The Corporate Counselor

- Insights into Japanese Corporate Law -

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NEGOTIATING TIPS FOR REPRESENTATION & WARRANTY INSURANCE POLICIES

The use of insurance to cover breaches of representations and warranties in an acquisition agreement ("R&W Insurance") remains a highly touted option in Japan to protect buyers and sellers from losses in M&A transactions, and continues to gain in popularity. Fueling this product surge are numerous papers and seminars that discuss the pros and cons of R&W Insurance (also known as W&I Insurance). However, once a transaction party in Japan opts to obtain R&W Insurance and receives a draft insurance policy, an insured may feel left at the altar to fend for itself. All too often a draft R&W Insurance policy will be delivered in a boilerplate form a few days prior to the signing date of the acquisition agreement when the transaction parties are scrambling to reach a deal. An ill-advised insured may believe that its R&W Insurance policy document is a standard non-negotiable form, and may quickly provide its sign-off after simply confirming the accuracy of basic factual matters. An insured adopting this approach may have unwittingly waived critical benefits that could have been negotiated into its R&W Insurance policy.

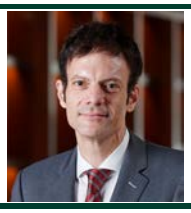
While R&W Insurance policies in Japan do contain many standard provisions, there is often room for an insured to maneuver better coverage under the policy and make the claim filing process smoother. Unfortunately, there is a dearth of publicly available information to help an insured understand the contours of a R&W Insurance policy in order to effectively negotiate with an insurance company. This edition of the *Corporate Counselor* aims to fill this information vacuum by providing tips to consider under a buy-side R&W Insurance policy issued in Japan (i.e., a policy to insure a buyer against losses arising from a seller's breach of its representations and warranties and certain pre-closing tax covenants in an acquisition agreement for a Japanese target company).

Tip 1: Confirm that the R&W Insurance Policy Provides the Agreed Coverage

A R&W Insurance policy is a bespoke document in many respects. As simple as this may sound, confirming the economics of the R&W Insurance policy is key as a coverage omission may jeopardize the amount of loss recoverable under the policy.

Among the key financial parameters of a R&W Insurance policy, the insured should confirm the: (i) premium amount (i.e., the cost to the insured for coverage under the R&W Insurance policy), (ii) underwriting fee (i.e., the amount the insured is required to compensate the insurance company for the legal fees incurred by its external counsel to undertake legal due diligence), (iii) limit of liability (i.e., the maximum coverage amount under the R&W Insurance policy), (iv) retention amount/deductible (i.e., the amount of loss that must be incurred by the insured before a claim can be made under the R&W Insurance policy, which is currently typically between .5% to 1.5% of enterprise value), and (v) *de minimis* threshold (i.e., the minimum amount of loss that must be incurred by the insured before a claim counts towards the retention amount, which is currently typically around .1% of enterprise value). Based on data made publicly available by a large R&W Insurance broker, the current average premium in Japan is approximately 1.6% of the limit of liability. The foregoing key financial parameters should be checked against the corresponding provisions in the insurance company's non-binding offer, which the insurance company issues when bidding for the project, and any subsequent variations that may have been discussed and quoted for separately.

The retention amount/deductible and *de minimis* threshold are selected by the insured based on pricing options offered by the insurance company, including whether the retention amount/deductible once reached tips to a lower amount or is fixed. The insurance policy should indicate that the claims threshold under the acquisition agreement should exhaust the retention amount under the insurance policy on a one-for-one basis even if a claim is not made against the seller under the acquisition agreement. Similarly, the insurance policy should stipulate that the *de minimis* threshold under the acquisition agreement and the insurance policy should be considered the same and not separate claim hurdles.



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Tip 2: Curtail Attribution of "Knowledge"

R&W Insurance policies do not permit so-called "sandbagging." In other words, an insured cannot recover under a R&W Insurance policy if the insured has knowledge of the breach prior to the effective date of its no claims declaration. Furthermore, for R&W Insurance policies issued in Japan, knowledge will be deemed to include all matters contained in the due diligence data room, due diligence reports, the disclosure schedules to the acquisition agreement and specified public searches if the information is considered "Disclosed" (as defined in the insurance policy).

An insured, therefore, should focus on the following defined terms and related provisions to help increase the likelihood of a successful claims adjudication process:

- "Knowledge" should be defined as narrowly as possible in light of the anti-sandbagging approach in R&W Insurance policies. For example, "Knowledge" could be defined to mean "*a particular fact, event or condition that the Insured's Deal Team had an actual conscious awareness and shall not include any constructive or imputed knowledge or any knowledge of any of the Insured's outside advisers or agents*." The "Insured's Deal Team" should be limited to no more than two to three persons (and ordinarily should be the same persons listed in the acquisition agreement if there is a similar defined term), and such persons do not necessarily need to have the ability to read, write or understand the language of the documentation in the due diligence data room.
  The Insured's Deal Team members, however, must be able to read and understand the due diligence reports that have been prepared for the insured in relation to the transaction.

