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Liberty Global Transaction Solutions™

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Claims briefing 2023

Key insights

Our data shows a drop-off in notification frequency on the 2020 YOA, but an increase on the 2021 YOA.

Accounting and financial issues have been responsible for 28% of our $1m+ claims over the last 18 months.

We have seen a substantial rise in R&W notifications involving condition of asset issues, especially in the Americas.

We are finding that our insureds are increasingly focused on claims service.

We recently made a £32.5m payment within six months from receipt of the claim notice.

Liberty GTS is one of the largest and most experienced M&A insurance teams in the market, with a team of more than 90 specialists operating in 14 jurisdictions across the Americas, Asia Pacific (APAC), and Europe, Middle East, and Africa (EMEA). We are also one of the few M&A insurers in the market to have a team of dedicated and experienced M&A claims professionals embedded within our M&A underwriting team across multiple jurisdictions.

We are proud to be able to leverage this unique combination to provide an in-depth assessment into M&A insurance claims via our annual claims briefing, which is based on data drawn from almost 500 notifications received since 2019.

"Whilst the last 12 months may have been quiet from a dealmaking perspective, the same cannot be said from a claims perspective. The predicted uptick in R&W claims based on the heightened M&A activity of 2021 and early 2022 is now upon us. This is the time where insurers that have invested in their claims function by building out a specialist in-house team dedicated entirely to servicing their claims, like Liberty GTS, will really differentiate themselves from their competitors. We were one of the first M&A insurers to recognize this and our annual claims briefing, now in its fourth year, is a key component of it. It underscores not only the emphasis that we place on claims and supporting our clients through the claims process, but also the value that we can add by sharing our data, including around paid claims, both to demonstrate that the product is working, but also to educate key stakeholders in the product about the types — and quantum — of issues that can arise, which adds to everyone's understanding of where due diligence time is best spent."

Rowan Bamford
President of Liberty GTS

Notification trends

Key insights

We are experiencing a slow-down in our monthly R&W notification count because of reduced deal activity in 2022 and 2023.

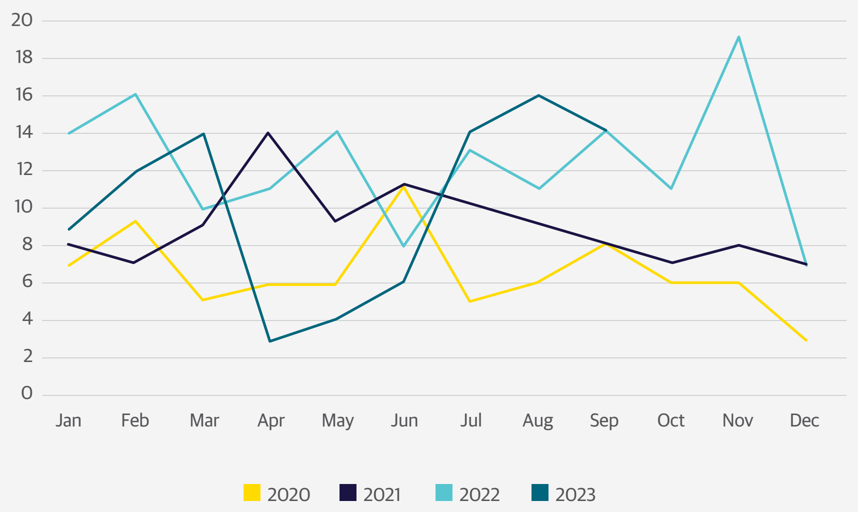
Our data shows a drop-off in notification frequency on the 2020 YOA relative to the 2019 YOA, but an increase on the 2021 YOA.

We have seen a fall in the proportion of R&W notifications where the (potential) loss exceeds the retention, but expect this to be short lived given the pressure that retentions have come under recently.

Our global R&W notification count increased once again in 2022, but has fallen back in 2023 YTD [see Figure 1].

Overall, we received 148 representations and warranties (R&W)[1] notifications across all of our regions in 2022: a year-on-year increase of approximately 38%. This increase was expected and reflects the substantial rise in the number of risks that we insured at the end of 2020 and throughout 2021 off the back of record deal activity. However, the indication is that the significant drop-off in deal flow in the last 18 months is starting to feed into fewer claims, as demonstrated by the fact that we only received 13 notifications in Q2 2023 (vs. 35 in Q1 2023 and 44 in Q4 2022). Whilst our monthly notification count picked up again in June and July (especially in the Americas), we think that this increase will be short lived given that deal flow remains suppressed and that it will start to fall back again as we close out the year.

Figure 1 **Notification count — global view**



Data based on R&W notifications received between January 1, 2020 and August 31, 2023

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

Our Americas region saw a busy end to 2022 and is the only region to register an increase in R&W notification count in 2023 YTD [see Figure 2].

We received 82 R&W notifications across the Americas region in 2022: a year-on-year increase of approximately 32%. A significant part of this increase was down to a busy end to the year with 26 notifications received in Q4 2022 (including 15 notifications in November alone — a record for a single month). We saw a slight dip in new claims activity in Q1 2023 with 22 notifications received. This was followed by a much more substantial drop-off in Q2 2023 with only six notifications received. However, we suspect that such a low number is an anomaly as demonstrated by the fact that we then received 22 notifications in July and August combined. This leaves our total notification count in the Americas at 50 for the year to date (compared to 49 at the same point last year), making it the only region that has registered an increase in 2023 YTD (albeit a very small one).

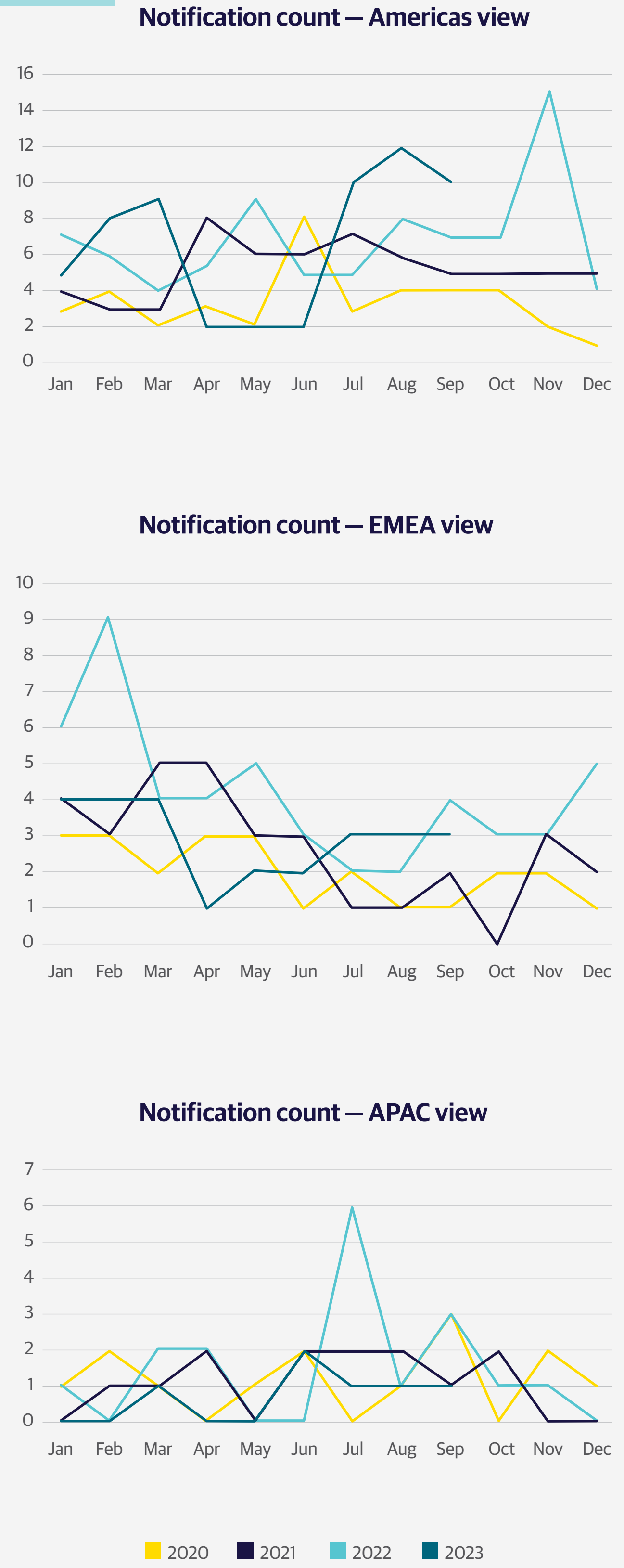
Our EMEA region saw the largest uptick in R&W notifications in 2022, but new claims activity is down in 2023 YTD [see Figure 2].

