HWF

Realising a project's full potential:
Contingent insurance

hwfpartners.com

Warranty and indemnity ("W&I") insurance is a common feature in M&A in the energy and infrastructure sector worldwide. Contingent risk insurance is gaining prominence to help unlock deals.

Both sellers and buyers use W&I as a strategic tool, allowing sellers to exit cleanly and reduce their tail liability while providing meaningful protection to buyers against breaches of warranties. The insurance market has become increasingly sophisticated and also diverse in its appetite for transactional risk insurance.

The increased use of W&I insurance to protect against unknown risks in M&A across a variety of infrastructure projects and technologies has also led to the development of a market of insurers who will cover what W&I policies typically won't, being identified issues.

W&I insurance generally provides cover for risks that are undiscovered and unforeseen. Therefore, the starting position in a W&I policy is usually an exclusion for known matters as the parties have the opportunity to provide for a price reduction, deferred payment mechanism or negotiate an indemnity to require the seller to retain liability for the known matter.

However, these solutions are often unsatisfactory and costly. Insurance can deliver attractive and cost-efficient alternatives.

When thinking about known risks, parties to energy and infrastructure deals should also be aware of:

Affirmative cover within the W&I policy

W&I insurers can offer "affirmative cover" i.e. provide positive cover under a W&I policy via coverage of an indemnity or warranty despite the risk having been identified.

Such matters are usually low risk and low value identified matters and whether affirmative cover can be offered under a W&I policy depends on the capacity constraints of the insurer, its expertise and approach to underwriting.

Affirmative cover may attract an additional premium and/or underwriting fee subject to the complexity of the known matter and the need for expert advice.

Cover will be in line with the usual structure of the W&I policy in that it will normally allow the insured to recover the amount which would have been recoverable from the seller had the seller stood behind the liability.

Specialist Insurance markets e.g.

- ***Title markets:*** It may also be possible to explore the "title" markets who insure title to land and more recently title to shares. Title markets can cover unknown risks and also low risk known risks which affect unencumbered rights over shares and/or land.

  If a risk can be insured with the title markets, it is usually advantageous for the client as the products tend to be quick to underwrite and low in cost with premiums starting from as little as 0.15% of the limit of insurance or rate on line ("RoL") which is the premium cost expressed as a percentage of the policy limit insured.

- ***Environmental markets:*** Generally the W&I insurance market will not underwrite environmental liability within a W&I policy and will only provide cover for projects with no or a low risk of environmental remediation liabilities.

  However, as most infrastructure projects take the benefit of long-term leases, as tenant or freeholder, the target / target group will usually have, subject to applicable law, varying degrees of responsibility for environmental remediation even if the target itself did not cause the contamination.

  Therefore, if the environmental liability on a relevant site is more than a low risk, for example, if the site is brownfield, then a specific environmental impairment liability **("EIL")** policy would be better suited to cater for the risk profile of the site.

  EIL policies can cover historic liability of a property for up to ten years and can also provide protection for future pollution liabilities along with business interruption in the event that the site has to close for remediation.

  EIL policies cover liability for pollution that the insured is held responsible for whether or not they are the polluter or know about the issue ahead of inception. For this reason, the policies are structured differently to a standard W&I policy. Pricing is highly bespoke dependent on the risk profile of the site(s) and/or type of project and historic land use. Detailed diligence may be required for the risk to be underwritten, but often a desktop quote can be obtained with relatively limited information.

Contingent markets

There is a growing market of insurers who have dedicated teams who focus on contingent insurance. The breadth of the subject matter covered by contingent insurance markets is limitless, spanning the full array of matters which may arise throughout the development and investment lifecycle of a project or business.

We have placed policies in respect of a range of matters concerning development rights including permit and planning challenges (actual or potential), vexatious litigants, challenges arising from a re-organisation or restructuring, taxation issues and also matters which may arise in the construction or operational phases of projects.

We have seen a widening in appetite of contingent insurers moving away from pure legal or technical interpretation risks to also insuring the risk of discovery of a breach or a potential breach.

Why consider a contingent policy?

