like horizontal mergers where, if the DOJ establishes high market shares, there is a presumption of harm to competition under well-established case law, the DOJ benefited from no presumption of harm under the sparse case law addressing vertical mergers. Without this presumption, the DOJ relied heavily on statements from the parties' internal documents and filings with regulators, complaints from competing distributors, and its economic expert's model predicting price increases. The court found this evidence lacking. Instead, the court determined that "real-world pricing data and the experiences of individuals who have negotiated on behalf of vertically integrated entities all fail to support the Government's increased-leverage theory."

Notwithstanding this decision, vertical mergers combining firms that control critical inputs or otherwise enjoy market power will continue to generate significant antitrust scrutiny. In fact, Judge Leon cautioned readers to resist the "temptation" to view this decision as "more than a resolution of this specific case." Even so, this decision makes clear that vertical theories of competitive harm require strong support based on real-world evidence. Further, the decision is likely to embolden merging parties to resist demands from antitrust regulators to remedy vertical concerns through divestitures of material assets, rather than behavioral commitments.

The decision is also a reminder that the antitrust agencies and courts continue to rely heavily on companies' internal documents to assess anticompetitive intent or effects of mergers—whether vertical or horizontal. Here, the court specifically contrasted this case with other recent merger challenges, stating this was not a transaction where documents of senior executives contained "direct, probative evidence of anticompetitive intent." Instead, the court found the "snippets" cited by the DOJ from interim drafts authored by lower-level employees unpersuasive. As always, it will continue to behoove parties to exercise caution and consult counsel when drafting documents explaining the rationale for their transactions. Finally, this case shows that parties that commit to defend their mergers in litigation and are able to endure a prolonged antitrust review may be rewarded.

The DOJ is appealing Judge Leon's decision.

ENDNOTES:

[1] https://www.justice.gov/opa/pr/justice-department-allows-comcast-nbcu-joint-venture-proceed-conditions.

[2] https://www.ftc.gov/news-events/press-releases/1996/09/ftc-requires-restructuring-time-warnerturner-deal-settlement.

REPRESENTATION AND WARRANTY INSURANCE IN JAPANESE M&A TRANSACTIONS

By Stephen D. Bohrer

Stephen D. Bohrer is a Foreign Law Partner at Nishimura & Asahi and a leader of the firm's Cross-Border Transactions Group. Contact: s_bohrer@jurists.co.jp.

Japan is one of the few developed M&A markets that has eschewed the usage of insurance to cover breaches of representations and warranties in local acquisition agreements. While the utilization of this insurance took its roots over 20 years ago in the United States as a solution for private equity sellers seeking to escape tying up acquisition agreement sales proceeds in an indemnity escrow account, its use by both private equity and strategic buyers and sellers has grown substantially in recent years. For example, Marsh LLC placed over 700 policies worldwide in 2017 (with a total worldwide market issuance estimated at approximately 2,800 during 2017), representing a 28% increase from 2016. During 2017, Japanese companies utilized insurance to cover breaches of representations and warranties on an estimated 10%

to 20% of their cross-border transactions, with Marsh placing during this period over $880 million of insurance coverage on behalf of Japanese companies (principally in connection with their acquisitions of U.S. companies). In contrast, the use of insurance to cover breaches of representations and warranties remains practically non-existent in the domestic Japanese M&A market, despite 2017 witnessing approximately 460 local acquisitions having a total deal value of approximately $43.2 billion.

With Japanese buyers gaining a better understanding of insurance to cover breaches of representations and warranties through their usage of this product in cross-border acquisitions, Japanese private equity activity earmarked to increase and the Japanese M&A market continuing its growth in size and deal sophistication, the use of this insurance product in domestic Japanese M&A transactions is inevitable. For deal professionals with their pulse on M&A, this trend should not come as a surprise.

This article discusses the (i) mechanics and advantages of using insurance to cover breaches of representations and warranties in M&A transactions, (ii) limitations of this insurance in M&A transactions, and (iii) local nuances and traps for the unwary when using insurance to cover breaches of representations and warranties in Japanese M&A transactions. Understanding the Japanese insurance market is not only helpful for local transaction parties, but such knowledge also could be invaluable for overseas buyers of Japanese assets when considering how to structure insurance in a given transaction, especially if claims under the policy will be paid in Japan.

