



Taxing times for M&A Insurance



Now in its fourth annual edition, the statistics captured by AIG's latest M&A Claims Intelligence Series show that representations and warranties insurance (R&W)¹ has the potential for both frequency and severity of claims and responds to a wide range of deal issues. The data and insights captured within the series have become a 'must-read' for buyers, sellers and their advisers as they seek to manage their transaction risk.

"We're hearing from our insureds and deal lawyers that they see real value in the AIG claims data," says Mary Duffy, global head of M&A insurance at AIG. "The insights it provides are simply not accessible from anywhere else."

AIG's M&A Insurance team underwrote policies in respect of over 800 M&A deals in 2018. The scale and breadth of AIG's portfolio – which spans multiple geographies and sectors – puts AIG in a unique position to share insights into common deal pitfalls, based on observations about the claims made on these policies.

This year, for the first time, the report lifts the lid on tax breaches – revealing the main sources of tax claim notifications. It also sheds new light on the long-tail nature of M&A claims.

At a glance

- Claims notification frequency has increased (to 26 percent) for deals between \$500 million and \$1 billion in size, while remaining constant across the wider portfolio, at a claims frequency of one in every five policies
- Claims severity has grown, with a doubling of the most material claims (valued over \$10 million), from 8 to 15%, at an average cost of \$19 million
- Tax breaches span a wide variety of types of issues, led by corporate income tax, employment, and sales taxes, and are the predominant driver of claims notifications in EMEA

Methodology

There were more than 580 claims during the study period – spanning policies covering approximately 2,900 deals, worth more than \$1tn in deal value – though the number of material claims was smaller. Many policies written during the study period still hold the potential for a claim. The period reviewed in this report (policies written by AIG between 2011 and 2017) represents a significantly larger pool of transactions than the period prior to 2011, given the growing use of R&W policies on transactions over the past eight years. Many of the policies are now reaching maturity, providing us with more intelligence on the complete policy life cycle. The results should not be considered conclusive with respect to the broader context of all private mergers and acquisitions, as the percentage of deals insured by R&W policies is still relatively small. Nevertheless, the snapshot of R&W claims activity contained in this report provides interesting insights to buyers, sellers, and M&A advisers.

¹ Usually referred to outside the US as warranty & indemnity insurance (W&I)

Claims Severity and Frequency

Evolving claims severity² is one of this year's big trends. The proportion of material claims³ over \$10 million has nearly doubled year on year from eight percent to 15 percent. The average claim size within that band was \$19 million, which is consistent with last year's average pay-out for the most material claims. "These numbers show that the claims are real and the claims are material," says Michael Turnbull, head of M&A for the Americas at AIG. "To remain viable, insurers need scale, experience and to be earning enough premium to cover the significant claims when they come in."

"We are seeing the severity claims on an increasing frequency and the interesting thing about that is we are seeing them all over the globe," adds Mary McIvor, global head of M&A claims at AIG. "In the last year we have even seen severity matters in Africa and Asia, and claim notifications increasing in places where we historically have not seen any".

The claims statistics for policy years 2011-2017 show that frequency remains highest for the largest, most complex deals. This year's data shows an increase in claims notifications for M&A deals between \$500 million to \$1 billion from 21 percent to 26 percent. Broken down by region, this band of deals drove the highest frequency of claims in both North America and internationally.

"The overall frequency for all deals on a global basis stands at 20 percent," says Duffy, "with one in five deals resulting in a notification. This has remained fairly steady over the past few years. But as the pool of data continues to grow, we are starting to see some trends emerge as we drill down more on specifics."

The Americas is a significant driver of claims notifications, with higher frequencies across all deal sizes. Turnbull thinks this in part reflects the sophistication of the insureds. "Clients are becoming more familiar with the way the product works and this is reflected in the notifications," he says. "Savvy insureds will provide adequate supporting documentation early in the claim to allow the process to proceed as efficiently as possible."