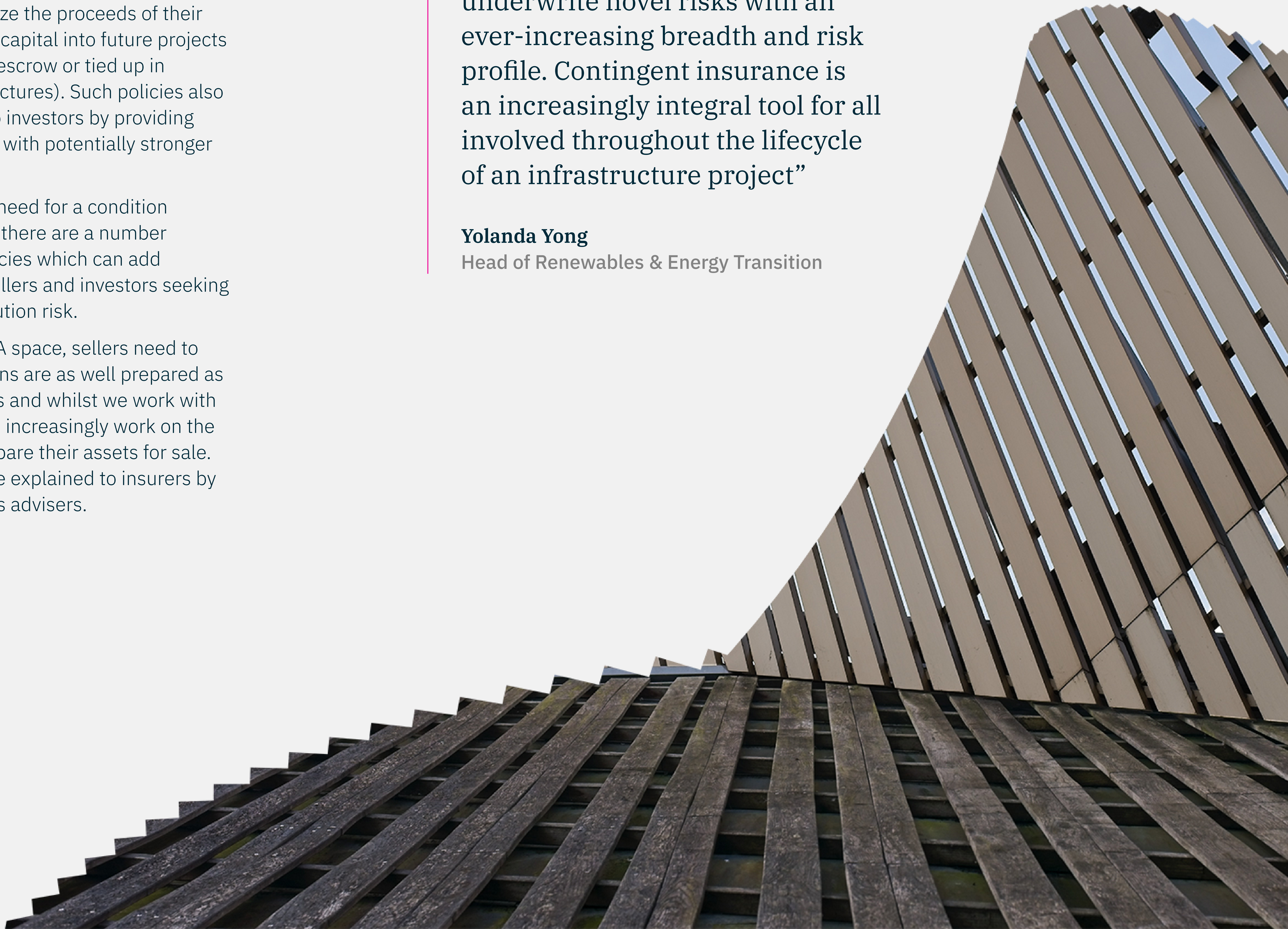
Where there are gating issues, a contingent insurance policy may be able to enable players at all stages of an investment cycle realize the proceeds of their sales quicker and redeploy capital into future projects (rather than leave funds in escrow or tied up in deferred consideration structures). Such policies also afford additional security to investors by providing an alternative counterparty with potentially stronger covenant strength.

Whether it is removing the need for a condition precedent or an indemnity, there are a number of additional insurance policies which can add significant value for both sellers and investors seeking to reduce transaction execution risk.

In a highly competitive M&A space, sellers need to ensure that their transactions are as well prepared as possible to optimize returns and whilst we work with both sellers and buyers, we increasingly work on the sell side to help sellers prepare their assets for sale. This allows for the risk to be explained to insurers by the target’s manager and its advisers.

> “HWF is constantly impressed by the ability of insurers to underwrite novel risks with an ever-increasing breadth and risk profile. Contingent insurance is an increasingly integral tool for all involved throughout the lifecycle of an infrastructure project”

Yolanda Yong
Head of Renewables & Energy Transition



What examples of contingent policies have we worked on?

Generally insurers need to be able to logically assess risk and won't underwrite change in law risk, or substantive decision making of an authority such as whether or not to grant a planning permission (however, for example, insurers are able to assess arguments to insure against the risk of a challenge to a permit being successful). Examples of policies we have sourced include:

Tax

Cover provided against the risk that:

i. the eligibility of the participation exemption is challenged by a tax authority on the disposal of a project company that is pre-trading;

ii. withholding tax is levied against the payee of dividends and/or interest where the substance of the recipient is challenged; and

iii. indirect capital gains tax is levied by the tax authority in the jurisdiction in which the target group is resident but where the seller is making a disposal of a holding company resident in a different jurisdiction.

