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CS26: Transactional Liability

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The Fundamentals of Representations & Warranties Insurance

PartnerRe

May 10, 2021

What Makes R&W Insurance Different?

- **R&W insurance is retrospective, not prospective in nature**
- There is no "standard" coverage for R&W insurance – each policy is bespoke
- R&W underwriters don't per se evaluate the underlying merger transaction – they underwrite the diligence performed by the respective parties.
  - Further, R&W underwriters receive outside counsel reports that diligence the diligence performed by the advisors to the primary transaction
    - Reinsurers then diligence the diligence of the diligence

- **Risks that become known during the underwriting process can be excluded or insured separately.**
- Insured damages can be multiplied if the insured valued the target company based on a multiple of EBITDA, revenue, cash flow, etc.
- The responsibility for the retention can be borne by both parties to the transaction.
- Policy terms are longer than is typical – 3/6 years
- Two types of insureds – "buy-side" or "sell-side"

The Intent of the Insurance – why buy?

- The intent of purchasing R&W insurance is to replace the traditional escrow funding of liabilities as a result of a breach of the representations and warranties made in the PSA.

- Typically, a seller would need to withhold 10% of the sale amount to cover any allegations made by the buyer, for a period of 12 months to 3 years.

- The transference of the monetary liability for a breach of the seller's representations to a 3rd party eliminates the need or reduces the amount of funds that must be held in escrow after the transaction closes.
- Further, a buyer being able to claim damages from a 3rd party preserves the relationship between the buyer and seller for future transactions.

One of the critical characteristics of R&W Insurance is that there is a tangible, economic benefit for the purchase of the insurance **even in the absence** of a claim for indemnity.

Key Underwriting Features of the Insurance

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- The insurance limit purchased is a function of the Enterprise Value (EV) of the transaction – typically 10%-20%
  - o Example: $500M EV for the transaction - $50M limit of insurance sought
  - o Pricing for the insurance is considered on a Rate-on-Line basis
    - ➢ Example - $50M limit x 3.0% ROL = $1.5M in charged premium

- Retentions are included as a percentage of EV
  - ○ Example = 1.0% Retention of $500M EV = $5M retention
  - ○ R&W retention provisions can be borne between buyer and seller, or exclusively by the buyer (No Seller Skin).
  - ○ Further, R&W retentions contain drop-down provisions, typically 50% after 12 months

Key Underwriting Features - Continued

- Claims resulting in indemnity payments are typically discovered within the first 12 months of the purchase of an asset, due to the completion of an audit, the preparation of annual taxes, or the operation of the business.

- After the first 12 months of ownership, the required retention of the buyer is reduced reflective of the likelihood of the discovery of a material claim being remote.

- The term of a R&W policy is 3 years for general reps, 6 years for fundamental reps

The Insurance Process

- Brokers provide submissions to potential markets, as is typical in obtaining any type of insurance.
- However, for R&W, it is possible that the submission materials are provisional based on the **outcome of an auction for an asset.**
  - In this instance, the seller of an asset may seek insurance on the buyers' behalf, in order to reduce their escrow obligations and potential for further involvement with the buyer once the sale is completed. This is known as a seller-flip.
- Upon receipt of the submission, potential markets provide **Non-Binding Indication Letters** to the buyer of the insurance. These NBILs provide indicated, but not final, pricing, terms and conditions, and "areas of focus" that will require more detailed diligence in the underwriting process.
- The purchaser of the insurance then determines based on the NBILs, which market they want to engage with in order to establish the primary layer of insurance.

Faith in the ability of the insurer to close the deal is a critical aspect of this decision.

The Insurance Process - Continued

- Once the primary market is chosen, access to the deal documents is provided to the insurance carrier.
- The insurer will then engage external advisors to "diligence the diligence" that was performed by the Buyer's deal team.
  - External advisors include attorneys who evaluate the terms and conditions of the PSA, potentially forensic accountants, and in the case of insurance companies, potentially other product specialists.
  - Main areas of diligence:
    - Tax
    - Employee Benefits
    - IT/Cyber
    - General Corporate (licenses, title, etc).
    - Financials
    - Environmental

