June 30, 2020

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The present note summarizes part of a broader study on investment screening insurance: Teoman Hagemeyer and Jens Hillebrand Pohl, “Managing the Risk of Self-Judging Security Exceptions Through Insurance: How Recent M&A Practice Copes with Investment Screening” (currently under peer-review).

The Rise of Investment Screening

National security is increasingly in the spotlight for cross-border corporate mergers and acquisitions (M&A) as host states have become more vigilant in screening foreign direct investment (FDI) involving critical technologies and infrastructure.

2018-2019 saw a significantly enhanced national security review in the US by virtue of the Foreign Investment Risk Review Modernization Act (FIRRMA)\(^1\). In addition, on 11 October 2020, the EU Investment Screening Regulation will begin to apply.\(^2\)

These developments follow years of steadily increased use of investment screening, including some highly publicised cases, such as the (envisaged) acquisitions of Aixtron SE, Lattice Semiconductor, Qualcomm and Grindr.

In practical terms, screening may lead to considerable, potentially fatal, delays in an investment.

Limited or No Legal Review

Investment screening is an administrative procedure, formal to a varying degree, by which a national authority of a host state (screening authority) may, on a case by case basis, assess, investigate, authorise, condition, prohibit or unwind individual FDI transactions on grounds of national security or public order. The review focuses both on the nature of the investment and the character of the third-country investor concerned, notably whether the investment concerns a ‘critical’ sector of the economy and whether the investor has links to a foreign government.

Invariably, investment screening involves limited legal review. Screening involves delicate national security assessments by host states to which courts and (international) tribunals are likely to pay utmost deference.\(^3\) At the domestic level, this may mean that screening decisions are non-justiciable. Or it may mean that a large margin of discretion is granted to the host state’s executive.

At the international level, so-called ‘security exceptions’ in bilateral investment treaties (BITs) or free trade agreements (FTAs) may provide a shield against legal claims by foreign investors. Moreover, since screening often takes place before an investment is made, the investor may not yet derive rights from an investment treaty. Absent pre-entry rights, which are only sometimes found in investment treaties, no investment will yet exist for the purpose of
Screening Represents a Risk to Investors

From the perspective of a foreign investor, the uncertain prospect of screening, as well as any measures taken in the course of screening, carry the risk that the investment will not take place as planned. The screening authority may not give clearance in time before the closing date agreed between the parties. The authority may block the investment. Or it may impose conditions that have not been agreed between buyer and seller and that may change the economics of the transaction.

This uncertainty involves some form of cost to the buyer and seller. Money may be sitting idly in bank accounts instead of being put to work. Even a mere delay may result in transactions failing.

Economically, screening losses normally include direct costs incurred as a consequence of the failing of the contemplated transaction, but could also include indirect costs and loss of opportunity, depending on the nature of the screening measure. For example, the imposition of a condition could alter the economics of a contemplated transaction and thereby affect the future profitability of the investment.

Paradoxically, this screening risk is by default borne by the seller, not the buyer (investor) in many jurisdictions. This is so, either by law or by established M&A practice. That is problematic because most of the grounds for screening are inherently linked to the investor, not the seller, who is at an information disadvantage and cannot control or manage such risk.

Default Allocation of Risk: Seller

Every individual allocation of screening risk is the result of a negotiation. Profit-maximizing investors and sellers will bargain and strive to reflect their respective interests to the highest degree in the M&A agreement. Seller and investor will try to push as much risk as possible onto the other party.

The default allocation of screening risk depends on the laws governing the M&A agreement (which for purposes of European M&A transactions has so far often meant English law), but in general it is the seller who is under the primary obligation to deliver its ownership rights to the investment to the investor. Upon delivery, the risk passes to the investor. Failure to deliver subjects the seller to liability toward the investor, such as damages and rescission of the contract.

In this setting, the delay or even prohibition of a transaction due to investment screening amounts to a breach of contract by the seller, who is unable to deliver. Moreover, screening laws have different ways of inducing compliance, for instance by nullifying the M&A agreement or by giving the screening authority the power to order divestment. These risks are by default burdened upon the seller.

Obviously, this default risk allocation can be paradoxical when the material grounds for delay or prohibition primarily lie with the investor. Yet, it is the seller whose performance is hindered by a screening process or measure based on these very reasons. To be sure, reasons for screening are not exclusively connected to the investor, but also relate to the nature of the investment (or target company’s business) and its significance for national security or state interests, recently also reaching into the political and economic spectrum.

