2024

Claims briefing

Exclusive insights guiding global decision making

Liberty Global Transaction Solutions™

Contents

Claims briefing 2024

Liberty GTS is one of the largest and most experienced M&A insurance teams in the market, with a team of more than 90 specialists operating in 10 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, now in its fifth year, which is based on data drawn from almost 525 notifications received since 2019.

Rowan Bamford
President of Liberty GTS

"The last 24 months have been challenging for anyone whose living is based on the volume of M&A transactions. Inflation pressures and high interest rates in most global economies have reduced the viability of many private equity plays, and this has impacted the number of deals everywhere, especially at the larger end of the market. While this was the case before the beginning of 2023, what was not understood was how long these conditions would linger. M&A transaction volumes may finally be starting to pick up again, but they are still significantly down on 2021 levels.

Curiously, despite these challenging market conditions, we have still seen a number of new entrants launch into the M&A insurance sector and several existing carriers expand their geographical footprint. These new entrants have attempted to win market share by cutting rates and broadening coverage. They were followed by many of the monoline managing general agents (MGAs) that operate in this space who, without any other lines of business to fall back on, risked being starved of income if they didn't compete. For the rest, it was a question of showing strategic patience, focusing on deals where they had a competitive advantage and avoiding trying to win deals at any cost by either cutting pricing or expanding coverage.

This underwriting dynamic was, of course, never going to be sustainable for long and we expect that rates — having already bottomed out following the return of more normal dealmaking conditions — will now start to increase and that coverage enhancements will begin to be pared back again or become more expensive to more accurately reflect the risk.

In the meantime, we at Liberty GTS will continue to look to focus on differentiating ourselves from our competitors in other ways, including via our proven track record of paying valid claims, which this year included a €46M payment — our largest ever. This is because, in our experience, it is a smooth claims process that an insured ends up valuing the most when it is faced with a deal that has gone wrong and the prospect of a significant and unexpected loss. That's why savvy dealmakers need to buy transactional risk insurance from trusted partners who are set up to deliver an exceptional claims service and are in the market for the long haul. Choose wisely."

Notification trends

1 R&W insurance is widely known as warranty and indemnity insurance (W&I) outside of the U.S.

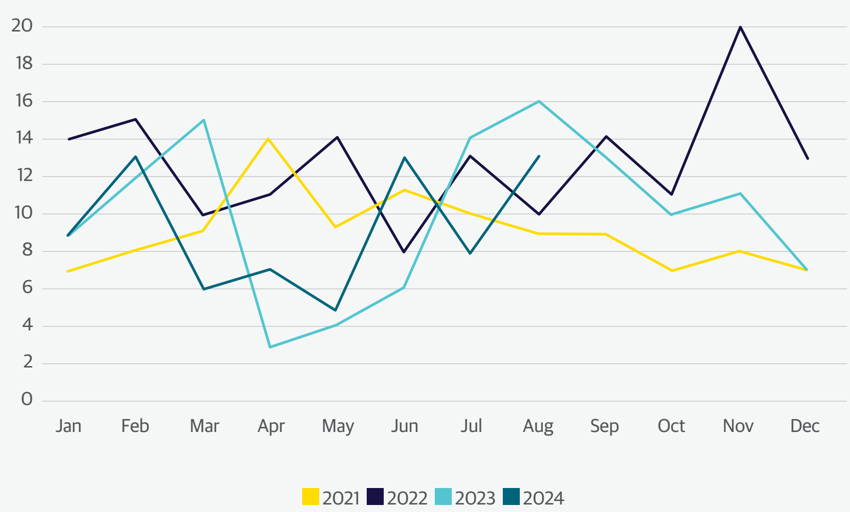
Our global R&W notification count fell in 2023 [see Figure 1].

Overall, we received 120 representations and warranties (R&W)[1] notifications across all of our regions in 2023: a year-on-year decrease of approximately 21%. This decline is down to the drop-off in dealmaking from Q3 2022 onwards and is a sign that the heightened notification activity that we have seen over the last few years following the M&A boom at the end of 2020 and throughout 2021 is now behind us.

Nevertheless, it has still been a very busy year for our claims team given the size of our existing claims inventory, which has grown considerably over the last few years. Whilst some M&A insurers have struggled to keep up with the demands of servicing and resolving these claims, others — like Liberty GTS — that have invested in their claims function by building out a specialist in-house team dedicated entirely to handling M&A insurance claims, have been able to continue to deliver the high standards of service and care that our clients and brokers expect.

As we move into 2024, our monthly notification count has continued to fall: we only received 53 R&W notifications in the first six months of this year compared to 71 in the final six months of last year. However, we do not expect that our notification count will drop much further from its current levels. This is because our policy count has started to pick up again, driven by an increase in deal activity, particularly at the lower to mid-end of the market. It will, of course, take a while for this to feed into an increase in claims activity, but our current expectation is that our notification count will pick up again toward the end of the year and into next.

Figure 1 **Notification count — global view**



Data based on R&W notifications received between January 1, 2021 and August 31, 2024

Our Americas region saw the smallest decline in R&W notification count in 2023 and was the only region to register an increase in notifications in Q1 2024 [see Figure 2a].

We received 76 R&W notifications across the Americas region in 2023: a year-on-year decrease of approximately 10%. This was largely down to a quiet end to the year with only 16 notifications received in Q4 2023 (compared to 29 during the same quarter in 2022). However, we are already seeing signs that notification activity is starting to tick up again. Indeed, the Americas was the only region to register an increase in notifications in Q1 2024 vs. the prior quarter, with 23 notifications received. In addition, the total number of notifications received through to the end of August (52) is trending slightly ahead of last year for the same period (50).

Our EMEA region saw a notable drop-off in R&W notifications in 2023 [see Figure 2b].

We received 35 R&W notifications across the EMEA region in 2023: a year-on-year decrease of approximately 28%. However, this was still above the figure (of 32) for 2021, which shows that claims activity is still high compared to historic standards. It has been a very quiet start to the year with only five notifications received in Q1 2024, but claims activity has picked up since and we expect this to continue as the year progresses. Indeed, in August, we received the highest number of notifications in one month since the turn of the year.

Our APAC region saw the lowest number of R&W notifications in three years [see Figure 2c].

We only received 9 R&W notifications across the APAC region in 2023. This represented a sizeable decrease on the 19 notifications that we received in 2022. It is the lowest number of notifications that we have received in this region in three years. This year has been another quiet year so far with only three notifications received through to the end of August.

Figure 2a Notification count — Americas view

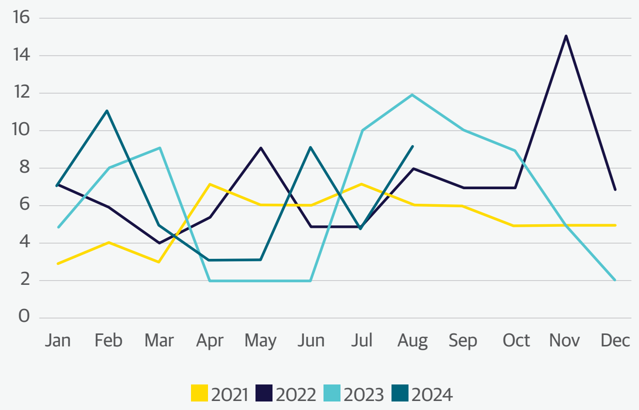


Figure 2b Notification count — EMEA view

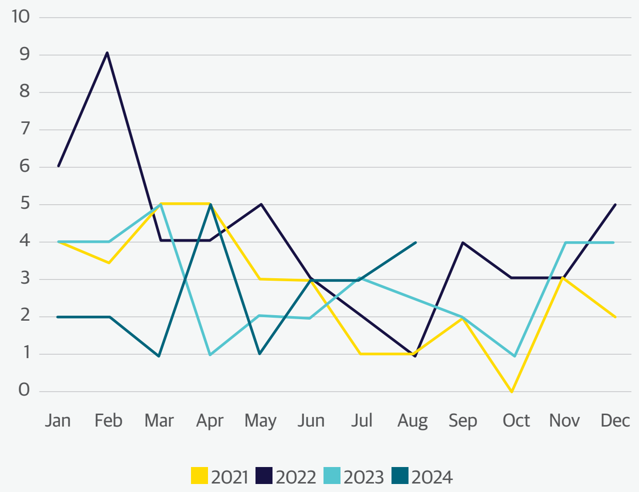
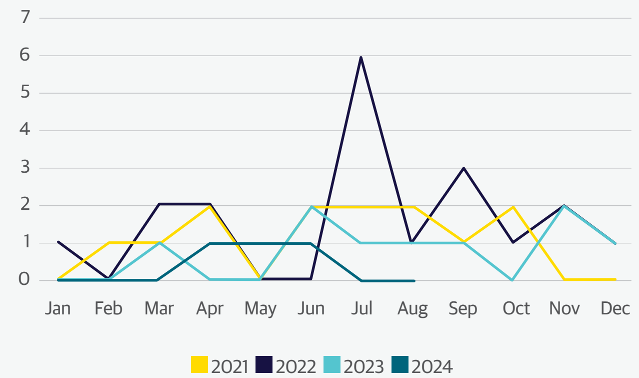


