2022

Claims briefing

Exclusive insights guiding global decision making

Notification trends

Third-party claims

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Liberty Global Transaction Solutions™

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Claims briefing 2022

Key insights

We have seen a slight drop-off in notification frequency with the figure for risks bound in 2019 currently running at **16%** compared to a historical average of around **21%**.

Our largest claims continue to be driven by **accounting- and financial-related issues**, with errors in management accounts being an increasingly common problem area.

We are seeing an increasing number of notifications involving large **($10M plus)** tax-related issues, although the majority of our tax-related notifications are received within 24 months of the policy incepting.

We have observed a significant increase in **third-party claims**, especially in the Americas.

We are likely to see an **increase** in certain types of risks due to the current economic headwinds, although we do not expect this to result in a sudden surge in R&W claims.

We recently made a **$19M** payment within seven weeks from receipt of the claim notice.

Liberty GTS is one of the largest and most experienced M&A insurance teams in the market, with a team of more than 80 specialists operating in 11 jurisdictions across the Americas, Asia Pacific (APAC), and Europe, Middle East, and Africa (EMEA). We are also one of the few M&A insurers in the market to have a team of dedicated and experienced M&A claims professionals embedded within our M&A underwriting team across multiple jurisdictions.

We are proud to be able to leverage this unique combination to provide an in-depth assessment into M&A insurance claims via our annual claims briefing, which is based on data drawn from approximately 335 notifications received since 2019. In this, our third briefing, we identify some of the key trends that we have seen in our notifications over the last 12 months and how these differ from previous years, both at a global and regional level. We also look at what could be driving the changes in our data and discuss how recent changes in the macroeconomic landscape could influence future claims trends.

> “Publishing our annual claims briefing is motivated by our understanding that we can add real value by sharing as many of our thoughts and findings as possible from the claims data that we hold. Not only does this educate key stakeholders in the product about the types — and quantum — of issues that can arise, which adds to everyone’s understanding of where due diligence time is best spent and which risks are more likely to manifest, it also helps to inform the market about risk and a fair allocation of risk in the form of retention sizes, attachments points, coverage, and pricing.”

Rowan Bamford
President of Liberty GTS

Notification trends

Key insights

We have seen a **slight drop-off** in the number of notifications received as a proportion of all risks bound, although there are some regional variations in our data.

We are seeing more instances of **multiple notifications** on the same deal.

We haven't seen any noticeable changes in terms of the type of notifications that we are receiving, with only **34%** involving a (potential) loss that exceeds the retention.

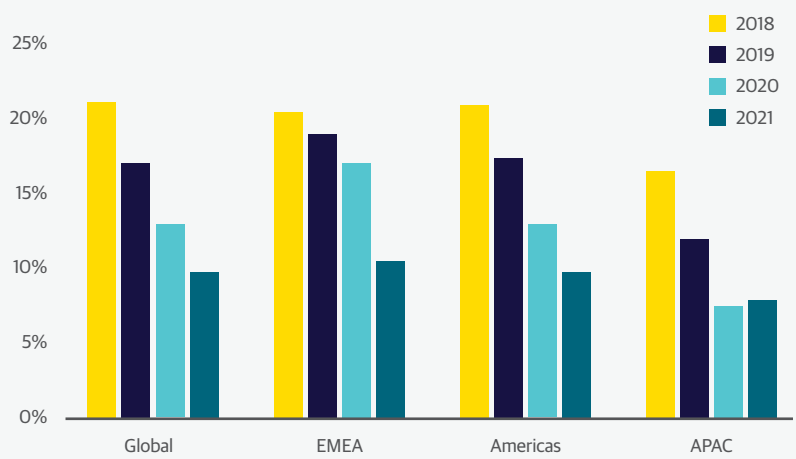
Notifications rose **37%** year-on-year, mainly due to the growth of our book.

Our notification frequency data indicates that we have seen a slight drop-off in the number of notifications received as a proportion of all risks bound (see Figure 1).

Historically, our data has shown that we have received a notification on approximately 21% of all representations and warranties (R&W)[1] risks bound. There are signs, however, that this is beginning to fall slightly. The figure for risks bound in 2019 is currently running at 16% and, while we would expect this number to increase slightly, it is unlikely to increase materially given that many of these policies are now 'off-risk' for a claim in respect of the general warranties and the majority of notifications are received within the first two years of the policy period (see Section 2). To put this statement in context, only 8 of the 111 R&W notifications that we have received so far in 2022 relate to risks bound in 2019.

It is too soon to project where the figure for risks bound in 2020 will end up since these risks are still in their relative infancy. However, it is currently sitting at 13.5% as at the end of July this year and, by way of a comparison, the 2019 figure was sitting at 14% as at the end of July last year. The early indication is, therefore, that the 2020 figure is likely to end up similar to, if not slightly lower than, the 2019 figure. This supports the notion, discussed in last year's claims briefing, that there has not been a surge in notifications as a result of COVID-19 as some commentators had feared might be the case when the pandemic hit.

Figure 1 **Notification frequency — global and regional view**



Data based on R&W notifications received as at July 31, 2022 relating to R&W risks bound between 2018 and 2021

1 Representations and warranties insurance is usually referred to outside the U.S. as warranty and indemnity insurance (W&I).

The reasons for the slight drop-off in notification frequency are potentially varied, but are likely to be the result, in part, of a better understanding among insureds (and their advisors) about the types of issues that they do not need to notify and the fact that, as the product matures, insurers have been able to adjust their risk appetite and underwriting approach as more claims data has become available.

There are some notable regional differences in our notification frequency data (see Figure 1).

In EMEA, notification frequency has historically remained broadly consistent at around 20% and we expect the figure for risks bound in 2019, which currently sits at around 18.5%, to end up at or around that level. This is higher comparative to our other regions with the most likely explanation for this being that in EMEA we receive a lot more precautionary notifications that relate to the commencement of a routine tax audit: if these notifications were stripped out then the figure would be at least a couple of percentage points lower. The figure for risks bound in 2020 is already at around 16.5%, which suggests that we may end up seeing a small uptick in notification frequency on this year of account. However, it does not appear that this is the start of a continuing upwards trend since the early indication is that the figure for risks bound in 2021 is following the same trajectory as the figure for risks bound in 2020.

In the Americas, notification frequency has been dropping off for the last few years. It currently sits at around 17% for risks bound in 2019, which is down from approximately 20.5% for risks bound in 2018. This is broadly consistent with the findings in other recent claims reports. We are, of course, paying close attention to our data in this region given the sharp increase in the number of policies that we have issued over the last few years in the Americas. However, as things stand, there has been no noticeable change in the numbers since, as at the end of July, the figure currently sits at around 10% for risks bound in 2021 and, by way of a comparison, the figure for risks bound in 2020 was sitting at almost exactly the same level as at the same point last year.

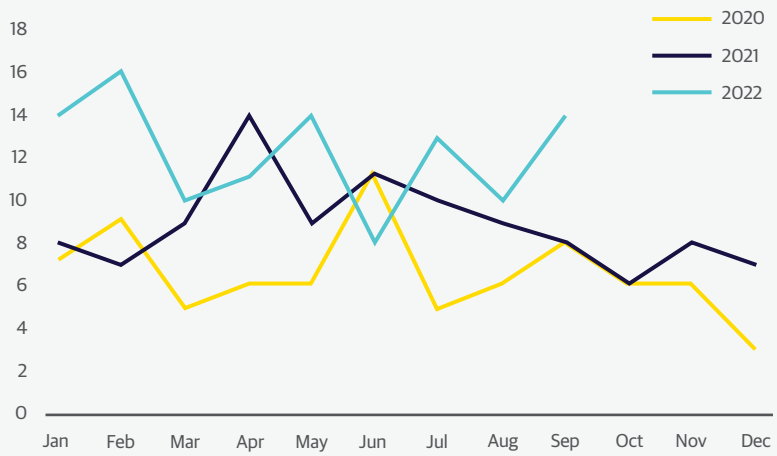
In APAC, notification frequency has been consistently lower comparative to our other regions for a number of years and is currently sitting at around 12% for risks bound in 2019. This could be because the product is slightly less established in this region outside of Australia, meaning that insureds do not always have the same systems in place that some more regular users of the product do to not only identify issues, but also to notify them. However, there is a suggestion that the gap is beginning to close since we have already received notifications on 8% of the risks that we bound in 2021, which is similar to the prior year even though it is 12 months more mature.

Our global notification count increased once again in 2021 (see Figure 2).

Overall, we received 107 R&W notifications across all of our regions in 2021: a year-on-year increase of approximately 37%. This is unsurprising given the significant increase in the number of risks that we have insured in the last few years. In 2019, we insured almost 370 risks. This rose to approximately 525 in 2020 and 670 in 2021 — a record year for us. The expectation is, therefore, that we will see even more notifications in 2022 and this is already being borne out in the numbers, with 111 received as at the end of September 2022.

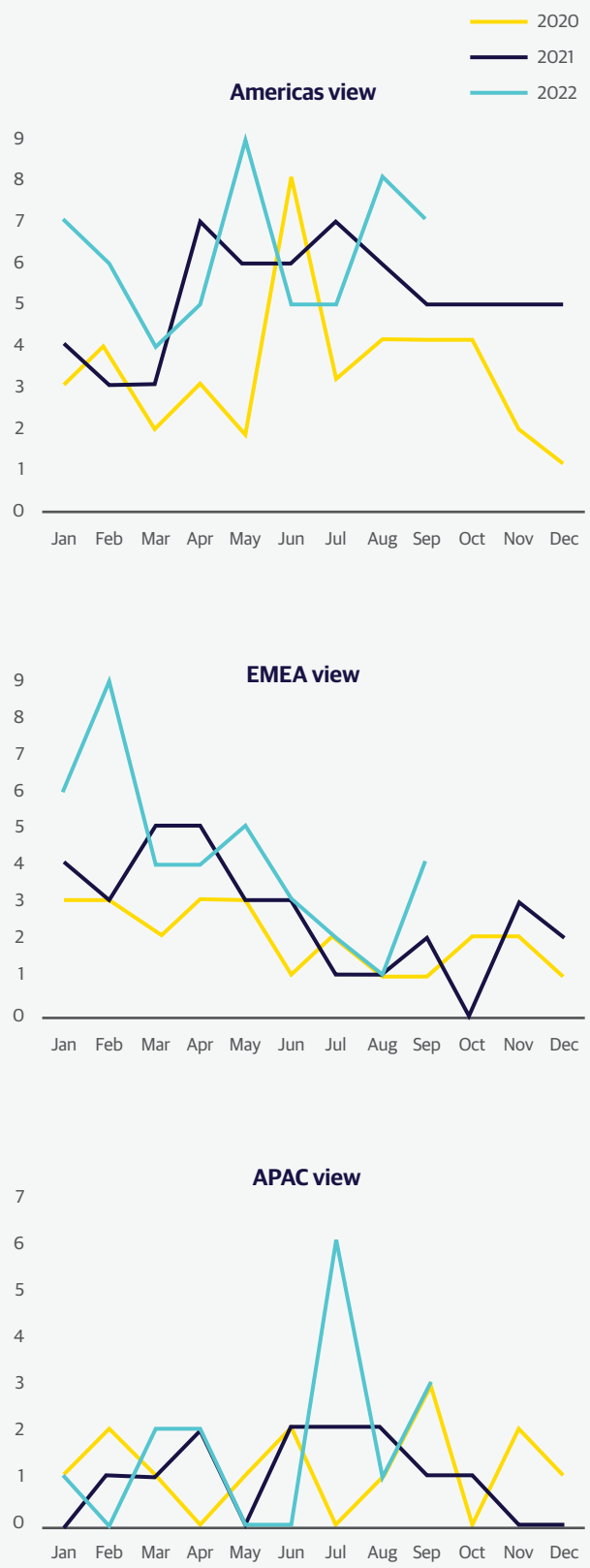
Interestingly, in both 2020 and 2021, we received the fewest notifications in Q4, with 15 and 22 notifications respectively. The reasons behind this may lie in the incredibly high deal flow toward the end of both years. We suspect that deal teams may have been more focused on signing deals and obtaining R&W insurance during this period as opposed to identifying and notifying claims. This might also help to explain why we experienced a significant increase in new notifications in Q1 2022 (40 in total). This is the highest number of notifications that we have seen in any quarter over the last three years and 21% more than the next highest quarter.

