

Representations and Warranties Insurance Claim Study

An analysis of claim trends,
data, and recoveries



Representations and warranties insurance has become a popular transactional risk management tool relied upon by strategic dealmakers. As the benefits of insurance have become more widely known, and competition among insurers has put pressure on decreased pricing and expanded coverage, Aon has seen a steady rise in the use of representations and warranties insurance policies as a deal facilitator by buyers and sellers alike. Continued favorable market conditions for sellers, such as shorter survival periods for representations and warranties, lower caps on indemnification obligations or even no seller indemnity, have also contributed to increased popularity with buyers. In the last three years alone, Aon

placed representations and warranties insurance policies on over 1,750 transactions in North America, representing almost \$70 billion in policy limits. With the greater number of representations and warranties insurance policies placed comes a growing number of claims, and those dealmakers that purchased insurance are watching closely to see how the policies respond to these claims and how insurers engage throughout the claim process.

The following study is an analysis of the approximately 340 claims made on more than 2,450 representations and warranties insurance policies placed by Aon in North America between 2013 and 2019.*



In the last three years alone, Aon placed representations and warranties insurance policies on **over 1,750** transactions in North America.

* Note that the data being reviewed is not static and additional claims will be made on the representations and warranties policies placed within the study period.

Highlights

■ **More than \$350 million above the policy retention has been paid**

by representations and warranties insurance to Aon clients in North America.

■ **More than \$525 million in total loss has been recognized**

(when factoring in erosion of policy retentions).

■ **30% of claims have been resolved,**

4% have been denied, **54% are active** and 12% are inactive to date (ones in which no correspondence has been provided in over a year).

■ **Claims were made on 22% of all policies placed between 2013 and 2017;**

however, the percentage of policies notified of a claim between 2014-2016 gradually increased from 18.6% on policies issued in 2014 to 25.3% on policies issued in 2016.



Claim size trended upwards in 2019, with an average claim payment of \$10.7 million and 26% of all claims paid this year exceeding \$10 million,

largely due to the larger deal sizes (and proportionately larger insurance policies) that Aon worked on in 2017 and 2018.



Deals valued over \$1 billion have yielded a slightly higher claim frequency

than smaller valuation bands, although only 9% of total claims made on these deals have resulted in a payment. This is lower than the average for smaller transactions.



No discernible difference

in the frequency of claims

for transactions that included a seller indemnity

(for breaches of any representations and warranties)

compared to ones without.

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Trends in Claim Frequency and Size

The Aon claims data through 2019 reveals two major trends:

- ▶ The percentage of policies notified with a claim has increased.
- ▶ Transaction sizes, limits placed and claim values have increased proportionately over the past several years.

07 | [Claim Frequency](#)

09 | [Claim Size](#)



Claim Frequency

The number of claims made on representations and warranties insurance policies has increased steadily over the past several years, reflecting 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, as illustrated in Figure 1, 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. Given the natural time lag between the closing of a transaction and the discovery of a breach, it is too early to determine whether this rise in claim frequency will persist for the 2017 policy year and onward.

The number of claims made on representations and warranties insurance policies has increased steadily over the past several years, reflecting more than a **400% increase** in total claims noticed in 2018 versus 2014.

Figure 1. Claim Frequency 2013-2019

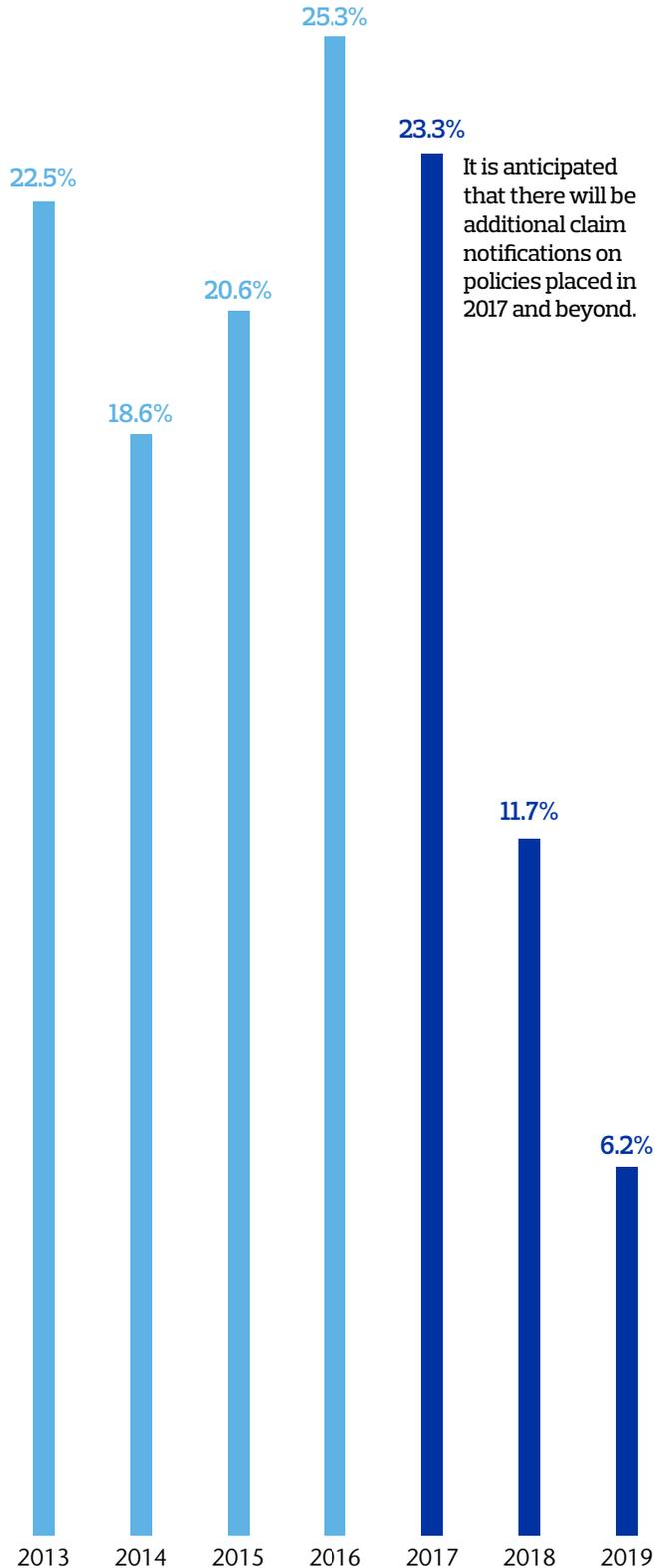
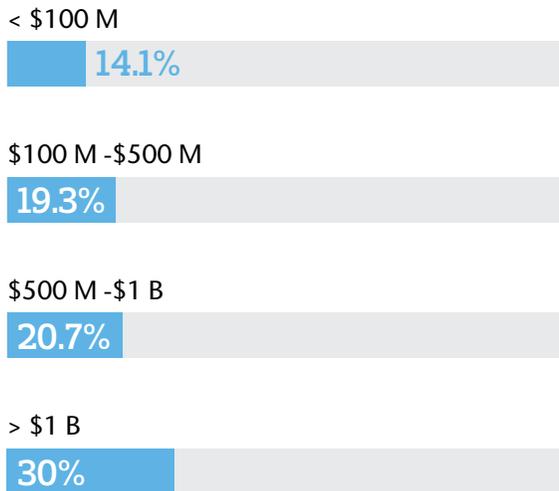
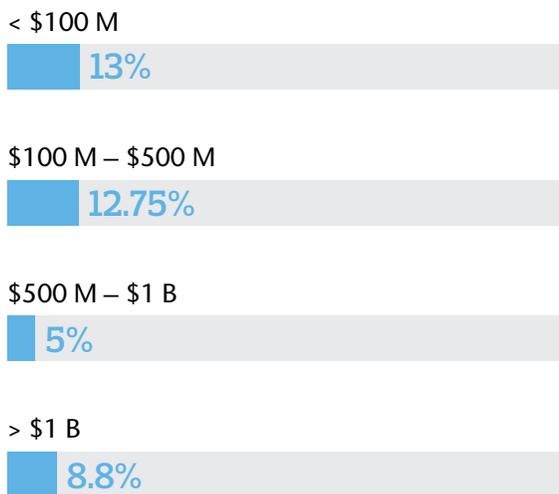


