



M&A insurance comes of age




In spite of uncertainty in some regions surrounding the corporate and political landscape, global mergers and acquisitions continue at a significant level. Unfortunately the high stakes and expectations surrounding major M&A deals can result in disappointment once the dust settles. This year's analysis of AIG's global warranty and indemnity (W&I) insurance claims paints a picture of a maturing market and an increasingly valued product.


W&I insurance policies provide cover for breaches of representations and warranties made in purchase agreements. It offers buyers and sellers a powerful tool to enable them to mitigate and improve risk as they enter into deals, giving protection against a wide range of losses resulting from these unknown risks.

As take-up of W&I insurance (also known as representations and warranties – or R&W – insurance) continues to grow and the coverage becomes broader, servicing and paying claims has grown in importance. "Buyers know now how the product works and that it can be relied on," thinks Dr. Dennis Froneberg, North Europe M&A manager at AIG. "The product has demonstrated its credibility."

For Michael Turnbull, Americas M&A manager at AIG, it is important for a tripartite partnership between carriers, brokers and insureds to be formed during both the underwriting and claims process. "Claims handling works best when the claimant and insurer work together in a collaborative manner," he says. "It is not meant to be an adversarial process. These claims can be complex, but the complexity usually stems from getting our arms around the calculation of damages. Once we've been able to do that, the rest is usually quite straightforward."



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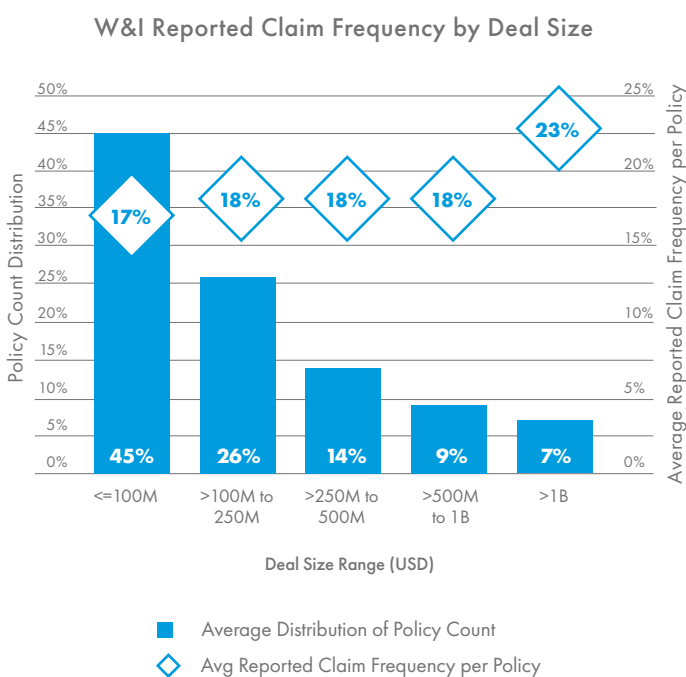
Michael Turnbull



Frequency continues to rise

Now in its second year, AIG’s analysis of W&I claims shows a marked increase in claims frequency year-on-year. Whereas last year’s report showed claims on policies issued during the period 2011-2014 reflecting a frequency of around one-in-seven (an average of 14% overall), that number has jumped to more than one-in-five (or an average of 21%) on that same group of policies, now that an additional year has passed. However, when policies issued during 2015 are added to the pool, overall frequency is 18%, four percentage points higher than the numbers reported last year.

“Frequency has gone up in a meaningful way,” states Mary Duffy, global head of M&A insurance at AIG. “You could speculate that buyers have become better educated about the scope of the cover. And there is the fact that the claims rate on the largest deals is going up. We do see large deals as being riskier, and we think it’s appropriate to maintain meaningful retentions and premium rates on those deals as a result.”



AIG has built a strong reputation for insuring some of the largest M&A transactions in the world. But with big, complex deals often come big problems, explains Maria Jose Cruz, South Europe M&A manager. “The more complicated a company is, and the bigger it is, the more likely there is to be an unknown liability somewhere in there which comes out of the woodwork to bite you. What we are really covering with W&I insurance are the unknowns.”