Mechanics and Advantages of M&A Insurance

The mechanics and advantages of insurance to cover breaches of representations and warranties will depend on the insurance standard applied. The policies generally follow either U.S. documentation and underwriting standards or so-called *Rest of the World* standards (essentially a UK-engineered insurance solution that insurance companies have successfully expanded globally). A policy following U.S. documentation and underwriting standards is normally referred to as a "Representation and Warranty Insurance Policy" and a policy adopting *Rest of the World* standards is normally referred to as a "Warranty and Indemnity Insurance Policy." For ease of reference and neutrality in this article, an insurance policy following either U.S. or *Rest of the World* documentation and underwriting standards is simply referred to as an "M&A insurance policy." Japan has not developed its own M&A insurance standard and by default follows the *Rest of the World* documentation and underwriting standard, subject to certain nuances (as discussed below).

There are material differences between M&A insurance policies following U.S. or *Rest of the World* documentation and underwriting standards. Annex A compares these approaches. The domicile of the insured, where a substantial portion of the target's assets are located, the identity of the seller and the documentation style of the underlying acquisition agreement normally factor into which insurance standard applies.

Mechanics

An M&A insurance policy can serve as a supplement or even a replacement for contractual indemnities, and can provide an important bridge when issues exist concerning the support of indemnification claims. In a nutshell, an M&A insurance policy most commonly covers a buyer for losses that are claimed during the policy period for breaches of an acquisition agreement's representations and warranties and tax indemnity for pre-closing taxes. M&A insurance policies do not cover covenant breaches, purchase price adjustments and other payment obligations.

The most common approach is to purchase a policy that covers losses up to approximately 10% to 25% of the target's enterprise value (*i.e.*, the target's debt plus equity), subject to a minimum loss retention amount (often 1% of the target's enterprise value). An experienced broker will be able to provide nuanced advice on what insurance loss retention options are available and the interplay with how the seller and the buyer share the financial burden of the loss retention amounts. Often the parties negotiate to match the claims thresholds under the acquisition agreement with those available under the M&A insurance policy.

Advantages

M&A insurance policies initially were championed by private equity sellers because the backdrop of an insurance policy would permit a lower amount of sales proceeds to be placed into an indemnity escrow account, thereby allowing a greater immediate cash distribution to the private equity partners and avoiding the conundrum of how to treat escrowed proceeds after the long-stop dissolution date of the private equity fund. A sell-side M&A insurance policy (a policy in which the seller is the insured) has become less common in recent years with sellers realizing they can achieve a cleaner exit when the buyer purchases a buy-side M&A insurance policy (a policy in which the buyer is the insured).

M&A insurance policies can have various useful features that can greatly benefit any type of buyer in an M&A transaction, such as having:

- regardless of the survival period stipulated in the acquisition agreement, a claim survival period equal to three years for breaches of non-fundamental/general warranties (*e.g.*, the accuracy of financial statements, employment matters and material contracts) and six or seven years for breaches of tax and fundamental warranties (*e.g.*, authorization to enter into the agreement and ownership of shares being sold);

- a full materiality scrape, meaning the policy will "read out" materiality qualifiers in the representations and warranties for purposes of determining whether a representation or warranty has been breached or in computing the amount of losses suffered (although typically this feature is available only for insurance policies adopting U.S. documentation and underwriting standards);

- no exclusions on the buyer's damage recovery, thereby permitting coverage for losses such as consequential and multiplied damages (so long as the acquisition agreement is silent on this matter or does not expressly exclude such losses, and typically available only for insurance policies adopting U.S. documentation and underwriting standards);

- no requirement to involve the seller in claims (although insurance companies will require the buyer to maintain subrogation rights against the seller in the event of seller fraud) since the buyer can seek recovery for damages directly against an insurance company, which can be especially helpful if the seller is located in a country where it is difficult to enforce a litigation judgment, the seller's financial condition is uncertain, or a seller is a member of the management team that will work at the target company post-closing (as initiating an indemnification claim against key management could negatively impact the business even more than the subject loss by creating a hostile work environment);

