HWF

Synthetics

A new approach to M&A in energy and infrastructure?

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> "Synthetics has the potential to revolutionise M&A for clients. HWF believes that for the right deal, synthetics can offer a way for clients to improve process and execution without impacting cover."

Yolanda Yong
Head of Renewables and Energy Transition

Executive summary

This note explores the potential benefits of use of synthetic W&I insurance over the traditional W&I approach. Warranty and indemnity ("**W&I**") insurance is frequently used as a tool in energy and infrastructure transactions to facilitate clean exits for sellers whilst providing the requisite warranty protection to buyers.

In the past few years, synthetic W&I insurance has been developed, initially, from use in distressed M&A to increasingly being used in a non-distressed M&A scenario. We weigh up the potential benefits and downsides in the use of synthetic W&I insurance to explore how it might facilitate a shift in approach to energy and infrastructure M&A, particularly where clients are acquisitive and have their own in-house or developed form of SPA they are comfortable using.

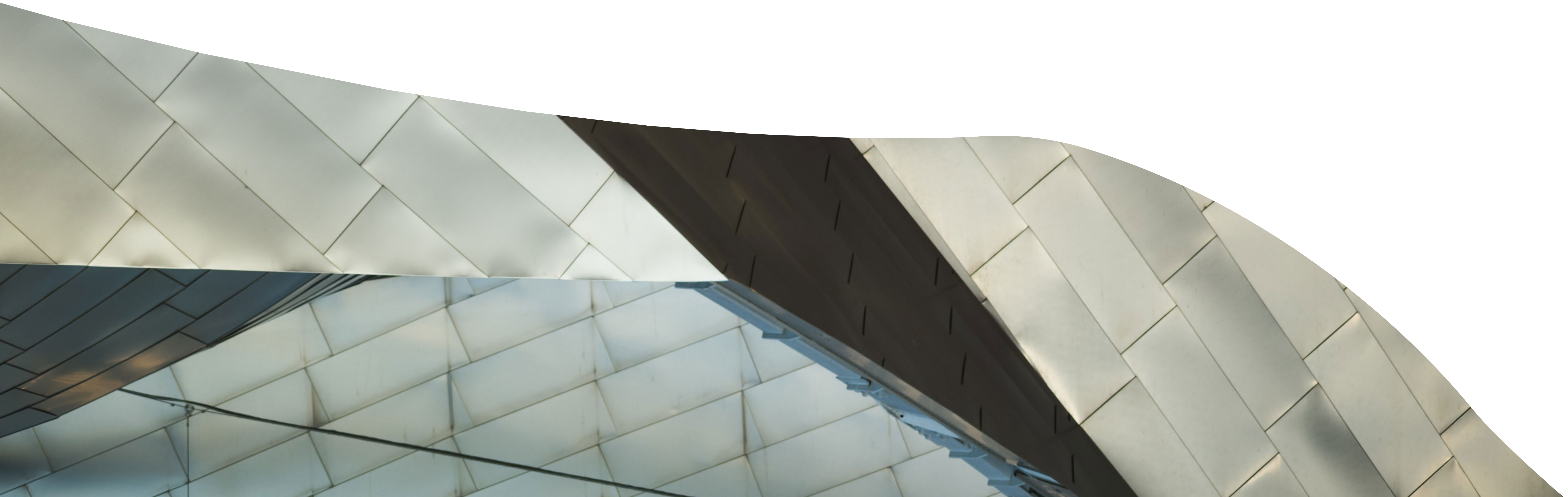
What is synthetic W&I insurance?

Synthetic W&I insurance is essentially a form of insurance where an insurer gives a suite of warranties under a W&I policy rather than a seller giving warranties under a SPA which are then underwritten by an insurer. The suite of warranties would be negotiated between the buyer and insurer rather than the buyer and the seller. The SPA would contain no warranties (or just limited warranties in areas not coverable by insurance) reducing both negotiation time and also the disclosure exercise as there would be no disclosure against warranties in the SPA.

When can synthetic W&I insurance be used?

Synthetic W&I insurance has been used to bridge the gap between an insolvency practitioner's inability to undertake disclosure or give business warranties and the buyer's requirement for a comparable level of warranty protection to non-distressed sales. Whilst synthetic W&I insurance in distressed transactions is a useful tool, the scope of its use can be broadened in non-distressed scenarios and we consider that its use is well suited to certain types of energy and infrastructure M&A.