Duffy notes a rise in the frequency of claims – an average of 23% (or nearly one in four) – for M&A deals worth over \$1 billion. While there is not one single answer as to why claims frequency is higher for mega-deals, factors that heighten the exposure include the scale and complexity of diligence required. It is almost impossible to “turn over every rock regardless of good intentions to be thorough”, explains Duffy.

Expectations as to what is considered “material” also vary depending on the size of the deal, explains Turnbull. “If you’re looking at a \$1 billion deal, something that is a \$1 million issue is probably not that material, whereas if you’re looking at a \$50 million deal it might well be considered material,” he explains. “So sometimes it comes down to the size of the target company and having to make a call as to what is material and what isn’t during that diligence process.”

The pressure to execute transactions quickly, particularly those involving large companies, could be another factor behind the increased frequency of claims in deals that are worth over \$1 billion. “Because you often can’t get to everything, those carrying out the diligence process are going to focus on the items they think are important,” says Turnbull. “That often means that some issues that are material aren’t looked at because you don’t have the time or ability to do that.”

“What we are really covering with W&I insurance are the unknowns.”

María José Cruz

Behind the breaches

The cross-border nature of many of the larger deals in 2015 could also impact claims frequency and severity, thinks Angus Marshall, UK M&A manager at AIG. Tax was the most common alleged breach for EMEA, responsible for 31% of notifications, in comparison to 15% on a global basis. "In EMEA you are really looking at a number of different tax authorities," he points out. "It's interesting to note that they all seem to be quite assertive and quite active really, in comparison to other regions." Tax claims are particularly common in Germany.

"There are very few examples of deals in which the target company operates in only a single jurisdiction," he continues. "Most have their operations spread across countries or regions, and as a result of that you can pick up all sorts of issues. Not only operational risks, which might not be well managed because they vary across a region, but also from a diligence perspective."

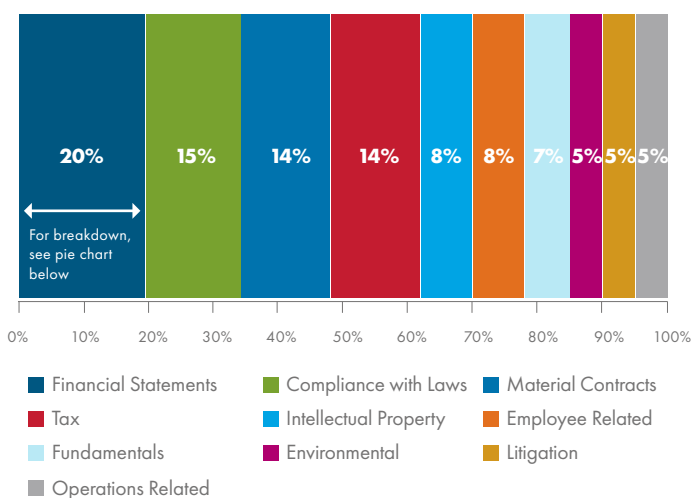
A comparison of last year's data (2011-2014) to this year's tells an interesting story. While last year's most commonly-alleged breaches, on a global basis, were reported for financial statements, tax and material contracts, the inclusion of the 2015 claims notifications has seen tax drop to fourth position, overtaken by "compliance with laws", which is now the second most common reason that is given for a breach.

Regionally, compliance with laws was the primary reason given for a breach in the Americas, a factor responsible for 19% of alleged claims breaches. Many of these are third-party claims, which may include allegations of violations of employment, consumer protection or competition laws, to name a few. In comparison to EMEA (10%) and APAC (8%), litigation was not a significant source of breach in the Americas, at just 5%. It was surpassed by intellectual property, responsible for 10% of breach notifications for W&I policies written in the Americas between 2011 and 2015.

