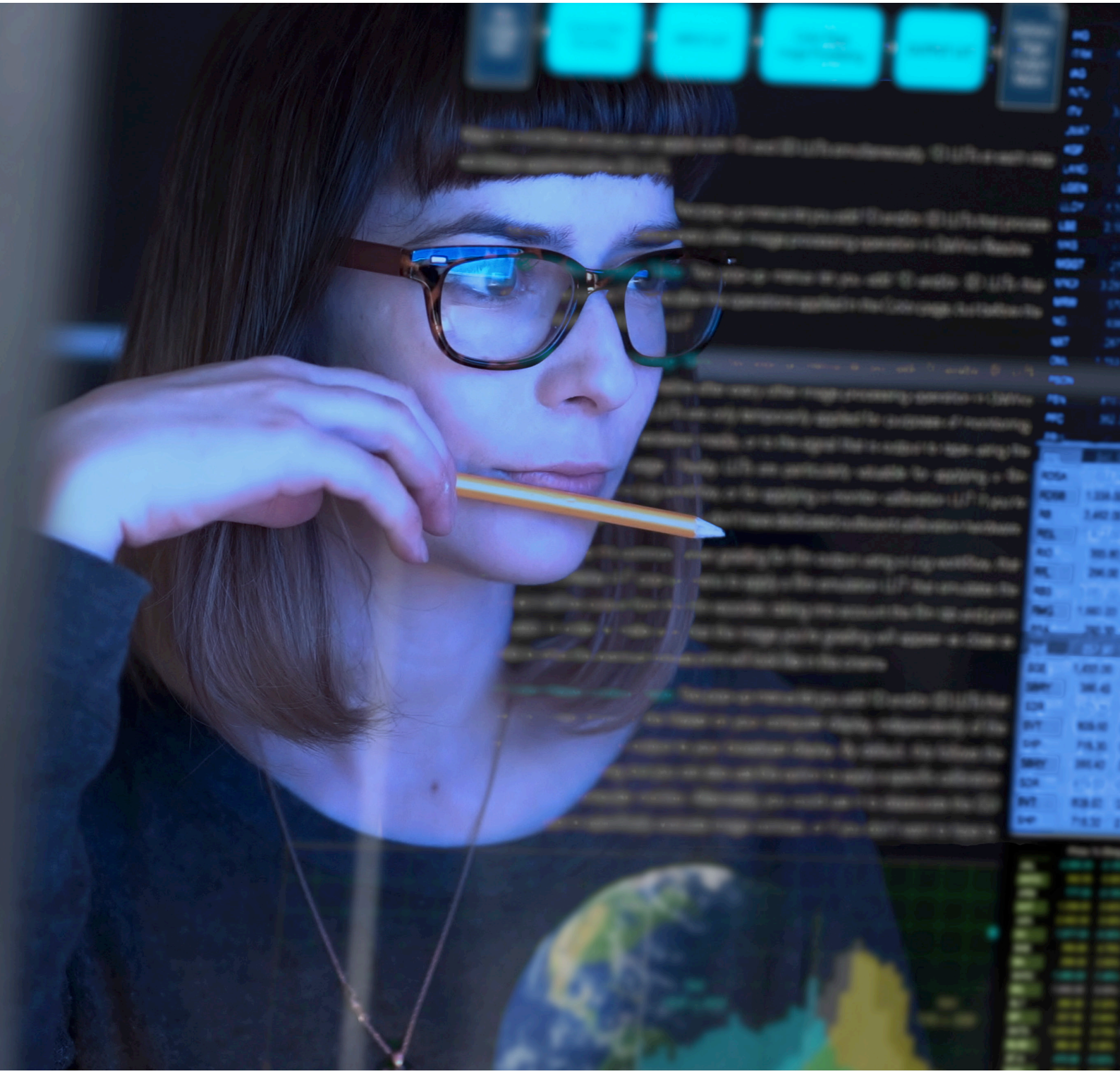
AIG

Claims Intelligence Series



M&A: Elevated claim levels put focus on due diligence

At a glance

- Claims severity[1] continues to remain high with the largest claims (valued over $10 million) having an average claim size of $19 million, and other average claim sizes remaining similar year on year across AIG's portfolio. The percentage of material claims[2] over $1m was steady at 57%
- Frequency of claims notification remains constant across the wider global portfolio, at an average of one in every five policies; with only the smaller deal sizes of <$100m having a slightly lower frequency
- Material contracts claims represent the fourth largest breach type at 12% of all breaches, with losses sometimes being alleged in excess of policy limits. Financial statements (21%), tax (19%) and compliance with laws (16%) form the largest W&I breach types
- Intelligence from AIG's claims analysis and underwriting expertise has helped reinforce some best practices for due diligence on material contracts, e.g. conducting calls with key customers, targeting internal controls around contract administration and understanding how expenses feed through to financial statements

Methodology

There were over 900 claims made on policies issued during the study period (spanning policies written between 2011 and 2019), covering over 4,000 deals, worth more than $1.8 tn in deal value – though the number of material claims was smaller. Many policies written during the study period still hold the potential for a claim. Some of the policies have reached or are now reaching maturity, providing us with more intelligence on the complete policy life cycle. The results should not be considered conclusive with respect to the broader context of all private mergers and acquisitions, as not all deals utilize W&I insurance. Nevertheless, the snapshot of W&I claims activity contained in this report provides interesting insights to buyers, sellers, and M&A advisers.

This sixth edition of AIG's M&A Claims Intelligence report focuses on the longitudinal view of claims trends in addition to highlighting aspects of due diligence for effective risk management during M&A deals.

