Lockton Transaction Liability Insurance: Market Update

The Americas

Fall 2023

Lockton's Transaction Liability (TL) Team presents this 2023 market update to detail the state of the representations and warranties insurance (RWI) market, report on recent RWI claims trends, and highlight the significant expansion of our tax and contingent liability practices to reflect the growth of these sectors.

In 2023, the TL insurance landscape has continued to be impacted by the challenging macroeconomic environment and corresponding M&A slowdown. While RWI pricing normalized in 2022 to rates observed prior to the frenzied M&A environment of late 2020 and all of 2021, the significant decrease in deal activity in 2023 has further softened the RWI market, driving rates and retentions to historic lows. In addition to the softening demand for RWI, the increased supply of insurance capacity via four new market entrants has amplified the already soft market.

Outside of RWI, the tax and contingent liability markets continue to mature and evolve as they gain acceptance as effective risk-shifting insurance products. In fact, carriers have increased investments in both product lines, and **we anticipate growth to accelerate in these areas as potential insureds are educated about the scope and availability of this coverage.**

A NOTE FROM OUR TEAM

In 2023, we expanded our team to nearly 40 individuals in North America, which included nearly doubling the number of team members working exclusively on Tax Insurance solutions, and onboarding several individuals that focus on intellectual property insurance. Our contingent liability team has also been rebranded as our "Intangible Asset and Contingent Risk Practice" to include not just traditional litigation and other contingent liability matters, but also intellectual property monetization solutions.

What remains resolute year over year is the dedication we have to our clients and their deals. The transaction is at the center of every conversation, and we work diligently with our trusted carrier partners to negotiate the strongest and most creative coverage solutions on behalf of our clients. You will not find this level of service or attention to detail at any other insurance advisor, and we are proud to be the standard of excellence in the transaction insurance market.

This market update gives us a great opportunity to reflect on recent product trends, innovations and developments as we prepare for the challenges of the next cycle to emerge. From our perch, it seems clear that the TL market is still evolving and has tremendous potential for growth ahead.

Sincerely,
Lockton's Transaction Liability Team

Contents

We have seen an incremental increase in M&A activity over the past two months and are closely monitoring how an uptick in activity will impact the RWI market and current trends.

The evolving RWI landscape

2022 ushered in marked change to the RWI landscape, as the overall M&A market pulled back from historic levels of activity, and this trend has continued in 2023. According to Dealogic, global M&A has decreased approximately 40% year over year, due to ongoing macroeconomic challenges, including interest rate volatility, related increased costs of capital, and political instability and war in Russia/Ukraine and the Middle East.

Although the depressed M&A market has been challenging for buyers and sellers alike, it has (not surprisingly) been favorable for insureds. The premium increases of 2021, driven by historic levels of M&A activity, proved to be transitory, and current rates are at a historic low. Pricing largely has shifted in tandem with changing market conditions, with average premium rates tumbling from approximately 5% at the height of the most recent market boom, to sub-3% today.

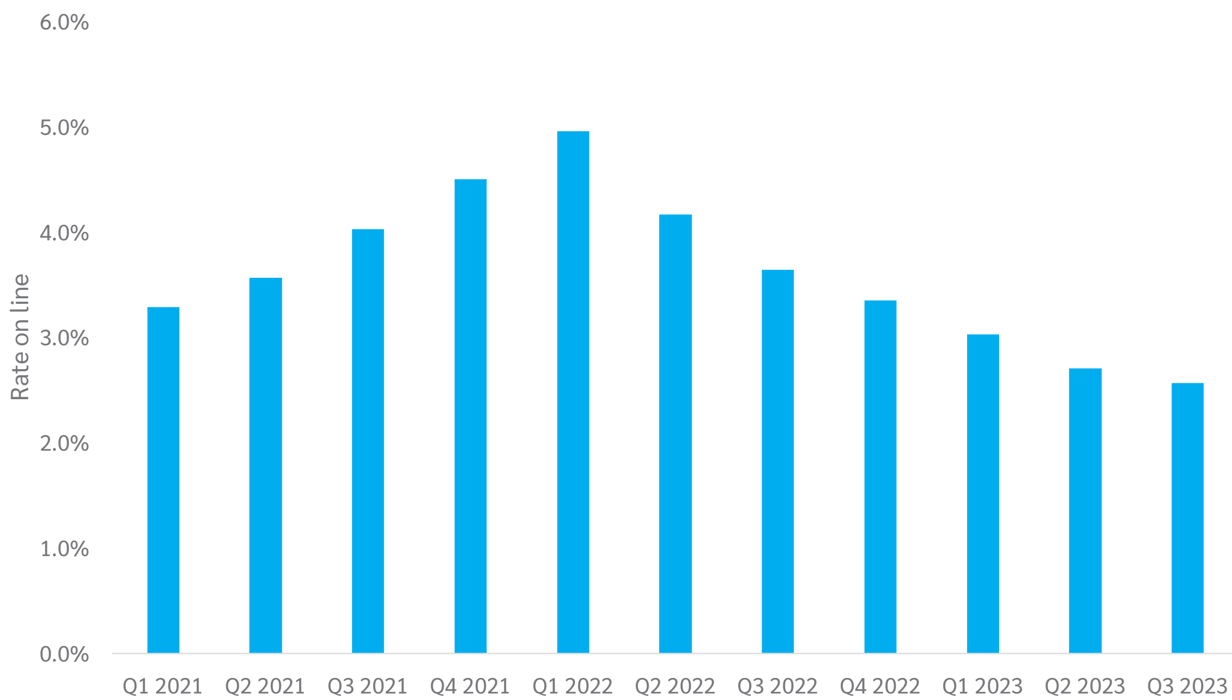
Along with favorable pricing changes, carriers also have significantly reduced retention levels (both initial and drop-down) across all transactions, and dramatically pared back deemed modifications to representations and warranties in underlying purchase agreements, each as predicted in our 2022 report.

