



What Happens After the Deal Closes?

Warranty and Indemnity Insurance
Global Claims Study

Foreword

The German market for Warranty and Indemnity insurance (“W&I,” also known as Representations and Warranties insurance) has grown significantly in the last 18 months. This local growth reflects an overall global trend in the market for insuring M&A deals. As W&I insurance becomes more familiar and trusted, we would expect this trend to continue in Germany.

Historically, law firms and M&A advisors have been slow to recognize the value of W&I insurance, but this is changing. A lack of experience with the insurance – not to mention few German speakers selling the product – meant M&A influencers were not familiar with insurance as a tool and thus weren’t using it, despite a strong economy and lots of local corporate M&A activity. Even now, despite growth in the W&I insurance market, some larger deals in Germany proceed without cover.

As the number of German M&A deals using W&I insurance has increased, inevitably so will the number of claims made on those policies, a trend we are already seeing. Deal makers have now recognized the value of the insurance in helping to close the deal, but are eager to understand how the policies will respond when there are problems identified post-closing.

Our claims study provides ample evidence that the cover has a key role to play in protecting companies from the material risks inherent in the business of mergers and acquisitions. In Germany, not only do AIG clients benefit from the experience and expertise of local, German-speaking underwriters to help close deals, but also of the German claims team who work extensively on W&I claims in the region and understand the local law and the nuances at play.

And with M&A activity in Germany set to grow by 65% between 2015-2020, according to one leading law firm, there is clear potential in the market. If trust in the product can be developed, all parties are able to see the benefits through good claims experiences and the M&A market remains highly active, W&I insurance in Germany will be part of even more deals in the future.

Dr. Dennis Froneberg
M&A Manager, Germany, AIG

Xianbei Li
Senior M&A Underwriter, Germany, AIG

Once viewed as a novelty, Representations and Warranties insurance (“R&W,” also known as Warranty and Indemnity insurance) has now become a valuable and increasingly popular tool that can help mergers and acquisitions progress more smoothly. It offers both buyers and sellers a tailored solution designed to cover breaches in representations and warranties that are provided by sellers in the particular transaction. This form of insurance can significantly reduce both parties’ inherent risk in doing a transaction, and in turn, help to minimize the time needed to reach an agreement and close the deal.

Despite the common PR rhetoric seen around the rationale for a given deal being “obvious” or a “perfect fit,” the reality is that any transaction of significant scale always contains unknowns and unforeseeable risks. Despite conducting the best due diligence, the unknowns remain until the dust settles long after the deal is closed. R&W insurance provides a powerful tool to help deal makers enter the turbulent waters of mergers and acquisitions – with the confidence of knowing that they have some protection against a wide range of losses resulting from these unknown risks. The policies have been quite effective for both private equity firms and strategic buyers and sellers. While not the direct purchaser, leading law firms and investment banks are also increasingly advising parties to purchase an R&W insurance policy when structuring their deals.

Learning From Over Fifteen Years of Experience

AIG has been assisting buyers and sellers close over 2,000 deals globally since the late 1990s. The number of deals and the breadth of the portfolio, spanning across geographies, industries, and sectors, uniquely places AIG to share insights into mergers and acquisitions based on observations about the claims made on those policies.

The period reviewed in this report (policies written by AIG between 2011 and 2014) represents a significantly larger pool of transactions than the period prior to 2011 given the growing use of R&W policies on transactions over the past five years. The results should not be considered conclusive with respect to the broader context of all private mergers and acquisitions, as the percentage of deals insured by R&W policies is still relatively small. Nevertheless, the snapshot of R&W claims activity contained in this report provides interesting insights to buyers, sellers, and M&A advisers.

Common Forms of Breaches Reported

Individual R&W policies reflect the specifics of a given deal, but a look at the types of alleged breaches reported, based on AIG global data from 2011-2014, include areas such as intellectual property, data, assets, accounts, contracts, property, and litigation – to name just a few.

On a global basis, the most commonly alleged breaches were reported for financial statements, tax information, and contracts. The U.S. had a slightly more diversified range of breaches reported, considering it was the only region to report alleged breaches in the areas of intellectual property, data, and insurance. In Europe, the Middle East, and Africa (EMEA) and Asia Pacific, there were significantly more accounts and alleged breaches of contracts than other categories.