Figure 2 **Notification count — global view**



Data based on notifications received between January 1, 2019 and September 30, 2022

Figure 3 Notification count — regional view



Data based on R&W notifications received between January 1, 2020 and September 30, 2022

Our Americas region saw the most significant increase in notifications (see Figure 3).

We received 62 R&W notifications across the Americas region in 2021: a year-on-year increase of approximately 55%. This was the highest annual increase of all of our regions. However, as with last year, the Americas region once again saw the largest increase in policy count in 2021 (jumping to 409 from 335 in the previous year). There was a nearly even split in notifications between the first and second halves of 2021, although the middle part of the year was particularly notable as being a busy couple of months for new notifications. In Q1 2022, we received 17 notifications in the Americas region. This was around a 70% increase in notifications when compared to Q1 2021, but consistent with the number of notifications that we received during Q4 2021. However, we have not seen a material increase in our overall notification count since then (with only 19 notifications being received in Q2 and 20 in Q3) and there have even been a couple of months where we have received fewer notifications compared to the same month in the previous year: a surprising statistic when set against the backdrop of our increased policy count in this region.

Our EMEA region saw a noticeable uptick in notifications during Q1 2022 (see Figure 3).

We received 32 R&W notifications across the EMEA region in 2021: a year-on-year increase of approximately 33%. Interestingly, over 70% of these were received in the first half of the year. Only 9 notifications were received during the remainder of the year. However, this was followed by a significant increase in notifications in Q1 2022 (19 in total). We observed a similar trend in Q1 2021 and suspect that this is partly a by-product of the holiday season resulting in a number of notifications being 'carried over' from the end of the year. Our EMEA notification count has fallen back in Q2 and Q3 2022, although it is tracking slightly higher on a monthly basis compared to 2021.

Our APAC region registered a small drop-off in notification count in 2021 (see Figure 3).

We received 13 R&W notifications across the APAC region in 2021. This represented a slight reduction on the 14 notifications which we received in 2020. However, we have seen an uptick in notifications during 2022. This included 6 new notifications in July alone — the most that we have ever received in any single month in this region.

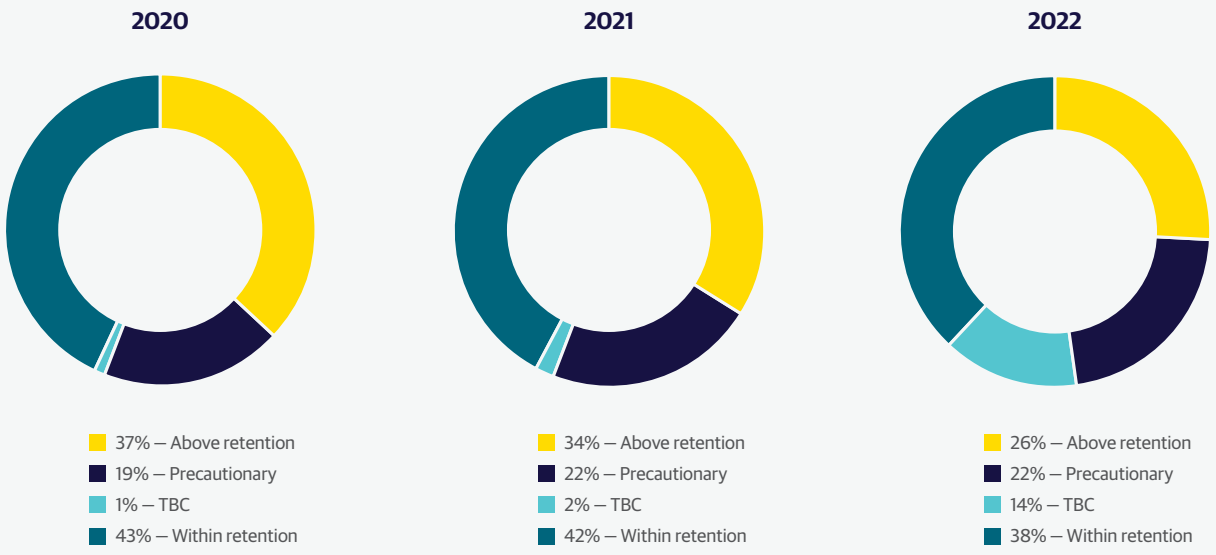
We are seeing more instances of multiple notifications.

In the last few years, we have seen a steady increase in the number of deals that have resulted in more than one notification at different points in time involving different issues. We classify any subsequent notification on the same deal as a 'multiple notification'. In 2019, just 10% of our notifications were 'multiple notifications'. This increased in 2020 to 16.5% and again in 2021 to 23%. The number appears to have steadied off since then with about 24.5% of the notifications that we have received so far in 2022 falling into this category. The trend, which is more pronounced in EMEA than our other regions, is probably due to an increased awareness among certain insureds around their notification obligations and is undoubtedly a contributing factor in the reason why the increased notification count that we have seen in the last few years has not translated to an increase in notification frequency. However, in general, it is unusual to receive more than one notification involving a loss or potential loss that exceeds the retention on the same deal, meaning that multiple payouts under the same policy are still rare despite the increase in multiple notifications.

The types of notification that we are receiving remain relatively consistent globally (see Figure 4).

In 2021, around 22% of our notifications were precautionary in nature (up from 19% in 2020). We find that these rarely end up resulting in a claim. The main exception relates to notifications involving a routine tax audit that subsequently results in an issue being identified by the relevant tax inspector.

Figure 4 **Breakdown of loss — global view**



Data based on R&W notifications received between January 1, 2020 and June 30, 2022

The most common type of notification that we receive involves a (potential) loss that is within the retention. In 2021, 42% of our notifications fell into this category. This was down slightly from 43% in 2020. We find that, in some cases, an insured that notifies us of a (potential) loss that is within the retention will ask us to confirm that it is a covered loss which erodes the retention. However, determining the extent to which the retention has been eroded is an important issue. This is primarily a function of the fact that R&W policies almost invariably adopt an aggregate retention for the entire policy period — which can span many years. In that light, while accepting a loss as eroding the retention may not have any financial impact upon the insured or the insurer in the first instance, it will result in the insurer assuming greater financial exposure to future claims — meaning that it needs to be investigated accordingly. This is especially the case given the increased instances of multiple notifications (see above). Therefore, an insured should expect that, in this situation, an insurer will approach the claim as if they were investigating a (potential) loss that exceeds the retention — asking the same questions and making the same requests. An investigation into whether a loss erodes the retention will, therefore, usually require time and effort (and, potentially, cost) on both sides and, as such, we often find that, in the end, the insured is happy to 'park' the issue on the understanding it will be revisited in the event of a further claim which, when aggregated with the prior claim, results in a total loss that is in excess of the retention.

Only 34% of notifications that we received last year involved a (potential) loss that was above the retention (down 3% from the previous year). However, we do not expect all of these will turn into actual claims under our policy. For example, some might involve an adverse tax finding which is successfully challenged, or a third-party claim that is intimated, but not pursued. In other cases, we might have an excess position, meaning that the loss is below our attachment point.

There has been no material change in our data in 2022, although it does include a material number of notifications where the (potential) loss has yet to be quantified, meaning that it is not possible to say at this point which bucket these will fall into even though they are likely to result in a loss of some description. This appears to be a by-product of the increasing tendency among insureds to notify earlier, with the result that an increasing number of our notifications tend to be quite high level and refer to matters which "may have occurred", or "are being investigated" (for example) with no indication of the possible quantum.

Timing of notifications

Key insights

The most common window for us to receive a R&W notification is now between 6 and 18 months after the policy incepting **(58% in 2022 YTD)**.

There has been little change in the percentage of R&W notifications being received more than 18 months after the policy incepting **(27% in 2022 YTD)**.

So far this year only **5%** of our R&W notifications have been received more than 36 months after the policy incepting, suggesting that a R&W policy might not have such a long tail as initially thought.

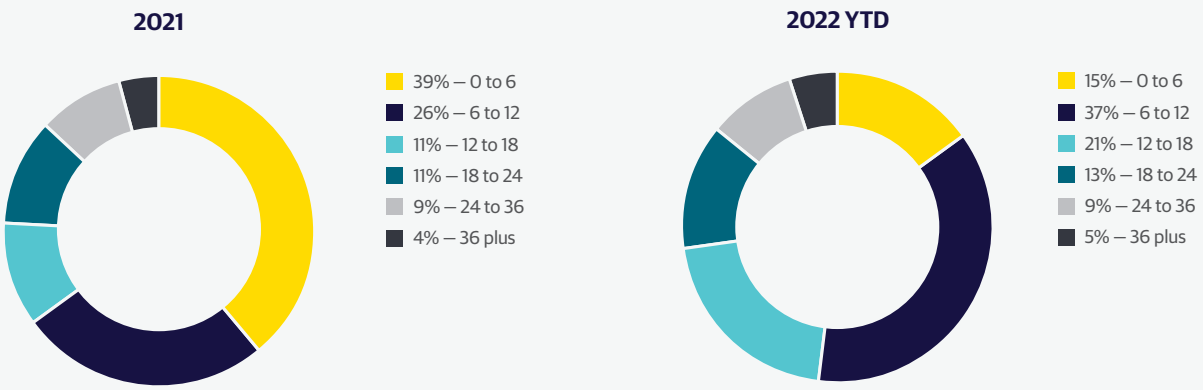
We continue to see the vast majority of R&W notifications being made within 24 months of the policy incepting (see Figure 5).

In last year's briefing we reported that we had seen a notable increase in the speed with which we were receiving notifications. We speculated that this was likely to be a by-product of both our increased policy count over the last few years and the fact that insureds are becoming better at identifying and notifying issues more quickly.

This year's data shows that, compared to last year, there has been a noticeable fall in the percentage of notifications being received within six months of the policy incepting (down from 39% to 15%). We suspect that this is because last year's timing data was probably skewed by the disproportionally large number of policies that were placed at the end of 2020 after M&A activity roared back from a near decade low in the early part of the year due to COVID-19.

The knock-on impact of this is that we have seen an increase in the percentage of notifications being received between 6 and 18 months after the policy incepting (up from 37% in 2021 to 58% in 2022 YTD). However, it makes sense that this should be the most common window for us to receive a notification. This is because, in many cases, it will take several months (at least) for a deal to close after the policy has incepted, and it is not until this point that the new owner takes control of the business and has an opportunity to check that everything is as it should be. In addition, it is normally during this window that the results of the first audit under new ownership will become available, which we find is a common trigger for a notification (especially to the extent that it relates to a financial statements issue).