Despite 2020 being a volatile year, AIG's global M&A insurance team underwrote over 700 policies to help support M&A deals. The M&A insurance business has rebounded dramatically in 2021. The scale and breadth of AIG's book of business puts AIG in a leading position to share insights into claims trends and what this tells us about the use of warranty & indemnity insurance (W&I)[3] insurance, its buyers – and some of the common deal pitfalls. Frequency and severity of W&I claims remained at elevated levels through the period of the study to the end of 2019, just before the start of the pandemic.

Last year's study highlighted the increase in severity of the largest material claims. The message from this year's study is that claim frequency and severity remains generally consistent with similar claim sizes and distributions across AIG's portfolio. A steady increase in the use of W&I insurance over many years has underpinned increasing numbers of associated claims.

As a result of the claims experience across the industry, pricing for W&I insurance has experienced a correction over the past year or so. AIG will continue to critically assess adequacy of pricing and focus on limits management, with an eye towards ensuring the long term sustainability of the product.

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

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

3 Usually referred to in North America as representations and warranties (R&W).

Average material claim sizes remain constant across AIG's portfolio: at $19m for the largest claims over $10m, $4m for claims of between $1m and $10m and $380k for smaller claims between $100k and $1m. While claim counts in the largest size band declined slightly, the overall counts of claims sized $1m to $10m+ remain similar to last year's study at 57% of AIG's claims, demonstrating the large numbers of sizeable W&I claims that exist in the market.

With regards to claim frequency, only the smallest deals show a frequency of less than 1:5. Across all other larger deal sizes the frequency comfortably exceeds 20%.

Policy breach types and material contracts

Year-on-year the types of policy breaches across the portfolio of claims remain similar. Breaches of the financial statements (21%), tax (19%) and compliance with laws (16%) representations form the largest W&I breach types claimed.

