NAGASHIMA OHNO & TSUNEMATSU
長島·大野·常松 法律事務所

NO&T Corporate Legal Update
コーポレートニュースレター

February, 2025　No.2

Unlocking the Possibility of Contingent Risk Insurance in M&A Contracts

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Introduction: Why is Contingent Risk Insurance Needed?

The use of representations and warranties insurance (so called "R&W insurance") in M&A transactions has been increasing. This type of insurance has been widely adopted for overseas M&A deals, and its use for domestic M&A deals has also been increasing since around 2020, when major general insurance companies in Japan started to provide domestic R&W insurance. Now, R&W insurance has become a familiar tool for those involved in M&A transactions.

However, it is important to note that R&W insurance does not cover all losses that may arise in relation to M&A contracts, and its coverage is limited to losses that satisfy the following requirements, among others: (1) a breach of a representations and warranties clause in the M&A contract needs to be established; (2) sufficient due diligence for the matter in issue must have been conducted before the execution of the M&A contract; and (3) such matter must not have been discovered during the contract-making process, including due diligence.

Therefore, R&W insurance does not cover risks that have been identified during the course of conducting M&A deals (i.e. known risks). Usually, these risks will be dealt with through other arrangements, such as adjusting the purchase price or adding special indemnity provisions. However, these arrangements are subject to negotiations between the parties and there is no guarantee that the counterparty will agree to them. In the worst-case scenario, the deal could break due to the parties' failure to reach an agreement on these arrangements.

In this newsletter, we will provide an overview of contingent risk insurance, which is being introduced in Western countries, and how it is used as a solution to deal with known risks that cannot always be covered by R&W insurance or existing contractual arrangements.

What are the Insurable Risks for Contingent Risk Insurance?

Contingent risk insurance is literally a type of insurance that covers losses incurred due to contingent risks. It can be used not only in M&A deals but also in other broader contexts, and irrespective of whether the risks are known at the time of purchasing the insurance. Although there are other types of insurance that cover specific types of known risks, such as tax liability insurance and environmental liability insurance, contingent risk insurance can be utilized to address various kinds of known risks.

That said, this does not mean that contingent risk insurance covers every potential liability. Indeed, the insurance company would examine whether it can insure the matter in issue from the following angles.

● **Legal Risk:**

The risk to be covered by contingent risk insurance must be a legal one, so that the insurance company can examine and determine whether it is insurable. In other words, business risks, such as the feasibility of future business plans, would not be insurable.

- **Probability of Risk Materializing:**

This refers to the probability that the risk will materialize and that losses will actually be incurred. In addition to the factual likelihood of whether the loss-causing event will occur, the strength of the legal basis supporting the insured's position will also be relevant. As such, if the insurance company believes that the insured's legal position is weak, the insurance company could conclude that the related risk is uninsurable. To this end, insurance companies will consider legal opinions submitted by the insured's counsel for the purpose of determining whether the matter in issue is insurable.

- **Quantum of Risk:**

This refers to whether the amount of the insured's potential loss in the case where the risk materializes can be determined based on the law and precedents. Conversely, if the matter entails risks that involve unpredictable amounts of losses, the insurance company may refuse to insure the risk.

In the underwriting process, the insurance company will examine whether the risk is insurable and how much the insurance premium should be. Among insurable risks, risks with low probabilities of materializing and whose potential losses can be quantified with more certainty tend to require lower premiums, compared with risks that have higher probabilities of materializing and whose potential losses are more difficult to quantify.

<u>Typical Situations for Contingent Risk Insurance</u>

As long as the risk which is found during the process of implementing M&A contracts is approved as an insurable risk based on the factors set out above, such risk can be covered by contingent risk insurance. In this section, we will look at some typical situations where contingent risk insurance might be a feasible solution for the matter in issue.

- **Title to shares**

During the process of considering the feasibility of an M&A deal, defects related to title to shares may be discovered, such as flaws in the history of share transfers or lost share certificates. Although the practical risks of title defects are not always high, it is difficult to ignore such defects because they are issues related to the very subject matter of the transaction. One way to deal with such risks is to use contingent risk insurance. In terms of the criteria set forth above, title defects are a type of risk that is relatively easy to measure in terms of its likelihood to materialize and quantifiability. As a result, they are usually considered to be a risk that can be insured for a relatively low insurance premium.

- **Pending lawsuits and other legal proceedings**

If, during the due diligence process, pending lawsuits or other legal proceedings are discovered, it may be possible to purchase contingent risk insurance for losses incurred in the event that an unfavorable judgment is rendered in respect of such legal proceedings (in lieu of including a special indemnity clause in the definitive agreement). For example, in a situation where a private equity fund is attempting to exit from a business as soon as possible, the use of contingent risk insurance would enable the fund to make a clean exit and achieve the early distribution of funds to its investors.

- **Bridging gaps in contract negotiations**

In situations where the parties are in strong disagreement over the handling of known risks that are discovered during the M&A process, such as potential violations of laws and disputes with third parties, contingent risk insurance can be an option for both parties to reach a compromise. A similar result (i.e. bridging gaps in contract negotiations) can be achieved by using R&W insurance, but the difference is that contingent risk insurance covers specific known risks, as explained above. In this sense, it can be said that R&W insurance and contingent risk insurance can co-exist in a mutually complementary way.

Conclusion

Contingent risk insurance is being used in more and more M&A transactions around the world, and it is envisaged that contingent risk insurance will become a common tool in the foreseeable future, just like R&W insurance. By understanding its characteristics and using it appropriately, contingent risk insurance can be an extremely useful tool for overcoming difficult situations that arise in a transaction. We hope that this newsletter will assist readers who may be in such situations.

＊We would like to express our gratitude to Mr. Pin Li Lim of Marsh (Singapore) Pte. Ltd. for his valuable advice in drafting this newsletter. Please note that the contents of this newsletter do not in any way represent the official position or opinion of Marsh (Singapore) Pte. Ltd.

February 18, 2025

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