CHAPTER 8

Representations and Warranties Insurance in Latin American M&A: A Long-Awaited Alternative in the Face of Current Challenges

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While representations and warranties insurance (RWI) is commonly used in many domestic private-target M&A deals in the US, the use of RWI in cross-border M&A transactions involving emerging markets has long been an up-and-coming trend yet to fully consolidate, especially in transactions involving Latin American targets. In recent years, RWI has gradually entered the cross-border transactional space and become an important risk allocation tool in cross-border M&A deals. Historically, RWI was often discussed but rarely used in Latin American M&A deals, mainly due to insufficient market penetration by insurance companies offering RWI in their portfolios. However, in recent years we have observed a significant increase in the frequency in which RWI is used, or at least available and seriously considered, in M&A deals in the region.

Dealmakers 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. Also, the current global turmoil and the environment of social unrest and political instability facing

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the globe and the region have shown that RWI can be a valuable tool to align parties' interests and expectations as to risk allocation, in a manner that may not otherwise be possible without transactional insurance.[2]

The increase in private equity-led Latin America M&A divestitures has also been a driving factor in the rising interest in RWI, because it may avoid potential misalignment between the fund life expectancy of the selling private equity fund, on the one hand, and the acquirer's expectation as to recourse, indemnification survival periods and holdback or escrow terms under the purchase agreement, on the other hand. 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.[3]

Nonetheless, the use of RWI in Latin American M&A deals continues to be in the early stages. Therefore, aggregated data regarding the use of this tool in the region is not readily available and the specific terms and scope of an RWI policy are likely to be highly bespoke. While there is no shortage of RWI guides for the US, these resources are limited with respect to Latin America. Notwithstanding, as is the case with many M&A constructs, RWI has been transplanted from US M&A practice into Latin American M&A practice,[4] and the use of RWI should be expected to follow US practice and developments, with certain notable differences highlighted in this chapter.

As market penetration by insurance companies offering transactional insurance in Latin America continues to develop, the relative cost of RWI in Latin American deals should generally be expected to remain higher than that of RWI policies issued in US domestic transactions due to reduced competition among, and limited risk appetite from, insurers that currently offer this product in the region. Although we have seen insurer competition increasing and RWI becoming more broadly available and cost-efficient, especially in transactions with less complex target operations for which due diligence efforts may provide a greater degree of assurance as to the likelihood of unexpected material contingencies, a disparity with the US market persists.

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2 See the 'Latin Lawyer M&A Roundtable' in this guide.

3 See the 'Private Equity Funds and Institutional Investors in M&A' chapter in this guide for an overview of transactions involving private equity funds and other institutional investors in Latin America.

4 For an introduction to the term 'legal transplant,' see Watson, Alan, *Legal Transplants: An approach to Comparative Law* (2nd edition, University Press of Virginia, 1993).

Against this backdrop, this chapter is intended as an overview of the main aspects that dealmakers should take into account when considering RWI and its implementation in Latin American cross-border M&A. The first section includes an overview of the 'nuts and bolts' of RWI, including the types of RWI policies available; policy period, deductible, limits and exclusions; associated cost; typical underwriting process; and key aspects of the process to make claims under the RWI policy. The second section focuses on factors that may impact whether RWI is available for a particular transaction, and the related cost of the policy. The third section includes reflections on the relative benefits that RWI can offer for both sellers and buyers, and the transaction as a whole. Finally, in the fourth section, we discuss the intersection of RWI and the purchase agreement.

'Nuts and bolts' of RWI

Types of RWI policies

RWI protects the insured party against financial losses resulting from the breach of representations and warranties (R&Ws) made by the seller or the target under the purchase agreement. There are two types of RWI policies, depending on who will be the insured party:

- a buy-side RWI policy, which is issued to the buyer as the insured party, allowing it to seek payment from the insurer for losses incurred as a result of the breach or inaccuracy of R&Ws made by the seller or the target under the purchase agreement; and
- a sell-side RWI policy, which is issued to the seller as the insured party, allowing it to seek payment from the insurer for losses incurred as a result of claims brought by the buyer against the seller for breach or inaccuracy of R&Ws made by the seller or the target under the purchase agreement.

In broad terms, both buy-side and sell-side RWI achieve the same ultimate financial effect, which is to allocate to the insurer the risk of breaches or inaccuracies of the covered R&Ws. Thus, the risk of any losses derived therefrom is shifted to the insurer and is not borne by either seller or buyer. However, the risk assumed by the insurer is not absolute as it is subject to the precise scope of the covered R&Ws and the relevant policy terms and conditions, including coverage limitations and exclusions. Therefore, as further explained below, the type of RWI policy issued in connection with a deal (i.e., sell-side versus buy-side) can be indicative of:

- the extent to which there will be recourse available to the buyer under the purchase agreement in connection with any insured breach or inaccuracy of the R&Ws; and

- the allocation of the risk that a claim under the RWI policy against the insurance company be denied.