We received 50 R&W notifications across the EMEA region in 2022: a year-on-year increase of approximately 55%. This was the largest increase across all of our regions. However, this included a number of precautionary notifications relating to the commencement of a routine tax audit. In addition, a significant number of these notifications — 29% in total — were on deals where we had already received a notification. Our notification count has fallen back in EMEA since the turn of the year with only 23 notifications received as at the end of August (compared to 35 at the same point last year).

Our APAC region registered a small increase in R&W notification count in 2022 [see Figure 2].

We received 17 R&W notifications across the APAC region in 2022. This represented a slight increase on the 13 notifications that we received in 2021. This included six new notifications in July alone — the most that we have ever received in any single month in this region. However, the APAC region has registered the biggest drop-off in notification count of any of our regions so far this year with only five notifications received as at the end of August (compared to 12 at the same point last year).

Figure 2



Data based on R&W notifications received between January 1, 2020 and August 31, 2023

Our data shows a drop-off in notification frequency on the 2020 YOA, but an increase on the 2021 YOA [see Figure 3].

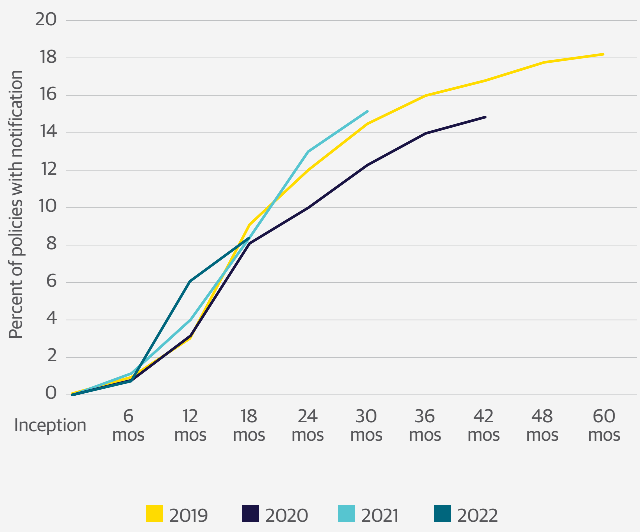
Our data shows that we have received a notification on approximately 18% of our 2019 YOA risks to date and, whilst we would expect this number to increase slightly, it is unlikely to increase materially given that these policies are now all "off-risk" for a claim in respect of the general warranties. Our expectation is, therefore, that notification frequency on the 2019 YOA will end up at or slightly below the historic average of 20%.

The evidence suggests that there has been a drop-off in notification frequency on the 2020 YOA as this is currently running at just under 15%, which is lower compared to where the 2019 YOA was at the same point in its lifecycle. This is probably not the outcome that many would have predicted at the outbreak of the COVID-19 pandemic when there was a concern that the ensuing disruption to supply chains and government-imposed shutdowns would lead to a spike in claims. Our data shows quite clearly that this did not happen. However, some of our notifications pertaining to this period (and beyond) can still be linked back to the impact of COVID-19. For example, we have seen several notifications involving issues around obsolete stock and inventory that was built up during COVID-19 and another notification involving a third-party claim that arose after a business relationship fractured due to the stresses created by COVID-19. That said, these types of notifications remain rare and the evidence suggests that, for the most part, companies have successfully navigated many of the challenges presented by COVID-19.

The early indication is that notification frequency has picked up again on the 2021 YOA as this is currently trending slightly ahead of the 2019 YOA at the same point in its lifecycle. 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.

Figure 3

Notification frequency by YOA — global view



Data based on R&W notifications received between January 1, 2019 and June 30, 2023

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 and it is important to remember, in this context, that it does not necessarily follow that there has been a breach of warranty simply because a recent acquisition has turned out to be less profitable than expected or run into unexpected difficulties. 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 it might not otherwise have done.

It is too soon to say where the figure for the 2022 YOA will end up given that it is still very early in its lifecycle, although our early data indicates that, in some of our regions, notification frequency is currently trending notably lower on this YOA compared to historic standards. This could be a reflection of the calmer deal environment in 2022, with deals taking longer to complete and buyers taking advantage of the less competitive landscape to scrutinize businesses more closely.

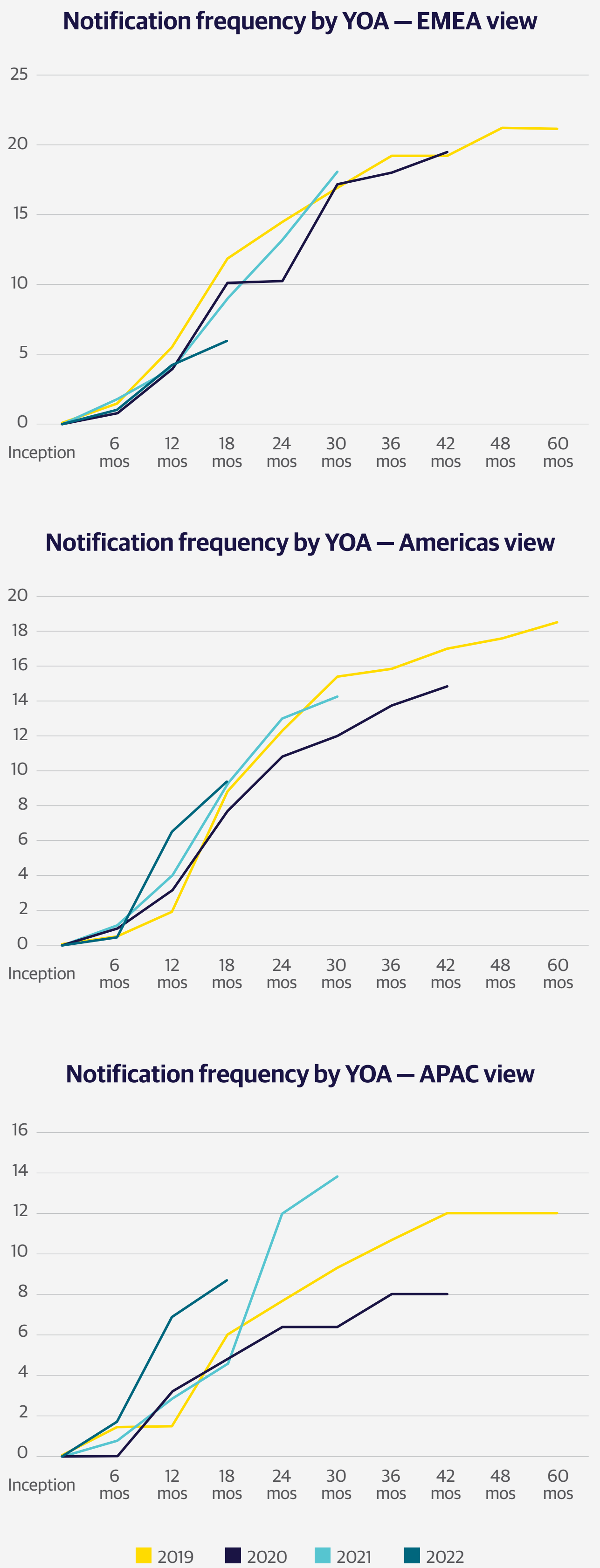
There are some notable regional differences in our notification frequency data [see Figure 4].

