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Consider A Key Insurance Tool For Environmental M&A Deals

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The renewable energy and climate and clean technology sectors have witnessed substantial growth and investment in recent years, spurred by accelerating energy transition initiatives and financial incentives passed into law.

We expect that these initiatives and incentives will result in continued expansion in 2024 and beyond, and mergers and acquisitions will continue to play a pivotal role in facilitating business transactions, project acquisitions and technology transfers in these sectors.

A critical risk allocation tool in many M&A transactions — including transactions in renewable energy and climate and clean tech — is transactional liability insurance, or TLI.

TLI can take the form of representations and warranties insurance, or RWI, as well as customized policies covering tax or contingent risks. As a result, the scope of TLI coverage is often a key factor in completing deals in this space.

In this article, we describe some of the coverage characteristics and considerations for buyers and sellers when obtaining TLI in these sectors for M&A transactions. We also provide practical insights into navigating the TLI underwriting process and maximum TLI coverage.

Transactional Liability Insurance: A Multifaceted Tool for M&A Risk Allocation

RWI — one of the most common forms of TLI — typically replaces or supplements indemnification provided by a seller in a private M&A deal for unknown historical business liabilities that are not discovered in buyer's due diligence.

RWI policies provide coverage for breaches of representations and warranties about the target business made by the seller in an M&A agreement.

Once a niche product, RWI has become standard in most private M&A deals in the U.S. In auctions, sellers often expect bidders — including non-U.S. bidders — to procure RWI as a prerequisite for submitting offers.

At the intersection of standard RWI and a tepid overall M&A market during the past 12 to 18 months has been a decline in premiums for RWI. In deals across all sectors, RWI premiums are at or near historical lows.

RWI premiums for deals in the renewable energy and climate and clean tech sectors have not been immune to this rate pressure, even though M&A in these sectors has continued to be active. This has resulted in a buyers' market for RWI in renewable energy and climate and clean tech, which is likely to continue for at least the beginning of 2024.

More broadly and beyond RWI, TLI can take different forms and, in appropriate circumstances, be customized to address a specific risk that has been identified in the target company or the transaction — for example, a specific contingent liability on the target company's balance sheet.

As we describe further below, buyers of these types of TLI in 2024 — especially in renewable energy and climate and clean tech transactions — can expect higher premiums than standard RWI.

The value of RWI and other forms of TLI can extend beyond the quantitative measurement of premium paid versus risk transferred away from the deal parties. These policies can often solve what can be challenging negotiating points that can delay or derail deal negotiations.

In considering TLI, however, buyers should understand that TLI policies are distinct from other types of insurance that a target company or buyer may have or obtain, such as title policies, cyber insurance and commercial general liability coverage.

Maximizing Value in Transactional Liability Insurance for Renewable Energy and Climate and Clean Tech Deals

In renewable energy and climate and clean tech transactions, TLI can be particularly valuable when assessing the probability and magnitude of certain risks that affect value is difficult. Below we describe some of these key challenges and provide practical insights into obtaining corresponding TLI coverage.

Tax Credit Risks

A significant portion of the value in renewable energy and climate and clean tech is driven by the potential to acquire energy tax credits and certain tax attributes that are often available to a target in the renewable energy space.

The 2022 Inflation Reduction Act marked a significant shift in long-standing U.S. federal tax law, enabling the sale of energy credits. This opened up a new avenue for renewable energy project owners to generate funds, particularly those who are unable to use the federal tax credits produced by their projects.

Among the buyers are banks with extensive experience in tax equity investments and corporate entities seeking a straightforward financial transaction that does not necessitate understanding the intricacies of tax credit projects such as power purchase agreements, capacity factors and nodes.

These corporate buyers want assurance that if the tax credits acquired are disallowed by the Internal Revenue Service, the seller will provide an indemnity payment to compensate for their loss. i.e., related to breach of tax representations.

Tax credit insurance becomes relevant where sellers are sponsors that have limited capital, a subinvestment-grade rating or limited desire for burdening their balance sheets with post-closing indemnity obligations.

Given the challenges in underwriting these tax risks, typical RWI policies do not cover losses that result from the amount, usability, availability or validity of these tax credits.

However, separate, tax credit-specific TLI can often be obtained to cover certain risks associated with these tax credits. For example, some tax credit insurance policies might insure against the risk that the IRS disallows tax credits based on a challenge to the eligible basis of the project or because construction began before the designated date.

Certain credits may also become subject to recapture as a result of future acts that are outside the control of the tax credit seller. i.e., casualty events, and the buyer's recapture loss may not be adequately covered by the project's property and casualty insurance given the other purposes for which such insurance is committed. TLI may be available to cover this recapture as well.

Tax credit insurance can also cover risks in connection with whether the IRS agrees that the project is sited in an energy community for purposes of higher percentage tax credits and, increasingly, whether prevailing wage and apprentice requirements have been met in certain projects.

Coverage under a tax credit insurance policy can be in addition to indemnification from the seller for a breach of tax representations. In that case, the indemnity is often backed up by a cash-sweep and sponsor guaranty, with the policy kicking in if the guarantor cannot perform or if the cash-sweep ceiling is reached.

Tax credit policies in favor of the buyer may alternatively cover the indemnification obligation of the seller for breach of the tax representations without requiring the buyer to seek indemnification from the seller. In any event, the buyer should obtain coverage on the accuracy of the seller's tax representations to the buyer.

Tax credit insurance policies can also be used to backstop existing indemnity obligations of a target company to tax equity investors in a situation where a prospective buyer of the target company does not wish to bear the risk of that existing indemnity.

