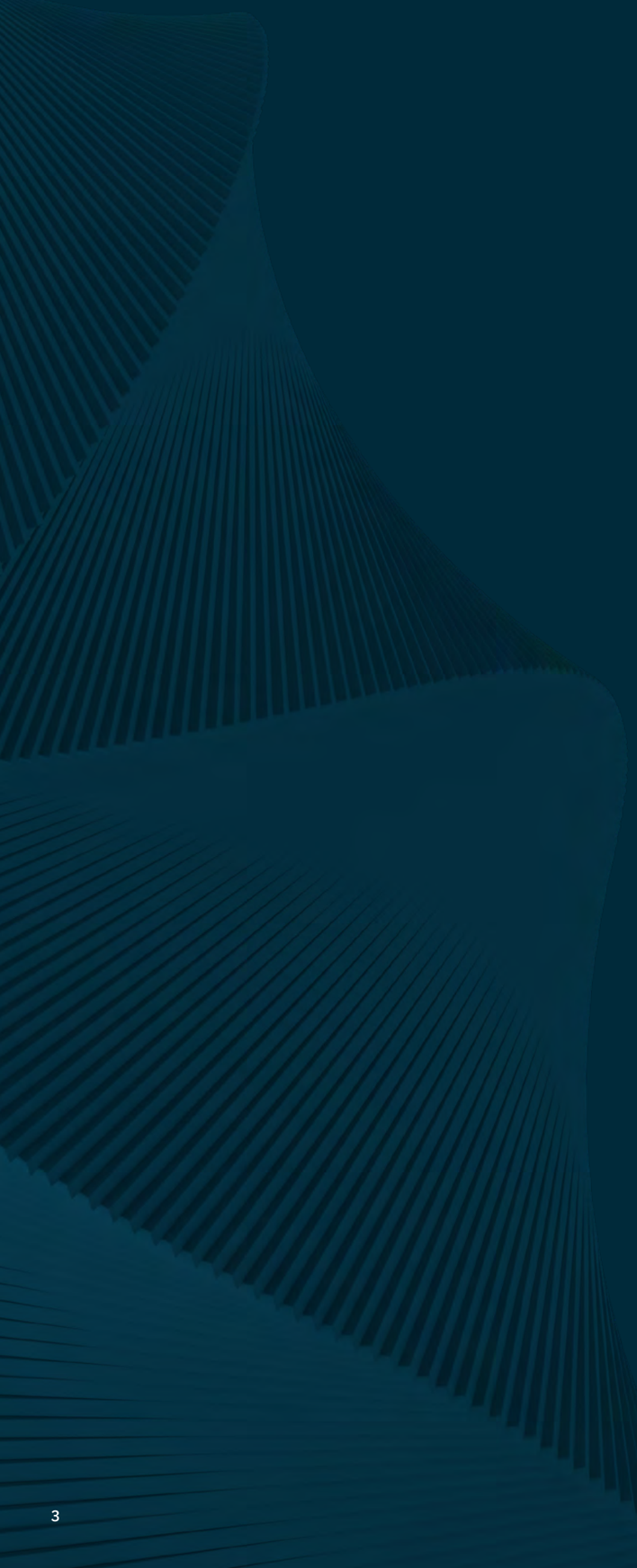
HWF

MARKET CLAIMS STUDY

An independent market-wide review of European W&I claims

2016–2023



HWF HAS LED THE FIRST INDEPENDENT EUROPEAN W&I MARKET CLAIMS STUDY, USING DATA FROM 16 INSURERS OVER A 7-YEAR PERIOD.

Insurance exists to protect against the unknown and unforeseen. This study shows that 43.75% of claim notifications over the last 7 years related to seller non-disclosure, fraud and third party claims. Those matters simply can't be diligenced, so there's tangible benefit to an insurance product that responds when they emerge.

The aim of this study was to drill into the utility of W&I insurance and present an honest picture for clients to digest. We went further than other published reports in the market in terms of the breadth and depth of data surveyed, and we've reported on matters others simply haven't thought about.

Our data set displays consistent evidence that W&I insurance ultimately works to protect buyers and facilitate M&A.

Will Hemsley
Partner

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INTRODUCTION

HWF is excited to release the first independent claims study of the European W&I insurance market.

Use of W&I insurance has increased over the last 10 years in a buoyant M&A market, particularly in the private equity space, driven by parties to M&A realising the benefits of a buyer having recourse to A-rated insurers whilst a seller is able to achieve a clean exit. This increased reliance on insurance products makes it more important than ever for clients to have confidence in W&I insurance and the ability to recover through claims.

Individual insurers and brokers regularly publish their own claims data, but for a claims study to be of real value it needs to be broader. It needs to capture data from multiple insurers, needs to cover policies placed by multiple brokers, and needs to cover a sufficient lookback period to give a comprehensive view of the claims market.

The HWF study does that. It's based on anonymised and aggregated data captured from 16 leading insurers in the European transactional risk market. That means this study is the first true independent study of the state of W&I insurance claims in Europe.

The results provide compelling evidence of the importance of W&I insurance. They show tangible benefits to insured parties of a well scoped W&I policy and, ultimately, that there is a well-developed insurance marketplace accustomed to settling claims of all sizes efficiently and pro-actively.

METHODOLOGY

The methodology used to compile this report, and to ensure the accuracy of the data, has not been used before in the European market. No other advisor in the transactional risk market has access to this data. That makes this report unique and builds on HWF's already leading position as an expert and trusted advisor in the transactional risk market.

To compile this report, the following methodology was used:

- **Data collection:** HWF engaged an independent third party to collect the data. Data was anonymised meaning individual insurers could not be identified. Ensuring data confidentiality was fundamental in facilitating insurer engagement given the sensitive nature of the questions.
- **Insurers:** 16 insurers participated in the study. 7 have been operating for the entire review period.
- **Lookback period:** Data relates to the period 1 January 2016 – 30 June 2023.
- **Jurisdictions:** This is a European study. That means it captures data from European insurers. Those insurers regularly place policies for non-European targets, so in particular this study includes data on the Middle East and Africa (MEA), a growing and important region in the transactional risk market. As readers will be aware, the North American market is quite different to Europe, so to ensure the quality of the data was not impacted, this study does not cover North America.

KEY TAKEAWAYS

- Use of W&I policies has accelerated year on year across a growing number of sectors, jurisdictions and deal sizes.
- W&I claims are arising widely across sectors, jurisdictions and deal sizes; W&I insurance is not specialised.
- A material number of claims are being paid; in aggregate there were payments on **5.48%** of policies across the review period with almost **10%** of policies in 2018/19 resulting in paid claims. These are very significant numbers for an insurance product responding to unforeseeable risks.
- The losses when claimed were serious: despite **45%** of notifications not initially specifying a quantum, **22.36%** of notifications were still above 50% of the policy limit.
- **43.75%** of notifications related to seller non-disclosure, fraud and third party claims. This is when the product is invaluable. Those risks simply can't be diligenced.
- **94.58%** of claims were paid within 2 years, with **24.75%** of claims settled within 12 months. This is far quicker than any resolution in a non-insured context.
- In light of the payment rate, and assuming it continues at the current level, it would not be surprising to see a hardening of rates for W&I in the European market in the future.
- A W&I insurance policy should be seen as an effective alternative dispute resolution mechanism: the claims process under a W&I insurance policy is more time efficient, less costly, less adversarial, less complex and arguably more likely to be successful than the same claim against a counterparty.