The Insurance Process - Continued

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- External advisors typically provide a written summary of their findings, highlighting any issues found in the deal diligence that require further underwriting.
- Supplementary to the written diligence, an underwriting call is held between the insurer, the seller and the seller's advisors (in a sell-side deal), the buyer, and the buyer's advisors to address various aspects of the buyers deal process.
  - Topics typically discussed on the underwriting call include:
    - Derivation of purchase price
    - Motivation of both parties
    - The process the buyer engaged in to purchase the asset
    - Specific areas of focus highlighted in the written diligence
- Based on the responses provided, insurers may choose to either include or exclude certain highlighted issues.
  - For example, if Cyber is highlighted as an area of focus, and it is apparent minimal diligence was performed by the deal team in the purchase process, insurers may choose to exclude Cyber entirely from final coverage.

The Insurance Process - Continued

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Based on the responses provided, insurers may choose to either include or exclude certain highlighted issues.

For example, if Cyber is highlighted as an area of focus, and it is apparent minimal diligence was performed by the deal team in the purchase process, insurers may choose to exclude Cyber entirely from final coverage.

After the underwriting call and diligence is complete, and any outstanding issues addressed, the insurer issues a quote to be bound at either sign or close of the deal.

If bound at signing, the insurance then covers the interim period between sign and close.

The Insurance Process - Continued

- Prior to closing, a final "bring down" call is conducted with deal team, their advisors, and insurers, to ensure that the condition of the asset that is the subject of the insurance has not changed between the earlier diligence and closing.

✓ The critical takeaway from this process is that the insurance covers the completion of the sale of the asset in its condition upon the close of the deal.

✓ ***There is no prospective coverage, which is atypical for insurance.***

The R&W Market

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- Current market estimates are ~$3B in GWP, with an expectation of further organic growth through the expanded adoption of the product, coupled with increasing rates.
  - Primary markets are US/Canada, UK, France/Germany/Netherlands, Nordics, Australia/New Zealand, Japan,
  - Emerging markets in Vietnam, Korea, Hong Kong Singapore, Latin America
- The general split by premium is 60/40 US to RoW.
- The product is highly utilized by Private Equity firms, particularly in auction settings to enhance the certainty around closing.
  - Product penetration rate 70%+ for PE firms, ~50% for Strategics
- Adoption of the product has continued to grow amongst strategic buyers as they have become more comfortable with the product and the nature of the indemnification provisions.

The Insurance Market

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- 30+ markets worldwide with primary capabilities
- Several more excess-focused, including the existence of excess-only facilities
- By premium, the market is roughly 60/40 insurance company to MGA.
- Typical limits from a single carrier are $50M but can range from $20M to $100M.
- MGA limits can be in excess of $150M
  - MGA limits are a consortia of individual carrier limits
- Distribution is dominated by large retailers (Aon, Marsh)

The Impact of Covid-19

- Most of the M&A transactions ground to a halt in April due to Covid.
  - 2 drivers: uncertainty around future economic outlook and diligence complexity
- Noteworthy, the smaller EV end of the market was less impacted by Covid given the relatively less complex nature of the deals.
- Q3 2020 saw a significant upswing in submission flow once the market adapted to Covid realities.

- 2020 topline GWP finished roughly in line with original projections due to significant 4th quarter production, but individual carriers' volumes varied materially.
- This expectation is up from earlier in the year, when estimates were closer to 50% of original projections.

Tax Insurance

- Tax insurance covers a known issue – different from R&W
- The IRS does not respond to every Private Letter Ruling request, or cannot respond in the necessary timeframe required for a transaction.
- Policies typically cover 1 of 2 issues – coverage for solar tax credits or coverage for a tax position (ex. S-corp status, tax-free reorg or spin off)
- Pricing is typically higher than R&W; Renewable energy credits pricing is lower
- Doesn't cover change in law
- Doesn't cover Net Operating Losses
- Underwriting is supported by opinion of outside counsel:
  - "Will" – 90% probable supported by IRS
  - "Should" – 70% - 80%
  - "More Likely Than Not" - >50%

Contingent Liability Insurance

- Can be a critical deal facilitation tool to reduce the perceived risk around a known issue
- Several types:
  - Specific Litigation, CFIUS break fee, fraudulent conveyance, successor liability, Payment Protection Program
- Pricing is widely varied – can be 10+% ROL
- Currently, the insurance policy covers judgements only – no settlements.
- Intent is to provide coverage for a "worst case scenario" – excess a pre-determined likely amount of damages
- Markets generally have less appetite for this business.