Figure 2. Claim Notification Frequency by Deal Size



When claim frequency statistics are broken down further based on deal size, the data suggests that larger deals are more likely to trigger a claim notice, with policies on transactions valued over \$1 billion yielding notices more than twice as often as transactions valued at less than \$100 million. Figure 2 shows the percentage of deals within each deal size category that were notified of a claim. Between 2013 and 2018, claims were filed on 30% of all policies with transaction values in excess of \$1 billion, whereas this number dropped to 20.7% for deals with transaction values between \$500 million - \$1 billion, 19.3% for deals with transaction values between \$100-500 million and down to 14.1% for deals with transaction values less than \$100 million.

Figure 3. Claim Payment Frequency by Deal Size



Interestingly, though, while claim frequency is higher on larger deal bands, a smaller percentage of the claims made on large deals have resulted in a payment. Figure 3 illustrates the percentage of claims made on deals within each deal size category that resulted in a payment. It shows that 13% of all claims made on deals with valuation of less than \$100 million were paid, the highest percentage of all deal bands, despite the lower rate at which claims were made on these deals. This number decreases to 12.75% for valuations between \$100-500 million, to 5% for valuations between \$500 million - 1 billion and to 8.8% for deal sizes in excess of \$1 billion.

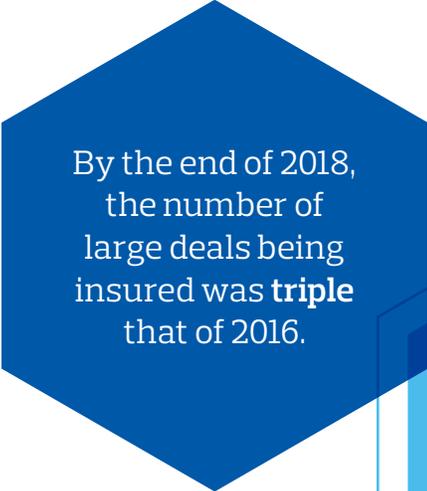
Claim Size

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.

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.

As noted above, this increase in claim size coincides with other contributing factors, such as an increase in the size of the deals that are using representations and warranties insurance and the size of the insurance programs that are being placed in connection therewith. In 2017, the number of deals with an enterprise value of \$500 million or greater that used representations and warranties insurance doubled over the previous year, and by the end of 2018 the number of large deals being insured was triple that of 2016. As a result, the average representations and warranties insurance policy limit for transaction values in this band has, while staying consistent as a percentage of deal size, risen from \$93 million in 2015 to \$127 million in 2018. In addition, the number of multi-carrier insurance programs with limits above \$100 million has gone up almost 500% between 2013 and 2019.



