

Claims Report

2021

This M&A Insurance Claims Report covers an exceptional 18 months¹, during which we placed 1,061 M&A insurance policies on 737 transactions across EMEA.

As we touched upon in our [Annual Review of 2020](#), the COVID-19 pandemic was challenging from many perspectives. However, global M&A deal volume has been breaking records since Q3 2020.

For Howden M&A, we have been working on more deals, placing more policies than ever. This has translated into a record number of notifications. Having access to such a large pool of data means we can produce this insightful report, which shows that M&A insurance is working.

We hope you enjoy reading this report and we look forward to discussing the key themes with you.

EMEA claims data from the last six years (2015 to H1 2021)

242

Notifications

18

Jurisdictions

12%

Notification rate²



Drew Wardrope
Managing Director

¹ The reporting period for this Claims Report runs from 1 January 2020 to 30 June 2021

² Number of notifications worked on since 2015 compared against total number of insured deals



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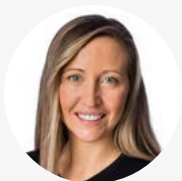
Howden M&A Claims & Advocacy Service

Our Claims & Advocacy Service comprises a team of solicitors, advocates and claims handlers

Since its launch in 2015, the team has built up a rich history of claims and advocacy work, working on almost 250 notifications, with clients seeing claims settled promptly and fairly.

How we help

- The team works with our brokers during policy negotiation and placement to secure insured-friendly policy wordings.
- As and when clients uncover an issue that could lead to a claim, the Claims & Advocacy team will work with the policyholder to prepare a notification pursuant to policy requirements, while structuring the notification to maximise claim success.
- We also work with clients after they have notified a claim. As experienced in-house insurance claim advocates, we can negotiate directly with the insurer rather than via legal counsel. This allows us to deliver practical and commercial solutions.
- Where the policy has been placed by Howden M&A, claims support will be at nil cost as this service is included in the brokerage paid by the policyholder as part of the policy premium.
- For claims relating to policies placed by other brokers, we can agree a fee structure that reflects the complexity of the claim.



Anna Robinson
Director, Head of Claims



The team has had a stellar year advising a record number of clients, negotiating significant settlements and agreeable outcomes. Our technical insight and practical approach played an important role in securing these results. In response to an increase in notifications, we are looking forward to growing our team to ensure our clients continue to receive high quality, diligent and timely advice.

2021

Market Overview

In Q2 2020³, European deals dropped significantly to a 10 year low. Since Q3 2020, deal activity has been phenomenal with the aggregate value of global deals during the 18 months to 30 June 2021 closing out at USD 2.26 trillion⁴.

The overriding theme for this Claims Report is that increased deal activity and use of M&A insurance has led to an increase in the number of notifications. We are receiving a record number of notifications but, given the fact that we placed cover on more deals than ever before, the notification rate (as a percentage) has dropped significantly.

This report demonstrates a continuation of certain trends that we highlighted in the 2020 Claims Report, such as the fact that 'mega-deals' attract a higher notification rate, when compared to transactions sub €1 billion. However, you will also see that there have been shifts in previous trends, such as the length of time between the inception of a policy and the date a notification is submitted.

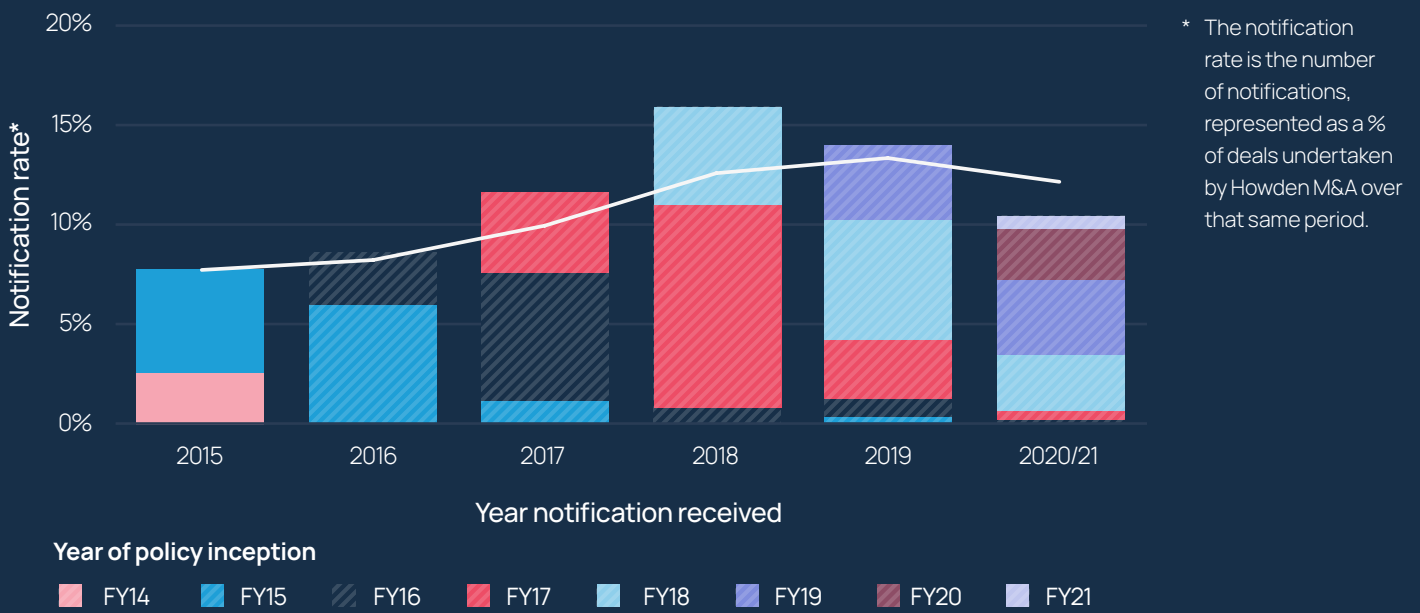
Almost 24 months have passed since COVID-19 first hit the shores of Europe and it has become clear that the pandemic did not bring about a surge in the volume of notifications and/or the number of COVID-19 related breach events anticipated at the outset. The deals undertaken during the local lockdowns would have diligenced COVID-19 or the policies would have excluded it. We therefore don't expect the position to change.

