



# E&P A&D Business Strategies: Getting the Deal Done

*Here are key factors when considering representation and warranty insurance in upstream A&D transactions.*

*Presented by:*

**Oil and Gas  
Investor**

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Thu, 04/28/2022



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*Editor's note: This article appears in the E&P newsletter. Subscribe [here](#).*

As representation and warranty insurance (RWI) became commonplace in the M&A landscape, its use in upstream A&D transactions generally lagged, with RWI initially being used by buyers to alleviate collection concerns in transactions with distressed sellers.

However, as A&D activity rebounded following the worst of the pandemic, dealmakers have increasingly implemented

RWI. Regardless of whether this trend is attributable to the influence of private equity in the oil and gas industry, the evolution of the RWI market and/or increased demand for the benefits of RWI during the recent wave of consolidations, dealmakers will increasingly be required to consider whether RWI makes sense for a particular transaction.

Keeping in mind this trend, this article focuses upon the benefits of RWI for sellers and buyers, as well as other practical considerations that can impact the analysis of whether using RWI makes sense for a particular transaction.



## Benefits of RWI for sellers

By shifting the risk of certain losses from the seller under the purchase agreement to an insurer or policy, sellers (and their investors and shareholders) increase the certainty of proceeds from the transaction by limiting the seller's post-closing exposure for contingent liabilities. Additionally, the amount of proceeds received by the seller at closing can be maximized in transactions in which RWI is used by significantly reducing or eliminating the need for a post-closing indemnity/holdback escrow.

By replacing or reducing the need for an indemnity/holdback escrow (as the buyer would instead look to a credit worthy insurer), a larger portion of the sales proceeds can be paid to the seller at closing. For certain types of sellers, such as private equity funds, individual sellers, post-bankruptcy sellers (with equitized shareholders) or seller groups, the ability to cleanly exit the asset or business and immediately distribute sale proceeds at closing can be of the utmost importance, and when RWI is utilized, the seller may be able to distribute substantially all of the sale proceeds following closing without risk that those distributions would be subject to clawback based on contingent liabilities arising from potential rep breaches. Similarly, a strategic seller that is not completely exiting through the transaction may have more certainty redeploying the sale proceeds into its business if the risk of a post-closing rep breach claim has been reduced or eliminated through the use of RWI.

However, the use of RWI is not a panacea. A RWI policy will generally not provide coverage for known contingent liabilities, so even if the seller is not generally liable for breaches of its representations and warranties, a buyer may still require a special indemnity, and potentially a corresponding escrow, for any known issues that it identifies during its diligence.

Additionally, where the transaction involves a staggered sign and close, the buyer will not have coverage for representation and warranty breaches that first arise or that the buyer learns about between signing and closing. This aspect of RWI means that information learned by a buyer through interim period disclosure schedule updates and amendments by the seller could result in exclusions from coverage. While a buyer may typically push for a more fulsome obligation for the seller to update its disclosure schedules, in the context of a transaction utilizing RWI, a buyer may have greater certainty of coverage if the seller's obligation to update its schedules for breaches of represen-

tations and warranties is limited to those that are necessary for the seller to "bring down" its representations and warranties at closing.

In addition, RWI will generally not cover breaches of covenants, so the parties will still need to address the appropriate indemnity structure for losses arising from covenant breaches.

Other potential sources of exposure in A&D transactions would also need to be considered, including special warranty of title claims and common "retained" liabilities. However, as RWI has been used more frequently in A&D transactions, some of these concerns have been alleviated by shifting certain of these potential sources of liabilities (that would commonly be addressed in a conveyance or other portions of the purchase agreement) into representations and warranties, some of which may be covered by the policy and in certain circumstances, but including stand-alone coverage for special warranty of title under the policy. Buyers should keep in mind though that this approach would mean that certain claims that might otherwise be a dollar one recovery under a traditional seller indemnity would now be subject to the RWI policy retention amount (i.e., the policy deductible).

## Benefits of RWI for buyers

In any transaction, the buyer and its valuation will be particularly focused on the risk profile of the underlying assets, with the buyer also being motivated to maximize, to the extent possible, its protection against unknown liabilities that the buyer has not factored into its price. Either a traditional seller indemnity or RWI can provide the protection a buyer seeks. However, given the nature of an RWI policy, a buyer may, in certain instances, find that the coverage under the RWI policy provides certain advantages to a traditional seller indemnity.

**Scope of representations and warranties.** In "no survival" transactions (i.e., where the acquisition agreement is structured so that the buyer only looks solely to the RWI policy for breaches of seller's reps and warranties), sellers are generally more accommodative when negotiating the scope of its representations and warranties, as the seller's exposure is more limited, meaning that the buyer may obtain a more fulsome (and/or less qualified) set of reps and warranties for purposes of buyer's post-closing protections. Please note, however, that sellers will still keep in mind the impact of the seller's representations and warranties

on its scheduling burden and the closing conditions under the purchase agreement, as well as the seller's potential exposure for fraud with respect to the representations and warranties.