In EMEA, notification frequency on the 2019 YOA is currently running at around 21%, which is broadly consistent with the historic average for this region. Our data suggests that notification frequency on the 2020 YOA is currently trending in the same direction, whilst the 2021 YOA is slightly ahead of the 2019 YOA at the same point in its lifecycle. However, notification frequency is notably down on the 2022 YOA so far.

In the Americas, there has been a notable drop-off in notification frequency on the 2020 YOA when compared to the 2019 YOA. We have seen an uptick in notification frequency on the 2021 YOA, but its trajectory has slowed down over the last six months and is currently sitting slightly below the 2019 YOA at the same point in its lifecycle. We saw a big jump in notification frequency early on in the lifecycle of the 2022 YOA, but this has since normalized. We suspect that this is down to the fact that these risks are more mature in general because — in a reverse of the usual 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 than normal.

In APAC, notification frequency has been consistently lower comparative to our other regions for a number of years. However, this appears to be changing with a significant increase in notification frequency on the 2021 YOA, which is currently running at just under 14%. We have also seen a big jump in notification frequency on the 2022 YOA. However, as noted above, we suspect that this is largely due to the unusual timing of deals in this year.

Figure 4



Data based on R&W notifications received between January 1, 2020 and June 30, 2023

We have seen a slight rise in the proportion of R&W notifications where the (potential) loss is within the retention and a corresponding fall in the proportion of R&W notifications where the (potential) loss exceeds the retention [see Figure 5].

A significant number of the notifications that we receive are precautionary in nature. This would include, for example, notifications relating to the commencement of a routine tax audit. In the last 12 months, 17% of the notifications that we received fell into this category (the same as in the preceding 12 months).

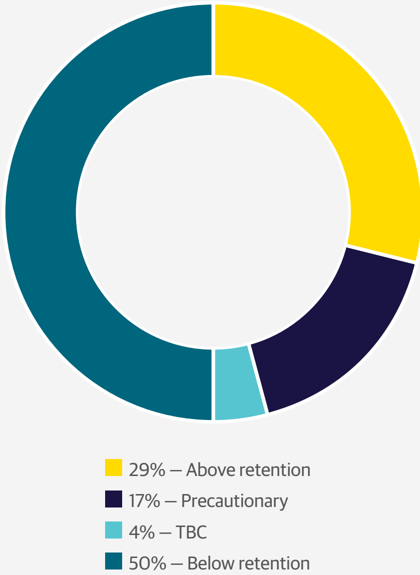
Our data shows that there has been a slight increase in the proportion of notifications received involving a (potential) loss that falls within the retention: in the last 12 months the figure was 54%, up from 50% in the preceding 12 months. This increase is likely to reflect, in part, an increased willingness among insureds to submit a notification even if the quantum of the issue in question falls within the retention, although it may also be indicative of increased instances of low-level losses.

We have seen a corresponding fall in the proportion of notifications involving a (potential) loss exceeding the retention in the last 12 months vs. the preceding 12 months. That said, we expect this trend to reverse moving forward, given the pressure that retentions have come under recently, as deal activity has fallen away leading to increased competition between M&A insurers. Ultimately, however, a long-term reduction in retentions is unlikely to be sustainable: they represent an important buffer that absorbs a material proportion of low-level claims, and continued downward pressure will just lead to narrower coverage as M&A insurers look to respond to the increased risk of payouts that they wouldn't otherwise be exposed to.

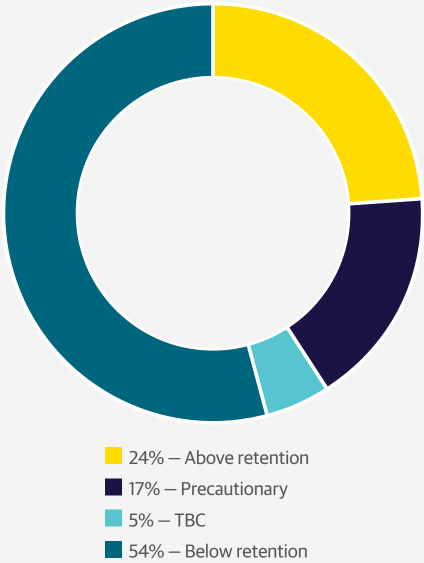
Home

Figure 5 Breakdown of loss — global view

Prior 12 months



Last 12 months



Data based on R&W notifications received between July 1, 2021 and June 30, 2023

Timing of notifications

Key insights

We have seen an increase in the number of R&W notifications being made more than two years post-inception of the policy.

This has included a number of R&W notifications that have been made late, which can create a number of complications.

We are seeing more "laundry-list" R&W notifications being made just before expiry of the general warranty period.

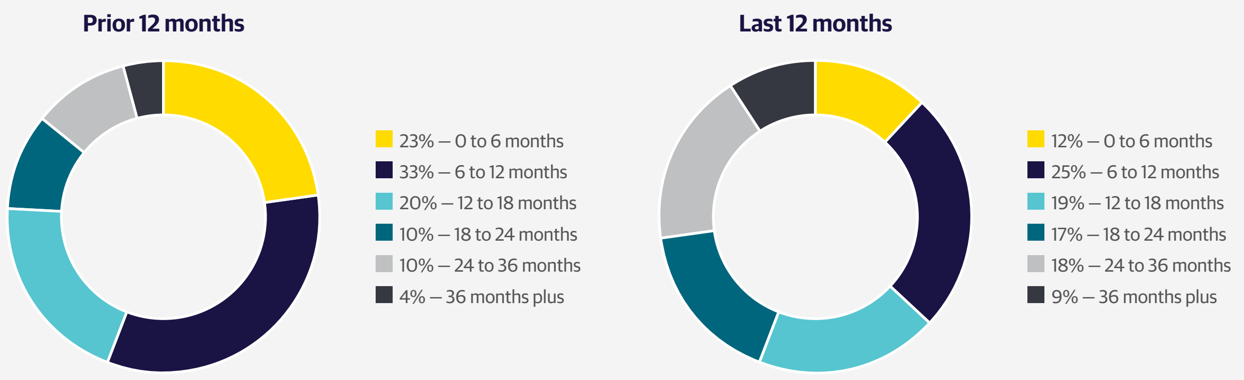
We are seeing more R&W notifications coming in slightly later in the policy period compared to previous years [see Figure 6].

The majority of notifications — 73% — are received within the first couple of years of the policy period. However, our data shows that there has been an increase in the proportion of notifications being made more than two years post-inception of the policy with 27% falling into this category in the last 12 months vs. 14% for the preceding 12 months. It is likely that part of the explanation for this lies in the fact that a greater proportion of the notifications that we have received over the last 12 months have involved either a tax-related issue or a non-tax-related third-party claim compared to the preceding 12 months. Our experience is that these types of notifications are often made later because an insured will usually only become aware of the underlying facts giving rise to them when the target company is contacted by the relevant tax authority or plaintiff (or shortly thereafter). Another contributing factor is likely to be the growth in the number of U.S. deals that we have insured over the last few years where a three-year policy period in respect of the general warranties is standard.

However, some of these notifications have not been made on a timely basis, which can complicate the claims process.

