

HOW TO MANAGE THE TITLE ELEMENT IN A MARITIME OR AVIATION M&A TRANSACTION

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Resumen

El “seguro de manifestaciones y garantías” (conocido como “warranty and indemnity insurance”) se ha ido configurando como una alternativa a los mecanismos tradicionales de garantía para las operaciones de M&A. Existen varias razones que hacen dicho seguro interesante para comprador y/o vendedor: delimitar y cuantificar una posible pérdida en jurisdicciones no conocidas, eliminar riesgos de insolvencia, evitar mantenimiento de responsabilidades en el balance, evitar conflictos en cuanto a manifestaciones y garantías...

Debido a la crisis durante los últimos años del sector marítimo y aviación, las operaciones de M&A han sido usuales, por lo que el sector podría intentar recurrir a dichas coberturas.

Además, dichos actores deberían tener en cuenta sus posibles contingencias como propietario de bienes muebles y estudiar la contratación de “seguro sobre el título de propiedad” (conocido como “title insurance”) sobre dichos bienes muebles. Dicho seguro, a pesar de estar configurado en relación a bienes inmuebles, podría aportar cobertura sobre bienes muebles?

Teniendo en cuenta la importancia del título sobre los buques y aeronaves, así como la complejidad de las transacciones con elementos multi-jurisdiccionales y problemas de registro sobre dichos bienes muebles, la protección de los derechos del propietario de esos bienes muebles ante los riesgos generados por anomalías en las escrituras debe ser considerada.

Why?

Current Shipping Market Conditions

Since 2014 increasingly tough trading conditions in the shipping industry have stemmed the flow of capital markets transactions. The oversupply of ships, depressed freight rates, unsustainable debt and negative macroeconomic environment have led to a slowdown in capital markets activity.

Bond and equity financing (excluding leasing, M&A and restructuring) dropped from \$23.2 billion in 2014 to \$10.3 billion in 2015. In the first eight months of 2016, approximately \$1.8 billion was raised through bond and equity financing. Given the dramatic reduction in the use of capital markets funding by the industry, where are the opportunities for shipowners now?

With public investors in Wall Street reluctant to invest in a volatile market, the shipping industry has turned to smaller and more targeted private placements, including private equity funds created by capital management companies focusing on the shipping industry. Debt capital markets transactions are also attractive to shipping companies since they provide longer maturities, fixed rates and higher flexibility in extending credit for riskier projects that banks do not finance.

The overall shipping market remains vulnerable due to the slowdown in global economic activity. Industry experts believe it will likely be a year or two before industry recovers and are generally not optimistic about the prospects of the IPO market in the near term. In the meantime, shipping companies will continue to seek financing through alternative capital markets options. Debt deals are possible for the right names and where the structure is robust, such as with the participation of a major ECA. The equity market will likely continue to be driven by private financing.

M&A (“warranty and indemnity”) Insurance

W&I insurance

First of all, W&I insurance is an insurance product that covers mainly the loss and damages arising from a breach of warranties given by the seller in an agreement for the sale and purchase of shares or other interests in a corporate vehicle (an SPA). The policy can be structured to cover:

- loss arising to the buyer as result of a breach of the seller warranties under the SPA (a “buyer insurance policy”); or
- loss arising to the seller as a result of a valid buyer claim against the seller for breach of the seller warranties under the SPA (a “seller insurance policy”).

In either case, it will be subject to the policy limit and agreed limitations and exclusions set out in the policy.

Who is using W&I insurance as a deal tool?

In general terms, W&I insurance was traditionally the preserve of private equity funds requiring a quick and clean deal exit of the nature outlined above. However, times have changed and the increased use of W&I insurance in corporate real estate deals has widened its exposure to a range of interested parties and it is now increasingly being placed by funds, UK and international corporates and sovereign wealth funds alike.

How?

M&A Insurance and Title

Real Estate Investors and W&I Insurance

- (i) Private equity funds which are exiting their real estate investments after a short to

medium term holding period can be interested in W&I. The decision to wrap a transaction with W&I insurance is taken at an early stage of a transaction and quite often before heads of terms have been signed or a formal bidding process has commenced.

- On the one hand, sellers (particularly funds and private equity investors) require a quick and clean exit following closing. This means that any form of contingent liability which would hinder the prompt upward distribution of sale proceeds is unattractive. Traditional SPA constructs designed to stand behind potential warranty and indemnity pay outs, such as escrow and deferred consideration mechanics, are therefore unattractive to these investors.
- On the other hand, more cautious and risk averse buyers are also requiring greater contractual protection from warranty packages as they are unwilling to simply “take a view” on due diligence. Buyers also require certainty that someone or something of substance will stand behind a warranty claim.