- "Disclosed" should be defined as narrowly as possible because this term will be used to impute knowledge to the insured, which reduces the scope of claims that the insured can make under the insurance policy. For example, "Disclosed" could be defined to mean "*fairly disclosed in such a manner so that, on review of the relevant document or material, a reasonable purchaser should be aware of the fact, matter or other information and be in a position to make a reasonably informed assessment of such fact, matter or other information, including the likelihood of the occurrence of the fact, matter or other information and the magnitude of the potential Loss arising therefrom, without the assistance of or guidance from any third party*." While not all insurance companies may be able to accept such an insured-friendly definition, it is nevertheless worth discussing during the negotiation of the insurance policy. Unlike other jurisdictions, Japan does not have publicly available databases that store information about material adverse events impacting a registered company, so any references to information in such databases as being deemed "Disclosed" to the insured should be deleted from the R&W Insurance policy. However, the insurance company may still include as "Disclosed" the results of certain public searches (e.g., company searches or real property searches conducted against the corporate or real property registries at the Legal Affairs Bureau of Japan, and searches on patent and other intellectual property rights on the Japan Platform for Patent Information) if and to the extent these have not been carried out shortly prior to issuance of the R&W Insurance policy or are not already deemed Disclosed pursuant to the disclosure schedules, other provisions in the acquisition agreement, or the due diligence reports.

Tip 3: Ensure that Provisions in the Acquisition Agreement Don't Negatively Impact Coverage in the R&W Insurance Policy

R&W Insurance coverage flows from the acquisition agreement in many respects. A R&W Insurance policy covers (i) breaches of the representations and warranties in the acquisition agreement and closing certificates, (ii) certain pre-closing tax covenants, and (iii) special indemnities separately agreed with the insurance company (if any). If a loss is not available under the acquisition agreement, then generally speaking a corresponding claim cannot be made under the R&W Insurance policy. It behooves an insured, therefore, to eliminate claim hurdles in the acquisition agreement because such obstacles ordinarily would prevent coverage under the R&W Insurance policy.

The above principle can be considered a "reverse order tip" to negotiate a R&W Insurance policy as it should be (i) first adopted towards recalcitrant sellers who insist on comprehensive liability limitation provisions in an

acquisition agreement even though the R&W Insurance policy will serve as the primary source for claims recovery, and (ii) then the broad coverage under the acquisition agreement should be used to bridge coverage under the R&W Insurance policy since the policy should generally provide no worse claims coverage than reasonable provisions in the acquisition agreement.

As a result of the foregoing, an insured should strive to streamline the indemnification provisions and seek a broad definition for "Losses" in the acquisition agreement. For instance, a buyer-friendly example for the definition of "Losses" in a Japan acquisition agreement (which the R&W Insurance policy could track) is "*all losses, damages, liabilities, deficiencies, and consequential damages awarded under a third party claim, diminution of value, lost profits, obligations or out-of-pocket costs or expenses, including without limitation in each case all related taxes, reasonable attorney's fees and expenses, and costs and expenses of investigation and dispute resolution*." Penalties and punitive damages should not be included as a "Loss" because such amounts are normally not allowed under Japanese law and, even if available, would not be covered by a R&W Insurance policy.

The indemnification obligations of the seller under the acquisition agreement should allow for claims to be made without extra qualifications because coverage under the R&W Insurance policy could be jeopardized. For example, the following language in red should be avoided in an acquisition agreement "*The Seller shall indemnify and defend the Buyer Indemnified Parties against, and shall hold the Buyer Indemnified Parties harmless from, any Losses resulting from, arising out of, or caused by any* ***material*** *inaccuracy in or* ***actual*** *breach of any representation and warranty of the Seller set forth in this Agreement.*"

The insurance company also may wish to partake in the defense of a third party claim (as further elaborated in *Tip 5*). Therefore, even if the indemnifying party has the option under the acquisition agreement to assume the defense of third party claims, an exception should be provided to allow the insurance company to assume the lead if it has elected under the R&W Insurance policy to settle or control the defense of third party claims over matters for which insurance coverage is sought.