16 INSURERS

7 YEAR LOOKBACK PERIOD

10,162 POLICIES PLACED

11.32% POLICY NOTIFICATION RATE

5.48% POLICY PAID RATE

63.78% NOTIFICATION PAID CLAIM RATE

94.58% OF VALID CLAIMS PAID WITHIN TWO YEARS

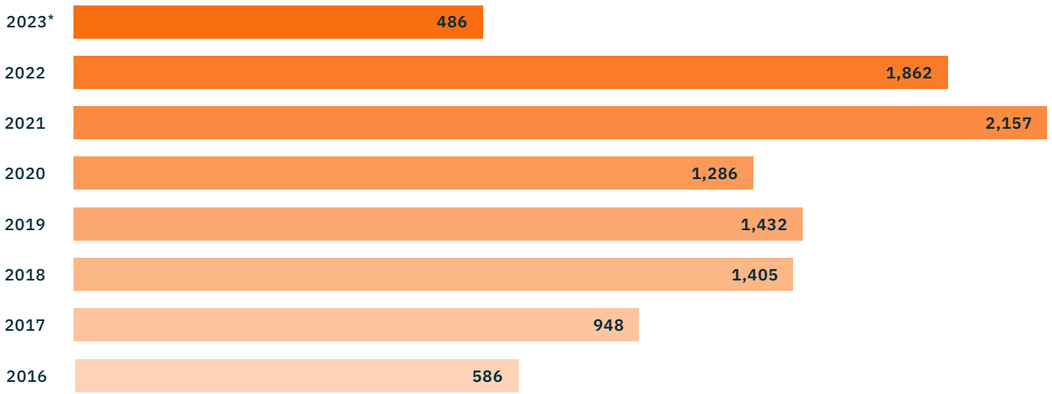
CLAIMS STUDY

HOW WIDESPREAD IS THE USE OF W&I INSURANCE?

PRIMARY POLICIES PLACED

The data shows that 10,162 primary policies were placed during the review period. Overall, there is broad year-on-year growth; the first half of 2020 was impacted by the M&A slowdown at the onset of the Covid-19 pandemic, but numbers rebounded strongly in the second half of the year to nearly surpass 2019 policy numbers.

Policy numbers in 2022 and 2023 were then slightly down on 2021 which reflects the cooling M&A market.

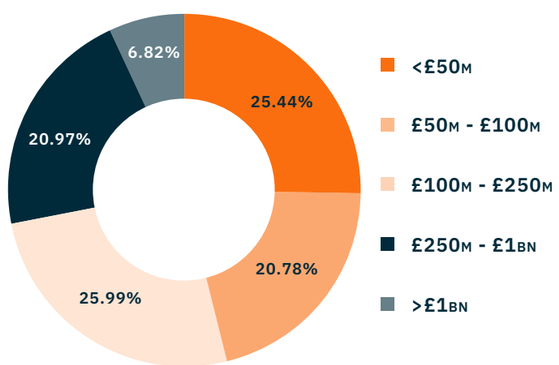


*JANUARY-JUNE

TRANSACTIONS USING W&I BY EV

Since 2016, W&I insurance has evolved from a transaction tool utilised in the lower mid-market to seeing broad uptake across transaction sizes and consistent use for deals with an EV of up to £1bn. Thereafter use decreases (which is to be expected given the number of deals in excess of £1bn EV will be lower), but a still material 6.82% of deals in the review period had an EV in excess of £1bn.

W&I insurance isn't a tool confined to the lower mid-market. It has evolved into a sophisticated product capable of being deployed on complex high-value transactions.



TARGET JURISDICTIONS

Insurers were asked to confirm where their policies were placed based on the target business jurisdiction.

The data clearly demonstrates that W&I insurance is a global product with strong insurer appetite to cover multiple jurisdictions. A prevalence of deals in the UK and Ireland is expected given, in particular, the UK's role in establishing the transactional risk market.

As the W&I insurance market has developed there has been a strong uptake of insurance throughout Europe. The MEA region represents 3% of policies across the review period; we expect this proportion to increase materially over the coming years as understanding and appetite for insurance products continues to grow in the region. The data also shows there is a strong flow of deals in wider jurisdictions, and the majority of the 'Rest of World' category is made up of Asian target businesses.

UK & IRELAND	W. EUROPE	NORDICS	ROW (EXC. N. AMERICA)
38%	19%	15%	13%

S. EUROPE	CEE	MEA
8%	4%	3%

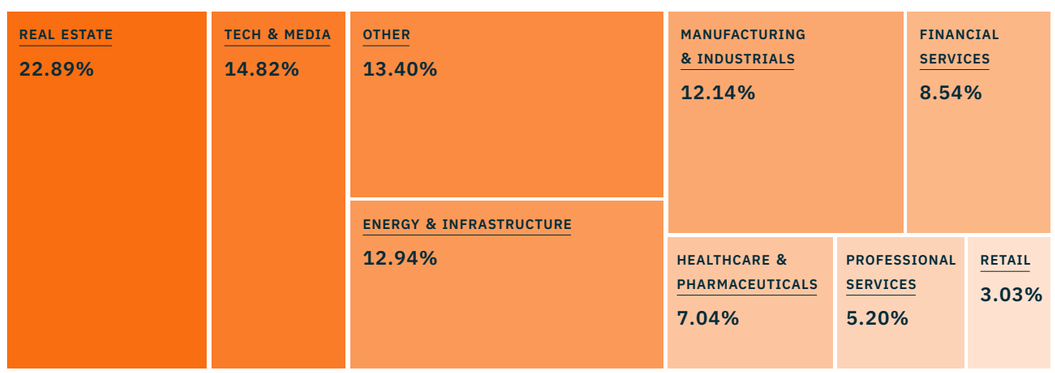
> **Use of W&I insurance policies has accelerated year on year across a growing number of sectors, jurisdictions and deal sizes.**
>
> DAVID WALL, CO-HEAD OF PRIVATE EQUITY

W&I POLICIES PLACED BY SECTOR

Use of W&I insurance is sector agnostic.

Whilst there is widespread use in historically stable sectors including real estate and infrastructure, across the review period the data also shows material uptake in perceived 'higher risk' and regulated sectors including healthcare, pharmaceuticals and financial services.

The 'Other' sector includes strong uptake in Educational Services, Gambling, Food Manufacturing, Marketing and Telecommunications.



HOW MANY NOTIFICATIONS HAVE BEEN MADE? HOW MANY HAVE BEEN PAID? WHEN ARE THEY PAID?

POLICIES WITH NOTIFICATIONS

In aggregate, 11.32% of policies placed across the review period have seen a claim notification. This is a material notification rate and we are confident it significantly surpasses the claim rate on uninsured deals (although this is not possible to verify).

As expected, the number of policies with notifications decreases for survey years closer to the present as claim periods remain open. We naturally expect claim notifications in later live years to increase over time, particularly for 2020/2021 given the high M&A volumes seen during and immediately following the Covid-19 pandemic.

Policies with paid claims:
In aggregate, 5.48% of policies placed across the review period have resulted in paid claims. That's a very significant payment rate. The years 2018/2019 were significant years for W&I as a product with 9.44% and 9.38% of policies placed in those years resulting in a claim and payment.

If we exclude 2018/2019 numbers which may distort the data, that payment rate drops to a still material 4.05%.

