M&A: A rising tide of large claims
Methodology

There were close to 700 claims made during the study period (spanning policies written between 2011 and 2018), covering approximately 3,500 deals, worth more than $1.3tn in deal value—though the number of material claims was smaller. Many policies written during the study period still hold the potential for a claim. Some of the policies have reached or are now reaching maturity, providing us with more intelligence on the complete policy life cycle. The results should not be considered conclusive with respect to the broader context of all private mergers and acquisitions, as the study is limited to policies underwritten by AIG. Nevertheless, the snapshot of W&I claims activity contained in this report provides interesting insights to buyers, sellers, and M&A advisers.

At a glance

- Claims severity\(^1\) continues to increase with the largest claims (valued over $10 million) at 19% of material claims, up from 15% in last year’s study and 8% the year before. The average claims size in this band also increased.
- From a regional perspective, North America has been hit particularly hard by claims severity.
- Frequency of claims notification has remained constant across the wider portfolio, at an average of one in every five policies; with increasing frequency among higher deal sizes.
- In terms of breach types, the frequency of financial statements and material contracts breaches increases with claim size.

The fifth edition of AIG’s M&A Claims Intelligence report sheds light on the increasing number of large claims and some of their unique characteristics.

AIG’s global M&A Insurance team underwrote over 800 policies to help support M&A deals last year. The scale and breadth of AIG’s book of business puts AIG in a leading position to share insights into claims trends over time, what this tells us about the use of warranty and indemnity (W&I)\(^3\) insurance by buyers and some of the common deal pitfalls.

Most strikingly, the loss numbers within this edition point to an increasing severity of loss. In AIG’s claims data to the end of 2017, just eight percent of material claims were valued at $10m or above. But this has risen to 19 percent in 2019, with an average claim size of $20m.

---

\(^1\) Claim severity is the amount of claim payments plus estimated case reserves (i.e. estimated potential future payments on claims already reported provided coverage and loss covered is confirmed) divided by the number of clients receiving claim payments or are expected to receive claim payments in the future on claims already reported.

\(^2\) Material claims are claims with an incurred loss greater than USD 100,000, large claims are those with an incurred loss over 1m USD, and claims described as the largest are over 10m USD.

\(^3\) Usually referred to in the US as representations & warranties insurance (R&W).
Claims size reflects a number of underlying trends, including the steady growth in use of W&I insurance on large deals and knowledge of the product and how it responds, as well as reflecting the maturity of AIG’s book of business.

A contributing factor to the severity trend is the impact of EBITDA multiples in valuation. “Buyers may use a multiple of EBITDA to determine the offering price for a target company. If a warranty is breached and it turns out that the EBITDA of the target company was overstated because of that breach, the buyer may believe they have overpaid,” says Mary Duffy, global head of M&A insurance at AIG. “In these cases the buyer may request that the EBITDA multiple will be considered in the measure of damages for the breach. While an EBITDA multiple is often not an appropriate way to measure damages, when it is it can have a dramatic effect on the size of the claim.”

Overall, claims frequency continues to be broadly consistent with recent years. Though for the largest claims – those with a potential for a covered loss at greater than $10m – there has also been a greater frequency of claims on the larger M&A deals, those valued at $500m or over.

Set against a backdrop of increasing claims severity and the onset of an economic downturn, a correction of M&A insurance pricing is inevitable.

“The increased frequency of claims for the higher deal sizes is partly driven by the fact that W&I insurance is far more commonly used,” explains Duffy. “It’s become such a regular feature on deals, and the insurance is more front of mind. We’ve seen a trend in claims being better framed at the initial notification stage,” says Duffy. “We’re seeing more forensic work being done by insureds at an early stage in many instances with more thorough documentation.”

With global claims frequency holding steady at one-in-five policies, it is clear the product is responding and that it has reached maturity as a deal facilitator. Set against a backdrop of increasing claims severity and the onset of an economic downturn, a correction of M&A insurance pricing is inevitable.

Fig 1  W&I Material Claims – Distribution of Counts and Average Size by Claim Size Band

<table>
<thead>
<tr>
<th>Claim Size Band</th>
<th>2019 Distribution of Material Claim Counts</th>
<th>Average Historical Severity</th>
</tr>
</thead>
<tbody>
<tr>
<td>&gt; $100k – $1M</td>
<td>46%</td>
<td>$4m</td>
</tr>
<tr>
<td>&gt; $1M – $10M</td>
<td>37%</td>
<td>$4m</td>
</tr>
<tr>
<td>&gt; $10M</td>
<td>19%</td>
<td>$4m</td>
</tr>
</tbody>
</table>

Fig 2  W&I Reported Claim Frequency by Deal Size
(numbers may not add up due to rounding)

<table>
<thead>
<tr>
<th>Deal Size Range (USD)</th>
<th>Average Distribution of Policy Count</th>
<th>Average Reported Claim Frequency</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;100M</td>
<td>25%</td>
<td>17%</td>
</tr>
<tr>
<td>100M – 250M</td>
<td>15%</td>
<td>22%</td>
</tr>
<tr>
<td>250M – 500M</td>
<td>9%</td>
<td>25%</td>
</tr>
<tr>
<td>500M – 1B</td>
<td>9%</td>
<td>20%</td>
</tr>
<tr>
<td>&gt;1B</td>
<td>9%</td>
<td>19%</td>
</tr>
</tbody>
</table>
The claims data offer valuable insight into the tail risk associated with the W&I insurance product, given that AIG has held a mature portfolio of business for nearly a decade. One interesting observation is that claims notifications on larger claims tend to be reported earlier. Sixty-six percent of large claims (those greater than $1m) and 72% of the largest claims (those greater than $10m) are reported within the first 12 months, compared with 60% of claims overall.

