



## Reps and Warranties Insurance in Latin America is Here to Stay, Latin Lawyer

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[Nicholas Rodríguez](#), a partner at [Jones Day](#) who focuses on cross-border M&A, joint ventures and corporate matters in Latin America, says representations and warranties insurance is primed for use across the region.

In 2018, Latin America experienced a slowdown in M&A activity which was caused in part by the presidential election super cycle, with contentious elections taking place in Brazil, Colombia, Costa Rica, Mexico and Paraguay. What's more, anti-corruption scandals buffeting many Latin American countries created market uncertainty, delayed major investment decisions and have presented a major challenge to M&A activity in the region.

Despite the political and economic headwinds in 2018, many investors continue to view Latin America as one of the most attractive emerging markets on a global scale based on improving economic conditions, elevated intra-regional competition and an increased focus on strengthening the rule of law. However, there is another trend driving deal making and reducing risks for would-be buyers and investors: the increased use of representations and warranties insurance (RWI) in international cross-border transactions.

### **RWI: An intuitive solution to a universal hurdle**

In M&A agreements, the buyer and seller will make representations and warranties to one another. These "reps", as they are colloquially known, are material facts, statements and assertions by a party about itself, and in the case of a seller, about the target companies being acquired. As a brief example, a seller will make extensive statements of, among other things, a target company's compliance with laws, liabilities, employees, properties, operations, environmental conditions, material contracts and financial condition.

The scope of representations and warranties and the indemnification for their breach is a point of contention for most buyers and sellers when negotiating a transaction. Even in private deals in the US, these terms are hotly contested because the interests of the parties are always at odds. This is because sellers will try to limit the scope of representations and warranties and insist on limited indemnities, while buyers will push for the broadest possible representations and warranties provisions available.

Jurisdictional variations on regulation and enforcement challenges compound these universal hurdles to make cross-border Latin American deals particularly complex. As with many cross-border deals, the negotiation of representations and warranties is further complicated where one of the parties is unfamiliar with the extensive diligence and drafting processes typically associated with a US-type deal. This clash of interests and the associated impediments play out against a backdrop that sees both parties aiming for the same two things: deal certainty and a speedy negotiation process. In this respect, RWI is increasingly being used as a solution

to facilitate M&A deals across the globe, particularly in Latin America. Though in its nascent stages in the region, RWI has been used in transactions in Brazil, Chile, Colombia, Mexico and Peru and is used with less frequency in other Latin American countries, such as Argentina.

### **RWI: nuts and bolts**

An M&A contract is, among other things, an agreement to allocate risks among the parties and representations and warranties and indemnification provisions are tools for allocating those risks. The seller makes certain representations about the target, the business, or the assets being sold and customarily agrees to indemnify the buyer if those representations are false or inaccurate. The seller's obligations are usually paired with some form of security or collateral for the benefit of the buyer such as an escrow (which is the customary and preferred security) or a holdback amount representing a portion of the purchase price. This means that, in such a case, either the buyer or a third-party escrow agent will retain a portion of the purchase price at closing to guarantee the indemnity obligations of a seller.

RWI is a means of reallocating the risks of representations and warranties breaches and may, if used properly, better align parties' interests. Specifically, RWI provides insurance coverage for losses from unintentional and unknown breaches of representations and warranties regarding a target company, its business, or its assets. If there is a breach of representations and warranties, an insured party can assert a claim directly against the insurance company for the portion of losses suffered that exceed the retention (ie, the deductible) under the RWI policy.

From a seller's perspective, RWI may help expedite the sale process and improve a seller's return on investment. This is because the seller is not required to place a large cash amount in escrow as security for its indemnity obligations under the purchase agreement. A seller may also attract superior bids because RWI may offer broader indemnification rights (particularly for a private equity or financial sponsor seller). Thus, by purchasing RWI at a fixed cost, a seller may significantly reduce or eliminate contingent indemnification obligations. This protection is especially important for minority or passive sellers who have minimal knowledge or control over a target company.

From a buyer's perspective, RWI mitigates the risk of not being able to enforce indemnity provisions where inter-jurisdictional legal processes may complicate matters. RWI policies are also highly customisable: they can provide protection beyond a limited indemnity cap; extend the duration of indemnification rights; or replace indemnification altogether, providing a sole remedy for breaches of representations and warranties. Bidders who obtain RWI policies may have significant competitive advantages in auction sales, which will enhance a buyer's purchase proposal (when compared to other bidders that require a large holdback or escrow to guarantee a post-closing indemnity obligation). RWI may also help buyers protect relevant relationships by avoiding requests for indemnification against sellers who could end up being key employees of the buyer as a result of the deal.