Figure 2c Notification count — APAC view



Data based on R&W notifications received between January 1, 2021 and August 31, 2024

Our data shows some variance in notification frequency between different YOAs

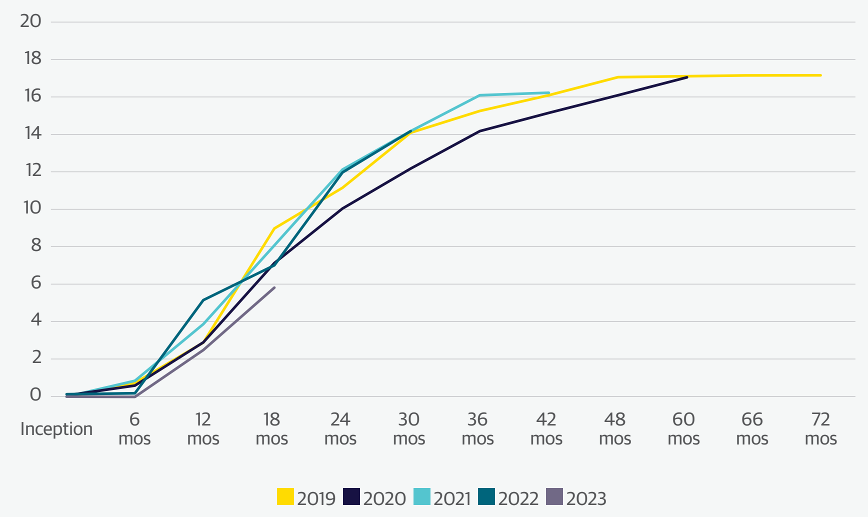
[see Figures 3 and 4a to 4c].

Our data shows that we have received a notification on approximately 18% of our 2019 year of account (YOA) R&W risks to date. These policies are now all "off-risk" for a claim in respect of the general warranties. In the last 18 months, we have received just four notifications involving 2019 YOA risks, all of which were on deals where we had already seen a prior notification. These notifications all involved tax issues, but none involved significant amounts.

We have seen notification frequency fall back slightly on the 2020 YOA vs. 2019 YOA, although there are some regional divergences in our data. In the EMEA region, notification frequency has been closely tracking the data for the prior year and currently stands at 21%. In both the APAC region and the Americas region, notification frequency has been running significantly behind the 2019 YOA when compared to the equivalent period in its lifecycle. However, in the Americas region, the gap has closed over the last few quarters due to an uptick in the number of notifications that we have received in the final months of the general warranty period in this region.

As noted in last year's claims briefing, we have seen a notable increase in notification frequency on the 2021 YOA vs. the 2020 YOA. The increase has been most pronounced in the EMEA and APAC regions, with notification frequency in both tracking well ahead of prior years. The reasons for this are potentially varied, but one explanation is that it could be a by-product of the frenzied state of the M&A market in 2021, when many deals were completed under compressed timeframes. It is possible that, in some instances, due diligence was compromised in the rush to get deals done and was not as extensive or as probing as it might otherwise have been, resulting in more issues — including some big issues — being missed. It may also be a sign of increased instances of "buyer's remorse" from buyers who bought at the top of the market in 2021. Of course, any such 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. In this context, it is important to remember 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. However, these conditions might provide a buyer with the incentive to make a concerted effort to look for a R&W claim in an attempt to recoup some of the lost value in circumstances where they might not otherwise have done.

Figure 3 **Notification frequency by YOA — global view**



Data based on R&W notifications received between January 1, 2019 and June 30, 2024

Our data indicates that notification frequency has dropped again on the 2022 YOA and 2023 YOA. The drop-off has been most pronounced in EMEA, with notification frequency on the 2022 YOA and 2023 YOA currently running 3% below the 2021 YOA when compared to the equivalent point in its lifecycle. This could be a reflection of the calmer deal environment in 2022 and 2023, with deals taking longer to complete and buyers taking advantage of the less competitive landscape to scrutinize businesses more closely.

The one outlier is the Americas region, which has actually seen a notable increase in notification frequency on the 2022 YOA vs. 2021 YOA. However, this is not that surprising as our 2022 YOA risks are actually more mature compared to what we would usually expect because — in a reverse of the normal way of things — a greater number were written toward the front end of the year when deal flow was still strong vs. the back end of the year when deal flow was much slower.

Figure 4a **Notification frequency by YOA — Americas view**

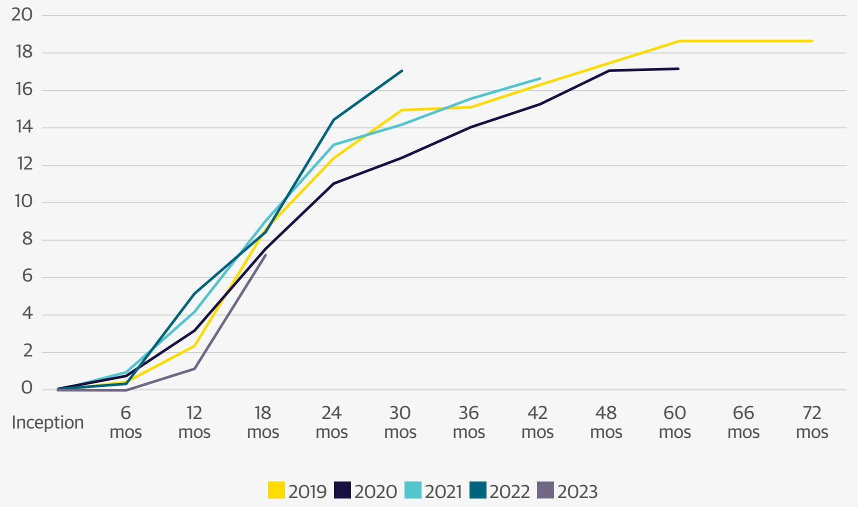
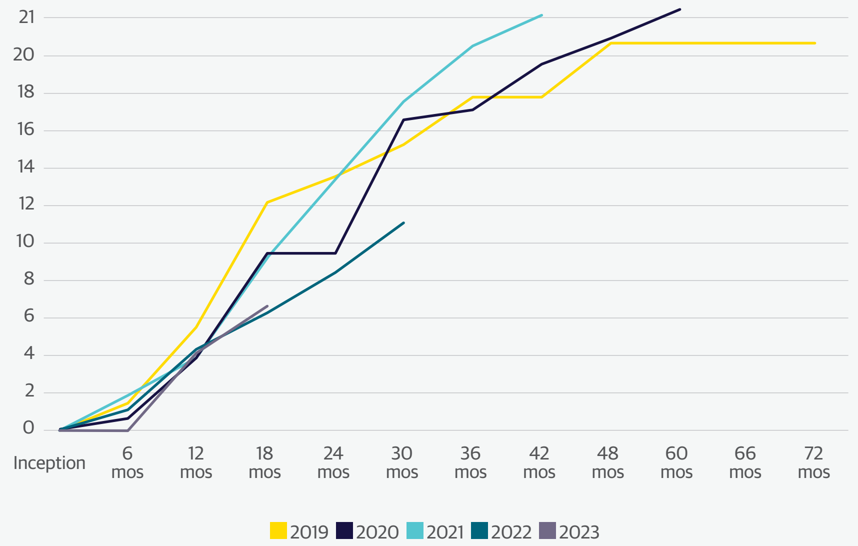


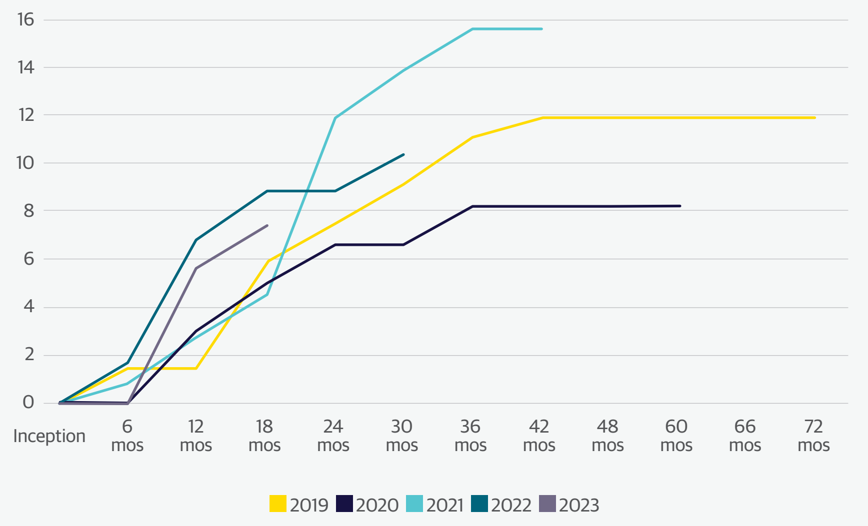
Figure 4b **Notification frequency by YOA — EMEA view**



Data based on R&W notifications received between January 1, 2019 and June 30, 2024

Figure 4c

Notification frequency by YOA — APAC view



Data based on R&W notifications received between January 1, 2019 and June 30, 2024

The proportion of R&W notifications involving a (potential) loss which is in excess of the retention and is resulting in paid or reserved claims has remained fairly consistent.