**Survival periods.** In addition to a potentially broader set of seller representations and warranties, the policy term will generally survive for three years with respect to most representations and warranties, with fundamental representations and warranties surviving for six years, giving buyers additional coverage beyond what they likely would receive absent RWI. In transactions in which RWI is being used as an alternative to an indemnity escrow, absent RWI, the seller will be increasingly motivated to limit exposure by pushing for short survival periods and thus a faster release of any held-back funds.

**Scope of losses.** While a technical point, buyers should keep in mind that the scope or types of losses covered by RWI is often broader than those recoverable under a purchase agreement utilizing a traditional seller indemnity. Generally, an RWI policy will not include broad damages exclusions, such as exclusions for consequential damages, lost profits or damages based on multiples of earnings, to the extent such types of damages are not prohibited or excluded under the purchase agreement. In transactions utilizing RWI, buyers should try to push back on broad damage exclusions in the acquisition agreement since those exclusions may narrow the buyer's coverage under the RWI policy.

**Amount of coverage.** An additional consideration for buyers implementing RWI is the amount of coverage. While a seller will customarily insist that its post-closing liability under the acquisition agreement is capped at a small fraction of the purchase price, there is generally no limit to the amount of coverage a buyer can purchase under an RWI policy. This optionality for buyers to purchase additional coverage can provide a meaningful risk management benefit when compared to the more rigid indemnity caps and escrow amounts (which rarely exceed 10% of the purchase price) associated with traditional seller indemnities.

## Other considerations

**Costs.** The cost of an RWI policy will need to be allocated between the parties. While it is common for the buyer to pay for the policy premium, the buyer's valuation or bid will nevertheless take this additional expense into account. In

this regard, parties will also need to keep in mind that the RWI market remains dynamic, and pricing fluctuates based upon market demand and insurer capacity, among other factors. Over the past five years, this market fluctuation has resulted in premiums ranging from as low as 2% of the coverage amount to, at times, more than 6%.

Additionally, for smaller transactions, dealmakers should keep in mind that most insurers will require a minimum premium amount, meaning that RWI may not be as cost-effective and appear comparatively more expensive for smaller transactions. The underwriting process is costly for insurers, so they will charge the buyer an underwriting fee (often \$30,000 to \$60,000), and if the buyer does not have exclusive negotiating rights with the seller, the insurer customarily also charges an additional underwriting premium currently ranging from \$50,000 to \$250,000, depending on deal size. These underwriting costs will generally be applied to the policy premium if a policy is ultimately bound but particularly in situations in which a bidder cannot obtain exclusivity due to there being multiple bidders remaining in the process. This additional cost should be kept in mind, and if the buyer is able to successfully negotiate an expense reimbursement or similar arrangement with the seller, these costs should be taken into account.

**Retention/deductible.** Similar to a basket or deductible construct in a traditional seller indemnity, coverage under the RWI policy will be subject to a retention amount (i.e., a deductible), which typically ranges from .75% to 1% of the purchase price, depending on deal size, for the first 12 months post-closing, often reducing to .5% thereafter. In some instances, a buyer will ask the seller to bear some portion of losses within the policy retention amount. For instance, a common construct is that for the first 12 months following closing, the seller will bear the first 50 basis points of losses arising from breaches of the representations and warranties, with the buyer bearing the next 50 basis points of losses. However, buyers should weigh the additional costs of this structure, such as the incentive this structure creates for the seller to potentially negotiate a more narrow rep package and the costs required to negotiate the required indemnity mechanics, against the benefits that a nominal indemnity provides.

**Timing.** A practical consideration that will need to be considered at the outset of any transaction is the timing to get to signing. If the buyer is well-prepared, the use of RWI may expedite signing, as it can significantly reduce the amount of time required to negotiate the acquisition



agreement by eliminating meaningful back and forth regarding the representations and warranties and the indemnity section. The process to underwrite and negotiate an RWI policy often takes two to three weeks. While RWI underwriting can often be expedited, it is not uncommon for A&D transactions to move rapidly, especially in a competitive situation or in a volatile commodity price environment.

In some instances where timing is paramount, a buyer can also consider binding the RWI policy after the acquisition agreement is signed, as most A&D transactions will have an interim period between signing and closing for purposes of the title and environmental defect process. The risk of this approach is that unexpected policy exclusions may arise during the underwriting process, at which point the buyer would not be able to negotiate recourse for those excluded losses with the seller.

**Due diligence.** The RWI insurer's diligence process

primarily consists of underwriting the buyer's due diligence. This insurer's advisors will review the buyer's diligence reports and schedule a call with the buyer's deal team, consultants and advisors to discuss and confirm the scope of due diligence that was conducted. Any material issues discovered during the buyer's diligence, and any perceived deficiencies that are identified in the buyer's diligence, may give rise to exclusions under the policy. Therefore, the buyer will need to ensure that fulsome due diligence is conducted to minimize exclusions under the RWI policy.

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