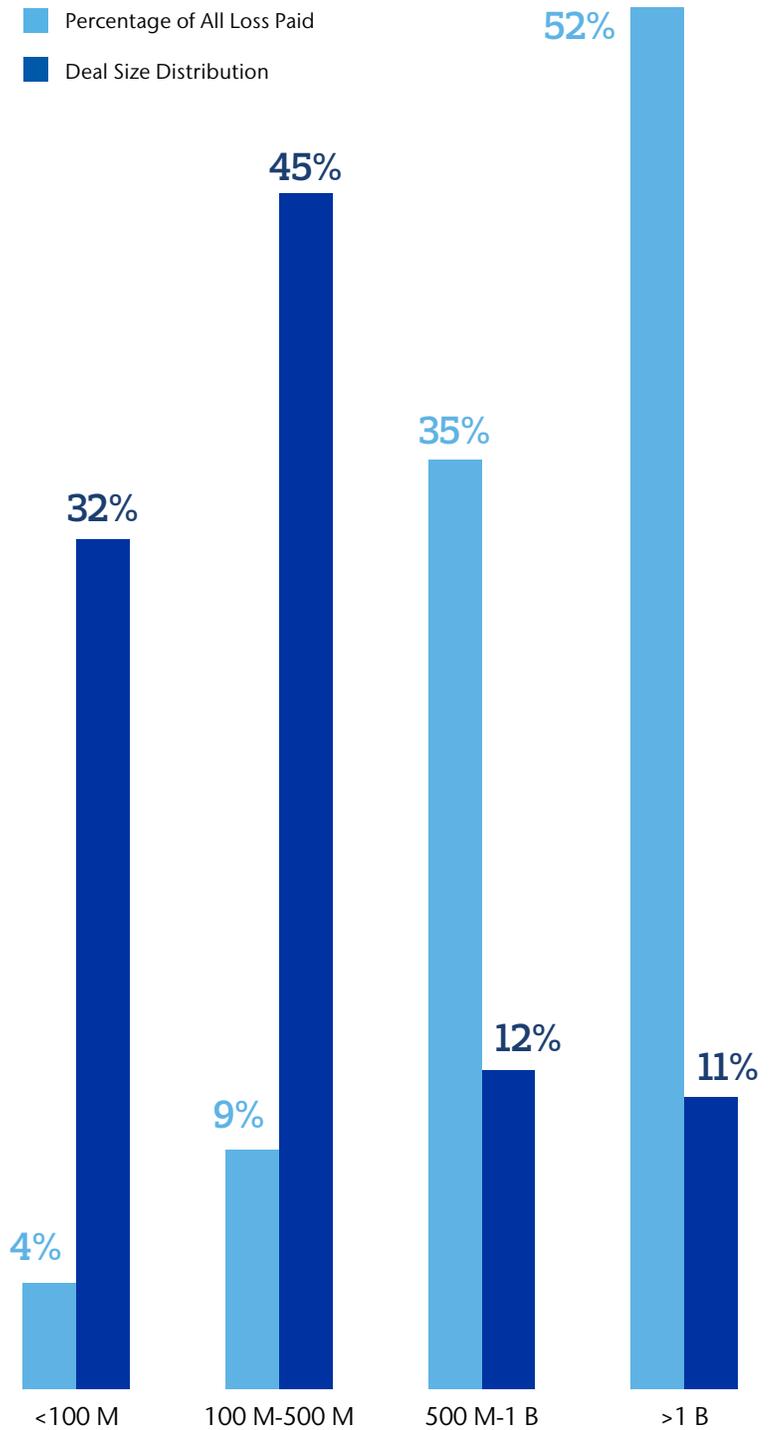
By the end of 2018, the number of large deals being insured was **triple** that of 2016.



The average payment above the policy retention has increased, **from \$5.4 million in 2017 to \$10.7 million in 2019.**

Figure 4. Deal Size Distribution with Average Settled Losses

The most significant claims and resulting payouts related to deals with transaction values greater than \$1 billion. The average claim payout on deals with transaction values of less than \$100 million between 2013-2019 is \$2.5 million, rising to \$6.3 million for deals valued between \$100 million and \$500 million, and \$24 million on deals valued between \$500 million and \$1 billion. In contrast, the average claim payout on deals valued over \$1 billion is \$36.1 million. A small sample size for payments on deals above \$500 million likely accounts in part for these higher averages.



Interestingly, when the average total claim payout for each deal band is viewed as a percentage of the average deal size for such band, the proportionate size of the claims becomes more apparent:

1.

The average payout for deals valued under \$100 million was 5.26% of the average deal size;

2.

The average payout for deals valued between \$100-500 million was 2.8% of the average deal size;

3.

The average payout for deals valued between \$500 million – 1 billion was 3.4% of the average deal size;

4.

The average payout for deals valued above \$1 billion was 1.16% of the average deal size.

Ultimately, while larger claims are being made on larger deals, the severity of claims has a tendency to be higher on smaller deals when viewed as a percentage of the overall deal size. One possible explanation for the inverse relationship between deal size and payout percentage is that while retentions tend to be smaller (as a percentage of deal size) on deals valued about \$1 billion, they are nonetheless significantly larger in actual dollars, requiring the policyholder to bear more of the loss before the threshold for a payment under the policy is reached.