The proportion of notifications that we receive involving a (potential) loss that exceeds the retention is holding fairly steady, ranging between about 30% and 35% over the last few years. However, with retentions falling over the last 36 months, it might be that we see this figure increase over the coming year(s). Of course, not all of these notifications result in a claim being made under our policy. In some cases, a claim is never made, perhaps because the insured is able to mitigate the (potential) loss. In other cases, we might have an excess position and the (potential) loss falls below our attachment point.

We have made a payment or reserved a claim on 2.5% of the risks that we wrote on the 2019 YOA with approximately 13.6% of the notifications that we have received on this YOA resulting in a payment or reserve to date. The number is showing signs of increasing slightly, but not significantly, as it currently stands at 14.4% for the 2020 YOA and 14.7% for the 2021 YOA, which are both less mature YOAs and where we have a number of ongoing which are still at an early stage which we have yet to pay or reserve.

Timing of notifications

A high proportion of R&W notifications involving an alleged breach of a general warranty are received within 12 months of closing [see Figure 5].

The general warranty period has now expired on all of the R&W policies that we issued in 2019 and 2020. We can, therefore, use the notification data we have for these policies to provide insights into the timing of notifications involving an alleged breach of a general warranty.

The data shows that a high proportion of our notifications — 49% — were received in the insured's first year of owning the target business (Year 1). We suspect that the heavy weighting to Year 1 is partly because some regular users of the product, assisted by their deal lawyers, are now carrying out a post-closing review of the target business as a matter of course. This is in part informed by previous claims experience, with the specific objective of quickly identifying potential breaches in respect of which they can make a claim.

There is then a steady decline in notification activity from this point onwards, with 27% of notifications coming in the second year of ownership (Year 2) and only 14% coming in the third year of ownership (Year 3).

Most notifications involving a (potential) loss of $1m+ are received within 24 months of closing, but we still see some significant issues being notified in Year 3 [see Figure 6].

We can also use this data to provide insights into the timing of our more severe notifications involving an alleged breach of a general warranty (i.e., any notification where the (potential) loss is more than $1M in excess of the retention).

Figure 5 Gap (in months) between closing and non-tax notifications

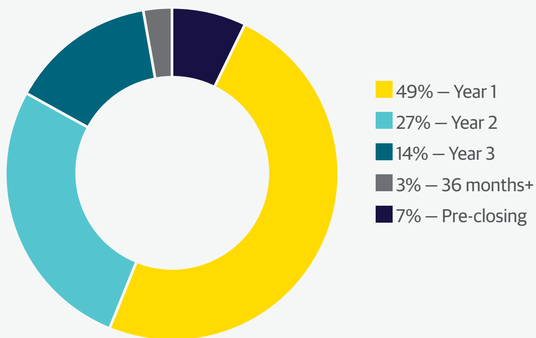
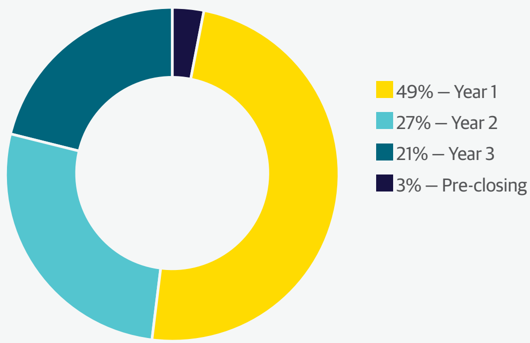


Figure 6 Gap (in months) between closing and non-tax notifications involving (potential) loss of $1M+



Data based on non-tax R&W notifications received on 2019 and 2020 YOA

This data shows that 49% of these notifications were received in Year 1. This isn't overly surprising given our previous comments about post-closing reviews becoming more common, coupled with the fact that it stands to reason that a more significant issue is more likely to come to light sooner than a less significant issue.

A further 27% of our more severe notifications were received in Year 2, with approximately half of these involving accounting and financial issues. This is probably because the results of the first audit under new ownership will normally become available shortly before or during this window, which we find is a common trigger for a notification.

Interestingly, 21% of our more severe notifications were received in Year 3, which is an outsized amount bearing in mind that Year 3 notifications only accounted for 14% of our total notifications across these YOAs (see above). We received a number of these notifications in the last few months of the general warranty period, including one where the claimed amount is for more than $100M. This is a trend that we have seen repeated on subsequent YOAs. We find that notifications like this are much more common in the Americas which suggests that, in this region at least, insureds (and their lawyers) are more systematic about assessing whether they have a policy claim post-acquisition and are more likely to have processes in place to do this, especially toward the beginning and end of the policy period. However, this also presents some challenges for insurers, particularly where notifications received late on in the policy period are not properly particularized or quantified, making it difficult to assess their merit and seriousness. The solution might be to require policyholders to fully particularize their claim by the end of the policy period or soon afterwards. This would still, of course, be more generous than the notice provisions in most purchase agreements, which typically require claims to be fully particularized within a matter of months after discovery.

The fact that we are seeing some significant issues being notified in Year 3 illustrates that a R&W policy providing cover for warranty breaches for longer periods of time compared to an uninsured deal continues to be a key advantage, where the seller would usually only be prepared to stand behind the warranties for a maximum of 24 months (sometimes less). However, with more large claims being received in Year 3, we expect that more M&A insurers are likely to scrutinize more carefully how they are pricing for extending cover beyond 24 months. In some regions, such as EMEA, this could include reverting to offering this only as a coverage enhancement for which an additional premium is payable as was the case historically.

We are seeing an increase in the number of instances of notifications during the extended reporting period of the policy [see Figure 5].

Each year, we see a small number of notifications involving an alleged breach of a general warranty being notified during the extended reporting period which is incorporated into most R&W policies in the Americas. The extended reporting period provides an insured with a short window — usually between four and 12 weeks — to make a notification even after the policy period has expired. It is intended to cater for issues that only became known to the insured in the days before expiry of the policy period and which might require more investigating before there is enough information to make a notification.

However, in some cases, we have found that the issues being notified during the extended reporting period have been known to the insured for a long time or involve a laundry list of items with little or no detail around them. This isn't consistent with the intended purpose of these clauses, and we expect that some M&A insurers may respond to this development by tightening up their wordings in order to preclude an insured from relying on the extended reporting provision if it learned about the issue in question more than a few weeks before expiry of the policy period or, perhaps, reducing the extended reporting period to a couple of weeks.

We are seeing some R&W insurers adopting a reckless approach to extending the policy period for general warranties.

One of the more recent coverage enhancements that has gained some traction, particularly in the Americas, is for insurers, in return for an additional premium, to synthetically classify a limited number of specific general warranties as fundamental warranties, thus providing longer cover for these warranties than would normally be the case.

We have adopted a very cautious approach to this enhancement and have only ever offered it infrequently and on a case-by-case basis, drawing on our wealth of claims data to evaluate the prevalence of claims in certain sectors and estimate the expected tail length for certain classes of risk. However, we have seen some MGAs go much further than this and in some cases offer to extend the policy period for all general warranties on some deals from three years to up to six years for no additional premium, in an effort to differentiate themselves from the competition.

It will be interesting to know if the capacity providers that back these MGAs are aware of this development given the considerable amount of additional risk that this will result in them taking on, particularly in light of the increase in the number of third-party claims that we are seeing in the Americas, which can often take time to manifest themselves. We expect that capacity providers will start to push back on their coverholders offering this enhancement once they realize how much additional exposure they are taking on, and we therefore expect three-year general warranty periods to remain the norm. This is a sign of the growing disconnect between what some MGAs, with their focus on top-line growth, are prepared to offer by way of coverage enhancements and what the more established players in the M&A insurance market are prepared to do.