(ii) A buyer may look to W&I insurance in circumstances where the seller is an SPV which may be wound up shortly following closing and the fund standing behind the seller is unwilling to provide a guarantee or some other form of contractual protection to the buyer.

The resolution of these risk allocation issues between a buyer and seller through the placement of W&I insurance can facilitate and expedite the transaction process and, subject to the comments below regarding insurers’ requirements for an arm’s length transaction, ease the negotiation of transaction documents.

Use of W&I Insurance in Real Estate Deals is well-Established

Deal teams are therefore well advised to familiarise themselves with W&I insurance as a deal tool, the underwriting process and the likely transaction cost so that these matters can be factored into deal timetable and returns.

Whilst similar considerations apply to the use of W&I insurance on a UK real estate transaction as to a European real estate transaction or other UK or European corporate disposal, key themes and differentiating factors include:

1. Lower deductibles: lower deductibles (meaning the aggregate loss to be incurred before an insurer is liable to pay out under a policy) are common on UK real estate deals given the perceived lower level of risk associated with these transactions. 0% deductibles are increasingly available, as are policies with deductibles that tip to zero once the relevant threshold has been exceeded, therefore allowing full recovery of the loss under the policy.
2. Lower policy limits: policy limits tend to be in the region of 10% to 20% of deal value.
3. Lower premium costs: increasing competition between insurers has generated lower premium costs and rates of less than 1% are available in the UK real estate sector.
4. Capacity and sophistication of underwriting teams: a growing number of insurance teams are providing W&I insurance coverage in the London market. This has led to both an increase in available capacity and underwriting teams who have a sophisticated knowledge of the due diligence issues common to UK real estate transactions and a wider use of in-house legal teams within insurers.
5. Use of separate title insurance: separate

title insurance can be placed with traditional title insurers to cover title to the property assets in excess of the W&I insurance policy limit at a more cost effective rate. For example, title insurance can be placed to cover 100% of the deal value whereas the W&I insurance policy limit may be 10% to 20%.

Risks behind Title Insurance

For many reasons, title to land may not be good, e.g. there may be an absence of rights of way, title deeds missing, etc. A defective title policy covers capital, damages, loss and legal expenses should another party be able to show better title to the land or prevent the use of rights of way or services.

Title insurance may also be used to avoid the need for extensive legal reviews of all leases and speed up the purchase process.

Restrictive covenant insurance is also available if it is thought that a property may have been used in breach of a restrictive covenant or the buyer intends changing the use of a property that may breach such a covenant.

How do Title and M&A Interact?

In a typical real estate transaction a seller will often require that the buyer do the real estate due diligence such as confirm state of title, the condition of the property, liens or lawsuits against the property, utility issues, etc.

Real property is a unique asset with a well-established system of title insurance for insuring ownership and rights. Generally, title insurance will provide certain assurances as to ownership of the property and whether there are any liens or other encumbrances (e.g., easements or restrictive covenants) that could adversely affect the property or its use.

(i) The buyer will want specific representa-

tions and indemnities regarding the real estate. If the SPA neglects to identify deeply those real estate issues, particular issues could arise.

Sometimes in a M&A transaction, it is a good idea to have separate SPAs— one for the business and one for the real estate. This way each agreement can deal with specific issues relevant to each transaction.

(ii) A buyer may want to obtain new title insurance if the current title insurance is deemed to be inadequate. It is important to make sure that the transaction does not negatively affect the existing title insurance.

(iii) Also, an acquiring company should consider obtaining title insurance in stock, as well as asset deals, as purchasing stock in a company that owns real property is an indirect purchase of the property. In stock deals, an acquiror may benefit if there is already a title insurance policy in favor of the target company in place.

Depending on the age and amount of the policy, it may be acceptable to forego a new title policy. If relying on an existing policy, however, it is important to verify the proposed transaction does not negate the insurance. Modern title policies provide more flexibility in allowing successors in interest or related companies to benefit from an existing title policy. In some cases, however, a new title policy or endorsement to the existing policy may be necessary.

Technology is transforming Title Insurance

The Title Insurance industry is finally beginning to move into the modern era and embrace technology because of three factors:

- (i) Increasing pressure from mortgage lenders (who are already adopting technology) to provide better integration.
- (ii) Better availability of electronic documentation

(iii) Increased profitability

In order to build a company that can scale profitably, title agents are looking increasingly at new technologies and software systems to help automate these inflows and outflows of data. Competitors that can solve these issues can gain significant competitive advantages, improve profitability, and become valuable strategic assets.

Particular Situations with Title Insurance

(i) Non-imputation Endorsements.

