Back to the Future? Representations & Warranties Insurance in Latin American Transactions

By Rubén Kraiem[1]

Historically – that is, until the advent of "New York style" acquisition agreements introduced at different times in recent years throughout the region – buyers and sellers in Latin America would typically structure M&A transactions to allow for a "clean break:" sellers would have minimal post-closing exposure for losses arising from circumstances or events associated with the transferred business. Outright fraud or demonstrable errors in financial reporting would be the only exceptions. In many cases, this went along with minimal due diligence or disclosure pre-signing, and a simultaneous signing and close of the transaction. In presenting their offers and negotiating a transaction, buyers would rely principally on their knowledge of the markets and industries involved. They would have access only to financial reports and a few other concrete items of due diligence that were deemed essential, and obtain minimal representations concerning only that very limited disclosure.

These practices were used with full knowledge that they might result in a somewhat reduced valuation for the transferred businesses: buyers knew that they would have limited recourse post-closing for a variety of risks or contingencies, and would naturally discount their offer price (thereby effectively "self-insuring" for those risks or contingencies). Sellers would accept that discounted price in return for having little risk of facing indemnity claims for risks that were generally perceived to be impractical to address in a contractual context.[2]

Practice has since evolved in the direction of having a robust pre-signing due diligence process, fulsome representations and warranties covering a range of events and circumstances relevant to the business (sometimes even with a catchall "full disclosure" representation), confirmatory due diligence between signing and close and, most importantly, a set of indemnity provisions that would entitle the buyer to claim against the seller for losses arising by reason of any breach of those representations and warranties. In many cases, there's also a statement that buyer's knowledge pre-closing of any event or circumstance constituting a breach of the representations and warranties will not, without more, preclude a claim for post-closing indemnity (i.e., the very opposite of an "anti-sandbagging" provision).

An important development in M&A practice, increasingly common in the United States market but with limited penetration thus far in Latin America, has the potential to once again transform Latin American practice – and quite possibly move the overall market in the direction of being even more efficient and more competitive: namely, the inclusion of representations and warranties insurance (RWI) as a tool for managing and allocating risk.

The typical RWI policy works as follows:

- The buyer and seller will have negotiated a normal "package" of representations and warranties, and seller will have agreed to indemnify buyer for losses arising from any breach of those representations and warranties. However, the seller's indemnity obligation will be subject to (1) an agreed deductible (i.e., no indemnity except for losses cumulatively in excess of a certain amount), (2) a very low cap (say, twice the amount of the deductible itself), and (3) a relatively short "survival" period (possibly as short as 12 months from closing). Thus, while seller will have at least *some* exposure[3] (and have a small, albeit meaningful, incentive to be prudent in terms of what representations and warranties it is willing to give), it will be a very limited indemnity, far below what would be considered "market" in a normal M&A transaction.

- Armed with that package of representations and warranties, the buyer[4] will contract with an insurer who will be given access to (but may or may not choose to delve deeply into) all existing due diligence materials, including typically a set of GAAP audited financials for the acquired business, and who will underwrite and issue an RWI policy, agreeing to cover losses incurred by buyer (or by the acquired business) arising from the breach of those representations,[5] subject to:

    1. various exclusions for particular risks the insurer is unwilling to assume (more on that below);

    2. an agreed deductible that is equal to whatever cap the seller has agreed to give for *its* indemnity exposure (and adjusted down, when seller's indemnity obligation expires, to the lower deductible originally agreed by buyer and seller as being buyer's risk);

    3. a coverage limit (large enough that the buyer feels it is very unlikely losses would exceed that amount, but within whatever boundaries will keep the premium RWI affordable); and

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[2] *See* R. Kraiem, *Leaving Money on the Table: Contract Practice in a Low-Trust Environment*, 42 Columbia Journal of Transnational Law 715 (2004).

[3] In more unusual cases, seller will agree only to representations and warranties that are given as a condition of closing (i.e., that those representations and warranties must be true, or true in all material respects, or true except for any breach that does not have a material adverse effect), but provide *no* indemnity post-closing. This reduces somewhat the incentive for seller to negotiate prudently, and thus poses a somewhat larger underwriting risk for the insurer.

[4] It is possible also that the seller will approach a RWI underwriter and negotiate the terms of a policy, which is then "stapled" to the seller's very limited indemnity and presented as a piece of the auction "package." Buyer will then be expected to absorb the premium cost associated with the policy, either by paying for it directly or factoring it as an upward adjustment to its valuation of the acquired business.

[5] RWI does not, by definition, cover other types of seller obligations, such as with respect to purchase price adjustments that are done post-closing on the basis of working capital, debt or other accounting true-ups. Careful drafting is needed in order to ensure that parties understand and address areas of potential overlap between post-closing price adjustment provisions and representations and warranties that cover at least some of the variables, like inventory and sales-channel management, and/or the use financial leverage, that could also drive those adjustments.

4. the functional equivalent of an "anti-sandbagging" provision: the buyer will represent to the insurer, typically by delivery of a statement to that effect upon issuance of the policy and, if later, at closing of the acquisition, that it (meaning, for purposes of the policy, a certain set of identified individuals) has no *actual knowledge*, sometimes defined as "actual conscious awareness and personal knowledge" and expressly *excluding* "imputed or constructive knowledge," of any events or circumstances constituting breach of the covered representations and warranties.