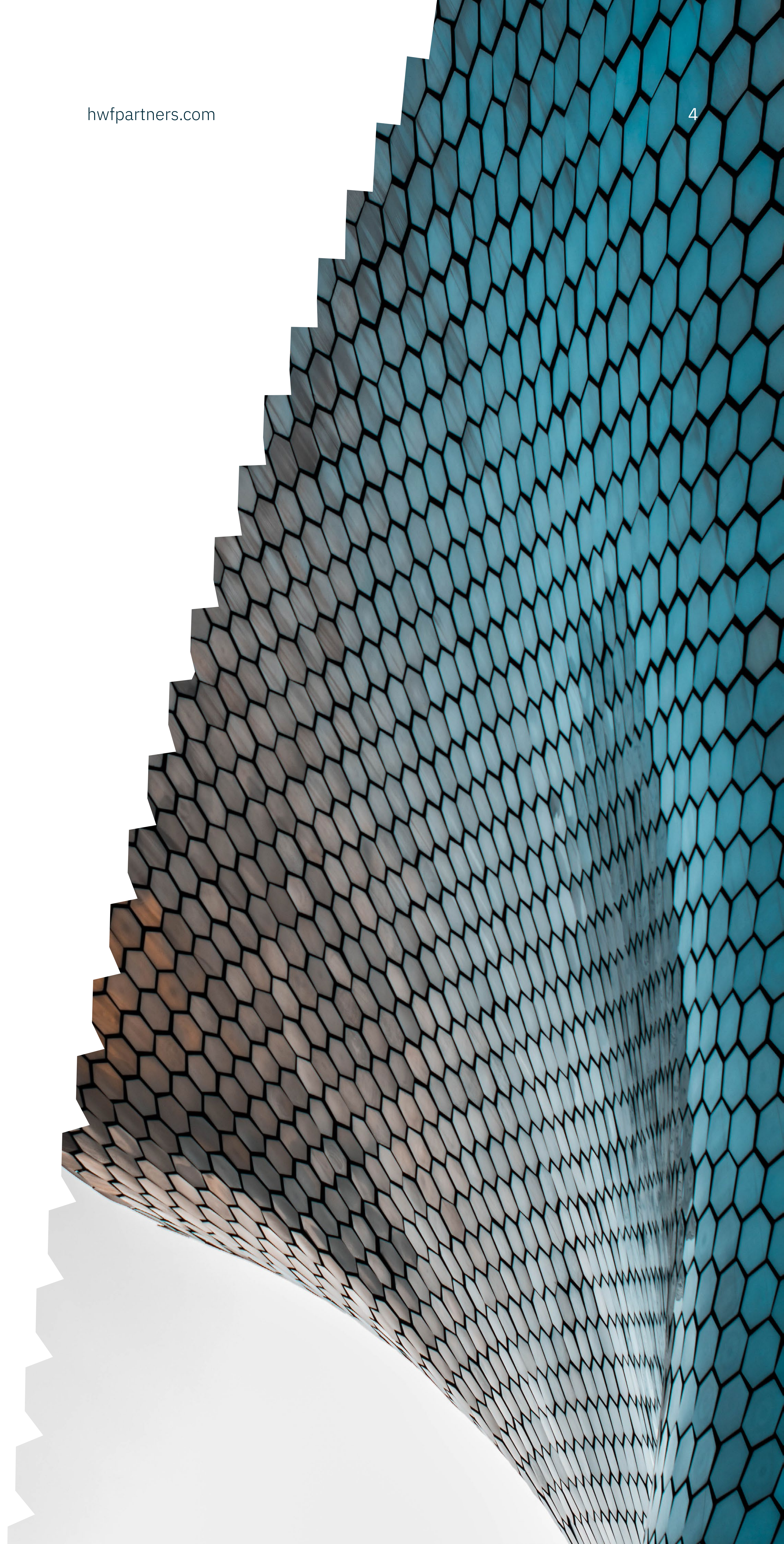
This paper considers the use of synthetic W&I insurance for non-distressed sales in the energy and infrastructure sectors, where such cover can **(i)** avoid the need for lengthy warranty negotiation between seller and buyer and **(ii)** allow for broader warranty protection than might otherwise have been offered by the seller.