While RWI has been available in the US and Europe since the late 1990s, its use has become widespread in the last decade. Initially, coverage was too expensive and the underwriting process was too lengthy. Now RWI is affordable and easier to obtain in the US and Europe. In fact, the premium for RWI in the US is approximately 2% of the party's coverage limit or lower. It is common for buyer-side policies to cover from 10% to 30% of deal value, while seller-side coverage ranges from 5% to 15% of deal value. RWI providers also charge an underwriting fee ranging from \$25,000 to \$50,000 per policy. The premium may be allocated between the parties, and for buyer-side policies, the buyer will often consider this cost when deciding on a purchase price. RWI policies include a "retention," or deductible amount, usually around 1% of deal value. In a competitive sale process, however, sellers will often insist that buyers absorb responsibility for the retention amount.

### **RWI in Latin American deals: common use**

While RWI is employed in a myriad of ways across Latin America, deals with RWI in the region are largely solicited by international or US buyers, typically seeking to differentiate their bid by guaranteeing the seller a nil recourse exit from the deal. But increasingly, regional entities are proactively preparing for a private sale or auction process by working with representation and warranty insurers to pre-approve RWI for the target business.

In this context, the seller will engage an insurance broker who will solicit insurance terms and seek to pre-package an insurance policy that the seller can present to a buyer. This allows the

seller to approach the buyer with coverage terms at the outset of the deal and (as part of its negotiation strategy) to be clear about what premium, if any, the seller is willing to pay for the corresponding RWI. Pre-packaging the RWI is particularly useful for closely held or family-held entities and private equity sponsors that hope to walk away from a deal with limited or no residual liability and avoid leaving cash or other assets held up in escrow or being required to provide a contractual guaranty. Given the utility and appeal of RWI, deal counsel should encourage sellers to reach out to brokers and potential insurers early in the process to test the market for the best potential terms and, more importantly, the availability of RWI in a particular Latin American jurisdiction.

### **RWI in Latin American deals: concerns and market dynamics**

In any deal in an emerging market, the areas of heightened scrutiny for insurers will centre on four main risks: political concerns, employee-related matters, tax, and potential fraud. Concerning political risks, insurers will often check whether there are potential expropriation risks or political volatility in the territory. Thus, when considering employing RWI, deal counsel should encourage early conversation to assess what aspects of coverage would be of fundamental importance to a buyer. Wherever heightened risk is recognised, it can potentially be covered by standalone policies or insurance already carried by the target company, keeping RWI premiums low.

Regarding premiums more generally, in Latin America these rates tend to hover above 3% and are typically between 4% and 5% of the coverage limit, with some insurers providing coverage up to 7%, depending on the type of business, nature and scope of representations and warranties, and due diligence. In Mexico (where carriers express greater levels of comfort and confidence), retention rates are generally around 1%, while deals in other parts of Latin America range from 1.5% to up to 4%.

These slightly elevated rates are distinct from those typically quoted in the US and Europe, where a crowded insurer market and increased RWI policy volume has placed downward pressure on premiums. In Latin America, on the other hand, RWI is in its nascent stages and only a handful of so-called "alpha carriers" possess the economic capability and presence on the ground necessary to underwrite the coverage typically sought in RWI. Though RWI premiums are generally higher in Latin America for most transactions, the current RWI market reflects where the US market was as recently as five years ago. As deal flow and investment continue to increase in Latin America, insurer presence is sure to follow, which will likely cause premiums to decrease.

In the interim, Latin American M&A participants should bear in mind that certain factors will dictate whether deals are likely to receive RWI coverage on the lower end of the premium spectrum. These include, among other things, whether the buyer has significant experience acquiring target companies and whether a comprehensive and extensive diligence is conducted concerning the legal, financial and accounting aspects of the target company. Other factors considered are whether the acquisition agreement is in English and governed by a jurisdiction with well-established jurisprudence for interpreting these types of agreements and if the target company has any specific risk exposure that may need to be excluded from coverage.

### **A look ahead**

Among other factors, M&A and private equity activity in Latin America has long been tied to the underlying political climate. As the dust continues to settle after the wave of 2018 elections, political and economic stability and the certainty of rule of law will determine the general direction and speed of M&A and private equity investments. As Latin American M&A and private equity investments continue to grow, deal counsel would do well to increasingly turn to RWI as a means of facilitating deals and eliminating risk. The more commonplace RWI becomes in Latin America, the more likely major insurers are to occupy the market, encouraging them to cover a broader scope of warranties and offer lower rates in the region.

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