Tip 4: Reduce Coverage Exclusions

A R&W Insurance policy will list the types of losses or matters that are not covered by the policy. The following are the typical coverage exclusions in a R&W Insurance policy, along with negotiation tips:

- **Standard exclusions**, which are matters the insurance company purports to exclude from all of its R&W Insurance policies in accordance with its prevailing practices (e.g., losses arising from environmental claims, product liability, and bribery): the insured should seek advice from an experienced R&W Insurance broker as to whether the insurance company's list is consistent with current market practice, as such R&W Insurance brokers have access to a wide pool of policies and non-binding offers from which to gauge the current market trend for standard coverage exclusions, as well as the past practices of the particular insurance company.

- **Industry specific exclusions**, which are matters the insurance company proposes at the insurance quoting stage: as the insured's negotiation position vis-à-vis the insurance company is at its apex during the bidding stage since multiple insurance companies are vying for the mandate, the insured should attempt to eliminate these exclusions either outright or through a commitment by the insurance company that the exclusion will be eliminated if the insured undertakes reasonably sufficient due diligence. The insured also should insist that coverage exclusions that have no relevance to the target company's business be deleted. For example, a target company engaged in the service industry should not be subject to an industrial product liability coverage exclusion.

- **Transaction specific exclusions**, which are matters the insurance company uncovers during its underwriting due diligence (e.g., inadequate review undertaken by the insured, gray areas uncovered during the underwriting due diligence call with the insured, and insufficient seller disclosure schedules in the acquisition agreement): the insured should evaluate whether to seek reinstatement of the subject exclusion by balancing the potential losses it could suffer due to the inability to make claims under the insurance policy for the excluded matter versus the potential impact on the insured's full portfolio of coverage that could be impacted due to the information the insured would learn by

undertaking the additional due diligence requested by the insurance company to eliminate the subject exclusion. While the insured may win the battle for reinstatement of the subject exclusion with extra due diligence efforts, the additional knowledge that the insured will obtain by undertaking further investigations could reduce the insured's ability to make claims under the R&W Insurance policy with respect to this newly acquired information based on the policy's definition of "Knowledge." As a consequence, the insured could experience a double ratchet shock by opening a flood gate of lost claims potential under the insurance policy when only a trickle was leaking, and incurring substantial fees to complete a due diligence exercise that left it in a worse position.

- **Acquisition agreement exclusions**, which are representations and warranties in the acquisition agreement that the insurance company views as too vaguely worded or unwarranted because the insured did not undertake sufficient due diligence to support its inclusion in the acquisition agreement (so the insurance company will either assert its deletion or re-word the representation and warranty): the insured should seek the advice of experienced legal counsel either to support the insured's position that the representation and warranty is appropriate, consistent with local market practice, and covered by existing due diligence, or to explore whether coverage for the relevant matters is still available under other representations and warranties that have not been excluded. If additional due diligence is requested by the insurance company to maintain the representation and warranty, then the insured also should consider the conundrum mentioned above regarding the overall impact on its claims potential arising from the "Knowledge" the insured will gain by undertaking further due diligence.

Regardless of the type of coverage exclusion contained in a R&W Insurance policy, the insured should confirm that the exclusionary language is clear and limited. For example, an insured may accept a properly worded exclusion that limits claims "*due to*" the subject exclusion, but the insured should carefully consider any exclusion that limits coverage for matters that "*arise out of*" or "*relate to*" the subject exclusion since tangential events could be captured by this wording.

Also, if there is insufficient time before the commencement of the insurance policy to remove an exclusion, then the insurance company may offer a post-commencement policy endorsement to remove certain exclusions. The insured should be cautious with this approach because there are no assurances that the insurance company and the insured will agree that the removal conditions have been satisfied and the negotiating leverage of the insured will be extremely low after the insurance policy goes into effect. This uncertainty is compounded when additional due diligence needs to be conducted and the results of such exercise could prove adverse to the coverage request, with no recourse available from the insurance company or the seller. Therefore, it would be advisable for the insured to delay the signing of the acquisition agreement (if practical) or be as specific as possible on the steps needed to satisfy the removal of the exclusion from the insurance policy.

Tip 5: Avoid Claim Processing Traps

The collection cycle under a R&W Insurance policy requires the insured to (i) timely file a claim notice to the insurance company, (ii) deliver more information to the insurance company about the loss upon its request, (iii) allow the insurance company time to evaluate whether the losses specified in the claim notice are covered by the R&W Insurance policy, (iv) permit the insurance company to participate in the defense and negotiation of a claim, and (v) subrogate certain rights to the insurance company if a payout under the policy is made to the insured.

Each of the foregoing should be carefully reviewed to avoid ambiguities or unreasonable requests that could negatively impact an insured's recovery prospects under the R&W Insurance policy:

Claim Notification Timeline. The triggering event for when a claim should be notified to the insurance company and the reporting timeline should be carefully reviewed to avoid claim prejudice. For example, compare the following language:

BAD:
The Insured shall deliver a Claim Notice to the Underwriters as soon as reasonably practicable and in any event within ***10 Business Days*** after the Insured becomes aware of (a) ***any fact or circumstance that could reasonably be expected*** to erode the Retention, (b) ***any fact or circumstance that could reasonably be expected*** to give rise to a Loss, or (c) a Loss.

