TRANSACTIONAL RISK INSURANCE

IN ENERGY AND INFRASTRUCTURE M&A TRANSACTIONS

ADVANT Nctm

1. INTRODUCTION

Among the contractual risk-allocation tools typically used in M&A transactions, transactional risk insurance policies and, more generally, insurance products specifically tailored for extraordinary transactions have become increasingly widespread.

These instruments are intended to facilitate negotiations between the parties by transferring to the insurer the risk of financial losses inherent in the transaction, thereby pursuing the seller's interest in achieving a clean exit while protecting the buyer against potential liabilities.

The solutions most commonly adopted in transactional practice include W&I policies, alongside other insurance products of a different nature, including: (i) policies covering specific known and identified risks that may emerge during the due diligence phase (Contingent Risk Policies), (ii) policies covering title to real estate assets (Title Risk Policies), and (iii) policies designed for fund closures (End of Fund Life Wrappers).

In addition, in today's increasingly sophisticated transactional insurance market, brokers have expanded their range of services to include analyses and assessments of the insurance coverage already in place within target companies. Such assessments are aimed at evaluating the adequacy and completeness of existing coverage, identifying uninsured risks, and determining whether the existing policy limits are appropriate in light of the target company's business activities.

The use of W&I policies and, more generally, transactional risk insurance products has progressively expanded across European civil law jurisdictions as well, driven by several factors, namely: (i) the gradual simplification of underwriting processes; (ii) the increased affordability of insurance premiums; and, above all, (iii) the introduction of tailored products, including solutions specifically designed for small and mid-sized transactions.

According to the latest available data, the number of policies underwritten in 2024 in connection with M&A transactions in the Italian market totalled nearly 400, meaning that approximately 20% of all Italian M&A transactions were backed by a W&I policy. This growth trend has remained steady in recent years and has also extended to the energy and infrastructure sectors, where insurance products accounted – consistently with broader M&A market trends – for approximately 20% of the total number of W&I policies underwritten in this particular market segment, which is characterised by a significant regulatory impact on generated cash flows.

2. REGULATORY FRAMEWORK AND IVASS CLARIFICATIONS

As mentioned, W&I policies provide insurance coverage in respect of the seller's indemnification obligations and may be structured as "buy-side" or "sell-side" policies, depending on whether the policyholder is the buyer or the seller. Such policies are governed by the Italian civil law provisions on contracts (Articles 1321–1932 of the Italian Civil Code) and, in particular, insurance contracts (Articles 1882–1932 of the Italian Civil Code).

The distinctive features of these instruments have only recently attracted the attention of legal scholars and courts, which, to date, have addressed them only sporadically and to a limited extent.

In the past, certain concerns had been raised regarding the compatibility of such policies with the prohibition set out in ISVAP Regulation No. 29/2009 (which prohibits insurance coverage for contingent liabilities arising from extraordinary corporate transactions[1]). In 2019, however, IVASS expressly clarified that, while confirming the general applicability of such prohibition, the following categories fall outside its scope: (i) buy-side policies based on "*(…) limited and identified*

[1] See Article 4, paragraph 2, of IVASS Regulation 29/2009, which provides that *"(…) in any event, cover intended to guarantee the reimbursement of contingent liabilities or capital losses on assets arising from valuations resulting from extraordinary corporate transactions (…)"* may not be issued.

commitments not arising from valuations, capable of adequate actuarial risk assessment and suitable for giving rise to indemnities that do not coincide with the consideration for the extraordinary corporate transaction (…)" and (ii) sell-side policies, when intended to insure the risk arising from the seller's indemnification obligations in the event of a breach of the specific warranties granted by the seller in the context of an extraordinary corporate transaction.

3. BUY-SIDE AND SELL-SIDE POLICIES

As noted above, W&I policies may be taken out either by the buyer ("buy-side policies") or by the seller ("sell-side policies"), although the former are by far the most common in market practice.

Both contract types are designed to cover the same underlying risk, namely liability arising from the inaccuracy, falsity or breach of the representations and warranties provided by the seller under the sale and purchase agreement, albeit with one significant difference: (i) under a buy-side policy, the buyer insures against the risk of a reduction in the value of the acquired shareholding; while (ii) under a sell-side policy, the seller insures against the risk associated with its obligation to indemnify the buyer for losses resulting from inaccuracy or breach of the representations and warranties.

Under buy-side policies, share purchase agreements commonly regulate the indemnification process by expressly coordinating it with the insurance coverage and stipulating that any claim for compensation by the buyer must be made exclusively against the insurer, while the seller is notified, for information purposes, where appropriate. Under this contractual arrangement, the seller is, in most cases, released from any further indemnification obligations towards the buyer or the target company, with the insurance proceeds constituting the buyer's sole remedy, to the exclusion of any other remedies available under the law.