Decreased but stabilized premiums

As difficult macroeconomic conditions continue to persist, global M&A activity has substantially decreased and demand for RWI has similarly contracted, placing downward pressure on RWI premiums. Over the past 12 months, new entrants have brought additional capacity to the RWI market and placed further pressure on pricing due to increased competition.

As we enter the fourth quarter of 2023, pricing has appeared to stabilize at or near historic lows, with current average premium rates between 2% and 3%, depending on size, sector and structural complexity. The chart below clearly illustrates the impact that slower M&A activity and increased carrier competition has had on rate.

AVERAGE PREMIUM RATE BY QUARTER (2021-YTD 2023)



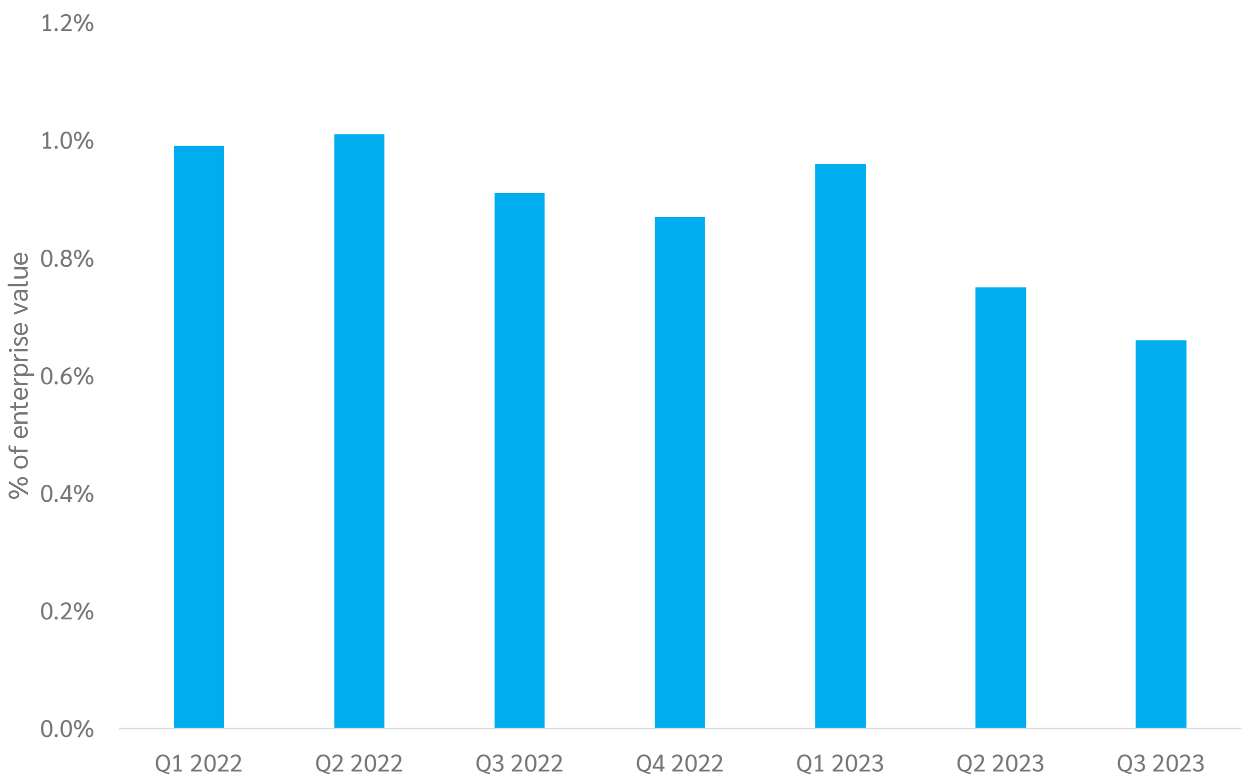
We have seen a noticeable increase in M&A activity over the past couple months and anticipate deal volume will accelerate as we approach year-end. While rates have proven to be both fluid and responsive to the broader M&A market, it remains to be seen whether an increase in activity will directly impact rates over the next few quarters; carriers are better positioned to meet an increase in demand due to improved underwriting resources but also cognizant of several significant claims that are currently pending.