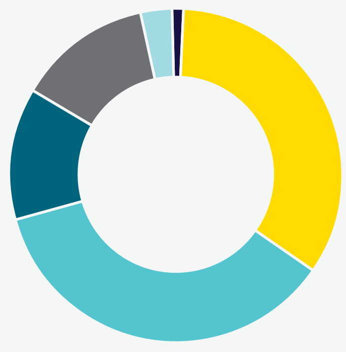
The vast majority of R&W notifications involving tax issues are received within 36 months of closing

[see Figure 7].

We often hear commentary about the long-tail nature of a R&W policy by reason of the fact that it provides at least six years of cover for fundamental warranties and tax-related issues. However, the number of notifications that we receive involving an alleged breach of a fundamental warranty is very small and a review of our R&W notifications involving tax issues received from 2022 onwards reveals that 70% of these were notified in Year 1 and Year 2. A further 13% were notified in Year 3 and just 11% in Year 4. Only 3% — comprising three notifications in total — were received more than four years after closing. All of these involved EMEA risks and none of them involved significant issues. Indeed, as things stand, we have only seen one tax-related issue being notified on an Americas risk more than four years after closing. This suggests that the risk of a tax-related claim beyond 48 months is actually very remote, with most tax authorities aiming to commence a tax audit within two to three years of receiving the relevant tax return, with four years being the cut-off in many jurisdictions absent of any evidence of a careless or deliberate act or omission.

Figure 7

Gap (in months) between closing and receipt of tax notifications



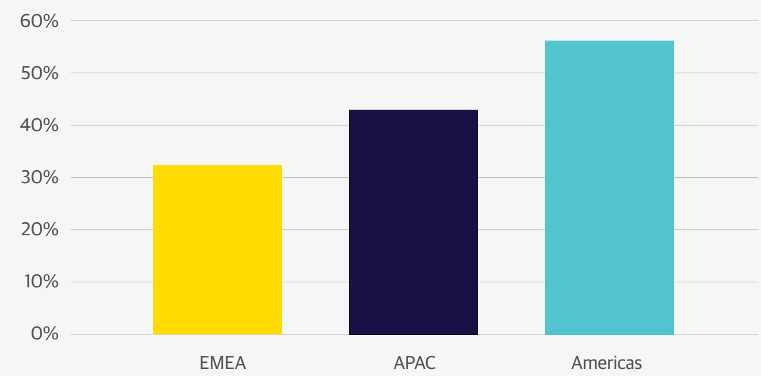
Data based on tax-related R&W notifications received from 1 January 2022 onwards

Focus on third-party claims

Third-party claims continue to make up a significant proportion of our notifications, especially in the Americas [see Figure 8].

In last year's briefing, we reported that more than half — 56% — of our global non-tax-related R&W notifications involved third-party claims. While this figure has decreased slightly in the last 18 months, to 50.7%, the Americas region continues to see a majority — nearly 57% — of its non-tax-related R&W notifications involving third-party claims. In contrast, our EMEA and APAC regions report lower figures over the same period, at 32.3% and 42.9% respectively.

Figure 8 **Proportion of R&W notifications involving a third-party claim**



Data based on non-tax R&W notifications received since January 1, 2019 onwards

Compliance with laws, intellectual property, and wage-and-hour disputes are responsible for many third-party claims [see Figure 9].

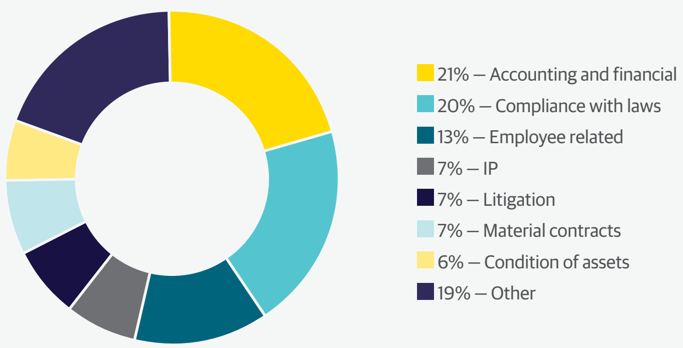
We find that three underlying causes of loss make up the bulk of our third-party claims: (i) compliance with laws; (ii) wage-and-hour class action lawsuits; and (iii) intellectual property (IP) disputes.

Compliance with laws claims have accounted for 19% of our notifications involving third-party claims. They are particularly prevalent in the Americas, with government investigations into past business practices the most predominant type of loss noticed. These claims most frequently involve the healthcare industry and investigations into billing regulations. We also frequently see claims involving data privacy compliance issues and, more recently, allegations around anti-competitive conduct (e.g., price fixing). These types of claims can result in significant fines, especially if not resolved promptly.

Wage-and-hour suits have accounted for 13% of our notifications involving third-party claims. They are frequently venued in California, where the laws and courts are believed to be largely employee friendly. It is typical for plaintiffs' lawyers to work on contingency-fee arrangements, meaning that nuisance-value settlement offers are generally rejected — especially where litigation funders are involved. There is also a legal system abuse risk associated with these claims, raising the possibility for outsized jury awards. We often find that the target's business-as-usual insurance program seldom provides coverage, as it generally excludes wage-and-hour claims (save for the occasional minimal sublimit for defense costs).

IP disputes have accounted for 7% of our notifications involving third-party claims. We find that these claims are usually pursued very aggressively by highly motivated plaintiffs determined to protect their IP rights. They account for a high proportion of the dollars that we have paid out or reserved in respect of third-party claims as they typically entail substantial litigation costs, given the high counsel fees, coupled with the fact that these matters are not easily resolved via dispositive motions. Indeed, we have handled several IP claims where the target company is likely to incur more than $5 million in defense costs, and achieving a sensible settlement is proving to be difficult given the entrenched position of the plaintiff. Another factor fueling the increase in IP claims, particularly in the Americas, is the rise of "patent trolls," who exploit patent litigation for settlements based on (often) frivolous claims. We find patent trolling to be less prevalent in EMEA and APAC, particularly in jurisdictions which have a loser-pays-costs regime.

Figure 9 **Underlying issue responsible for third-party claims**



Data based on non-tax R&W notifications received since January 1, 2019 onwards

Defense costs are presenting M&A insurers with significant exposure [see Figure 10].

Most significantly, the paid and reserved amounts related to third-party claims — and defense costs in particular — have surged over the last few years. They currently account for about 17% of total dollars that we have paid or reserved to date. The majority of this is attributable to the Americas region, where we have paid or reserved more than $40M in relation to defense costs alone.

It is becoming increasingly common to receive litigation budgets exceeding $5M, particularly in IP and complex contractual disputes. In the Americas, we have seen multiple claims involving eight-figure defense spend. Indeed, one of our largest payments to date involved a complex contractual dispute, with nearly $30M paid out, $20M of which was for defense costs. Another ongoing litigation, involving a hotly contested IP infringement dispute, is expected to result in more than $10M in defense costs through trial.

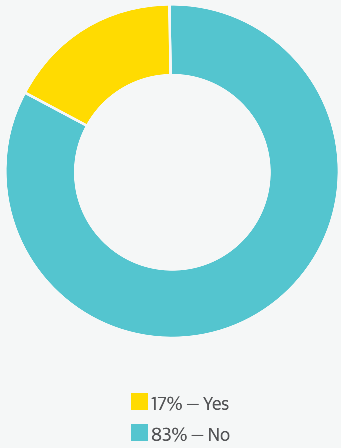
There are a number of factors driving increased defense costs exposure.

The litigation style in the Americas, characterized by extensive motion practice and intensive discovery, inherently leads to costly disputes — more so than seen in EMEA and APAC. We presume that the recent surge in defense costs is also being driven by macroeconomic factors, particularly inflationary pressures, which have prompted law firms to increase their hourly rates.

While the law firms used to defend third-party claims are often preapproved in R&W policies — with their rates deemed reasonable — it is not always the case that the preapproved firm will be the most suitable or cost-effective choice. As a result, as evidenced above, it is becoming more common for defense costs to materially erode or exhaust retentions — a trend that is likely to be exacerbated by the pressure that retentions have been under recently, coupled with the fact that, in the Americas, third-party claims frequently arise after the retention drop-down date, when the retention is generally halved one year post-closing.

Figure 10

Dollars paid or reserved that are associated with third-party claims



Data based on tax-related R&W notifications received from 1 January 2022 onwards

This is likely to prompt questions over whether M&A insurers need more input over key decisions relating to a covered third-party claim and the associated defense costs spend than is currently the case in some jurisdictions.

Early notice of third-party claims is crucial.

It is critically important that M&A insurers receive prompt notice of a third-party claim and are given the ability to closely associate in its defense. Our experience underscores that, by maintaining active dialogue regarding a claim's status and any key developments, an insurer can expeditiously reach a coverage determination — frequently aligning the interests of both carrier and insured in contesting the third-party claim — and assess the reasonableness of any key strategic decisions or settlement proposals. While rare, we have encountered instances where third-party claims were noticed after the dispute had already been settled (on one occasion for an eight-figure sum). We find that delayed notification complicates the claims process, especially if key decisions have already been made.