CAS Reinsurance Seminar – Transactional Liability Session

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June 8, 2021

Agenda

- Hartford's Transactional Liability Perspective
- Claims Market Data
- The Claim Resolution Process
- Hartford Claim Case Studies

Transactional Liability – Hartford's Perspective

- A Line Claims Handler Perspective
- Private Equity Middle Market Focus
- Primary Policies are the Sweet Spot
- Limited Exposure to Large Towers

Transactional Liability – Claims Market Data (Overview)

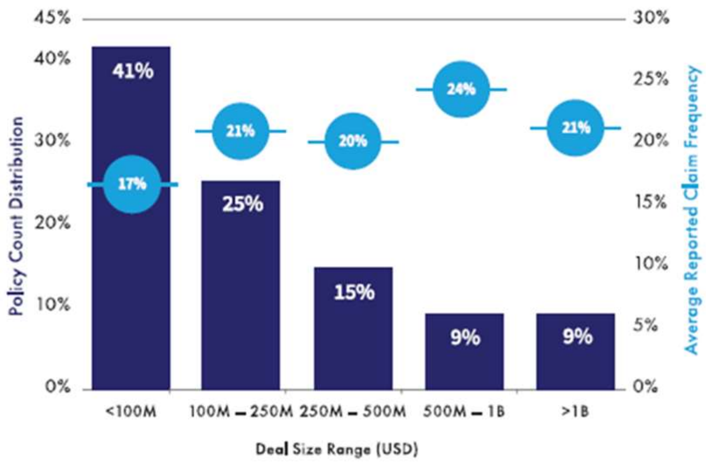
- The number of claims made on representations and warranties insurance policies has increased steadily over the past several years.
- Given the natural lag between the closing of a transaction and the discovery of a breach, claim data is not complete or available on most recent policy years.
- Aon's 2020 transactional risk claims study reflects a more than a 400% increase in total claims noticed in 2018 versus 2014.
- This dramatic rise in claims largely is attributable to the increase in the number of policies placed in the same time period.
- However, Aon also reports the percentage of policies notified with a claim rose from 2014 to 2016, increasing from 18.6% on policies issued in 2014 to 25.3% on policies issued in 2016.

Transactional Liability - Claims Market Data (Overview)

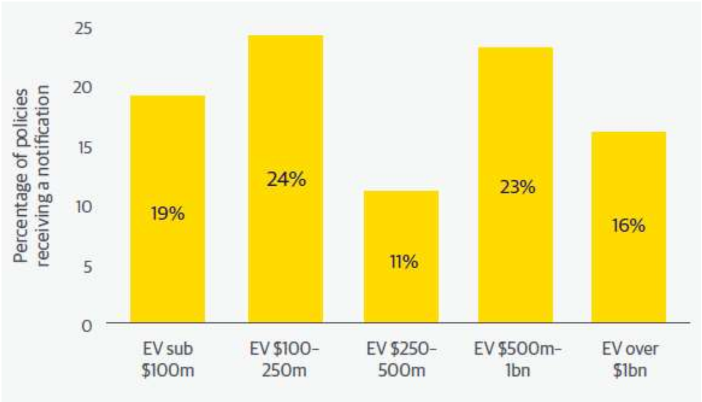
Source	Data Set	Frequency (overall)	Frequency (by type)	Severity
Aon 2020 R&W Insurance Claim Study	Policies: ~2,450 R&W Claims: ~340 Period: 2013 – 2019 Region: N. America	~22%	Financials: 23.5% Tax: 11% Compliance: 14% Contracts: 9% Employee: 10% Litigation: 6.5% Intellectual Prop: 5%	Although the likelihood of payment generally decreases as EV increases (because of the larger retentions), claims on policies with EVs ≥ $500M resulted in 87% of the total $350M losses paid. Claims on transactions with EVs <$100M accounted for 4% of the total losses paid, with an average claim payout of $2.3M.
AIG 2020 M&A Claims Study	Deals: ~3,500 R&W Claims: ~700 Period: 2011 – 2018 Region: Worldwide	~20%	Financials: 20% Tax: 18% Compliance: 16% Contracts: 13% Employee: 9% Litigation: 7% Intellectual Prop: 7%	19% of material claims alleged loss of > $10M. 37% of material claims alleged loss of $1M - $10M. 46% of material claims alleged loss of $100K - $1M. Average severity of $20M, $4M, and $340K, respectively, in each of the above claim bands.
Liberty GTS 2020 Claims Study	Policies: ~2,000 R&W Claims: ~325 Period: 2010 – 2019 Region: Worldwide	~16.5%	Financials: 15% Tax: 19% Compliance: 13% Contracts: 16% Employees: 14% Litigation: 13% Intellectual Prop: 5%	8% of claims alleged loss of >$10M. 15% of claims alleged loss of $1M – $10M. 77% of claims alleged loss of <$1M. Claims on transactions with EVs <$250M 67% accounted for 67% of paid claims by value, likely explained by lower frequency of claims on larger deals and higher excess attachment points.