In addition to many standard title insurance endorsements, in a transaction involving the acquisition of stock or other ownership interests, a buyer should consider obtaining a non-imputation endorsement so that it is not imputed with the knowledge of a partner, officer, director or employee of the seller, which could potentially negate the benefit of the title policy.

(ii) Taxes.

What are the tax and/or reassessment issues regarding the real estate? Is there a transfer tax, even one for a change of control arrangement? If an M&A transaction involves leases of real property there will be considerations regarding assignments and subleases, repairs and maintenance, landlord's liens and representations and warranties.

Who?

Private Equity funds could be interested in title insurance because of business diversity, growth, strong management teams, ability to leverage the platform to add other services, customer base.

What? Difficulties with Moveable Assets

The title to moveable assets needs to be pro-

tected due to various reasons, as explained below. Acquiring "good and marketable title" over a vessel or aircraft can present challenging difficulties due to the international elements involved and special Registries.

Particular complexities with Moveable Assets that threaten Title to them

SPV – One Asset Company: Real Estate, Maritime and Aviation

For example, Cayman Island's SPV's have been used in almost all types of aircraft financing transactions, including export credit backed financings, tax leases (in particular German and Japanese leveraged leases), securitisations and enhanced equipment trust certificate transactions.

The main characteristics of a SPV are the following:

- a. The ownership of the aircraft/vessel does not vest with the airline/shipowner, but with an SPV owned and controlled by a trust company which holds title in an off balance sheet capacity.
- b. In the event of default, if the lender seeks deregistration in the airline's (for example) jurisdiction, the lender should be able to count on the exercise of the deregistration rights rather than having to rely solely on a mortgagee's rights.
- c. The principal loan and security documentation will be entered into by the SPV rather than the airline, thereby avoiding potential enforcement problems in the airline's own jurisdiction where the legal system may be very different from the English or American system.
- d. In addition to legal certainty, ownership of the aircraft will be in a jurisdiction with political, economic and social stability which may

give comfort to a lender in cases where the airline is based in a jurisdiction where there is perceived risk.

e. Ownership of the aircraft will vest in a bankruptcy-remote structure which should be unaffected by the bankruptcy of the airline, thus avoiding the significant difficulties that could arise if title to the aircraft vested with the airline or in a special purpose subsidiary or affiliate established by it.

f. Taxation or, more properly, the absence of taxation and therefore the absence of withholding tax on account of any charge to tax is a principal reason for establishing the SPV in an offshore jurisdiction.

Forum Shopping: Tax reasons

Many of the traditional maritime nations (including EU countries) have introduced schemes in the form of tonnage tax regimes. These regimes are designed to enable companies to determine their taxable profits at fixed rates according to the tonnage of their ships rather than by reference to their business results. This is because they may have the effect of reducing the levels of taxable profits and also because they provide advance security.

Two Registration Process

Many flags of convenience permit a two-stage registration process:

(i) The vessel will be provisionally registered with the buyer's chosen flag. The fact that the registration is provisional only at that stage usually means that further documents are required to be delivered to the registry, or perhaps that survey requirements need to be met, before registration can be made permanent. Crucially, for ships whose acquisitions is being financed through loans which will be secured by mortgages over the ships, with len-

der's approval ship mortgages usually can be registered over ships which have provisional registration status only.

(ii) Subject to delivery within a prescribed period of any additional documents required by the authorities of that flag (including, for example, evidence of the ship's permanent deletion from her previous flag), or satisfactory completion of any outstanding surveys of the ship, the provisional registration of the ship will be converted into permanent registration. However, if the additional documents are not delivered within the prescribed period, or if the survey requirements are not met for any reason, the provisional registration of the ship could lapse.

Maritime Liens

A maritime lien is a secret lien that arises by operation of law automatically and gives the lienholder a property right in maritime property (for example, vessels) and the right to foreclose the lien in admiralty, which can present difficulties to the title holder. It is not created consensually and there is no requirement that a maritime lien be recorded or otherwise perfected by any filing.

Under the International Convention on Maritime Liens and Mortgages 1993 (different in US), the maritime liens set out in article 4 shall take priority over registered mortgages, "hypothèques" and charges, and no other claim shall take priority over such maritime liens or over such mortgages:

(a) Claims for wages and other sums due to the master, officers and other members of the vessel's complement in respect of their employment on the vessel, including costs of repatriation and social insurance contributions payable on their behalf;

(b) Claims in respect of loss of life or personal injury occurring, whether on land or on water,

in direct connection with the operation of the vessel;

(c) Claims for reward for the salvage of the vessel;

(d) Claims for port, canal, and other waterway dues and pilotage dues;

(e) Claims based on tort arising out of physical loss or damage caused by the operation of the vessel other than loss of or damage to cargo, containers and passengers' effects carried on the vessel.