Claims for breaches of the material contracts representations constitute the fourth largest breach type at 12% of all breaches and are among the largest claims. Due to their significance AIG performed a deep-dive into these claims. Analysis of claims triggered by a material contract breach reveals some key observations:

- Claims citing material contracts breaches occur in all regions. In EMEA, they made up 51% of claimed losses during the 2016-2019 period, up from 23% in the 2011-15 period
- Claims are experienced in virtually all industry classes, but are especially prevalent in the manufacturing and technology sectors
- Importantly, material contracts breaches tend to result in more severe losses. The top 6% of material contracts claims account for 63% of loss dollars paid on those claims. Breaches related to a change in customer relationship can result in large claimed losses

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

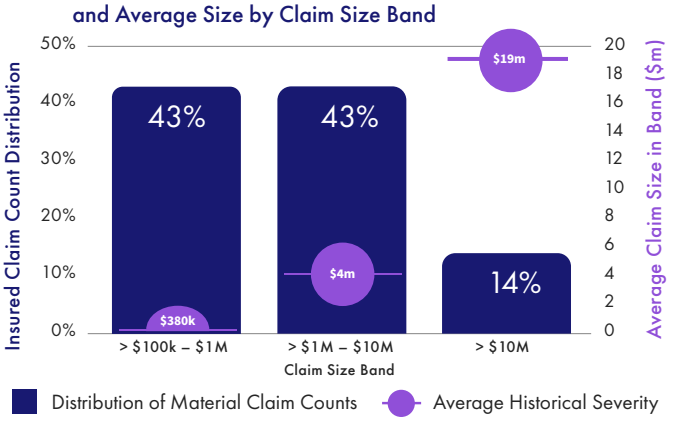


Fig 2 W&I Reported Claim Frequency by Deal Size

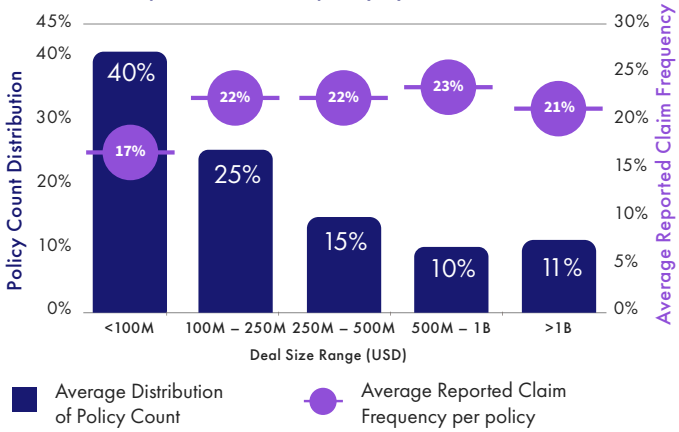
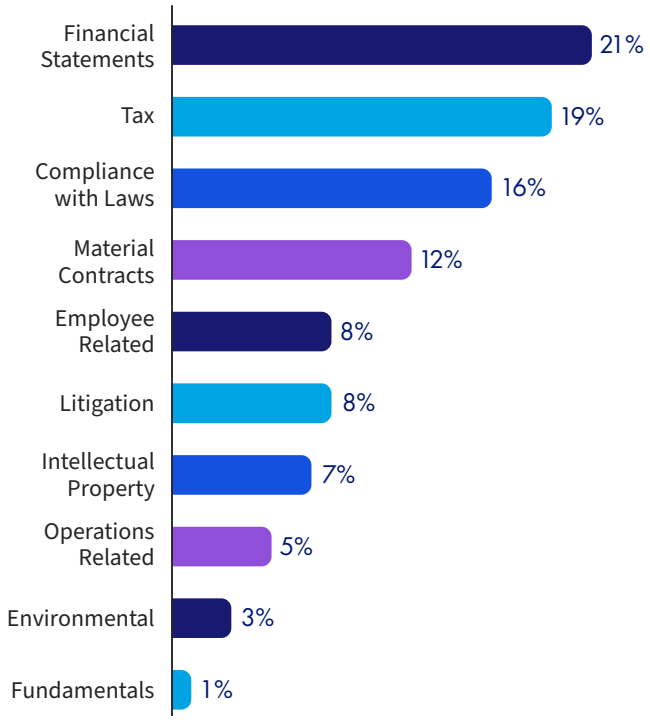


Fig 3 W&I Reported incidents by breach – Total



As M&A activity is expected to see further growth, AIG will continue to critically assess adequacy of pricing and limits management to ensure sustainability.