Transactional Liability - Claims Market Data (Frequency by Deal Size)

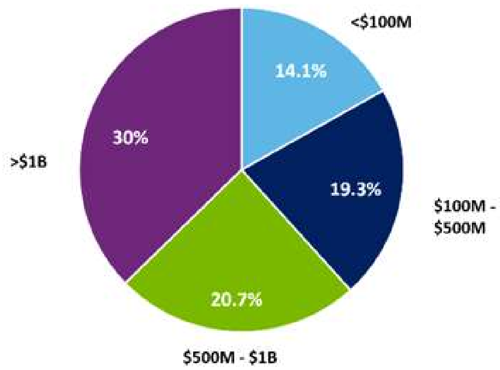
- **AIG Claims Report**:



- **Liberty Claims Report**:



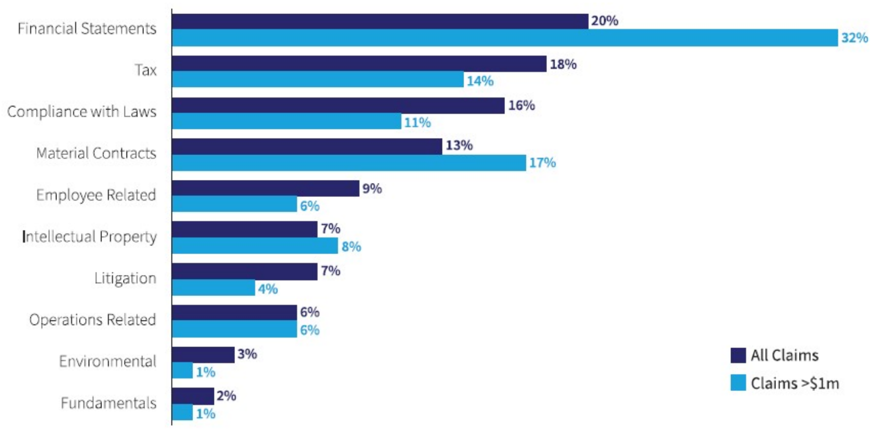
- **Aon Claims Report**:



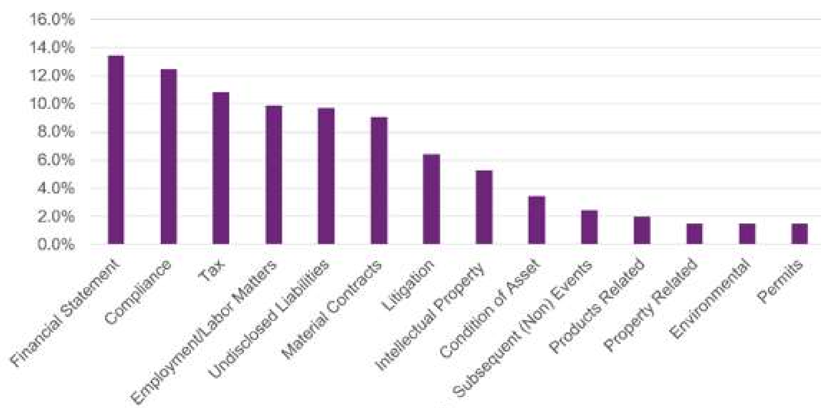
- **Takeaways**:
  - Historically, claims are received on ~20% of policies.
  - Frequency has risen in recent years:
    - Aon: 18.6% in 2014 to 25.3% in 2016
    - Liberty: 14% in 2013 to 19% in 2017 (still developing).
  - In general, deals with enterprise values below $100M have reported lower frequency than larger deals; however Liberty has reported slightly above market frequency for lower EV deals (possibly explained by broad risk appetite and overexposure to routine tax claims in EMEA and APAC).

