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Latin America Trend to Watch: Representations and Warranties Insurance

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Over the course of the past year, we have observed a progressive increase in the frequency with which representations and warranties insurance (RWI) has been considered for Latin America M&A transactions. The increase in private equity-led Latin America M&A transactions likely has had an impact on the rising interest in RWI, in no small part as a result of the life expectancy of private equity funds. As more region-specific funds reach maturity and the return of capital to their investors becomes imminent, the pressure increases to seek clean exits where a selling fund does not retain significant post-closing financial risk through indemnity covenants.

Deal-makers also have been motivated to find alternatives to traditional post-closing risk allocation in Latin America because of the increased complexity of deals, the number of regulatory or court-mandated transactions and distressed divestments, the increased sophistication of passive investors that are unwilling to assume direct risk, and the more competitive nature of global auction processes.

The coming year is expected to bring an uptick in deal-makers seeking to deploy RWI in Latin America's complex M&A transactions.

Rise of RWI

RWI protects the insured party against financial losses resulting from unknown breaches by a seller or target of their representations and warranties (including litigation costs) in a transaction agreement. As with other novel legal and financial risk allocation structures and solutions that have been introduced in Latin America, RWI policies first took root elsewhere.

In the U.S., RWI has been around since the late 1990s and gained meaningful traction in 2011. RWI policies written by finance and insurance company AIG between that year and 2016 (the last year covered by AIG's most recent RWI report) represented a significantly larger pool of transactions than the period prior to 2011. Global demand for RWI policies also has more than tripled since that year, according to reinsurance company Munich Re. Latin America deal-makers have been paying close attention to this evolution. According to insurance brokerage and risk management services firm Arthur J. Gallagher & Co., AIG has noted at seminars that it alone has paid more than $100 million in claims.

Such favorable reports of claims being paid and RWI carriers acting reasonably throughout the claims process, coupled with increased recognition of the benefits of RWI for buyers and sellers, are luring Latin America deal-makers previously on the sidelines into the game.

However, Latin America deal-makers should proceed with caution and work with their RWI brokers as early as possible to confirm the insurance is available to them and the cost is acceptable under the specific circumstances. While RWI policies have been implemented in a broad range of industries across Latin America, not all countries are regarded as equal by RWI carriers. It appears Chile and — at least until the first quarter of 2018 — Mexico have had higher levels of RWI carrier interest than other significant

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jurisdictions, such as Argentina, Brazil and Colombia. As the region continues to warm up to the concept of fronting some costs for unknown risks that may never materialize, RWI carriers also are being cautious. Each market is different, and the common perception of higher political and economic volatility — including widespread corruption scandals, which tend to increase fears of fraud — may cause RWI carriers to be more prudent and increase prices in emerging markets. Similarly, less deal flow and higher perceived uncertainty on underlying applicable law of the representations and warranties' subject matter also makes it more challenging to put a price tag on unknown risks.

The Latin America M&A transactions that are likely to fare the best in terms of RWI coverage and cost have the following characteristics:

- a well-regarded ultimate beneficial owner of the insured party;
- an insured party in the U.S. or other jurisdiction with high historical deal flow;
- a simple business model that is not heavily regulated;
- sophisticated counsel and accountants;
- an English-language acquisition agreement governed by U.S. or U.K. law;
- a high-quality due diligence process with a U.S.-style detailed diligence report; and
- arm's length negotiation of representations and warranties.

Implementation of RWI in Latin America

While there is no shortage of RWI guides for the U.S., such resources with respect to Latin America are limited. The discussion below of the main features of RWI in Latin America draws on our deal experience and on information that key RWI brokers have provided us.

RWI Basics. A policy issued to a buyer, known as a buy-side policy, requires the carrier to pay the buyer upon a verified claim. One issued to a seller, known as a sell-side policy, requires the carrier to pay the seller following a verified payment by the seller to the buyer with respect to an indemnity claim.

RWI significantly reduces the scope of a seller's indemnity obligations, as the buyer looks mostly to the RWI carrier instead of to the seller for recovery in the covered areas. SRS Acquiom's 2018 Buy-Side Representations and Warranties Insurance Deal Terms Study found that, where buy-side RWI is present, the median size of the seller's escrow expressed as a percentage of the purchase price drops from 10 percent to just 1 percent.