Figure 5 **Gap (in months) between policy inception and notification — global view**



Data based on R&W notifications received between January 1, 2021 and July 31, 2022

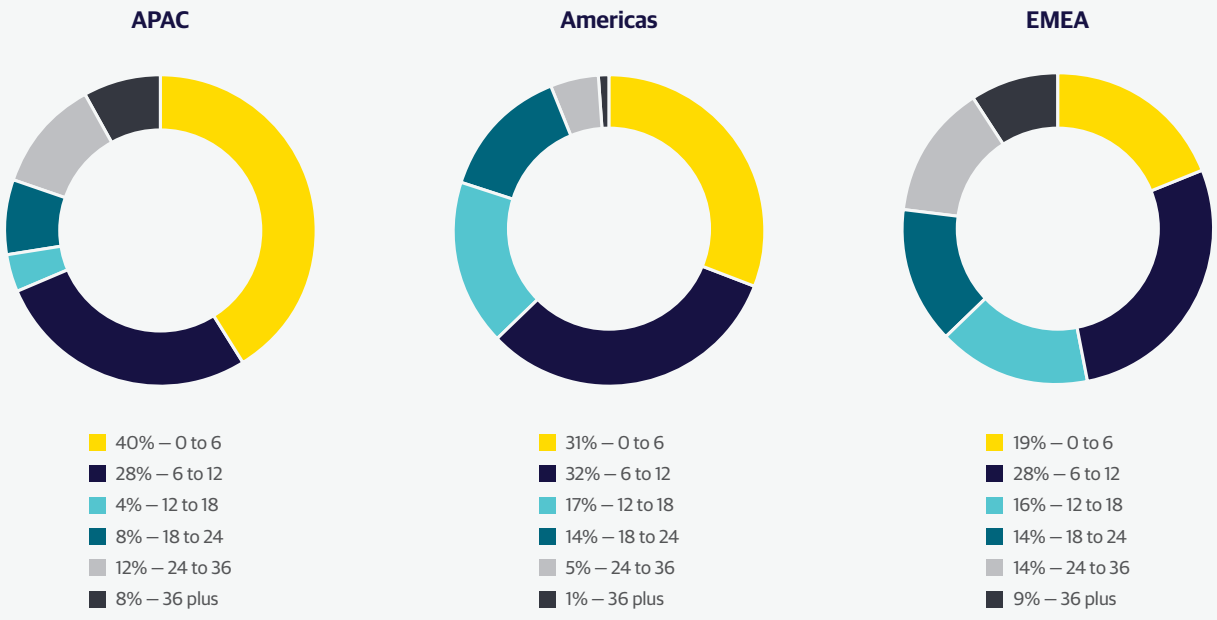
What is reassuring from our perspective is that there has been very little change over the last few years in the percentage of notifications being received more than 24 months after the policy incepting (15% in 2020; 13% in 2021, and 14% in 2022 YTD). Furthermore, so far this year, only 5% of our notifications have been received more than 36 months after the policy incepting (which is virtually the same as in 2021). Indeed, since the beginning of 2021, we have only received 12 R&W notifications more than 36 months after the policy incepting. Only two of these related to a breach of a general warranty. The remainder involved tax-related issues with only four involving a (potential) loss in excess of the retention (but none of these are expected to give rise to a material payment under the related policy). This adds further weight to comments that we have made in our previous claims briefings that a R&W policy may have a shorter tail than initially thought.

There are some subtle differences in our regional data (see Figure 6).

Our data from the last 18 months suggests that our EMEA notifications tend to come in slower compared to our other regions, with only 47% being received within 12 months of the policy incepting (compared to 63% of our Americas notifications and 68% of our APAC notifications). However, the gap does narrow slightly when looking at the percentage of notifications received within 18 months of the policy incepting (with EMEA at 63%; APAC at 72%; and the Americas at 80%).

Interestingly, during the same period, a noticeably higher percentage of our EMEA notifications were received more than 24 months after the policy incepting compared to our Americas notifications (23% vs 6%). This is despite the fact that the default position in EMEA is a two-year policy period for the general warranties (compared to a three-year policy period in the Americas). It is also notable that 9% of our EMEA and 8% of our APAC notifications were received more than 36 months after the policy incepting whereas, in the Americas, only 1% of our notifications fell into this category. The most likely explanation for this lies in the larger number of tax-related notifications that we receive in EMEA and APAC, although mostly precautionary in nature, which are in general, notified later in time compared to other types of notifications.

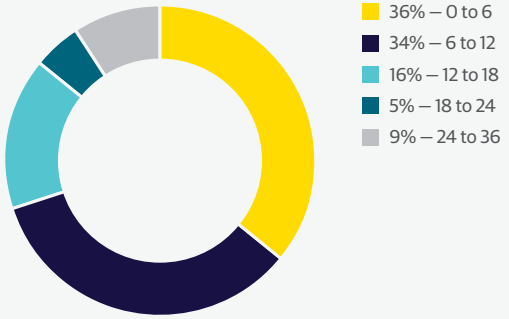
Figure 6 **Gap (in months) between policy inception and notification — regional view**



Data based on R&W notifications received between January 1, 2021 and August 31, 2022

Figure 7

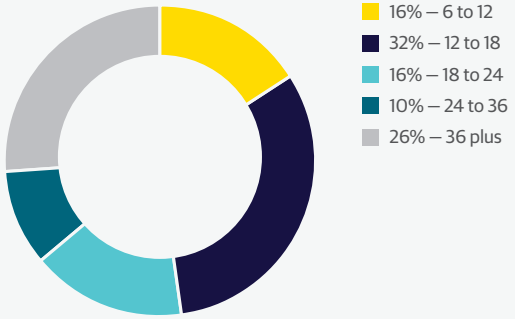
Gap (in months) between policy inception and notification — non-tax-related R&W notifications involving a (potential) loss in excess of the retention



Data based on paid and reserved R&W claims as at August 31, 2022 relating to R&W risks placed from January 1, 2019 onwards

Figure 8

Gap (in months) between policy inception and notification — R&W notifications involving a (potential) tax-related loss in excess of the retention



Data based on R&W notifications received between January 1, 2019 and July 31, 2022

A significant proportion of the non-tax-related R&W notifications that we have received in the last 18 months involving a (potential) loss in excess of the retention were notified within 12 months of the policy incepting (see Figure 7).

An analysis of non-tax-related notifications that we have received in the last 18 months involving a (potential) loss in excess of the retention reveals that 70% of these were received within 12 months of the policy incepting. This suggests that our larger non-tax-related claims tend to be received early on in the lifecycle of the policy. However, it is still possible to receive a notification in respect of a significant issue in the third year of the policy period. Indeed, 9% of the notifications that we have received in the last 18 months involving a (potential) loss in excess of the retention were received in the third year of the policy period, with three of these being high-severity ($10M plus) notifications. This reinforces the point, discussed in last year's briefing, that insurers still need to price properly for extending cover beyond 24 months in respect of the general warranties where this isn't already the default position.

We see very few tax-related R&W notifications involving a (potential) loss that exceeds the retention being made more than 36 months after the policy incepting (see Figure 8).

Our data shows that the majority of tax-related notifications involving a (potential) loss that exceeds the retention are made within 24 months of the policy incepting. We have only received five such notifications more than 36 months after the policy incepting within the last three years (and in all cases they were received within 48 months of the policy incepting). Indeed, if we look back over our data from the last 10 years, we have only had three examples of a tax-related notification of any sort being notified to us more than 48 months after the policy incepting, and none of these have resulted in a paid claim. This suggests that, while a typical R&W policy will provide at least six years of cover for tax-related issues, the risk of a claim beyond 48 months is actually very remote.

Deal size trends

Key insights

Notification frequency rate is relatively **consistent** across different deal size brackets at a global level.

However, deals with an EV of **over $1B** have the lowest notification frequency rate in both EMEA and the Americas.

In the last few years, deals with an EV of **$250M** or less have accounted for **64%** of our paid and reserved claims by value.

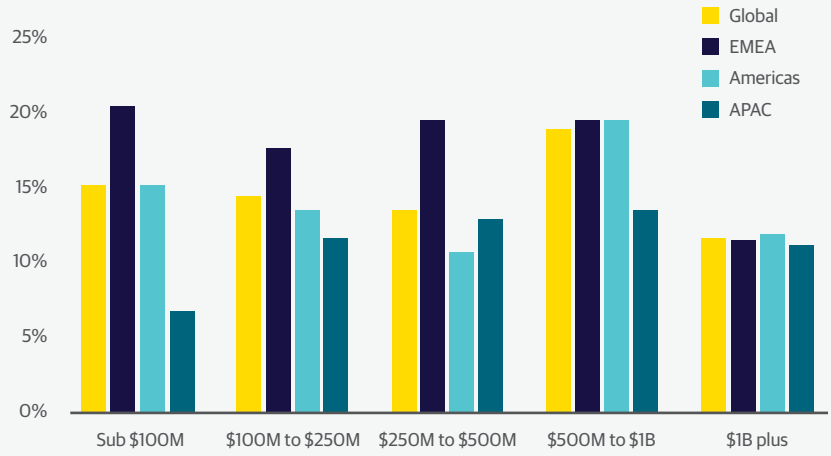
We have not seen any notable changes in terms of notification frequency rate across different deal sizes during the course of the last 12 months (see Figure 9).

Our data based on risks bound in 2019 and 2020 shows that, at a global level, there is not a significant difference in notification frequency rate across different deal size brackets.

We have seen the highest notification frequency rate on deals with an EV of between $500M and $1B (at around 19%). However, the high notification rate involving this deal size bucket appears to be confined to risks bound in 2019 and, as discussed below, few of these have translated into paid claims, meaning that it is difficult to draw any firm conclusions from this.

We also continue to see a relatively high notification frequency rate on deals with an EV of $100M or less (at around 15%) and, as discussed below, this deal size bucket actually accounts for a relatively large proportion of our paid claims by value. This suggests that these types of deals carry an appreciable risk despite the comparatively small limits that they typically involve. We have discussed the possible reasons for this in our previous briefings (such as the fact that smaller deals are much more likely to be primary buy-outs, in which case the target company will not have been through the rigor of institutional ownership, which tends to place a significant emphasis on accountability, clear reporting, and improving compliance functions).

Figure 9 **Notification frequency broken down by deal size**



Data based on R&W notifications received as at July 31, 2022 relating to R&W risks bound between 2018 and 2021

The data also shows that deals with an EV of over $1B (sometimes referred to as 'mega-deals') have the lowest notification frequency rate of any deal size bucket (at around 12%). This statistic is likely to be of particular interest to the market given the significant increase in the number of submissions relating to 'mega-deals' over the last 24 months. However, it may be that we see a drop-off in these types of deals in the coming months despite the increased capacity in the R&W market and the fact that carriers are prepared to deploy more limit higher up in larger towers of R&W insurance, where the risk is lower. This is because current macroeconomic conditions have led to a significant tightening of the leveraged debt market, which is making debt more scarce and expensive impacting 'mega-deals' the most.

This year, we have broken down the data by region and this shows that there are some interesting variations in what we are seeing (see Figure 9).

In EMEA, there is a relatively wide divergence in the data with a noticeably higher notification frequency rate on deals with an EV of $100M or less (at around 20%) and a noticeably lower notification frequency rate on deals with an EV of over $1B (at around 12%).

In the Americas, we have seen a relatively high notification frequency rate on deals with an EV of between $500M and $1B (at around 19%). The data for the remaining deal sizes is relatively consistent and ranges between around 15% for the smallest deals and around 12% for the largest deals.

In APAC, in contrast to our other regions, we have seen a relatively low notification frequency rate on deals with an EV of $100M or less (at around 6.5%). There is very little divergence between the remaining deal sizes, with notification frequency being at or around 12%.

We see high-severity notifications across all deal sizes, but they tend to be more common on larger deals in the Americas.

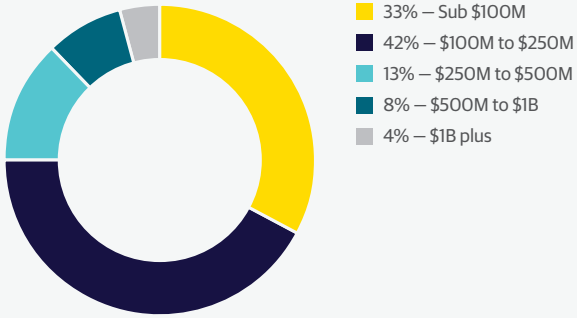
We have seen no material change in the proportion of our notifications that involve high-severity ($10M plus) issues, which remains low (at 9%). We continue to see these types of notifications across all deal sizes, although our only paid claim in the last 18 months for an amount in excess of $10M involved a deal with an EV of under $250M. That said, we tend to find that high-severity notifications are more common on larger deals in the Americas. This is because we see more notifications in this region that relate to either a breach of the financial statement warranties or the material contracts warranties and there is a greater risk that the resulting EBITDA impact of these types of issues will be larger in the context of a bigger business. We also see more third-party claims against big corporates in this region where the headline amount being claimed by the plaintiff can be quite large (at least initially). Of course, the size of a claim is a slightly crude measure in the sense that some claims are not pursued and, for those that are, the amount being claimed does not necessarily correlate to the amount which is actually recovered under the policy. However, in the Americas the tendency is to build a tower made up of a number of layers, each totaling between $20M and $30M. This means that insurers in this region tend to have less exposure to high-severity claims that are for amounts in excess of these figures. In EMEA or APAC — where insureds are more open to a single policy approach (in part because dealing with a single insurer lends itself to a less complicated claims process) — it is much rarer to see a claim in excess of $25M. Indeed, we have only seen two such claims in EMEA and none in APAC since the beginning of 2020.