"The proportion of material claims over \$10 million have nearly doubled year on year"

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

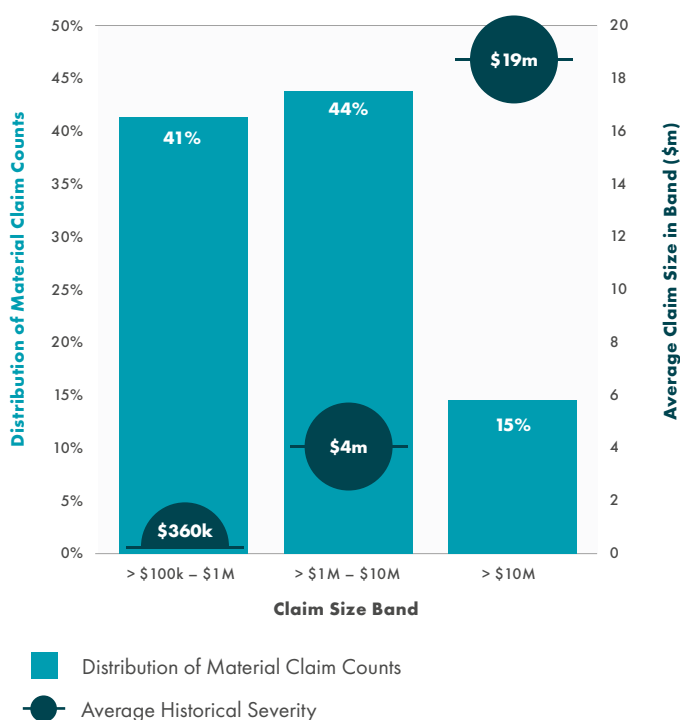
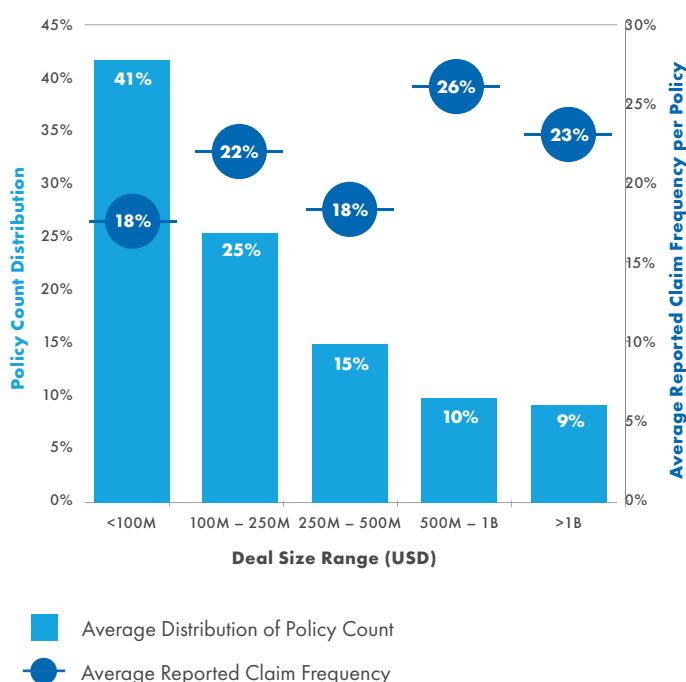


Fig 2 **R&W Reported Claim Frequency by Deal Size**



² Claim severity is the amount of claim payments plus estimated case reserves (i.e. estimated future payments on claims already reported) divided by the number of clients receiving claim payments or are expected to receive claim payments in the future on claims already reported.

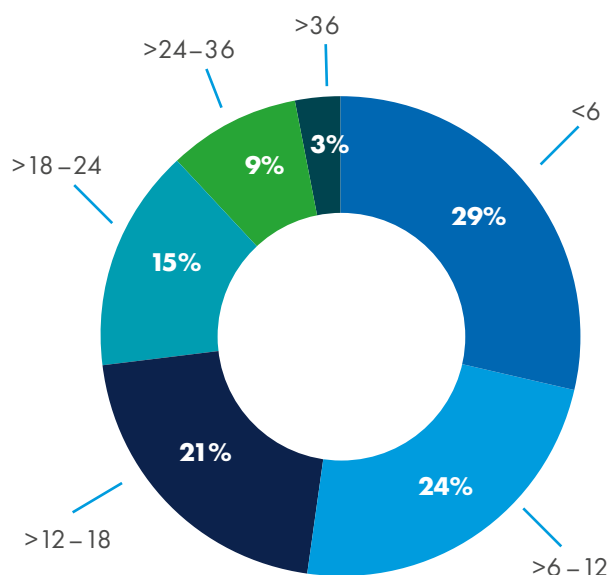
³ Material claims are claims with an incurred loss greater than USD 100,000

Competitive market defies material claims

The increasing frequency of large claims coupled with declining rates and broadening terms and conditions is presenting challenges, according to Turnbull. "If carriers have come into this business hoping they're going to make a lot of money with no real hits, that's just not going to happen."