Since the buyer looks to the RWI carrier instead of the seller for recovery in the covered areas, RWI significantly reduces a buyer's exposure to the risks of seller credit and enforcement of foreign judgments. The latter is of particular importance to a buyer if, as is the case in many Latin America M&A transactions, the seller holds assets in multiple jurisdictions, and certain jurisdictions in the region have complex foreign judgment enforcement rules.

RWI can be a useful tool for a buyer entering a Latin American market for the first time. Such a buyer often keeps much of the target business' existing management in place after the closing and may structure the transaction so the seller keeps an ownership stake, even if temporarily, in the target business post-closing. Under those circumstances, the buyer's assertion of an indemnity claim could sour its relationship with its new employees and partner. A buy-side RWI policy might enable the buyer to avoid this awkward situation, since the buyer would make the claim to the RWI carrier.

In a hotly contested auction, a prospective buyer can make its bid stand out by easing the seller's indemnity obligations in reliance on a buy-side RWI policy. This is especially true in Latin America M&A, as RWI is not yet as common.

RWI also can benefit both sellers and buyers in an M&A transaction with multiple sellers, where sellers — whether as a matter of policy or simple financial wherewithal — do not offer joint and several liability for indemnities, because RWI obviates the need to pursue multiple parties for varying percentages of losses and allows a single process with the RWI carrier.

RWI policies that have been bound for Latin America M&A transactions have mostly been buy-side. It is unclear whether this is due to RWI carriers having less of an appetite for sell-side RWI policies or sellers not being willing to cover the cost of the policy or accept the mechanics of the seller first fronting the indemnity payments and then getting reimbursed by RWI carriers.

Cost. Generally, RWI policies are more expensive in Latin America than in the U.S. For instance, premiums, which are one-time and usually expressed as a percentage of the RWI policy limit, range at least 0.5 percent higher on each end for a Latin America transaction than the 2-4 percent in the U.S. There is no difference in cost when it comes to RWI broker fees and taxes on the policy (which typically are dependent on the registered address of the insured party). Some expected cost differences also exist among different Latin America jurisdictions that may be driven by deal flow, legal certainty and the perceived macroeconomic risk (including currency risk) in each locale.

Time. Some brokers indicate that the RWI process in Latin America is only a couple of days longer than for a U.S. policy, while others suggest it's an additional three weeks. Other than taking slightly longer to complete, the process for a Latin America RWI policy is no different than for a U.S. one. The duration of the process may depend on whether the RWI carrier is willing and able to rely on the buyer's diligence reports rather than require full-blown diligence by its independent U.S. and local counsel.

Policy Provisions. The deductible/retention for Latin America RWI policy often is in the 1-2.5 percent range, compared to generally below 1 percent for a U.S. policy. As for a policy limit, it is unclear whether it is lower in Latin America than in the U.S. Some RWI brokers say that Latin America RWI policies have lower limits due to limited RWI carrier appetite. Others maintain that RWI policy limits in Latin America tend to be higher because of smaller deal sizes. Still others believe the limits are comparable to those in the U.S., at 10 percent of the purchase price.

Exclusions. Insurers protect against unknown risk. Therefore, as is the case in other jurisdictions, RWI policies typically do not cover known issues, including those revealed in the diligence process or identified in the disclosure schedule. There also are various subject areas that RWI carriers will generally attempt to exclude from RWI policies, including data protection and cyberattack matters, compliance with certain labor and employee benefits laws (including on wages and pension matters), certain tax matters such as the ability or time frame in which a target or buyer may utilize net operating losses, open audits, transaction-related taxes and product liability, and fraud by the insured party. Additional subject areas that RWI carriers typically seek to exclude for Latin America RWI policies include bribery and corruption, money laundering, and expropriation risk.

Among other issues, quantifying such risks is extremely difficult for RWI carriers on the basis of transaction diligence, and although they may be perceived as having a low likelihood of occurring, these risks have been more pervasive in Latin America than elsewhere in the past couple of years. Furthermore, when the risk materializes, it tends to have a severe and long-lasting negative impact not only on the target but also on the buyer. Separate, additional insurance policies to cover gaps in the RWI policy may be available at increased cost for some, but not all, of these exclusions.

Conclusion

With its expected increased prominence in the new year, now is the time for deal-makers with roles in premier Latin America M&A transactions to get up to speed on RWI.

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