We receive significantly more notifications involving medium-severity issues on smaller deals compared to bigger deals (see Figure 10).

A deeper dive into our severity data shows that, in the last few years, deals with an EV of $250M or less have been responsible for 75% of our medium-severity ($1M to $10M) notifications. Indeed, almost 35% of the notifications that we have received on deals with an EV of between $100M and $250M fall into this category. The figure for deals with an EV of $500M or more is only 5%.

Figure 10

Breakdown of medium-severity R&W notifications according to deal size



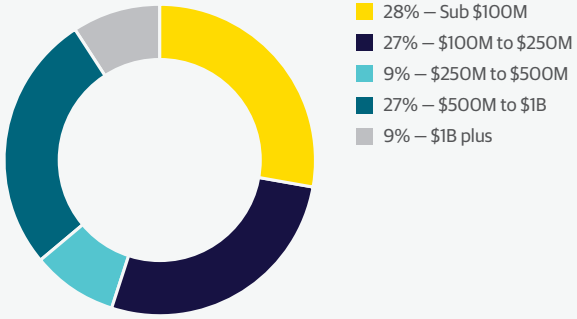
Data based on R&W notifications received as at July 31, 2022 (excluding third-party claims) relating to R&W risks bound from January 1, 2019 onwards

Our data also suggests that claims involving a large (potential) loss as a proportion of the total policy limit are more common on smaller deals compared to bigger deals (see Figure 11).

An analysis of the notifications that we have received in the last 18 months involving a (potential) loss that is for more than half of the total policy limit shows that 55% of these were on deals with an EV of less than $250M. Indeed, so far this year, we have paid out the full policy limit on three occasions and in each case the claim involved a deal with an EV of less than $250M.

Figure 11

Breakdown of R&W claims for more than 50% of policy limit according to deal size



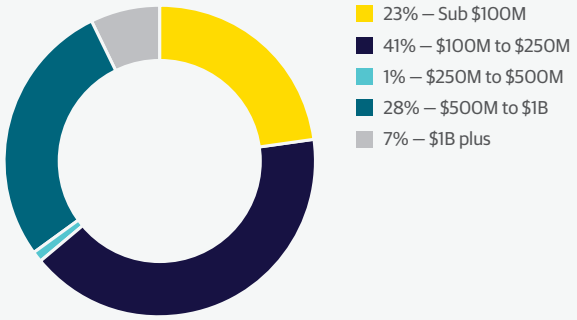
Data based on R&W notifications received between January 1, 2020 and August 31, 2022 (excluding third-party claims)

We have paid out and reserved more on smaller deals compared to bigger deals (see Figure12).

In light of the above, it is no surprise that, in the last few years, deals with an EV of $250M or less have accounted for 64% of our paid and reserved claims by value. There is, of course, a lot of capacity at this end of the market, which has led to broader coverage and lower retentions being offered on these deals. If this trend continues then we may see some carriers start to become more cautious in terms of how they approach these deals and look to tighten cover accordingly.

Figure 12

Breakdown of paid and reserved R&W claims by value according to deal size



Data based on paid and reserved R&W claims as at August 31, 2022 relating to R&W risks bound from January 1, 2019 onwards

Section 4

Type of claims

Key insights

We are seeing an increasing number of large **($10M plus)** tax-related notifications, although the majority of tax-related notifications are received within 24 months of the policy incepting.

We have also seen a noticeable **increase** in claims involving condition of asset and IP-related issues.

Accounting- and financial-related issues were behind **29%** of our high-severity and **32%** of our medium-severity R&W notifications.

Tax is the most commonly cited breach type in all of our regions

(see Figure 13 and 14).

Our data shows that tax-related issues continue to account for a large number of our R&W notifications: 36% in APAC, 34% in EMEA, and 17% in the Americas. However, as we have commented in our past briefings, a significant number of these are precautionary in nature and involve the commencement of a routine tax audit. In fact, 33% of the tax-related notifications that we have received in the last 18 months fell into this category. That said, we have noticed an increase in tax-related notifications that involve a (potential) loss of some description. This is something we predicted in last year's briefing on the basis that national and local governments would be looking to increase tax revenues significantly in order to fund their borrowing and expenditure in connection with COVID-19-related measures. This pressure is likely to intensify given the significant cost of living measures that may need to be implemented to support people through a period of high inflation. The main issues that we are seeing involve corporation tax, sales tax, or property tax issues. However, the majority of these notifications involve low-level losses which either fall within the retention or do not translate into a large claim under the policy. This is because tax losses tend to be one-off issues meaning that it is not appropriate to quantify the resulting claim by reference to a transaction multiple — the claimed loss is nearly always based on the amount of the unpaid tax liability. This helps to explain why we have never made a payment for the full policy limit in respect of a tax-related issue. That said, we have noticed a rise in the number of tax-related notifications involving large amounts in the last 18 months. In fact, tax-related notifications made up 12% of our high-severity ($10M plus) notifications in the last 18 months: a significant increase compared to previous years. They also made up 9% of our medium-severity ($1M to $10M) notifications over the same period (see Figure 15). It is notable, however, that the majority of these have involved either transfer pricing issues (which are typically excluded under a R&W policy) or withholding tax issues (which were identified during the due diligence stage and excluded from cover). These notifications have so far been confined to Europe and APAC. This may indicate that the tax authorities in these regions are more active and are taking a more robust approach compared to their counterparts in the Americas. Indeed, we have yet to see a tax-related issue involving a (potential) loss that exceeds the retention in the Americas (although the U.S. government recently announced a huge $80B cash injection for the Internal Revenue Service which may, in time, lead to an increase in audit activity and, potentially, adverse findings).

Figure 13 **Top 12 breach types — global view**

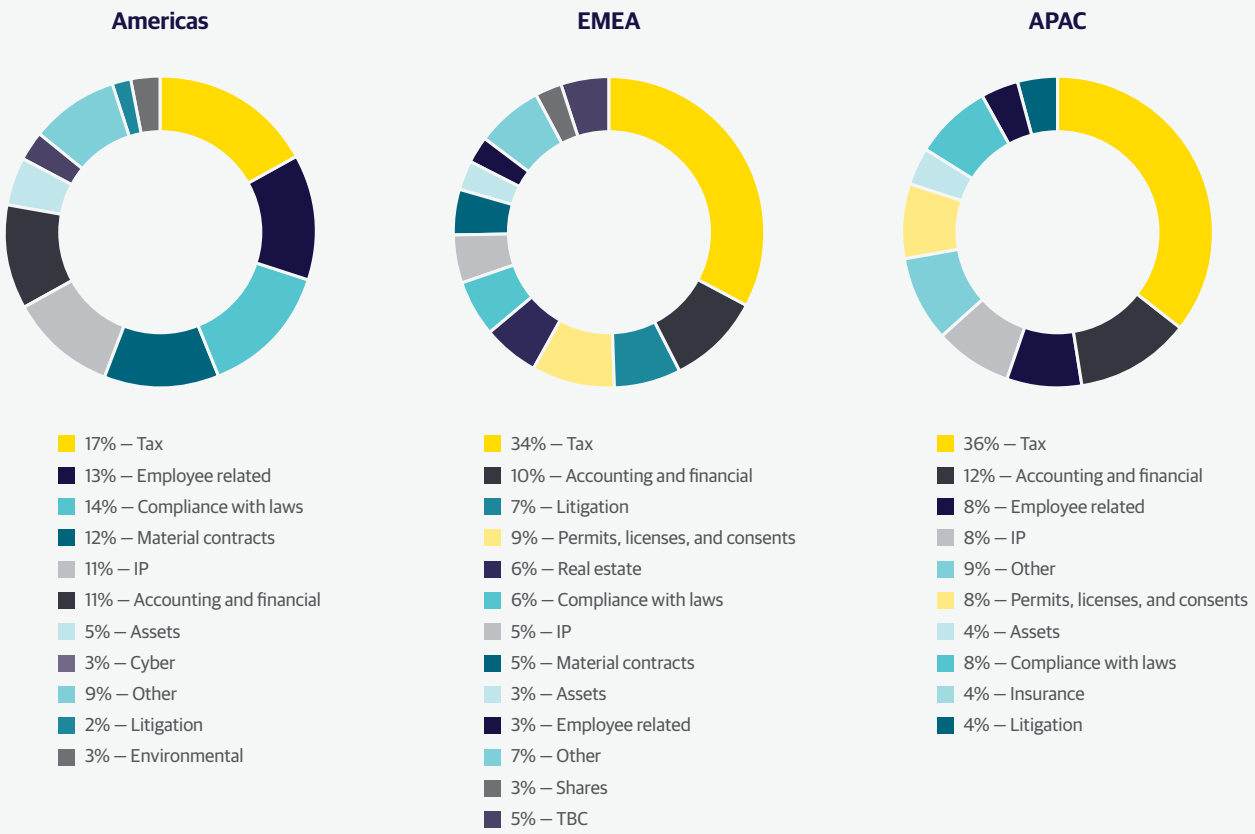
Data based on R&W notifications received between January 1, 2020 and July 31, 2022

We have seen a noticeable increase in notifications involving condition of asset and sufficiency of asset issues (see Figure 13).

We have also seen a noticeable increase in claims involving both condition of asset and sufficiency of asset issues in the last 18 months. We find that these claims are typically for large amounts even though no multiple is usually involved as demonstrated by the fact that they made up 12% of our high-severity and 18% of our medium-severity notifications over this period (see Figure 15). We have found that, in many cases, the issue in question has been latent, making it very difficult — if not impossible — to identify it before a problem manifests even if extensive due diligence has been carried out.

Our experience is that companies with large, high throughput capital equipment are particularly susceptible to condition of asset issues. We often find that there is more to these types of claims than meets the eye when it comes to any coverage assessment. For example, it can be difficult to determine the dividing line between a breached representation and ordinary 'wear and tear'. There are also various quantum-related issues to consider, especially where the claim is quantified as being the cost of repair or replacement, plus any lost profits that result from any associated downtime. This is because if an asset (or part of an asset) is repaired or replaced then it may have some ancillary benefits that would not have otherwise been enjoyed. For example, the asset in question may run more efficiently, or it may require less maintenance (and, therefore, ongoing CAPEX or downtime) than originally envisaged or its useful life (and, therefore, value) may be extended. These benefits will need to be factored into the loss calculation. That is why, in our experience, the key to resolving these types of claims efficiently is to involve subject matter experts from the outset who really understand the asset and the knock-on effects of any issues.

Figure 14 **Breakdown of breach types — regional view**



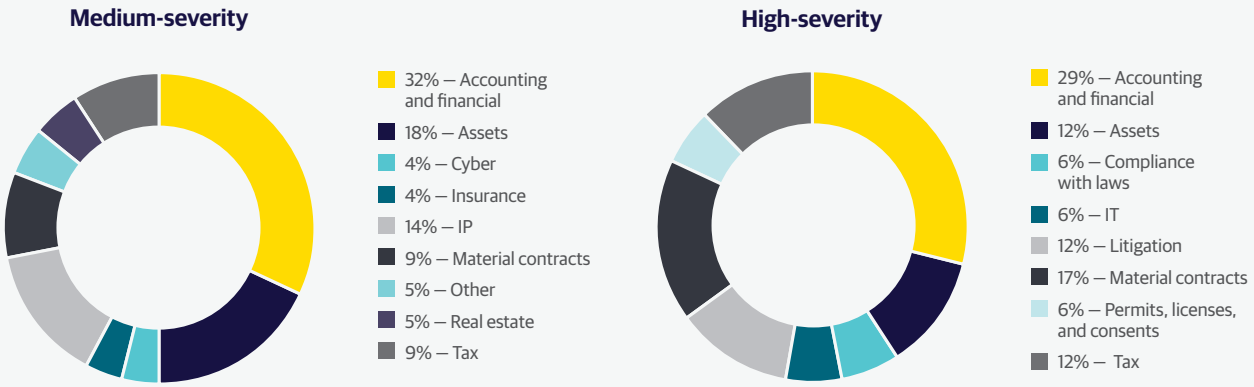
Data based on R&W notifications received between January 1, 2021 and July 31, 2022

Our larger claims continue to be driven by accounting- and financial-related issues (see Figure 15).