^{3&4} Data taken from White & Case M&A Explorer (M&A activity by value Q1 2020 – Q2 2021)

Section 1:

Notification Rates

Notifications continue to fall in percentage terms after the 2018 high

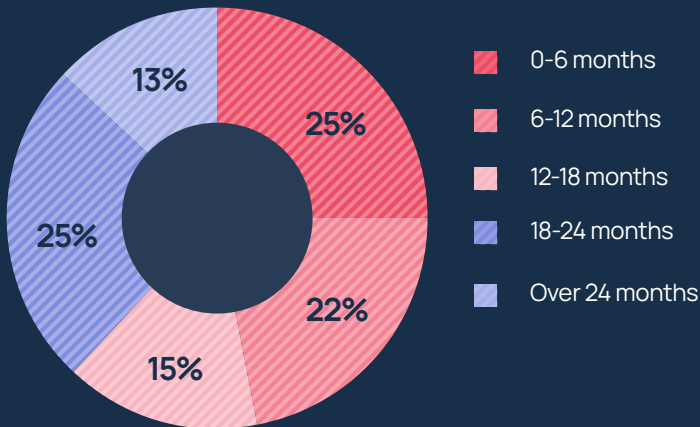


Notifications dropped from 14% to 10% between 2019 and 2020/21, which is a considerable drop when you look at that statistic in isolation. However, as mentioned in the Market Overview section of this report, we have grown our market share and seen an exponential increase in the use of M&A insurance with the absolute number of notifications doubling, albeit over an extended period.

To 'normalise' the peaks in deal and notification numbers, it is better to focus on notification rates over the long term. You can see from the white line above that, when you look at our entire book of notifications since 2015, notification rates have been relatively stable in the last three years. The average notification rate across all of our deals now stands at 12%.

Notifications are being made later

Notifications by months since inception



The 2020 Claims Report stated that 90% of notifications are made within the first 18 months of policy inception, whereas during this reporting period, that number dropped to 62% as the proportion of notifications after 18 months rose significantly from 10% to 38%.

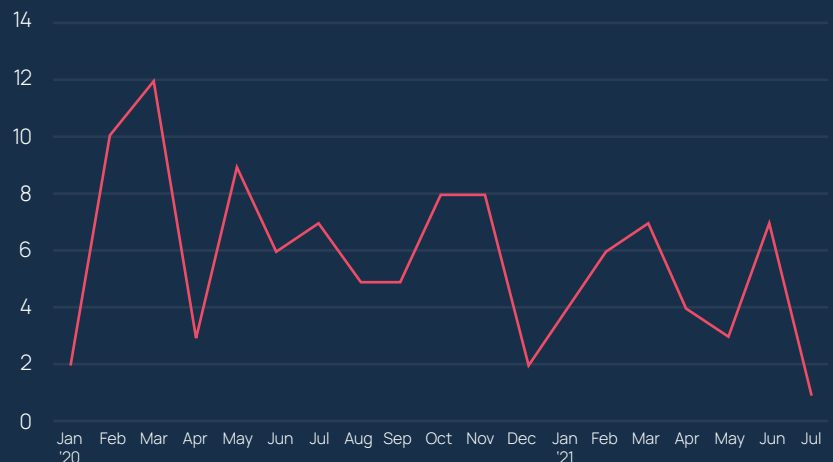
This may be explained by the insurance market offering longer warranty periods in recent years, meaning policyholders have more time to uncover issues that relate to the general warranties. We are also seeing a rise in tax claims, which benefit from longer warranty periods.

The 2020 Claims Report touched upon the “long-tail” nature of W&I claims and how one major insurer had extended their reserve period for W&I policies, which in turn has impacted their pricing model. We know of other insurers looking at doing the same. This is mainly due to the downward pressure on rates seen up until this year, rather than historic loss patterns (at least in EMEA).

See page 14 of this report for a breakdown showing how breach events change over the life of a policy.