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Other Claim Trends

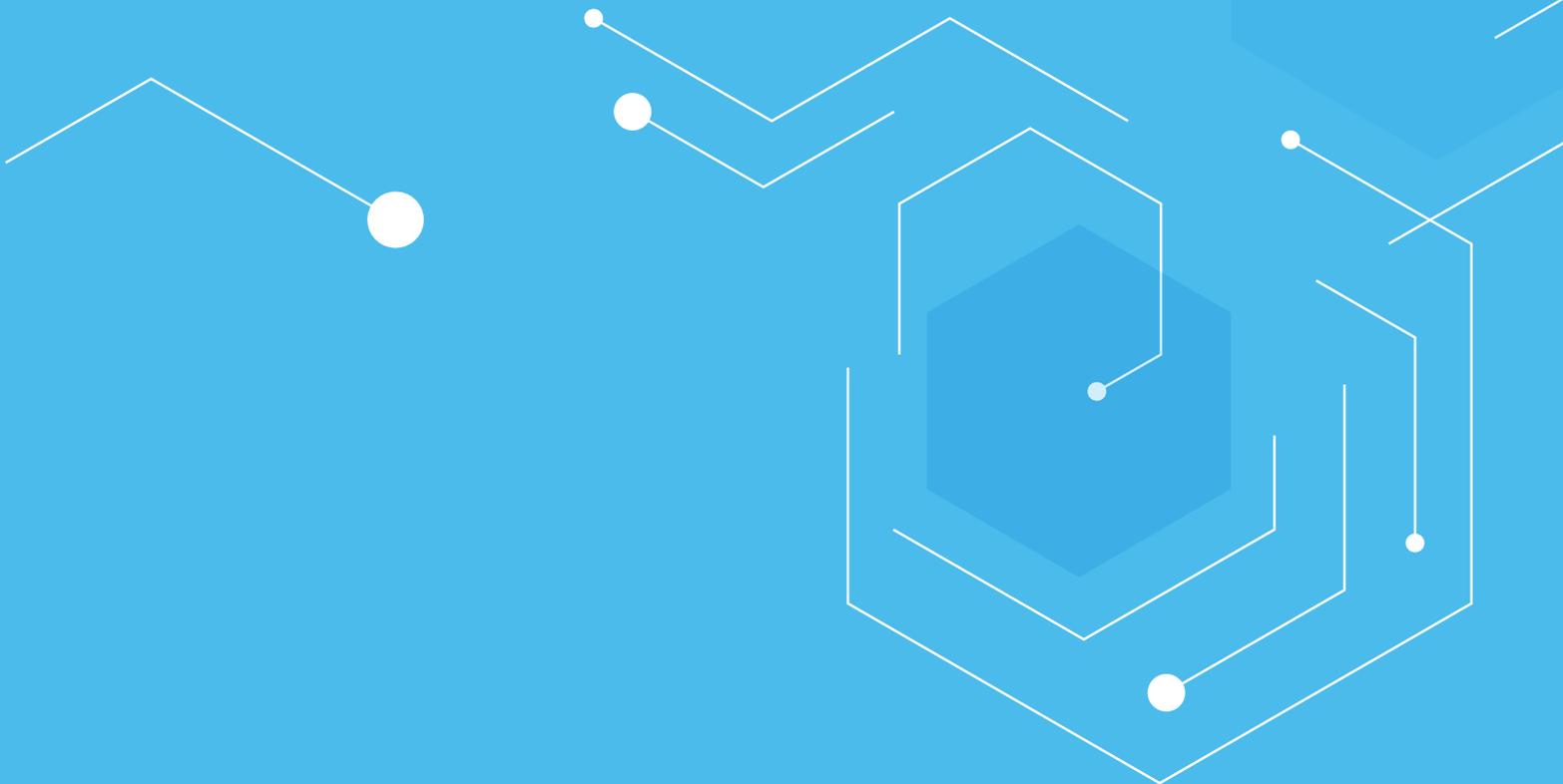
13 | **Timing for Discovery of a Breach**

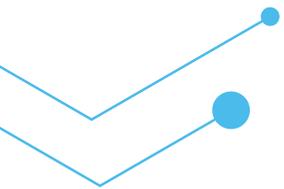
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Timing for Discovery of a Breach

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. 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. 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.

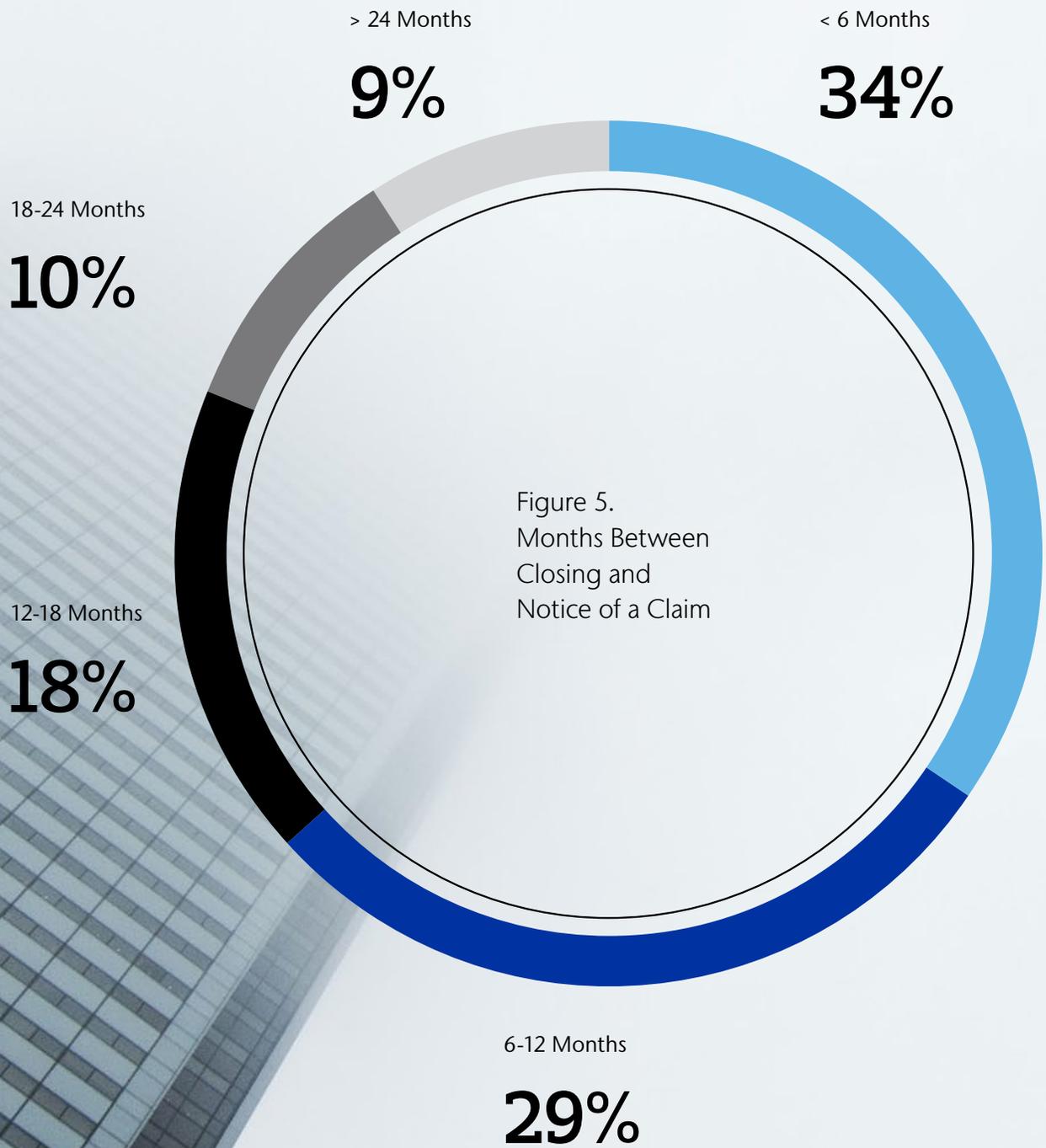
Although not very common, Aon has observed some claim notices for breaches discovered after signing of the transaction agreement and reported to an insurer prior to closing. Most of these claims relate to pre-signing breaches (as opposed to “interim breaches,” which generally are excluded from coverage under the representations and warranties insurance policies for the relevant time periods).