Dennis Froneberg, Europe M&A manager, AIG, expects the dynamics of a competitive insurance market for R&W to play out over the next couple of years. "With a higher number of large claims coupled with a competitive market there's a profitability challenge. Increasing severity may necessitate higher rates."

Fig 3 **Distribution of Average Claim Report Lags from Policy Inception Date (in Months) – Policy years 2011-15**
(numbers may not add up due to rounding)



A meaningful number of claims continue to come in after the first two years, pointing to the potential long-tail nature of R&W claims. "We've had a steadily increasing percentage of claims that came in later than 24 months," says Froneberg. "There is a tendency to enter into longer duration contracts and it is important to remember that there is a long-tail element to this business."

Overall, 74 percent of claims are notified within the first 18 months and 29 percent of claims notifications are expected within the first six months from policy inception. "The critical period is the first 18 months because that is when the target company and the new buyers have taken over management of the operation and have gone through an entire audit cycle," explains Darren Savage, Asia Pacific M&A manager at AIG, "which is often when you start to find problems."

New analysis carried out this year provides further clarity on notifications made beyond the first 24 months of policy inception. As fig. 3 shows, nine percent of claims are notified between two and three years, with another three percent notified after three years. In the Americas this is even more significant, with 11% of claims coming in between two and three years and three percent after three years. It should be noted that unlike the data represented in the other charts within the report, figure 3 includes only the portfolio's mature policies in order to more accurately reflect the average claim report lags over time.

Looking at claims data for all policies 2011-17 further trends emerge. "The fact that in North America we get nearly half our claims after 12 months is very interesting and contrasts with the international business," says Turnbull. "One of the reasons this is significant for AIG is that on many policies issued in the US and Canada the retention usually drops down to a smaller number after 12 months."

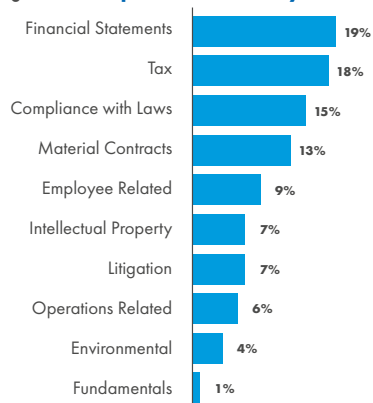




Regional breach trends

Globally, there has been little change to the main R&W breach types, with financial statements, tax, compliance with laws and material contracts driving the majority of claims notifications. However, each of the three regions that make up AIG's global M&A book of business reflect its own market-specific characteristics. Tax continues to dominate as the main breach type for EMEA (25% – see 'Unpicking tax breaches' on page 7), while this is far less pronounced in the Americas and Asia Pacific.

Fig 4 R&W Reported Incidents by Breach Type



“The increasing frequency of large claims coupled with declining rates and broadening terms and conditions is presenting challenges”

That Europe dominates in the overall frequency of tax breach claims notifications is likely to be driven by audit regimes of the tax authorities in a number of European jurisdictions, says Froneberg. “Germany, for instance, has a system whereby corporates beyond a certain threshold in size can expect to have a regular tax audit,” he explains. “As a result, we are likely to see a notification in respect of M&A transactions undertaken, even if ultimately it does not result in a financial loss.”

“It is interesting that EMEA is an outlier for tax, which might be explained by the fact that there are more jurisdictions to diligence in Europe when doing cross-border transactions,” adds Angus Marshall, UK M&A manager at AIG. “But if that’s the theory then logically it should apply almost equally to Asia Pacific because Asian tax jurisdictions are probably even more complicated as you don’t have the unification that you get in Europe through the EU. So it’s intriguing that our experience hasn’t yet borne that out.”

Financial statements breaches are once again the biggest driver of all claims notifications, and within that broad category undisclosed liabilities make up nearly a third of all financial statement breaches. “There are regional variances in the scope of undisclosed liability warranties,” says Marshall. “Coverage for undisclosed liability warranties has become far more common in the UK.”