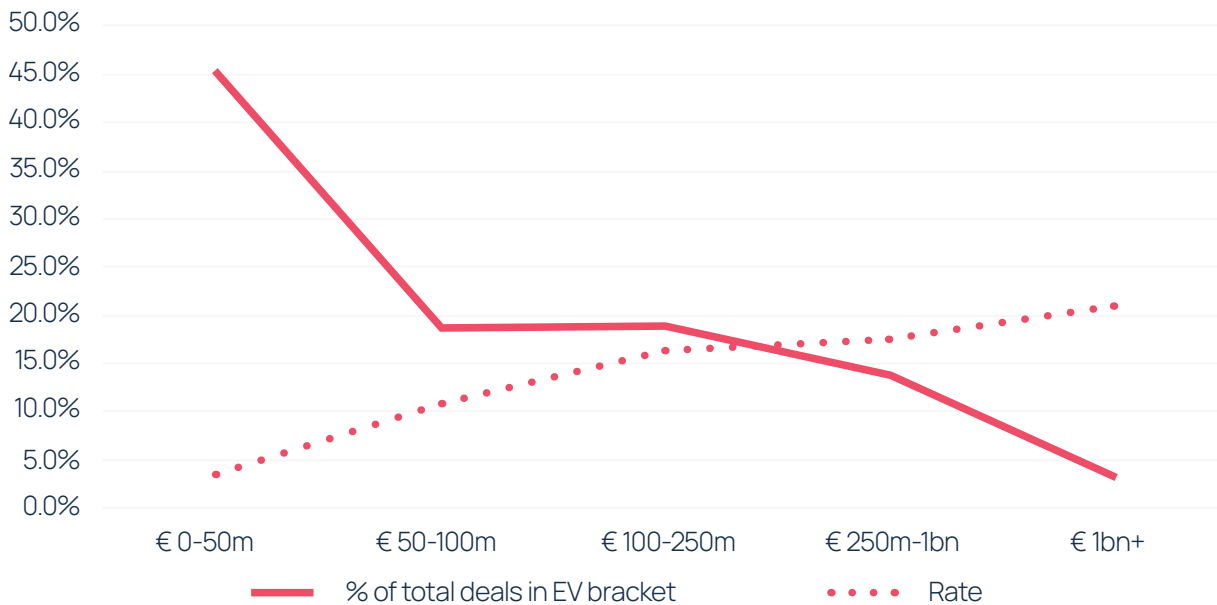
Notifications throughout the reporting period

As you can see from the graph, there was a sharp fall in the number of notifications when the UK and Europe went into lockdown. That is understandable given the focus for many investors was adjusting to new working arrangements, resetting strategies and, for many, survival. However, after May 2020, we saw the monthly notification rate become relatively stable albeit with seasonal fluctuations.



Large deals continue to generate more notifications

Notification rate vs EV



Although the average notification rate (when compared to number of policies) has dropped generally, it increased for mega-deals (those deals above € 1 billion EV). This is contrary to Liberty's findings in its 2021 report⁵ whereby small deals (less than US\$ 250 million) produce more notifications, and account for largest paid notifications, but Liberty is, anecdotally, seeing the gap narrow between mega-deals and other deals. However, AIG's 2020 report⁶ is consistent with the findings of our report. The AIG report concluded that large deals (valued at US\$ 500 million and over) produce a higher frequency of claims, with potential for covered loss greater than US\$ 10 million.

As highlighted in our 2020 Claims Report, large complex deals are more difficult to diligence and issues can be missed, especially during fast-paced competitive auction processes. Insurers have continued to price this into their models, with mega-deals priced at an average rate of 1.36% in 2020 and lower value deals priced at an average rate of 0.97% in 2020.

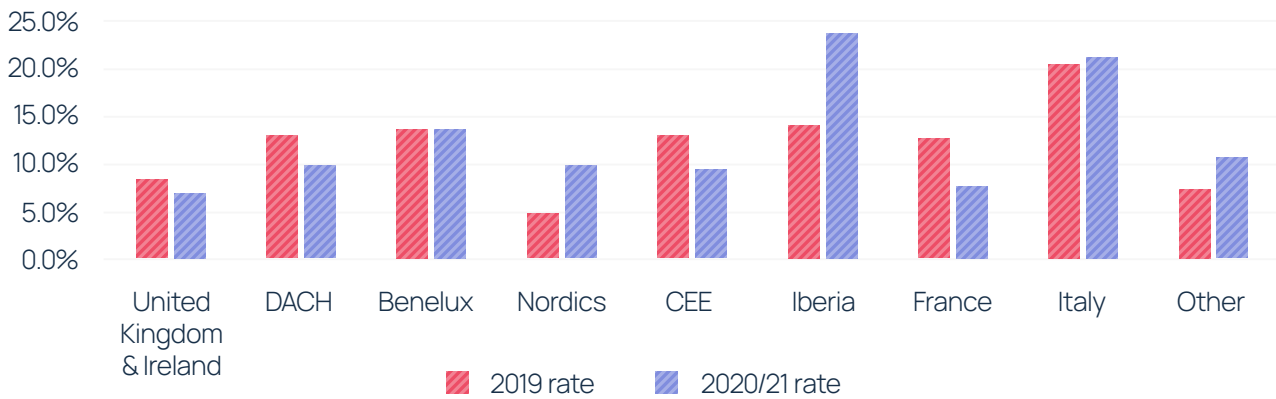
⁵ 2021 Claims briefing; Liberty Global Transaction Solutions

⁶ Mergers & Acquisitions 2020 Claims Report; AIG



Notification rates are seeing regional 'spikes'

