

R&W Insurance: a Useful Tool for Private Equity & Venture Capital Transactions

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A major challenge in M&A deals is to negotiate collection devices and guarantees, such as escrow accounts and security interests. There is a natural tension between the purchaser's desire to obtain maximum protection, and the seller's aspiration to receive the price and cease to have responsibility for liabilities involving the company that is being sold. Such tension is exacerbated when the seller is a private equity or venture capital (PEVC) fund, given the frequent need to wind up the fund within a tight timeframe.

Largely used in the American and European markets, an interesting alternative to overcome deadlocks over collection devices and guarantees has recently been made available in Brazil by insurance companies: the representations and warranties (R&W) insurance. Such insurance covers losses, including litigation costs, suffered by either the seller or the purchaser as a result of misrepresentations in M&A deals (provided, of course, that the insured party was not aware of the misrepresentation at the time of execution of the relevant agreements or closing).

Contingent liabilities known by the parties, even if the likelihood of a loss is low, are generally not covered. The insurer may impose additional exclusions in view of the particularities of each case. And there is often great flexibility for the insured party to negotiate other exclusions it might be comfortable with, which usually leads to reductions in the insurance premium (for example, if the seller does not have many employees and the purchaser is confident that all representations made with regard to compliance with labor laws are true, it may feel no need to insure against the risk of misrepresentations in this field).

Although there is room for negotiation, it is trade usage to have an indemnification cap between 10% to 30% of the value of the deal and to limit the period of coverage to no longer than 3 to 5 years. In most cases the premium for R&W insurance corresponds to 3% to 7% of the amount involved in the transaction, though a minimum fee is almost always charged regardless of the size deal, which may make it economically unfeasible for smaller cases. Preliminary quotations can be obtained by furnishing insurance companies with drafts of the relevant agreements.

To mitigate the risk of fraud and moral hazard, insurance companies hardly ever provide a firm quotation without reviewing the purchaser's due diligence report (and in extraordinary occasions, insurance companies may also get briefly involved in the actual due diligence process). An underwriting fee is charged to cover related expenses.

From the purchaser's standpoint, R&W insurance offers the following advantages: (1) reduction of frictions along the negotiation process (which is desirable, for instance,

where the seller will continue to do business with the purchaser); (2) assurance that losses related to misrepresentations will be indemnified (within coverage limits), regardless of the seller's financial condition; (3) agility in the collection of indemnification, without the need to await the end of strenuous litigation with the seller (and/or other guarantors); (4) possibility of making a more attractive buyout offer with the promise to pay the whole price or a large fraction of it upon closing; and (5) better negotiating position to obtain financing for the buyout (given a lower risk of large unforeseen losses that could negatively impact cash flow).

From the point of view of the seller, some of the benefits of R&W insurance are: (1) better bargaining position to negotiate the payment of the whole price (or a large fraction of it) upfront; and (2) reduced exposure to unforeseen expenses with the payment of indemnification.

The main downside of R&W insurance is its cost, which is often higher than the expenses related to the typical collection devices and guarantees. However, such expenses are not the only cost of collection devices and guarantees: sellers generally accept to reduce the price of the deal where purchasers agree neither to deposit part of such price in escrow accounts nor to request extensive guarantees (which is evidence that sellers charge a sort of fee, included in the asking price, to consent to collection devices and guarantees). Furthermore, buyers and sellers are frequently uncomfortable with insurers' extensive degree of interference in the conduct of litigation, which limits the insured parties' ability to settle the dispute or to insist on appealing without the insurance company's consent.

R&W insurance works as a substitute or a supplement to collection devices and guarantees. The decision to buy R&W insurance instead of, or together with, an escrow account, security interests or personal guarantees involves a cost-benefit analysis, which should take into consideration the concrete aspects of each deal. The extensive use of such insurance in transactions carried out in international markets shows it is an important and efficient tool, of which dealmakers, investment bankers and M&A lawyers in Brazil should be well aware.

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