On the one hand, sell-side RWI covers the financial risk of the seller resulting from its indemnity obligations contemplated in the purchase agreement, as it requires the carrier to pay the seller following a verified payment by the seller to the buyer with respect to an indemnity claim. Sell-side RWI policies are therefore premised on the fact that the buyer has recourse under the purchase agreement and are moot in 'no recourse deals'. Therefore, the seller generally bears the risk that a claim be denied by the carrier under a sell-side RWI policy.

On the other hand, buy-side RWI eliminates or significantly narrows the seller's indemnity obligations under the purchase agreement, as the buyer looks mostly to the RWI carrier instead of the seller for recovery in the covered areas. A buy-side RWI policy may be issued regardless of whether the buyer has recourse against the seller under the purchase agreement for the covered matters, in addition to the RWI. Absent recourse against the seller, the buyer will exclusively bear the risk that a claim under a buy-side RWI policy be denied by the insurance company. If the buyer has recourse against the seller, the seller will likely bear this risk to the extent of its indemnification obligations under the purchase agreement, especially if the parties have agreed that the buyer must first seek recovery from the buy-side RWI and may only collect from the seller to the extent it is unable to recoup under the RWI.

Buy-side RWI policies are overwhelmingly used more than sell-side RWI policies because, among other reasons, contingencies known by the insured party are typically excluded from coverage under RWI policies (see 'Exclusions', below). Considering that the buyer is less likely to be aware of contingencies of the target business than the seller, buy-side RWI policies are expected to entail a more narrow range of excluded contingencies due to knowledge of the insured party. Not surprisingly, over 97 per cent of the transactions in which RWI is used involve a buy-side RWI policy.[5]

5 Woodruff-Sawyer & Co, 'Guide to Representations and Warranties Insurance', 2023, p. 9. In addition, according to the most recent market survey on private target M&A deals in the US published by the American Bar Association as at the time of writing, 95 per cent of the transactions in which representations and warranties insurance was used from 2018 to the first quarter of 2021 involved a buy-side RWI policy (American Bar Association, Business Law Section, 'Private Target Mergers & Acquisitions Deal Points Study', December 2021 (ABA 2021 Survey), p. 122).

Cost

The main cost components of RWI are the premium, the broker fee, the underwriting fee and taxes payable on the policy.

The premium is a one-time payment to the carrier, usually expressed as a percentage of the RWI policy coverage limit. Premiums in the US typically range between 2.5 per cent and 3.5 per cent of the policy limit.[6] However, as noted above, costs associated with RWI issued in Latin American deals tend to be higher than in the US due to reduced penetration and competition among insurers in the relevant markets. Although there is no aggregated data for RWI in the region, premiums in Latin American deals should be expected to be between 3.5 per cent and 5 per cent of the coverage limit.[7]

The amount of the premium will be impacted by the terms of the RWI policy, the transaction terms and the specific circumstances of the target, including the jurisdiction and industry in which it operates, perceived legal certainty and macroeconomic risk (including currency risk). Insurance companies are willing to agree on enhancements to the policy to cover some of the excluded items (see 'Exclusions', below), for an increase in the premium. Thus, the amount of the premium in each case will ultimately depend on the facts and circumstances at hand.

RWI policies issued in Latin American deals should bear no difference in cost when it comes to RWI broker fees (typically ranging in the US in the low tens of thousands of dollars and often absorbed within the RWI premium if a policy is ultimately bound) and taxes on the policy (which typically are dependent on the registered address of the insured party). The insured party is usually required to pay an underwriting fee (sometimes referred to as a 'diligence fee') to the carrier to cover diligence and other costs incurred in the underwriting process, including outside counsel engaged by the insurer for diligence purposes, if any. The underwriting fee in the US typically ranges between US$25,000 and US$50,000.

Regardless of whether an RWI policy is buy-side or sell-side, the parties can negotiate the allocation of the premium and other RWI costs between buyer and seller. In a competitive sale process, it is not uncommon for the seller to ask the buyer to cover all RWI cost, including the full amount of the premium. However, if the buyer has more leverage, it is usually well advised to request that

6 See, for example, Marsh LLC, 'Transactional Risk Insurance Map', 2023, p. 2 (indicating that, as at Q1 2023, premium rates in the US and Canada range between 2.7 per cent and 3.5 per cent of the policy limit).