Claims Market Data (Frequency by Type of Breach)

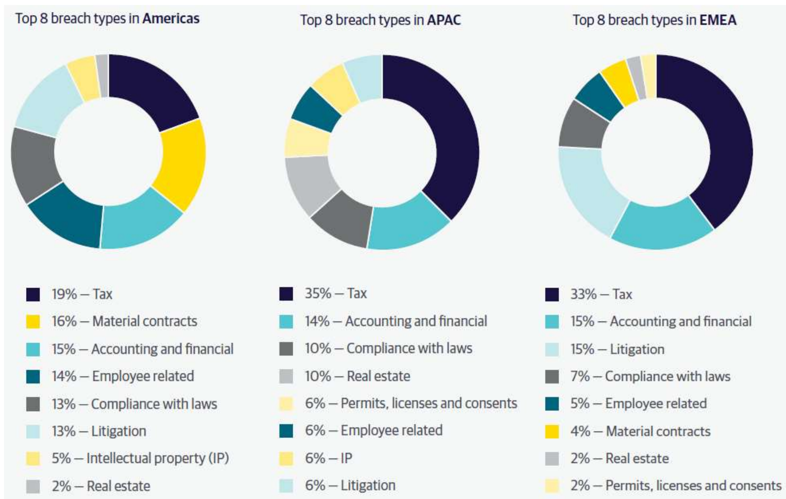
- **AIG Claims Report:**



- **Aon Claims Report:**



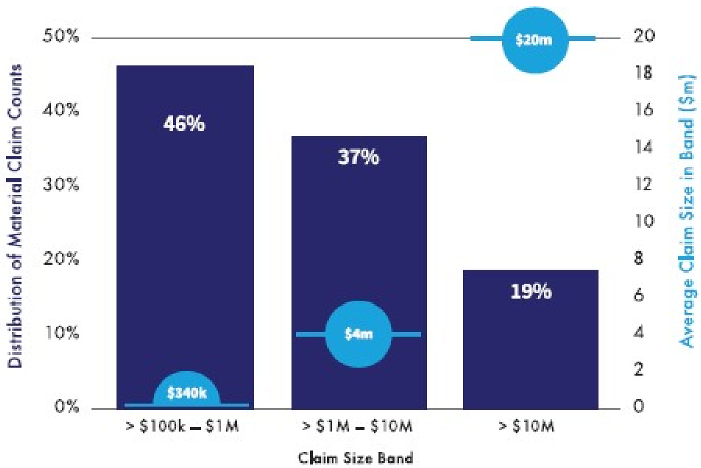
- **Liberty Claims Report:**



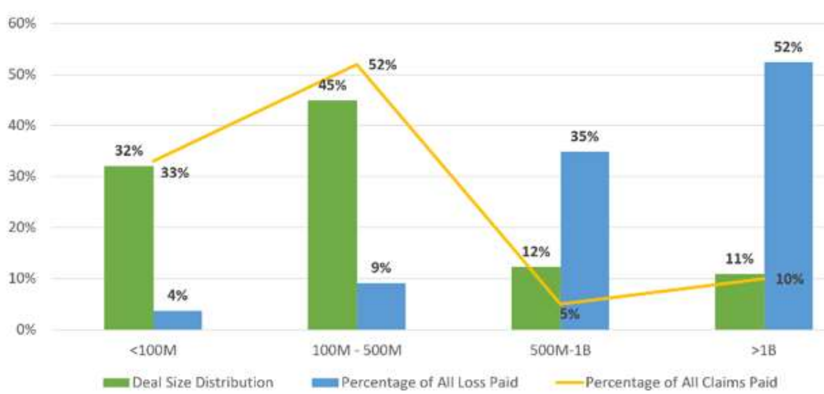
- **Takeaways:**
  - The most common breach reported continues to be inaccuracy of financial statements representations.
  - Compliance representations also result in frequent claim notifications, but severity of such claims is lower.
  - Liberty study found more frequent claims notifications related to tax representations, but this result may be influenced by frequency of such claims in EMEA and APAC. Only a small subset of such claim notifications resulted in substantive loss.