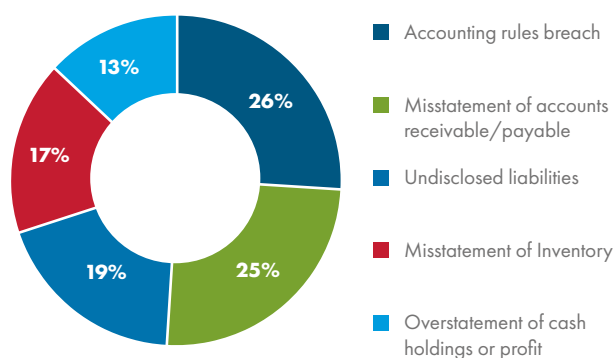
In Asia Pacific, financial statements and material contracts were the cited cause of nearly two thirds of W&I breaches. The third main source of breach in APAC – responsible for 11% of notifications – were employee-related. "In places like China, where we are seeing a lot more deals closed, we do see employee-related issues as a risk," observes Darren Savage, Asia Pacific M&A manager at AIG. We have seen cases where Chinese companies have breached their social housing and welfare obligations towards employees."

For the first time in this year's analysis, AIG has delved more deeply into claims involving financial statements. It shows a fairly even split between the different sources of financial statement breach types. Accounting rules statement breaches and misstatement of accounts receivable/payable were the two most common reasons given, at 26% and 25% respectively.

W&I Reported Incidents by Breach Type



W&I Financial Statement Breach Type



As a class of business, W&I insurance can be somewhat long tail in nature, meaning that claims can arise years after the policy has been taken out. However, data collated by the W&I claims team on how soon notifications are made after policy inception shows that half of all notifications are received within the first 12 months.

This suggests that, even with a rigorous due diligence process, risk remains, thinks Froneberg, particularly given that 27% of claims are lodged in the first six months. "A lot of issues are being identified within a really short timeframe," he notes. "It is interesting that the first six months [from policy inception] have higher reporting frequency than the six months after that (23%). It suggests that no diligence process is foolproof."

While the number of claims made after 24 months is a fairly small proportion on a global basis, at just 8%, it is still a meaningful number, and generally consists of third party claims.

This is backed up by what Savage has observed in his region. "Most deals in APAC, apart from some in Australia, are cross-border. It's just the nature of Asia as a region and the fact that there are so many countries. So a lot of the claims potentially do take quite a long time to develop and a lot of what we are seeing is tax related."

Savage observes that buyers of W&I insurance are becoming more familiar with the product. Where breaches do occur they are submitting notifications that are well-structured. "We are getting repeat buyers and they understand what they can and can't claim for, and they are becoming much more sophisticated in their use of the products," he notes.

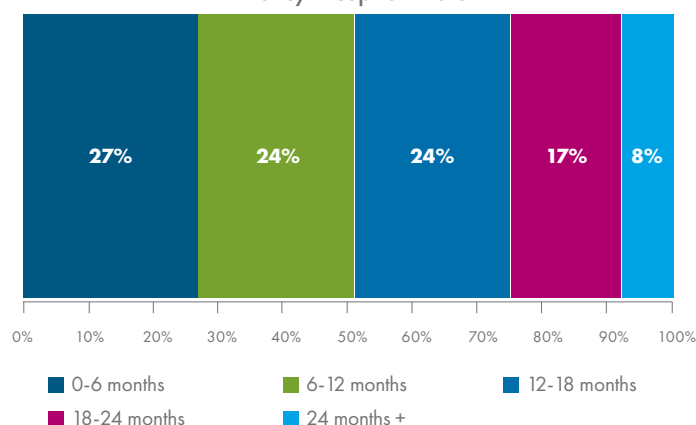
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While fewer policies are sold on the sell-side, these do result in a much higher frequency of claims, at 29% versus 18% on the buy-side. The much smaller sample size could be one factor skewing the loss numbers. Fewer sell-side policies are taken out as buyers have become more comfortable with the insurance and willing to rely on it, rather than a seller indemnity.