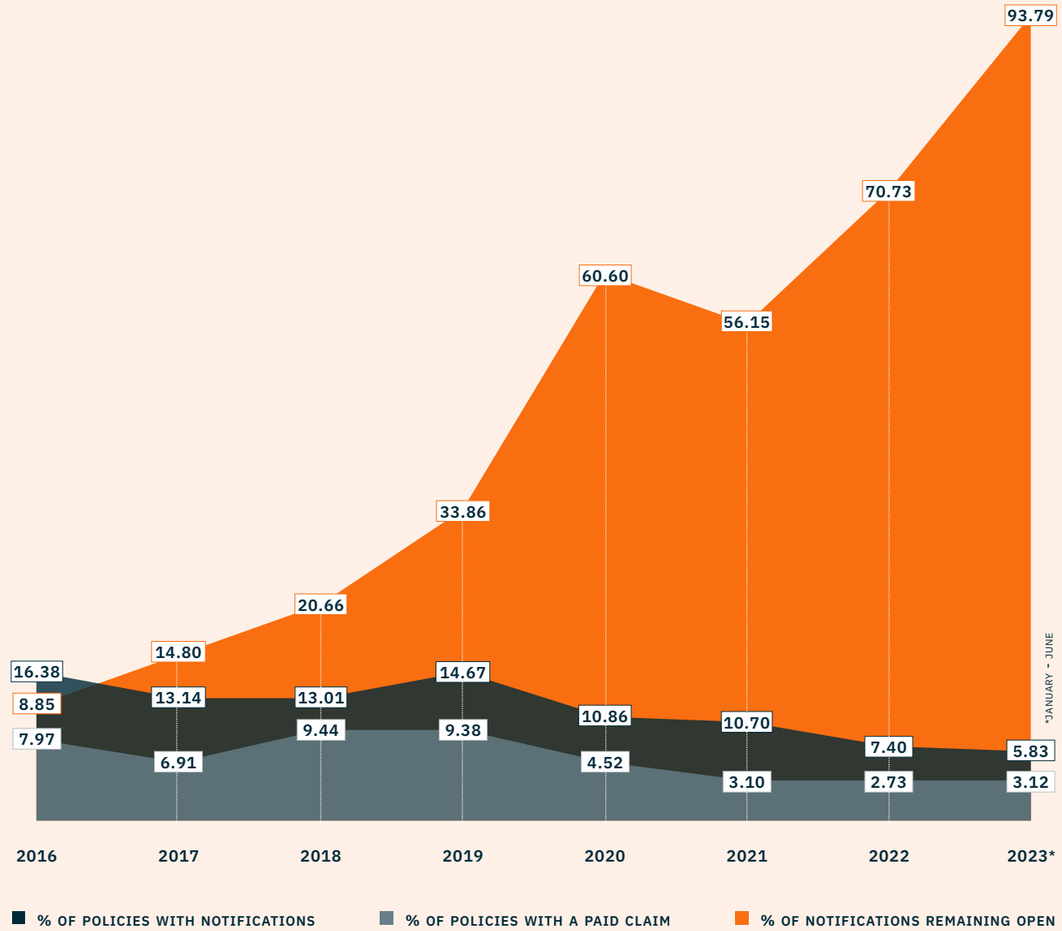
When talking about paid claims it's important to remember that not all claims result in a full limit payment. So whilst the aggregate number of paid claims is material, there still remains a competitive insurance market with insurers competing for insured transactions. This payment rate also helps explain insurers' increased focus on underwriting and robust due diligence in order to mitigate their risks.

When thinking about these numbers it's important to remember the context. This is an insurance policy which is designed only to respond to the unknown and unforeseen. That is why, in general, pricing is very competitive. Ideally these policies are designed only for worst-case scenarios.

It is sometimes easy to forget that point in the discussions about the utility of the product. But, in fact, what we see in the data is that in a very material number of instances these policies are responding and when they do they are invaluable in protecting parties from the inevitable challenges associated with complex transactions. The unknown and unforeseen remains rare, but the utility of the policies is clear.

Notifications with paid claims:
If we divide the aggregate number of paid claims across the review period by the aggregate number of closed notifications, the data shows us that 63.78% of closed notifications have resulted in a paid claim (including, for the avoidance of doubt, claims beneath the policy excess which were notified to erode that excess for future claims). That's a material payment rate, particularly in light of the 11.32% notification rate coupled with, in our experience, insured parties being more willing to submit claims against a third party insurer than they would against an uninsured seller or warrantor (particularly if that seller or warrantor is now part of the buyer group following a PE-backed transaction).

Notifications still open:
It is no great surprise that historical claims are more likely to have settled. Evidence from insurers is that the vast majority of notifications remaining open from early years of the review period are complex tax claims which are not capable of settlement until liabilities have crystallised and tax authority assessment processes have run their course.

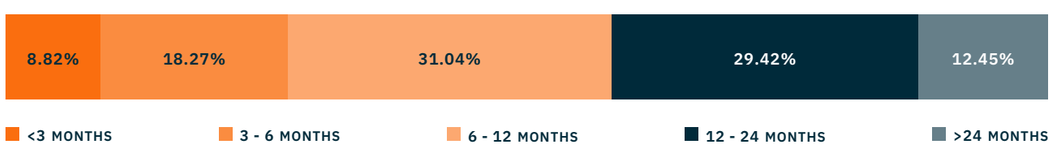


"A material number of claims are being paid; in aggregate there are payments on 5.48% of policies across the review period with almost 10% of policies in 2018/19 resulting in paid claims. These are very significant numbers for an insurance product responding to unforeseeable risks.

CLAIM NOTIFICATION TIMING

The data shows no real surprises. 8.82% of claims are submitted in the 3 months following inception of a W&I insurance policy, and another 18.27% within 6 months of inception. The majority of claims are submitted by the end of the 12-24 month period following policy inception.

12.45% of claims being submitted longer than 24 months from policy inception is not insignificant, and, despite an ability to cover general warranties for 3 years as a common policy enhancement (which we don't see clients opt to take on a regular basis), data shows the significant majority of these claims are for tax matters.



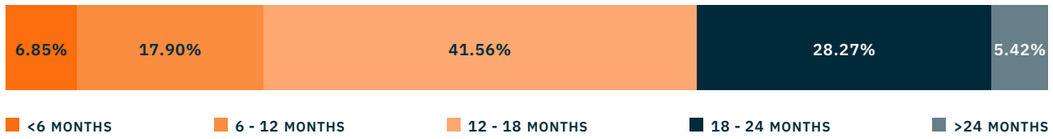
> **94.58% of claims are paid within 2 years, with 24.75% of claims settled within 12 months.**

CLAIM PAYMENT TIMING

The data confirms that since 2016, 94.58% of claims are settled within 24 months from notification. With the majority, 41.56%, of those claims being settled in the 12-18 month period following notification and 24.75%, almost a quarter of claims, being settled within 12 months of notification.

This data is compelling; it shows a well-established claims settlement process that is in contrast with the timing for claims settlement in an uninsured context.

As we discuss in the article *'Claims Process: Recovery in Insured and Uninsured Claims'* on page 35 of this report, an uninsured claim where a seller is not in the business of covering and settling claims can quite easily result in a much lengthier and more costly recovery process.

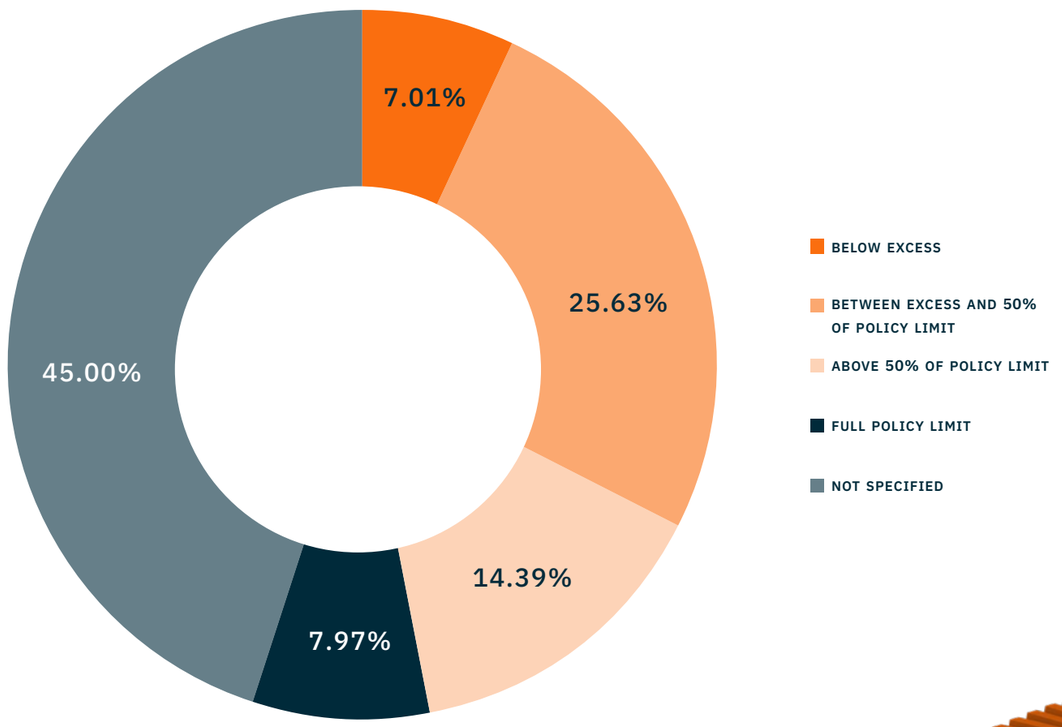


CLAIM NOTIFICATION QUANTUM

It isn't surprising that a significant proportion of notifications (45%) do not specify a claim quantum. Insured parties are typically under an obligation to notify claims as soon as reasonably practicable, and in reality calculating the quantum of a claim at an early stage may be difficult. In our experience, insured parties are also hesitant to notify a claim at what may ultimately be a lower quantum of loss than they ultimately suffer.