GOOD:
The Insured shall deliver a Claim Notice to the Underwriters as soon as reasonably practicable and in any event within ***30 Business Days*** after any ***person who is a Representative Director or general counsel*** of the Insured has ***Actual Knowledge*** of (a) ***Breach***, (b) a ***Third Party Demand***, or (c) a Loss.

Supplied Information. The insured should carefully scrutinize the type of information that should be included in a claim notice to confirm that the requested information is reasonable in scope and the insured would likely possess at the time the claim notice must be furnished. Regardless, a savings clause should be inserted to ensure that a claim notice will not be invalid if it fails to provide all of the necessary details or it does not identify all of the provisions of the acquisition agreement that are breached. In addition, if the insured is subject to a pre-existing confidentiality agreement, then it should not be required to provide the insurance company with information that would lead to the insured breaching its confidentiality covenant.

Insurance Company Participation. Ordinarily, the insurance company will prefer for the insured to directly handle dispute resolution under the acquisition agreement with a requirement that the insurance company is kept informed about the progress of the dispute. However, the insurance company will reserve the right to participate in the defense and settlement of a claim that would reasonably be expected to lead to a payout under the R&W Insurance policy. If the insurance company elects to participate, then the insured would not be allowed to undertake certain actions without the consent of the insurance company. In such instances, the insured should confirm the R&W Insurance policy stipulates that the insurance company's consent will not be unreasonably withheld, conditioned or delayed. The insured also should confirm that the R&W Insurance policy includes a monthly legal fees reimbursement mechanism if the insured leads the defense against a third party claim or the prosecution of a direct claim against the seller because dispute resolution can be extremely costly and take a long time to complete, so the insured should not have to front this potential large expense.

Subrogation. If any claim is paid by the insurance company under the R&W Insurance policy, the insurance company typically insists on being subrogated to the insured's rights (if any) against the third party responsible for the loss or against a third-party insurance company responsible for covering the loss. The subrogation provision in a R&W Insurance policy, however, usually prevents the insurance company from asserting claims against the buyer or the seller (except for fraud claims against the seller) or against owners, officers, and employees of the acquired business as the ability of the insurance company to seek redress against these persons would diminish the intended shift of loss allocation to the insurance company. An acquisition agreement will normally contain requirements about the ability of the insurance company to subrogate claims against the owners, officers, and employees of the acquired business, and the insurance policy should track such provisions. In addition, the insured may request that the insurance company limit its subrogation rights against the acquired business's customers, clients, and suppliers because the insured will not want an insurance company's lawsuit impacting valuable relationships that could jeopardize the success of the acquired business. Furthermore, the insured should confirm that the R&W Insurance policy requires the insurance company to defend against any counterclaims made against the acquired business, the insured, or the seller brought in connection with any actions pursued by the insurance company when exercising its subrogation rights.

Tip 6: Confirm Premium Payment Timing

Unlike other jurisdictions that require the payment of the insurance premium after the closing date of the acquisition agreement, the premium for R&W Insurance policies issued in Japan is usually required to be paid in full on or shortly before the commencement of the policy. Many insurance companies offering R&W Insurance policies in Japan, however, are willing to delay the premium payment due date for up to 20 business days after the commencement of the policy. An insured should confirm the availability of this delayed payment scheme with the insurance company in advance. The insured also should confirm that the R&W Insurance policy provides that if the transaction does not close, then the insurance company will promptly return in full any premium paid, and if not, that the amount to be retained by the insurance company as a termination fee is reasonable and acceptable to the insured; however, the underwriting fee will not be returned to the insured if the insurance company has already incurred this expense with external counsel.

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The R&W Insurance policy has transformed from a boilerplate insurance policy, with terms largely dictated by the insurance company, to a highly negotiated, customized document that is meant to function like the structured indemnification provisions in an acquisition agreement that it is typically replacing. While the tips above are geared towards R&W Insurance policies issued in Japan, many of them may also serve as a useful reminder for policies issued in other jurisdictions.

Small changes in key provisions of a R&W Insurance policy can result in significant changes to the overall level of risk transferred to the insurance company or retained by the insured. Although premium rates for R&W Insurance policies have gradually declined each year, the overall cost of a policy remains a major expense. To justify this expense and ensure value, an insured should retain experienced legal counsel and an expert R&W Insurance broker to assist in negotiating and concluding an insurance policy that best suits the needs of the insured and maximizes coverage.

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