposal, thereby making its proposal more attractive to the seller. Second, while negotiating seller's representations and warranties and the indemnity provisions in the transaction purchase agreement, a buyer may obtain more fulsome representations and warranties from the seller by shifting certain post-closing financial responsibilities to a third-party insurer. Third, in the event the buyer intends to retain any portion of seller's management team post-closing, a buyer may protect its internal organization by turning to a third-party insurance provider for recourse in the event of seller's breach of a representation or warranty as opposed to submitting a potentially hostile claim against its employees.

What are the disadvantages of R&W Insurance?

Despite the advantages R&W insurance policies offer to both buyers and sellers, there are a number of drawbacks associated with adding another party to the M&A transaction process. The R&W insurance provider has its own best interests to protect; therefore, buyers and sellers must consider the R&W insurance policy as another transaction document to carefully review and negotiate as part of the broader purchase and sale transaction. In addition to the administrative cost associated with negotiating the R&W insurance policy, R&W insurance providers often request certain policy terms that may be a disadvantage to the buyer, the seller or both.

One disadvantage of most R&W insurance policies relates to gaps in coverage resulting from a laundry list of exclusions from the policy's scope. These exclusions often include liabilities that may arise from breaches regarding environmental representations and seller's special warranty of title. To address these gaps in coverage, a buyer and seller may have to negotiate these potential post-closing liabilities separately. Additionally, R&W insurance providers often require the seller to retain 0.5-2.5% of the sales proceeds as buyer's initial source of recovery for any breaches of seller's representations and warranties; buyer may only seek recourse from the insurance provider after exhausting seller's retention amount. Although the retention amount is much less than required under a typical indemnity escrow, a seller's retention requirement still negates one of the fundamental advantages of an R&W insurance policy to sellers, which is the ability to quickly distribute the sales proceeds and wind-up the selling entity.

Where is the R&W Insurance Market Heading?

As the usage of R&W insurance in oil and gas M&A transactions continues to grow, the market among R&W insurance providers has become increasingly competitive. Many buyers are successfully negotiating with R&W insurance providers to reduce the typical list of exclusions from coverage. In recent months, R&W insurance policies have even included coverage for breaches of seller's special warranty of title and have limited exclusions to specific findings during

due diligence rather than including broad categorical exclusions. R&W insurance providers have also become increasingly willing to eliminate the seller's retention requirement and, instead, agree to serve as the sole source of buyer's recourse in the event of seller's breach of a representation or warranty. As competition continues to increase among R&W insurance carriers, policy norms will likely continue to evolve in favor of both buyers and sellers.