In the last 12 months, we have received several large claims which have been notified in the third year of the policy period. This included one that involved a full limit loss of €12m and another that subsequently resulted in a payment of almost $30m. However, there is evidence to suggest that some of these claims were not notified on a timely basis. This would usually be fatal for a claim on an uninsured deal because the sale and purchase agreement (SPA) will contain very strict

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



Data based on R&W notifications received between July 1, 2021 and June 30, 2023 provisions around when and how a claim must be notified, which must be complied with, failing which the claim will not even get off the ground. The position is, of course, more nuanced on an insured deal given that these provisions are typically disapplied for the purposes of the policy. This is a significant advantage of a R&W policy which is seldom discussed. However, it is important that insureds understand that this does not give them license to sit on issues — the consequence of late notice can still be severe to the extent that it has prejudiced insurers and, regardless, only serve to set the claim off on the wrong foot by increasing the knowledge gap between the parties. A common example is where we only receive notice of a tax issue upon receipt of an adverse finding by the competent tax authority, even though this has been preceded by an audit in which the issue(s) that are the subject of the finding were discussed at length with the relevant tax authorities without any reference to us.

Notifications in the Americas tend to be made earlier on, but we are seeing more "laundry-list" notifications being made just before expiry of the general warranty period.

Our regional data shows that we tend to receive more notifications earlier on in the lifecycle of the policy in the Americas region. This could indicate that insureds (and their lawyers) in this region 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.

Historically, it has been relatively unusual for us to receive a notification more than three years post-inception of the policy in the Americas region. This is because we see far fewer notifications involving tax-related issues in this region compared to our other regions. However, we have seen a trend over the last 18 months of some insureds making a notification in the last few weeks or days of the general warranty period (which will typically end three years after the closing date of the transaction) in what appears to be a concerted effort to ensure that anything that could be a claim or that might develop into a claim has been notified to the policy before expiry. These types of notifications — which will often involve multiple issues — are often precautionary in nature, but not always (as evidenced by the fact that we have received two such notifications so far this year which have been for our full limit of liability). They can be difficult and time consuming to investigate given the time that has passed since the representations were given and the historic nature of the issue(s). This is a trend that we are monitoring carefully because, ultimately, an insured that submits a notification like this could be said to represent a different risk profile for us, especially where the issues were discovered by means to a detailed review exercise conducted by the insured (or its lawyers) late on in the policy period specifically for this purpose.

However, it is still very rare to receive a R&W notification more than four years post-inception of the policy (especially in the Americas).

We only receive a very small number of notifications more than four years post-inception of the policy — as demonstrated by the fact that we have received just four such notifications since the beginning of 2020. These all involve either EMEA or APAC tax-related issues. Indeed, we have never received a notification on an Americas risk beyond this point indicating that, in this region at least, the chance of a loss materializing late on in the lifecycle of a policy is very remote.

Claims severity

Key insights

We have seen an uptick in claims severity on the 2021 YOA, especially in EMEA.

We anticipate that claims severity will drop back again on the 2022 YOA and beyond, but the impact of this is likely to be tapered by the current rating environment.

How we define severity:

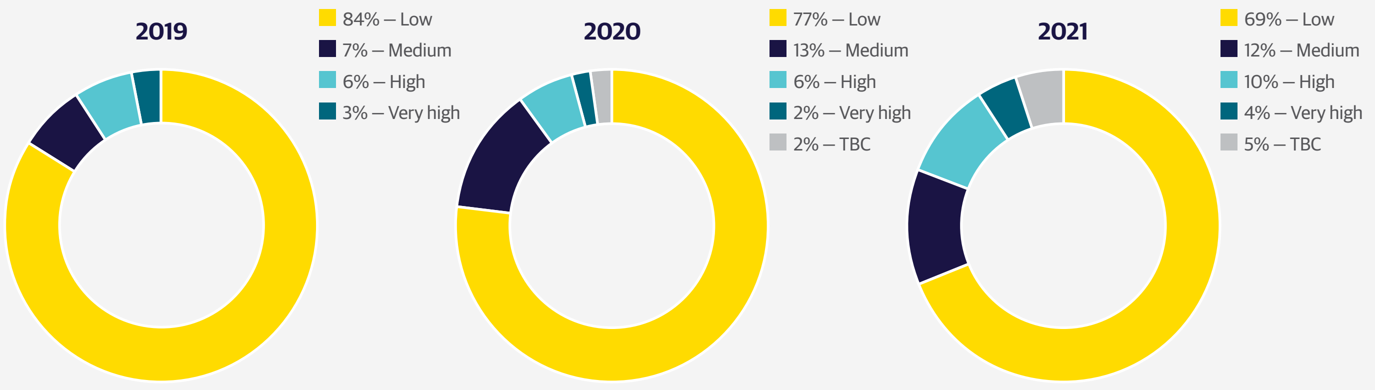
- Low-severity claims involve a precautionary notification or a claimed amount of less than $1m.
- Medium-severity claims involve a claimed amount of $1m to $10m.
- High-severity claims involve a claimed amount of $10m to $100m.
- Very high-severity claims involve a claimed amount of $100m+.

We continue to monitor the size (or severity as we refer to it here) of the claims that we are receiving. Of course, this is a slightly crude measure in the sense that some claims aren't pursued and, for those that are, the amount being claimed does not necessarily correlate to the amount which is actually recovered under the policy. However, it is still a useful yardstick that does offer up some interesting insights.

The vast majority of our R&W notifications still involve low-severity issues, but we have seen an increase in notifications involving medium-severity issues [see Figure 7].

Our data indicates that notifications involving medium-severity issues are more prevalent than they were a couple of years ago with the proportion of notifications falling into this category almost doubling. This increase has largely been driven by smaller deals with an EV of $250m or less, which suggests that these types of deals carry an appreciable risk despite the comparatively small limits that they typically involve. This could be because, on smaller transactions, there is a potential risk that a buyer will only carry out limited due diligence, resulting in a less complete picture of the target. In addition, there is a lot of capacity at this end of the market resulting in broader coverage and retentions being offered on these deals — an issue that has been exacerbated by the current lack of larger deals in the market.

Figure 7 **Claims severity — global view**



Data based on R&W notifications attaching to 2019, 2020 & 2021 YOA

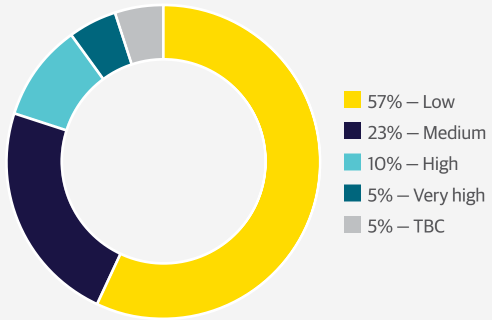
There has been an increase in claims severity on the 2021 YOA, particularly in the EMEA region [see Figure 8].

Our data also indicates that there has been an uptick in claims severity on the 2021 YOA compared to both the 2019 YOA and 2020 YOA, with a greater proportion of our R&W notifications involving high-severity or very high-severity issues. The increase in claims severity on the 2021 YOA has been particularly notable in the EMEA region, where 23% of our R&W notifications attaching to this YOA have involved medium-severity issues and a further 15% have involved either high-severity or very high-severity issues — a significant increase on prior years. This includes a number of claims for the full policy limit, with two of these alleging a total loss of more than €200m, and a number of smaller, but still significant claims, for amounts of between €5m and €10m.

We do not think that the increase in claims severity on the 2021 YOA is down to inflation because most R&W claims are quantified on a diminution of value basis with the resulting loss being assessed as at the date of the breach of warranty. Instead, the reasons are likely to be similar to those mentioned earlier in the context of the increase in notification frequency that we are seeing on the 2021 YOA. In addition, it may also have something to do with the valuation environment in 2021 (which, according to Bain & Company's fourth global M&A report, saw multiples hit an all-time high of 15.4x) having the potential to feed into larger damages calculations in instances where the insured is looking to assess its loss by reference to the valuation multiple used — a common scenario in the context of claims involving a financial statement issue or material contract issue. This is something that we continue to monitor closely even though the very favorable rating environment in 2021 means that M&A insurers are more insulated against the risk of an increase in claims severity on this YOA than might be the case on others.