Contractual Risk Shifting to the Investors

Apart from defining the primary obligations of the parties, typical M&A agreements also include provisions on representations and warranties (R&W), covenants, closing conditions and termination rights. These provisions are among the most important to allocate risk.
Several tools have emerged in M&A practice to shift risk to the investor.

- One possibility is provisions triggering so called reverse break-up fees. By design, regular break up fees have to be paid by the seller to a (prospective) investor if the seller is unable or unwilling to fulfil an M&A agreement, for instance by accepting a higher bid by another investor.\(^7\) By requiring the investor to pay a reverse break-up fee in case of non consummation of an M&A transaction due to (contractually specified) reasons tied to the review process, sellers shift the screening risk to the investor.

  Reverse break-up fees are notuncommon tools of M&A practitioners to mitigate certain risks of the seller; they are especially used to allocate the risk of failing to obtain antitrust clearance (antitrust risk). Thus, it seems natural that the M&A market reacted to enhanced investment screening activity by applying the tried and tested reverse break-up fee clauses to screening risk. In the context of investment screening, reverse break up fees are contingent upon the clearance of the transaction by the screening authority, failure to obtain which voids the agreement and triggers a payment obligation of the investor. The few reported fees indicate that (in the US) the fee level is similar to the market standard for antitrust reverse break up fees.

- A second path to relieve the seller of risk (without necessarily placing it on the investor) conditions the seller’s obligation to deliver on the clearance of the transaction by the screening authority.\(^8\) Thereby, the seller is not in breach of contract if such clearance cannot be obtained. Hence, at least if the investor is only obligated to pay the purchase price upon delivery, the clause stalemates the transaction and the parties at least legally share the screening risk.

**Insurance Against Screening Risk?**

Facing these challenges, have investors found a workaround to this problem? A new trend can be discerned in recent cross-border M&A practice. Investors have begun assuming the screening risk from sellers and transferring it to third party risk carriers by means of insurance.\(^9\) In exchange for the premium and under the terms of the insurance policy, the insurer alleviates the risk burdened investor of its potential indemnity vis-à-vis the seller in case the clearance by the screening authority cannot be obtained (in a timely and unconditional way). Potential liability for reverse break up fees arising from US investment screening can reportedly be insured at premiums between 10 to 15 percent of the fee.

Insurance against screening risk appears to have emerged as an adaptation of existing insurance coverage for R&W breaches in M&A transactions.\(^10\) Its emergence is unsurprising in light of the aforementioned trend in M&A practice of shifting screening risk to investors. Having an information advantage with respect to their own situation, which may be relevant to the screening process, e.g. with respect to ownership structure, investors are better placed than sellers to negotiate insurance terms and provide disclosures required by prospective insurers.

To understand the role of screening-risk insurance as a risk mitigant, it is useful to compare it with traditional M&A insurance. In general, a party bearing the risk attributable to breach of R&Ws in corporate acquisitions (merger risk), which it either retains or assumes by means of the M&A agreement, has the option of reducing or eliminating the risk by insuring it. Whether the party does so depends on its risk preferences, a valuation of the risk in face of the probability of the undesirable event and the potential loss caused by it.

Given the risk allocating function of M&A agreements, the popularity of insurance products to cover merger risks is no surprise. Insurance products known as ‘Warranty and indemnity (W&I) insurance’, ‘R&W insurance’ or—more broadly—‘transactional insurance products (TIPS)’ (which are collectively referred to here as ‘traditional M&A insurance’) cover some of the merger risk burdened upon the investor by alleviating the latter from potential financial liability arising from the M&A agreement. Insurers usually charge a premium of 2 to 3 percent of the coverage and cap policy
coverage at 10 to 20 percent of the transaction value.

Screening risk is not covered by traditional M&A insurance and differs fundamentally from the risks that are covered by the latter in at least three regards:

- Screening risk involves a measure by a third party—the screening authority—whereas traditional M&A insurance usually covers risks associated with the other party.

  However, management of such risks is not entirely new to M&A practice. For instance, the operation of certain businesses requires licences or operating permits, which can be denied or withdrawn by the authorities competent to grant them. Likewise, parties to M&A transactions can anticipate a certain tax treatment of their transaction or tax exemptions for the target company, which may not materialise. M&A practice manages some of these risks, especially those concerning tax contingencies, through TIPs.