There is a clear habit of notifying claims to erode the policy excess for future claims. The majority of quantified claims then sit between the excess and 50% of the policy limit (25.63%) and 14.39% of claims are above 50% of the policy limit but less than the full limit.

> **The losses when claimed are serious: despite nearly half of all notifications not specifying a quantum, nearly 25% of all notifications were for an amount greater than 50% of the policy limit.**
>
> REBECCA WYNNE, PARTNER



WHERE ARE CLAIMS ARISING?

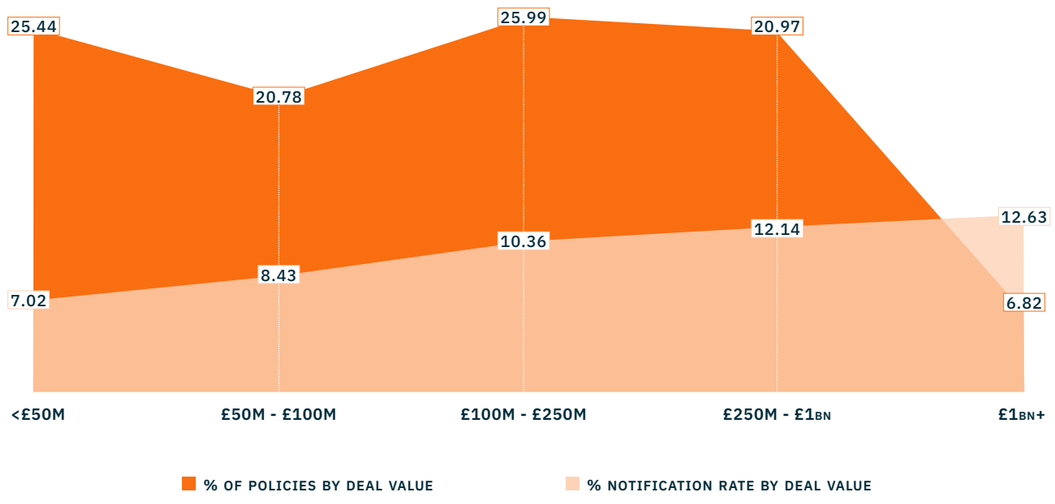
NOTIFICATIONS BY DEAL VALUE

It's clear from the data that more claims materialise on larger deals. Claim notification rates increased with target EV in every category surveyed, with a notification rate of 12.63% on deals in excess of £1bn. Given the size and complexity of target businesses with larger EVs this isn't unexpected, and helps explain the market trend of insurers on those larger deals closely focusing on due diligence scopes and processes to try and gain comfort and mitigate their exposure. HWF have authored a series of articles on this topic called *'The Diligence Debate'* which give practical advice on how an insured can pre-empt insurer requirements to achieve robust cover from a W&I insurance policy.

Conversely, notifications on deals with an EV of less than £50m are the lowest level surveyed, at 7.02%. Whilst that is still a material notification rate, smaller deals are typically easier for a buyer to diligence and flush out any issues with their advisors, meaning they can be dealt with as part of the wider transaction ahead of signing.

The takeaway from this data is that W&I insurance is being relied on by parties across the M&A market. Importantly, for a product that has evolved rapidly over the last decade, its use in supporting large scale M&A appears to be well-established with a clear path to claim notification.

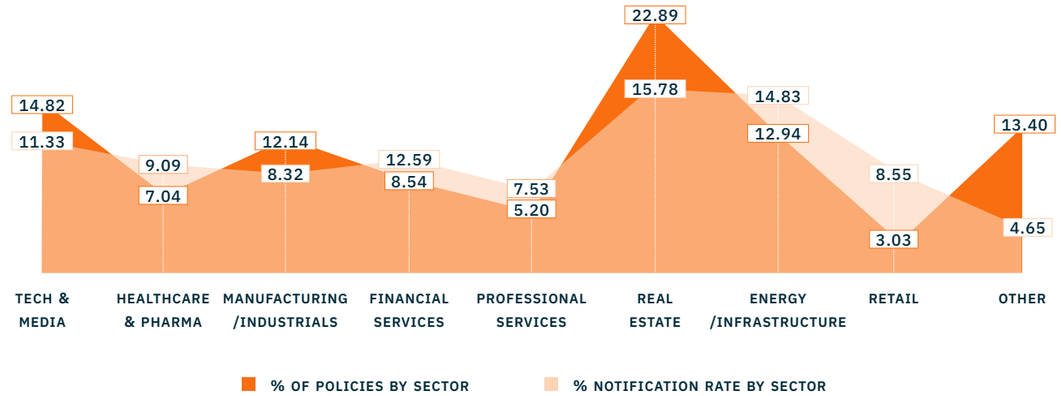
> **W&I claims are arising widely across sectors, jurisdictions and deal sizes; W&I insurance is not specialised.**
>
> ADRIAN FURLONGE, PARTNER



NOTIFICATIONS BY SECTOR

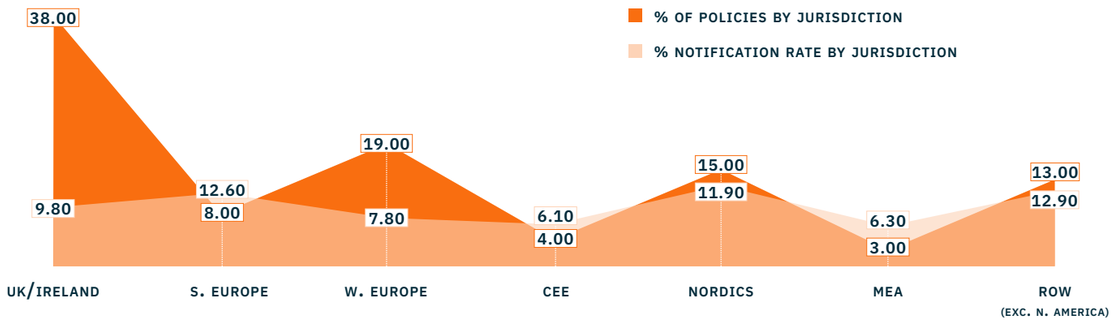
The data clearly shows that certain sectors result in a higher notification rate. Healthcare and Pharmaceuticals, Financial Services, Professional Services, Energy / Infrastructure and Retail all display a high notification rate when compared to the proportion of policies placed in those sectors.

Broadly, those sectors contain operational and/or regulated businesses which are perceived as higher risk. The data supports that view and, save in the case of Energy / Infrastructure, we would expect to see W&I insurance pricing at the higher end of market ranges for those sectors.



NOTIFICATIONS BY JURISDICTION

Clear trends are evident. Southern Europe accounts for just 8% of policies placed, but of those policies there was a 12.60% notification rate; CEE accounts for 4% of policies and with a resulting notification rate of 6.10%; and MEA accounts for only 3% of policy placements but has seen a notification rate of 6.30%. These figures align with the market perception of those jurisdictions as being more likely to result in claims, which in turn is evidenced by the broadly higher pricing seen in those jurisdictions. As those jurisdictions are more recent adopters of W&I insurance, particularly the MEA region, insurers will be closely monitoring notifications (and ultimately paid claims) in order to refine their pricing and coverage moving forwards.