Falling retentions

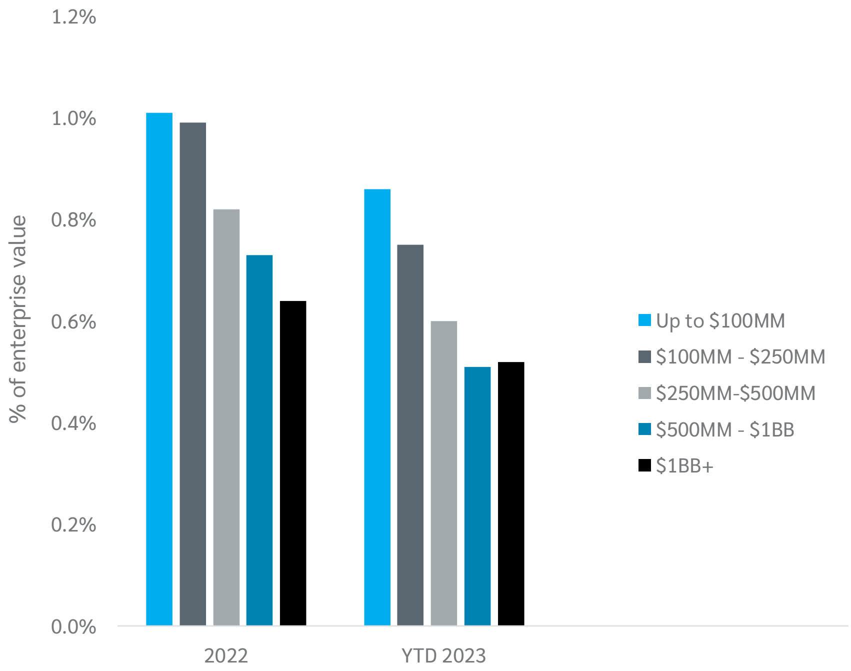
While pricing has largely stabilized, self-insured retention levels continue to fall as carriers seek to differentiate their terms from the competition. In last year's report, we highlighted that several carriers started to offer initial retentions of less than 1% of enterprise value ("EV") for transactions valued at or below $100 million. In 2023, this trend has persisted across the market, and it is now exceedingly rare for carriers to offer a 1% of EV initial retention across transactions of all sizes and industries. Carriers have also become more aggressive, and initial retentions commonly approach 0.50%-0.75% of EV in the sub-$100M EV range.

The charts below reflect the steady drop in retention levels over the last several quarters, with significant changes becoming apparent in Q2 and Q3 of 2023, as the market shifted toward more aggressive retention offerings.

AVERAGE RETENTION BY QUARTER (2022-YTD23)



INITIAL RETENTION BY ENTERPRISE VALUE (2022-YTD 2023)



Several carriers have also begun toggling with the drop-down retention levels, which historically remained at 0.50% of EV across all transactions. Now carriers are selectively offering drop-down retentions in the 0.30%-0.45% of EV range to further distinguish terms.

To the extent M&A activity remains at or near current levels and the frequency and severity of claims remains stable, we anticipate carriers will continue to reduce retention levels in an effort to win deals.

Public style exits still popular

Since 2014, we have generally observed a steady increase in the use of “public style” deal structures, whereby buyers’ sole recourse for breaches of representations and warranties is in the RWI policy, except in the case of fraud. However, as the pendulum has shifted toward a buyer-friendly M&A market, 2023 has marked the first year where we’ve witnessed a year over year decrease in public style exits.

An estimated 50% of Lockton’s placements in 2023 continue to reflect no indemnity structures, which is meaningfully higher than historical levels. The frequent use of this construct even in a buyer-friendly environment is likely attributable to the familiarity clients have with the RWI product and process, along with carriers’ increasing comfort with underwriting to a no seller indemnity standard.

Current market developments

Secondary marketplace growth

As the credit market has tightened and the buyout market remains muted, private equity clients have turned to alternate forms of liquidity, including the secondaries market, which has led to significant activity in GP-led secondaries transactions. Lockton has been at the forefront of the evolution of RWI in the rapidly growing secondaries space and maintains approximately 60% of the market share on GP-led (and other secondaries) structures working on upward of 100 secondaries placements to date.

In 2023, a number of additional carriers expanded their appetite to underwrite secondaries transactions, with a majority of the carriers in the RWI industry now open to underwriting such opportunities both on a primary and excess basis. We anticipate private equity clients will continue to turn to the secondaries market for liquidity, and the RWI market is well positioned to handle such increased demand.

Agreement comments

Although the scope of representations and warranties contained in purchase agreements have remained buyer-friendly, carriers generally have refrained from proposing a significant number of deemed modifications, presumably in light of the competitive underwriting landscape.

Interaction between RWI & underlying insurance

As part of the underwriting process, RWI carriers scrutinize the underlying property and casualty (P&C) insurance that will be available for target companies immediately post-closing, as the RWI is intended to sit in excess of (and not in lieu of) commercially adequate insurance at the target.

When certain P&C markets have hardened due to adverse claims experience, such as the cyber market in 2021, RWI carriers have responded by requiring that RWI coverage sit specifically in excess of, and no broader than, such specified underlying policies. However, with the softening of the cyber market and increased competition in the RWI space, carriers generally have shifted away from requiring specifically excess positions and reverted to solely underwriting to the existence of such underlying insurance. This position remains heavily negotiated and subject to the specifics of a transaction, but there has been a pronounced shift in carrier approach in an effort to capture greater market share.

RWI claims

With another year of experience to draw from, Lockton remains uniquely positioned to identify meaningful RWI claim trends and to draw on that knowledge to maximize value as we place future policies.

RECOVERIES

Lockton's clients have recovered nearly $385 million from RWI carriers, with insurers recognizing just under $500 million in losses when accounting for retentions.