Traditional W&I cover vs synthetic W&I cover

Overview and comparison of the typical process for the traditional and synthetic W&I cover

Traditional W&I cover	Synthetic W&I cover
A traditional W&I insurance process envisages:	**A synthetic W&I insurance process envisages:**
The seller and/or management team (the "**warrantor**") giving a negotiated set of warranties (and possibly a tax covenant) and undertaking a thorough disclosure exercise.	The warranties and limitations not being negotiated by the warrantor and the buyer or included in the transaction documents. Instead, the W&I insurance policy will include a suite of warranties (and possibly a tax covenant) (in the same form as if they were given by the warrantor, but as agreed between the buyer and the insurer) and typical limitations for a W&I insurance backed transaction.
The warrantor's liability being capped at a nominal amount (typically £/€1) subject to retaining liability for fraud and subject to relatively short time limitations.	The warrantor would not be required to undertake specific disclosure, but would still need to populate a data room in response to a due diligence questionnaire in the usual way. The insurer will seek comfort from the buyer's Q&A and due diligence. Insurers may require the warrantor to respond to supplementary Q&A to ensure a broad set of warranties are covered (i.e. where there are gaps between the buyer's diligence material and the suite of warranties), but this would be limited and targeted in nature.
The buyer taking out a W&I insurance policy as recourse above the cap and potentially beyond the temporal limitations offered by the warrantor under the transaction documents.	The buyer having sole recourse under the W&I insurance policy in respect of the suite of warranties. No recourse would be included in the transaction documents.