7 ibid.

the seller assume or share the costs of the RWI, under the argument that the RWI is covering risks that would otherwise need to be covered by the seller under indemnity provisions in the purchase agreement. Pursuant to the American Bar Association's latest biannual market survey on private target US M&A deals, the seller assumed all or part of the RWI costs in at least 32 per cent of the deals using RWI between 2020 and the first quarter of 2021 (despite 95 per cent of the relevant policies in that period being buy-side RWI).[8] According to a recent survey by LexisNexis, at least 17 per cent of the acquisition agreements in 2022 expressly required sellers to assume some (15 per cent) or all (2 per cent) of the cost of the policy premium.[9]

Retention

RWI policies include a deductible, referred to as the 'retention'. In the US, the retention usually ranges between 0.5 per cent and 1 per cent of the deal value, although higher deductibles may apply for smaller transactions or in special circumstances.[10] The retention in RWI policies issued in Latin America should be expected to be around 1 per cent of deal value. However, the retention may be higher depending on the relevant jurisdiction and specific circumstances of the target business (going up to 2 per cent in some cases). Many RWI policies in the US provide for a drop of the retention (usually by 0.5 per cent) after a specified period of time has passed since the policy was issued (usually on the first anniversary of the closing), but some carriers may not be willing to offer a drop of the retention in Latin American deals.[11]

In a competitive environment, the seller may require that the buyer assume the risk below the retention, as would be the case in a no recourse deal. Conversely, when the buyer has more leverage, it may require that the seller provide indemnification for breaches of R&Ws below the retention, subject to customary limitations on indemnity, such as a de minimis amount, as applicable. Furthermore, if the seller

8 ABA 2021 Survey, op. cit., p. 124.

9 LexisNexis, 'Market Trends 2022: Representations & Warranties Insurance', April 2023, p. 5.

10 See, for example, Marsh LLC, op. cit., p. 2 (indicating that, as at Q1 2023, the retention in the US and Canada ranges between 0.75 per cent and 1 per cent of the deal value).

11 ibid.

is liable for all or some amount of the losses below the retention and arising from breaches of R&Ws, a buyer with negotiation leverage may require a holdback or escrow in connection therewith.[12]

Recourse against the seller for breach or inaccuracy of the R&Ws covered under the RWI (e.g., with respect to all or some amounts below the retention) has the potential of lowering the cost of the RWI, in the form of a reduction in the premium. Insurance companies will have more confidence in the quality of the R&Ws and in the seller's diligence and overall process in granting R&Ws if buyer has recourse against the seller. Insurance companies assume that, if the seller has 'skin in the game', it will be more zealous in negotiating the specific wording and relevant qualifiers of R&Ws and in making appropriate disclosures of exceptions thereto. The seller's indemnity obligations usually do not need to be substantial relative to the deal value or even the RWI policy limit for the insurance company to be able to offer a discount in the premium, as long as the RWI carrier deems these obligations to be enough for the seller's interests to be aligned with those of the insurer when negotiating the relevant terms of the purchase agreement. According to SRS Acquiom's 2023 M&A Deal Terms Study, the presence of RWI significantly increases the frequency of deals with indemnification clauses providing for no indemnity basket at all (e.g., only 6 per cent of deals with no RWI in 2022 included no indemnity basket, while 40 per cent of deals with RWI in 2022 included no indemnity basket).[13] The notable decrease of the use of indemnity baskets in the presence of RWI evidences a willingness to shift some or all of the risk below the retention to the seller.

The RWI policy usually does not include a de minimis amount. However, significant materiality thresholds in the scope of the buyer's due diligence review may prompt certain carriers to increase the retention or, less market standard in the US (but more common for European insurers), attempt to include a de minimis amount in the policy.

Policy period

In sell-side RWI policies, subject to a specified maximum term, the policy period tends to match the survival period of the seller's indemnification obligations under the purchase agreement, because the insured risk stems from these obligations. In

12 See the 'Indemnity Escrows and Other Payment Guarantees' chapter in this guide for an overview of escrow agreements, holdback provisions and other guarantees that may be used in the context of M&A transactions in Latin America.

13 SRS Acquiom, '2023 M&A Deal Terms Study', 2023, p. 66.

buy-side RWI policies, however, it is more common in the US to see a three-year policy term for operational and non-fundamental R&Ws and a six-year policy term for tax and fundamental R&Ws.[14] No aggregate comparable data is available specifically for RWI policies issued with respect to Latin American deals. The rationale for policy periods may be impacted by the underlying applicable statute of limitations and other considerations that are specific to each underlying jurisdiction. Nonetheless, we would not expect the aggregate trend on policy period to be substantially different in Latin American deals from what is observed in policies issued for US deals, especially considering that most insurers offering RWI in Latin America are based in the US.

Coverage limit

The total coverage limit of RWI policies issued with respect to M&A transactions in the US usually ranges between 10 per cent and 25 per cent of the deal value. Most carriers are open to a policy enhancement to cover breaches of true fundamental representations (i.e., title, organisation, good standing, authorisation and capacity) beyond the general limit of the policy, often up to 100 per cent of the deal value, in exchange for an increase in the premium amount.