Looking ahead

We anticipate that, as exposure to third-party claims becomes more frequent (and more severe), M&A insurers will apply more scrutiny at the underwriting stage around litigation risk in general and start to take increasingly robust positions in respect of any potential exposures that are identified during due diligence, even if it is classified as being a low-risk item.

We also expect that, because R&W policies often sit excess of any other valid, applicable, and collectible insurance coverage, more detailed questions will be asked by M&A insurers about the adequacy of the risk and insurance due diligence that has been performed by the buyer. The focus here will be on checking that the buyer has a comprehensive understanding of the target's existing insurance programs, their scope and limitations, and how it has got comfortable that they adequately address key risks in order to avoid a situation where the R&W policy becomes the first port of call for, or starts to be treated as top-up cover for, business-as-usual risks.

The increase in defense cost spends may also cast a spotlight on some of the things that constitute a third-party claim. For example, in the Americas, a tax audit will typically qualify as a third-party claim regardless of whether or not there is an allegation that the target business has underpaid tax. This can result in an M&A insurer being liable for the costs associated with dealing with what ultimately turns out to be a clean audit. This is the case even though these costs, which can be substantial, represent, in truth, a business-as-usual risk for the target business. Whilst the number of notifications we have received to date in the Americas relating to the commencement of a tax audit is comparatively low (certainly compared to EMEA), they are on the increase, and this is likely to focus the minds of M&A insurers on this issue.

It is possible that significant exposure to third-party claims may also increase M&A insurers' scrutiny on the trigger for coverage in respect of defense costs. As things stand, a R&W policy will typically provide coverage for defense costs if the allegation(s) made by the third-party, if true, would show that there has been a breach of an insured warranty. The problem with this, however, is that it can lead to a situation where a R&W insurer ends up funding the defense of a lawsuit even where there is little or no merit to the allegation(s) and, by extension, no breach of warranty. This is out of step with the intent of a R&W policy, which is to provide coverage for actual breaches of warranties only, and may prompt increasing discussion around whether coverage for defense costs should be restricted to situations where the insured can establish that the allegations made by the third party are actually true and that, as such, there has been a breach of an insured warranty.

Contingent legal risk insurance

In the last few years, many M&A insurers — including Liberty GTS — have invested significant resources in expanding their capabilities in the contingent legal risk insurance space. This is a product that is designed to offer protection against one-off identified legal risks and can be used in a wide range of circumstances. These legal risks can come in many forms but can broadly be classified as involving matters that are either “in-litigation” or “not-in litigation”.

The products that have been developed to cover “in-litigation” risks take two forms: adverse judgment insurance (“AJI”) and judgment preservation insurance (“JPI”).

An AJI policy protects the defendant in an active lawsuit against some or all of the exposure associated with a final adverse judgment.

A JPI policy protects the plaintiff in an active lawsuit against the risk of a damages award secured earlier in the litigation being either overturned or reduced on appeal.

The popularity of JPI policies has increased over the last few years in particular. This is off the back of a better understanding both about the existence of the product and its benefits amongst trial lawyers who have, in turn, been presenting it to successful litigants as an effective means of locking-in an agreed-upon amount of a judgment or award, regardless of the outcome on appeal. This provides the judgment holder with a degree of certainty and also an ability to access the monetary benefit of the judgment or award before the appellate process has concluded and without fear that it will need to pay it back in the event of a subsequent reversal.

The policies have been used in a variety of cases (including patent infringement, breach of contract, international arbitration, and business torts to name a few), either by way of a stand-alone policy or a large program involving multiple insurers, to preserve a wide range of damages awards (ranging from $5 million up to $1 billion).

On each of the JPI risks that we participated on, we took our own detailed independent legal advice as part of our underwriting process (in addition to reviewing the legal advice of the insured), and in each case the advice received was that the legal merits were strongly in favor of the insured. We also considered factors such as the identity of the judge(s) (where known at the point of inception), data in respect of their judgments being overturned on appeal, the forum in which the litigation was heard and its record for making interventionist judgments as well as factoring in the equities of the case in question. Again, in each case we concluded that the balance of these factors was in favor of our insured.

In many cases, our views about the risk in question have been confirmed since, as things stand, about 40% of the JPI and AJI policies that we have written are officially off-risk with the litigation having been resolved in the insured's favor and several others are expected to come off-risk shortly.

However, despite careful underwriting of these risks, we have still seen two JPI risks fall over after the judgment that we insured was unexpectedly overturned on appeal and all further appeal options available to the insured ended in failure. Together, these two risks, one of which involved U.K. litigation and the other of which involved U.S. litigation, have resulted in payouts of approximately $58M.

Furthermore, we have seen (or know of) recent adverse developments on several other JPI risks since policy inception, and, while the underlying litigation remains ongoing in each case, the appeal options open to the insured in some instances are quite limited. These include several risks involving large towers where, unless things change, the subscribing insurers could face a full limit loss.

All of this has led us to conclude that, if risks such as these, which we and our advisors regarded as very strong risks, result in losses and/or adverse developments with the frequency and severity that we have experienced in recent months, then we cannot profitably underwrite "in-litigation" risks. In certain cases, the appellate judgments appear significantly contrary to not only a more reasonable reading of the law, but also, the degree to which the first instance judgments favored our insured. It is impossible to know the reasoning behind such a divergence in legal analysis and holdings between the courts. As such, we decided to stop writing "in-litigation" risks in May 2024. We were the first M&A insurer to take this decision and expect that others will follow, particularly as reinsurer scrutiny mounts over this sub-class of business.

However, we still have appetite for "not-in litigation" risks (also known as "specific risks"). These risks are often, but not always, identified in the context of an M&A transaction. They are typically low probability, but high-severity risks that, if not insured (or otherwise addressed in the transaction structure), can prevent the deal taking place as the seller will regard the risk as sufficiently low that it is unwilling to accept a price reduction or escrow mechanism, but a cautious buyer may not proceed without some protection against the possibility that the low risk might crystallize in the future.

Examples of "not-in litigation" risks include: legacy deal liabilities that might prevent the liquidation of a private equity fund, contingent liabilities to creditors that might make a security trustee unwilling to distribute insolvency proceeds, and the risk of a regulatory body determining that a business has been operating without the necessary permits or licenses or that it has been operating in breach of their terms.

Our claims experience in respect of "not-in litigation" risks is very different to that of "in-litigation risks" and we have yet to pay any claims in respect of any of the risks that we have written to date. Going forward, we expect M&A insurers will pivot away from "in-litigation" risks to focus (almost) exclusively on these risks. Indeed, we are already seeing an increase in submissions involving "not-in litigation" risks as brokers redeploy resources to address the drop-off in appetite for "in-litigation" risks.

Claims outcomes

We have paid out or reserved almost $340M involving R&W claims

[see Figure 11].

In total, we have paid out or reserved almost $340M in insured loss involving R&W claims. A significant proportion of this amount has been paid or reserved in the last 12 months driven, in part, by a large EMEA claim (discussed below), but also because we are seeing an increasing number of claims that involve deals from the M&A boom of 2021 — when we wrote a record number of policies — maturing into paid claims. Indeed, we have paid out or committed to pay out around $125M this year alone through to the end of August. This demonstrates that buyers with good claims continue to derive significant value from their decision to purchase a R&W policy.

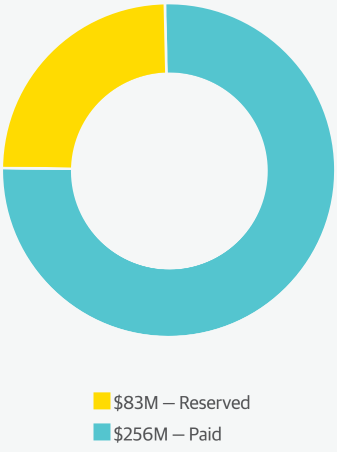
Our largest payment so far this year was for €46M and was our biggest ever.

This year, we resolved a very large R&W claim brought by B&C KB Holding GmbH in connection with their acquisition of the Schur Flexibles group for a payment of approximately €46M which, when combined with the payments made by the primary and second excess insurer, resulted in B&C recovering approximately €120M. The payment to B&C is the largest recorded to date under an EMEA R&W policy and represents a watershed moment for the product. It demonstrates unequivocally that even the most severe claims are getting paid. It is particularly notable here that the claim under the R&W policy was resolved amicably and within nine months of insurers being presented with a fully particularized claim, whereas the claim that B&C are also pursuing against the seller remains unresolved and is the subject of a costly arbitration. This shows that an insured will typically face fewer hurdles when it is seeking to recover its loss from an M&A insurer compared to from the seller. This is because M&A insurers have an incentive to behave reasonably in a claims scenario because if they don't, then their reputation will suffer and this could impact their standing in the eyes of repeat buyers of the product, law firms, and brokers. This matters much less to a seller, especially if they are transacting with the buyer on a one-off basis.