Under the less common sell-side policies, by contrast, the insured party is the seller, who is indemnified by the insurer upon receipt of a claim from the buyer. In such case, the buyer's contractual right to seek indemnification directly from the seller remains unaffected.

From a legal classification perspective, sell-side policies qualify as liability insurance under Article 1917 of the Italian Civil Code, as the seller insures against the risk of losses caused to the buyer as a result of breach of representations and warranties. Buy-side policies, on the other hand, are generally classified within the category of insurance against "various financial losses" under Article 2(3)(16) of Legislative Decree No. 209/2005.

Buy-side policies are considered atypical in two respects: first, they do not insure loss affecting a specific asset, since representations and warranties typically relate not to the shareholding itself, but rather to the underlying business and operations; second, they do not protect the buyer's claim against the seller, which is often contractually excluded in advance precisely because of the policy.

Legal scholars have observed that buy-side insurance covers indirect loss, consisting of the loss of the economic benefit that the buyer intended to derive from the business that is the subject of the sale, by assuming the risk of a reduction in such value due to inaccurate representations by the seller. Such loss may manifest itself both as an outlay necessary to restore full economic benefit and as a loss of profit. It follows that the policy taken out by the buyer cannot be classified as insurance against direct damage to a specific asset, but must be classified under the residual branch of insurance against financial loss.

4. KEY CONSIDERATIONS FOR W&I POLICIES: (I) KNOWLEDGE OF THE POLICYHOLDER, (II) THE INSURER'S RIGHT OF SUBROGATION AND (III) THE RELATIONSHIP BETWEEN THE POLICY AND THE INDEMNITY OBLIGATIONS

As is typical of insurance contracts, knowledge of the policyholder also plays a central role in W&I policies, having a direct impact – alongside a thorough risk assessment – on the insurability of the risk, as well as on the amount of the premium due. Indeed, the insurer's assessment is based on the information known and disclosed by the policyholder; these must not be distorted by inaccuracies or omissions, which would vitiate the insurer's consent to enter into the contract.

In this regard, it should be noted that W&I policies normally define the concept of "relevant knowledge", limiting it to the actual knowledge of a specific group of individuals (the Transaction Team), and also stipulate that insurance cover shall be deemed excluded if the inaccuracy of the contractual representations or warranties was known to the policyholder. In this regard, the provisions of the Italian Civil Code stipulate that (i) in the most serious case of fraudulent or grossly negligent misrepresentations, the insurer is entitled to seek the annulment of the contract (Article 1892 of the Italian Civil Code); while in cases of ordinary negligence, the insurer may withdraw from the contract or reduce the compensation payable, in accordance with the provisions of the Italian Civil Code (Article 1893 of the Italian Civil Code). On the other hand, the validity of clauses granting the insurer an automatic termination right may be questionable, as they conflict with the provisions of the Italian Civil Code.

The distinction between buy-side and sell-side reports is also significant when it comes to due diligence: the insurer's review primarily focuses on the due diligence reports prepared by the buyer's advisers as part of a "second-level review" – also known as the "underwriting" process – carried out independently by the insurer with the aim of ascertaining the actual extent of the risks and providing for, where appropriate, exclusions from cover. As part of this process, the insurer will also assess the overall volume and quality of the information made available by the seller to the buyer and their advisers, requesting additional information where deemed necessary (through so-called "UW questions") and organising a dedicated underwriting call to facilitate understanding of the risks and, consequently, the definition of the policy's coverage terms.

In the context of sell-side policies, however, where the seller acts as the policyholder, the seller's knowledge of breaches may encourage opportunistic behaviour (moral hazard), although this risk is at least partially mitigated by the insurer's right of subrogation against the party responsible for the damage, as provided for in Article 1916 of the Italian Civil Code.

Finally, depending on the circumstances and the terms of the negotiations, the insurance policy may serve as a supplement to the seller's indemnity, covering the amount exceeding a contractual limit, or it may constitute the sole remedy available to the buyer. The choice between one solution or the other is almost always the result of the parties' negotiating requirements and the seller's willingness to assume a certain degree of risk; on the understanding that in such cases the sale and purchase agreement and the policy must be drafted in a coordinated manner, so as to avoid overlaps or gaps in their respective provisions.