As with other aspects of RWI policies issued in respect of M&A deals in Latin America, there are no statistics readily available in connection with typical coverage limits under these policies. Some RWI brokers say that RWI policies issued with respect to Latin American deals have lower limits, as a percentage of the deal value, than RWI policies issued in respect of US deals, due to limited RWI carrier competition and appetite. Others maintain that RWI policy limits in Latin America tend to be higher, as a percentage of the deal value, because of smaller deal sizes. Still, others believe that the policy limits in Latin America are comparable to those in the US.

Exclusions

RWI generally covers unexpected financial risk derived from breaches of R&Ws. Therefore, RWI is not designed or intended to cover, and does not cover, breaches of covenants or price adjustment payments. However, coverage through R&Ws on the underlying subject matter of some covenants may be obtained under RWI. For instance, the risk of breach of seller's interim operating covenants often can be covered indirectly, through an 'absence of certain changes' R&W.

14 SRS Acquiom, *Tales from the M&A Trenches, Post-Closing Practices to Mitigate Post-Closing Risks* (5th edition, March 2019), p. 150.

Insurers only protect against unknown risk. As is the case in the US and other jurisdictions, RWI policies typically do not cover breaches of R&Ws derived from known or expected issues, including those revealed in the diligence process or identified in the disclosure schedule.[15]

There also are various subject areas that RWI carriers will generally exclude from RWI policies, including data protection and cyberattack matters, compliance with certain labour and employee benefits laws (including on wages and pension matters), certain tax matters (such as open audits, transaction-related taxes or the ability of the target or buyer to, or time frame in which the target or buyer may, utilise net operating losses), product liability, certain environmental matters (such as pollution and handling and release of hazardous materials), and fraud by the insured party (in the case of buy-side RWI policies, breaches of covered R&Ws that occur due to fraud or fraudulent misrepresentation by the seller are usually covered, subject to the insurer's subrogation right with respect to any claims involving fraud by the seller). Additional subject areas that RWI carriers almost always seek to exclude for Latin America RWI policies include bribery and corruption, money laundering, and expropriation risk. Separate insurance policies and products may be available to cover some, but not all, of these exclusions.

Among other issues, quantifying the underlying risks of these excluded matters is extremely difficult for RWI carriers on the basis of transaction diligence, and although some of the excluded items may be perceived as having a low likelihood of occurring, most of the risks (e.g., anti-corruption) have been more pervasive in Latin America than in other jurisdictions in recent times. Furthermore, when the risk materialises, it tends to have a severe and long-lasting negative impact not only on the target but also on the buyer.

Further, insurers may seek to have additional exclusions on a jurisdiction-specific, industry-specific or deal-specific basis. These exclusions may include specified matters that in the opinion of the insurer were not sufficiently reviewed during diligence, or items relating to diligence findings.

Depending on how competitive the M&A process is, the buyer may require that the seller provides indemnification for excluded items under the RWI policy and may even require an escrow or holdback to guarantee liquidity for these risks.

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15 We have confirmed in discussions with brokers that in certain instances, issuers have been willing to broaden coverage in the US for certain interim breaches (i.e., breaches of R&Ws first arising between signing and closing, of which the insured party has actual knowledge as of the closing). Time will tell whether these coverage enhancements will be available with respect to M&A deals in Latin America.

Underwriting process

Typically, the insured party (likely the buyer) will engage an RWI policy broker. The broker will then reach out to potential insurers and provide them with limited key information regarding the deal, which is generally only disclosed after the insurers sign a customary non-disclosure agreement or joinder to the buyer's non-disclosure agreement with the target or the seller. The information typically shared with the insurers includes the management presentation or confidential information memorandum, recent target financial statements, the draft purchase agreement, the proposed purchase price and the requested coverage. Insurers that are interested in issuing a policy for the relevant deal will then provide the broker with quotes and the broker will prepare a summary comparison chart of proposed key policy terms, including coverage limit, retention, premium, exclusions, enhancements and areas of required heightened diligence (which may ultimately result in additional exclusions). The quotes will typically be subject to confirmatory due diligence by the insurer.

Once the prospective insured party has selected a preferred insurer, the insurer may require the execution of a 'non-binding indication letter', setting forth the key terms of the policy, in addition to payment of the underwriting fee. In competitive auctions and other circumstances in which the buyer has not entered into an exclusivity agreement with the seller or target with respect to the transaction, a buyer seeking an RWI policy may be required to pay an exclusivity fee to the insurer to proceed with the underwriting. Pre-exclusivity underwriting is not very common and therefore the exclusivity fee charged by carriers can be material (e.g., low to mid hundreds of thousands of dollars), depending on market capacity and how much competition and appetite there is for the target business. However, the exclusivity fee is likely to be credited against the premium if a policy is issued thereafter.

