JLT SPECIALTY
PRIVATE EQUITY GROUP

June 2017

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WHITE PAPER SERIES - SUPPORTING U.S. PRIVATE EQUITY IN INTERNATIONAL ACQUISITIONS

Challenging Local Customs in Representations (Reps) and Warranties Insurance

Private Equity firms have become global organisations. Law firms boast offices in the most far-flung of locations. This is excellent when it comes to understanding local customs and deal culture, but collaboration and the deployment of universal best practice can lag behind territorial expansion. When organisations stop talking, it becomes easy for the best outcomes to slip out of reach and for the local "market" position to be accepted, most often favouring the seller.

Historically, the insurance industry has had a poor reputation for knowledge sharing and international collaboration. Insurers have been able to offer different terms and conditions by territory (even if the perceived risks and loss ratios are similar), reliant on a lack of coordination from brokers. This frustrates sophisticated insurance buyers who have justifiably aggressive expectations based on what they have achieved in their home territories. Never is this more apparent than when negotiating a Representations and Warranties Insurance policy to support an international acquisition.

In this white paper, JLT's Private Equity Group will shed light on how far US Private Equity can push to achieve the best available "US-style" coverage when transacting overseas. The Paper is co-authored by JLT's Private Equity Group in London, Frankfurt, New York and Hong Kong.

U.S. REPS AND WARRANTIES POLICIES VS. REST OF THE WORLD – WHAT ARE THE DIFFERENCES?

Putting insurance to one side (and understanding that it varies by state), it is generally understood that the indemnification position achieved by buyers in US governing law transactions is stronger when compared with other jurisdictions. Notable benefits include the typical disclosure standard (no general disclosure of the dataroom and specific disclosures often being limited to particular reps), materiality-scrape provisions applying to the representations, the scope of the definition of loss and sandbagging clauses in the sale agreement, to name a few.

Mergers & Acquisitions (M&A) insurers operate in a competitive market, and as such, there is pressure to mirror the underlying sale agreement liability position with the coverage offered by the policy. In the US, insurers have accepted that the matters described above are characteristic of the way that deals are done locally, and as such, agree to follow the positions outlined above (subject to certain caveats, which we discuss later).

Outside of the USA, a very different stance is taken both in the underlying sale agreement and the policy. This can be a difficult pill to swallow for US buyers accustomed to the position described above. Perhaps the biggest concern is the

insurers' approach to disclosure for the purposes of the policy. With a small number of exceptions, there is a general expectation that the dataroom and the buyer's due diligence (DD) reports will be referenced in the policy and that any breaches of a rep contained therein, would be deemed disclosed (and therefore excluded from coverage). In reality, the end position may not be materially different, as US underwritten policies will rely heavily on specific exclusions for "known" matters identified in both the dataroom and DD reports, however, the ex-US position can be less clear when establishing exactly what is and is not covered by the policy.

The fear of what might be lurking in the dataroom is very real when faced with thousands of documents and the commercial pressures to get a deal done within a prescribed timeline.

TECHNICAL VIEW: A STRONG U.S. REPS AND WARRANTIES POLICY

Before we explore the recent "hybrid" coverage positions taken by insurers when working with US Private Equity in international acquisitions, let us first take the key aspects of a typical US sale agreement in turn and set out an insured-friendly position under a reps and warranties policy.

DEFINITION OF LOSS

Often an area of significant negotiation, the definition is more recently leaving opportunities to recover under various and multiple heads implied by silence in the sale agreement. Multiplied damages, diminution in value and consequential loss are the specific items most often debated, and the policy should be able to match the "silent" position agreed by the buyer and seller ("silence for silence"). If multiplied damages and consequential loss (for example) are expressly included in the sale agreement definition, it is unlikely that the insurer will match it in the policy and they would most likely look to apply specific exclusions. Specific exclusions should also be expected in relation to punitive and exemplary damages as well as special loss.

MATERIALITY SCRAPES

All insurers purporting to be credible primary options for US transactions should be willing to follow a full or partial materiality scrape in the agreement for the purposes of the policy. Where a full scrape is applied (so that it is removed for the purpose of determining a breach and the resulting quantum), insurers may require that certain reps retain a qualifier, where in their view it would be reasonable for such a concept to apply. The most common examples are the financial statements, compliance and "no undisclosed liabilities" reps. Insurers will pay very close attention to due diligence materiality thresholds and seller disclosures (requiring that buyer's counsel have pushed the seller to disclose on the basis of the full scrape). This is even more relevant where the seller's liability in respect of the representations post-completion is low or nil. Logically, insurers may not be willing to apply a "synthetic" materiality scrape in the policy, if the scrape is not included in the sale agreement itself.

SCOPE OF THE FUNDAMENTAL REPRESENTATIONS

The scope of the defined group of Fundamental Representations is often wider in US transactions when compared to the standard "title to the shares and capacity to sell" position that is expected in Europe and further afield. It is increasingly common to see intellectual property, sufficiency of assets, environmental and employee benefits

reps included within the definition. If pushed, insurers should follow this, although if the Fundamental Warranties are capped at the full deal value, it is sensible to apply a sublimit within the policy for the General Representations (allowing the corresponding premium for the amount of capacity allocated in respect of Fundamental Representations to be proportionately less expensive than for the capacity exposed to General Warranty claims).