In the Americas region, we have made two payments for more than $10M so far this year. This comprised a $25M payment in connection with a material contract claim in our capacity as the second excess insurer and a $12.2M payment in connection with an inventory misstatement in our capacity as the primary insurer. We have also resolved a number of other claims for amounts between $1M and $10M.

Figure 11

Paid and reserved claims by value



Data based on paid and reserved claims as at September 30, 2024 involving risks placed from January 1, 2019 onwards

We have only made one payment for more than $1M in the APAC region so far this year. However, we are aware of a number of large APAC claims in the market — both resolved and unresolved — so we don't necessarily see this as being representative of what other M&A insurers are experiencing in this region.

The majority of our paid and reserved claims result from just five breach types [see Figure 12].

Our data shows that just five breach types have been responsible for 97% of the dollars that we have paid or reserved, even though, collectively, these breach types have only accounted for 72% of our notifications received to date. We discuss each of these breach types in more detail below.

Accounting and financial issues continue to be responsible for a significant proportion of our paid and reserved claims and also the most dollars paid [see Figure 12].

Accounting and financial issues have made up only 14% of our notifications to date yet have been responsible for 59% of the dollars that we have paid or reserved — the most of any breach type by some considerable distance — at an average cost of around $15.5M. This reflects the fact that these types of claims are, in some cases, extremely large. Indeed, accounting and financial issues have been responsible for 50% of our largest 10 claims by value. That said, we still see a lot of much smaller claims involving accounting and financial issues, as demonstrated by the fact that 55% of the payments or reserves we have made involving this breach type have been for less than $5M.

The issues that we are seeing remain varied. However, revenue recognition issues and inventory-related issues continue to be a recurring theme and, more recently, allegations around the failure to disclose unbudgeted capital expenditures (CAPEX) spends. Although not strictly an accounting and financial issue, we have also seen several claims recently based on alleged errors in the vendor financial model which the insured says that it relied on to value the target business.

Case study: the claim was based on various adjustments that were made by the target group's auditor to the figures that formed the basis for the warranted accounts. This resulted in a substantial reduction to the last 12 months' run-rate earnings before interest, taxes, depreciation, and amortisation (EBITDA) of the business. We paid out our full £32.5M limit within six months of receiving the initial claim notice.

Figure 12 **Key statistics according to breach type**

	% of overall R&W notification	% of overall dollars paid and reserved	Average cost per paid and reserved claim
Accounting and financial	14	59	$15,549,621
Assets	7	5	$12,746,683
Compliance with laws	14	15	$7,668,003
IP	7	5	$5,666,676
Material contracts	7	11	$20,898,773
Tax	23	2	$1,371,784
Total	**72**	**97**	

Data based on paid and reserved claims involving R&W risks placed from January 1, 2019 onwards

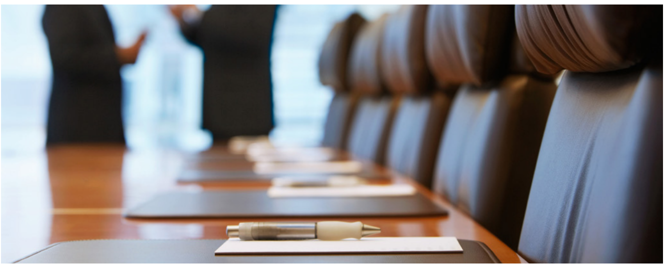
Material contract claims, although rarer, are behind the largest claims on average [see Figure 12].

Material contract issues have made up only 7% of our notifications to date and have been responsible for a similar proportion of the dollars that we have paid or reserved. However, whilst still comparatively rare, these claims, when they do occur and are verified, come at an average cost of around $20M, which is the highest of any breach type. This is because these claims are nearly always for significant amounts, particularly if they revolve around either the non-renewal or early termination of a material contract where either the nonrenewal or early termination itself, or the circumstances giving rise to the same, occurred prior to the closing date.

We tend to find that claims where the nonrenewal or early termination took place prior to closing are more straightforward to adjust. This is because, where the nonrenewal or early termination took place after closing, the insured will need to show that this was caused by circumstances that existed prior to closing, which should have been disclosed. However, this can be difficult absent of clear evidence to that effect because the reality is that customers can decide to make relationship changes for a whole host of reasons, some of which may be entirely unconnected to the circumstances that were not disclosed.

We find that disagreements around quantum tend to be more common on material contract claims compared to other claims. The argument usually made by the insured is that the nonrenewal or early termination of a material contract goes directly to the valuation of the target company — and the more important the customer relationship to the business, the larger the alleged impact on value. This can, however, be an overly simplistic way of looking at things, particularly as no business expects its customer base to remain static and a certain amount of customer churn is inevitable. That said, we have made a number of payouts involving material contract issues where we were satisfied that this approach was justified, resulting in a significant recovery for our insured.

Case study: the claim involved the termination of a key customer relationship which occurred not long after closing and was attributed to various service failings by the target business over an extended period. We worked closely with the insured and its advisors to run down various quantum-related issues and ended up paying out our full $25M limit.



We are seeing a rise in paid claims involving issues with target company assets [see Figure 12].

We have seen a notable increase in claims involving issues with target company assets — most typically condition of assets and/or sufficiency of asset issues — in the last few years, especially in the Americas. These claims, which have made up 7% of our notifications to date, are technically complex and typically require an extensive amount of expert input as part of the adjustment process. They usually, therefore, take longer to resolve than most claims, especially where the issue is notified to us late on in the policy period. That said, we are now starting to see some develop into paid claims, including several for significant amounts. Indeed, whilst these types of claims are only responsible for 5% of the dollars we have paid out to date, the average payment or reserve in respect of these claims currently stands at around $12.5M — the third highest of any breach type behind only material contract issues and accounting and financial issues.

As we discussed at length in last year's claims briefing, these (potential) payments are resulting in increased scrutiny at the underwriting stage around, in particular, condition of asset issues and this explains why insurers are generally more cautious around providing cover for these issues than they used to be.

Case study: the claim involved a gas turbine that had to be shut down after a fatigue crack was discovered in the rotor shortly after closing. The rotor had to be replaced and the turbine was shut down for an extended period whilst the repair was carried out. We compensated the insured for the cost of the replacement rotor and the resulting business interruption loss up to our full $5M policy limit.

Intellectual property and compliance with laws issues are resulting in some large payments, especially in respect of defense costs [see Figure 12].

As we discussed in Section 3, we have also seen an uptick in paid claims involving compliance with laws issues and IP issues, with the vast majority of these involving third-party claims. These issues have made up 14% and 7% respectively of our notifications to date. The defense costs spend associated with these claims can be very significant: more than $20M in the case of one paid claim and more than $10M up to and including trial in one ongoing matter. This helps to explain why the average payment in respect of these issues is climbing and currently stands at $8.1M (in respect of compliance with laws issues) and $5.6M (in respect of intellectual property issues).

Case study: the claim was based on a high-stakes dispute with a customer around allegations that certain medical equipment sold by the target business was not up to code and, therefore, violated federal law. The claim settled for a substantial amount shortly before the arbitration hearing. We put the target in funds to pay the settlement sum and reimbursed it in respect of its substantial defense costs, paying out close to our full $30M policy limit in the process.

We see a lot of notifications involving tax-related issues, but these are only responsible for a relatively small proportion of our paid claims

[see Figure 12].

Tax-related issues have made up 23% of our notifications to date — the largest proportion of any breach type by some distance. However, many of these are simply notifying us of the commencement of a routine tax audit and do not result in a formal claim — especially in EMEA and APAC. That said, as we commented in last year's briefing, we are finding that a growing number of our tax-related notifications involve an adverse finding, indicating that tax authorities are starting to take more aggressive positions on whether tax is due. The main issues that we are seeing involve corporation tax, sales tax, or property tax issues. However, that aside, 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. In fact, tax-related issues have accounted for only 2% of the dollars that we have paid out at an average cost of around $1.25M. 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. Indeed, the largest payment that we have made so far this year is for just under $4M and we have never paid out our full policy limit in respect of a tax-related issue.

Case study: the claim involved a tax break that had allowed the target company to avoid paying registration duties amounting to approximately €800,000 if it developed a property that it had acquired within a fixed period of time. The tax authority subsequently sought to claw-back the tax break on the basis that the development work had never been carried out. We confirmed cover in principle even before the tax authority had made its final decision and promptly reimbursed the insured in respect of the full amount due.