For example, this can arise where investment time horizons and ownership expectations may vary among different equity investors. Tax credit insurance can be used to more closely align those risk allocations by shifting some of the indemnity risk to one or more insurers.

These tax credit insurance policies are subject to separate underwriting processes, i.e., distinct from RWI policies, and insurers often require additional due diligence in order to issue these policies.

"Known Issues" Limitation

One of the fundamental principles of RWI is that it is not intended as an absolute liability shifting tool — in other words, known issues are generally not covered by RWI.

This means that any issues or breaches of representations and warranties that were known to the insured parties before the policy was issued are typically not covered.

This would include any matters disclosed on the disclosure schedules to the M&A agreement. At the same time, certain known issues, e.g., disputes or claims that are pending and have not been resolved, may be eligible for a different type of TLI: contingent liability insurance.

As the name implies, contingent liability insurance can cover certain risks that may materialize if certain conditions are met — for example, a risk of damages if a target company loses a pending court case. Contingent liability insurance can be obtained in the context of an M&A deal, but it can also be used in non-M&A situations as well.

Similar to the tax insurance described above, contingent liability insurance will require a separate underwriting process, and insurers will thoroughly review the details of the pending case or other known issue to determine whether it can be underwritten.

Environmental Risks

In renewable energy and climate and clean tech deals, environmental risks are often near the top of the list of risks that could significantly affect value realized by the buyer. These risks can include pollution, contamination or noncompliance with environmental regulations.

RWI providers will normally require targeted diligence into environmental matters, which often include environmental site assessments, e.g., Phase I, for all material real property within the scope of the transaction.

This generally requires the buyer to engage an environmental consulting firm, though seller-provided Phase Is may be able to streamline the process for the buyer's diligence and RWI underwriting.

Initially, underwriters of RWI policies may seek specific exclusions — for issues related to asbestos or polychlorinated biphenyls, for example — or sublimits related to specific types of environmental issues that they consider heightened risk matters.

However, buyers will often have the opportunity to address specific risks and obtain coverage by undertaking more extensive due diligence as part of the underwriting process.

In other cases, where the underwriter considers a representation too broad or vaguely worded, making it difficult to adequately diligence, the underwriter may seek to narrow the scope of the representation for purposes of the policy coverage through devices such as knowledge qualifiers.

Budgets and Capital Expenditure

Many renewable energy projects are under development at the time they are involved in an M&A deal and still require significant construction or capital expenditure costs to complete the project.

As a result, representations that speak to construction and capital expenditure budgets, such that a cost overrun would constitute a breach of the representation, are often excluded from RWI coverage. Buyers should narrowly focus the representations on these topics in order to create correspondingly narrow exclusions from RWI coverage.

Performance Guarantees

Many renewable energy projects come with performance guarantees, such as the expected energy output of a solar farm or the efficiency of a technology application.

Since these guarantees relate to future events, insurers may seek to exclude representations that relate to these guarantees from RWI coverage. However, representations that speak to related subjects, such as the sufficiency of assets that may be required to attain a certain performance level, may be eligible for coverage.

As a result, buyers should seek to narrowly tailor any proposed exclusions from coverage on these subjects by distinguishing between any forward-looking statements or representations on future events and representations on related, but current, business and operational conditions.

Future Legislative and Regulatory Changes

The renewable energy and climate and clean tech sectors are heavily influenced by market dynamics and government policies. For example, changes in subsidies, incentives or regulations can affect the financial performance of projects and technologies.

RWI and other TLI policies typically would not cover risks arising out of future events, including changes to laws. Given the nature of these risks, this is one area where buyers and sellers will typically have to get comfortable sharing the risks among themselves.

Technology Assets

Climate and clean tech deals often involve cutting-edge technologies and innovations. Assessing the technological risks and uncertainties associated with these innovations is critical to the value proposition of the deal.

Some RWI providers may be cautious about covering business risk related to emerging technologies. For example, insurers will generally not cover the success of novel technology or the future ability to commercialize it, even if those concepts are the subjects of representations.

However, representations and related diligence may cover related areas — such as legal rights in the technology — that may, in turn, be covered by TLI. Helping insurers understand the technology and its provenance will be important factors in obtaining this coverage.

Key Takeaways

RWI and other forms of TLI are valuable risk management tools in renewable energy and climate and clean tech M&A deals. The availability of these types of insurance has expanded as deals in these sectors become more prevalent, with customization options to address industry-specific concerns.

In addition to the topic-specific insights summarized above, buyers should keep in mind the following when working with insurers to craft the best possible TLI coverage.

Parties seeking TLI must be aware of the diligence required to obtain coverage and the limitations of coverage. TLI in these sectors will require a thoughtful, tailored due diligence process by the buyer that is designed to address the underwriting requirements of the TLI insurers.

Navigating these complexities requires a deep understanding of the industry and careful negotiation of policy terms to align risks, diligence and insurance coverage. Policies can often be structured to address specific goals of a buyer and the specific contexts in which risks may arise.

Determining the scope of coverage is often a negotiated, iterative process. Buyers should engage with their advisers and insurers as early as possible in the process to get ahead of potential underwriting gaps that may negatively affect the scope of coverage. Many of these gaps can be addressed in some respect if they are identified at an early stage.

Buyers should encourage their TLI broker to work closely with the buyers' property and casualty insurance brokers to avoid gaps in coverage. TLI underwriters will normally have an interest in confirming the reasonableness and overall strength of a target's existing insurance coverage and that the transaction will not create too much risk of uninsured claims that would fall to the TLI policy, i.e., prior acts coverage.

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