5. ADDITIONAL INSURANCE PRODUCTS FOR THE M&A MARKET

Alongside W&I policies, commercial practice has recently seen the emergence of complementary insurance products such as "Tax Liability Insurance", i.e. policies designed to cover specific tax risks; and "Contingent Risk Insurance", intended instead to manage known but difficult-to-quantify risks, such as pending or threatened litigation (litigation buy-outs) or administrative permits whose validity or effectiveness is under challenge.

In so-called "distressed M&A" contexts – i.e. transactions involving targets affected by financial distress – there has also been a rise in so-called "Synthetic W&I" policies, which do not rely on the seller's representations and warranties, but are instead based directly on due diligence carried out independently by the insurer. Within this framework, the insurance function is not limited to transferring the risk arising from the breach of existing contractual warranties, but also addresses their absence or insufficiency, offering the buyer – unlike standard W&I policies – protection that is independent of the contractual structure of the transaction.

In competitive sale processes, by contrast, so-called "stapled W&I" policies have become increasingly common. Such policies are pre-arranged in order to make the transaction more attractive to potential buyers. From a functional perspective, they are intended to standardise risk allocation and make the transaction process more efficient. By negotiating the W&I policy in advance, the seller can offer bidders a uniform level of protection, thereby reducing information asymmetries and expediting negotiations concerning representations and warranties. For the buyer, in turn, the policy constitutes an immediately available protection mechanism, without the need for separate insurance negotiations.

Apart from the need for the seller to negotiate the policy with the insurer in advance, stapled W&I policies essentially follow the same legal principles as buy-side policies: the insured risk remains the loss suffered by the buyer as a result of inaccurate representations and warranties made by the seller, and the latter is normally released from any further indemnity obligations, except in cases of wilful misconduct or gross negligence. The legal classification likewise remains that of insurance against financial loss.

Finally, mention should be made of so-called "End of Fund Life Wrapper" policies, designed for investment funds. These policies fall within the sell-side category and are intended to insure against any liabilities arising from a series of interconnected transactions, such as those completed by a fund during its operational life, through to divestment and the subsequent distribution of proceeds to investors.

6. THE MARKET FOR SO-CALLED "TRANSACTIONAL INSURANCE" IN THE ENERGY AND INFRASTRUCTURE SECTOR: MANAGING THE UNDERWRITING PROCESS FOR EFFECTIVE INSURANCE COVER

In the Italian energy and infrastructure market, W&I policies have seen increasing use and have become widely adopted instruments in M&A transactions, particularly in relation to operational renewable energy plants, especially where government incentives are involved.

This widespread use can be explained by the significant economic value of the assets being acquired and sold, the complexity of the regulatory and authorisation framework – particularly with regard to incentivised plants – as well as the broad range of potential risks associated with breaches of representations and warranties, particularly in environmental and tax matters. In this context, W&I policies enable efficient risk allocation by transferring to the insurer the exposure arising from unknown events and significantly reducing the seller's post-closing liability.

In terms of transaction volume and commercial conditions, the energy and infrastructure segment is one of the areas where W&I insurance is most frequently used, also due to premiums that have become increasingly competitive over time. In transactions involving energy assets, market trends show premiums calculated as low percentages, thereby making W&I insurance an attractive tool for institutional investors and infrastructure funds and contributing to faster transaction execution in deals requiring specific expertise to coordinate acquisition or investment agreements with the mechanisms of insurance products available on the market.

It is therefore worth considering which aspects require particular attention to ensure that policies operate effectively, including at the claims stage. In this respect, it is important to emphasise the significance of managing the underwriting process, which deserves careful attention even before it formally begins – specifically in the assessment of risks within the due diligence report and the identification of proportionate mitigants – through to the negotiation of the policy's terms and conditions with the insurer.

In these activities, the involvement of a legal adviser with adequate knowledge of the characteristics of the relevant assets is not only useful when negotiating the acquisition agreement, but may also prove crucial in aligning the representations and warranties and the findings of the due diligence with the actual scope of the insurance cover, thereby reducing the risk of unexpected exclusions or disputes at the claims stage. In negotiating the terms and conditions of the policy, in particular, specialist legal support can ensure consistency with the agreed contractual framework and optimise the scope of exclusions by strategically addressing retention levels, definitions and claims mechanisms. This requires an adequate understanding of the underlying risks, enabling identified critical issues to be translated across different technical languages, moving from technical to contractual language and, ultimately, from contractual to insurance language.

Piero Viganò
piero.vigano@advant-nctm.com

Giuliano Proietto
giuliano.proietto@advant-nctm.com

Jacopo Arnaboldi
jacopo.arnaboldi@advant-nctm.com

Michele Motta
michele.motta@advant-nctm.com