Approximately
2/3 of claims are
noticed within
the first year
post-close.



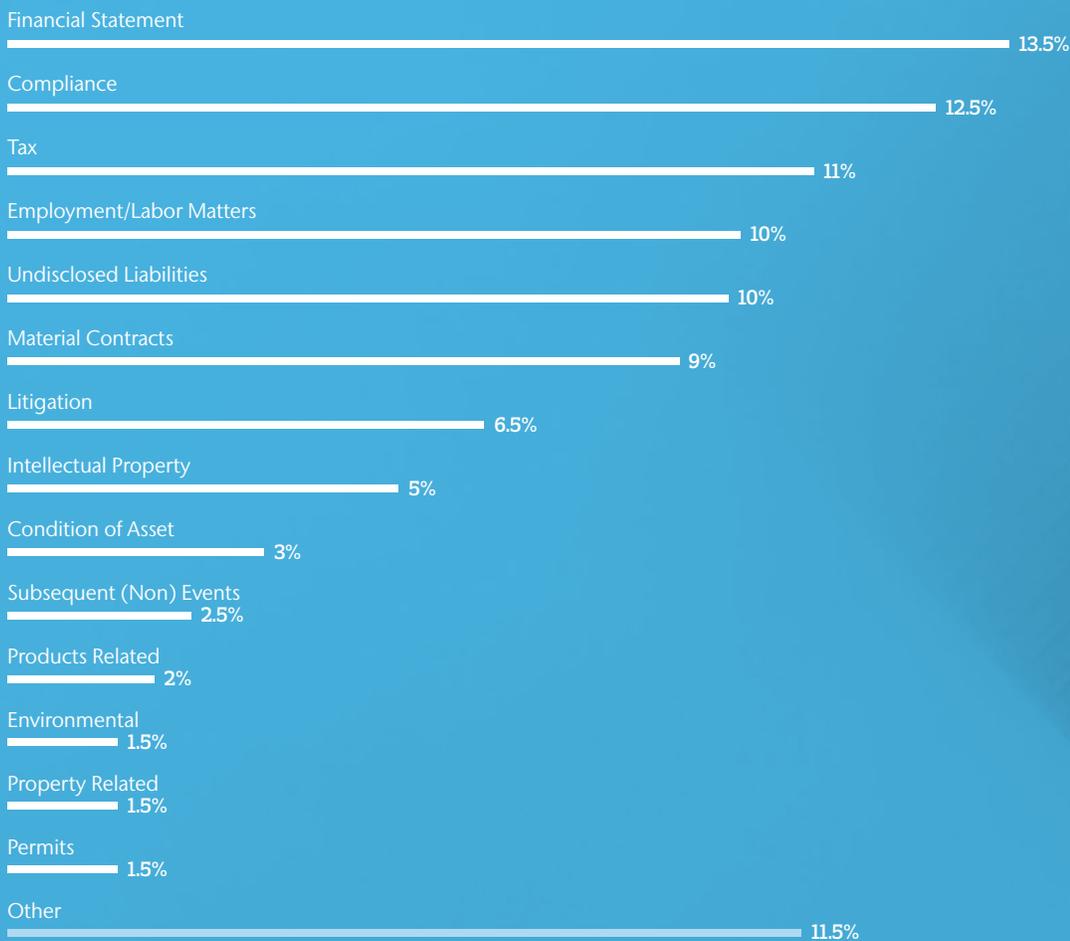
Nearly **60%**
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warranties.



Frequency by Type of Breach

Figure 6 illustrates the types of representations and warranties alleged to be breached most frequently (either individually or in connection with other alleged breaches): 13.5% of breaches reported during the study period related to inaccuracies in the financial statements, 12.5% arose from a failure to comply with applicable laws or governmental authorities, 11% related to tax matters, 10% related to the no undisclosed liabilities representations, and another 10% related to employment- and labor-related matters. Material contracts breaches round out the top six, cited 9% of the time.

Figure 6. Frequency by Type of Breach



* Example of "other" breaches includes breaches of representations and warranties around food safety and quality, privacy and data security, product labeling, licenses, export matters, inventory, etc.

Severity by Type of Breach

The type of representation or warranty alleged to have been breached can indicate the likely severity of loss that may arise from such breach, as certain representations and warranties are more likely to result in the incurrence of loss — beyond dollar-for-dollar loss — such as lost profits or multiplied damages. The obvious example is a financial statements breach, but this might also be true for breaches of compliance with laws, no undisclosed liabilities, material contracts or other representations and warranties if, for example, the resulting loss is recurring.

Relatedly, there has been a recent increase in the frequency of claims alleging multiplied damages due to breaches of material contracts and material customers representations and warranties. While carriers and clients typically reach consensus quickly on the occurrence of such breaches, calculating the related damages often can be more challenging. Understandably, when buyers value a business, their models typically assume that material customers/contracts will not be terminated in the near term, and therefore view the termination of any such material contract or customer as having an impact in the form of lost future revenue beyond a mere dollar-for-dollar loss. Carriers, in turn, have noted that the analysis may be affected by a variety of factors, such as the length of the contract and the type of business. In the end, these claims, like all others, are dealt with on a case-by-case basis, with detailed analysis of the applicable facts and circumstances.