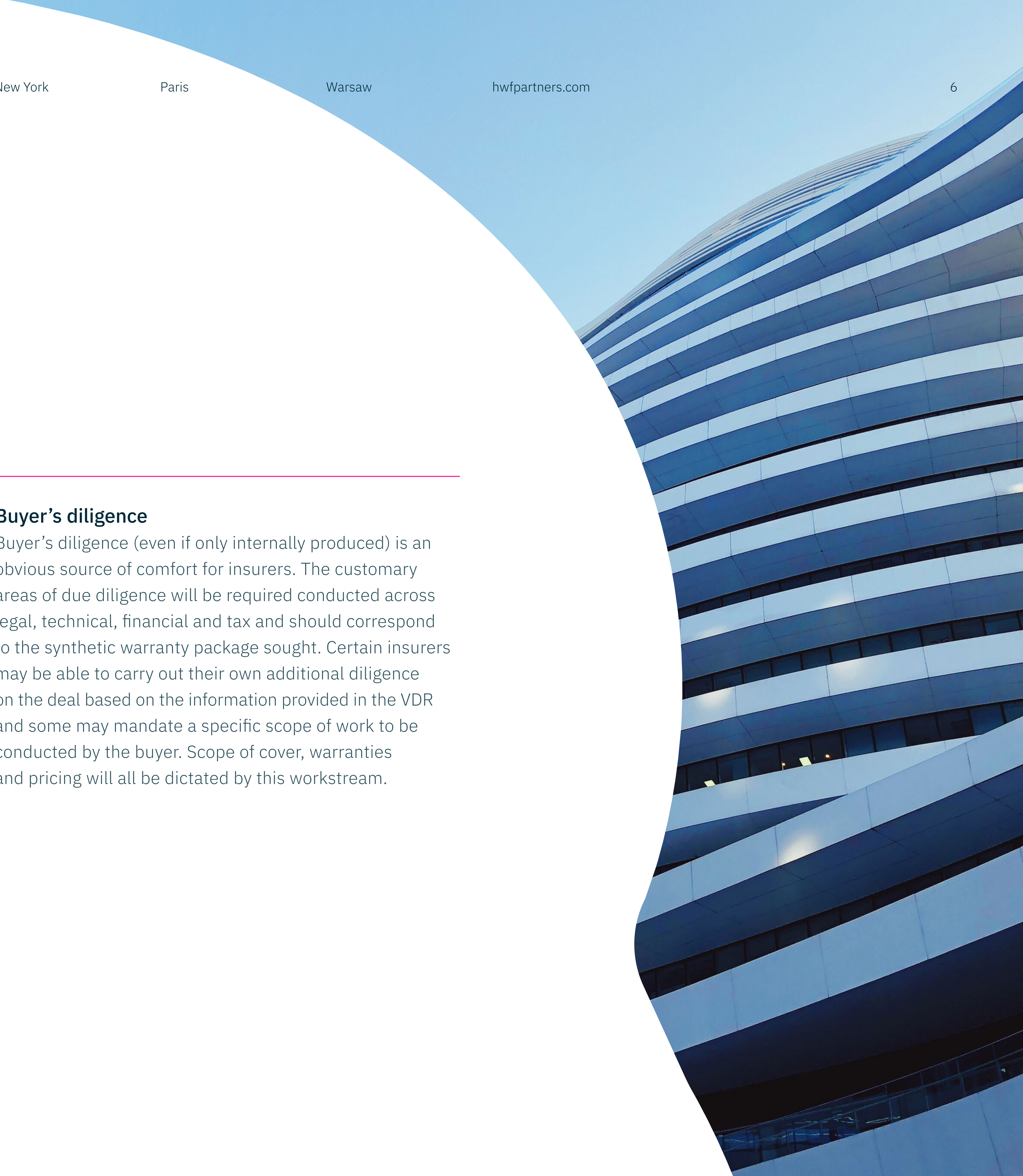


Traditional W&I cover vs synthetic W&I cover

Traditional W&I cover	Synthetic W&I cover
Benefits	***Benefits***
Most participants in energy and infrastructure transactions (or at least their advisors) will be familiar with the traditional W&I insurance process and will take comfort from the tried and tested route.	Insurers will often offer a broader scope of warranties compared to a warrantor negotiated package and the process to agree the warranties will be less iterative. For repeat transactions (e.g. bolt on acquisitions for a renewables portfolio) this process can be further streamlined as the buyer and insurers can work from an agreed base of warranties.
Insurers and buyers take additional comfort from the warrantor being required to turn their attention to the suite of warranties and undertake meaningful disclosure, even where recourse is limited to £1.	The seller's deal team will not be required to direct as much time to answering the targeted Q&A in comparison to undertaking specific disclosure process for the purpose of preparing a disclosure letter, freeing up time for other transaction workstreams.
	In competitive processes, a synthetic policy can be used to significantly enhance a bid, where the proposal will require the seller and its advisors to commit far less time, and therefore expense and provide increased execution certainty (i.e. by removing the negotiation of a majority of the warranties and all provisions relating to them).
	Where buyers have previously had to accept only title and capacity warranties (e.g. minority interests from passive investors) or very limited business warranties (e.g. competitive auction processes), a synthetic policy can be used to bridge the gap between the buyer's requirement for protection and the seller's disinclination to provide broad warranty protection and undertake a fulsome specific disclosure exercise.
	Repeated use of a synthetic policy may lead to efficiencies and cost savings across the transaction, delivering a consistent package of warranties that the buyer's stake holders are comfortable with.

Traditional W&I cover vs synthetic W&I cover

Traditional W&I cover	Synthetic W&I cover
Limitations	***Limitations***
Where insurers will not stand behind certain warranties (e.g. bribery and corruption in challenging jurisdictions), buyers may retain these warranties in the transaction documents to flush out any potential disclosure of these matters (even where recourse is limited to £/€1).	Given the novelty of this product, sellers and buyers are likely to have less comfort that a synthetic policy will deliver the desired or predicted outcome. HWF has a wealth of experience in W&I insurance in the energy and infrastructure sectors and synthetic policies and can help all parties successfully navigate this process.
A warrantor will often seek to negotiate a more limited suite of warranties than an insurer would be prepared to cover and as a result the buyer's coverage position may be more limited than if the warrantor were removed from the negotiations.	The buyer will not be able to rely on a disclosure letter to elicit disclosure of specific matters in relation to warranties that would be uninsured (and therefore not included in the synthetic policy). However, the buyer can obtain a similar level of comfort by seeking responses from the seller's deal team to targeted Q&A and in our experience, it is unusual that specific disclosure results in the disclosure of material issues not identified in the due diligence phase.
Key members of the seller's deal team will be required dedicate a substantial amount of time to the disclosure process, often at a point in the transaction where output is increased across all workstreams. Splitting time between the disclosure process and other workstreams can delay/hinder the transaction process.	



Synthetic W&I cover: The process and parameters

The importance of due diligence

As is the case with traditional W&I insurance, the scope of cover under a synthetic W&I insurance policy is directly proportional to the extent and scope of the information disclosed and diligenced by the buyer and its advisors. However, given the lack of a formal disclosure process where no warranties are being given under the transaction documents there are some specific considerations insurers will rely on to assess their final synthetic cover position, including:

Population of the VDR

In the absence of specific disclosure, insurers will expect the seller/warrantor to collate as much information as possible in a virtual data room ("**VDR**"). The quality of the information provided, how up to date such information is, and the extent to which it aligns with the required warranties will have a direct impact on the breadth of coverage offered. Where the process permits (i.e. bilateral sales), we recommend involving insurers in the due diligence questionnaire/VDR population exercise, as parties can gain comfort that the relevant level information is provided to allow for synthetic cover. HWF has worked with insurers to produce a key Q&A/VDR information request list.