Where sell-side policies are purchased, W&I underwriters are dealing with a different, and sometimes more challenging perspective. "The buyer will pay for advisors in different specialist areas – financial and legal are first amongst them – to review information provided by the seller," explains Rory O'Broin, M&A group counsel at AIG. "It is the result of that work, the due diligence reports, that we use to underwrite. Equivalent reports are often not available from sellers."

W&I Distribution of Average Claim Report Lags from Policy Inception Date



Lifting the lid on severity

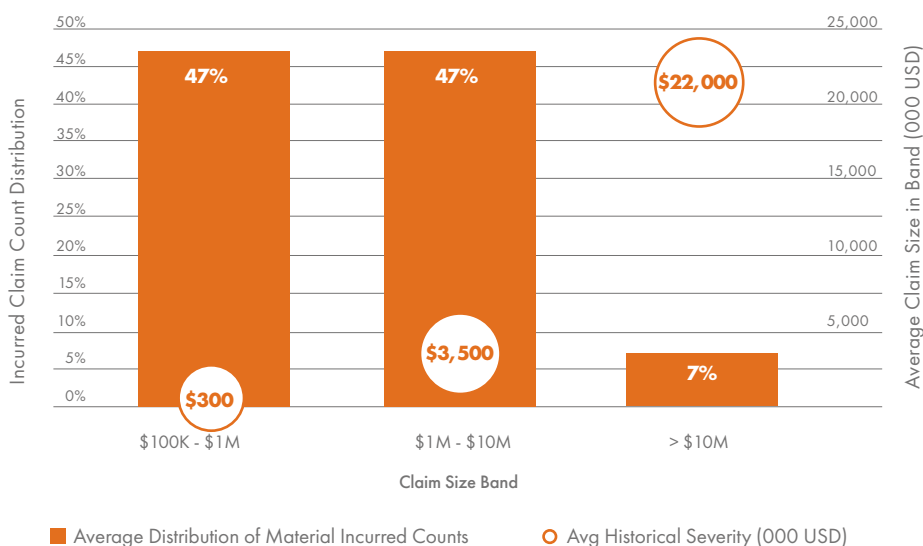
The significant breaches that can arise from the largest M&A deals are also reflected in the severity statistics, available this year for the first time. Analysis of AIG’s most material W&I claims (those in excess of \$100,000) during the period 2011-2015 indicates that roughly 55% incurred a seven digit claims cost.

The average for nearly half of these material claims is \$3.5m and a small, but meaningful, proportion (seven percent) are over \$10m, averaging \$22m. The final claims figures are likely to be even higher, given the fact the numbers do not take into consideration excess layers above AIG’s retention that may have paid out.

“The material claims numbers are a pretty good demonstration that as an W&I carrier we’re paying some sizable claims,” says Turnbull. “We all understand the potential for high severity claims in this line of business. We’ve written a number of eight figure checks in different geographies. The claims statistics show that we’re paying out an average of \$3.5m on a fairly regular basis – so people are at least getting back the premium and then some,” he continues.

“We’re seeing claims across the board in terms of severity and it means that the product is responding to a whole host of different situations,” Turnbull adds. “It tells us that people are using the products more than they have been, and perhaps are becoming more familiar in bringing claims. This speaks to the growing maturity of the product and how the market is moving forward more generally.”

W&I Material Claims - Distribution of Counts and Average Size by Claim Size Band



Claims case studies

Financial statements breach (US)

A global manufacturer of sporting goods purchased a buy-side W&I policy on an acquisition. The buyer calculated the purchase price by applying a multiple to the target company's annual earnings as reported in the company's audited financial statements. After the transaction closed, the buyer re-audited the financial statements of the company in anticipation of a public offering, resulting in a calculation of lower earnings.