The insurer will require access to the data room and a copy of all due diligence reports (including from outside counsel, accounting firms and other advisers) and a copy of the disclosure schedules, all of which are usually expressly provided on a 'non-reliance basis.' Thereafter, the prospective insured party and the insurer will (1) hold an 'underwriting call' to discuss the status, scope and findings of the diligence review and other items relevant to the negotiation of the purchase agreement and the scope of the R&Ws (the insurer may follow up with specific questions after the call), and (2) negotiate and agree on the terms of the RWI policy, based on a form provided by the insurer.

The RWI policy can be bound prior to signing of the purchase agreement or between signing and closing, in each case, effective as of the closing. Buyers seeking a buy-side RWI are well advised to secure the terms of the RWI prior to

signing. The purchase agreement does not typically include a condition to closing for the benefit of the buyer on an RWI policy being actually obtained, because it is in buyer's control to secure the policy prior to signing, assuming RWI is available to begin with.[16] Further, as discussed, deals involving RWI often have no recourse or limited recourse against the seller. Therefore, the buyer should be the party most interested in confirming the availability and terms of the RWI (its only expected source of recovery), prior to executing the definitive agreements. When the terms of the RWI policy are agreed prior to the execution of the purchase agreement, the buyer and the insurer will typically enter into a binder of insurance, which will include a draft of the policy as an exhibit thereto and provide for the issuance of the policy upon satisfaction of certain customary conditions, including:

- payment of the premium in full;
- payment of the underwriting fee in full;
- consummation of the closing under the purchase agreement;
- absence of any amendments to the purchase agreement that adversely impact the insurer;
- a certificate from the insured party on the absence of knowledge of any breach of R&W (referred to as a 'no claims declaration'); and
- delivery to the insurer of an electronic copy of the data room and copies of final due diligence reports.

Prior to issuing the policy at closing, the insurer will require a 'bring-down call' with the insured party's deal team and third-party advisers on outstanding diligence questions and to enquire whether there have been any additional diligence findings since the date of the diligence reports provided to the carrier. Absent materially adverse issues, the terms of the policy are not typically revised after that call or the finalisation of the insurer's diligence.

The duration of the underwriting process will depend on whether the RWI carrier is willing and able to rely on the parties' diligence reports, rather than require full-blown diligence by its independent US and local counsel. In the US, the entire process from engagement of the RWI broker to a final negotiated RWI policy can sometimes be done in as little as two weeks, assuming no full-blown independent diligence by the insurer. Some brokers indicate that the RWI process

16 Pursuant to the ABA 2021 Survey, only 12 per cent of deals referencing RWI in 2020 to the first quarter of 2021 included a stand-alone condition for the benefit of the buyer on obtaining RWI. Twenty-three per cent of those deals included this condition for the benefit of the seller and 66 per cent of the deals did not include any stand-alone condition on RWI. See ABA 2021 Study, op. cit., p. 125.

in Latin America is only a couple of days longer than that for a US policy, while others suggest it may take an additional three weeks. Other than possibly taking longer to complete, the process for a Latin America RWI policy is no different than that for a US policy.

In a highly competitive auction, the seller may indicate to the bidders that it will be providing no indemnity or very limited indemnity and will encourage them to use RWI as the sole source of recovery. Moreover, in that type of auction (especially in jurisdictions where availability of RWI is not clear or where there is uncertainty that it would be available at reasonable cost), the seller is generally well advised to engage a broker early in the process to confirm availability of RWI for the transaction. Sellers may also seek to pre-package a buy-side RWI policy that would be presented to bidders along with other transaction materials (typically during Phase II of the auction), which not every carrier may be willing to do in every deal (particularly US carriers) and should be expected to be subject to confirmation of the identity of buyer and the final terms and conditions of the deal. Bidders should bear in mind that they are not required to engage the broker that has worked with the seller in confirming availability of RWI or pre-packaging the RWI policy or to purchase the RWI policy from any of the seller's proposed carriers. Bidders can, of course, engage a different broker to survey the market and confirm whether better terms (including better coverage or more efficient costs) can be independently obtained. The merits of going down this route should be carefully assessed, considering, among other things, (1) time constraints; (2) RWI market depth and likelihood that other brokers and carriers may offer better terms for the particular transaction; and (3) the competitiveness of the auction, including whether the bidder may put itself at a disadvantage compared to other bidders that may go with the pre-packaged broker, carrier and policy, as applicable, especially if recourse against the seller in lieu of RWI coverage is on the table, because the seller will need to educate itself on the terms and reliability of the bidder's proposed policy and carrier.