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Expert Involvement in Claim Resolution

Insurers often engage legal counsel as well as forensic accounting and subject matter experts to assist with claims to ensure that they are adequately and efficiently understanding the breach, and ultimately reaching a fair result with respect to the associated loss.

Insurance carriers have engaged legal counsel to assist in approximately 21% of claims and have worked with forensic accountants on an average of 7% of all claims since 2013. However, the number of claims where forensic accountants are participating on behalf of insurers has trended upward in recent years. While forensic accountants were engaged less than 1% of the time for claims made between 2013 and 2015, and engaged an average of 6.5% of the time for claims made in 2016 and 2017, they were engaged an average of 9% of the time for claims made in 2018 and 2019. Notably, claims alleging a financial statements breach accounted for 35% of the claims where legal counsel was involved and 65% of the claims where forensic accounting experts were brought in to help analyze the claim.

When only paid claims are taken into consideration, the involvement of outside experts increases further, with insurers engaging legal counsel 56% of the time and forensic accountants or other outside experts 28% of the time since 2013. In the last three years, the use of legal counsel and outside experts on paid claims has been higher than the historical average, with insurers engaging legal counsel for 64% of claims resulting in a payment, and forensic accountants on 40% of those same claims. This rise in the use of outside experts in recent years may be explained by the frequency with which a breach of financial statements (and thus, loss on the basis of a multiple) is being alleged, the growth in the size of representations and warranties claims and the sheer number of claims alleging loss above the policy retention.

Insurance carriers increasingly are using outside counsel and experts to assist them in evaluating claims.

Insurance carriers have engaged legal counsel to assist in approximately **21%** of claims and have worked with forensic accountants on an average of **7%** of all claims since 2013.

Impact of Other Variables on Claim Frequency

There was no impact seen on the frequency of claims when comparing policies purchased by clients operating in the private equity space versus policies purchased by strategic corporate clients undergoing a merger or acquisition. The number of claims seen from each of these two types of insureds was equal to the proportion of policies purchased by each.

In addition, there was no difference in the frequency of claims when comparing policies placed for deals where buyer and seller shared the retention versus policies placed where buyer was solely responsible for the retention, even as the latter policies have grown as a percentage of the overall book. Although insurers historically have indicated that they feel a greater sense of security when sellers have some “skin in the game”, the data suggests that this does not materially influence the likelihood of a claim. Two logical explanations are (i) that many sellers are repeat participants in the M&A space with reputations to uphold and (ii) that the typical size of a seller’s contribution to the retention (typically 50%) may not be sufficiently different from a seller retaining no indemnity obligation at all.





03

Claim Resolution

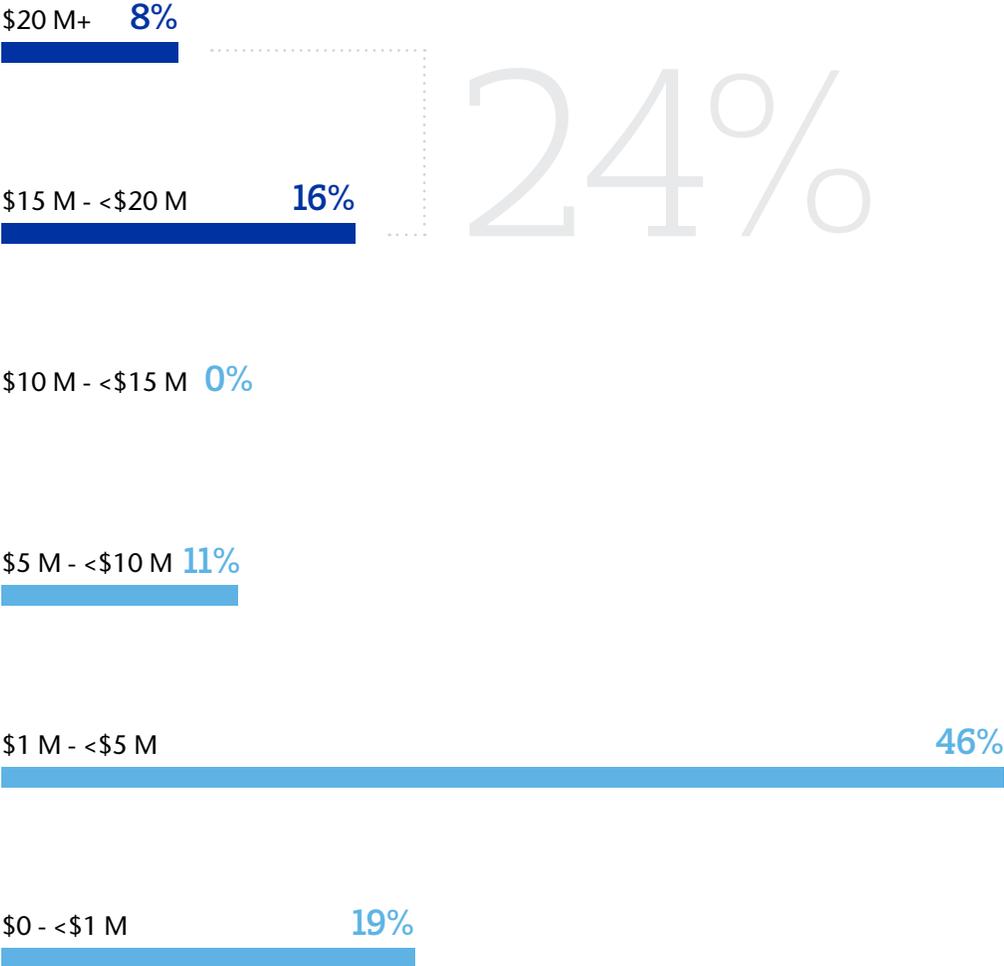
To date, Aon has been involved in more than 340 claims that have been made by its clients on policies placed in North America since 2013. Of those claims, 18% settled within the retention, 12% became inactive over time, 12% resulted in a payment by the insurer, 4% were denied coverage, and 54% remain active. Of the 13 claims that were denied, 10 were due to a specific policy exclusion, two were denied on the basis that the matter was previously disclosed by the seller (which the insureds accepted) and one was denied due to the insured's failure to comply with the terms and conditions of the policy (entering into a material settlement with a third party without the knowledge or consent of the insurer). One dispute with an excess carrier currently is being litigated.

