

The Rise Of Reps And Warranties Insurance In Upstream M&A

By **Robert Gray and Rebecca Seidl**

Representations and warranties insurance, or RWI, policies provide insurance coverage that either supplements or replaces indemnification provided by a seller for breaches of certain representations and warranties in a purchase and sale agreement.

These representations include fundamental corporate representations and warranties related to the operations of the assets or target company — for example, financial statements, intellectual property, material contracts, labor and employment, employee benefits, and tax matters. In the context of an upstream energy transaction, this might also include royalties, preferential rights, leases, bonding, plugging, imbalances and regulatory matters.

The benefits of RWI policies include longer survival periods than what the seller may be willing to provide, and smaller indemnity escrows, allowing sellers to receive a greater portion of cash consideration at closing. In addition, post-closing, both buyers and sellers benefit in the event of a continuing business relationship if indemnity claims are made against an insurer, rather than by the buyer against the seller or management

The use of RWI policies in merger and acquisition transactions has grown exponentially in the past decade, with more innovative insurance products being developed in response to market developments. Private equity sponsors and strategic buyers of private companies, as well as private equity sponsors exiting their investment, are increasingly using buy-side RWI policies in their transactions.

The practice of insuring title on oil and gas transactions has been slow to develop, given the unique nature of oil and gas assets. However, the use of RWI policies has been building in the oil and gas transaction space, and in light of expected consolidations and reorganizations, we anticipate an expansion of the use of such products in upstream oil and gas transactions.

One recent example of an oil and gas upstream acquisition involving a RWI policy is Talos Energy's \$640 million acquisition of producing assets and exploration prospects in the U.S. Gulf of Mexico from multiple companies backed by Riverstone Holdings and other private equity firms, which closed on Aug. 4.

As a result of the COVID-19 pandemic and depressed oil prices, we expect to see a sharp rise in the number of U.S. Bankruptcy Code Section 363 sales of distressed upstream oil and gas assets. In brief, most Section 363 sales occur on an "as is, where is" basis — meaning



Robert Gray



Rebecca Seidl

there are no post-closing seller indemnities for breaches of representations and warranties.

Therefore, the risk shifts to the buyer and due diligence becomes even more critical. However, RWI policies tailored for Section 363 sales can create a win-win for buyers and sellers. The buyer will have a remedy for breaches of representations and warranties — actual or synthetic — against the insurer and the seller will benefit from having a more attractive and valuable asset.

The purpose of this article is to provide guidance to transactional lawyers as to key RWI terms in upstream oil and gas transactions, and recommend certain steps to be taken in upstream oil and gas title diligence.

Special Warranty of Title

Typically, the seller is asked to make representations with respect to a specified oil and gas property — e.g., a well, a lease, a unit, etc. — that the seller (1) is not obligated to pay a share of expenses greater than the leasehold working interest for that property shown on a schedule to the acquisition agreement, and (2) is entitled to receive a share of the oil and gas production or revenues from that property not less than the net revenue interest for the property, also shown on a schedule.

In most upstream oil and gas transactions, the seller will disclaim any kind of title warranty other than the one(s) expressly set forth in the conveyance instrument. Oil and gas assets are most often sold with a special warranty of title, or SWT.

By giving an SWT, the seller is limiting its liability for title defects that (1) arose before the seller acquired the interests, and (2) may have arisen during the time the seller owned the asset but for which it is not responsible under the "by, through or under" concept. An SWT does not assure the buyer that it is receiving any interest of any kind — only that the seller didn't cause any defects to occur — so buyers often negotiate for other title related assurances beyond the SWT.

The details vary from state to state and among transactions, but the SWT is typically a provision in the assignment or conveyance of the oil and gas properties and is often worded:

Assignor does hereby bind itself to warrant and forever defend, all and singular, title to the Properties, unto Assignee, against every person whomsoever lawfully claiming or to claim the same or any part thereof, by, through or under Assignor, but not otherwise.

In the special warranty of title, the seller warrants against a title defect that arises during the period of time in which the seller owned the oil and gas properties. Most commonly, this would include a prior transaction in which the seller transferred some or all of the interest it is purporting to now transfer, and/or a prior encumbrance that arises during the period that the seller owned the oil and gas properties.