- no ability of a seller to thwart payment of claims as is possible under escrow agreements, since the escrow agent ordinarily will require the consent of both the buyer and the seller to release escrowed funds (so a disgruntled seller could refuse to release funds as a gaming tactic to negotiate a better settlement with the buyer); and

- the potential for a buyer to make its purchase offer comparatively more attractive in an auction context by proposing a lower cap and shorter survival period for the seller escrow or indemnity limits (with even the possibility for the seller to have no indemnification obligation if the buyer purchases a policy that provides no recourse against the seller for any portion of the losses).

Also, having an M&A insurance policy as the main recovery source for a buyer's losses under an acquisition agreement could create an incentive for a seller to be more flexible in its negotiations over the scope of the representations and warranties since the sellers' liability normally would be capped at its portion of the loss retention amount (or zero if the buyer purchases a policy that provides no recourse against the seller for any portion of the losses). Such potential greater seller flexibility could result in the seller accepting more changes to the representations and warranties, potentially leading to the buyer receiving more robust coverage than would have been available had the insurance policy not been secured.

Limitations of M&A Insurance

Despite its benefits, M&A insurance is not a panacea. There are limitations with M&A insurance policies that may diminish the utility of this product to an insured due to the treatment of information known by the insured, the magnitude of the due diligence that must be performed by the insured, and the type of losses that are excluded from coverage.

M&A insurance policies do not permit so-called "sandbagging." In other words, an insured cannot recover under an M&A insurance policy if members of the insured's deal team have knowledge of the breach prior to the effective date of the policy. Such persons will be identified by name in the M&A insurance policy. Furthermore, for M&A insurance policies that follow *Rest of the World* documentation underwriting standards (which the Japanese market follows), knowledge will entail not only a person's actual knowledge but also deemed knowledge of all facts, matters or circumstances contained in the due diligence data room, due diligence reports and disclosure schedules if the information is "fairly disclosed" (a term defined in the policy). A buyer, therefore, will not be able to claim under an M&A insurance policy if information that would cure a breach has been fairly disclosed in the data room regardless of whether the deal team members listed with having knowledge actually read or understood such posted information.

Given the crux of assessing knowledge to loss recovery under an M&A insurance policy, a buyer should expect that insurance companies will require the buyer to (i) demonstrate that it has undertaken a full market standard due diligence on the target's business (as opposed to a focused due diligence on commercial issues), (ii) perform supplemental due diligence on material open items or issues identified in due diligence reports, and (iii) update its due diligence exercise if there has been a meaningful gap in time between the end date of due diligence and the effective date of the M&A insurance policy. The knowledge learned from each of the foregoing most likely would be excluded from coverage under the M&A insurance policy, thereby increasing the buyer's transaction fees without commensurate insurance coverage (but at the same time should provide the buyer with a better understanding of the target's business, which should prove helpful in the buyer's post-transaction integration planning and its ability to potentially negotiate an upfront purchase price reduction).

M&A insurance policies also do not provide blanket coverage for all risks. A set of standard exclusions apply, driven by the fact that either there are risks that should be covered under other insurance policies or there are areas that an insured typically cannot thoroughly investigate, such as losses relating to pollution, anti-corruption and bribery, cyber/data security, pension plans, economic sanctions, product liability and transfer pricing.

M&A insurance policies additionally will exclude from coverage (i) highlighted language in the acquisition agreement's warranties (for M&A insurance policies following *Rest of the World* documentation and underwriting standards), and (ii) transaction-specific exclusions arising from the insurance company's evaluation that the buyer did not sufficiently demonstrate that it confirmed the accuracy of the warranties provided by the seller under the acquisition agreement through its own due diligence (for both U.S. and *Rest of the World* policies). If a buyer can demonstrate that it sufficiently analyzed the risk or that the risk actually is inconsequential, then insurance companies are typically open to reconsidering the inclusion of the transaction-specific risk (although the buyer's efforts to remove the exclusion from the M&A insurance policy will likely result in it incurring further due diligence fees).