23 | **The Claim Process**

24 | **The Aon Advantage**

Representations and warranties insurers have paid more than \$350 million to Aon clients in North America, and recognized more than \$525 million in total loss (when factoring in erosion of policy retentions). The payments made on individual claims range from \$300,000 to more than \$50 million. Of these payments, the majority were between \$1 and \$5 million but, as shown in Figure 7, 24% have been above \$15 million.

Figure 7. Percentage of Claim Payouts Above the Policy Retention That Fall within Each Payment Band



The Claim Process

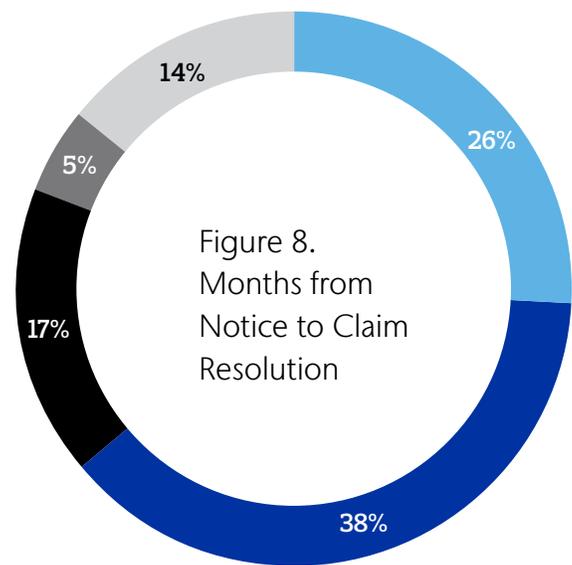
Unlike the typical posture of a litigation, the representations and warranties insurance claim process works optimally when it is collaborative, with the initial goal being to ensure that the insurance carrier understands the breach and the resulting loss. The length of time it takes to settle a claim varies widely, based largely upon the complexity of the claim, but also the availability of supporting information. As shown in Figure 8 below, it takes time to gather and provide ample supporting documentation as well as conduct calls and meetings to explain the details of the breach and validate the loss (similar to what is required when dealing directly with a seller in an indemnity claim). There may also be other matters, such as the insurer's subrogation rights to the extent that a payment is made (including against the seller in cases of fraud), which can add complexity to the claims negotiation.

While a claim has been resolved in as little as ten days, larger and/or more complex claims have taken longer (in some cases more than a year) to resolve. That said, approximately 25% of the claims made since 2013 were resolved within six months of filing the claim notice, and the majority have been resolved within 12 months of providing notice to the insurance carrier.

Claims alleging a breach of financial statements usually have taken longer to resolve, with 28% of these claims taking 12 or more months to reach a resolution due to their complexity as well as the potential application of multiplied damages. While the data indicates that 50% of tax claims take longer than 12 months to settle, this is misleading because this time period often includes the time it takes for the tax authority to complete the audit. By contrast,

all of the claims alleging a breach of undisclosed liabilities representations and warranties were resolved in under 12 months and 80% of claims alleging a breach of compliance with laws representations and warranties took less than 12 months to reach a conclusion.

To date, six of Aon's clients' claims have used mediation, four have commenced arbitration (with two resolved before the hearing and two still active) and two have resulted in a complaint being filed against insurers in court.



- < 6 Months
- 6-12 Months
- 12-18 Months
- 18-24 Months
- > 24 Months



The Aon Advantage

Many clients, although perhaps familiar with representations and warranties insurance, have limited experience navigating a claim. Due to the nature of these claims, the claims process can be both complex and involved. For this reason, Aon has built an industry-leading team dedicated to providing support and guidance to clients dealing with a representations and warranties insurance claim. With the assistance of the brokerage team, the claims specialists partner with clients and their advisors to navigate the claims process from when an issue is identified until the time that a claim is resolved, assisting with notification, facilitating discussions with insurers, and leveraging knowledge gained from past experience. Aon's commitment to continuing to service its clients beyond just the placement of insurance has resulted in significant benefits and positive outcomes for them in the context of representations and warranties insurance claims.

04

Claim Case Studies

The following are examples of claims where Aon has worked closely with clients to achieve a successful resolution.

26 | **Loss of Material Customers**

26 | **Financial Statements Breach**

27 | **Condition of Asset Breach**

Loss of Material Customers

A private equity firm purchased a \$10 million representations and warranties insurance policy with a \$1 million retention in connection with the acquisition of a service provider. Post-close, the buyer discovered that multiple material customers of the company had notified the sellers of the termination, or the intent to terminate, their relationship prior to the close of the transaction. This information was not disclosed to the buyer and represented a breach of the material customer and financial statements representations. The buyer contacted Aon and filed a representations and warranties insurance claim alleging that the resulting loss was recurring in nature and had an impact on the valuation of the company. The buyer sought damages on the basis of a multiple in the amount of approximately \$3 million.

Upon review of the facts, the insurer agreed that the situation constituted a breach of the specified representations and warranties in the transaction agreement. Due to the nature of the damages being sought and the alleged impact on purchase price, the insurer engaged a forensic accounting expert and, among other supporting documents, reviewed the analyses, models, projections and background documents used to determine the purchase price of the target company. Ultimately, the insurer agreed with the insured's assessment of loss and paid damages on the basis of a multiple as well as the insured's legal fees for a total of more than \$2 million (after application of the policy retention).