MOST COMMON BREACH TYPES

Financial statement and compliance with laws reps are most commonly cited.

MULTIPLIED DAMAGES

Carriers continue to scrutinize claims seeking losses calculated as a multiple of earnings, but are paying "on a multiple" when losses are adequately supported.

CLAIM FREQUENCY

Data suggests that the historically reported 20% figure has decreased as clients and their advisors gain greater understanding of what is and isn't covered.

Key RWI claim trends at a glance

Since 2018, our clients have submitted nearly 400 claims on RWI policies.

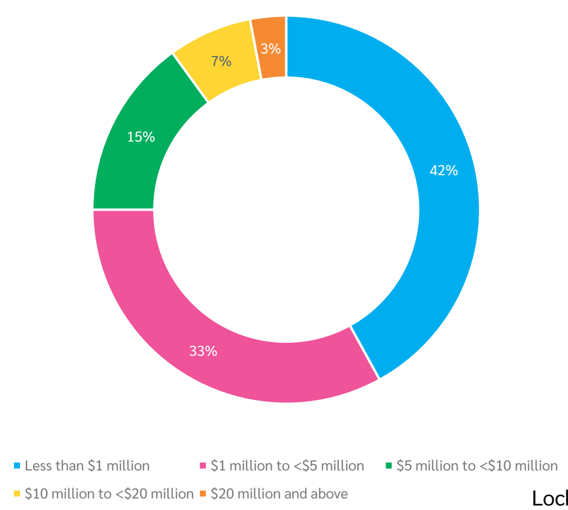
OF THOSE CLAIMS:

- 22% Resulted in payment net of the retention
- 29% Remain active
- 23% Settled within the retention or were held in abeyance by agreement under mutual reservations of rights given the alleged loss amount
- 23% Were withdrawn or are inactive
- 3% Were denied

Claim severity — size of payments

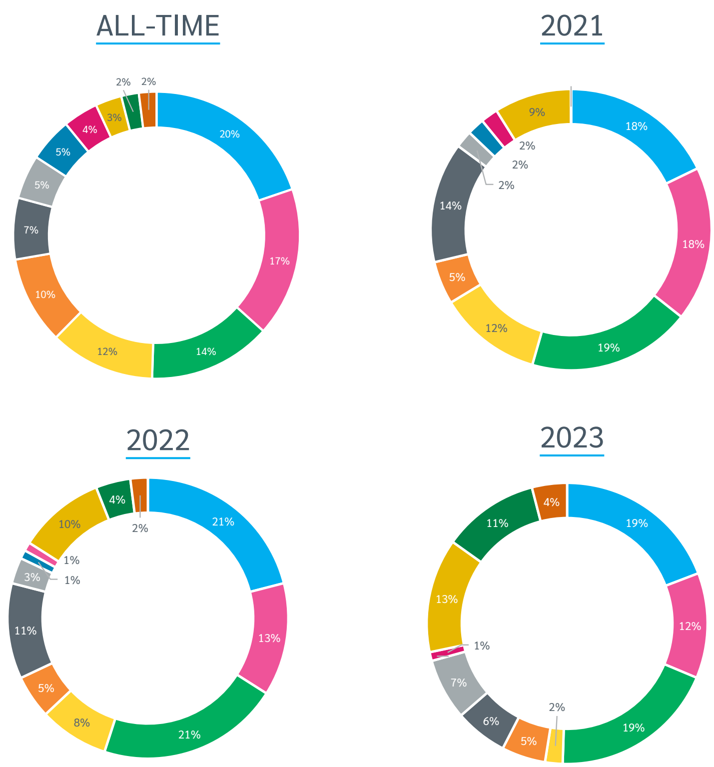
Twenty different insurers have paid Lockton clients nearly $385 million to resolve RWI claims. When accounting for retentions, insurers have acknowledged slightly less than $500 million in loss arising out of Lockton-placed RWI policies.

THE $385 MILLION IN PAID LOSS IS BROKEN OUT AS FOLLOWS, WITH PERCENTAGES INDICATING THE NUMBER OF PAYMENTS PER RANGE DIVIDED BY TOTAL NUMBER OF PAID CLAIMS:



Types of breaches

Claims filed by breach type



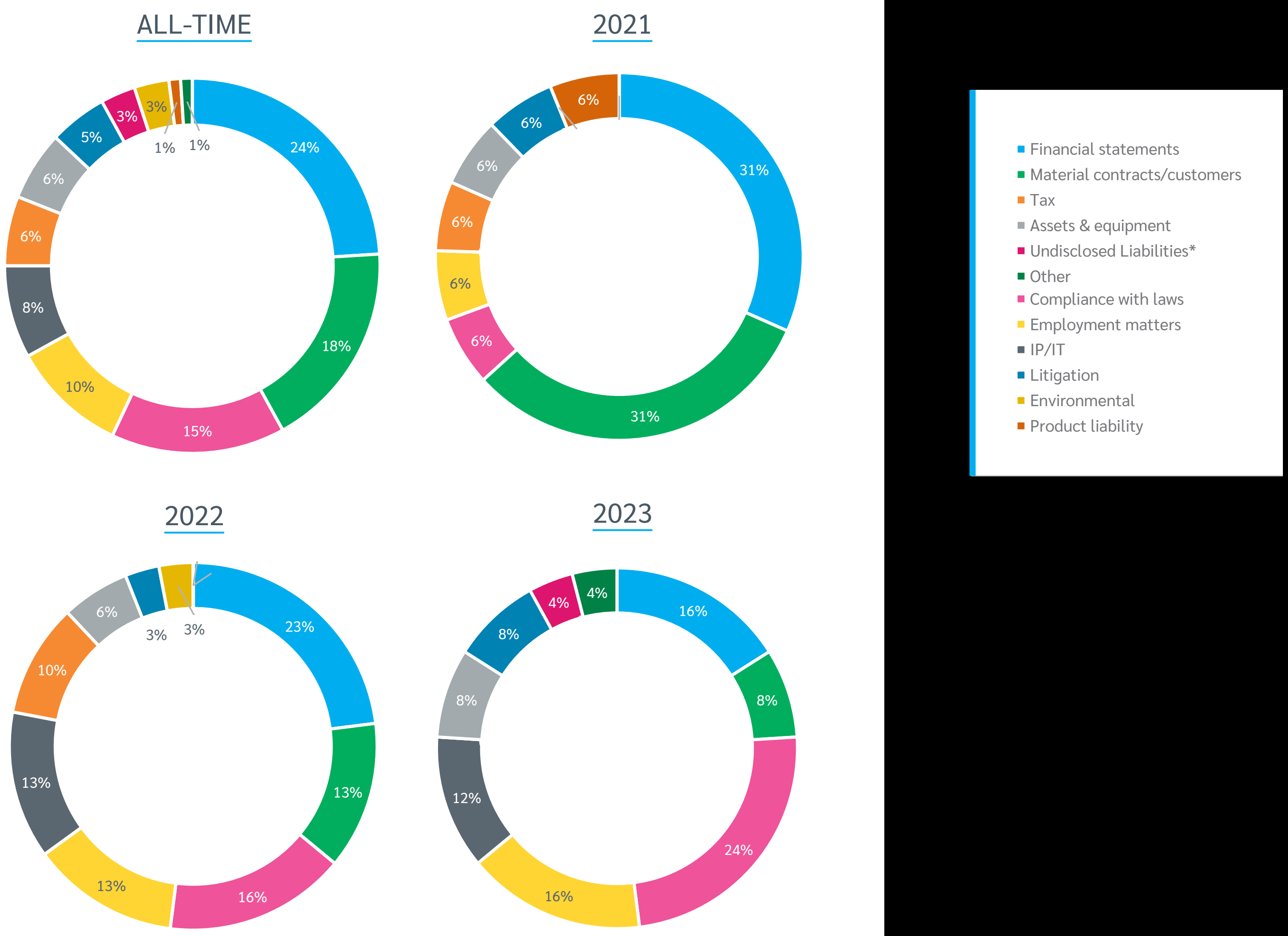
- Financial statements
- Material contracts/customers
- Tax
- Assets & equipment
- Undisclosed Liabilities*
- Other
- Compliance with laws
- Employment matters
- IP/IT
- Litigation
- Environmental
- Product liability

> Once again, claims with a financial statement component remain the largest source of claims activity for Lockton-placed RWI policies, accounting for 20% of all claims submitted.

As illustrated above, the frequency of RWI claims alleging a breach of a financial statement representation has remained remarkably consistent since Lockton entered the RWI market, whereas the prevalence of other claim types has fluctuated over time. For example, the percentage of claims alleging breaches of compliance with laws representations has decreased over the past several years (and now stands significantly below Lockton's historical average); conversely, claims alleging breaches of material contract/material customer representations represent a higher percentage than they have historically. However, while the actual percentages have fluctuated year-over-year, the top three categories of breaches — financial statements, compliance with laws and material contracts/material customers — represent the same top three, in the same order, as we reported in last year's market study.