Aircraft Registration

The Capetown Convention provides that aircrafts (and Mobile equipment) will need to be registered in the International Registry in Dublin. The following summarises the regime:

The Capetown Convention. Scope of Application

The Convention and the Protocol applies to airframes, aircraft engines and helicopters. Following proff. Saunders, "*cette reprise de contrôle de l'actif financé est non seulement une condition d'amélioration de son financement, elle est aussi une condition impose par les agences de notation pour les opérations de titrisation et pour l'accès aux marchés de capitaux des financiers aéronautiques.*"^[1] It means that the new Convention will assist the issuers acceding to the capital markets.

The process of uniformity of aircraft finance law is not new, as the Geneva Convention 1948 already aimed to create an international registry. However, the flexibility for the States to declare whether they seek to be bound by all or particular dispositions will increase the ratification of this

Convention. The widespread scope of the Capetown Convention will be attractive for aircraft financiers, as it is the most ambitious and unique treaty in the history of international aviation finance laws.

The International Registry

The Convention establishes an international legal regime for the creation, enforcement and priority of security interests in three categories of mobile equipment – aircraft equipment, railway rolling stock and space assets. The Convention applies to each category through a separate Protocol. Fundamental to the effectiveness of the regime is an international registration system.

In terms of success, asked what assumptions there were concerning the likely number of registrations and searched in the Registries per annum, a Workshop participant representing the International Society of Aviation Telecommunications ("SITA") replied that approximately 50,000 Registry aircraft transactions were expected per annum – a very low number in terms of a data base for registrations. The Registry is administered by the Irish company Aviareto, supervised by the OACI and operated through an automatic 24h system.

Article 26 of the Convention guarantees universal access to the Registry and not limited to nationals of Contracting States. Therefore, anyone who complies with the procedural requirements of the Convention, Regulations and Procedures may access the Registry. However, it is not possible to effect a registration relating to an interest under a transaction involving a debtor, lessee or buyer under a title reservation agreement or seller who was not situated in a Contracting State at the time of the conclusion of the agreement creating or providing for an in-

[1] Cf. A. Saunders/I. Walter, New York University Salomon Centre Air and Space law Review, Volume XXIII, 6, 1998, 243-276.

ternational interest,^[2] unless the aircraft object in the form of an airframe or a helicopter is registered in a Contracting State pursuant to the Chicago Convention.

Title and Ownership under the Convention

The registration merely gives notice but does not create guarantee from the Registrar. Either debtor or creditor could, as they agree between themselves, initiate a registration. Both parties named in a registration would be “*approved users*” of the Registry system. Each “*registered user entity*” would have an “*administrator*” who could approve a number of “*authorized registry users*” – persons who have the authority and status to create registrations.

It must be noted that, under art. 17(2)(i), the Registry must provide for “notice registration”, not contractual document registration. Registration of an interest or prospective interest in an aircraft object is made by transmitting to the Registry basic information about the transaction or a non-consensual interest such as a lien.

Effects of Registration

The priority rules of the Convention subject the proprietary rights of a secured creditor, or the ownership of a lessor, or title reservation seller of an aircraft object to defeat. Defeating in respect of a registration relating to the security agreement, lease or sale contract is not effected or is effected

after a competing interest created under a transaction with the debtor, lessee or buyer has been acquired and registered in the aircraft object.

Similarly, the ownership rights of a buyer of an aircraft object can be defeated unless a registration disclosing those rights is made. However, registration does not entail any legal guarantee or presumption that the lessor, seller or buyer is the owner of the aircraft object identified in the registration. Ownership in this context remains a matter to be determined under the applicable law – *i.e.* Spanish law. The ANA does not contain a detailed list of the ways to acquire ownership, except from some rules related to the building and discovery of aircrafts.

Como hemos visto, las dificultades para obtener financiación en el sector marítimo y aviación puede llevar a una mayor consolidación del sector, a través de operaciones de M&A. Por ello, los actores envueltos deberían tener en cuenta la contratación de programas de “seguros de manifestaciones y garantías”, hechos a medida para las particularidades del sector.

Además, teniendo en cuenta los riesgos a los que navieras y aerolíneas se enfrentan en relación al título de propiedad sobre buques y aeronaves, dicho “seguro de manifestaciones y garantías” debería combinarse con “seguros sobre el título de propiedad”, con el fin de proteger la titularidad sobre dichos bienes muebles y poder ofrecer los mismos en garantía.

[2] Arts. 3(1) and 4 Capetown Convention.