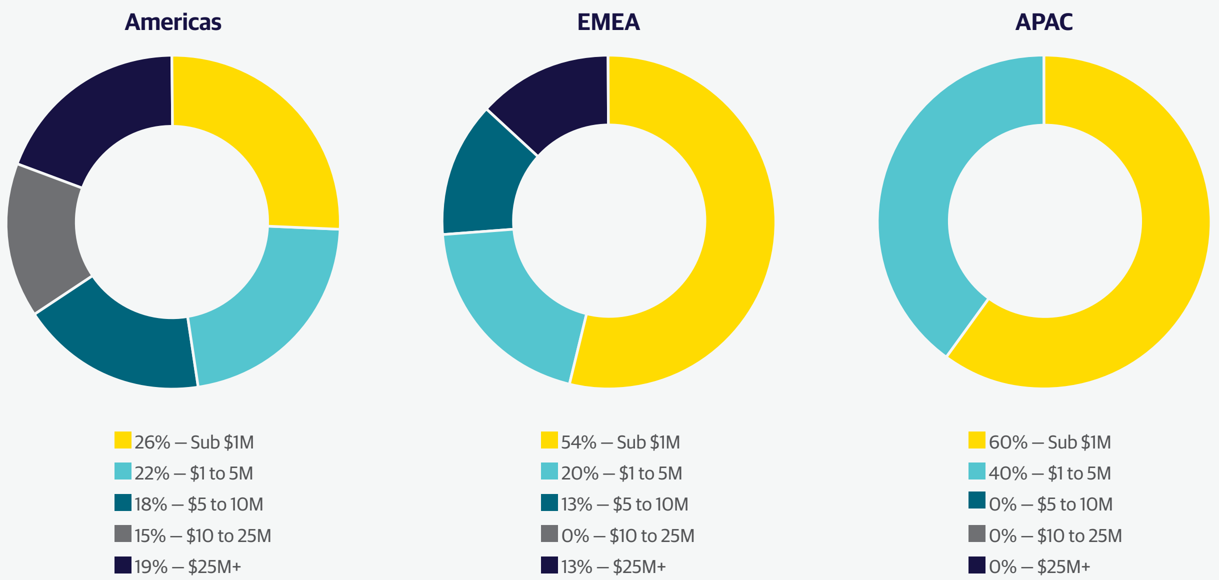
We tend to see more larger payments in the Americas as a proportion of our paid claims globally [see Figure 13].

An analysis of our paid and reserved claims that we have participated in across each of our regions shows that we tend to see more larger payments as a proportion of our paid claims in the Americas region compared to our other regions with 34% being for more than $10M. We suspect that part of the reason for this is because we have paid and reserved more claims in the Americas region involving accounting and financial issues or material contract issues which, as noted previously, involve higher payments on average. However, in the Americas the tendency is to build a tower made up of a number of layers, each totaling between $20M and $30M, which limits an insurer's exposure to claims where the amount claimed is more than this. The increased risk of large claims in the Americas is also reflected in the higher pricing for the product in this region vs. other regions.

In EMEA, we tend to see more low-level tax losses than we do in other regions, which helps to explain why 54% of our paid and reserved claims have been for less than $1M. We still find that very large claims are unusual in EMEA, having only paid or reserved two claims for more than $25M to date, both of which involved accounting and financial issues. That said, it is not uncommon to see payments in the $1M to $10M range, with this bracket accounting for 33% of our paid and reserved claims in this region.

The smaller nature of most APAC deals means that larger payments are less common, with all our paid and reserved claims to date being for less than $5M. However, as noted earlier, we don't see this as being necessarily representative of what other carriers in the APAC market are seeing.

Figure 13 **Breakdown of payments or reserves by dollar amount — regional view**



Data based on paid and reserved claims involving R&W risks placed from January 1, 2019 onwards

We find that multiples are rarely applied to calculate loss if the claim does not involve material contract issues or accounting and financial issues [see Figure 14 and 15].

Our data shows that a multiple (or some other valuation metric) has been used to calculate loss in 48% of the claims that we have paid or reserved to date. Nearly all of these claims involve either an accounting and financial issue or a material contract issue. A multiple can, of course, have the effect of driving up the overall loss number (sometimes significantly depending on the size of the multiple), so this helps to explain why claims that relate to a breach of the financial statements and/or material contracts warranties tend to be for larger amounts compared to other claims. That is not to say, however, that loss is quantified in this way on every claim where these warranties are implicated: some are instead quantified on a dollar-for-dollar basis. In fact, our data shows that 19% of our claims involving an accounting and financial issue, and 25% of our claims involving a material contract issue, have been quantified on this basis. This typically happens where the underlying issue is one-off in nature (e.g., an undisclosed liability or a third-party claim involving a material contract) and doesn't impact the target's recurring EBITDA from which the purchase price may have been calculated.

It is relatively unusual for a multiple (or some other valuation metric) to be used to calculate loss where the claim involves a different issue. Indeed, we have yet to pay or reserve a claim involving a condition of asset issue, a tax-related issue, or a compliance with law issue where the loss has been calculated on this basis. We have paid and reserved a claim involving an insurance issue and a regulatory issue, both of which were quantified by reference to a valuation metric, but we find that most notifications involving these issues are not actually quantified on this basis.

Our data also shows that a greater proportion of our paid and reserved claims are calculated by reference to a multiple (or some other valuation metric) in the Americas region (50%) vs. the EMEA region (26%). Whilst all of the claims that we have paid and reserved to date in the APAC region have been quantified by reference to a multiple (or some other valuation metric), the sample size is not big enough to draw any useful conclusions from this. Rather it is likely to reflect the fact that all of the claims that we have paid and reserved in this region to date (except one) have involved either an accounting and financial issue or a material contract issue.

Figure 14

Proportion of paid and reserved claims where loss is calculated according to a valuation metric — breach type view

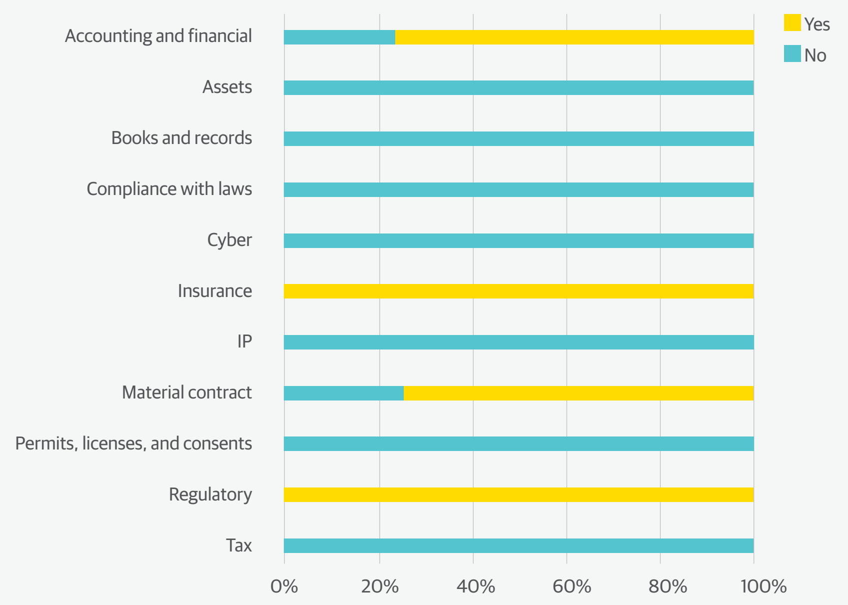
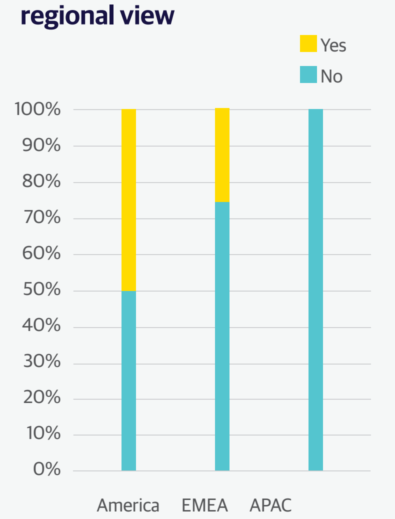


Figure 15

Proportion of paid and reserved claims where loss is calculated according to a valuation metric — regional view



Data based on paid and reserved claims involving R&W risks placed from January 1, 2019 onwards

We have paid out or reserved the most dollars on smaller deals, but the average payment or reserve in respect of these claims is lower vs. larger deals

[see Figures 16, 17, and 18].

Our data shows that deals with an estimated value (EV) of under $100M have been responsible for a significant number of our paid and reserved claims with an average payment of around $3M. This includes several payments for our full policy limit. Indeed, our experience 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.