Transactional Liability - Claims Market Data (Severity)

- **AIG Claims Report:**



- **Aon Claims Report:**



- **Liberty Claims Report:**

- **Takeaways:**
  - A significant majority of claims allege loss of <$1M; and 25% or less of claims notified result in paid loss.
  - In general, larger transactions have resulted in more paid loss and higher average payouts.
  - The financial statements and material contracts reps remain the greatest risk for severity.
    - Breaches of the accounting/financial reps and the material contracts reps have accounted for 63% and 14%, respectively, of the total losses paid by Liberty.
    - Similarly, AIG's report notes that breaches of the accounting/financial reps and the material contracts reps have accounted for 32% and 17%, respectively, of claims alleging loss in excess of $1M.

Transactional Liability – Claims Market Data (Severity)

- A notable trend over the past few years relates to an increase in the size of the claims being made. The first claim alleging over $200 million in loss was filed in 2018, and in 2019, several claims alleged loss in excess of $100 million. 2019 was also the first year in which losses were paid not just by primary layers, but also by multiple excess layers. *(Aon)*

- Perhaps not surprisingly, the average payment above the policy retention has increased, from $5.4 million in 2017 to $10.7 million in 2019. The number of claim payments over $10 million has also increased in the last few years from 17% of all claims paid in 2017 to 26% of all claims paid in 2019. *(Aon)*

Transactional Liability – Timing for Discovery of a Breach

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- The majority of representations and warranties insurance claims reporting an alleged breach are filed within 12 months from the date that the transaction closed (63%). This likely is attributable to the fact that companies are being operated by the buyer, and most have completed their first audit cycle within one year post-close, during which time unknown issues often are uncovered. *(Aon)*
- The median time period between closing and the insured filing a claim notice is 10 months, whereas the average time period is 12 months. Nevertheless, slightly more than one-third of claims are noticed more than one year post-close, and the percentage of claims being reported later has grown over each of the past three years. *(Aon)*
- When examining the type of breach reported more than one year post-close, nearly 60% of such claims arise out of third-party litigation or tax audits, while approximately 18% result from a breach of the financial statements representations and warranties. *(Aon)*

Transactional Liability – The Claims Process

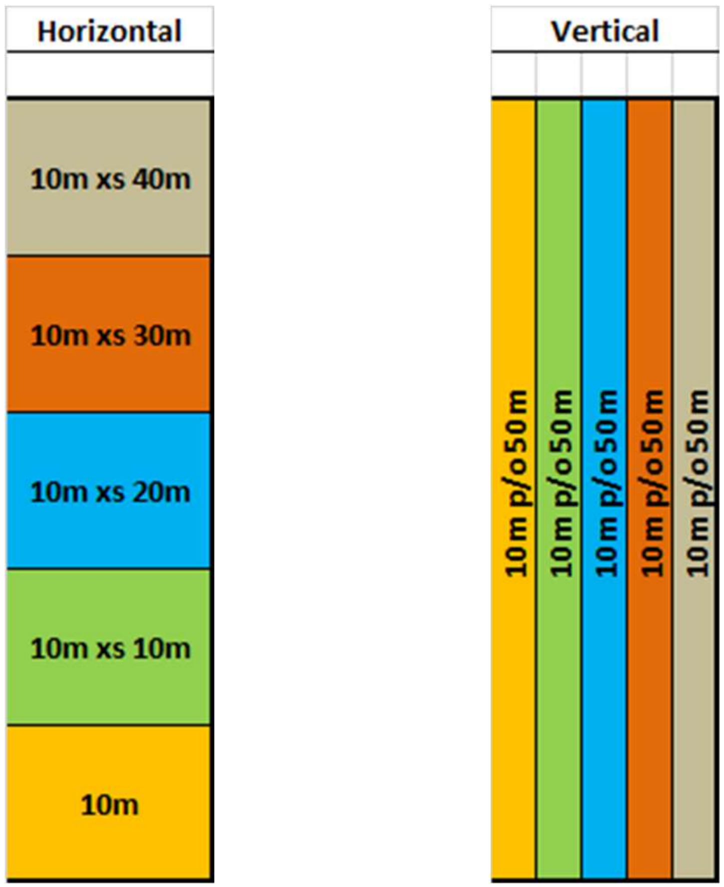
- First Party v. Third party Claims
- Typical Length of the Claim Resolution Process
- Insurer Informational Disadvantage in Claims Process
- Experts Involvement in Claim Resolution
- Damages: Diminution in Value Claims
- Subrogation Issues
- Claim Studies - Examples of Claims That Hartford has Made Payment Under Buyer-Side Policies:
  - Loss of Material Customer
  - Condition of Asset Breach
  - Regulatory Investigations