“Other breach types that fall under financial statements are discoverable during the diligence process, but undisclosed liabilities are far more difficult to identify,” he adds.

While the lowest source of claims notifications at one percent, the very existence of breaches of so-called fundamental representations and warranties (such as title and authority) remains noteworthy, thinks Duffy. "It always surprises our readership that it's not zero for breaches of fundamentals," she says. "We've heard some say in the past that there's never been a claim for fundamentals. They are considered very low risk, and quite rightly, but these claims do exist."

Currently, litigation is driving 12 percent of claims on policies issued in Asia Pacific, which stands out from North America (five percent) and EMEA (eight percent). Within Asia Pacific more generally there are signs of a maturing market, notes Savage. "Notification with respect to policies issued in Asia is on the rise, which reflects the increased use of R&W throughout the region, particularly in markets like Korea and Japan."

"The actual notifications themselves are becoming more sophisticated and now include detailed quantification of loss, which in previous years was not the case," he adds. "It is a positive development and shows clients are adapting and improving their understanding of the product and the information they provide with notifications."

From a sector perspective, the statistics on most common breach types do not come as a surprise, with compliance with laws common in regulated sectors such as health & pharma (30%), and financial services (15%). Equally, intellectual property is responsible for 16% of claims notifications when it comes to technology deals, while material contracts breaches are more of an issue within financial services (17%) and manufacturing (16%) transactions.

The right claims partner

Addressing M&A claims handling, McIvor stresses the fact that the process and information needed to adjust a claim will differ in each circumstance. "Engaging with someone who knows what they are doing and what to look for can be invaluable to our insureds. Each of these deals is individually negotiated with a thousand different factors that can come into play, and so understanding how the terms of the policy should apply to any given unique situation can be a challenging exercise. Even for those most familiar with the transaction."

"For that reason we have a global team of dedicated subject matter experts who deal with M&A claims, because having that experience with regard to the intent and operation of these unique policy provisions is essential in successfully handling these complex claims," she continues.



Unpicking tax breaches

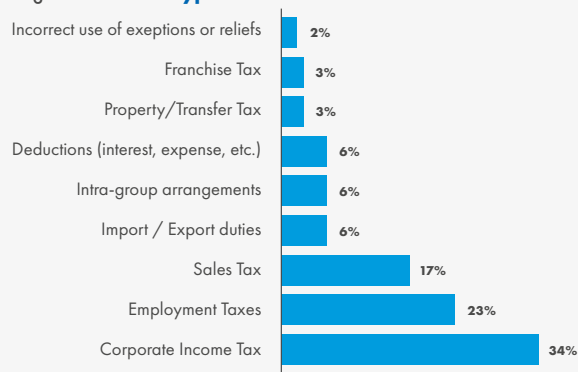
With tax responsible for over a quarter of claims notifications on R&W policies within EMEA and a significant proportion of claims notices globally, this year's report provides further insight into the types of tax breaches that are driving losses. The trends are consistent across the whole book, with corporate income tax, employment and sales taxes driving the bulk of claims notifications across the regions.

"There is real consistency between the breach types across the regions," says Rory O'Brein, M&A group counsel, Mergers & Acquisitions AIG, who also leads AIG's international practice group for Tax and Contingent Liability. "Unlike standard reps and warranties, our tax claims will usually have the same underlying claimant, the relevant taxation authority, and their focus tends to be on the same things. This is very much in the context of the internationalisation of tax enforcement and increasing cooperation between authorities."

The approach and experience of tax auditors is critical to where losses arise. "When tax authorities review an M&A transaction, they will be focused on corporate income tax," says O'Brein. "Deals bring significant one-off transaction costs and authorities will want to make sure they have been taxed appropriately. It is also the area in which they have the most experience in terms of everyday activity."



Fig 5 Tax Breach Types



"Even if something else has prompted their attention, the authority will always want to consider corporate income tax," he continues. "We expect to see corporate income taxes dominate our tax breach notifications for years to come."

Given the international context of the transactions, it may seem strange to see only six percent of claims relating to intra-group arrangements, such as management services charges. "The real risk here may be much higher," remarks O'Brein. "Our R&W policies typically exclude pure transfer pricing risks and so the numbers here only tell part of the story."