- If and when claims for indemnity do in fact arise, the buyer will first absorb losses up to the deductible amount, and then claim against the seller to the extent of *its* (very limited, if any) exposure under the indemnity provisions of the purchase agreement. The idea behind RWI is that (1) at least to the extent of the risks that it does in fact cover, all of buyer's *additional* recovery, up to the amount of the policy limit, will be paid under the RWI policy by the insurer; and (2) the insurer will *not* have a right of subrogation as against the seller (so seller will not have any back-to-back exposure, which would defeat the purpose of not giving an indemnity), *except* in cases where there has been fraud or intentional misrepresentation by seller – and in such cases buyer should in any case have a claim against the seller (to which the insurer *would* be subrogated) that is not affected by the indemnity cap.

The striking result is that, for the parties to an RWI-covered transaction, the position is very nearly the same, at least to the extent of the risks covered by the policy itself, as it would have been if the parties had followed the historic M&A practice in the region – i.e., before "NY law style" transactions were the norm: (1) little, if any, contractual indemnity exposure to the seller; (2) a somewhat discounted purchase price (inasmuch as buyer will presumably deduct the premium it needs to pay to the insurer, unless it is unable to do so for competitive reasons) that is nevertheless significantly protected from claims;[6] and (3) a bias in favor of buyer assuming risks of which it has, for whatever reason, actual knowledge. Material liability exposure for the seller, at least for those items covered by the RWI policy, is limited to cases of fraud or intentional misrepresentation. However, the buyer is not (and this is obviously the critical difference) required to self-insure. Instead, the insurer has stepped into the shoes of the seller as indemnifying party – in return, of course, for a premium paid to it by buyer – subject only to an "anti-sandbagging" representation by buyer and whatever other limits or exclusions have been agreed.

As of this writing, few insurers have worked to penetrate the Latin American M&A market. So even in the larger jurisdictions (like Mexico and Brazil), only one or two companies are ready to offer RWI policies. Pricing is therefore not nearly as competitive as it is in the United States. More importantly, the coverage exclusions that insurers are likely to require in the Latin American market specifically are so broad that the policy may be of limited (if any) value to a prospective buyer, who may prefer simply to self-insure for those few risks that the insurer would otherwise be willing to cover. Exclusions that are especially problematic, but still commonly used on the basis that the risks involved are simply too difficult to underwrite, include carve-outs for: (1) environmental risks; (2) regulatory non-compliance, whether or not the seller has knowledge of the non-conforming conduct in question (i.e., irrespective of whether there is "fraud or intentional misrepresentation"); (3) tax risk; (4) labor risk; and (5) corruption/improper payments.

Many of the structural challenges that are typically encountered in M&A transactions, for at least many of the key markets in the region, present obstacles here: a lack of transparency and predictability in regulatory enforcement, a tendency still to apply "form over substance" in designing tax and other compliance strategies, and the sheer difficulty parties often encounter in compiling a proper record of due diligence. A very interesting set of questions is likely also to arise in terms of (1) ensuring that expressions such as "fraud or intentional misrepresentation" are interpreted in a manner that is consistent and predictable under applicable law, (2) aligning expectations as to what the "anti-sandbagging" representation by the buyer does or not cover, and (3) what law should apply to the acquisition agreement in order for the insurer to underwrite its policy in the first place (in nearly all cases, the insurer will require that the law governing the insurance contract also be used as the governing law of the underlying acquisition agreement).

That said, if experience is a guide then it seems likely that this market trend will, as other "transplants" have done, become more and more the norm in the region, especially as the regulatory mechanisms that drive any eventual exposure become somewhat more transparent and predictable, and as auditing/accounting/enforcement practices align increasingly across jurisdictions – thus providing a sounder basis for underwriting. If and when the issuance of RWI policies becomes commonplace in Latin American M&A deals, the market will have travelled, as the expression goes, "back to the future:" the old deal dynamic will likely reassert itself, with sellers once again insisting on a clean break – and buyers being willing to price their bids accordingly, while effectively outsourcing their indemnity coverage.

But RWI will not only enable sellers to better manage and reduce their exposure: it has the potential also to simplify the actual deal negotiation[7] and, if properly structured and agreed by knowledgeable parties, *improve* available valuations, create more efficient and competitive sales processes (with considerably less friction between the eventual buyer and seller, both before and after closing) and stimulate the market generally. If the price is right (i.e., if the premium is affordable for the extent of coverage offered), it should offer the best of both worlds: a relatively clean break for the seller and the efficient outsourcing of risk by the buyer. Parties and advisors who understand the product, and are able to use it as a competitive tool, will have a corresponding advantage in this new market.

[6] That said, the fact that the insurer offers what is – by definition – a highly reliable credit should help a prospective buyer in making a more competitive bid, inasmuch as the collection risk is less likely to be discounted from the offered price.

[7] One interesting illustration of this relates to the use of holdbacks and/or escrow provisions that often accompany a seller's indemnity obligation and raise difficult credit and risk-allocation issues. Naturally, the use of RWI reduces the need for this sort of tool and will thus streamline negotiations.