The difference between the two earnings calculations arose in large part from a lower valuation of the company's inventory and accounts that were prepared for the later public offering. The buyer argued that the higher valuation at the time of the transaction caused it to overvalue the company in the purchase price. More specifically, the buyer argued that the seller had breached its representation that the company's financial statements complied with generally accepted accounting principles, and its separate representation that the company had an adequate system of accounting controls. The buyer also alleged breaches of representations that the company was in compliance with applicable laws, and that the company did not have any liabilities, commitments or obligations that were not disclosed.

AIG engaged forensic accountants to work with the insured company's accounting and internal financial personnel to evaluate the alleged breaches and quantify the amount of the buyer's losses from any breaches found. AIG's experts confirmed that breaches of representations had occurred and that the buyer had provided documentation to support its claim for loss. AIG quantified the amount of the buyer's loss and paid a significant amount to cover the losses incurred by the buyer.

Misstatement of inventory (Europe)

AIG insured an international industrial group in connection with the acquisition of an EMEA-based engineering services business. Following the transaction, the insured's auditors identified a failure by management to make the correct adjustments in respect of the erroneous booking process for certain stock. As a result, the insured argued that accruals were understated in the target by several million dollars, which led to an overstatement of earnings.

The insured had therefore suffered loss by significantly overpaying for the target and sought recovery under its W&I policy. A breach of the financial statement warranties was claimed, and our M&A claims adjusters were able to quickly confirm a breach. A lack of evidence presented some challenges in quantifying the loss. However, by engaging forensic accountants, the adjusters were able to work proactively with the insured's advisers to verify the analysis behind the claims against the evidence actually available. Following this review process, AIG paid out an amount in the tens of millions of dollars.



Undisclosed liabilities (Asia Pacific)

The insured buyer, a business financing company, purchased the target company and conducted extensive due diligence of each of the target's main accounts. Following completion, it was discovered that one of the accounts had bad debts running into millions of dollars. Upon further investigation, the insured buyer discovered the invoices had been fraudulently created by that client.

The insured claimed various breaches of warranties and was able to evidence the proportion of the purchase price it had attributed to the particular client account, to substantiate its claimed loss. The insured also became aware the seller had obtained an audit opinion that had not been disclosed in the due diligence material, which had flagged concerns with the invoicing practices of the particular client account in question.

AIG granted indemnity in relation to breaches of warranty in relation to the failure to disclose the audit opinion. AIG fully indemnified the insured and then worked with the insured to secure recovery against the client in relation to the fraudulently-issued invoices, which was able to be achieved in a collaborative way.

Methodology

AIG has been assisting buyers and sellers with over 2,500 deals insured globally since the late 1990s. The number of deals and the breadth of the portfolio, spanning across geographies, industries, and sectors, uniquely places AIG to share insights into mergers and acquisitions based on observations about the claims made on those policies.

The period reviewed in this report (policies written by AIG between 2011 and 2015) represents a significantly larger pool of transactions than the period prior to 2011 given the growing use of W&I policies on transactions over the past five years. The results should not be considered conclusive with respect to the broader context of all private mergers and acquisitions, as the percentage of deals insured by W&I policies is still relatively small. Nevertheless, the snapshot of W&I claims activity contained in this report provides interesting insights to buyers, sellers, and M&A advisers.

About AIG's M&A insurance team

W&I claims can be complex, incorporating difficult issues as diverse as the scope of the warranties insured. When you are facing a significantly large loss on a transaction, you do not want your insurance claims handler learning about how a deal works for the first time. AIG has assembled a global network of in-house claims professionals to manage and resolve these types of claim. Made up of experienced professionals located in strategic offices throughout North America, Europe, and Asia Pacific, claims handlers work in partnership with the underwriting team. AIG insureds benefit from dealing with knowledgeable claims handlers who understand the complex nature of W&I claims and can focus on the key issues and bring them to resolution as quickly as possible.

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The scenarios described herein are offered only as examples. Coverage depends on the actual facts of each case and the terms, conditions and exclusions of each individual policy. Anyone interested in the above product(s) should request a copy of the policy itself for a description of the scope and limitations of coverage.

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