It is within the categories that some variation does begin to emerge. "Franchise taxes have evolved in the US as a levy on a company's economic presence in individual states," observes O'Brein. "These account for over five percent of our tax notifications in the US, but just does not exist as a risk in Europe."

"On the other hand a complex social security regime in Europe, with significant variation between countries, perhaps accounts for the large percentage of employment-related claims that we are seeing in the EMEA region," he adds.

In light of the fact that over a quarter of claims in EMEA are driven by tax breaches, O'Brein thinks it is important to stress the need for diligence. "We are seeing claim notifications across the board and across a variety of tax types and there is definitely a volume of tax notifications that we are having to deal with. Therefore, the need and the value in targeted and well scoped out tax diligence by buyers is important."

Claims Case Studies⁴

Financial Statements (EMEA)

AIG provided a buy-side R&W policy to the purchaser of a manufacturing business in Eastern Europe. Shortly after the acquisition, the purchaser became aware of a number of issues that had not been disclosed at the time of the transaction. First, a key piece of equipment did not operate at the capacity agreed between the company and the supplier and therefore a dispute had arisen between the parties. Second, the target company had not complied with its own employee bonus system and so, as a matter of law, the company was obliged to pay the maximum possible bonuses to its employees. Third, the target company had presented VAT receivables as assets in its financial statements, but did not retain sufficient documentation for the company to actually recover these amounts of VAT.

AIG worked with the insured to evaluate the alleged breaches, with the assistance of local legal advisors, expert accounting and engineering advice. Working with AIG and the advisors, the Insured was able to establish that there had been breaches of certain warranties and what losses it had suffered, and AIG, consistent with its terms, confirmed coverage under the policy.

Compliance with Laws (Asia Pacific)

After acquisition and in the course of planning certain building works at the target's factory site, the insured buyer became aware that a perimeter wall of the target's factory was constructed so as to protrude over the property's boundary and on to public land in breach of the relevant building laws. The insured's surveyor recommended that the situation involving the illegal structure be rectified immediately to avoid fines and/or penalties that could be levied by the authorities.

The buyer claimed breaches of warranty under the Share Sale Agreement concerning compliance with laws applicable to the Group Companies in all material respects. The buyer claimed losses in relation to rebuilding and relocating the wall as well as business interruption losses suffered during the period of shut down of the factory.

Based on the terms of the policy, AIG granted indemnity for the breach of warranty and worked closely with the Insured during rebuilding of the wall, to verify and indemnify the insured's losses.



Fundamental Warranties (North America)

A Private Equity buyer purchased an R&W policy in connection with the acquisition of a company involved in providing energy related products and services. Shortly after the closing, the buyer received a demand for appraisal from certain common shareholders of the company and ultimately an appraisal action was filed, alleging that those shareholders had not received the transaction proceeds to which they were entitled. The defence of that suit was tendered to the seller, who opted to control the defence in accordance with the terms of the Acquisition Agreement.

Plaintiffs sought several million dollars, which they claimed was the portion of the purchase price to which they were entitled. A claim was subsequently submitted under the R&W Policy for alleged breach of the Capitalisation Representation. The matter was successfully settled, with AIG making a contribution on behalf of the buyer under the terms of the policy.

⁴ The scenarios described herein are offered only as examples. Coverage depends on the actual facts of each case and the terms, conditions and exclusions of each individual policy. Anyone interested in the above product(s) should request a copy of the policy itself for a description of the scope and limitations of coverage.



About AIG's M&A insurance team

AIG has been assisting buyers and sellers with over 4,000 deals insured globally since the late 1990s. R&W claims can be complex, incorporating difficult issues as diverse as the scope of the warranties insured. When you are facing a significantly large loss on a transaction, you do not want your insurance claims handler learning about how a deal works for the first time. AIG has assembled a global network of in-house claims professionals to manage and resolve these types of claim. Made up of experienced professionals located in strategic offices throughout North America, Europe, and Asia Pacific, claims handlers work in partnership with the underwriting team. AIG insureds benefit from dealing with knowledgeable claims handlers who understand the complex nature of R&W claims and can focus on the key issues and bring them to resolution as quickly as possible. With market conditions putting increasing pressure on the M&A insurance market, it is more important than ever for clients to choose an insurance partner that is knowledgeable and tested.

CLAIMS FIRST

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