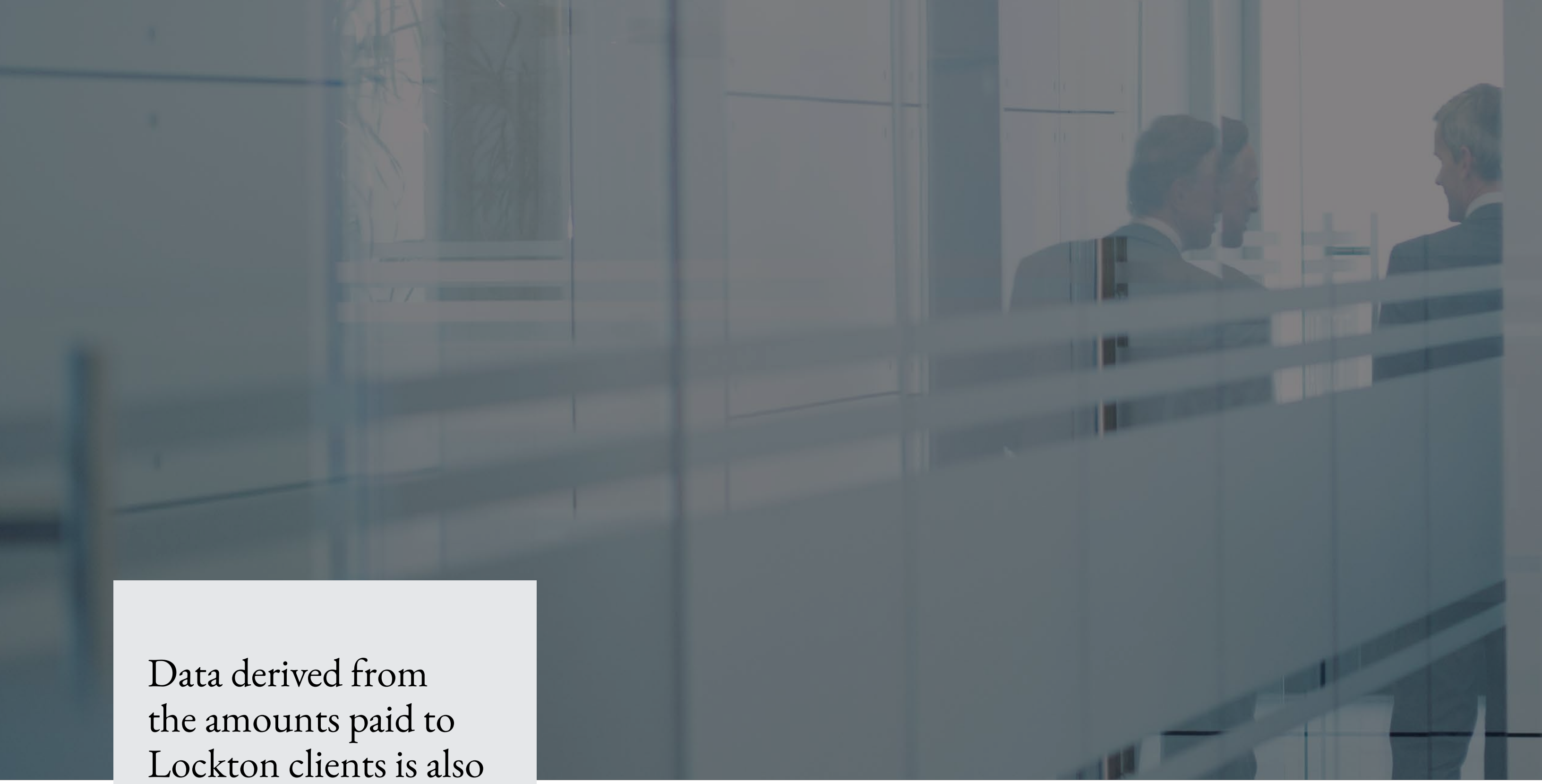
*Note that given the substantial overlap between undisclosed liabilities misrepresentations on the one hand, and tax and financial statement misrepresentations on the other, we count a breach of the undisclosed liabilities representation for data reporting purposes only if the insured has not also asserted a claim under a tax or financial statement representation.

Numbers of claims paid (net of retention) by breach type



As the charts above illustrate, the percentages of claims giving rise to payments tell a slightly different story from the data derived purely from claim submissions. Historically, nearly one quarter of claim payments involved financial statement misrepresentations, but that figure has decreased over the past year. However, it remains too soon to tell whether such decrease reflects a trend or whether the year-to-date 2023 figures are merely a one-year anomaly.

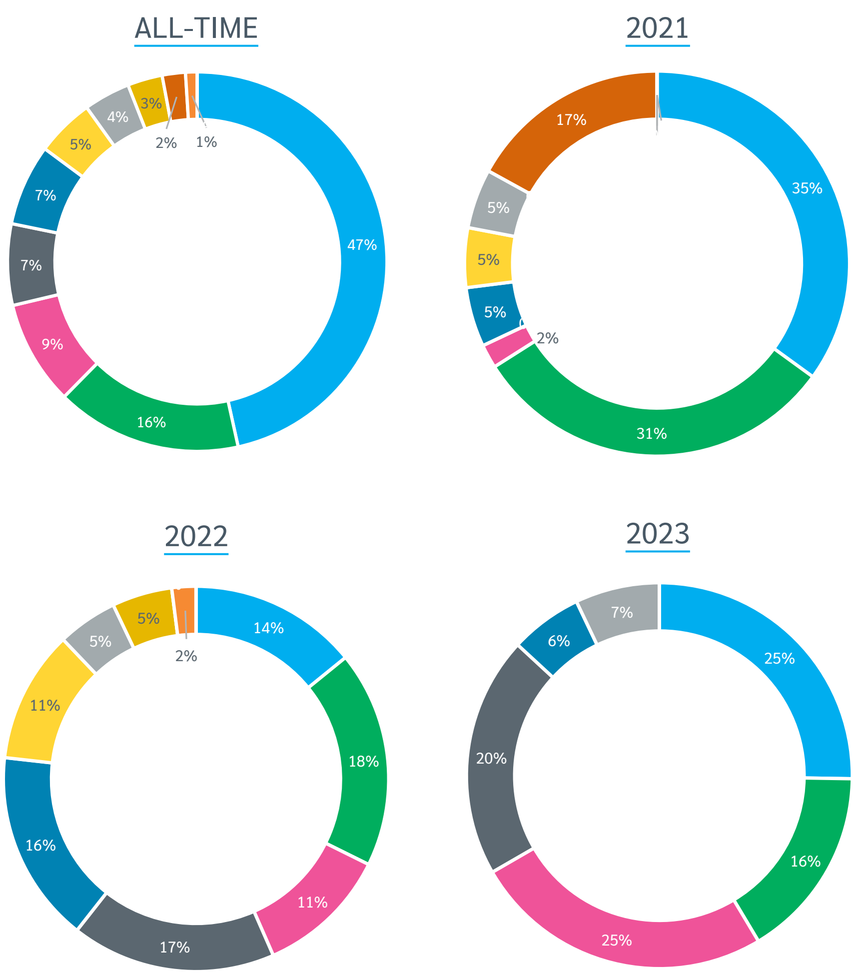
Data also suggests that payments for claims alleging breaches of compliance with laws representations are on the rise. While payments from such breaches constituted only 15% of payments in the past, that figure has been steadily increasing over the last three years. We are observing a similar, though less pronounced, increase in payments made on claims arising out of employment and IP/IT breaches.