Figure 8

Claims severity — EMEA view for 2021 YOA



Data based on R&W notifications attaching to 2021 YOA

We anticipate that claims severity will drop back again on the 2022 YOA and beyond, but the impact of this is likely to be tapered by the current rating environment.

Our data for the 2022 YOA and beyond — although limited — suggests that claims severity has started to drop back again. This includes the EMEA region, where we have yet to receive any notifications involving either a high-severity or a very high-severity issue. This may be connected to the fact that deals are taking longer to complete, with buyers taking advantage of the less competitive landscape to scrutinize businesses more closely, thus increasing the likelihood of issues being picked up as part of the due diligence. We are also starting to see higher interest rates (which increase the costs of finance) and higher inflation (which impacts margins) influencing the price that buyers were willing to pay, resulting in a reduction in the size of multiples, especially in certain sectors (e.g., technology). This should, in theory at least, result in smaller claims (and, therefore, payouts) in some instances on deals which signed in 2022 and 2023 compared to what we might have seen had the same deal occurred a few years ago when multiples were higher. This is especially the case for claims involving larger deals given the greater risk in the context of a big business that the EBITDA impact of, say, a breach of the financial statement warranties or the material contracts warranties will be for a higher dollar amount. However, the impact of any drop-off in claims severity is likely to be tapered by the much more challenging rating environment that M&A insurers are operating in at the moment given the current slowdown in deal activity.

Common breach types and emerging trends

Key insights

We are seeing more tax-related notifications involving an adverse finding.

Our largest claims continue to stem from accounting and financial issues.

We expect to see an uptick in material contract claims and third-party claims due to the current economic environment.

We have seen an increase in notifications involving IP issues.

We continue to find that a significant number of our notifications involve tax-related issues [see Figures 9 to 11].

Our data shows that tax-related issues made up 28% of our notifications in 2022 (up from 22% in 2021). This increase is something that we predicted in last year's briefing on the basis that national and local governments would be looking to increase tax revenues significantly in order to fund their borrowing and expenditure in connection with COVID-19-related measures. This pressure is likely to intensify given the significant cost of living measures that may need to be implemented to support people through a period of high inflation and the knock-on effect that high interest rates will have on the cost of debt. The main issues that we are seeing involve corporation tax, sales tax, or property tax issues. Our experience is that withholding tax issues and carry-forward tax losses are also being scrutinized particularly carefully, especially in EMEA. We have also received several notifications involving landfill tax issues. The rules around this tax can — depending on the jurisdiction — be very prescriptive and we have seen a number of targets that operate in the waste recycling sector facing a large tax bill after falling foul of them.

Figure 9 **Top 10 breach types — global view**

Data based on R&W notifications received between January 1, 2022 and June 30, 2023 on policies placed since January 1, 2019

Whilst many of our tax-related notifications still relate to the commencement of a routine audit, a growing number actually involve an adverse finding indicating that tax authorities are starting to take more aggressive positions on whether tax is due. In fact, in the last 18 months, tax-related notifications have accounted for 13% of our $1m+ claims. This has included several notifications involving Mexican tax issues. We predict that, as a result, there will be more scrutiny at underwriting stage around tax risks in general, and increasingly robust positions being taken both in respect of any potential exposures that are identified during due diligence, even if it is classified as being a low-risk (but high-value) item, and issues that are known to be under audit at the time of the transaction. This may mean that insureds may have to look at alternative ways of managing these risks such as via a bespoke tax insurance policy (a product which is designed to de-risk one-off identified low-risk issues).

We are seeing more compliance with law issues, especially in the Americas [see Figures 9 to 11].

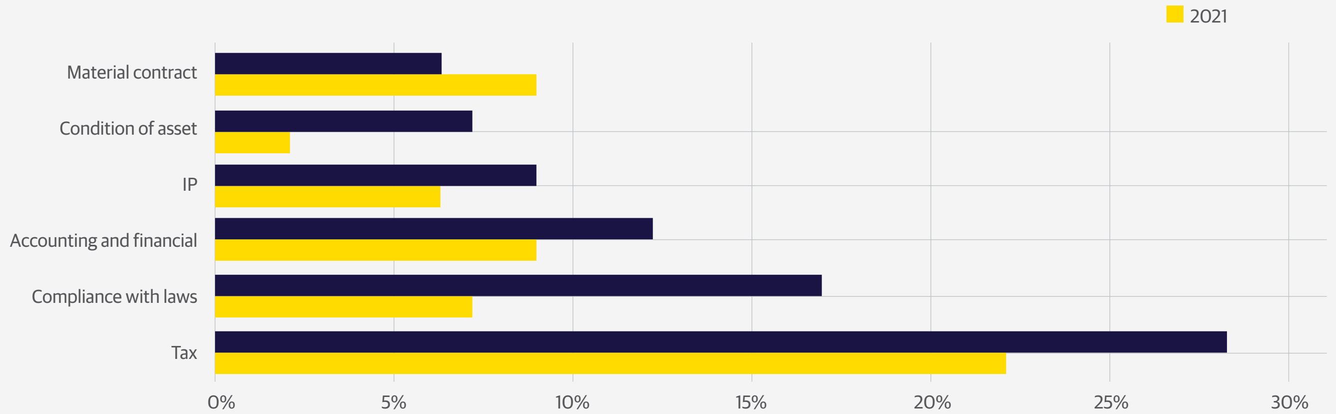
We have observed a significant increase in the proportion of notifications involving compliance with laws issues. These made up 17% of our notifications in 2022 (up from 7% in 2021). However, compliance with laws issues have only accounted for 8% of our $1m+ claims over the last 18 months indicating that, despite their relative frequency, many of these notifications involve low-severity issues. These types of notifications can cover a range of issues, but invariably involve third-party claims. They are especially common in the Americas where they have overtaken tax as the most commonly cited breach type. Notable themes include an uptick in class action lawsuits impacting the consumer products sector covering both false advertising and product liability issues. We have also seen an increasing number of notifications relating to alleged noncompliance with data privacy laws, particularly those that govern the collection and storage of biometric data (such as the Illinois Biometric Information Privacy Act (BIPA)). Our expectation is that U.S. plaintiff firms are likely to become much more active in this space as legislation like this becomes more commonplace and that, as such, M&A insurers will be looking for appropriate ways to manage their exposure to this risk.

Our largest claims continue to stem from accounting and financial issues [see Figures 9 to 11].

We continue to see a significant number of notifications involving accounting and financial issues. These made up 12% of our notifications in 2022 (up from 9% in 2021). These types of claims are often for large amounts as demonstrated by the fact that they accounted for 28% of $1m+ claims over the last 18 months – the highest of any breach type by a significant margin. This is because, depending on the jurisdiction, losses resulting from such breaches are often calculated by buyers by reference to a transaction multiple. These types of claims can encompass a whole range of issues given everything that feeds into the accounts, and so it is difficult to pinpoint any discernable trends. However, inventory-related issues and revenue recognition issues remain a common source of claims. We have also seen several claims relating to accuracy of (unaudited) carve-out accounts and, specifically, issues with how expenses have been allocated between the business that is being sold and the business that is being retained.