Notification rates across jurisdictions



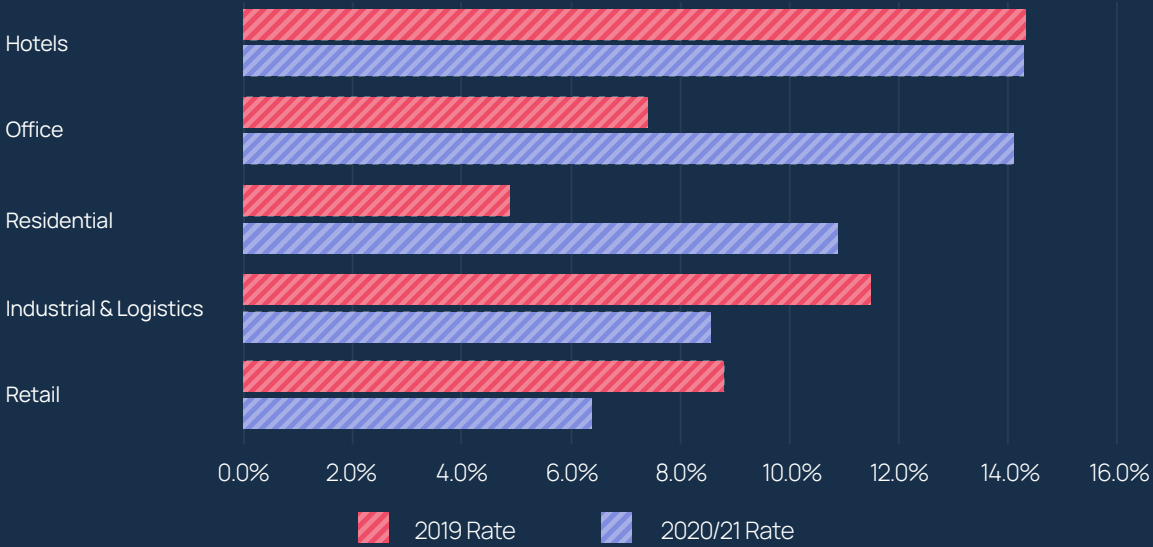
Generally, across jurisdictions, notification rates have been relatively stable.

However, notifications are increasing in the Nordics for both operational and real estate deals. Whilst the Nordic region has generally had the lowest notification rate in Europe, the severity of the notifications has been substantial. In 2020, there were two arbitrated cases in Norway that resulted in multi-million Euro awards with one being for a full limit loss. This has impacted the level of cover that policyholders are taking out in the region. In the first six months of 2021, we saw policyholders involved in Nordic deals increase their average level of W&I cover to approximately 30% of the transaction value.

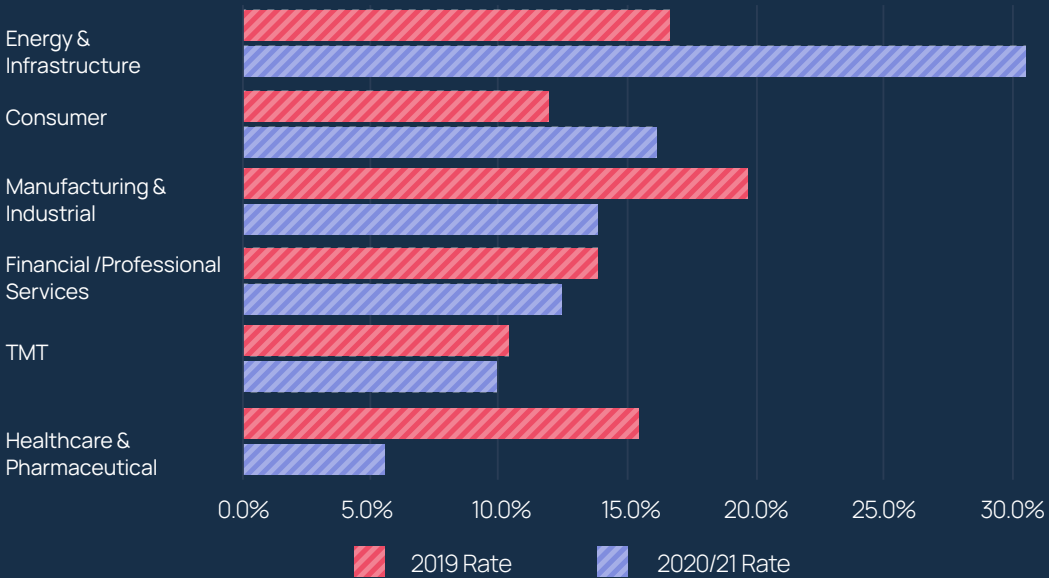
With the M&A insurance market coming of age in Iberia, the region saw a considerable surge in notifications as sophisticated policyholders took advantage of the protections offered by W&I insurance policies.

Real estate deals attract fewer claims

Real Estate



Operational



As has been the theme over the years, the inherent nature of operational deals (client contracting arrangements, large workforces and, typically, length of time as a going concern), means they produce more notifications than real estate deals.

On close analysis of real estate deals, there has been a change in the sectors attracting the higher notification rates. This has been driven by the number of deals undertaken in these sectors, rather than any overriding or common issue. For example, the absolute number of notifications in the logistics sector has remained the same but in 2020, the number of deals increased by 140%⁷. Likewise, the number of deals in the office sector increased by 30% but the number of notifications remained the same.

Operational sectors have also seen a change in the notification rankings, again driven by increased deal volume in sectors that fared well during the pandemic such as the healthcare and pharmaceutical sector. That sector's notification rate dropped dramatically from 16% to 6% but the number of insured transactions increased by 64%.

For those sectors that saw a significant rise in the notification rate, notifications were primarily driven by:

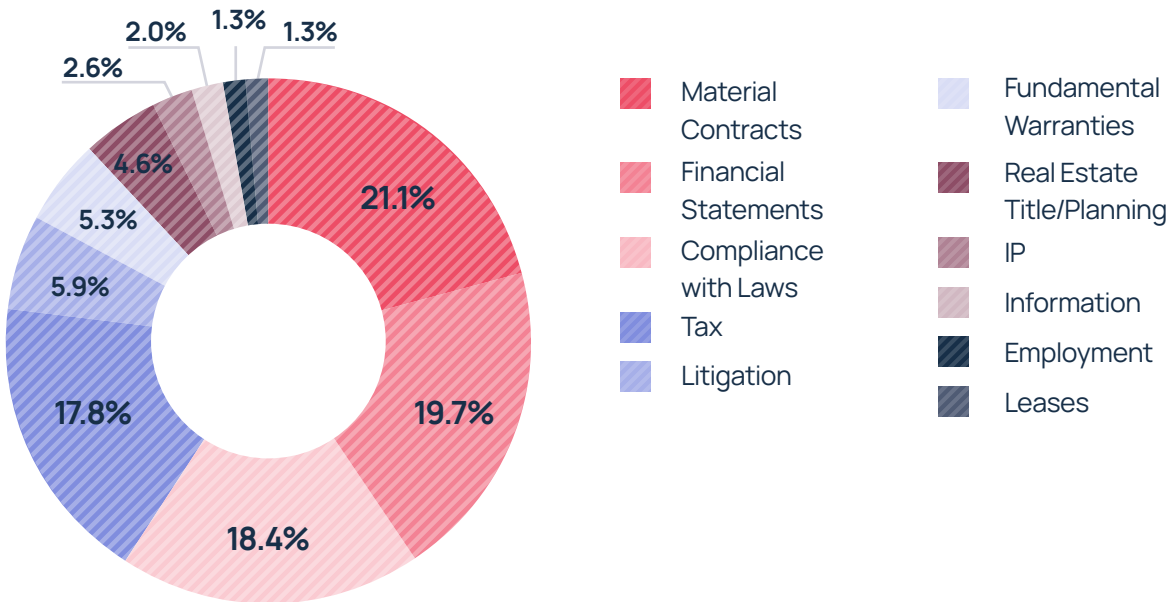
- issues relating to the insureds' obligations under material contracts for energy and infrastructure; and
- issues arising out of the leases e.g. undisclosed fit-out obligations or, 'use' agreed in the lease being contrary to permitted use for office and residential.

⁷ Calendar Year 2019 vs Calendar Year 2020

Section 2:

Breach Events

Commonly breached warranties

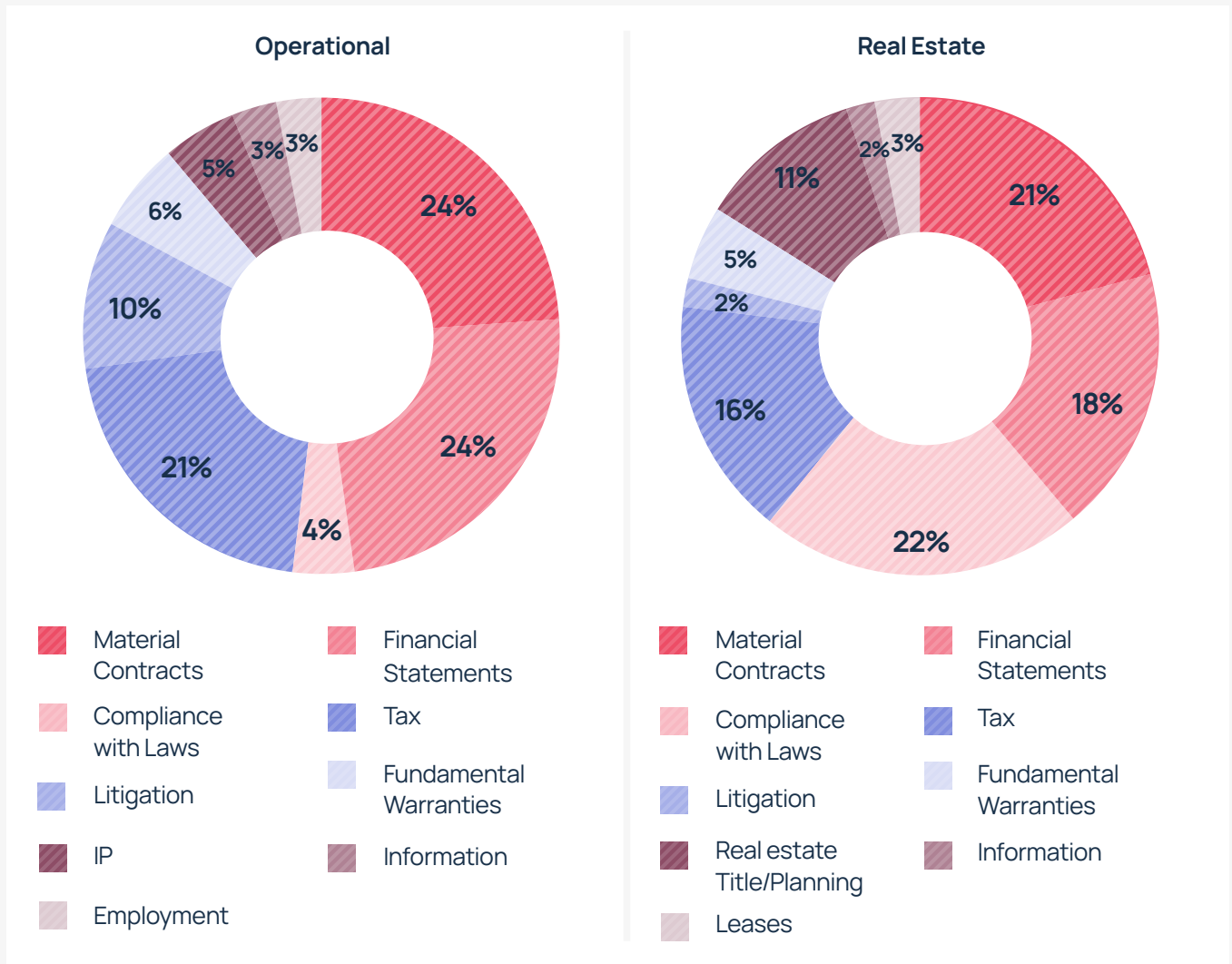


Across all deals, Material Contracts and Financial Statements continue to be two of the most commonly notified warranty breaches, with the share of Tax notifications dropping by 10%. However, we have seen a marked increase in notifications relating to Compliance with Laws warranties, with the rate of such notifications increasing from 3% in the 2020 Claims Report to 18.4% in this report.