Our average payment or reserve on deals with an EV of between $100M and $250M is slightly higher at around $6.5M and higher still for deals with an EV of between $500M and $750M at around $12.5M. This makes sense: bigger deals usually involve bigger policy limits and, further, where the claim involves a financial statement or material contract issue, there is a greater risk that the resulting EBITDA impact from the issue in question will be larger in the context of a bigger business resulting in a bigger claim.

We have paid out or reserved a significant amount on deals with an EV of between $500M and $750M with an average payment of around $21M — the highest by some distance. However, the data for this deal size bucket is skewed somewhat by one very large payment and, if this was stripped out, the average payment would be around $7M.

Interestingly, we have actually paid or reserved the least dollars on deals with an EV of $1B. We think this reflects in part the fact that these deals at this end of the spectrum are scarcer and involve large retentions which absorb a lot of the issues that are notified to us. The current average payment or reserve in respect of this deal size bucket is a little under $10M, which is actually less than several of the smaller deal size buckets. However, we have seen (and continue to see) a number of large claims involving this deal size bucket, especially in the Americas, and some of these have generated or are expected to result in large payments.

Data based on paid and reserved claims involving R&W risks placed from January 1, 2019 onwards

Figure 16

Total number of paid and reserved claims by deal size

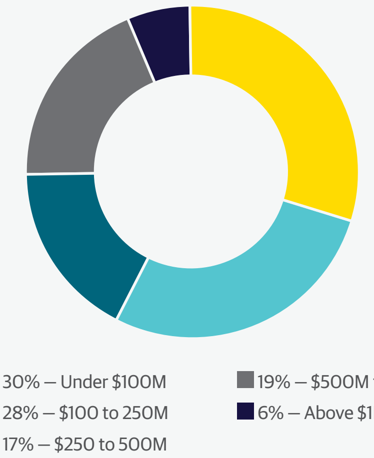


Figure 17

Total amount of dollars paid or reserved by deal size

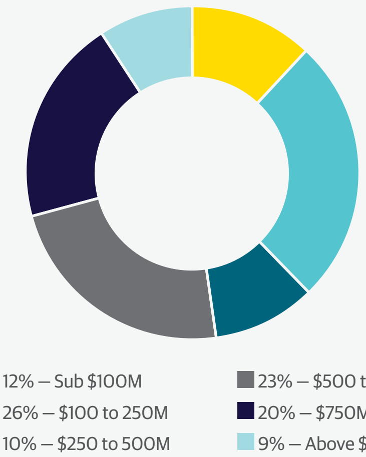
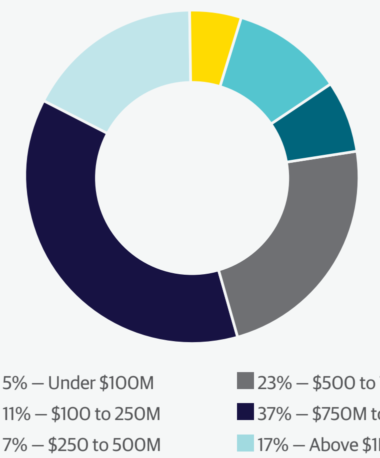


Figure 18

Average payment or reserve according to deal size

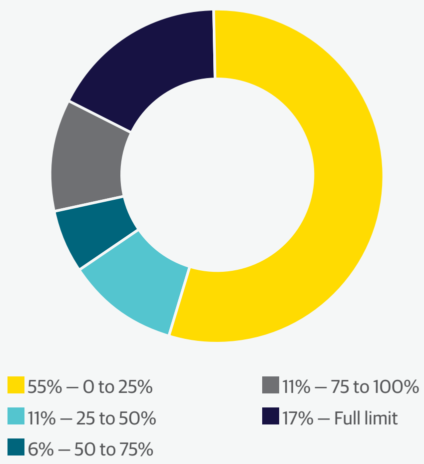


The majority of our paid claims have involved payments for less than 25% of the policy limit, but 17% have been for the full policy limit [see Figure 19].

Our data shows that 55% 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 as reflected in the fact that 17% of our payments over the last few years have been for the full policy limit.
In each case, the insured was left with a significant uninsured loss but probably ended up in a better position because of its decision to purchase R&W cover (because 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 19

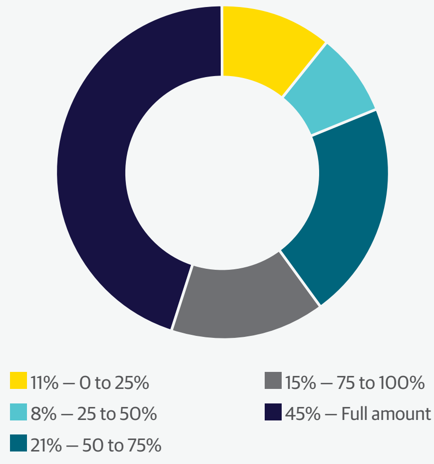
Payment or reserve as a % of limit purchased



Data based on paid and reserved claims involving R&W risks placed from January 1, 2019 onwards

Figure 20

Payment or reserve as a % of initial amount claimed



Data based on paid and reserved claims involving R&W risks placed from January 1, 2019 onwards

We have paid (or reserved) the full amount claimed in many cases [see Figure 20].

A closer look at the claims that we have paid (or reserved) to date reveals that:

- We have paid (or reserved) 100% of the initial amount claimed in 45% of cases.
- We have paid (or reserved) more than 50% of the initial amount claimed in 81% of cases.
- We have paid (or reserved) less than 50% of the initial amount claimed in 19% 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 11% of cases. From our insureds' perspective, this provides comfort that we are paying claims – in many cases 100% of the amount being claimed – demonstrating that the product is working.

Declinatures are rare, and where they do happen they are often not challenged [see Figure 21].

As illustrated previously, we can point to many examples of claims processes that have run incredibly smoothly ending in a positive outcome for our insured. However, we do, on occasion, decline claims, although this is rare (accounting for less than 10% of claim outcomes). Where we do, it is only after careful consideration of whether this course of action is legally and commercially justified.

The most common reason for declining a claim is because we are not satisfied that the insured has demonstrated that there has been a breach of warranty (e.g., because the warranty is qualified by seller knowledge and the insured has not adduced any evidence that the seller processed the requisite knowledge). We also receive a number of notifications every year where the claim notice cites a warranty that we either did not cover or has been rewritten for the purposes of the policy. The most common exclusions that come into play are the disclosed and/or actual knowledge exclusion. We also see a number of claims notified each year which are captured by a deal-specific exclusion (particularly those relating to tax) or a boilerplate exclusion (such as, in EMEA, a property defects exclusion). We have never declined a claim purely as the result of a late notice issue or on the basis that we do not think the insured has suffered any loss.

In most cases, provided that the rationale for the declinature is communicated clearly and explained properly, we find that it is rarely challenged by the insured. Occasionally, disputes over coverage do arise, but we will always try and work with our insured to resolve any differences in a sensible and pragmatic way where this happens. In our experience, full-blown coverage disputes remain rare, and we currently only have two claims in litigation, both of which are in our capacity as an excess insurer.

Figure 21 **Basis for declining a claim**

Data based on notifications received on R&W risks placed from January 1, 2019 onwards

We are increasingly looking at subrogation opportunities following payouts.

An insurer's potential right of subrogation is an important tool at its disposal in the event that it makes a payment under the policy. However, it is usual for a R&W policy to provide that the insurer may only exercise its subrogation rights against the seller where it has been fraudulent, deliberately deceitful, or engaged in willful concealment. This means that it is a seldom-used right. Fraud is not easy to prove. It is a serious allegation and not something that can be pled casually. Another problem is recovery. Often, by the time the issue is discovered, the proceeds of sale may have been paid away and it could be that the seller, to the extent that it is a corporate entity, has since been wound up or is just a shell company. This adds an further layer of complication and expense to subrogated claims.

Fortunately, although risk of a fraud has always existed due to the temptation of trying to make a business as attractive as possible with a sale on the horizon, it is not an issue in the vast majority of R&W claims. However, we are starting to see more claims where it is potentially an issue. This could be because the combination of a tougher trading environment and lower valuations has placed increased pressure on sellers and management, providing them with a greater incentive to cross the line. We find that most frauds tend to involve accounting-related issues, but we have also seen an increase in allegations involving undisclosed material issues that implicate warranties which are qualified by seller knowledge. We currently have an interest in a number of ongoing actions that are being pursued by the insured against the seller and are actively contemplating commencing a subrogated claim in several other cases.

Given the above, it is vital that an insured is mindful of an insurer's potential right of subrogation, especially if fraud is suspected, and takes steps to protect the same prior to payment being made and, more generally, does not do anything that might cut across it, e.g., by concluding a settlement with the seller on a "full and final" basis, with no carve-out for fraud.

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