Our data shows that accounting- and financial-related issues were behind 29% of our high-severity and 32% of our medium-severity notifications despite only making up 11% of our notifications over the last 18 months. This is the highest of any breach type by a significant margin. The reason for this is that, depending on the jurisdiction, losses resulting from such breaches are often calculated by buyers on a multiple-of-EBITDA basis.

It goes without saying that these claims can encompass a wide range of issues, given everything that feeds into the accounts. However, an issue that we have seen arise on more than one occasion in the last 12 months involves the double counting of a significant amount of revenue associated with a key customer. In both instances, the resulting claim was for an amount in excess of the policy limit. This indicates that close attention needs to be paid to any large increase in revenue associated with a single customer — especially in the period after the most recent audit — and questions asked about what is driving this increase.

Figure 15 **Breakdown of breach types responsible for our medium- and high-severity notifications**



Data based on R&W notifications received between January 1, 2021 and August 31, 2022

We are also increasingly mindful of the fact that, prior to a divestment, attempts are often made to exhaust all possibilities up to the limit of what is permissible in order to increase EBITDA. In some cases, misjudgments may be made (whether knowingly or unknowingly) as part of this process. The hope, of course, is that any such misjudgments are caught as part of the audit process. However, an audit will only provide limited comfort if there is a long gap between the last audit and the deal signing and, in any event, we have seen a number of claims recently involving allegations of errors in the audited accounts based on decisions that were taken by management in the lead up to the sale of the business (such as around revenue recognition, the capitalization of expenses, and the failure to write off obsolete inventory).

We are seeing an increase in notifications citing breach of a warranty that is qualified by the knowledge of the seller.

We are seeing more instances of seller knowledge issues in our notifications. This includes several situations where it is being alleged that material information — typically involving a material contract — came to light in the lead up to signing which was not passed on to the buyer. In these types of situations, insurers will typically require proof of or express acceptance of seller knowledge. It is understandable that the insured might feel that the seller "must have known" or "should have known" of certain issues, including by reason of the fact that other people had similar knowledge or because the seller had means of acquiring such knowledge. However, circumstantial evidence from which an inference might be able to be drawn is rarely sufficient. Instead, an insured will need to produce objectively verifiable evidence of seller knowledge, usually in the form of documentary evidence (e.g., emails or instant messages) or witness evidence,

to support its claim. In the latter case, the witness evidence ideally would come from the seller (although this may be difficult to obtain). The witness evidence of current or former employees, while helpful, will need to be carefully considered for credibility and weight, taking account of the circumstances of their departure from the business (if applicable) and their motive for providing such evidence. In these type of situations, it is also particularly important that an insured takes appropriate steps to preserve any potential subrogation rights that insurers may have against the seller in the event of a payout.

The increase in notifications involving IP-related issues is almost entirely driven by third-party claims.

We have seen a notable uptick in claims involving IP-related issues in the last 18 months, especially in the Americas. This is to be expected since, during times of economic uncertainty, it is not unusual for there to be an increase in both trade secret theft and IP infringement claims as businesses try to gain a competitive advantage and seek to monetize and generate revenue from investments in research and development. We examine this issue in more detail in Section 5 as we are finding that these are very costly claims to deal with.

We are finding that compliance with laws issues continue to be a common source of notifications.

We continue to see a large number of notifications citing compliance with laws issues and we expect this trend to continue, particularly in light of the rapid growth in ESG-related legislation. However, generally speaking, this breach type has proven to be relatively benign from a claims severity standpoint to date as reflected in the fact that it has not been responsible for any of our medium-severity notifications in the last 18 months. An interesting issue that can arise on these claims relates to the insurability of fines resulting from a breach of law. This is ultimately a local law issue that will need to be assessed on the facts of the particular case.

We have noticed an uptick in claims involving director remuneration and severance issues.

We have received a number of notifications this year involving issues around director remuneration and severance. The subject matter of these notifications includes favorable variations to severance terms being agreed and large salary increases or bonuses being awarded in the lead up to the sale of the business. This suggests that this is an area that needs to be interrogated more closely in the lead up to signing.

Focus on third-party claims

Key insights

In 2021, **48%** of our non-tax-related notifications involved a third-party claim.

A **significant** number of the third-party claims that we receive involve either employee- or IP-related disputes.

We expect this trend to continue, thus **increasing** the spotlight on the coverage provided for these types of claims by R&W policies.

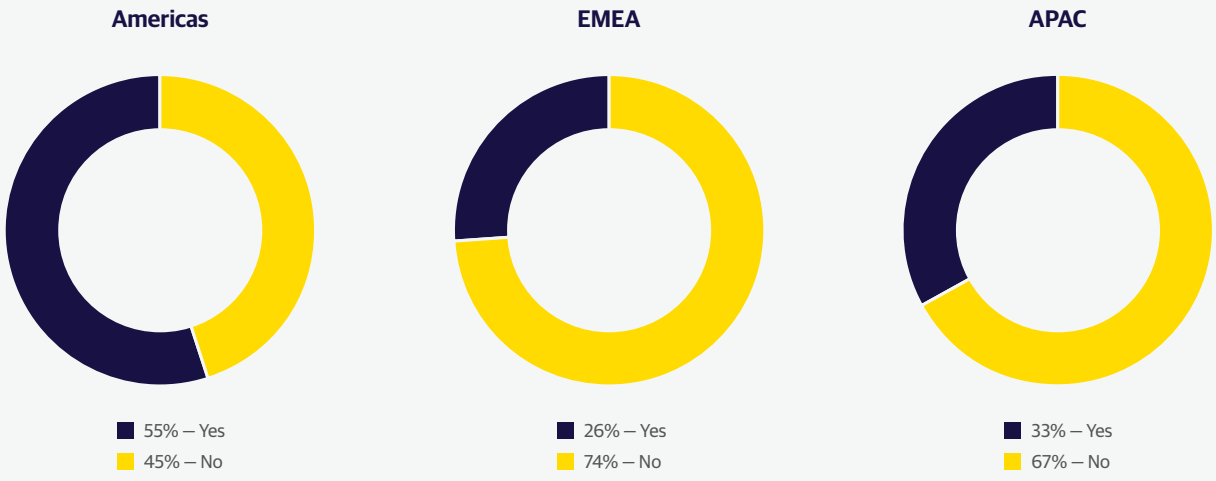
We are seeing a significant increase in third-party claims, especially in the Americas region (see Figure 16).

In 2020, just 28% of the non-tax-related notifications that we received involved a third-party claim (as is typically defined in a R&W policy). This jumped to 48% in 2021 and the number has stayed high into 2022 (at 45%). The reasons for this are potentially varied but are indicative of the increased litigation threat faced by corporations, which is likely to be heightened as businesses explore all means of generating revenue when facing economic headwinds.

A deeper dive into our data shows that the Americas region is driving this phenomenon where 55% of the non-tax-related notifications that we have received since 2020 have involved a third-party claim. In APAC and EMEA, over that same period, the figures are only 33% and 26% respectively. This reflects the more litigious business environment in the Americas region, and the U.S. in particular.

This development has significant implications for insurers bearing in mind that a R&W policy will typically provide cover for, among other things, the costs of defending a third-party claim regardless of whether the underlying allegations have any merit. These costs can be significant and, as discussed below, we are seeing more and more instances of defense costs eroding the entire policy retention or a significant portion of it, even on deals with a relatively high attachment point.

Figure 16 **Percentage of non-tax-related R&W notifications involving third-party claims — regional view**



Data based on non-tax-related R&W notifications received between January 1, 2021 and July 31, 2022

We find that many third-party claims are notified more than 12 months after inception of the policy.

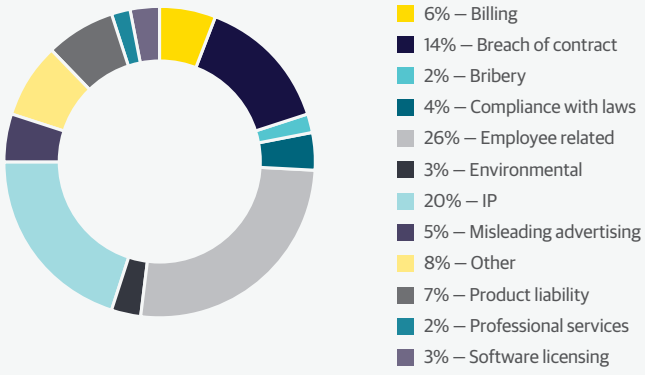
In many cases, an insured will only become aware of the underlying facts giving rise to a third-party claim at the point that the claim is actually asserted by the plaintiff (or shortly thereafter). This can be many months after signing and it is not a surprise, therefore, to find that many third-party claims are noticed more than 12 months after inception of the policy. This represents an additional risk factor for insurers when it comes to any policy with a retention that drops down (usually by 50%) 12 months after closing, which is the norm for most U.S. risks.

A significant number of third-party claims involve employee-related or IP disputes (see Figure 17).

Our data reveals that nearly 50% of the third-party claims that we have received since 2019 onwards involved either employee- or IP-related disputes.

We are finding that many of these employee-related disputes involve wage and hour lawsuits. These have become rife in recent years, especially in the U.S., and — as discussed in last year's claims briefing — can be surprisingly expensive claims, in part because they can result in additional employee-related tax liabilities as well as an increased wage bill. They are also seldom covered by the target's business-as-usual insurance and there is also a social inflation risk associated with these claims in some jurisdictions, as they are susceptible to plaintiff-friendly jury awards. We predict that, as a result, insurers are likely to become increasingly proactive in terms of managing their exposure toward such claims going forward.

Figure 17 **Underlying cause of third-party claims**



Data based on R&W notifications received as at July 31, 2022 relating to risks bound from January 1, 2019 onwards

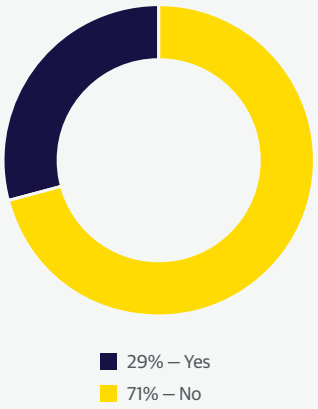
These claims, however, are typically less severe in terms of potential exposure than IP-related disputes, which account for 20% of the third-party claims that we have received since 2019. These claims can involve a range of issues, but many involve patent disputes. These claims are usually pursued very aggressively and defended vigorously. They often involve factual questions which cannot be resolved easily via an early dispositive motion and usually require significant expert testimony. This can make them especially costly to deal with and it is not unusual to see very large budgets for the defense of these types of claims. Indeed, we have several ongoing claims involving IP-related disputes where a relatively high retention (of $1M plus) is expected to be exhausted in its entirety by defense costs alone. Furthermore, we recently paid out a full policy limit in connection with an IP-related dispute where the defense costs incurred were almost as much as the settlement payment. We would not be surprised if this trend continues.

The early notice of a third-party claim is critical.

We have seen several examples in the last 12 months of third-party claims that have been notified long after the underlying litigation was commenced. While rare, the delay in notifying a third-party claim, especially when it involves active litigation, can complicate the claims process, especially to the extent that key decisions have already been taken. While true for all claims, it is particularly important for an insured to provide notice of a third-party claim as early as possible and to then maintain an active dialogue with insurers about its status and any key developments. We find that this is crucial in allowing an insurer to expeditiously reach a coverage determination and to assess the reasonableness of any key strategic decisions or settlement proposal(s). For example, during the course of last year, an insured provided us with notice of a third-party claim involving an IP-related dispute within weeks of receiving the complaint. The insured and its counsel then kept us closely appraised of the status of the dispute and provided us with key documents throughout the process. Because of this, we were able to confirm coverage for the underlying settlement payment within days of the settlement being reached, resulting in a payment of $4.5M. This would not have been possible without the information being provided by the insured and its counsel in advance.

Figure 18

Percentage of third-party claims that result in us incurring investigation costs



Data based on R&W notifications received as at July 31, 2022 relating to R&W risks bound from January 1, 2019 onwards

We have incurred costs in connection with 29% of the third-party claims that we have received since 2019 (see Figure 18).