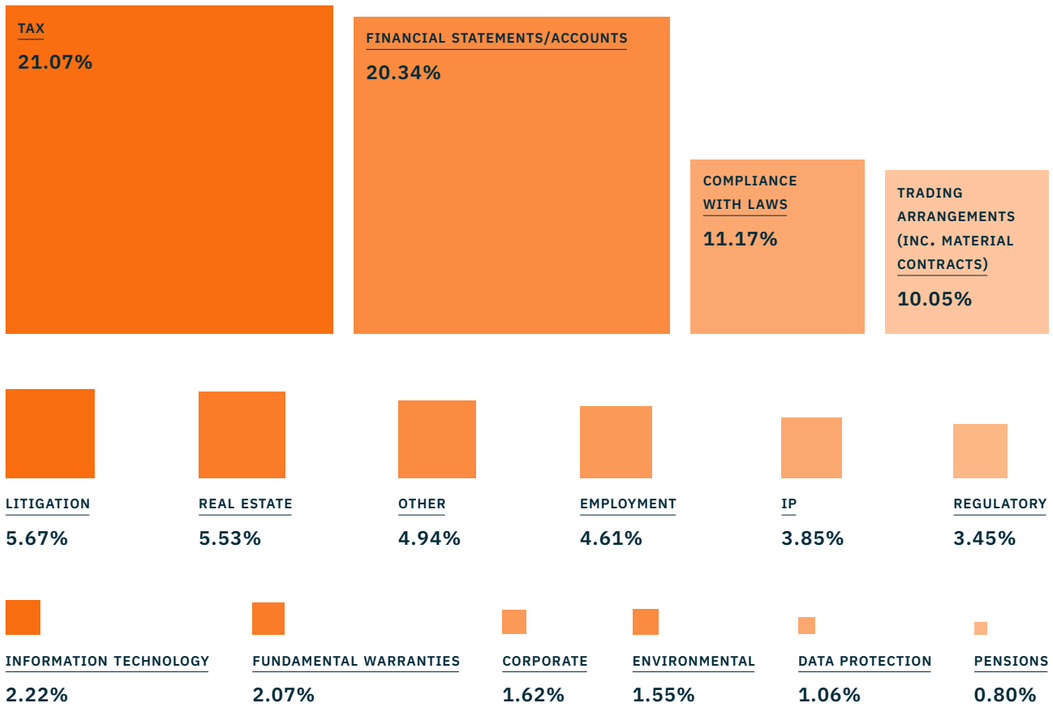


WHICH WARRANTIES ARE BEING BREACHED AND HOW?

TYPES OF BREACH

It is normal for insureds to allege multiple categories of warranties are breached in a claim notification, however there are clear patterns in the subject matter of warranties being claimed against throughout the review period.

Most notifications relate to breaches of Tax (21.07%), Financial Statements/Accounts (20.34%), Compliance with laws (11.17%), and Trading arrangements (inc. Material Contracts) (10.05%) warranties.

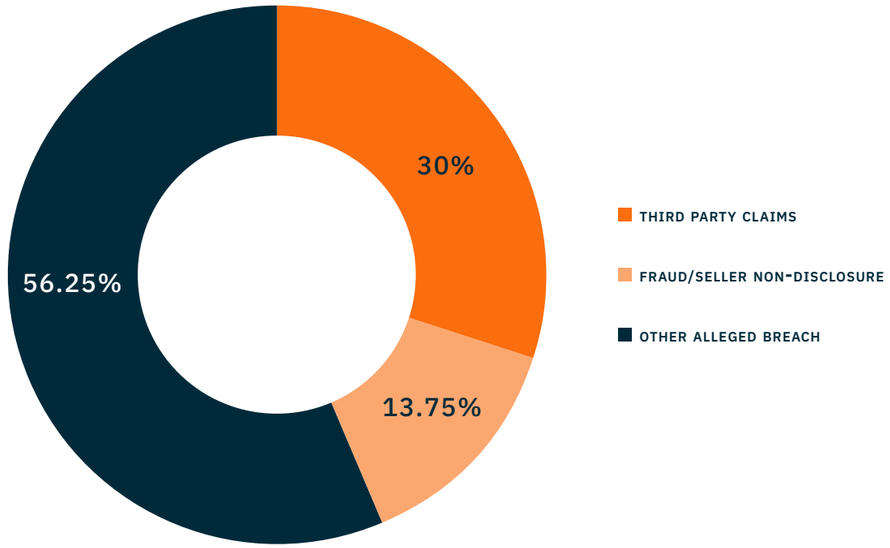


> **43.75% of notifications are related to seller non-disclosure, fraud and third party claims. This is when the product is invaluable. Those risks simply can't be diligenced.**
>
> WILL HEMSLEY, PARTNER

NOTIFICATIONS: FRAUD, NON-DISCLOSURE AND THIRD PARTY CLAIMS

The purpose of W&I insurance is to protect against unknown liabilities that can't be discovered in due diligence, particularly where losses flow from seller fraud, non-disclosure or third party claims.

Over the review period the data is clear; 13.75% of notifications relate to fraud and/or seller non-disclosure whilst a further 30% relate to third party claims. This aggregates to 43.75% of notifications relating to matters which, by their very nature, couldn't have been discovered through due diligence. So there is compelling data to show the benefit of an insurance product that reacts to those unknown, unforeseen and unquantifiable liabilities.



CASE STUDIES

EXAMPLES OF PAID CLAIMS UNDER W&I POLICIES

MATERIAL CONTRACT ROYALTY UNDERPAYMENT

- The insured buyer discovered that the target company, which sold equipment for upstream oil and gas operations, had made a significant underpayment of royalties to one of its main suppliers under a material contract as a result of an internal error.
- The target company reached a settlement with the third party supplier for the unpaid royalties and the buyer brought a claim under the W&I policy for a breach of a material contracts warranty.
- The target company was valued on the basis of a multiple of the group's expected EBITDA, and the insured claimed under the policy for the value that the purchase price was overstated as a result of the breach.
- The insurer accepted that the material contracts warranty was likely to have been breached and paid the difference in the purchase price after reviewing the accounting evidence.
- HWF worked closely with the insurer throughout the process to ensure that the insurer had all of the necessary information to accurately assess the quantum of loss.

The result was a $2.2 million payment to the insured.

IFRS ACCOUNTING RULES

- The insured buyer discovered that revenue for commercial contracts had been recognised up front at a time inconsistent with the IFRS accounting rules. Certain contracts could not then be performed, or in some cases were cancelled, with the result that the value of the business was significantly less than the insured believed when making an EBITDA valuation based on the accounts.
- Once the contracts had been cancelled the buyer brought a claim under the W&I policy for a breach of the Accounts and Material Contracts warranties.
- The target was valued on an EBITDA multiple and the insured claimed under the policy for the value that the purchase price was overstated as a result of the breach.
- The insurer accepted that the warranties had been breached within several weeks of the claim and accountants were instructed to determine quantum.
- The quantum of loss and a settlement figure was agreed within weeks of the accountant's final report.

The result was a $9.6 million payment to the insured.

HWF worked closely with the insurer throughout the process to ensure that the insurer had all of the necessary information to accurately assess the quantum of loss.

REVENUE DOUBLE COUNTING

- The insured bought a company involved in the marketing sector which was headquartered in Scotland, albeit with operations across Europe.
- Shortly after completion it became apparent that customer invoices had been erroneously duplicated resulting in (i) the number of customers of the target being misrepresented, and (ii) such revenues being double-counted.
- As a result of this issue, various warranties were allegedly breached, including those which related to the target's accounts.
- The insured engaged actively with the claim enabling insurers to complete their coverage investigations swiftly.

Ultimately insurers paid out over £20 million within 12 months of the formal claim notice being received.

FAILURE TO OBTAIN RENEWABLES LICENSES

- This claim was in respect of a buy-side W&I insurance policy that was obtained for the acquisition of a renewables portfolio. In particular, it related to the acquisition of a target that owned and operated 27 solar parks in southern Europe.
- Within 12 months of completion, the insured discovered that several of the sites within the portfolio did not have the relevant licences in place to operate. As a result, the insured was required to cease operations at these sites pending rectification of the licencing position.
- The insured claimed under the W&I insurance policy for, *inter alia*, (i) the costs incurred in procuring the relevant licenses, some of which the insured was ultimately unable to obtain with the resultant loss of operational capacity at such sites also claimed, and (ii) the loss of profits that it was unable to generate while the relevant solar farms were not operational.
- Following the insured's collaborative approach to providing the information requested by insurers in order to assess coverage, insurers were able to confirm breach within one month.
- Insurers also agreed to pay elements of the insured's loss at that point with the rest assessed following crystallisation.