Insurer's and buyer's Q&A

Insurers will want to be able to review the Buyer's Q&A and ask detailed questions to the buyer and their advisors and receive responses to fill any gaps in their understanding of the business or clarify any grey areas which might be excluded under the policy if not clarified. In a synthetic process this may involve insurers proposing limited and targeted Q&A that will require Warrantor input to gain comfort in relation to gaps that would otherwise have been plugged by a disclosure letter.

Buyer's diligence

Buyer's diligence (even if only internally produced) is an obvious source of comfort for insurers. The customary areas of due diligence will be required conducted across legal, technical, financial and tax and should correspond to the synthetic warranty package sought. Certain insurers may be able to carry out their own additional diligence on the deal based on the information provided in the VDR and some may mandate a specific scope of work to be conducted by the buyer. Scope of cover, warranties and pricing will all be dictated by this workstream.

Policy differences

The policy will be similar to a standard W&I insurance policy with a few notable differences:

Process

Insurers should be engaged in the process earlier to ensure that both: (a) the buyer and the insurer agree a suite of warranties that provides the buyer with the desired or expected level of protection and (b) the parties are aligned on the diligence and information requirements to deliver the agreed suite of warranties. However, once this "front loading" is undertaken the buyer can offer a more streamlined approach to signing/ completion than the typical route of seller backed warranties, by removing the need to negotiate warranties and for the warrantor to undertake a fulsome disclosure exercise.

General disclosures

The policy will contain a schedule of general disclosures which would mirror a market front end disclosure letter containing matters such as those discoverable on the face of the accounts, from public registers, corporate searches etc.

Warranties

The policy will contain the suite of warranties negotiated and agreed with the insurer. Certain insurers can provide their own synthetic set of warranties pre-agreed at quote stage. Others require the buyer to provide a set that is then negotiated with the insurer as the diligence process unfolds. There are advantages to both. The former gives more certainty both as to cover and speed of delivery at the outset. Whereas the latter may give broader coverage if time permits and information flow is favourable.

Pricing

Most insurers will likely require a marginally higher premium to provide a similar level of cover under a synthetic W&I insurance policy as opposed to a traditional W&I insurance policy (a limited number will actually provide a synthetic policy at the same price whereas others seek to charge considerably more); for the majority the increased cost is broadly in line with the costs of other enhancements that can be sought in relation to a W&I policy (e.g. an additional premium uplift of 10-40%, depending on the complexity of the asset, target business and jurisdiction). Insurers will also likely require a higher underwriting review fee to reflect their higher workload, we expect the fee to increase by a range of 20-30%.

Limitations

The policy will contain a standard set of limitations to claims such as matters taken into account in the accounts, buyer voluntary acts, change in law etc.

Scope of coverage

Warranties whose content can be factually ascertained on the basis of the information provided to the insurers (i.e. through disclosure of the VDR, due diligence reports, and the buyer's Q&A) are insurable synthetically. As is the case for both synthetic and traditional W&I insurance, some warranties will require specific due diligence and targeted Q&A to ensure coverage, and so the scope of diligence should be considered from the outset to ensure robust protection. For synthetic W&I cover in particular, consideration should be paid to the following types of warranties:

Knowledge qualified or opinion-based warranties and third party actions

Such as third party performance of key contracts, will need to be supported by targeted Q&A where this information cannot be readily ascertained form review of the VDR material.

Compliance with laws

Comfort will likely need to be provided by a combination of disclosure/a review of the target groups' policies and manuals, standard court searches and Q&A.

Position since the accounts date

Current management accounts will need to be reviewed/considered.

Related party transactions

Should be included in the scope of any review of commercial arrangements of the target group.

> As noted above, under a synthetic W&I insurance backed transaction the buyer will not have the benefit of uninsured warranties given by the warrantor for the purposes of eliciting disclosure. In this instance, the buyer should rely on targeted buyer Q&A to obtain comparative confirmations from the seller.

Use of synthetic W&I insurance in energy and infrastructure M&A

In the energy and infrastructure sectors, the following types of assets/transactions lend themselves to synthetic W&I insurance:

Shovel ready renewable projects

In particular where the buyer is making a series of acquisitions and seeking to replicate its package of due diligence and transaction documents.

Portfolios of energy or infrastructure assets

Which have a limited operational element (i.e. where operations and management services are contracted to third parties).