Data derived from the amounts paid to Lockton clients is also revealing.

While financial statements misrepresentations certainly drive claim frequency, the amounts recovered for such claims show that they are also a major contributor to claims severity as well.

Amounts paid (net of retention) by breach type



Timing considerations

Claim notifications

RWI policies typically have a three-year term for general representations and a six-year term for fundamental representations, tax representations, and the pre-closing tax indemnity. Nonetheless, a substantial majority of RWI claims are submitted within 18 months after inception.

As demonstrated in the table below, most RWI claims are submitted in the first year of a policy's term. Although we have seen a decrease in the percentage of claims brought during the first six months after inception, the percentage of claims made within the first 12 months has remained remarkably consistent at approximately 60%.

TIME FROM POLICY INCEPTION TO CLAIM NOTICE

	All claims	2021 claim notice	2022 claim notice	2023 claim notice
Less than 6 months	25%	47%	23%	12%
6-12 months	34%	14%	39%	47%
13-18 months	19%	24%	12%	19%
19-24 months	9%	10%	10%	6%
25-36 months	9%	5%	11%	10%
More than 36 months	3%	0%	4%	6%

Claim resolutions

On an overall basis, we have observed that the average time from claim submission to claim resolution is approximately one year. However, we derive little significance from that aggregate figure because duration is dependent on the specific facts of each claim, and there are many variables that can affect this. For example, a relatively simple claim in which the insured promptly provides all necessary information can be resolved within a month. Conversely, large complex claims can take over a year, and longer in certain circumstances. Third-party claims can also last years if driven by underlying litigation.

Notwithstanding the foregoing, as a general matter, the following factors will often play an important role in determining how long an RWI claim will take to complete:

- Whether outside experts are involved
- Whether a claim involves a large number of documents or data.
- Whether the insured is seeking to recover loss based on a multiple of EBITDA

In addition to those indicators, the single biggest variable in determining whether a claim can be resolved quickly or whether it might languish is often the responsiveness of the insured. Given the nature of the product, insurers must be provided with the facts necessary to validate an insured's claim of breach and to independently quantify the loss caused thereby. Some claims may go dormant for extended periods of time while insureds gather information, analyze loss data, or simply direct their focus on the day-to-day business at the expense of closing the claim, and in such instances, the claim process inevitably gets protracted.

To maximize the chances of a smooth and efficient process, first and foremost, we encourage our clients to engage with us early and often so we can provide guidance on all aspects of the claim. Additionally, we encourage insureds to promptly provide insurers with reasonably requested information and to educate them on the substance of the claim so they are better equipped to make timely coverage determinations. Insurers often are willing to work with insureds to minimize burden and intrusion, recognizing that insureds have businesses to run. If requests are overly burdensome or insurers seek commercially sensitive materials, insurers routinely agree to tailor their requests to obtain the necessary information through less intrusive means.

Representative 2023 claim resolutions

SCENARIO 1: FINANCIAL STATEMENT MISREPRESENTATION — MULTIPLE APPLIED

In its first post-closing audit, a target company determined that due to a keystroke mistake, the financial statements reflected several hundred thousand dollars of revenue that never existed.

Upon discovery of the mistake, the insured submitted a claim notice under its RWI policy. Because the financial statement error had occurred in the financial statements for the LTM period, which the buyer had used to determine the purchase price for the company, the insured sought to recover as loss the amount of the mistake times the multiple of EBITDA that had been applied to value the deal.

Following review of the claim materials, the insurer agreed that the mistake had caused a breach of the financial statement representation, and paid the entirety of the loss (net of retention) – a seven-figure amount – less than six months after the claim notice was first submitted.

SCENARIO 2: COMPLIANCE WITH LAWS — THIRD-PARTY CLAIM

After closing, the target company was named as a defendant in a putative class-action lawsuit that alleged repeated violations of California wage and hour laws. The alleged violations occurred both before and after the transaction closed.

The insurer acknowledged that the complaint qualified as a third-party claim under the policy and, accordingly, agreed to pay 100% of defense costs incurred in excess of the retention. The insurer also agreed to forgo its consent rights with respect to settlement of the case, which gave the insured latitude to reach a commercially reasonable settlement of the underlying litigation.

After the lawsuit was settled, the insured and insurer worked together to determine a fair allocation of the settlement amount to account for the fact that some of the alleged noncompliance occurred post-closing. The parties agreed that the insurer would pay a substantial amount of the settlement, which covered all loss attributable to alleged wage and hour law violations that had occurred up to the date the complaint was filed. The insurer paid that seven-figure loss promptly upon resolution of the allocation discussion.