Claims process under the RWI policy

RWI carriers usually have standardised and relatively expeditious processes to review claims. Insurers typically approach the claim process with a much more commercial perspective than sellers may approach indemnity claims, because at the end of the day handling these claims is inherent to the insurers' business model. The last thing an insurer wants is to build a reputation for being unreasonable in the handling of claims, as insurers are continuously competing for business in future deals, potentially involving the insured parties making claims under existing policies. Insured parties who are repeat players in the M&A space

should also be wary of earning a reputation of being difficult to deal with, as insurers may factor in that reputation when assessing the availability and cost of future RWI policies issued to those parties.

The claim process is typically kicked off by the delivery of an initial claim notice by the insured party, followed by the insured party's assessment of the breach and incurred loss. Thereafter, the insurer and the insured party will discuss an investigation plan, often including a preliminary investigation by the insurer, followed by information and document requests. Finally, the insurer will issue a coverage position and negotiations will take place, as needed.[17] The majority of claims are resolved within one year, with approximately a quarter of the claims being resolved within six months.[18] Claims issued with respect to assets in Latin America may take longer, due to expected reduced familiarity of the carriers with the underlying jurisdictions compared to the US. The insured party is often encouraged to be forthcoming with relevant information required to assess the breach of R&W and the loss incurred, relative to the level of information that it would otherwise share with the seller in connection with an indemnity claim. The amount of time it will take to resolve the claim will depend to a great extent on information flow, in addition to the complexity of the claim.

Pursuant to recent data from AON on RWI policies issued to AON clients, 18 per cent of RWI policies issued in 2015–2021 resulted in at least one claim by the insured party under the policy. The most frequent breaches of R&Ws cited as a basis for these claims were breaches of the R&Ws on compliance with laws (15 per cent of claims) and on financial statements (14 per cent of claims). However, claims for breaches of R&Ws on compliance with laws amounted to only approximately 8 per cent of all recovered losses, while breaches of R&Ws on financial statements and material contracts amounted to 41 per cent and 32 per cent of all recovered losses, respectively, because damages arising out of breaches of R&Ws on financial statements and material contracts tend to be sought by insured parties beyond a simple dollar-for-dollar calculation.[19]

17 M&A Insurance presentation by AON to Skadden, April 2022.

18 See AON, 'Representations and Warranties Insurance Claims Study; an analysis of claim trends, data and recoveries', 2020, p. 23.

19 AON, '2023 Transaction Solutions Global Claims Study', 2023, pp. 6–9.

Insurability factors

There are several factors that may impact the RWI carriers' appetite to issue an RWI policy and the cost thereof. Considering the limited offerings of RWI alternatives in the Latin American M&A space, sellers and buyers should seek to structure the deal around these factors to increase the likelihood that RWI may be obtained and reduce the cost at which it may become available. These factors include:

- a well-regarded ultimate beneficial owner of the insured party;
- a sophisticated insured party with an established track record in M&A, such as private equity funds, preferably based in the US or another jurisdiction with high historical deal flow;
- a simple target business model that is not heavily regulated;
- sophisticated counsel and accountants involved in the transaction, performing a customary due diligence process, and availability of a data room and US-style detailed due diligence reports from these advisers;
- an English-language acquisition agreement governed by US law, UK law or the law of another jurisdiction with a robust body of case law on M&A matters;
- high-quality terms and conditions under the purchase agreement; and
- arm's-length negotiation of the R&Ws, preferably including some recourse against the seller for any breach thereof (e.g., with respect to losses below the retention).

The above list is non-exhaustive. In essence, insurers welcome any deal trait that enhances the predictability of contingencies, legal certainty or the likelihood that any material contingencies have been identified during due diligence.

Sellers expecting bidders to obtain RWI should make sure that the factors that they can control are structured in a manner that favours the availability of RWI at a reasonable cost (e.g., engaging top-notch advisers, selecting an applicable law with an established body of M&A case law that is familiar to the RWI carriers, preparing transaction documents in the English language, conducting vendor's due diligence and documenting a robust process for disclosure of contingencies). As it is, RWI carriers are already cautious on the basis of factors that tend to be out of the control of the parties. 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 conservative and increase prices in emerging markets. Similarly, less deal flow and higher perceived uncertainty on the underlying applicable law of the R&Ws' subject matter also makes it more challenging to put a price tag on unknown risks. 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. For example, it appears that Brazil, Chile and Mexico have historically had higher levels of RWI carrier interest than other significant jurisdictions, such as Argentina, Colombia and Peru.

Relative benefits of RWI

Outlined below are some of the main benefits that RWI brings to the table for each of the parties and the transaction as a whole.