State aid

Cover provided for any interest which became payable in relation to a subsidy deemed by the European courts to be illegal state aid in France.

Regulatory

i. Cover provided to a developer against the risk of a challenge lodged by a neighbour of a solar project against the local authority's decision to award the project an environmental permit being successful in the High Court in The Netherlands;

ii. Cover provided to mitigate against the risk that the Italian authorities rule that two solar projects should be deemed as a single plant, meaning that a preferential tariff rate would be forfeited.

Disputes

i. Protection sourced for a variety of disputes, including active litigation commenced by a land agent in respect of land sourced for development of solar projects in Italy;

ii. Cover arranged to meet a party's liability to pay its opponent's legal costs following an unsuccessful conclusion of a dispute;

iii. Policy safeguarded returns arising from a successful judgment and allowed claimant to "lock-in" the upside of a case-win – had it been overturned on an appeal, the policy would pay out.

Historic liability

Cover provided in respect of an expired right of first refusal **(a "ROFR")** which a Buyer wanted protection against in the event the beneficiary of the ROFR brought a challenge against the seller and/or third party buyer of the shares;

Termination payment for a long term concession agreement

Protection was sourced for an equity investor in a toll road who was concerned that the local authority was going to exercise a right to terminate the concession agreement which would have resulted in a loss to the investor. Cover was sought for the difference in the equity return and the termination payment due under the concession agreement.

Process

In order for insurers to provide terms, usually they need the underlying documents concerning the risk and, in some cases, the expert opinion which assesses the risk profile. Due to the bespoke nature of many known risks, more groundwork is usually needed at the outset in order to obtain terms. Once terms have been sourced, the underwrite can be completed in as little as 5 business days.

Costs

As per W&I insurance, the cost of contingent policies include the premium, any insurance premium tax payable on the policy which is determined by the domicile of the insured and usually an underwriting fee. Insurers may require an upfront underwriting fee (which may be waived if the policy is ultimately placed) to consider more complex contingent risks especially those requiring specialist input. The cost of the policy is usually between 2- 10% of the limit of insurance required however it can sometimes be higher or lower.

> "Transactional risk insurance is increasingly dynamic and innovative. The cornerstone of the product continues to be mitigating downside risk. But increasingly the focus is upon using novel and bespoke insurance solutions to unlock commercial value in a variety of commercial settings."
>
> **James Williamson**
> Head of Contingent

Cover

- ***Retention:*** The retention on a contingent risk policy can vary considerably. In some instances, for example, if it's a title policy or a tax policy there can be nil retention but more commonly there will be a retention applied under the policy.

  The retention may only apply in respect of defence costs, particularly where the insurer considers the detection risk to be high, but in some cases it may apply to the actual insured loss.

  The retention may be structured as a horizontal excess, whereby once exceeded the insurer will pay the amount of loss in excess of the retention or it may be structured as a vertical excess where, if a 5% excess were applied, the insurer will only pay 95% of any loss regardless of the size of the claim.

- ***Insured Loss:*** The definition of insured loss would be bespoke to the risk but is typically very simple – in effect, if the known risk materializes then the policy pays.

  Contingent policies would generally cover defence costs in the event the contingent risk arises, which is an additional advantage for a policyholder.

  Further, a contingent tax policy will commonly include cover for the advance tax payments in order to appeal decisions of a tax authority, thereby protecting against any loss to cash flow or even additional borrowing costs to fund such tax.

Benefits of a contingent risk policy

In summary, rather than simply asking for a seller to provide an indemnity or seeking to rely on other contractual mechanisms, parties have further resources at their disposal to allow transactions to take place.

Contingent insurance can, often relatively cheaply, unlock access to capital (e.g. drawdown under finance arrangements) or unlock areas of deadlock in negotiations where otherwise a price reduction, an indemnity or escrow would otherwise be sought in the transaction documents and can offer significant upside protecting or minimizing the impact to the IRR of a project.

Key contacts

Further details about us please see hwfpartners.com.

Yolanda Yong
Head of Renewables and Energy Transition
+44 7885 246 578
yolanda.yong@hwfpartners.com

Rowley Higgs
Partner
+44 7977 125 420
rowley.higgs@hwfpartners.com

Tim Dobbing
Associate Director
+44 7858 422 677
tim.dobbing@hwfpartners.com

Mark Parrett
Head of Tax Insurance
+44 7966 638 235
mark.parrett@hwfpartners.com

James Williamson
Head of Contingent
+44 7799 228 806
james.williamson@hwfpartners.com

Alex Harding
Head of Claims
+44 7590 916 950
alex.harding@hwfpartners.com