To bring some life to this data, we have set out some anonymised examples of paid claims involving the top three commonly breached warranties:

Warranty type	Facts
Material Contracts	A key client of a supply chain solutions business terminated its contract. The seller was aware of the termination and deliberately failed to disclose it to the buyer. The warranty was qualified by seller knowledge, which the buyer demonstrated by producing emails between the seller and the target discussing the termination.
Financial Statements	The financial statements of a steel manufacturer overstated inventory of a particular alloy. The overstatement arose as the stock-take of alloy was counted manually and entered into the system. Handover instructions for a change in personnel missed this task which led to an error in the financial statements.
Compliance with Laws	A software audit was carried out after completion and it was discovered that the target, an IT services provider, held an insufficient number of licenses, infringing copyright and IP laws.

Commonly breached warranties: Operational v Real Estate



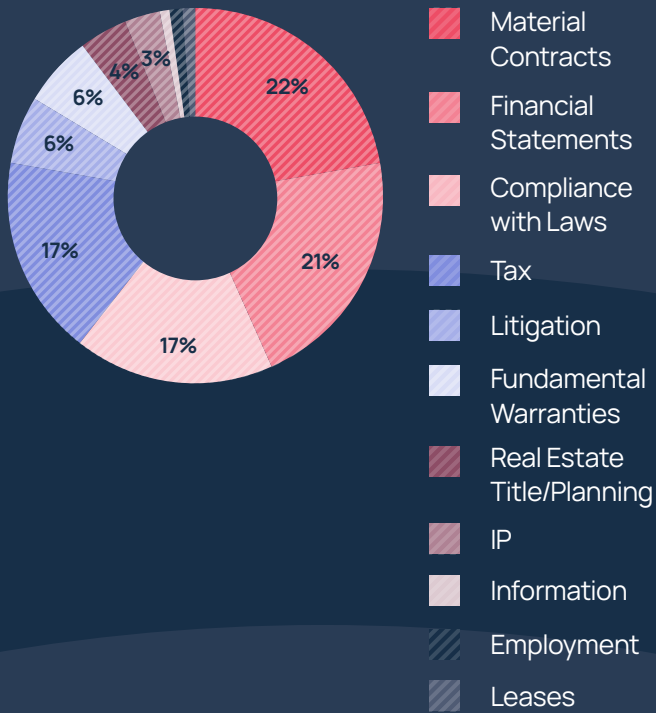
Given the difference in trading nature between operational and real estate deals, some of the differences between the breach events are self-explanatory. It is clear from the above that the rise in notifications made against the Compliance with Laws warranties was driven by the real estate sector.

The most common fact pattern underlying a Compliance with Laws breach for real estate deals involves issues with property or assets that do not comply with planning laws (e.g. walls encroaching over boundaries) or safety and environmental laws (e.g. water treatment machinery and waste management conducted in breach of permit).

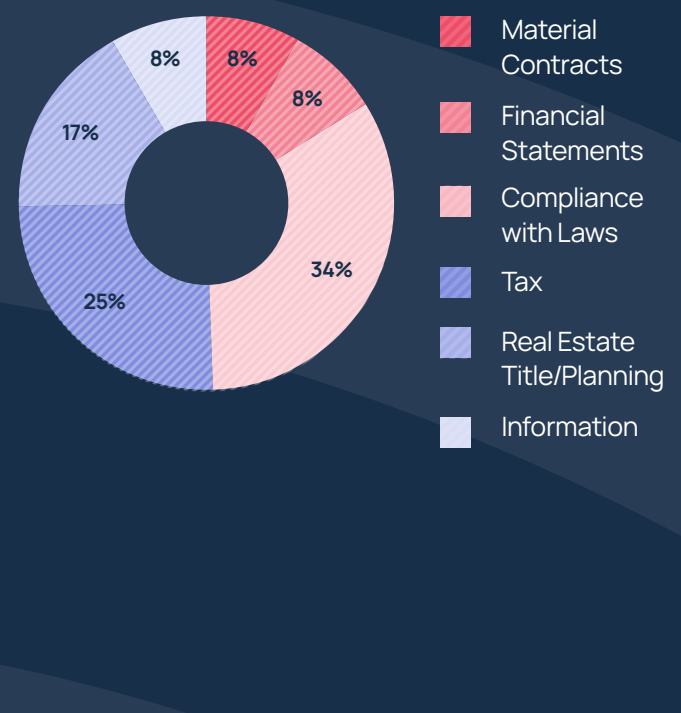
Breach events vary by size

Our work on mega-deals has continued to increase year-on-year and we are seeing a marked difference between the list of breaches notified for transactions above €1 billion and those below. For example, issues involving employment matters only appear for transactions below €1 billion, most likely because of these issues not meeting or exceeding the de minimis levels agreed in policies for mega-deals.

Transactions below €1bn



Transactions above €1bn



Breach events differ over time

As reported in Section 1, notifications are being made later in the policy period.

The top three warranty breaches are consistent no matter when a breach is notified. However, the data shows that it takes longer for Tax matters to be notified, which is understandable given audit cycles and the extended warranty periods.