Benefits to the transaction and both parties

RWI offers an important risk allocation solution and can render significant benefits to both buyer and seller and to the transaction as a whole, regardless of the type of policy in place (i.e., sell-side or buy-side) or the allocation of cost thereof. The main and most obvious benefit is that it aligns otherwise incompatible interests and expectations, allowing for a clean (or cleaner) exit of the seller from the target business, while at the same time affording buyer protection against unknown contingencies that could otherwise take a premature significant toll on the valuation of the target, in the absence of recourse.

RWI also reduces transaction costs by expediting and simplifying the negotiation of the purchase agreement between the parties, particularly with respect to the R&Ws, and by potentially eliminating or considerably narrowing discussions on indemnity and escrow.

RWI can also 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. RWI obviates the need to pursue multiple parties for varying percentages of losses and allows for a single process with the RWI carrier. This is particularly handy if some of the selling entities are unaffiliated minority and passive investors who may be reluctant to grant indemnification on the basis of operational R&Ws negotiated by the controlling shareholder, with respect to underlying matters of which the minority or passive investors have limited or no knowledge or ability to control.

Benefits to the seller

RWI eliminates or reduces the seller's financial risk for losses arising out of breaches of R&Ws under the purchase agreement. The seller's rate of return on investment at closing is maximised because:

- in the absence of recourse, the buyer is not required to discount the purchase price on the basis of contingencies that have not materialised and would be covered under the RWI policy;

- the seller's post-closing exposure is eliminated or significantly reduced; and
- the need for a holdback or escrow dissipates, maximising the amount of consideration actually received by the seller at closing. For instance, according to SRS Acquiom's 2023 M&A Deal Terms Study, the average indemnity escrow amount in 2022 drops from 11.5 per cent of the transaction value in deals with no identified RWI to 1.2 per cent of the transaction value in deals with an identified RWI.[20]

As mentioned above, RWI allows selling private equity funds, and other institutional investors reaching maturity and relevant milestones for return of capital to their investors, to liquidate their investment in the target and distribute proceeds, without pending indemnity obligations that would delay an otherwise clean fund wind-up and dissolution. The authors have experience with deals in which specialised private equity funds at the end of the applicable fund life have been able to successfully close deals in which RWI was used to allow for a clean exit, including deals in the power and energy space.

Finally, RWI can be a powerful tool to facilitate deals with financially distressed sellers. Distressed sellers' creditworthiness does not provide sufficient assurances for effective recourse. Also, these sellers likely need to receive the proceeds of the transaction at closing to disburse them shortly thereafter to creditors or use them to cover critical operational needs. RWI provides a solution for both of these issues by eliminating or reducing reliance on recourse against the seller and providing buyer with the ability to look at the insurer for creditworthiness and liquidity risks, instead of the seller.

Benefits to the buyer

Because the buyer looks to the RWI carrier instead of to the seller for recovery in the covered areas, as noted above, RWI significantly reduces a buyer's creditworthiness risk, which would otherwise be largely dependent on the identity and financial wherewithal of the seller.

RWI can be a useful tool for a buyer entering a Latin American market for the first time. This type of buyer often keeps much of the target business's existing management in place after the closing and may structure the transaction so that 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

20 SRS Acquiom, '2023 M&A Deal Terms Study', op. cit., pp. 78–79.

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 American M&A because not all bidders are likely to consider RWI, as RWI is not yet as common and many bidders are unfamiliar with, and even sceptical of, the benefits of RWI.

If completed prior to signing, the RWI underwriting process may enhance the buyer's diligence efforts, as it may put the focus on and uncover certain risks that may have not been otherwise identified in diligence.

As mentioned above, RWI also simplifies the process that the buyer is required to undergo to recoup losses incurred due to a breach of R&W, especially in transactions that would otherwise have involved recourse against multiple sellers. In Latin American cross-border M&A transactions, the seller or its assets are often located in jurisdictions (or multiple jurisdictions, including in the event of multiple sellers) that have complex foreign judgment enforcement rules, involving lengthy and costly recognition proceedings. In the absence of RWI, the buyer would be required to invest significant time and effort in obtaining recognition and enforcement of any judgment before being able to recoup.

The intersection of RWI and the purchase agreement

In some transactions, the purchase agreement does not include any references to the RWI, despite one of the parties using RWI. In these cases, it is likely that the insured party will independently obtain the policy and assume all costs thereof. However, although not strictly necessary, there are certain provisions that the parties should seek to include in the purchase agreement in connection with the RWI.

If the insured party has not obtained a binder of insurance prior to signing, it should seek to include covenants in the purchase agreement requiring the other party to reasonably cooperate and provide assistance in the process to obtain the RWI. As mentioned above, if the buyer has substantial leverage in the negotiations, it may attempt to include a stand-alone condition to closing on actually obtaining an RWI policy, but this condition is not customary and may significantly diminish the standing of a prospective buyer's bid in a competitive auction.