We have incurred costs in connection with approximately 29% of the third-party claims that we have received since 2019. This is because it is fairly common for us to instruct counsel to monitor the defense of the underlying claim and liaise with the insured's retained defense counsel in respect of the same. In addition, third-party claims can require significant analysis to confirm whether they qualify for coverage under a R&W policy. Examples of complicating factors include where there are multiple allegations (some of which are covered and some of which are not covered) and/or allegations relating to pre-and post-closing conduct and/or counterclaims brought by the target and/or potential issues over the reasonableness of a settlement. The latter is something that we will look particularly closely at where the plaintiff is an entity or person with whom the target is anxious to maintain a good relationship going forward (with the risk being that the settlement may not be a true reflection of the underlying merits of the claim itself). Thus, there are a number of considerations at hand when it comes to third-party claims which can make them costly to evaluate, even when the underlying claim itself may have little merit or be for an amount that is within the retention.

We expect to see more payments involving third-party claims, resulting in a greater focus on the coverage associated for these types of claims and litigation risk in general.

We have already made several payments in connection with third-party claims this year and we expect this trend to continue. This is likely to increase the spotlight on the coverage provided for these types of claims by R&W policies. For example, we may start to see an increase in retentions, particularly on smaller deals, in order to protect against the risk derived from more third-party claims. We may also see more discussions around the apportionment of defense costs where, for example, the third-party claim involves pre-and post-closing conduct or a mixture of allegations, only some of which would trigger a breach of warranty if substantiated or a counterclaim. We also predict that there will be more scrutiny at underwriting stage around litigation risk in general, and increasingly robust positions being taken in respect of any potential exposures that are identified during due diligence, even if it is classified as being a low-risk item (perhaps because the circumstances in question have not yet crystallized into an actual claim). This may mean that insureds may have to look at alternative ways of managing these risks, such as via a bespoke contingent legal risk insurance policy (a product which is designed to de-risk one-off identified low-risk issues).

Sector trends

Key insights

The pharma and biotech sectors account for roughly **16%** of the high-severity claims that we have received in the last few years.

We have received claims on **50%** of the gas turbine deals we have written since the beginning of 2020.

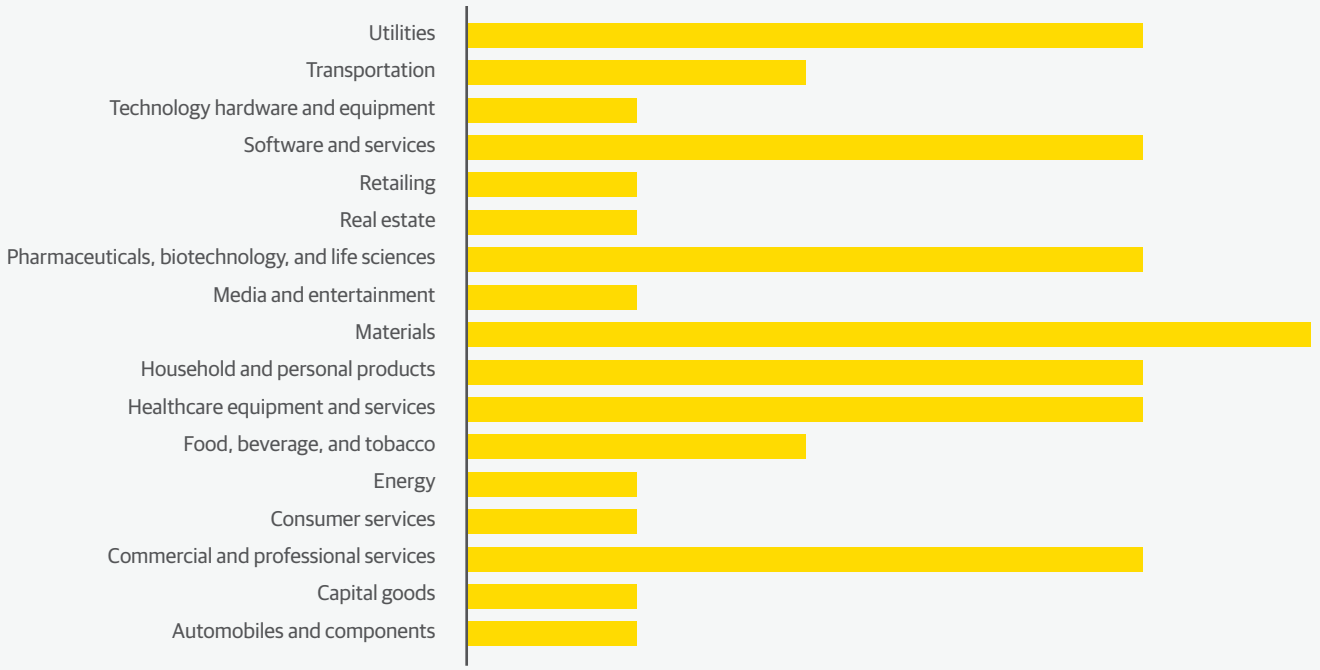
We have seen a number of losses relating to **defects** or **deficiencies** in the critical systems of a property.

We have received a number of large claims involving the pharmaceuticals, biotechnology, and life sciences industry group

(see Figure 19).

Our data shows that pharma and biotech deals have accounted for a significant number of our medium- and high-severity notifications despite making up only 4% of the notifications that we have received since 2019. Indeed, the pharma and biotech sectors account for roughly 16% of the high-severity claims that we have received over this period, which makes them the worst performing sectors across our entire portfolio for which we have any meaningful data. Furthermore, within our EMEA region, three of our four largest claims are in these sectors. Our review of our notifications in this space reveals that there is no single issue or identifiable group of issues leading to the alleged warranty breaches. They have included intellectual property issues, production issues, condition of asset issues, regulatory compliance issues, and product liability issues. This suggests that they are difficult deals to diligence effectively, especially where the business concerned is involved in the manufacturing of new, complex products using untested production processes.

Figure 19 **Breakdown of medium- and high-severity R&W notifications by industry group**



Data based on R&W notifications received between January 1, 2021 and August 31, 2022

A significant number of our claims involving the utilities industry group relate to gas turbine deals.

We have seen three claims on gas turbine deals in the past 18 months, all of them alleging a breach of the condition of assets warranty and all of them for a sum greater than $5M. This means that we have received claims on 50% of the gas turbine deals we have written since the beginning of 2020. This shows us that even good-quality technical diligence may not identify all latent defects that cause a gas turbine to fail after closing. These machines are extremely complex and constructed from many thousands of highly engineered components, so this is perhaps not surprising. As a result, we will no longer write these risks without a condition of asset exclusion, in respect of the turbine, although this does mean that, where we do quote, we are able to do so at a materially lower price than before.

We have seen a lot of claims activity involving the waste recycling industry.

We have received a number of notifications involving waste recycling deals over the last couple of years. The subject matter of these notifications has been varied, but includes several environmental and permitting issues and a large claim relating to landfill tax — a form of environmental tax that is applied in some countries to increase the cost of landfill and is a type of tax that certain tax authorities, especially in the U.K., are pursuing very aggressively.

The real estate sector is one of the few sectors where we have not received a high-severity notification.

In last year's briefing we explained that, while frequent, the notifications that we have received involving the real estate sector have tended to be at the lower end of the severity spectrum and it is one of the few sectors where we have not received any high-severity notifications over the last few years. This remains the case. However, we do appear to be seeing more notifications involving low-level losses. A number of these have involved defects and deficiencies in the critical systems of the property (such as fire safety, lighting, heating, or air conditioning) despite the fact that most insurers tend to exclude these issues as a matter of course.

Emerging trends

Key insights

We are likely to see an **increase** in certain types of risks due to the current economic headwinds.

We expect to see more claims arising from **ESG-related** issues.

The impact of **high inflation** on the size of payouts is likely to vary depending on how the loss has been quantified.

The current macroeconomic and geopolitical environment poses numerous challenges for businesses. We do not expect this to result in a sudden surge of R&W claims, but it may lead to a reduction in deal volume.

The global economy is facing a number of significant headwinds in the form of ongoing supply chain issues, high inflation, and rising interest rates. This, in turn, is impacting consumer confidence, despite relatively high employment rates. The ongoing invasion of Ukraine is adding to the uncertainty and creates a number of significant sociopolitical risks, especially in Europe as winter approaches and concerns grow over a looming energy crisis. A long recession is being forecast in some parts of the world. This is all likely to weigh on the M&A industry in the coming months and increases the possibility of more instances of 'buyer's remorse', especially to the extent that the buyer considers that it may have bought at the top of the market or that the business it has acquired may not deliver the expected returns. However, if our experience from COVID-19 is anything to go by, we do not anticipate that this will lead to a sudden flood of R&W claims. This is because any buyer looking to bring a R&W claim will still need to demonstrate a breach of a covered warranty and resulting loss stemming from that breach and it is important to remember, in this context, that it does not necessarily follow that there has been a breach of warranty simply because a recent acquisition has turned out to be less profitable than expected or run into unexpected difficulties. This is especially the case since the warranties on which a buyer relies are given at a certain point in time and will speak to events that existed as at that date or a historic date; they don't generally cover future events or the future performance of the business (and if they do, then insurers will not cover them).

The more likely scenario is that we will see an increase in certain types of risks.

We anticipate that the current environment will, instead, lend itself to an increase in certain types of risks. We have identified a number of potential areas of concern below. This is by no means intended to be a comprehensive list, but it is indicative of where deal teams (and their advisors) might consider spending more time and energy during the due diligence process.

Undisclosed price increases

The inflationary pressures that have built up in the economy due to the supply chain issues created by COVID-19 and the disruption caused by the ongoing invasion of Ukraine are likely to lead to an extended period of repricing. We have already seen this manifest itself in various ways, including in energy and commodity prices. This could mean that we see more claims relating to undisclosed price changes going forward. The risk is particularly acute if the price change is imposed on the target late in the day, just before signing, as in this situation the right information might not get through to the right people in time for the issue to be disclosed, particularly in a big business. This increases the importance of a buyer taking active steps to understand the target's pricing arrangements with its suppliers and the contracting parties' ability to amend the terms of an agreement or to terminate it. We take additional comfort, in this situation, if we know that the buyer has also asked and been allowed to speak with key suppliers as this will usually flush out any issues that have not been picked up as part of the desktop due diligence.

Undisclosed customer incentives

We have seen a number of claims already this year relating to undisclosed customer incentives with the allegation being that these were either not properly reflected in the accounts or were given outside of the usual course of business. This is probably a by-product of the fact that customer incentives (which can range from rebates to discounts on future orders) were used as a means of retaining customers through the pandemic — a trend that is likely to continue given the current economic climate. As such, we expect this to become an area of increased focus for buyers and their advisors during the due diligence process.

Inventory issues

The supply chain issues that resulted from the pandemic and which have been exacerbated by the invasion of Ukraine are ongoing and continue to impact businesses and their customers. This is a particularly critical issue for businesses whose operations are heavily reliant on large amounts of diverse inventory, such as the automobile industry, where we have already seen shortages of key components result in forced production shutdowns. Furthermore, any bottlenecks in the supply chain that impact the speed with which inventory is able to move give rise to potential issues around stock deterioration and obsolescence. Therefore, understanding supply chain risks remains a crucial part of the due diligence process and a heightened area of concern for us at the underwriting stage.

Accounts receivable

We anticipate that we could see more claims in the coming months relating to accounts receivable issues, such as the setting of inadequate bad debt reserves and errors in terms of quantifying a company's total accounts receivable. Indeed, one of our largest paid claims to date resulted from an allegation that the target's management had knowingly underestimated the accounts receivable reserve, which caused more revenue to be recognized in the financial statements than management knew could be realistically collected. We are, therefore, paying much closer attention as part of our underwriting to the size of the accounts receivable figure in the accounts relative to the size of the balance sheet and asking more questions around this issue.