Reinsurers' Perspective on Risk

2 primary concerns for reinsurers

Aggregation

Volatility



Aggregation

- Horizontal
  - Multiple layers from different cedents
- Vertical
  - Multiple shares from various cedents
- Combo of both

- As a result, reinsurers <u>may</u> have more exposure than primary companies

Control Aggregation

- Monitor which cedants are participating on which coverholders
  - Not as simple as it sounds
  - Can only monitor aggregation after the business is written
    - May not even be possible if deal names are not provided with bordereau
  - Non-recurring business: every deal is new

- Know your cedents
  - Risk tolerances
  - Risk appetites – Small vs Large, Industries
  - Understand their internal controls

Volatility

- Transactional Liability is priced using "Rate-On-Line" approach
  - Example – 3% ROL for $30M limit = $900K premium
    - Equates to a return period for full limits loss is ~33 year.
  - Excess layers are even more volatile as ROL are closer to 1.0%

- Pricing for $1B tower of insurance = EX. ~$16M in premium = 62.5 year return period

- If the pricing is wrong, the impact could be significant

- Aggregate covers or features add to the volatility

R&W – Actuarial Perspective

Actuaries use the past to predict the future

Used in Rating, Reserving, Risk modeling, etc

R&W presents several challenges

Market driven pricing

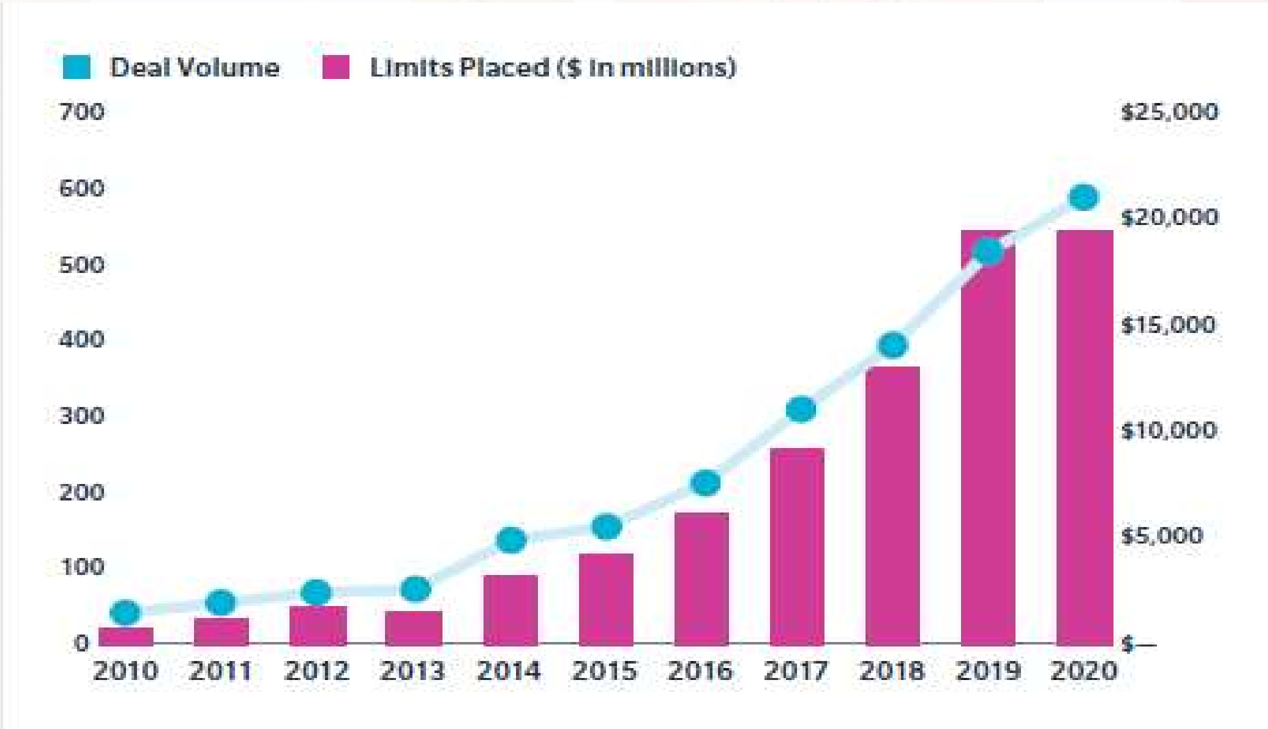