In light of the foregoing, a buyer will need to carefully examine the actual risks not covered by the M&A insurance policy and consider whether it is necessary to obtain from the seller a special indemnity agreement for such excluded matters. If a special indemnity between the buyer and the seller is agreed, then an escrow agreement may be necessary to support payment claims under the special indemnity (so the buyer may need to negotiate an escrow agreement and pay escrow agent fees even if an M&A insurance policy is purchased).

Special Considerations When Obtaining M&A Insurance in Japan

While a buyer may have options in terms of how an M&A insurance policy is structured, fundamentally the policy will follow a general underwriting standard that will be subject to the legal requirements and market practices of the jurisdiction in which the policy is issued. As mentioned above, Japan typically follows *Rest of the World* documentation and underwriting standards.

For M&A insurance policies issued in Japan to a local domiciled policyholder, there are a number of nuances that the insured and even those accustomed to purchasing M&A insurance policies outside of Japan should understand, including:

Compliance with local insurance regulations. Japan's Financial Services Agency imposes relatively strict insurance regulations on policyholders, insurance brokers and insurance companies. Therefore, the suitability of the broker to appoint and the insurance companies to approach (and their ability to support the desired deal structure) should be considered from the outset.

Policy format. Japanese insurance regulations require insurance companies to file their template M&A insurance policy with Japan's Financial Services Agency. The filed policy is very basic. Changes to the filed policy are expected and negotiated through a set of additional clauses called "endorsements." During the insurance underwriting process, an insurance company will release a set of endorsements to bring the policy in line with the specifics of the transaction and most recent best practices for M&A insurance policies. Subsequent negotiations between the insured and the insurance company entail modifying the insurance endorsements. This process differs from some other countries where changes are made directly to the base policy. Ultimately, the same coverage position may be achieved, but how the endorsements weave through the filed M&A insurance policy requires special attention and should be reviewed by an experienced broker and legal counsel.

Premium paid at inception. Typically, an M&A insurance policy comes into effect on the signing date of the acquisition agreement. M&A insurance companies around the globe, unless restricted by local regulations, collect all or the majority of the premium after the deal closes. Japanese insurance regulations mandate that the insurance premium must be paid in full in order for the M&A insurance policy to come into effect, so payment must be made on or before the signing date of the acquisition agreement. An insured may not expect to have such payment obligation so soon in the M&A process, so advance notice is advisable to avoid glitches.

Binder documentation. When the signing date and the closing date are different, insurance companies typically issue "binder agreements" in the U.S. and "cover notes" in the UK that set forth the conditions pursuant to which the policy can become effective, such as the deal closing and the payment of the premium. Since the full premium amount must be paid when the policy comes into effect in Japan (typically the signing date of the acquisition agreement), the provisions that typically appear in the binder or cover note will be directly imbedded into an M&A insurance policy issued in Japan, and insurance companies will provide a simple insurance certificate at policy signing against the execution of an application form by the insured.

English language documentation. It is currently not possible to purchase an M&A insurance policy if the deal documentation will be in Japanese only. However, a select number of insurance companies are willing to offer an M&A insurance policy if the insured will provide an English translation of the executive summary and other key sections of the due diligence reports, along with a full English translation of the final version of the acquisition agreement. As providing the insurance company with an English translation of the final acquisition agreement will by nature occur at the very end of the negotiation process, an insured would be well advised to provide an English translation of the first draft of the acquisition agreement and interim material changes in order to reduce excessive last minute negotiations with the insurance company (and possible lapses in coverage between the M&A insurance policy and the acquisition agreement due to an impasse in discussions with the insurance company). While English language documentation is commonplace in cross-border transactions involving Japanese target companies, the usage of English language documentation in a purely domestic Japanese M&A transaction is exceptional, so advance preparations and adjustments to the deal's timetable are essential (although the expense of providing English language documentation could prove too burdensome for an insured and discourage it from purchasing an M&A insurance policy).

