HWF

Optimising the outcome

HWF's tips on due diligence in E&I transactions

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At HWF we believe quality of coverage should be the key focus for any client.

What and Why?

Increasing claims volumes in respect of W&I policies have led to greater scrutiny of due diligence (“**DD**”) by insurers. HWF’s series, the Due Diligence Debate, delves into how to scope DD in order to maximise coverage under a W&I policy. This flyer examines some of the key considerations raised in the series and focuses them through an Energy and Infrastructure (“**E&I**”) and, more particularly, a renewable energy lens.

Basic principle

The starting point for an insurer is to require that the subject matter of any warranty is diligenced for that warranty to be covered. However, not all areas covered by the warranties are capable of or merit the same level of DD. The insurer expects the DD to be proportionate to the risk. It is therefore generally a case of explaining the level of risk and how the DD has been scoped appropriately.

Which reports are required?

As a minimum, an insurer will require for E&I projects legal, technical, financial and tax DD to be conducted. They would then expect to see specialist DD e.g. environmental, commercial, insurance, IT where customary and where there are likely to be greater exposures to those areas.

Scoping of specific diligence

As core infrastructure assets, such as renewable energy projects, often have limited operational elements to the businesses (with most operational functions contractually outsourced, no employees, limited IT/IP) the DD scope can be relatively focussed, as can the suite of warranties.
In our experience, particular thought needs to be given to:

i. accounts;
ii. subsidies and revenue contracts (if relevant);
iii. real estate;
iv. environment;
v. permits; and
vi. tax.

To the extent that the business is spread across multiple jurisdictions, insurers will expect the DD exercise to include review by local advisors for key legal and tax risks. Materiality in this context is crucial to coverage. Sampling exercises are generally acceptable provided that it can be evidenced how the sample gives visibility across the entire portfolio. Financial DD should mirror the accounts warranted including whether on a group or individual company basis.

Are external advisers required?

Again, it is really a question of proportionality. In house DD is acceptable provided it is carried out to the same standard as that of an external adviser and gives the insurer sufficient visibility on the potential exposures. This means demonstrating to the insurer that:

i. the review was carried out by someone with the requisite experience and expertise to identify the potential issues;
ii. the scope of this review was akin to that which would be carried out by a third party adviser; and
iii. the findings of this exercise are captured in writing. Bullet points summarising the issues as for an executive summary should suffice.

If internal DD is forming part of any DD scope, you should always flag this as far in advance as possible as different insurers have different appetites to internal DD, with some being fine with financial but less so with internal technical and tax for example.

Vendor due diligence

Where vendor due diligence (“**VDD**”) is available, most buyers will limit their due diligence to a review of the VDD and will not necessarily conduct their own review of the underlying documents in the data room. VDD should provide analysis and commentary on findings rather than be a factual description of the matters in the data room. Consequently, if the VDD scope and/or content is not deemed appropriate by the insurer, the buyer’s diligence will never satisfy their requirements. To avoid this situation HWF are happy to give some guidance on the VDD scoping requirements of the insurers with the auction draft SPA or if the insurance can be hard stapled.

Key warranties and points to note

Accounts
As with many other asset classes, renewables assets are often not actually valued using the accounts themselves, but rather projected revenue streams and costs using historic reference points. Depending on the stage in the asset's lifecycle the accounts may have little to no bearing on the valuation. We will ensure that insurers proportionately scrutinise the accounts. Thought should also be given as to how granular accounts warranties need to be or how relevant they are to the assets.

Accreditation & Regulatory Compliance
From our own experience and discussions with insurers generally, we are aware this is an area where claims have occasionally arisen and where attention is focussed. Insurers (as would a prudent buyer) usually require eligibility for subsidies and general regulatory compliance to be scrutinised in reasonable detail. The level of detail will be determined by the warranties and complexity of the applicable regime.

Material Contracts
Breaches of warranties relating to material contracts is also another area of focus due to the relatively high proportion of claims that arise in this space. Insurers will want to ensure that the client is aware of obligations, liabilities and the history of how the contracts have been performed to date. Sampling may be appropriate for portfolios and where a logical methodology has been applied, materially the same template contract has been used across projects and the size of the sample correlates to the value being placed on the assets in a portfolio.