Financial Statements Breach

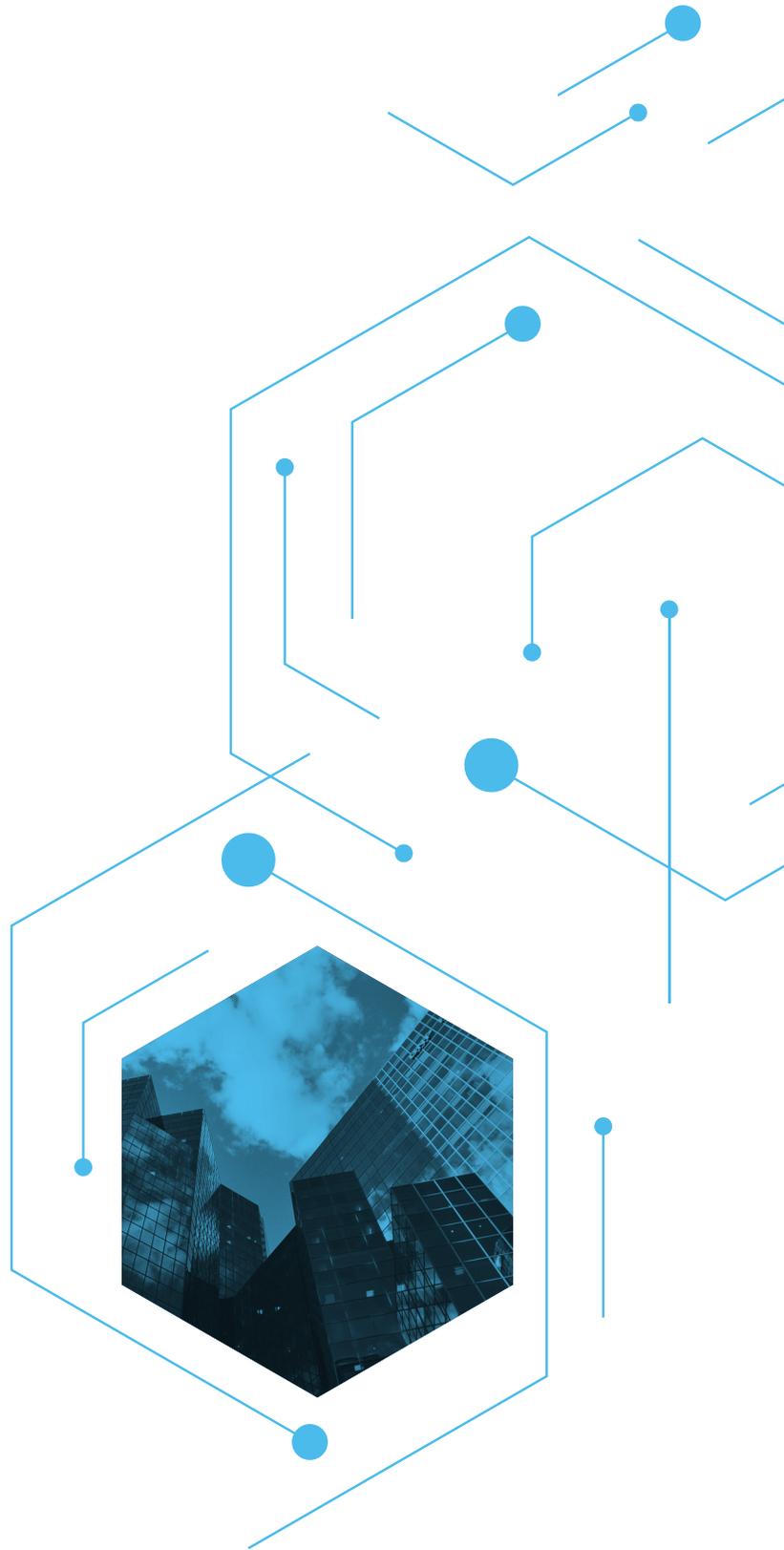
Within one year of its purchase, a private equity firm began to investigate when the company it had acquired was falling far short of projections. As a result, it discovered that there were a number of errors in the target company's financial statements at the time of the acquisition, including a failure to account for certain expenses, which did not fairly represent the company's financial position and the results of its operations. In addition, the buyer believed that the seller failed to disclose a material change to one of its business relationships as well as its knowledge of a contractual agreement under which the company owed money to a third party. The buyer submitted an insurance claim under its representations and warranties primary and excess insurance policies with an aggregate limit of more than \$50 million over a sizable retention.

The issues identified by the buyer had a direct and recurring impact on the company's EBITDA such that the buyer sought damages on the basis of a multiple. To assist in investigating the claim and determining loss, the insurers in the representations and warranties insurance program engaged forensic accounting experts. Aon worked closely with the buyer and its advisors to successfully demonstrate the breaches and the loss to insurers resulting in acknowledgement of loss beyond the primary insurance limits.

Condition of Asset Breach

Approximately eight months following the close of a transaction, a strategic buyer completed testing of physical assets. The testing demonstrated that one of the assets it had purchased was in poor condition and required significant repair, or even possible replacement. This constituted a breach of the representations and warranties of the seller with respect to the condition of the assets being purchased, and the buyer made a claim under its representations and warranties insurance policy, which had a \$5 million limit of liability.

The insurer reviewed the findings of the experts retained by the buyer as well as other supporting documents to confirm that the asset required the repairs for which the buyer was claiming loss. The insurer also reviewed various invoices to verify the cost of the repairs. Ultimately, the buyer's costs to repair the asset were covered in full.





Aon's Transaction Solutions team has been leading the creation and advancement of transaction liability insurance since the market's inception. Comprising former senior M&A and tax attorneys and other senior M&A leaders, Aon brings a depth of knowledge and passion for developing tailored solutions to your complex deal risks that are unparalleled in this industry. We know firsthand that the timing and sensitivity of a deal are paramount to its success and work closely with your deal teams and insurance providers to advise and execute solutions that improve your deal outcomes.

For more information about this study or about Aon's dedicated claims advocacy, please contact

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If you have any questions about your specific coverage, or are interested in obtaining coverage, please contact your Aon broker.

About Aon

Aon plc (NYSE:AON) is a leading global professional services firm providing a broad range of risk, retirement and health solutions. Our 50,000 colleagues in 120 countries empower results for clients by using proprietary data and analytics to deliver insights that reduce volatility and improve performance.

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