English language M&A insurance policy. Insurance companies have registered only the English language version of their template M&A insurance policy with Japan's Financial Services Agency. While some insurance companies have translated their English language template, fully binding Japanese language M&A insurance policies are not yet available (which domestic Japanese companies may find discouraging). As a result, the M&A insurance policy will apply only to an English language version of the acquisition agreement (which can be a translation of the acquisition agreement). An insured undertaking a purely domestic Japanese M&A transaction with Japanese language documentation will need to be comfortable at the outset with the requirement to provide an English translation of the acquisition agreement, and may wish to engage proficient legal counsel and an insurance broker who are familiar with this product in order to provide the requisite language translation and advice to ensure a smooth insurance underwriting process.

No premium tax. Insurance premium payments are subject to taxation in most countries. For example, the Netherlands imposes a 21% tax on top of premium payments. Fortunately, in Japan premiums are not subject to the imposition of a premium tax, which could lead to cost savings when a policy is issued in Japan. Separately, claim proceeds paid to a Japanese policyholder under an M&A insurance policy are treated as taxable income and subject to income tax. Insurance companies may include a tax gross-up in the insurance policy (in return for a higher premium payment), but professional tax advice should be sought to ensure that there is no "tax-on-tax" effect (as the gross-up itself may be taxable).

Anti-social forces not covered. Most Japanese acquisition agreements include a unique representation and warranty that the target company's management is not associated with "anti-social forces" (essentially, a code-name for organized crime). The pervasive influence of organized crime in Japan cannot be underestimated, and local buyers are accustomed as a best practice to obtaining assurances that management is not associated with racketeering. However, as most M&A insurance policies (irrespective of whether the policy is placed in Japan or elsewhere) exclude losses arising from bribery claims, this staple Japanese representation and warranty will escape coverage under an M&A insurance policy.

Catch-all and vague contract provisions may not be covered. Generally speaking, acquisition agreements entered into between Japanese parties in domestic M&A transactions tend to have more vaguely worded representations and warranties in comparison to acquisition agreements used in the United States and Western Europe. The use and acceptance of vague terminology may be due to a perceived local preference that contracting parties should not engage in intense upfront contract negotiations and should amicably resolve disputes in light of the overall importance for Japanese businesses to maintain good relations. However, insurance companies will have difficulties providing M&A insurance coverage on clauses that are too opaque and may either exclude the subject provisions from coverage or deem the provisions to be more narrowly defined, resulting in a potential coverage gap between the acquisition agreement and the M&A insurance policy over a particular representation and warranty (unless the acquisition agreement is revised to follow the coverage under the M&A insurance policy).

Insurance company competition and environment. Compared to the U.S. and Europe, Japan has relatively fewer insurance companies offering M&A insurance policies. However, the number of insurance companies that have registered their template M&A insurance policy with Japan's Financial Services Agency include some of the biggest and most active underwriters. Namely, AIG General Insurance, three syndicates through Lloyd's Japan (Pembroke, Beazley and Allied World), Tokio Marine HCC, Aioi Nissay Dowa, Sompo Japan Nipponkoa, and Mitsui Sumitomo Insurance. Nonetheless, with relatively fewer insurance companies chasing Japanese deals, a natural outgrowth is presumably lower competitive pressure on pricing and insurance terms.

While the focus of this article is on domestic Japanese M&A transactions, most of the considerations listed above also would apply to an M&A insurance policy issued to a policyholder in Japan in connection with its overseas acquisitions (currently the most frequent purchase scenario for this insurance product).

Conclusion

Despite the potential limitations of an M&A insurance policy to an insured, the use of this product is widespread and growing in various M&A markets. Clearly, an M&A insurance policy can provide great benefits to sellers who seek a clean exit from an investment without contingent indemnification exposure, and an M&A insurance policy can serve as a useful recovery tool for buyers who cannot or do not want to file a claim against a seller.