Figure 10

Changes in frequency of common breach types



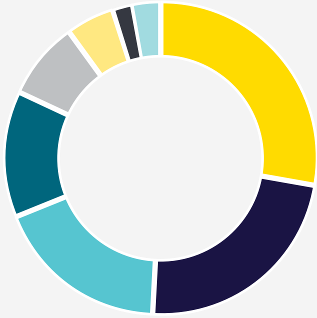
Data based on R&W notifications received between January 1, 2021 and December 31, 2022

The current economic environment creates the conditions for an increase in material contract claims [see Figures 9 to 11].

We have seen a slight drop-off in the proportion of notifications involving material contract issues. These made up 6% of our notifications in 2022 (down from 9% in 2021). Nevertheless, these claims still accounted for 18% of our $1m+ claims in the last 18 months, indicating that they remain a significant source of exposure for us. Our expectation is that this drop-off may only be temporary. This is because, with their margins being squeezed by high inflation, customers are going to be more incentivized to terminate or not renew contracts with a target company if they think that they can get the same product or service from another company at a lower price. This creates the environment for a potential rise in material contract claims and increases the importance of buyers trying to speak with the target's key customer(s) wherever possible as part of their due diligence in order to flush out issues like this.

Figure 11

Breakdown of medium- and high-severity claims by breach type



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

We are finding IP claims to be increasingly common and costly [see Figures 9 to 11].

We continue to see a large number of notifications involving trade secret theft and IP infringement claims. These made up 9% of our notifications in 2022 (up from 6% in 2021). Unsurprisingly, they are most common in the IT, pharma, and consumer products sectors. We find that these types of claims are often pursued very aggressively, presumably because companies are very protective of their IP given the competitive advantage it can provide them with and the amount of money and time that they invest in research and development. This means that they tend to be expensive to litigate. Indeed, we are involved in a number of ongoing claims where the target is projected to incur in excess of $5m in defending IP-related lawsuits, and achieving a sensible settlement is proving to be very difficult given the entrenched position of the plaintiff(s).

We have seen a significant uptick in large condition of asset claims [see Figures 9 to 11].

We have also seen a noticeable increase in claims involving condition of asset issues, especially in the Americas. These made up 7% of our notifications in 2022 (up from 2% in 2021). These are seldom small claims as demonstrated by the fact that this breach type has accounted for 23% of our $1m+ claims over the last 18 months. Indeed, we estimate that, in the Americas, condition of asset issues are currently exposing as much limit as accounting and financial issues. We examine these types of claims in more detail in the next section.

M&A insurers are facing increasing exposure from defense costs spends associated with third-party claims.

In last year's briefing, we commented that we were seeing a significant number of notifications involving third-party claims, especially in the Americas region. This continues to be the case. Indeed, in the last 12 months, 56% of our non-tax-related notifications fell into this category (vs. 49% in the preceding 12 months). This developing trend has significant implications for M&A insurers bearing in mind that a R&W policy will typically provide cover for, among other things, the costs of defending a third-party claim regardless of whether the underlying allegations have any merit. These costs can be significant, as demonstrated by the fact that our largest payment in the Americas this year — almost $30m in total — involved a third-party claim, with a significant part of the payment relating purely to defense costs, which exceeded $20m. Indeed, it is increasingly common for us to see large defense cost spends eroding retentions and we expect this to continue given the recent fall in retentions and as law firms increase their hourly rates due to inflationary pressures. This may prompt increasing discussion around whether M&A insurers (i) need to have 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 or (ii) introduce a mechanism for reimbursing defense costs if it is subsequently demonstrated that the third-party claim was without merit, meaning that there has been no breach of warranty or (iii) think about sublimiting defense costs.

Focus on condition of asset claims

Key insights

We have seen a substantial rise in notifications involving condition of asset issues, especially in the Americas.

These claims are often for large amounts.

M&A insurers are likely to become much more focused on the quality and extent of the due diligence that has been carried out by the buyer into condition of asset issues.

We have seen a noticeable increase in R&W claims involving condition of asset issues over the last 12 months and the current economic downturn creates the conditions for this trend to continue as some companies may look to reduce CAPEX spends on new assets or push out planned maintenance on older assets in order to free up cash. These claims are often for large amounts even though no multiple is usually involved. Indeed, the largest claim that we have received so far this year involves a condition of asset issue and, in the last 12 months, we have received five notifications involving condition of asset issues alleging loss that is in excess of our policy limit, with three of these in our capacity as an excess layer insurer. With many condition of asset claims being quantified as the cost of repairing or replacing the relevant asset, the current high-inflation economic environment is likely to drive up the size of these claims further. The result is that condition of asset claims are front and center of many M&A insurers' minds this year, especially in the Americas, where coverage for these types of issues is more common than in other markets.

We have seen these claims across a wide variety of sectors. However, our experience is that infrastructure-orientated companies in the energy and utilities sectors are particularly susceptible to condition of asset issues together with manufacturing businesses with large, high-throughput capital equipment. We have also seen issues with businesses where key equipment is regularly exposed to substances with corrosive properties (such as chemicals or saltwater).

We often find that there is more to these types of claims than initially meets the eye when it comes to any coverage assessment. For example, the dividing line between a breached condition of asset representation and ordinary "wear and tear" (which is a standard carve-out) is, in many cases, a matter of subjective opinion and can be difficult to determine. This is particularly the case where there is a long gap between the acquisition and the claim being reported, as this makes it harder to ascertain the condition of the relevant asset at the time that the representations were given. There are also various quantum-related issues to consider. This is because if an asset (or part of an asset) is repaired or replaced then it may have some ancillary benefits that would not have otherwise been enjoyed. For example, the asset in question may run more efficiently, or it may require less maintenance (and, therefore, ongoing CAPEX or downtime) than originally envisaged or its useful life (and, therefore, value) may be extended. These benefits will need to be factored into the loss calculation. That is why, in our experience, the key to resolving these types of claims efficiently is to involve subject matter experts from the outset who really understand the asset and the knock-on effects of any issues.

A common theme in many of the condition of asset claims that we have seen is that the issue in question has been latent, making it very difficult – if not impossible – to identify before it manifests as a problem. Examples include fatigue cracks in critical machinery, construction defects in buildings, and corrosion to pipelines. The evidence suggests, therefore, that even when good-quality due diligence has been carried out, there is an appreciable risk that significant issues may still fall between the gaps. This risk is exemplified where the assets in question are difficult to access (e.g., in the case of underground pipes or cables) or are too numerous to due diligence individually (e.g., in the case of a solar panel farm), or cannot practicably be due diligenced in their entirety (e.g., in the case of very complicated pieces of machinery constructed from many thousands of highly engineered components).

It is perhaps surprising, given the above, that we continue to see sellers being prepared to give wide-ranging representations that speak to the condition of the target's assets in their entirety and are not knowledge qualified. Instead, the main safeguard relied on by the seller is that these representations will invariably contain a materiality qualifier which effectively serves to disqualify the buyer from bringing a claim in respect of relatively minor issues. However, in the Americas, where it is common practice to scrape materiality for the purposes of the policy, M&A insurers do not enjoy the same protection. This is likely to put insurers in an increasingly difficult position of having to decide, on some deals, whether to stand behind these representations unamended or to adjust coverage for them in some way for the purposes of the policy.

Regardless of the above, it is likely that M&A insurers will become increasingly focused on the quality and extent of the due diligence that has been carried out by the buyer, especially in respect of assets that are essential to the target's operations. Investigations may extend to what extent it has been checked that the assets in issue are still under warranty; that maintenance has been carried out on the assets at regular intervals and in accordance with the manufacturer's recommendations; that questions have been asked around the causes of any unplanned downtime and repair history; and whether there is other insurance in place that could potentially respond to a loss (such as machinery breakdown cover). If the buyer has only due diligenced a sample of assets (because there are too many to inspect individually) then insurers will also be looking to check that the sample of assets diligenced is representative of the target's asset base both in terms of ensuring that all key asset classes are in scope and that not only the newest of the in-scope assets are the subject of the sample.