Real Estate
Certain insurers used to stipulate that a certificate of title ("**COTs**") would need to be prepared in respect of each property for cover to be provided. This is usually the preferred approach for many acquirors of early-stage assets for project finance purposes given the importance of land rights.

For operational portfolios, whilst no one land right is necessarily the same, it can be disproportionately expensive to prepare COTs or reports on title for land rights for an entire portfolio. In such circumstances, the usual approach may be to undertake a sample, possibly also reviewing diligence conducted for project financing or historical acquisitions of the project sites.

If there are known title issues at the site(s), HWF can procure specific title insurance to deal with such issues. Title insurers can also provide cover for title to the property in the absence of any DD at a very reasonable cost, but our experience is that most buyers prefer to gain visibility on the land rights.

Insurers, like lenders, will require in date searches to be provided (in the UK this would be searches run within three month date of signing the SPA) checking for any encumbrances over the land or rights of way required for the project. If the transaction timetable does not allow for such searches to be run, it is possible to seek a "No Search" insurance policy which takes a matter of days in the UK and are an acceptable substitute for in date searches.

> "Coverage can be vastly improved with a thorough explanation of the rationale for due diligence scoping. This requires expertise which our team, with deep industry knowledge, are uniquely placed to offer"

Rowley Higgs
Partner, Head of Infrastructure

Environmental

The starting point for insurers is to exclude liabilities relating to environmental remediation but most will agree to remove this exclusion for low-risk assets (e.g. solar and onshore wind) if:

i. it can be demonstrated the projects are located on greenfield sites (where there has been no prior activity); and
ii. there is clean Phase I DD. Specific environmental insurance protection can be obtained (either as part of the W&I policy or as a standalone policy) where there is a medium risk of contamination on site.

Condition of Assets

It is not usually possible to get cover for the condition of the assets themselves as W&I insurance is not intended to be a substitute for robust component warranties, project contracts and project insurers.

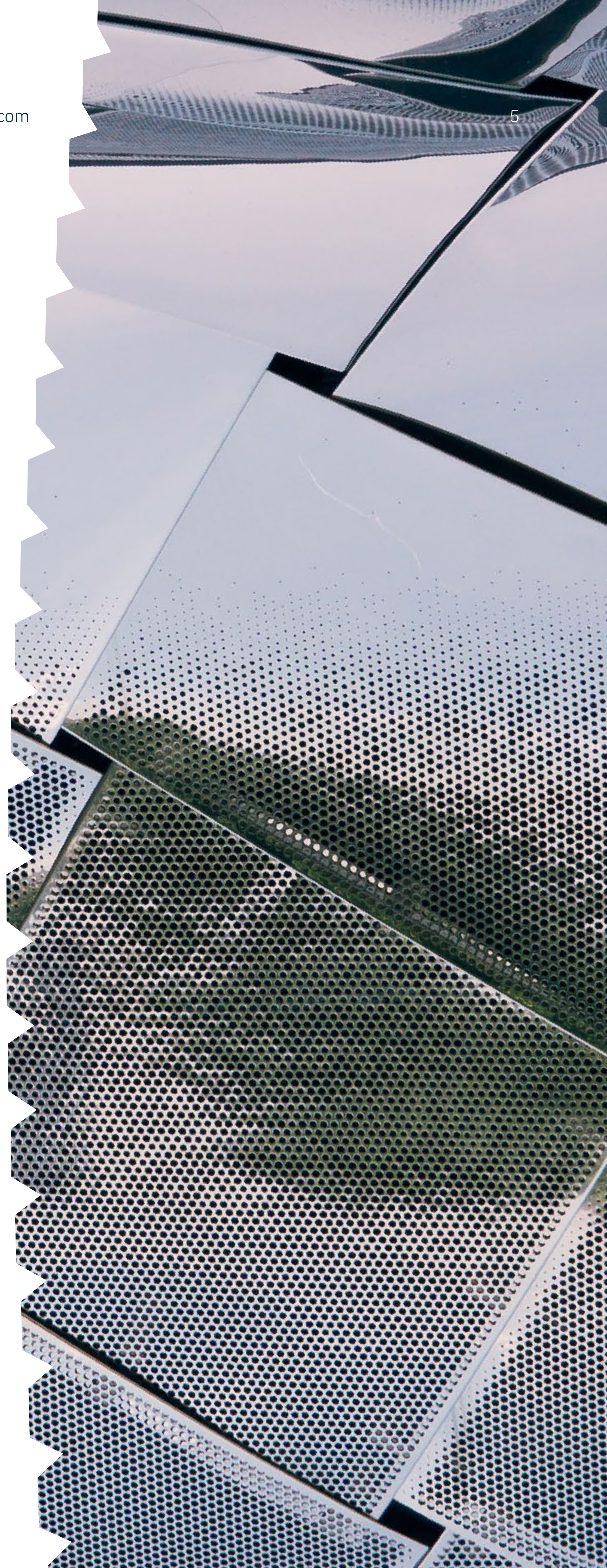
- ***Development stage assets:*** insurers will usually remove this exclusion where material assets have not yet been installed.
- ***Operational projects:*** If there is detailed technical DD of the assets on site which evidences the assets are generally in good repair and/or which details any capex expectations clearly, it may be possible to get cover for appropriately negotiated warranties (which may need to be qualified by awareness and/or materiality or boxed).