This could be something voluntary like a mortgage that the seller granted. It could also be an involuntary lien, such as a tax lien or mechanics lien, that arises as a matter of law when the seller fails to pay its taxes or fails to pay a contractor.

We have seen a number of recent examples of insurers and buyers successfully negotiating tailored RWI policies to include coverage for breaches of the SWT, and of buyers limiting exclusions from coverage to specific title defects found in the course of due diligence, rather than including broader categories of exclusions.

The use of RWI policies in oil and gas transactions, and the continuing development of innovative products attractive to both buyers and sellers alike, is certainly a trend to watch and to consider in appropriate situations.

Defensible Title

Defensible title is a mechanism in the purchase contract that tests whether the seller's title is represented and warranted as "defensible," and often allows for a price adjustment or other recourse if it is not defensible.

Because there is no generally recognized definition in the law of "defensible title," it is defined on a per-transaction basis in the transaction documents as part of the SWT. In this instance, the underwriter will need to make a decision whether it intends to provide the coverage, and then customize the policy to specifically include matters subject to the SWT, and then expressly exclude all other matters not specified.

The seller gives the buyer a period of time, after signing — and sometimes, in private company transactions, after closing — to perform its title due diligence and submit title defect notices to the seller. If the buyer determines that title to a property is not defensible, above a certain threshold, then the buyer is entitled to some relief — a partial price reduction, an exclusion of the property from the deal, a covenant to cure the defect, a holdback in escrow of a portion of the purchase price, etc.

Typically, coverage for the SWT will bind at the time title due diligence, including the defect process, has been completed.

RWI in Upstream Oil and Gas Transactions

RWI serves as post-closing security, and a mechanism to shift the indemnification risk in upstream oil and gas transactions from the seller to the insurer.

The insurers typically hire land experts and outside law firms to review the title due diligence completed by the buyer between signing and closing, with all representations except environmental and title conditionally bound at signing, and title being bound at closing.[1]

Considerations for Upstream Oil and Gas Title Due Diligence

The insurer, and the buyer seeking RWI coverage, should confirm that the following oil and gas title due diligence matters have been addressed:

- Identifying the exact names of the entities that own interests in the oil and gas properties;
- Obtaining summaries from relevant engineering reports that list wells and reserves, as well as applicable working interest and net revenue interests;

- Reviewing the allocated values list for leases and wells;
- Obtaining a list of title opinions, title reports, run sheets, title policies, title work performed in prior acquisitions, significant title curative work and other evidence of the seller's title to the relevant oil and gas interests;
- Performing a due diligence investigation that includes checking record title in the county real property records for the properties;
- Confirming that the time periods covered by the buyer's record searches are consistent with the RWI policy and the time periods since the seller acquired the properties;
- Confirming which liens are to be released at or before closing, or excluding them from coverage;
- Investigating, as needed, any title related litigation and excluding from coverage as appropriate; and
- Confirming preferential rights to purchase and consents to assign have been handled properly (if they arose by, through or under the seller). If any are outstanding at closing, they should be excluded from the RWI policy coverage.

Conclusion

As we continue to see the consequences of the COVID-19 pandemic on the market, and the resulting increase in the number of transactions done under Section 363 of the U.S. Bankruptcy Code, we expect additional opportunities for creative and agile RWI insurers developing policies that fit the unique terms and conditions of upstream oil and gas transactions.

Depending upon the needs of the particular insured, under the right circumstances, RWI in the acquisition of assets out of a Section 363 sale may be an attractive option for buyers and sellers and, therefore, RWI insurers as well.

With the increase in the use of RWI policies in upstream oil and gas transactions, we expect to see an increase in competition in the RWI insurance market. Along with this increase in

competition, we expect to see RWI policies continue to develop into a win-win for both buyers and sellers of upstream oil and gas assets.

Robert Gray is a partner and Rebecca Seidl is counsel at Mayer Brown LLP.

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[1] In recent upstream oil and gas transactions, although insurers have included SWT claims in RWI policies, such policies have not entirely covered environmental representations, leaving buyers to obtain separate blow out and pollution coverage.