In total insurers paid out just under €5 million.

VAT LIABILITIES ON CROSS-BORDER SUPPLIES

- The buyer acquired a target headquartered in the UK, albeit with global operations, operating in the manufacturing sector.
- A number of years after signing, the tax authorities conducted an audit of the acquired entity's operations.
- The audit focused upon VAT compliance in respect of cross-border supplies and concluded that these had been incorrectly treated from a VAT perspective.
- As a result, the insured was able to establish breach of both the tax warranties and tax covenant.

Incurred loss totalled nearly €10 million which was acknowledged under the policy by insurers.

> **Upon receiving the claim the insurer initially denied cover... However, after negotiations between HWF and the insurer, the insurer made a settlement offer.**

IP INFRINGEMENT DISPUTE

- The insured buyer was a strategic healthcare company which acquired a company which made bionic limbs.
- The insured alleged a breach of a freedom to operate warranty by the seller for failing to adequately disclose a third party litigation involving a patent infringement in which the third party claimed unpaid and future royalties. The seller had disclosed that it was suing a third party for patent infringement, but failed to disclose that the third party was counterclaiming for the same infringement and the seller had not disclosed that it had failed to renew the patent.
- Upon receiving the claim the insurer initially denied cover on the basis that the subject matter of the infringement had been disclosed. However, after extensive commercial negotiations between HWF and the insurer, the insurer made a settlement offer because, notwithstanding that a related disclosure had been made, importantly the seller failed to disclose that the relevant patent had not been renewed.

The insured received a settlement payment of approximately €2 million.

DIGITAL COMMUNICATIONS COMPANY REVENUES

- The insured buyer acquired a target which was a digital signage company to enhance its digital communications platform.
- The insured alleged that various warranties had been breached in respect of the monthly recurring revenue of each customer.
- The purchase price of the target was calculated by multiplying the monthly recurring revenue by 72 months.
- Various potential policy exclusions were considered by the insurer as being applicable, including whether 'Deal Team Members' had 'Actual Knowledge' of the relevant facts, however the insurer recognised that these points would not provide a total defence to the claim. It was also possible that the insurer could require the insured to pursue certain claims against the seller.

However, the insurer chose to enter a commercial negotiation with the insured and made a settlement payment of $2.5 million with a commitment from the insurer not to pursue any other recovery as part of the agreement.

RETAIL COMPANY EMPLOYMENT LIABILITIES

- The target, a retail company, was approached by a number of ex-employees and their union representatives regarding alleged failures to meet pay awards in full. The insured notified the matter to the insurer on the basis that the underpayments amounted to breaches of employment, tax and liability warranties.
- The heads of loss in respect of which the insured sought indemnity included the target's liability for the above underpayments that occurred prior to deal completion and a separate diminution in value loss that the insured considered it had suffered due to employee and related costs of running the target business post-completion being greater than warranted.
- The calculation of the diminution in value element of the loss involved assumptions regarding the EBITDA multiple that was appropriate for calculating the value of the business at completion.

Both the insured and insurer retained expert accountants to advise on these issues. Following correspondence the parties were able to agree a mutually acceptable multimillion-dollar settlement sum.

UNDISCLOSED PENSIONS OBLIGATIONS

- After the acquisition, the insured buyer identified certain undisclosed pensions and deferred compensation obligations of the target companies which related to current and former employees of the target group.
- The insured filed a claim asserting that these undisclosed liabilities rendered the warranted accounts non-compliant with the relevant accounting standards and failed to provide a true and fair view of the target group's financial position. Additionally, the insured alleged that the non-disclosure of these pension commitments constituted a breach of a specific pension warranty.
- The assessment of the claim involved complex factual matters, particularly in determining the applicability of a customary W&I pension underfunding exclusion and the appropriate accounting treatment under both GAAP and IAS accounting standards.

A settlement was agreed with the insured on mutually agreeable terms, resulting in a substantial settlement amount within only a few months of the first notification.

HWF assisted the parties to reach a quick settlement and consequently the insurer was able to confirm cover for 75% of the claim amount within 8 days.

LOSSES UNDER A FACILITY AGREEMENT

- The insured buyer acquired a telecommunications company in the Middle East. Following completion, a dispute arose in relation to the exercise of redemption rights under a loan facility.
- The insured alleged that there had been a breach of reporting obligations under the loan facility. Urgent settlement discussions began between the certificate holders under the facility and the obligor because of time limits on the relevant redemption payments and a settlement was reached to avoid litigation.
- The insurer quickly accepted that there had been a breach of warranty for failure to comply with the relevant reporting obligations which precluded the valid exercise of a call right and was also satisfied that the settlement that was reached reflected the risk of losses that might be suffered in any dispute.
- The insurers were able to quickly get on top of the relevant issues thanks to a helpful initial call with the insured and the fact they were provided with as complete a set as possible of the relevant documents and correspondence.

HWF assisted the parties to reach a quick settlement and consequently the insurer was able to confirm cover for 75% of the claim amount within 8 days.

REAL ESTATE TAX CLAIM

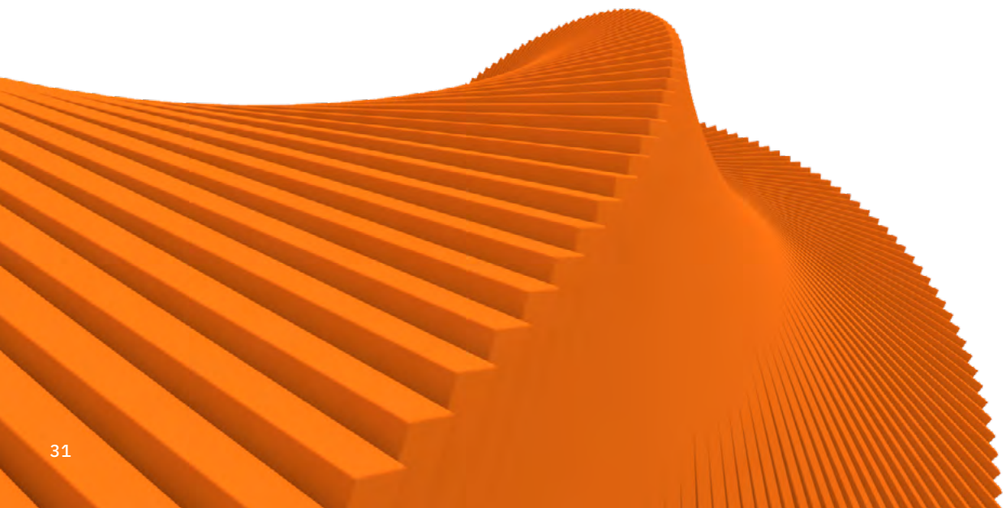
- The insured acquired a portfolio of commercial real estate assets. This included a site in France that was in a state of disrepair. The target company that owned the site had taken advantage of a tax break that allowed it to avoid paying registration duties if it developed the site within a fixed time period.
- The time period passed without development commencing (due to various unforeseen delays) and the French tax authority subsequently demanded that the target company pay the required registration duties (plus interest), which amounted to €836,209.
- The insurer was able to confirm a coverage position less than two months after receiving the claim notice and before the tax authority issued a final assessment.

This resulted in the insured being immediately reimbursed upon payment of the additional tax due.

FORGED ACCOUNTS

- The claim related to an allegation that the local manager of a subsidiary company of the target passed off a set of forged accounts as the audited accounts. The insured's position was that it only saw the forged accounts during the due diligence process and these were the accounts that were warranted as being 'true and fair' in the associated SPA.
- The alleged loss was for the difference between the respective balance sheets: about €4m.

The insurer was able to verify the underlying facts giving rise to the claim and, despite preferring a different methodology for assessing loss, ended up making a payment of around €3.6m, which represented approximately 90% of the amount claimed after application of the retention.



SUMMARY OF CASE STUDIES

What all these case studies have in common is they illustrate the utility of W&I when a genuinely unforeseen issue arises after completion which, unless the policy was in place, would cause material losses to the buyer.