It is important that buyers and their deal team advisors adapt accordingly and start preparing for this increased scrutiny now in order to maintain a smooth underwriting process, especially on deals where condition of asset issues are likely to be a heightened area of concern. In the meantime, M&A insurers will be closely monitoring whether this helps to stem the flow of large claims that the market is seeing in respect of condition of assets issues, or whether they need to be taking additional steps to manage their exposure.

Claims handling

Key insights

We are finding that our insureds are increasingly focused on claims service.

The experience and attitude of the insurer and its claims handling team are crucial to an efficient process.

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

M&A insurers are increasingly being judged on their claims service.

Our experience is that there has been a notable shift in the mindset of insureds in the last few years in terms of what is important to them when selecting an insurance carrier, with a much larger emphasis on claims service. This is particularly the case for insureds that have already been through the claims process because they will know that not all M&A claims experiences are the same; they can vary depending on the experience and attitude of the insurer and its claims handling team. This makes it increasingly important for insureds to look beyond the lowest premium and nonessential coverage add-ons and scrutinize at the outset which insurer or entity will be sitting behind their policy. This includes making inquiries about how that insurer or entity is set up to handle claims and its track record for paying claims. Indeed, it is has become increasingly common for us to be asked to provide this information at quoting stage so insureds can factor it into their decision. It is why, as a business, we have taken a strategic decision to invest in our claims function and to seek to differentiate ourselves from our competitors in this space, many of whom are specialist managing general agents (MGAs) who will have to refer certain decisions back to the panel of insurers that provides their capacity, even if they are responsible for the day-to-day handling of a claim. It is also why we aim to be as transparent as possible about the claims process and our track record of paying claims. The reason is obvious: claims goes to the heart of what we are selling, and maintaining confidence in the claims process is critical for the continued success of the product.

The claims process requires collaboration from the outset, with transparency and communication being key to a successful resolution.

The claim investigation phase should be a collaborative process and a continuation of the partnership already in place between the insurer and its insured. The key is to try and strike the right balance between ensuring that the insurer gets the information that it needs to reach a coverage decision and making sure that the process of getting there does not become overly burdensome and drawn out. This is not always a straightforward tightrope to walk and relies on the reasonableness of the positions taken by both sides and an understanding that it can take time to bottom out particularly complex issues. It helps, of course, if the claim is being handled by an experienced claims team that understands the product and has been through the claims process many times over. This cannot be taken for granted given the large number of new insurers that have recently entered the M&A insurance space (whether writing the business directly or via a MGA). We have a specialist in-house team dedicated entirely to servicing our claims, which is made up of qualified attorneys, and can point to many examples of claims processes that have run incredibly smoothly, ending in a positive outcome for our insured. We discuss some of these examples in the next section.

Of course, we do not always share the insured's views on certain issues, but when this happens we will always try and work with our insured to resolve any differences in a sensible and pragmatic way. In our experience, full-blown coverage disputes remain rare, and we currently only have one claim in litigation. Ultimately, 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. Indeed, we have seen many instances of sellers taking very aggressive positions in response to the same claim that has been presented to us, resulting in the seller and the buyer becoming quickly entrenched in a costly dispute. This demonstrates that, even though the claims process may not always work perfectly, an insured will typically face fewer hurdles when it is seeking to recover its loss from an M&A insurer on an insured deal vs. from a seller on an uninsured deal.

There are other equally important stakeholders in the claims process.

It is important to appreciate that there are more stakeholders in the claims process than just the insured and the insurer. The broker has an important part to play as demonstrated by the fact that most brokers now have dedicated M&A claims experts sitting within their business with whom we work daily. The broker is in a prime position to understand the needs of both parties and can communicate to an insurer where resolution of a particular claim is especially urgent or crucial to a business and can similarly communicate to an insured why certain documents need to be produced in order to substantiate a claim. These types of candid conversations are crucial for maintaining momentum and help to prevent the breakdown of communication and limit the likelihood of disputes arising, which works to everyone's benefit. The parties' professional advisors also have an important part to play to the extent that they are involved in the claims process (this is not the case for every claim as we handle many ourselves without any external assistance). Ultimately, we view the engagement of advisors as a tool to make the claims process more streamlined and less cumbersome for our insureds given the complexity of some transactions and the level of scrutiny sometimes required to confirm coverage. In terms of selection, we hand-select advisors, specific to our business, which have both the proper expertise and outlook toward the claims process that will promote an efficient and collaborative experience (by, for example, ensuring that we are asking the correct questions from the outset). It is vital that the insured's advisors approach the claim in the same way and with an understanding that achieving the correct balance between collaboration and advocacy is important. Adopting an overly aggressive position at the outset is likely to be counterproductive and actually increases the risk of a dispute, especially if insurers have not been provided with the information that they reasonably need to make a coverage assessment.

The claims process can be more challenging when there are multiple insurers involved.

We are seeing a trend in EMEA (and to a lesser extent in APAC) whereby insureds are increasingly looking to build a tower made up of a number of policies that are each written by a different insurer in circumstances where, depending on the limit required, they might have taken out a single policy written by one insurer. This practice is, of course, already common in the Americas. However, in the event of a claim, then depending on its size, an insured will have to deal with multiple insurers (and, quite possibly, legal advisors) in a tower scenario, some of whom may take inconsistent positions on issues such as requests for further information and documentation, the handling of a third-party claim, and even coverage. This is undoubtedly an issue that the market needs to address, with better coordination required between layers, particularly in the event of a large loss, because there is a risk that a significant amount of time and money can otherwise be wasted on navigating these issues at the expense of focusing on helping the insured recover and move forward as fast as possible. Of course, many of these claims handling challenges can be avoided by adopting a single policy approach because the insured will only need to deal with one insurer in this scenario. The usual reason that is given by some insureds for not going down this route is that they have reservations about putting their trust in a single insurer in case they don't pay or they behave improperly in the event of a large claim. The key to getting comfortable with this risk is to understand at the outset who sits behind the policy and their claims handling capabilities. An established insurer with a strong balance sheet that writes M&A insurance for its own account and has dedicated in-house M&A claims experts, like Liberty GTS, is going to be best placed to respond promptly and sensibly to a claim, whatever its size, and to deliver an expedited and efficient claims service to its clients no matter what the policy limit.

Claims outcomes

Key insights

We recently made a £32.5m payment within six months from receipt of the claim notice.

We have paid or reserved 100% of the initial amount claimed in 43% of cases.

Our two largest paid or reserved claims in the last 12 months both involve financial and accounting issues.

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

This includes a £32.5m payment involving a financial statements issue which was paid within six months of the claim being notified to us and represented our full limit of liability under the relevant policy. The broker commented that: *"Liberty's collaborative approach to this claim, resolving it, and making the resulting payment impressively quickly, shows that an efficient and clear process with an insurer which recognizes that its reputation hinges on its claims performance is far more appealing for an aggrieved buyer than the uncertainty that can come from adversarial litigation against a seller."* Of course, claims such as this serve to demonstrate not only the value of purchasing a M&A policy, but also the importance of selecting an insurer with a dedicated claims function and a strong balance sheet to absorb large losses — after all, the true value of an insurance policy lies in the ability of the insurer to deal with claims promptly when they arise and to honor them regardless of their size.

The EMEA region has accounted for the largest share of our paid and reserved claims in terms of dollar amount in the last 12 months.

This includes three payments or reserves in excess of €10m, with two of these being for our full primary layer limit and the other in our capacity as an excess layer insurer. The significance of these losses should not be underestimated — both because of their size and because they were paid or reserved within a short period of time from each other. In fact, they serve to illustrate unequivocally that the product is working and that insureds are succeeding in extracting significant value from their decision to purchase a R&W policy.