Warranty breaches for notifications submitted within 18 months

Commonly breached warranties	%
Material Contracts	23%
Financial Statements	19%
Compliance with Laws	17%
Tax	12%
Fundamental Warranties	7%
Real Estate Title/Planning	7%
Litigation	6%
Information	4%
IP	2%
Leases	2%
Employment	1%
Total	100%

Warranty breaches for notifications submitted after 18 months

Commonly breached warranties	%
Tax	28%
Financial Statements	21%
Compliance with Laws	21%
Material Contracts	17%
Litigation	5%
IP	4%
Employment	2%
Fundamental Warranties	2%
Total	100%

Payment of claims

Most claims conclude with a payment

The legal action between Japanese construction conglomerate Lixil and a consortium of 20 insurers⁸, (the Grohe Claim) caught the attention of the mainstream media in 2020. This case related to Lixil's 2014 acquisition of the German bathroom fittings maker, Grohe. Commentary from some corners of the media said this case shone a light on how difficult it can be to secure cover for a W&I insurance claim.

However, **our experience shows that it is clear that W&I insurance works with 74% of claims resolving positively**: 57% resulting in a payment and, where the quantum did not exceed the policy retention, 17% eroding the retention.

The number of notifications validly declined has increased to almost 26% from 13%. This increase is likely explained by insureds' increased willingness to notify insurers on a precautionary basis as they become more familiar with the product. For a typical claim, it will be immediately apparent if a notification falls within the scope of an exclusion and there is usually no downside in notifying. A notification may be made in these circumstances when further investigation is required to determine conclusively whether or not an exclusion applies, particularly if the policy period is about to expire.

Approximately 17% of paid claims were resolved following our involvement to negotiate cover or quantum issues. 10% of these negotiated settlements related to quantum issues. Quantum is usually the most complex part of a W&I claim in terms of producing evidence and explaining the assumptions underlying the purchase price.

Typical quantum issues in a W&I claim relate to:

- (i) evidencing the appropriate EBITDA multiple; insurers may wish to understand how different business divisions were valued and how this relates to the claimed loss, and evidencing the EBITDA;⁹
- (ii) subjectivities such as how the issue underlying the breach would have been taken into account by the buyer and seller in negotiating the purchase price had it been discovered before signing. Insurers may want to understand how any matters discovered before signing were negotiated between the parties, to enable them to understand how a hypothetical negotiation involving the notified matter would have played out; and
- (iii) producing a copy of the valuation model used to calculate the purchase price.

⁸ Frankfurt Higher Regional Court, Order (Beschluss) as of 26 November 2020, file number (Aktenzeichen) 26 Sch 14/20

⁹ This was the issue in the settled case of **Seahawk Bidco Ltd. v. Lloyd's Syndicate 1686 and others**, case number CL-2020-000280, in the High Court of Justice in England and Wales where one of the quantum issues was the appropriate multiple to apply to loss caused by the seller overstating EBITDA for the target's major business division. This proceeding resolved in April 2021 by way of confidential settlement



Reasons for declinature



Actual Knowledge	10%
Breach Conditions	10%
Disclosed	20%
Property Defects Exclusion	40%
Transfer Pricing Exclusion	20%
Total	100%

Closed claims with actual loss



Covered Paid	40%
Covered Paid Quantum Issues	10%
Initially Declined and Paid	7%
Validly Declined	26%
Within Retention	17%
Total	100%

Reasons for declinature

Not all W&I claims will be paid, nor should they be. The media failed to highlight this fact about the Grohe Claim. Commentators should have explained to the general public that, as with the assessment of all claims, the Grohe Claim turned on a very specific set of facts, and the application of a specific policy exclusion for fraud of management providing assistance to the seller in connection with the sale. This exclusion is unusual and not something included in policies placed by Howden M&A.

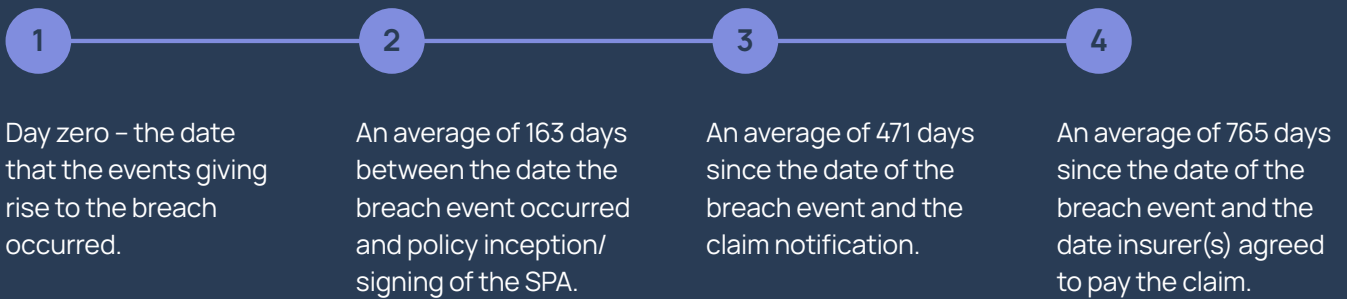
The data provides a breakdown on the reasons why claims are declined. The application of a property defects exclusion is the most common (40% of declinatures) followed equally by transfer pricing and the exclusion for disclosed matters. The application of these exclusions can be identified early as transfer pricing usually depends on the substance of the tax authorities' allegations as to why tax is payable and a property defects exclusion will turn on whether the loss is due to a defect evident in the property.

Confirmation of the application of the disclosed matter exclusion often requires some investigation as full details of the loss need to be ascertained to compare this information with that disclosed in the due diligence or data room.

Payment of claims

With insurers and MGAs becoming more familiar with adjusting claims, helped by the claims frequency, we expect settlement times to decrease year-on-year. The time it takes to discover a claim however is not something that can be controlled or determined. Interestingly, our claims data shows that, on average, it takes approximately three years to discover a tax issue and half that time to discover non tax issues.