Tax

We are aware that many infrastructure projects can build up considerable reliefs (primarily capital allowances or equivalents) to which purchasers attribute value when buying assets from developers. The general position adopted by insurers is to exclude liabilities arising out of the loss of tax assets, but we can achieve the removal of this exclusion (or carve out of capital allowances and certain other losses/reliefs from it) if:

- the SPA allows recovery for such losses/reliefs;
- sufficient due diligence is undertaken – HWF can provide guidance; and
- it can be demonstrated that the buyer has attributed value to these tax assets in its calculation of the purchase price.

Insurers may charge an additional premium to remove this exclusion and allow recovery for such tax assets/reliefs.



HWF’s DD Scoping tips

The below observations are DD scoping tips in relation to achieving broad cover for assets in the renewable energy industry, but many of the points are equally applicable to other industries such as Data Centres, Fibre Optics and EV charging.

Asset/Business	Typical DD	HWF Comments
Development & Construction Projects	External Legal (Corporate, Finance, Real Estate, Planning, Grid Connection) and Technical DD Internal Finance and Tax or a limited external Third-party adviser review	The biggest talking point for early-stage projects from a DD perspective is normally that internal finance and tax DD is being undertaken. Most insurers that target these assets understand that they have not yet traded and so do not require a deep dive review in these areas provided the guidance above is adhered to. Evidencing there is a limited environmental risk is the other key area. For construction assets, which, in our experience, are sold more frequently in southern Europe than the UK, some insurers will request updated DD at completion to cover repeated warranties. Our view is that interim covenants and conditions precedent should provide sufficient visibility on the changing nature of the asset rather than updated DD.
Operational Projects	External Legal (Corporate, Financing, Real Estate, Planning, Grid Connection, Project Contracts including any supply and revenue agreements), Finance and Tax and Technical DD	For operational projects the focus of DD shifts to valuation, accreditation, and tax. External Finance and Tax DD is not a pre-requisite, but it will be much more challenging to find a wide range of competitive terms in the absence of good quality written DD.
Portfolios	Sampled Legal (Corporate, Real Estate, Planning, Grid Connection, Project Contracts, Accreditation, Disputes, IT), Finance and Tax, and Technical DD	Key to DD scoping for portfolios is the extent of the sampling exercise. As set out above, it is crucial to ensure that you can evidence how the sample gives visibility across the portfolio. If contracts are being sampled then an explanation is required whether each form utilised by the Target has been reviewed.
Developers	Legal (Corporate, Employment, Benefits, Real Estate, Planning, Grid Connection, Project Contracts, Accreditation, Disputes, IT), Insurance, Finance and Tax, and Technical DD	The main distinction for platform deals or investments into developers rather than the projects themselves is that the target is a fully operational business with more moving parts including potentially large numbers of employees. The business is more akin to services business, where the DD therefore needs to focus on the target’s ability to retain the team and their ability to successfully identify opportunities and deliver projects. As such the scope should include scrutiny of employment, pensions and benefits, project identification and delivery processes and insurance. In addition, valuation is very important to determine the appropriate scope of review for the pipeline.

Key contacts

Further details about us please see hwfpartners.com.

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