Fraud

There is a risk that the challenges presented by the current economic environment may provide target management with a greater incentive to cross the line in order to boost the top-line — either to present the target in the most flattering light ahead of a sale (which is a particular risk in the case of owner-managed businesses) or to avoid breaching financial covenants or future cash flow difficulties. This risk may be exacerbated if oversights and checks have become diluted due to remote working or multiple mergers, giving fraudsters an opportunity to find new ways of overriding existing internal controls. Indeed, we have already received several significant claims this year involving allegations of fraud. The types of issues we see differ in terms of the range of sophistication: from an allegation of a local manager passing off a set of forged accounts as the audited accounts to an allegation of a long-running and elaborate fraud around revenue recognition issues. This reinforces the need now more than ever for rigorous forensic scrutiny to be applied across the entire due diligence process, since identifying and investigating potential red flags is the best way to avoid later complications.

Cyber

The invasion of Ukraine and the resulting isolation of Russia has moved cyber even further up the risk agenda as concerns grow about the possibility of state-sponsored attacks against Western businesses. These concerns are compounded by fears that many businesses do not have adequate cyber insurance cover in place to deal with the multiple losses that can flow from a serious incident due to an ever-expanding data universe and the evolving regulations surrounding sensitive data. Indeed, we received a notification within the last 12 months where the estimated loss suffered by the target is significantly higher than the $1M limit provided by its underlying cyber insurance cover. We, and many other M&A insurers, are increasingly focused, therefore, on managing cyber risk, in many cases by excluding cover for cyber-related issues altogether and, in other cases, limiting it by only covering specific cyber-related warranties that we are satisfied have been properly diligenced (including technical testing of the adequacy of the target's cybersecurity systems) and sublimiting our exposure.

Third-party claims

As discussed in Section 5, we have seen a significant increase in third-party claims in the last 12 months, especially in the Americas region. We do not expect to see any let-up in this trend in the near term, particularly given that, during times of economic uncertainty, litigation is seen almost as a means of raising revenue. This is likely to necessitate an increased emphasis on the identification of circumstances that could give rise to future disputes (as opposed to ongoing and/or threatened disputes) during the due diligence process.

ESG issues

We expect to see more claims arising from ESG-related issues, reflecting the increased importance of this area and the reality that buyers are increasingly expecting sellers to give specific warranties on these issues. Indeed, for many industries, separate ESG due diligence reports have become the new norm in sales processes and this is likely to become standard market practice for most M&A deals within the next couple of years. The raft of associated legislation that has been or is due to be implemented will create more pitfalls for businesses to navigate and may also necessitate considerable expense to the extent that these require the adoption of new ways of working. A business that does not keep up with these changes or fails to live up to its own ESG credentials (or ensure that its suppliers live up to theirs) will be susceptible to enforcement action or litigation, including from increasingly active action groups especially as the rules governing disclosure linked to climate change develop. As a result, we expect ESG risks to become a much more significant area of focus for insurers during underwriting, especially given the possibility of a compliance lag as companies try to get to grips with a raft of new and complex legislation and rules.

We might see some higher payouts in the short term due to inflation where claims are being quantified on a dollar-for-dollar basis.

The impact of the current inflationary environment on claims that are quantified by reference to the dollar-for-dollar loss flowing from the breach of warranty (i.e., on an indemnity basis) is likely to be fact specific depending on the nature of the underlying issue.

In some cases, we can expect to see higher payouts in the immediate future. This is especially the case for claims that involve an expenditure of some description by way of remedial action. Take, for example, a condition of asset claim where the resulting loss is quantified as being the cost of repair (including labor) and any replacement parts. These costs are going to be higher now than they were this time last year because of inflation. Indeed, we are already seeing this issue impacting some of our claims. In the most extreme example, we have seen the quantum of a claim almost double in the space of six months due to extreme price volatility.

However, we do not expect every claim that is quantified on this basis to be affected in this way and, in many instances, the impact of inflation is likely to be much more muted. This will include many third-party claims where we often find that the resulting R&W claim is quantified on a dollar-for-dollar basis. Take, for example, a wage and hour lawsuit where the resulting loss is quantified as being the amount of any damages award or settlement plus any costs incurred in defending the claim. It is unlikely that any such award or settlement will be much higher now to the extent that a significant part of the claim is based on the historic failure to pay wages in the period before inflation took hold. It is only the costs incurred in defending the lawsuit that are likely to be higher as law firms look to raise their hourly billing rates.

However, this is likely to be counterbalanced in the long term by smaller payouts in some cases where claims are being quantified on a diminution of value basis.

The reality is, however, that many of the claims we receive are quantified by reference to the difference between the market value of the target as warranted and the market value of the target with the warranty breached (i.e., on a diminution in value basis). In these cases, the difference in value is assessed as at the date of the breach of warranty meaning that, for historic deals, the inflation that we are seeing now is simply not going to be a relevant factor when it comes to the loss calculation.

However, to the extent that the claim in question relates to an existing or future deal, then the current inflationary environment may actually result in a lower payout. Take, for example, a claim where the insured is seeking to apply an EBITDA multiple to arrive at its loss calculation on the basis that the breach of warranty has a negative impact on the target's recurring EBITDA from which the purchase price may have been derived. In these cases, assuming that it is appropriate to apply an EBITDA multiple (which is not always the case), the size of the multiple can obviously have a significant impact on the size of the payout. Over the last few years, the size of multiples has remained high, reflecting what has been very much a seller's market. However, pricing is likely to become a greater point of deal-making contention as higher interest rates (which increase the costs of raising finance) and higher inflation (which impacts margins) result in increased pressure on returns on investments. This, in turn, is likely to impact the price that buyers are willing to pay, resulting in a reduction in the size of multiples, especially in certain sectors (e.g., technology). The impact of this will not be felt straight away as the claims that are coming through now are in connection with deals that signed in the last few years. However, in time, we may see smaller claims (and, therefore, payouts) on some current or future deals compared to what we might have seen had the same deal occurred before inflation took hold and valuations were higher.

Section 8

Claims handling

Key insights

The most common cause for delay in the claims process is **lack of supporting** information.

The more **engaged** the insured can be during the investigation process the better.

A **collaborative approach** is more likely to foster the best results.

We often see the same problem areas during the claims investigation process.

In last year's claims briefing we included a section on the claims handling process which offered some practical tips on things like when to notify a claim, what should be included in the claim notice, and what to expect in terms of the investigation stage.

In this year's briefing we focus on some of the common problem areas that arise from time to time during the claims process and include some suggestions in terms of how to best navigate them.

Failing to include the broker from the outset

Many M&A broking teams now have experienced claims advocates sitting within the business who can provide invaluable help to their insureds on the dos and don'ts of making a claim. In general, we find that most insureds are now involving their broker in the claims process from the outset as opposed to only looping them in later (perhaps when there is a problem). We find that this usually works better as the broker can bring a huge amount of experience to the process and have an important role to play acting as a conduit between the parties. This applies even when legal advisors have been appointed by the insured, as our experience is that the involvement of a broker can help to ensure that the correct balance is achieved between collaboration and advocacy.

Lack of understanding about how the claims process works

M&A claims need to be investigated properly and this involves more than just kicking the tires. At the outset of any claim, there is usually a significant knowledge gap between the parties. The insured owns and understands the business and it has usually spent time investigating the nature and impact of the potential breach(es) before submitting a notification. The insurer is starting from scratch. That knowledge gap takes time to close and we still find that there are often unrealistic expectations in terms of how long that can take. It is unhelpful, perhaps, that many wordings now state that insurers will provide their coverage response within a certain number of business days (sometimes as few as 20) of receiving the claim notice or receiving the additional information that it has requested to assess the claim. It is absolutely right, of course, that insurers should be trying to reach a coverage decision as quickly as possible, but there are going to be some claims where, given their complexity, meeting such a deadline is going to be challenging — investigations can be wide ranging and involve extensive document requests, interviews, expert input and are, in many cases, an evolving process. This is why it is critical that there is an open and transparent dialogue between the parties about the status of investigations and timings from the outset.

We do not see a lot of value in publishing statistics on how long it takes to resolve a claim since, ultimately, this depends on many factors such as the complexity of the underlying issues, the quality of the information provided to insurers, and the reasonableness of the positions taken (by both sides) — each claim is different. However, our sense, based on our own experiences and anecdotal evidence, is that the claims process is getting quicker as the product becomes more established and claims handlers (and their advisors) more experienced. Inevitably, there is some room for improvement. The general feedback that we hear from brokers and more regular users of the product is that they would like to see more focused requests for further information and documents; issues or concerns being identified and addressed as soon as possible; quicker response times; and claims handlers that make themselves available to speak and do not let their lawyers do the claims handling. These are all of the things that we measure ourselves on when handling a claim and, as a result, we have had some real success stories. For example, last year, we agreed to a $19M payout within about seven weeks of receiving the claim notice (see Section 9 for further details).

Not updating insurers during the investigation phase

We are finding that, for the most part, insureds are getting better at putting insurers on notice of an issue soon after it has been identified. However, we still get situations where the first correspondence that we receive is a lengthy and very detailed claim notice, perhaps with expert reports attached, indicating that the insured has spent a lot of time carrying out extensive investigations before submitting the notification. The problem with this approach is that it may not only constitute a breach of the insured's notification obligations under the policy, but it can also be counterproductive, since it risks exacerbating the knowledge gap between the parties. The better approach is to notify insurers immediately upon discovery of the issue(s) and to keep insurers updated during the investigation phase. This helps to reduce the knowledge gap and gives insurers the chance to understand the issue(s) better at an earlier stage and ask some initial questions, potentially resulting in a smoother claims process overall. In addition, looping insurers in at the outset increases the options available in terms of next steps. Let's say, for example, that an insured thinks that some of the properties that it has acquired may not comply with local health and safety laws. It plans to appoint an expert to carry out an inspection to opine on the issue and quantify the remedial costs required to fix the issues. If insurers are forewarned about this then they could appoint their own expert to carry out an inspection at the same time. Alternatively, it might be that the parties could agree to appoint a joint expert. We suggested this approach recently in respect of a notification involving a potential breach of International Financial Reporting Standards (IFRS) in the context of the preparation of a set of accounts. Either option is likely to save time, reduce the potential scope for disagreement, and could lead to an earlier resolution of the claim.

Failure to provide adequate supporting information

The most common cause for delay in the claims process is lack of supporting information. It is important, in this context, for an insured to anticipate which documents insurers will need to assess the claim and to include all relevant documentation at the outset. The more that can be provided the better, as this allows insurers to tailor any requests for further information or documents accordingly. For example, where a claim has been quantified on a diminution in value basis, it is standard practice for insurers to request to see the original valuation model, any comparator company analysis, and any associated advisor reports and investor committee papers. It is not uncommon, however, for this request to be refused (at least initially) on the basis that the information is confidential and/or commercially sensitive. This is not the most helpful position to take since, while this information does not necessarily prescribe the way in which the loss must be calculated, it does provide a useful starting point in that it will support how the original purchase price was calculated and how this might have changed in light of new information. Therefore, providing it to insurers at the outset can save a significant amount of time and result in a much quicker quantum assessment. We discuss a good example of this in Section 9 below.

Adoption of unrealistic positions at the outset (by both sides)

It goes without saying that an insured is entitled to expect that its insurer will not adopt an unrealistic position in response to its claim under the policy. However, the reverse is also true: an insurer is entitled to expect that its insured will not make (and then maintain) an unrealistic claim under the policy in the first place and will provide them with sufficient information and time to consider policy coverage. The failure to adhere to these basic principles by either party can cause frustrations and result in delays.

From an insured's perspective this means:

- Considering at the outset whether it has a valid claim in consultation with its broker: casting a critical eye over the potential claim before it is presented to insurers can help to identify potential issues and ensures that the position adopted at the outset is reasonable.
- Engaging with the insurer's questions and requests: the insurer will be working hard to get its head around the claim and to bottom out any issues as quickly as possible, but it will need the insured's help with this and so the more engaged the insured can be during this process the better.
- Taking a realistic approach to quantum: an insured should avoid quantifying its claim on a dollar-for-dollar basis if that isn't the correct measure of damages, and it should also resist the temptation to calculate its loss by reference to a transaction multiple where it isn't appropriate to do so.
- Putting the correct amount of pressure on the insurer to arrive at a coverage decision on a timely basis: adopting an overly aggressive position at the outset is unlikely to foster a collaborative approach and actually increases the risk of a dispute, especially if insurers have not been provided with the information that they reasonably need to make a coverage assessment.