“Just 12% of large claims were notified after 18 months,” observes Duffy. “However, it is worth pointing out that one of our larger paid losses was a claim made after three years. So the tail risk is real.”

Year-on-year there has not been a significant change in policy breach types across the portfolio of claims as a whole. However there are some interesting observations by size of claim. Financial statement breaches are a more dominant driver of claims notifications within this bracket, increasing from 20% of breach types overall to 32% for large claims and 38% for the largest claims.

While breaches of the material contracts warranty represent 13% of notifications overall, this breach type increases to 17% of large claims and 19% of the largest claims. “This is consistent with the way we look at material contract risk, which is that it has a real frequency and severity element,” says Duffy.

While compliance with laws is the third most common breach type overall, responsible for 16% of all claim notifications, this is a less dominant driver for large claims, reducing to 11%.

“AIG receives a large number of claims on compliance, but they tend to be smaller claims overall,” observes Duffy. “For buyers in regulated industries it is quite common, once they start managing the target company, to identify some instances of non-compliance, at which point they will put us on notice out of an abundance of caution. But it may be that not all of the identified compliance breaches lead to covered losses.”

As the risk environment continues to evolve, it has never been more important to partner with an M&A insurance carrier that has global experience, knowledge and claims-handling expertise. The long-term strength of an insurance partner is as important as the product itself. While the insurance can be used strategically to help facilitate deals, it’s also important that it responds as expected when a covered loss occurs.
The buyer purchased a buyer-side W&I policy in connection with its acquisition of an industrial services business. After the closing, the buyer identified problems with the company’s financial records, including, most notably, that one of the company’s divisions had fallen behind in recording invoices from vendors supplying materials necessary for the delivery of the company’s services.

The buyer asserted that these recording failures caused the company to understate the expenses of the company and, as a consequence, to overstate the EBITDA derived from the target company’s unaudited income statement. The buyer’s insurance claim asserted that the seller breached its representation that the financial statements had been prepared in accordance with GAAP, and that this breach caused it to overpay for the company.

Based on the terms of the policy, AIG’s investigation with forensic accountants verified that the claimed overstatement was based on financials that did not comply with GAAP. After substantiating a reasonable calculation of the insured’s actual loss and the record of the buyer’s valuation of the target, AIG confirmed coverage under the policy and made a payment with respect to the loss.

About AIG’s M&A insurance team
AIG has been assisting buyers and sellers with over 5,000 deals insured globally since the late 1990s. 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. With market conditions putting increasing pressure on the M&A insurance market, it is more important than ever for clients to choose an insurance partner that is knowledgeable and tested.
This document considers M&A claims in the context of an AIG insurance programme only. Reliance upon, or compliance with, any of the information, suggestions or recommendations contained herein in no way guarantees the fulfillment of your obligations under your insurance policy or as may otherwise be required by any laws, rules or regulations.

The purpose of this document is to provide information only and you should not take any action in reliance on the information contained in this document. This document is not a substitute for you undertaking your own investigations and obtaining professional or specialist advice. No warranty, guarantee, or representation, either expressed or implied, is made as to the correctness or sufficiency of any representation contained herein. AIG does not accept any liability if this document is used for an alternative purpose from which it is intended.

American International Group, Inc. (AIG) is a leading global insurance organization. Building on 100 years of experience, today AIG member companies provide a wide range of property casualty insurance, life insurance, retirement products, and other financial services to customers in more than 80 countries and jurisdictions. These diverse offerings include products and services that help businesses and individuals protect their assets, manage risks and provide for retirement security. AIG common stock is listed on the New York Stock Exchange.

Additional information about AIG can be found at www.aig.com | YouTube: www.youtube.com/aig | Twitter: @AIGInsurance www.twitter.com/AIGinsurance | LinkedIn: www.linkedin.com/company/aig. These references with additional information about AIG have been provided as a convenience, and the information contained on such websites is not incorporated by reference into this report.

AIG is the marketing name for the worldwide property-casualty, life and retirement, and general insurance operations of American International Group, Inc. For additional information, please visit our website at www.aig.com. All products and services are written or provided by subsidiaries or affiliates of American International Group, Inc. Products or services may not be available in all countries, and coverage is subject to actual policy language. Non-insurance products and services may be provided by independent third parties. Certain property-casualty coverages may be provided by a surplus lines insurer. Surplus lines insurers do not generally participate in state guaranty funds, and insureds are therefore not protected by such funds.