Furthermore, by grouping types of claim into key themes, stress points within the M&A process become evident. These require focus in the due diligence process and can be wide ranging – encompassing matters of contract administration, contract terms with third parties and accounting issues.

With material contracts breaches sometimes resulting in losses being alleged in excess of W&I policy limits, identifying issues prior to closing is particularly critical for buyers.

Fig 4 **Analysis of AIG material contracts claims since 2014**

Note: Percentages total over 100 due to claims with multiple breach types

Source: AIG claims paid and open claims since 2014

Intelligence from our claims analysis and underwriting expertise has helped identify some best practices, expanding the scope of more traditional "legal" contract review to encompass more practical elements of due diligence:

- It is important to conduct calls with key customers, rather than solely relying on seller representations about the relationship, and beware of sellers imposing any limitations on what can be discussed
- Due diligence needs to be tailored to include an investigation into the target's internal controls around the administration of contracts, in addition to reviewing the contracts themselves. Speak with the individuals directly involved in managing key customers or contracts
- Fully understand how expenses and associated costs that could impact the profitability of a particular contract feed through to the financial statements
- For strategic buyers, don't place too much reliance on your existing relationship with key customers for comfort; scrutiny of the target company's practices around its material contracts is still important and can help avoid significant losses

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For insureds, the long-term strength of an insurance partner is as important as the product itself. Insurer experience, knowledge and claims-handling expertise is critical to ensure response is as intended when a covered loss occurs.

Claims case studies[4]

Change in customer relationship

The insured, a strategic buyer, purchased a target company in the business of global digital marketing. The insured asserted that the seller had breached the transaction's customer relationship representation in the acquisition agreement because two material clients of the target had materially modified their business relationships with the target before the closing. The insured claimed that the seller failed to disclose that the target agreed to a reduction of the rates charged for certain services provided to one client that were to take effect about two months before the closing, and that a second client notified the target several weeks before the closing that the scope of a substantial new project would be reduced significantly due to a change in business strategy. The insured claimed that these undisclosed reductions in customer relationships caused the target to lose substantial earnings, and as a result it overpaid for the target. The insured brought a claim under the W&I policy for these alleged breaches. The loss calculation was a complex exercise needing the input of experts, but after evaluating the availability of coverage, AIG resolved the claim for a substantial amount that was mutually agreeable.

Breach of material contracts

After acquisition, the insured buyer became aware of a complaint from a customer of the target company, alleging that certain components supplied by the target under a material contract did not meet contractually agreed specifications, such that it breached the terms of the supply contract. The insured asserted breaches of the warranties under the share sale agreement including material contracts and financial statements warranties. The insured undertook further testing and investigations to determine the extent of non-compliance. Ultimately the insured was required to replace the non-complying units as well as to pay contractual penalties as per the terms of the supply contract, due to the delayed supply in respect of the breaches. The insured submitted a claim for indemnity under the W&I policy. AIG confirmed coverage under the policy and the insured was indemnified with respect to the loss.

About AIG's M&A insurance team

AIG has been assisting buyers and sellers with over 5,500 deals insured globally since the late 1990s. W&I claims can be complex, incorporating difficult issues as diverse as the scope of the warranties insured. When you are facing a significantly large loss on a transaction, you do not want your insurance claims handler learning about how a deal works for the first time. AIG has assembled a global network of in-house claims professionals to manage and resolve these types of claim. Made up of experienced professionals located in strategic offices throughout North America, UK, Europe, and Asia Pacific, claims handlers work in partnership with the underwriting team. AIG insureds benefit from dealing with knowledgeable claims handlers who understand the complex nature of W&I claims and can focus on the key issues and bring them to resolution expeditiously. 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.

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 products should request a copy of the standard form of policy for a description of the scope and limitations of coverage.

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