DISCLOSURE APPROACH

Insurers will not deem the contents of the dataroom as disclosed, following the typical sale agreement position. The onus is on the underwriter to specifically exclude matters, rather than rely on general disclosure. In the disclosure schedule itself, in some instances we see language added to state that the specific disclosures are made against (and will only apply to) specific warranties. Further, we have seen language to the effect that the disclosures have been made "for informational purposes only". Where these provisions are included, it is important to remember that the fundamental exclusion under a reps and warranties policy is the Actual Knowledge of the insured, so whilst it may appear to improve the buyer's position in the agreement, it would not change their ability to claim under the policy.

REPRESENTATIONS GIVEN ON AN INDEMNITY BASIS

Insurers will follow the standard US position that representations are given on an indemnity basis (and therefore loss is paid on a dollar for dollar basis, including the costs incurred pursuing the claim).

LOOKBACK PERIODS

Insurers will endeavour to match the lookback periods that apply to the representations. Their ability to do so will be influenced by the hold period of the current seller, as well as the parameters set during the due diligence exercise.

SANDBAGGING CLAUSES

The ability of the buyer to bring indemnification claims under the sale agreement for matters that are within its knowledge at the time of signing varies state by state. For example, in California, it is not possible to bring a claim if it was within the buyer's knowledge, whereas in New York, it is. Where there is pro-sandbagging language in the sale agreement, it is important to remember that under the insurance policy, the Actual Knowledge exclusion will apply, so the provision cannot be mirrored by the policy. Pro-sandbagging clauses are one of the main reasons for insurers' reluctance to offer sell-side policies, as it would be possible to enter into a policy which could result in a loss on day one of the policy period (as a result of a breach of warranty that was known by the buyer).

SURVIVAL PERIODS

Insurers should, as standard, cover General Representations for 3 years from Completion and Tax and Fundamental Representations for 6 years. If the survival periods for other warranties are extended, it should not be an issue to secure coverage, however, it may have a slight impact on the premium.

SIGNING AND COMPLETION

Insurers accept (but cannot follow) the standard position between Signing and Completion that updating of disclosures will not be permitted. More commonly the seller is obliged to inform the buyer of any matter that would render the rep untrue, without limiting the buyer's rights to indemnification. Insurers cannot match this, and will typically hold a bring-down call before covering the Completion Representations. In some cases, usually where the gap is very short, insurers have agreed to provide "new breach" cover for an additional premium, although this is very rare indeed.

PRICE AND POLICY ATTACHMENT POINTS

US Reps & Warranties policies typically cost between 2.8% and 4% of the limit of indemnity required. The policy attachment points are usually 1.25% to 2% of the total deal value, dropping to a lower level on the expiry of the General Representations. The policy attachment point operates as a fixed retention, liability for which is often shared between buyer and seller.

HYBRID COVERAGE – HOW CLOSELY CAN WE MIRROR THE U.S. POSITION?

As a general rule, it is significantly easier for insurers to adopt US-style coverage where the underlying agreement includes the US features (regardless of the actual governing law of the agreement), rather than applying them "synthetically" in the policy alone. As such, to achieve the greatest benefits from the insurance, advice should be taken from an experienced broker or your legal counsel during the initial drafting of the sale agreement (or during the first buyer's mark-up). Similarly, when approaching insurers, the best terms will be achieved if the request for the listed enhancements is made during the first approach (rather than looking to apply them later in the process).

The following menu of enhancements is now available to US buyers in international transactions for an additional premium (as described below); however, it is important to note that the starting point for the additional cost is significantly lower than typical US premium ranges.

1 No general disclosure of the dataroom

   Emphasis on the insurer to exclude matters specifically rather than rely on general disclosure.

2 No general disclosure of the due diligence reports

Including seller DD, buyer DD, other legal advice furnished to the insured, publically available information as searchable on public register and any additional reports.

3 Removal of the “Warranty Spreadsheet” (a schedule to the policy listing specific coverage comments against the warranties)

   This encourages full coverage for the representations as drafted, rather than any additional awareness or materiality qualifications imposed by the insurer in line with their expectations of the “market” position.

4 Application of a full or partial materiality scrape

5 Policy indemnification on an indemnity basis

6 Erosion of the policy retention for uncovered loss (possible, but less common)

   Usually only possible on very “clean” transactions with minimal policy exclusions (and subject to a sensible attachment point).

The appetite of the insurers varies, however typical additional premium rates to apply the full suite of changes would be approximately 50% - 100% of the base premium. As such, the total eventual insurance cost would in most cases be the same, or slightly lower than typical US pricing. Policy attachment points of 1% to 2% of the deal size will give the best chance of securing the greatest number of the enhancements.

It is equally possible to select a limited number of the US-style provisions, based on perceived importance.

CONCLUSION

The listed coverage enhancements look to place the US policyholder into a position that they are familiar and comfortable with. As policies are increasingly used to replace seller liability entirely, this increased protection is very important.

The objective of Reps and Warranties insurance is to effectively transfer the negotiated liability position of a seller to an insurer. The ability to apply US style coverage in international transactions arguably goes beyond this goal, putting the buyer into a position that they would not be able to reach in an uninsured commercial negotiation. This advancement should give confidence to US Private Equity when investing overseas, knowing that their route to recovery in the event of a loss is familiar and standardised.

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Registered in England No. 01536540. VAT No. 244 2321 96.

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