R&W Claims by Breach Type



*All other includes: Property, Assets, Environmental, Data, Fundamentals, Information, Insurance, Pensions, and Multiple Warranties

Frequency of Claims Varies With the Size of the Deal

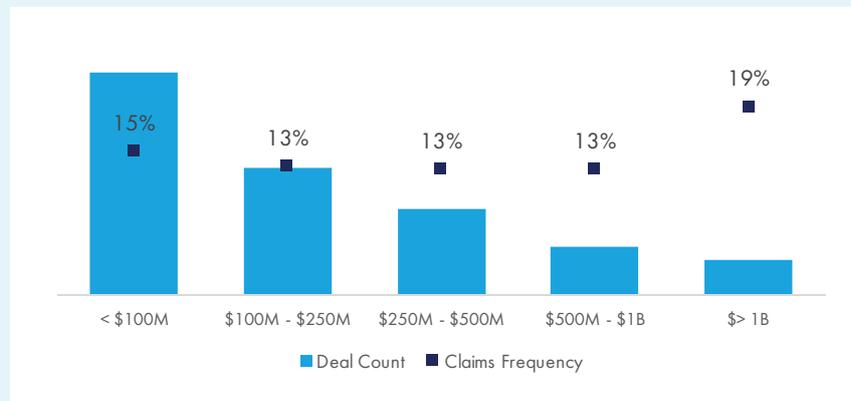
As with any potential expense, a buyer or seller may question whether purchasing R&W insurance when doing a deal is worth it. After all, what are the odds it will be needed? While the answer to that specific question will vary depending on the details of a given transaction, AIG's own claims data provides strong evidence that a significant number of transactions do run into problems after the deal has closed.

According to the data, approximately one in every seven policies issued globally reported a claim. The frequency of claims varies by region, with transactions in Asia Pacific having the highest claims frequency and EMEA the lowest (18% vs. 11.4%). Interestingly, however, the majority of the largest losses came from EMEA.

The probability of a claim being filed against an R&W policy also varied by the size of the deal covered, with deals at either end of the spectrum being somewhat riskier than those in the middle.

For example, only one in eight (about 13%) of deals between US\$100 million and US\$1 billion faced a claim. But for deals smaller than US\$100 million the frequency was slightly higher at 15% and for those greater than US\$1 billion, the percentage was higher still at one in five (19%).

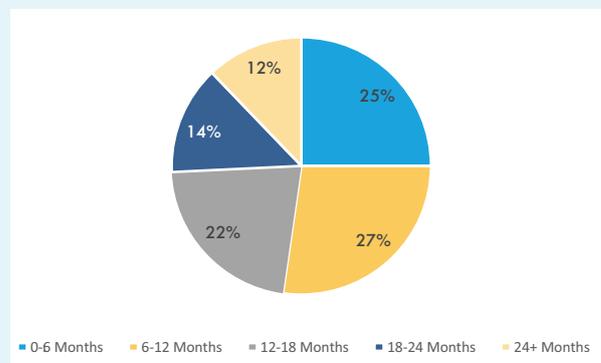
R&W Claims Frequency by Deal Size



Although Trouble Generally Comes Earlier Rather Than Later, the Risk Does Not Go Away

If difficulties are going to arise after inking a deal, they usually do so fairly quickly. Specifically, more than half of all global claims reviewed were reported within the first year after a deal closed, and 74% were filed within the first 18 months. Even though the odds of having a claim decrease if a transaction makes it through the first year and a half that does not mean trouble cannot still be around the corner, however, as 26% of claims were still reported 18 months or more after the close of the transaction.