A W&I insurance policy is not a substitute for good due diligence or a well-negotiated deal but it is designed to cover a party for the inevitable fact that large commercial transactions are complex and unknown issues arise.

ALEX HARDING, HEAD OF CLAIMS

A small minority of users of the product have criticised W&I insurance for a low payment rate, particularly for issues which may be excluded from cover because they have been partly disclosed or were known to the buyer. But this is to misunderstand the structure of the product and the pricing. The product is competitively priced and represents a very small percentage of deal value precisely because it is intended only to be required in the relatively rare circumstances when the warranties given are not accurate (although, strikingly, our data reveals notifications and paid claims are actually not infrequent). W&I should not be compared with other forms of insurance which pay out whenever the insured suffers any loss on a particular risk, regardless of the basis for the loss.

A useful recent example of what W&I insurance is not intended to cover was highlighted in the recent High Court case of *Finsbury Food Group PLC v Axis Corporate Capital UK Limited & Ors*. In *Finsbury* the target was a specialist manufacturer of gluten free baked goods. Finsbury alleged that certain recipe changes and product price reductions by the target business amounted to a breach of warranty that there had been no material adverse change in the trading position of the target group and no price reductions since the relevant accounts date.

A detailed review of the case is beyond the scope of this study, but in basic terms the judge held against the insured because:

- there had not been a 'material adverse change' in the position of the company as a result of the alleged breach;
- the witnesses for the buyer gave 'untruthful' evidence about the state of their knowledge of the facts that formed the basis for the breach of warranty claim; and
- the court found that the buyer would have purchased the business for the same price regardless of the breach and so there was no loss.

The key point is that, unlike all of the above case studies, W&I insurance does not represent a fall-back option to correct a bad bargain or to substitute careful diligence.

The case studies are important because they illustrate the wide-ranging number of unknown circumstances when the policy does respond and pays – that is the purpose of the product and why it remains vital for buyers.

CLAIMS PROCESS

RECOVERY IN INSURED AND UNINSURED CLAIMS

Despite its growing use, a significant proportion of M&A transactions are still implemented without W&I insurance. The decision on use of W&I insurance can be driven by factors ranging from the personal preference of parties to pricing, available coverage and commercial factors outside parties' control. Any discussion on warranty and/or tax covenant claims in the M&A market is therefore incomplete without contrasting insured and uninsured claims.

W&I insurance has developed over the last decade alongside the widespread encouragement and adoption of alternative dispute resolution methods to try and avoid parties needing to litigate in the courts. In England and Wales, the Ministry of Justice and judiciary have gone to great lengths to incentivise parties to try and resolve disputes by avenues other than the courts as litigation is often time consuming, disproportionately expensive, unnecessarily adversarial, procedurally complex and too regularly it is disconnected from the commercial concerns of the parties. In short, it can be a very inefficient exercise.

> **More parties to M&A transactions should be aware of the benefits of bringing a claim under a policy as a form of alternative dispute resolution.**

The result has been a series of measures to try and get parties to negotiate earlier, to limit burdensome document requests and witness evidence, to develop mediation and neutral evaluation processes and to apply costs consequences to those parties who do not accept reasonable settlement offers.

The benefit of these initiatives is now self-evident and any lawyer will routinely advise their client early on in a potential dispute on how to avoid court proceedings or arbitration.

However, in the context of M&A, there has been very little commentary on the very obvious benefit of warranty and indemnity insurance as a form of alternative dispute resolution:

- **Efficient resolution:** for a buyer, by replacing the counterparty to the transaction with an insurer, you immediately avoid many of the significant downsides of bringing a claim for breach of contract against the seller and make an efficient resolution of any dispute significantly more likely.
- **Time, cost and complexity savings:** the claims process under a warranty and indemnity insurance policy is more time efficient, less costly, less adversarial, less complex and arguably more likely to be successful than bringing the same claim against a counterparty to a transaction.
- **Pre-packaged form of alternative dispute resolution:** more parties to M&A transactions should be aware of the very obvious benefits of bringing a claim under a policy rather than having to litigate against a seller to recover what they are owed.

TIME

In an uninsured context, bringing even the simplest claim for a warranty breach can often take years to resolve.

Assuming a claim is not able to be resolved commercially at the very outset of any threatened claim, which is rare in circumstances when there is any material amount of money involved, time periods involved in any court proceedings or arbitration are extremely lengthy.

Under the Civil Procedure Rules in England and Wales there are prescribed time periods for pre-action correspondence, completing the steps to formally file a claim, pleading statements of case, allowing the defendant adequate time to respond, convening a Case Management Conference, allowing time for any interim applications, undertaking extensive document disclosure, drafting witness statements and expert reports and preparing for trial.

> **In contrast to a claim against a seller, insurers generally have a commercial incentive to pay good claims promptly.**

Assuming a complex breach of warranty claim is contested to trial, it would be rare to see a resolution by judgment from the English High Court in less than 2.5 - 3 years, and very often longer.

Even if a claim is capable of settling before trial, because of the procedural hurdles that the parties have to comply with to formally articulate the claim in full, and then to start exchanging documents, which may shed light on the actual merits and facilitate settlement, it is still very difficult for a claim to be settled quickly.

In practice, it is not uncommon for it to take six months to a year before statements of case have been finalised and for it to be two years before a full document disclosure exercise has been completed. To take a recent example, MDW Holdings Ltd v Norvill [2021] EWHC 1135 (Ch) concerned a breach of warranty claim. The factual issues in dispute were not overly complicated and the quantum claimed not particularly high:

- first notification of a claim under the SPA was made on **23 August 2017**.
- first instance judgment by the High Court awarding the Claimant £382,600 in damages for breach of warranty was handed down on **4 May 2021**.
- further judgment on consequential matters including costs was handed down on **23 July 2021**.
- High Court judgment was then appealed by the Defendants and the decision of the Court of Appeal was handed down on **28 June 2022**.

It took almost five years to obtain a payment of less than £400,000 in the courts. While in certain circumstances arbitration can be procedurally quicker the difference in time periods with litigation is often not meaningful.

In contrast, our survey data shows that of the paid claims on primary W&I policies placed since 2016, 94.58% of payments were made in less than 2 years.

The main reason for this difference is because upon receipt of a claim the insurer's process is immediately to analyse and understand the merits and assess whether a payment should be made under the policy.

In contrast to a claim against a seller, insurers generally have a commercial incentive to pay good claims promptly. As such, the process for reviewing the claim is often one of fact-gathering and neutral analysis from the beginning rather than being adversarial, which obviously has the benefit of increasing the speed of the process.

As only a very small percentage of claims against insurers are contested before the courts or arbitration, the parties to an insured claim generally do not have to concern themselves with following the procedural steps required under the Civil Procedure Rules or arbitral procedure in anticipation of a claim being issued. Obviously each case will turn on its merits, but in general far fewer claims against an insurer will reach court proceedings or arbitration.

Instead, correspondence is focused on the insurer identifying the key legal and factual points of dispute as quickly as possible and seeking supporting documentation from the insured.

PROSPECT FOR SETTLEMENT

As already noted, unlike an uninsured defendant, insurers generally have a commercial incentive to pay meritorious claims. All insurers who participated in our study made it clear that they wanted their claims data to be published and examples of paid claims known more widely precisely because they know that the strength of W&I insurance as a product relies on insurers responding positively to good claims.

This dynamic is unique to an insurer and materially increases the prospects of settlement of a claim compared to an uninsured seller.

Even if a claim is meritorious, defendants to a claim in an uninsured context will regularly employ delay tactics and be obstructive in response even if they are aware that ultimately they will likely have to make a settlement payment. This is because defendants know a claimant will often accept a lower settlement amount if faced with the prospect of incurring higher costs associated with a contested dispute over a prolonged period. Even in commercial negotiations where there is very little chance of a claim ever reaching court or arbitration, the prospect of lawyers running up fees is often a key issue in the negotiations.