- Screening risk involves the risk of non consummation of the transaction rather than mere post closing liability. This makes screening risk similar to antitrust risk. Merger control under antitrust law can require parties to obtain approval of the transaction by antitrust authorities (e.g. Art. 4, 6 (1) Merger Regulation\textsuperscript{11}). It is also not uncommon that antitrust authorities subject merger clearance to conditions (e.g. Art. 6 (2), 8 (2) Merger Regulation). Moreover, antitrust authorities can veto transactions and even dissolve them after implementation (e.g. Art. 8 (3), (4) Merger Regulation). In addition, antitrust law provides for enforcement mechanisms at least as effective as those of investment screening.\textsuperscript{12}

  If parties decide to share antitrust risk,\textsuperscript{13} the distribution of risk is subject to provisions in the M&A agreement. In practice, M&A agreements contain risk handling provisions that crucially inspired those discussed above. These provisions usually navigate between the extremes of a so called ‘hell or high water’ clauses (requiring the investor to accept any conditions or even divestments imposed by the antitrust authorities) and full risk bearing by the seller. Despite the hefty break-up fees for materialised antitrust risk, however, no insurance is available for antitrust risk to the best of the authors’ knowledge, which—given the availability of screening-risk insurance—places screening risk in yet another separate risk category.

  This leads, thirdly, to the final and arguably most important difference between screening risk and merger risk: legal remedies against screening measures are severely limited or even completely barred, both before state courts and arbitral institutions. The material criteria which screening measures are based on, viz national security and public order, are for legal and practical reasons either non reviewable by adjudicators or subject to their utmost deference to state choices. Typically, screening measures involve a self judging element regarding their substantive legal criteria. This uniquely distinguishes screening from antitrust risk, where the application of pertinent laws can draw on a rich case history and is fully reviewable by courts. In addition, antitrust risk is—at least nominally—apolitical. In a nutshell, while investors faced with an adverse antitrust decision could expect judicial review of the decision, this is not the case for screening measures.\textsuperscript{14}

Piecing together the availability of insurance products designed for merger risks on the one hand, and the unavailability of such products for antitrust risk as well as the limited contestability of screening measures on the other hand, results in a puzzling picture of screening risk and screening risk insurance, which is explicable only in terms of insurance against political risk.\textsuperscript{15}

Unlike antitrust clearance, screening measures are subject to less rigorous and less transparent material criteria. Screening measures are subject to law but also to limited contestability. Even where such measures are subject to adjudication, they normally involve host state assessments in matters of public policy, notably national security and
public order, to which adjudicators are likely to defer to a high degree. To the extent of such deference, screening measures are political events and the risk attributable to such measures are a kind of political risk.

In view of these differences, and insofar as screening measures constitute political rather than legal measures, screening-risk insurance constitutes a type of insurance against political risk. A distinguishing feature of screening-risk insurance, however, concerns the level of loss compensation.

Screening-Risk Insurance: A Hybrid Between M&A Insurance and Political Risk Insurance

Screening-risk insurance borrows features from both traditional M&A insurance and political risk insurance. For investors, even if screening-risk insurance does not provide an equivalent to full reparation, it can serve as a useful mitigant of screening risk, either as true insurance or as a means of obtaining enhanced bargaining power.

An important difference between screening-risk insurance and conventional investment insurance against political risk concerns the level of compensation. While the former is meant to compensate for costs incurred as a direct result of the failure to consummate an agreed investment transaction, compensation under the latter is based on the standard of damages applicable to delinquencies under international law, which amounts to full reparation in the case of unlawful takings.\(^\text{16}\)

However, such a comparison is inapposite. A screening measure is not per se unlawful under international law:

- The investor may not yet have derived rights to protection under an investment treaty by the time the screening measure is made.
- Even if such rights have already vested, investment treaties often contain security exceptions that could be invoked to prevent liability for screening measures.
- The legal and factual consequences of screening measures can take many forms besides outright prohibition of a contemplated investment, including investigative measures or the imposition of conditions. If a screening measure leads to a delay beyond the closing date of an agreed M&A transaction, it does not follow that the investor would have a claim under international law.

While internationally unlawful screening measures are conceivable in spite of the large leeway that host states enjoy in matters concerning their national security, a right to compensation for future profits as a result of investment screening in violation of international law must nevertheless be considered exceptional. Consequently, screening risk normally corresponds to the loss that can be expected from internationally lawful screening measures.