To help maximize the benefits and coverage under an M&A insurance policy, an insured should retain an experienced broker and legal counsel who understand the insurance options available and can carefully review and amend the M&A insurance policy. Even though policy language is becoming more standardized, coverage is customized for each deal, and some terms are negotiable. In addition, an insured and its advisors should carefully scrutinize each insurance company's non-binding intention letter (a commitment solicited at the outset of the insurance underwriting process from the insurance company to underwrite the risk). Although non-binding, an insured should expect that the insurance company will adhere to the provisions in its non-binding intention letter through-out the underwriting process, so it would be prudent for an insured with the assistance of advisors to take advantage of its relatively greater bargaining strength at the early stages of the underwriting process to weed out provisions from the letter that could materially detract from the ultimate benefits of the issued M&A insurance policy.

Annex A
Comparison of Insurance Underwriting Standards

	Rest of the World **Policies (Warranty & Indemnity Insurance)**	**United States Policies (Representation & Warranty Insurance)**
Target Business Location and Policyholder's Domicile	Principally, the United Kingdom, Europe, Asia, and Australia Rapid growth in less developed countries	Principally, the United States Availability outside the U.S. growing for U.S. style agreements
Typical Insurance Coverage Amounts (Limits)	10% to 35% of enterprise value (often higher for smaller deals), with up to a maximum of approximately $600 million in coverage	10% to 25% of enterprise value, with up to a maximum of approximately $1 billion in coverage Match full materiality scrape (if in acquisition agreement) No exclusions on buyer's damage recovery (permitting coverage for losses, such as consequential and multiplied damages)
Loss Retention to Insured	1% of enterprise value is standard, although some insurers will quote 0.5% for targets in mature markets (such as the UK, Europe and Australia) Seller often assumes the full retention amount, however, nil seller recourse deals are becoming more common Tipping retention becoming more common in mature markets, including tipping to zero	1% of enterprise value is standard, although some insurers will quote lower than 1% (such as 0.85%) to attract business Buyer often assumes the first half of retention amount and seller assumes the second half, unless it is a nil seller recourse policy Insurance companies often willing to halve the retention for claims discovered later than 12 to 18 months after closing
De Minimis	0.1% of enterprise value (minimum)	None
Premium	0.8% to 2.5% of the coverage amount purchased, depending on the jurisdiction and industry of target Premium rates dropped approximately 30% in Europe, 18% in Asia and 19% in Pacific from 2016 to 2017	2.5% to 4% of the coverage amount purchased Premium rates dropped approximately 13% in the U.S. from 2016 to 2017

Payment of Premium	Standard position is for policy to come into effect at signing, but the premium is not paid until closing (except for certain countries, such as Japan, where the premium must be paid at signing) If deal does not close, insurance companies will retain 10% of the premium	Standard position is for policy to come into effect at closing and premium due shortly after closing Policy can incept at signing for a 10% non-refundable deposit
Underwriting Fee	$25,000 to $35,000 (or up to $50,000 if non-English documentation involved) Underwriting fee usually subtracted from premium if policy purchased List of underwriting questions provided in advance of due diligence call	$25,000 to $45,000 (or up to $50,000 if non-English documentation involved) Underwriting fee is in addition to the premium, and buyer must have exclusivity to commence underwriting List of underwriting questions not provided in advance of due diligence call (just a general category of questions)
Excess Line Underwriting Fee (for syndicated insurance)	Each insurance company joining the underwriting syndicate generally agrees to contribute towards the lead insurance company's legal fees on a *pro rata* basis based on the amount of the premium received	Additional $5,000 charged to the insured for each insurance company joining the underwriting syndicate
Buyer's Knowledge	Anything the insured is aware of at policy inception is a standard exclusion (i.e., no sandbagging), including information "fairly disclosed" in disclosure schedules, due diligence reports and the data room Knowledge often limited to specific deal team members	Anything the insured is aware of at policy inception is a standard exclusion (i.e., no sandbagging), but no imputed knowledge of information "fairly disclosed" in disclosure schedules, due diligence reports and the data room Knowledge often limited to specific deal team members
Expense Example	Deal size: $200 million enterprise value Loss coverage purchased: $20 million Deductible: $2 million / De Minimis: $200,000 Premium: $160,000 to $500,000	Deal size: $200 million enterprise value Loss coverage purchased: $20 million Deductible: $2 million / De Minimis: none Premium: $500,000 to $800,000 (plus underwriting fee)