Average payment time frame





Six practical steps for ensuring your claim has the best chance of success:

1

Involve your claims broker early.

2

Notify within the timeframe provided in the policy and seek insurer consent for next steps.

3

Particularise each element of warranty breach and enclose evidence in the notice.

4

Regularly update the insurer and respond promptly to insurer questions.

5

Identify applicable SPA limitations or policy exclusions early.

6

Include evidence of impact of warranty breach on purchase price.

Section 4:

Case studies

Case study 1: European Airline, Financial Statements Breach

The claim


- Shortly after signing, the insured discovered that the accounting treatment of capitalised lease expenses for two aircraft leased by a subsidiary as receivables was not in accordance with applicable accounting standards.
- The lease expenses were recorded as a receivable because it was highly probable that the aircraft lease would be extended with a purchase option at the end of the lease, giving rise to an economic benefit. However, the lease documents did not explicitly agree the future extension and economic benefit which was a requirement for treatment as a receivable.
- This resulted in the management accounts materially misstating profits in breach of the financial statements warranties.

Cover issues

- The insurer accepted a warranty breach but challenged the amount claimed by the insured which was based on the amount of the expense multiplied by the EBITDA multiple.
- The insurer's challenge was based on its view that (i) the subsidiary involved was loss making which would have been taken into account when calculating the purchasing price and (ii) it was not convinced the seller would have agreed to reduce the purchase price had this issue been discovered before signing.

Successful outcome

- Howden M&A negotiated with the insurer to agree a settlement sum of approximately €8,5 million following protracted lawyer to lawyer correspondence.
- This claim demonstrates the value of involving your claims broker in the claims process as they can negotiate with the insurer directly.



Case study 2: UK Real Estate Portfolio, Breach of Planning Laws

The claim

- The insured acquired a leasehold development that was used as serviced apartments in breach of planning consent. The insured claimed under its title policy for any amounts due to third parties to rectify the planning issue and any diminution in value of the property if the planning issue could not be rectified.
- The planning breach was one issue along with several others that were the subject of a wider litigated dispute with the landlord which included allegations that the insured was in breach of its lease by using the property as serviced apartments. The landlord sought for the lease to be forfeited. The additional issues fell outside the scope of the title policy. While the insured planning issue could be resolved for a nominal sum, and was covered by the title policy, resolving this issue was inconsistent with the insured's wider litigation strategy. If the lease was forfeited, the property would reduce in value significantly. The insured continued with its litigation strategy, seeking cover for defence costs relating to the insured planning issue allegations.

The initial declinature

- The insured could have remedied the planning issue easily for a nominal sum so the insurer initially declined to cover any defence costs relating to the planning issue and offered to pay the insured the amount that would have resolved the insured planning issue to discharge its obligations under the policy.
- The insurer's offer was within the terms of the policy which gave the insurer the discretion to elect to resolve claims by paying a sum equivalent to the loss or conducting the defence. Since the litigation mostly related to uninsured issues, the insurer had no interest in taking on the defence.

Successful outcome

- The insurer agreed to cover the portion of legal costs related to defending the planning issue, amounting to approx. £600,000.
- This claim demonstrates insurers' willingness to take a pragmatic approach to claim settlement in circumstances where a tension exists between the insurers' policy rights and the wider commercial interests of the insured.

Section 5:

Outlook

Absolute number of notifications will increase

Transactions are being undertaken at a record pace, meaning issues may be missed or not uncovered during the due diligence process. With that in mind, notifications are expected to increase.

Pricing adjustments

Recent hikes in W&I pricing have been driven principally by capacity constraints in the market (in the face of unprecedented demand). However, with insurers continuing to gather ever more insightful W&I claims data, we anticipate that W&I claims history will play an increasingly important role in driving future price rises. In particular, we expect to see further pricing divergence at sector level, with those sectors with higher historical loss ratios being impacted disproportionately.


M&A insurance claims beyond W&I insurance

We are placing an increasing number of policies covering 'known issues' and the Claims & Advocacy Team has started to see a rise in notifications being made under these policies, particularly title and tax. In the next 12 to 18 months, we expect to see an increased proportion of our claims portfolio be made up of claims under these policies.

Increasing claims severity

With Howden M&A advising on an increased number of €1 billion+ deals (15 in H1 2021 vs 10 in the whole of 2020), given the increased frequency of claims for these higher deal sizes and generally, we expect to see a greater range in the complexity and its average claim size.

Testimonials



“A highly knowledgeable team with great technical understanding and ability to negotiate an optimal settlement for the claim.”

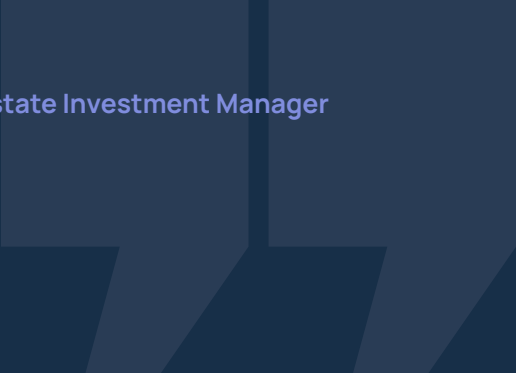
Jonathan Ennis, Eversheds Sutherland

“Howden M&A’s claims team provided robust strategic advice throughout the claims process, with clear and structured guidance from start to finish.”

Line Verroken, CBRE Investment Management

“An innovative team, willing to negotiate with insurers to secure the best outcome for their clients. A very trusted advisor throughout.”

Director of Insurance & Risk, Global Real Estate Investment Manager





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