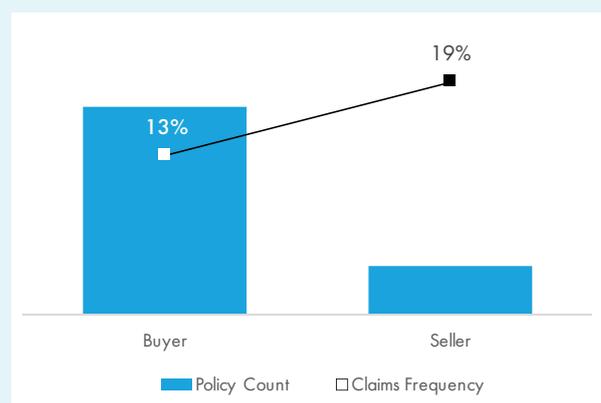
Timing of Claims Reported



Both Buyers and Sellers Beware

An R&W policy covers breaches of the seller's representations and warranties to the buyer. The policy can be purchased by either the buyer for its own loss arising from a seller's breach (innocent or otherwise), or the seller to cover claims brought by the buyer for negligent or innocent breaches. While sellers have only purchased about one-quarter of R&W policies AIG has issued to date, they are more likely to report a claim (19% vs. 13%). That said, policies purchased by buyers were more likely to have a large loss as the majority of the top 15 largest claims reported during the review period belonged to buyer-side policies.

Buyer-Side vs. Seller-Side Claims Worldwide



R&W Insurance in Action

Below are some specific examples of claims that can help provide a better understanding of how an R&W insurance policy can respond to a breach. In all three of the examples, the possession of an R&W policy helped expedite the resolution of unexpected difficulties following a transaction so that the parties could move on to focus on business rather than lengthy negotiations and litigation.

Europe

One leading AIG-insured accountancy and business advisory firm sold its UK investment management business. After closing the deal, the buyer brought a claim against the seller for alleged breaches of the warranties regarding the financial statements of the target, regulatory compliance, and claims in respect of how certain funds had been invested in the past. To help bring the matter to a speedy resolution, AIG provided cover to the insured which enabled it to agree to the terms of the settlement with the buyer. AIG paid out a substantial sum in settlement and expenses.

Asia Pacific

The buyer of an Australian company in the financial services sector purchased a buyer-side R&W policy. After closing, the buyer subsequently became aware that a counterparty of the target company had been submitting fraudulent invoices to the target, resulting in millions of dollars in payments. The buyer pursued legal recourse against the counterparty, but also made a claim under its R&W policy for breach of the financial statement and material contracts warranties. The claim was resolved when AIG agreed to pay the claim in full.

U.S.

The buyer of a global business purchased a buyer-side R&W policy. More than two years after the transaction closed, the company received a subpoena from multiple government authorities in connection with a multi-national investigation into anti-competitive behavior in their industry, with allegations that employees of the company engaged in price fixing for a period that began before the transaction closed. The company was subsequently investigated by multiple other countries and also sued in a civil antitrust action. The actions constituted a breach of the seller's representation that the business complied with all laws, and as such were covered by the R&W policy. While certain criminal fines were not covered by the policy, AIG ultimately paid out a significant amount to cover other loss of the buyer.

Mergers and Acquisitions Are Here to Stay – With Challenges

Global merger and acquisition activity is on the rise and is expected to continue to grow in 2016. This increased activity often translates into heightened competition for attractive assets. As the frenzy of deal-making increases, R&W insurance will continue to provide sophisticated buyers and sellers with a competitive tool that reduces risk and assists them in reaching their transaction goals faster – and with far fewer headaches.

About AIG – Unparalleled Experience and Expertise

R&W claims can be complex, incorporating difficult issues as diverse as the scope of the warranties insured. When you are facing a significantly large loss on a transaction, you do not want your insurance claims handler learning about how a deal works for the first time. AIG has assembled a global network of claims professionals to manage and resolve these types of claims. Made up of experienced professionals located in strategic offices throughout North America, Europe, and Asia Pacific, claims handlers work in partnership with the underwriting team. AIG insureds benefit from dealing with knowledgeable claims handlers who understand the complex nature of R&W claims and can focus on the key issues and bring them to resolution as quickly as possible.



Bring on tomorrow®

The scenarios described herein are offered only as examples. Coverage depends on the actual facts of each case and the terms, conditions and exclusions of each individual policy. Anyone interested in the above product(s) should request a copy of the policy itself for a description of the scope and limitations of coverage.

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