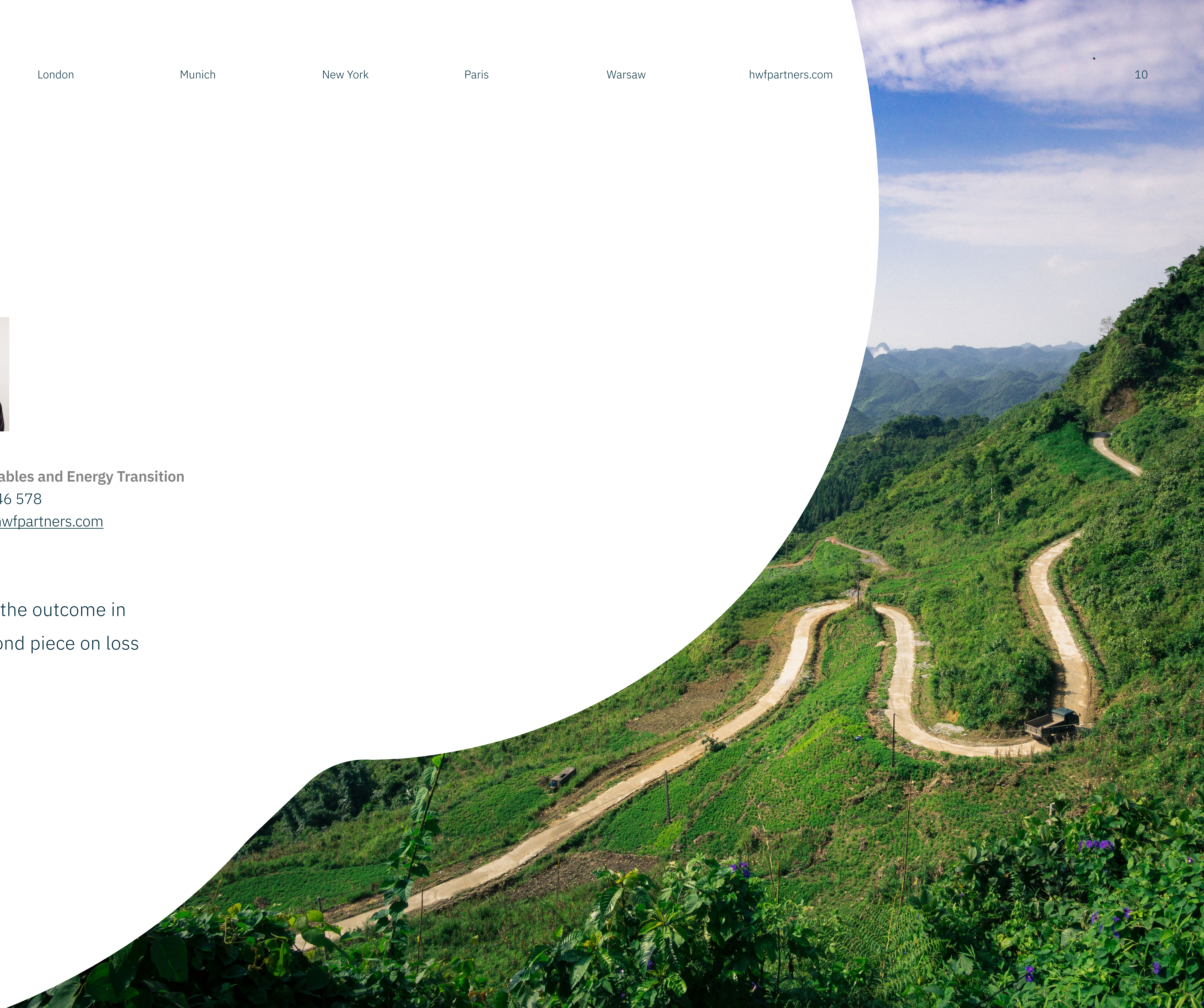
Competitive auction sale processes

Where a bidder is seeking to reduce execution risk for the seller and limit warranty negotiations, provided the preferred bidder will be given the opportunity to ask limited targeted Q&A once selected.

Considering synthetic W&I cover?

HWF can advise on:

- viability and suitability of synthetic W&I insurance;
- warranties we expect to be covered synthetically based on the diligence materials available and any areas where warranties are likely needed to be given by the seller; and
- diligence requirements we believe insurers would expect to be satisfied to offer synthetic cover.



Key contacts

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In case you missed it, you can find our first piece on optimising the outcome in relation to due diligence for E&I transactions here, and our second piece on loss of tax assets here.

HWF would like to thank Brynn Horner from CMS Olswang Nabarro LLP for her contribution to this article.