Section 9

Paid claims

Key insights

We recently made a **$19M** payment within seven weeks from receipt of the claim notice.

We have paid (or reserved) **75%** of the initial amount claimed in **56%** cases.

Our two largest payments in the last 12 months both involved **errors** in the management accounts.

We have paid out **more** in the last 12 months on deals involving corporate buyers.

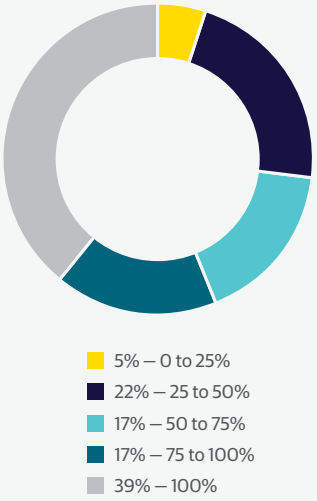
We have paid a number of substantial claims over the last 12 months.

The largest payment that we were involved in over the last 12 months was for $55M (of which our share was approximately $4.7M). The claim involved numerous financial statements-related issues and was resolved within about 20 months. We had an excess position on a quota share basis and paid out 62.5% of our total participation on the layer in question.

The largest single payment that we made in the last 12 months was for $19M. This payment was particularly notable for being agreed in under seven weeks from receipt of the claim notice. This is unusually quick for a payment of this size, but there were some unique characteristics to the claim that made it possible: it was a single-issue claim; there was a very clear breach of various financial statement representations; and the insured was extremely proactive in terms of providing us with the material that we needed to assess quantum (e.g., it provided us with a copy of its valuation model alongside the claim notice). We were also assisted by the way we are set up to handle claims, with our own dedicated claims function, and because, unlike many managing general agents (MGAs), we did not have to consult with lots of different capital providers before resolving to pay the claim. Our insured reported being "pleased at how professionally and expeditiously Liberty handled our insurance claim — the process was collaborative and cordial from the outset of the claim to its final resolution." This payment demonstrates how an open and collaborative approach maximizes the chances of valid claims being verified and paid quickly and that, with the right claim and the right information, we can move fast.

Figure 20

Payment or reserve as a % of initial amount claimed



Data based on paid R&W claims as at August 31, 2022 relating to R&W risks bound from January 1, 2019 onwards

We have paid or reserved the full amount claimed in 39% of cases (see Figure 20).

A closer look at our paid and reserved claims involving risks written from 2019 onwards reveals that we have paid (or reserved):

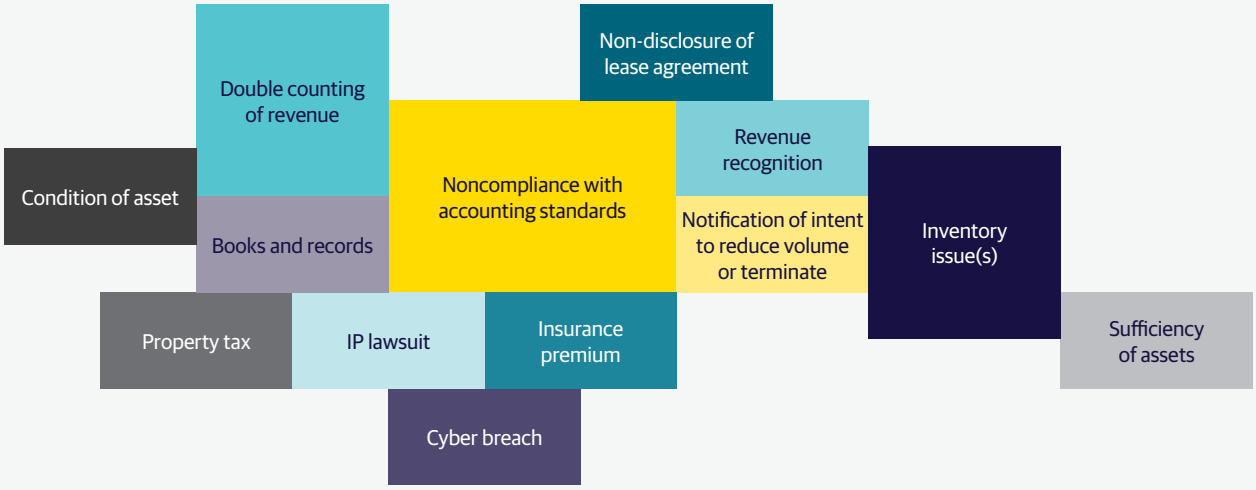
100% of the initial amount claimed in **39%** of cases	More than **50%** of the initial amount claimed in **73%** of cases	Less than **50%** of the initial amount claimed in **27%** of cases

These statistics are good news for both us and our insureds. From our perspective, they are reassuring because they show that our insureds are, for the most part, being realistic when it comes to the claims that they are pursuing and how they are quantifying these: we have paid (or reserved) less than 25% of the initial amount claimed in only 5% of cases. From our insureds' perspective, they provide comfort that we are paying claims — in many cases 100% of the amount being claimed — demonstrating that the product is working.

Our most recent paid and reserved claims have involved a variety of issues, but a significant number relate to errors in the management accounts (see Figure 21).

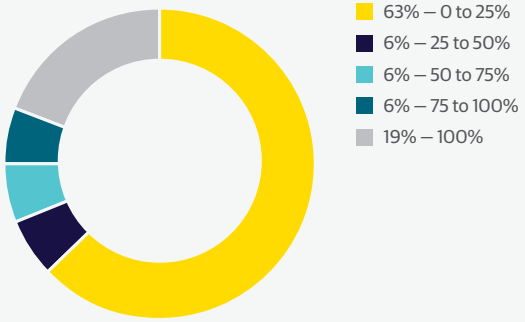
The single biggest driver of our paid and reserved claims (both in terms of number and value) continues to be accounting and financial issues. We are finding that an increasing number of these claims involve errors in the management accounts (as opposed to in the audited accounts). Indeed, our two largest paid claims from the last 12 months both fell into this category. This suggests that increased scrutiny needs to be applied to the management accounts as part of the due diligence process. This is particularly the case where the sale and purchase agreement (SPA) includes very extensive management account warranties or there has been a long gap since the last audit and significant reliance is being placed by the buyer on many months' worth of management accounts for the purposes of valuing the business. Historically, insurers have taken comfort from the fact that the management accounts are typically warranted to a lower standard than the audit accounts in this scenario. However, as insurers see more claims involving management accounts issues, the more likely it is that they will look at these types of deals as being higher risk and reflect this in things like pricing.

Figure 21 **Paid or reserved claims by underlying cause of loss**



Data based on paid or reserved R&W claims as at August, 31 2022 relating to R&W risks bound from January, 1 2019 onwards

Figure 22 **Payment as a % of total insurance limit**



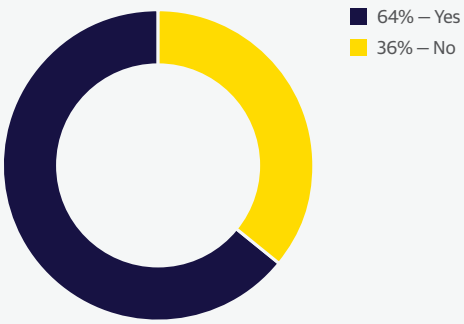
Data based on paid R&W claims as at September 30, 2022 relating to R&W risks bound from January 1, 2019 onwards

The majority of our paid claims have involved payments for less than 25% of the policy limit, but 19% have been for the full policy limit (see Figure 22).

Our data shows that 63% of the payments that we have made over the last few years have been for less than 25% of the total insurance limit purchased. It is worth noting, however, that these payments can still involve large amounts depending on the size of the policy limit purchased even though they may be relatively small by reference to the deal value. Of course, where the product really comes into its own is when there has been a large loss by reference to the deal value. This type of situation does occur from time to time albeit almost invariably on smaller deals with an EV of under $250M which typically involve smaller limits (see Section 3) – as reflected in the fact that 19% of our payments over the last few years have been for the full policy limit with all of these being for $5M or less. In each case, the insured was left with an uninsured loss, but probably ended up in a better position because of its decision to purchase R&W cover (since the policy limit purchased will often be higher than the liability cap that the seller would have been prepared to agree to if the deal were not insured).

Figure 23

Proportion of payments where loss has been calculated by reference to a transaction multiple



Data based on paid R&W claims as at August 31, 2022 relating to R&W risks bound from January 1, 2019 onwards

The majority of our paid claims involve a loss that has been calculated by reference to a transaction multiple (see Figure 23).

Our data also shows that 64% of the claims that we have paid over the last few years involve a loss that has been calculated by reference to an EBITDA multiple. This is not surprising: a loss that is calculated by reference to a multiple is, after all, more likely to exceed the retention than a loss that is not. It is for this reason that we will always look very carefully at a claim that has been quantified on this basis. This will invariably involve us engaging an expert to conduct a detailed investigation into whether this is an appropriate approach in the context of that specific claim. An investigation of this nature can take time and require the exchange of a significant amount of information, but our data demonstrates that we can (and do) get comfortable paying claims on this basis where it is justified.

We have paid several large claims in the last 12 months in connection with deals involving corporate buyers.

We have found that deals involving corporate buyers have accounted for three out of our five largest paid claims in the last 12 months. It could be argued that this is indicative of the fact that a corporate buyer that transacts on an infrequent (or even a one-off) basis is perhaps not as well placed to know where to look for problems based on their experiences from previous deals compared to an institutional buyer that transacts on a much more regular basis. However, the limited nature of the data means that it is not possible to draw any clear conclusions on this point. What the data does demonstrate, though, is that there is a significant benefit to corporate buyers in opting to purchase R&W cover as opposed to opting to proceed uninsured as, in each of these cases, the product stepped in to absorb what would have otherwise resulted in a significant loss, meaning that the target didn't have to divert funds away from the business and could use these instead to fund future growth opportunities.

Conclusion

"We at Liberty GTS are well placed to deal with the challenges that flow from an increase in claims activity and to leverage our extensive experience and knowledge to provide a more tailored service to our insureds, both at the point of underwriting and in the event of a claim. The work that we do around our annual claims briefing is a key part of this and we hope that the insights it contains can encourage wider discussion about claims and their importance to the continued success of this product. Please do not hesitate to reach out to us if you would like to discuss any of the issues covered in our briefing or have any questions about the claims process."

Simon Radcliffe
Global Head of Liberty GTS Claims

Luke Marcoux
Head of Liberty GTS Claims for the Americas

The recent boom in M&A activity has fueled an unprecedented demand for M&A insurance in the short term. However, in the long term, this is likely to result in a significant increase in claims activity, which is likely to shape the M&A insurance market in a number of different ways over the next few years.

1 We expect to see a notable shift in the mindset of insureds in terms of what is important to them when selecting their insurance carrier, with a much larger emphasis on claims service. A prime concern will be how insurers are set up to handle M&A claims and whether they will be dealt with by an experienced and specialist in-house claims team that has full control over their processes and decisions. This is only to be expected: M&A insurers compete on price, they compete on coverage, they compete on deal execution, but they should also compete on the quality of their claims function too.

2 We are likely to see a more streamlined and efficient claims process as the product becomes more established and insurers learn lessons from their past experiences and start to tailor their approach to handling M&A claims accordingly. This ought to result in a smoother claims experience for insureds and increase their confidence in the product and how it responds in a claims scenario.

3 We are likely to see a more data-driven approach to underwriting as new claims trends emerge fueled by the challenges presented by the current macroeconomic and geopolitical environment. This data will undoubtedly shape future underwriting decisions, leading to changes in appetite for some deals and some jurisdictions. It may also lead to shifts in both pricing and coverage. It is important that deal teams adapt accordingly and focus more attention on the areas where M&A insurers are seeing claims or else assume more of the risk themselves.

4 Related to the above point, there is an opportunity for M&A insurers, like Liberty GTS, who have sufficient data and an effective claims feedback loop to provide more tailored coverage to their insureds taking into account the issues and areas where they are not seeing claims, both at a sectorial and jurisdictional level.

Special thanks for the development of this briefing are attributed to Hannah Wood, Head of Marketing and Business Development for Liberty GTS, and Sophia Farrant, Marketing Assistant for Liberty GTS.

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