> **The costs of bringing a claim against an uninsured party in England (and elsewhere) are so high because of the detailed procedural requirements... In contrast, a claim under a W&I policy does not require formal pleadings, document disclosure exercises or detailed witness statements.**

In contrast, insurers have a reputational incentive to avoid taking claims to litigation or arbitration, as well as a clear desire to obtain repeat business from their insured clients, and therefore will very rarely use the prospect of litigation as a form of leverage over the claimant or employ obstructive tactics.

In general, claims processes under W&I insurance policies are collaborative and parties are often more willing to concede points to reach a constructive solution. From HWF's perspective, we are able to assist in this process by engaging with an insurer as soon as a notification is made to try and facilitate an efficient and focused exchange only on the most important aspects of the claim.

As the claims study data shows, almost 10% of primary W&I policies placed in 2018-2019 resulted in a paid claim, which is very significant for an insurance product which is responding to unforeseeable risks. The importance of W&I insurance is illustrated further by the fact that 63.78% of closed notifications between 2016 and June 2023 resulted in a paid claim.

COST

One significant advantage of bringing a claim for breach of warranty under a W&I insurance policy is the cost saving in comparison to advancing the same claim against a seller in a contested dispute. Obviously there remains a remote possibility of a claim against an insurer being litigated or going to arbitration but the likelihood of that occurring is significantly less than the same claim against a seller being contested in the same way.

To return to MDW Holdings Ltd v Norvill, following the first instance judgment in which the Claimant was awarded £382,600 in damages (the original claim was for £1.2 million), the Claimant made costs submissions at the consequential hearing stating that its costs to date were over £1.1 million (net of VAT and prior to the Court of Appeal hearing).

In short, the costs of bringing the claim to the point of a first instance judgment were almost equivalent to the amount of damages actually being sought for the breach, and the amount of damages actually awarded were significantly less.

The costs of bringing a claim against an uninsured party in England (and elsewhere) are so high because of the detailed procedural requirements that a claimant has to comply with under the relevant procedural rules (even including during pre-action correspondence). In contrast, a claim under a W&I policy does not require formal pleadings, document disclosure exercises or detailed witness statements.

Instead the claims procedure is usually an iterative process in which the insured outlines the factual and legal position in correspondence, sometimes evidenced by relevant documents or expert work as the claim develops, and the insurer generally has follow up questions and requests additional information until it can provide a clear coverage position.

Having spoken to a number of lawyers who have brought successful claims under W&I policies with HWF, we estimate that the average cost of bringing such a claim would be 10% of the value of an equivalent uninsured litigation or arbitration claim.

PRESERVING COMMERCIAL RELATIONSHIPS AND THE CREDITWORTHINESS OF THE INSURER

One of the main advantages of bringing an insured claim is that clearly it allows a buyer to preserve its commercial relationship with the seller as well as ensuring that any payment is being made by an 'A' rated entity.

> **The importance of W&I insurance is illustrated further by the fact that 63.78% of closed notifications received between 2016 and June 2023 resulted in a paid claim.**

SUMMARY OF CLAIMS PROCESS

The claims process under a W&I insurance policy is more time efficient, less costly, less adversarial, less complex and actually more likely to be successful than bringing the same claim against a counterparty to a transaction.

More parties to M&A transactions should be aware of this important benefit of W&I insurance.

ABOUT

HWF CAPABILITIES

We are a market leading transactional risk insurance brokerage. We enhance our client offering through our expert-led claims advocacy capabilities.

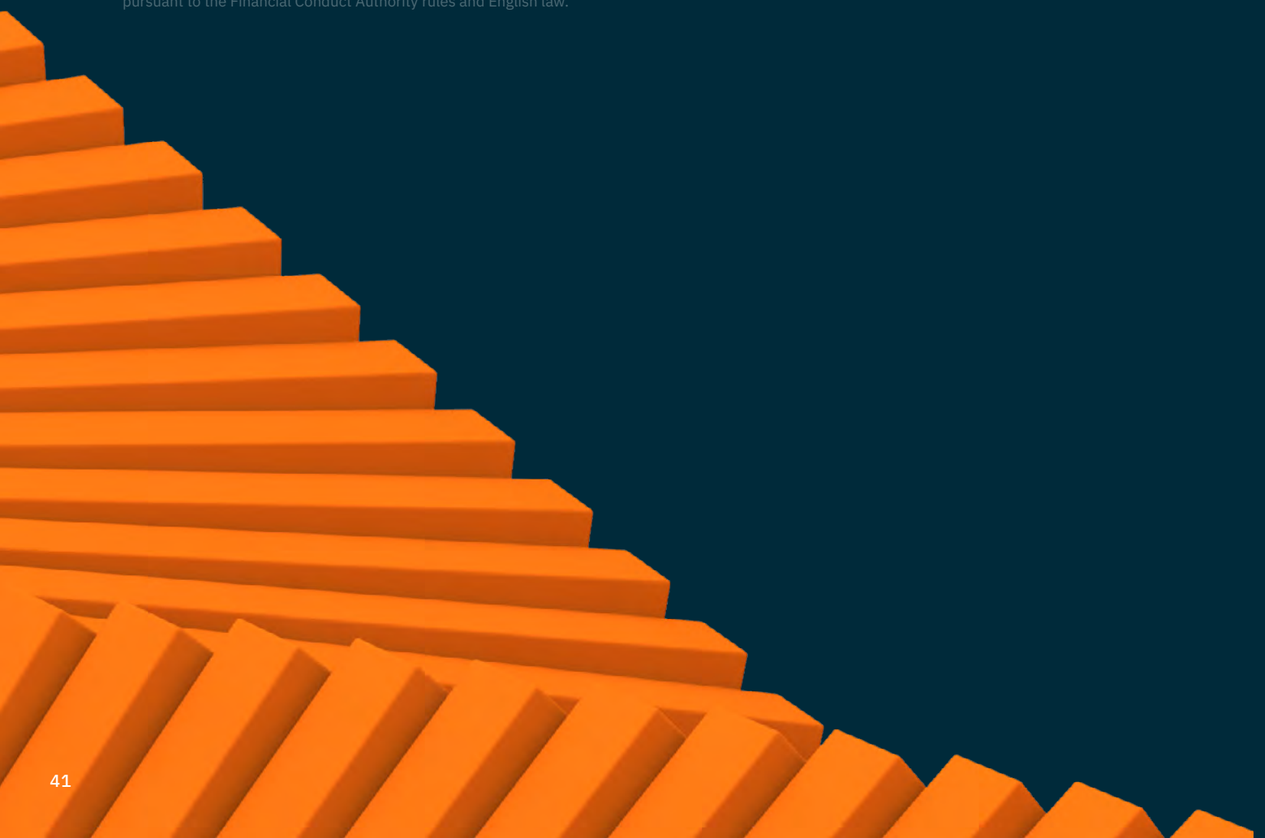
Our claims team is fully integrated into our business, working alongside our brokers in structuring policies from the outset to include insured friendly provisions and to mitigate any risk of non-recovery in the event of an actionable breach.

If a claim arises, HWF are available to assist in every step of the claims process, from notification to settlement. Importantly, we are claims advocates, and are able to negotiate on a client's behalf directly with insurers which allows us to leverage our commercial relationships to deliver practical results.*

If you would like to discuss this report or any claims related matter in further detail, please contact Alex Harding (Head of Claims), David Wall (Co-Head of Private Equity), or your usual HWF contact.

For further details about us please see hwfpartners.com.

*HWF does not provide legal advice and only provides claims advocacy pursuant to the Financial Conduct Authority rules and English law.



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PARTICIPATING INSURERS

This study wouldn't be possible without the co-operation of the 16 participating insurers. We are grateful for their involvement to allow this report to be produced.

To protect their data, certain participants wish to remain anonymous, however, participants include those insurers set out opposite:

ACQUINEX Acquisition Insurance

ambridge®

beazley

Brockwell An Optio company

cfc

HAMILTON

Liberty Global Transaction Solutions™

mosaic INSURANCE

nexus

optio

riskpoint® Insurance since 1917

RYAN TRANSACTIONAL RISK

TOKIO MARINE HCC

VALE INSURANCE PARTNERS

HWF

HWFPARTNERS.COM

Dubai Frankfurt London Munich New York Paris Warsaw