Is Screening Risk Insurance an Effective Risk Mitigant?

Can insurance provide an alternative to compensate affected investors facing screening risk? Generally, a state’s actions that frustrate an M&A transaction may be reviewed for their legality. The state might be held accountable for the breach of an investor’s legitimate expectations. However, with respect to investment screening, investors have limited legal means to challenge such state actions.

Through insurance, the investor shifts the screening risk to a third-party risk carrier, an insurer. The insurer compensates the investor for the payment of a reverse break fee regardless of the legality of the measure at hand. While legal remedies open up the possibility of compensation for lost profits, insurance is limited to the contractually agreed reverse breakup fee.

Screening risk insurance is thus no perfect substitute for legal remedies, but it may nonetheless be an alternative tool for managing the political risk inherent in investment screening.
For host states, screening-risk insurance provides a useful mechanism by which they can facilitate compensation of investors without having to disclose information contrary to their essential security interests and thus a means by which host states can remain attractive to FDI in spite of investment screening.

1 The law amends the 1950 Defense Production Act, especially Sec. 721 thereof.
3 In some jurisdictions, e.g. the US, courts have no jurisdiction to review screening measures, see 50 US Code § 4565 (e) (1).
4 Such obligation seems to be common to many major jurisdictions. See, for instance, Sec. 91 of Annex I Proposal for a Regulation of the European Parliament and of the Council on a Common European Sales Law, COM/2011/0635 final - 2011/0284 (COD); § 2-031 Uniform Commercial Code; Art. 1582 French Civil Code; Section 433 (1) German Civil Code; Art. 555 Japanese Civil Code.
5 Some jurisdictions free the seller from its delivery obligation (and the investor of its corresponding payment obligation) if delivery is (legally) impossible due to the screening measure. Some jurisdictions free the seller from its delivery obligation (and the investor of its corresponding payment obligation) if delivery is (legally) impossible due to the screening measure.
6 In jurisdictions where the investor bears the risk as soon as the contract is concluded, the logic applies vice versa.
7 Generally, reverse break-up fees have to be paid by the investor for reasons specified in the M&A agreement, for instance due to lack of willingness or ability to complete the transaction.
9 For instance, Aon plc, which also brokers M&A risk insurance, litigation and contingent liability insurance, offers insurance against (CFIUS) review issues; Reuters also reported that Jardine Lloyd Thompson Group plc has begun brokering such ‘CFIUS-risk insurance’ covering reverse break-up fees incurred in consequence of blocked or delayed transactions; Zurich Insurance Group Ltd. includes the risk from CFIUS scrutiny in its risk analysis and recommends “political risk insurance”; whether a specific insurance product is available, is not clear.
10 Also referred to as M&A insurance, representations and warranties (R&W) insurance or warranties and indemnities (W&I) insurance.
12 Closing a transaction prior to regulatory approval—in antitrust parlance: ‘gun jumping’—in many jurisdictions entails the danger of being fined significantly (cf. Art. 7 (1), 14 (2) Merger Regulation).
13 Other than that, parties can agree that either is entitled to rescind the contract (without or with monetary consequences) in case merger approval has not been acquired by a specified (‘drop dead) date.
14 See, e.g., 50 US Code § 4565 (e) (1): ‘The actions of the President […] and the findings of the President […] shall not be subject to judicial review.’ See similarly Art. 35 Foreign Investment Law of the People’s Republic of China.
15 Political risk is covered under a range of insurance products, including investment insurance, sovereign non-payment insurance and other cross-border insurance. Political risk insurance in a narrow sense refers to investment guarantees issued by public guarantors and political risk insurance underwritten by private political risk insurance, normally covering political violence, expropriation, contract frustration, wrongful calling of bonds, business interruption and currency inconvertibility. Sovereign non-payment insurance covers both the inability and unwillingness of sovereign debtors to honour their obligations and thus both credit and political risk. Likewise, political risk and credit risk are both covered under medium or long-term insurance for credit on private debtors in cross-border trade
transactions, such as export risk insurance.

16 This comparison is complicated by the fact that political risk insurance is normally subject to important limitations, including ceilings, risk-sharing provisions, valuation rules, limits, exclusions, covenants and conditions, which result in significant deviations from the level of damages to be expected under international law.

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