The largest payment that we made in the Americas region in the last 12 months was for an amount that was very close to our full $30m policy limit and involved a Canadian risk. This is the first significant payment that we have paid in Canada and represents, therefore, a significant milestone for the product in this region.

We also paid out several smaller claims in the APAC region in the last 12 months, with the largest being for AUD$5m.

Our paid and reserved claims have arisen from a variety of issues, but accounting and financial issues continue to be responsible for our largest in terms of dollar amount [see Figure 12].

Our two largest paid or reserved claims over the last 12 months have both involved accounting and financial issues. In both cases, the warranted accounts were alleged to overstate significantly the profitability of the target during the presigning period resulting in a loss that was significantly in excess of the level of insurance cover purchased. Our third largest paid or reserved claim involved a material contract issue. This is in line with our historical data, which has consistently shown that these types of issues are responsible for most of our paid claims. This is due to the fact that, depending on the jurisdiction, losses resulting from such breaches are often calculated by buyers on a "multiple-of-EBITDA" basis as the breach will be alleged to reflect a reduction in the target's recurring EBITDA, from which the purchase price may have been calculated. Where this happens, we will often engage an expert to conduct a detailed investigation into whether this is an appropriate approach in the context of that specific claim. An investigation of this nature can take time and require the exchange of a significant amount of information, but our data demonstrates that we can (and do) get comfortable paying claims on this basis where it is justified.

Figure 12

Common causes of paid and reserved claims

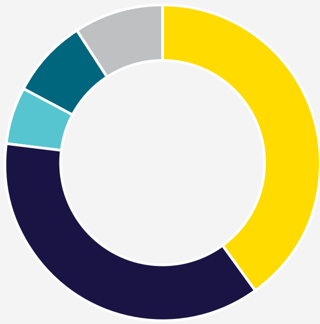
Data based on paid and reserved claims as at August 31, 2023 relating to risks placed from January 1, 2019 onwards

The majority of our paid and reserved claims have been for less than $5m, but a number of our payments involve more significant amounts [see Figure 13].

Our data reveals that 77% of our paid and reserved claims have been for less than $5m. It is worth noting, however, that these payments can still involve significant issues in the context of a small deal. Indeed, several of these payments equated to our full policy limit. It is also worth noting that some of these payments were made in our capacity as an excess layer insurer, meaning that the total insurance payout received by the insured was actually higher. However, where the product really comes into its own is when there has been a large loss regardless of the deal value. This type of situation does occur from time to time as reflected in the fact that 17% of our paid and reserved claims have been for more than $10m. In some of these cases, the insured was still left with an 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 was not insured).

Figure 13

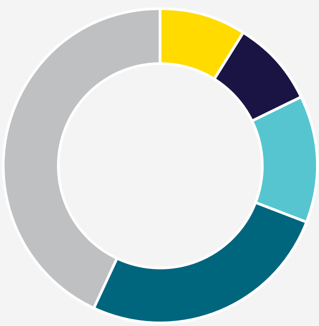
Breakdown of payments by dollar amount



Data based on paid and reserved claims as at August 31, 2023 relating to risks placed from January 1, 2019 onwards

Figure 14

Payment or reserve as a % of initial amount claimed



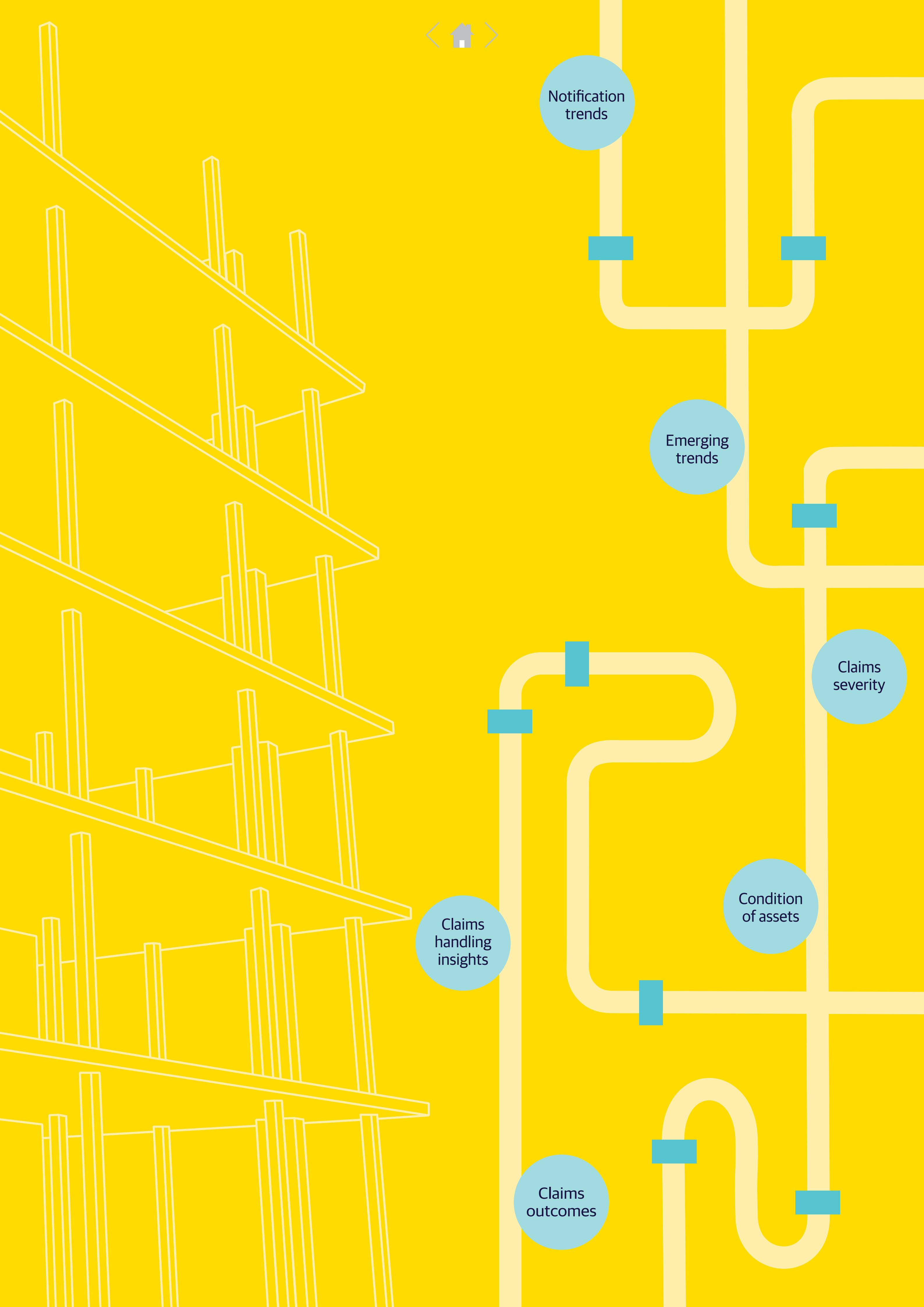
Data based on paid and reserved claims between January 1, 2022 and August 31, 2023 relating to risks placed from January 1, 2019 onwards

We have paid (or reserved) the full amount claimed in many cases [see Figure 14].

A closer look at the claims that we have paid (or reserved) in the last 18 months reveals that:

- We have paid (or reserved) 100% of the initial amount claimed in 43% of cases.
- We have paid (or reserved) more than 50% of the initial amount claimed in 82% of cases.
- We have paid (or reserved) less than 50% of the initial amount claimed in 18% 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 9% of cases. From our insureds' perspective, they provide comfort that we are paying claims – in many cases 100% of the amount being claimed – demonstrating that the product is working.


Notification trends
Emerging trends
Claims severity
Condition of assets
Claims handling insights
Claims outcomes

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