Non-renewing business

Terms & Conditions are still evolving

Rapid Growth

Aggregation

R&W's Rapid Growth



Src: Marsh 2020 US and Canada Transactional Risk Year in Review

R&W – Growth Drivers

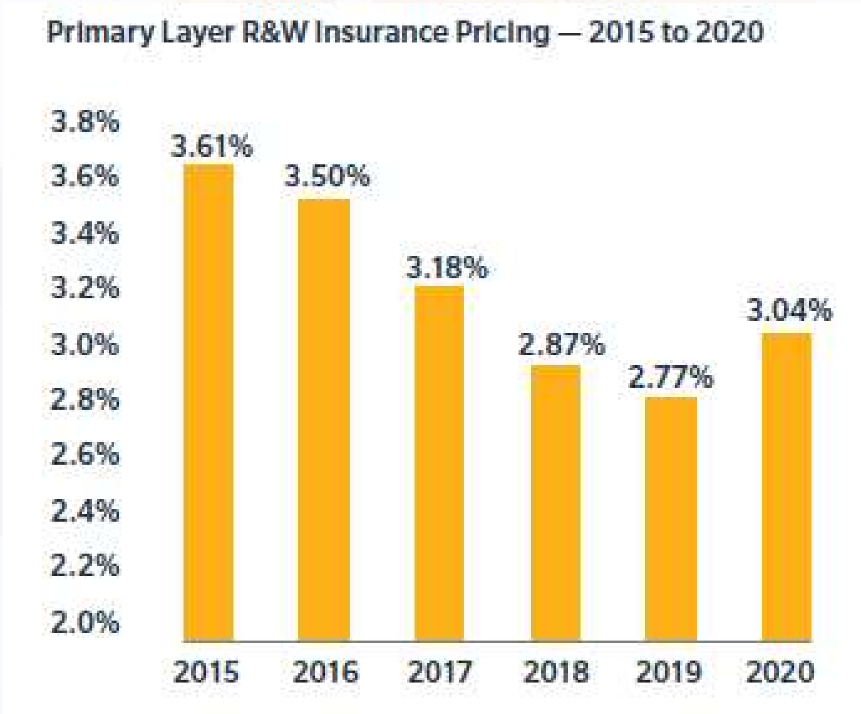
- Relative new product 10 yrs ago
  - Niche product, few players (AIG, Lloyd’s)
  - Over time, results turned out very good (LRs < 40%)
- Drove new entrants into the market
- Greater acceptance by Investors
- Will continue to grow

Loss Development

- Early View was this line is short tailed
  - Most claims reported within 2 yrs and settled by 1st accounting cycle

- Reality
  - Most notifications are made within the 1st 18 mths but 20% are 18mths +
    - Larger deals tend to have later notification toward the end of the policy
  - While notifications are high, loss development still takes time
    - Investigation
    - Forensics / Audit
    - Legal opinions
  - Not short tailed

Rate on Line has fallen over time



Src: Marsh 2020 US and Canada Transactional Risk Year in Review

The Actuary’s Role

- Data is still developing… will get there eventually
- Understand the business
  - Changes in risk drivers, rates, limits, deductible, insureds
  - Be close to the underwriting and claims
- Look at alternative methods
  - Frequency/Severity analysis
  - Techniques used in other non-renewal types of business
  - Modelling techniques

Be Part of the Process

Questions?