If the seller has agreed to indemnification obligations in the absence of RWI coverage and a binder of insurance has not been entered as of the execution of the purchase agreement, the seller should seek to include covenants requiring the buyer to use some level of efforts to obtain the RWI.

In any event, the seller is well advised to include provisions relating to the confidentiality of the information to be provided to the insurer, and the handling thereof, including the requirement that the carrier enters into a customary non-disclosure agreement or a joinder to the non-disclosure agreement executed by the buyer in connection with the transaction.

If the parties will share some or all of the costs of the RWI policy (e.g., the premium or the broker or underwriting fees), provisions and covenants should be included to that effect. For example, if the buyer will obtain a buy-side RWI policy but the seller will share some of the costs thereof, the buyer may seek to include these costs as transaction expenses to be deducted from the purchase price to be paid to the seller at closing.

In the event that the seller is granting recourse to the buyer in the absence of coverage under the RWI policy, whether for matters below the retention or exceeding the coverage limit, upon coverage being denied by the insurer or with respect to exclusions under the RWI policy, the indemnification provisions should be revised accordingly to reflect any agreed-upon recourse hierarchy[21] and the scope of any indemnification obligations of the seller for matters not within the scope of the RWI policy. Areas of frequent debate between the parties in the presence of RWI include whether the seller should be liable to the buyer for breaches of fundamental representations or certain key areas excluded from the RWI policy (e.g., bribery and corruption), because the underlying subject matters tend to be within the seller's control and the financial consequences for the buyer upon a breach thereof tend to be dire.

The negotiation of the scope of the R&Ws should not be heavily impacted by the presence of RWI, other than the fact that the seller may be more amenable to broader R&Ws where there is no or limited post-closing recourse against the seller in connection therewith. Nonetheless, the scope and quality of the R&Ws in the presence of RWI tends to follow market practice because insurers will likely exclude coverage for atypical R&Ws or offer to cover broader R&Ws at an additional cost. Also, the seller should be expected to continue to be careful not to compromise closing certainty by agreeing to an overly broad set of R&Ws and increasing the risk that the agreed-upon standard for the 'bring-down' of the R&Ws at closing is not satisfied.

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21 Pursuant to the ABA 2021 Survey, in 2020 to the first quarter of 2021, 38 per cent of deals in which RWI was used but was not the buyer's sole source of recovery required that the buyer first pursue a claim under the RWI prior to being able to recover from the seller. See ABA 2021 Survey, p. 128.

Other provisions that may be present in the purchase agreement in connection with the RWI include clarifying language to the effect that survival provisions under the purchase agreement do not impact the RWI policy period; and in the presence of a buy-side RWI policy, covenants requiring the buyer not to obtain an RWI policy providing for subrogation rights against the seller other than in the case of fraud, and requiring that the buyer does not agree to amendments to the RWI policy that adversely affect the seller, including with respect to subrogation rights.

The RWI policy is often self-contained as to the defined terms and other provisions that trigger coverage thereunder (other than the covered R&Ws, which are contained in the purchase agreement and included by reference), including with respect to the definition of covered losses, events constituting a breach of R&W, knowledge and other exclusions. However, in deals in which a buy-side RWI policy is put in place in addition to indemnification obligations granted by the seller, the RWI policy may be informed by the relevant provisions and defined terms in the purchase agreement (e.g., the definition of 'losses'). In those cases, the buyer should be careful not to accept limitations to the relevant defined terms and provisions that it is not willing to accept with regard to the RWI carrier. The RWI policy usually follows the materiality scrape provisions in the purchase agreement, for the purpose of determining whether there has been a breach of a R&W and the extent of the losses incurred.

Conclusion

With its expected increased prominence, it is timely for dealmakers with roles in the premier Latin American M&A transactions to brush up on RWI. As long as carriers continue to be willing to offer RWI at an accessible cost, the current global and regional environment of economic growth uncertainty, social unrest and political instability can incentivise the use of RWI, because:

- sellers will be looking for a clean exit (in particular private equity funds reaching maturity) and will be increasingly reluctant to offer substantial recourse in the face of current uncertainty;
- the volume of distressed M&A transactions could increase, forcing buyers to seek alternative sources of recovery; and
- US-based insurers provide a solution to creditworthiness and country risk, particularly in transactions involving local sellers.

As a result of RWI carriers warming up to the particular conditions of dealmaking in Latin America, including market, political and economic volatility, and the increase in deal flow and deal complexity in recent years, we expect RWI

carrier competition to continue to increase in the region, and we encourage parties to M&A deals to explore the availability of RWI, as reasonable costs and other terms and conditions are now available for many Latin American deals. That said, this may not be true for every deal, and Latin American dealmakers should proceed with caution and work with their RWI brokers as early as possible to confirm whether RWI is available to them at an acceptable cost under the specific circumstances.

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