SCENARIO 3: PHYSICAL ASSETS MISREPRESENTATION

During diligence, the seller disclosed that it had reserved a $1 million capital expenditure to account for roof repairs that were needed on one of the facilities to be sold as part of the transaction. After closing, the insured determined that the entire roof was faulty and had to be replaced. The insured also discovered that due to the roof's poor condition, the facility had incurred significant water damage.

After validating the costs incurred, the insurer promptly paid nearly 95% of the total amount of the insured's loss (including attorneys' fees), less the retention and the disclosed $1 million capex estimate, for a total payment in the seven figures.

Overview of the tax insurance market

State of the market

Tax insurance is designed to address identified tax risks that generate sufficient economic uncertainty to warrant transferring the risk to the insurance markets for a fixed upfront premium payment. It has been most often used previously to protect renewable energy tax credits and certain tax elections and qualifications. More recently, tax insurance has expanded to address a broad array of tax risks, including those identified during transactions and excluded from RWI policies, tax-free internal transactions, transfer pricing and valuations, and transferable tax credits. Tax insurance policies have been secured by publicly traded and private companies, private equity firms and their portfolio companies, estate planners, and individual taxpayers.

The Inflation Reduction Act & transferable tax credits

There has been a dramatic surge of interest in transferable tax credits, as transferability of credits was introduced by the Inflation Reduction Act. enacted in August 2022. As more domestic and U.S. multinational corporations look for ways to lower their effective tax rates and mitigate tax costs, the renewable energy tax credit market, once dominated by financial institutions, now has thousands of new entrants. Guidance regarding the sale and purchase of these tax credits, including detailed registration and reporting requirements, was initially released in June of 2023 but will continue to be published and revised throughout the remainder of this year and beyond.

Transfer pricing

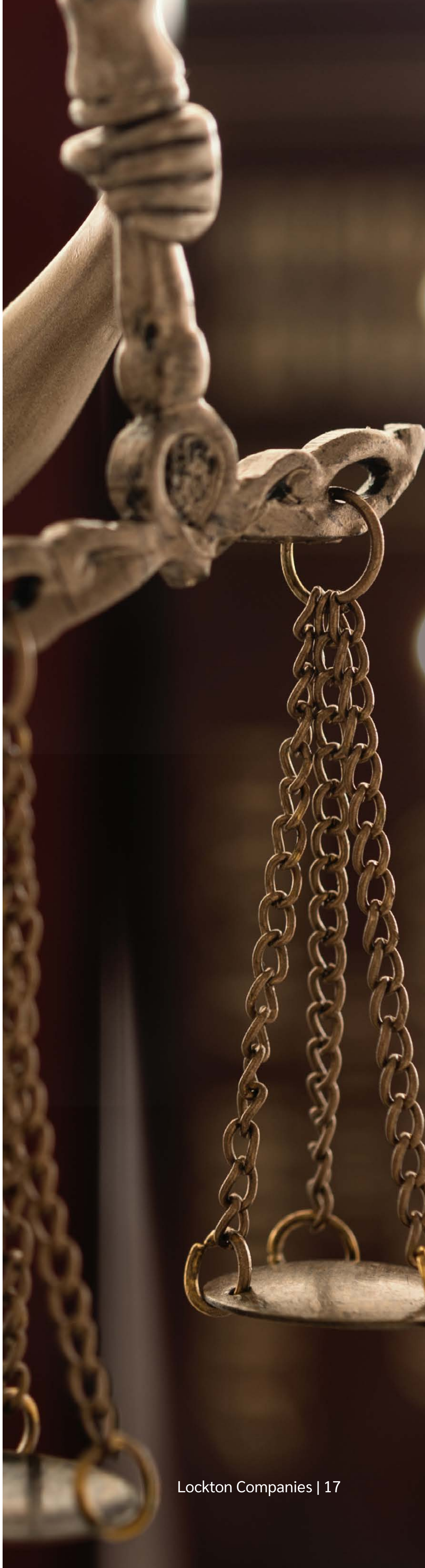
There also has been a steady increase in interest in exploring tax insurance to address transfer pricing and related risks, especially in light of the growing worldwide adoption of the OECD's Pillar II 15% minimum tax rules, with early adoption in South Korea; proposed rules announced in the Czech Republic, Denmark, Germany, Ireland, Netherlands, Norway and Sweden; and indications that proposals are forthcoming in Japan, Australia, Canada, Hong Kong and Singapore. Recently released guidance indicates that U.S. transferable tax credits will receive more favorable treatment under these rules than initially indicated, but there is no shortage of complexity as transitional safe harbor and country-by-country rules continue be proposed and enacted. As taxpayers and their advisors grapple with their understanding and implementation of the global web of Pillar II rules, the tax insurance market will evolve to mitigate and take on this risk.

Intangible asset & contingent risk (IACR)

Over the past year, Lockton's Transaction Liability team has seen a substantial increase in requests from our clients to help them solve issues at the intersection of risk and finance. Because of this increased demand, Lockton's Litigation Insurance vertical expanded this year to include two intellectual property insurance experts, Craig Taylor and Jason Sandler, who joined Contingent Risk Practice Leader Michael Perich to create Lockton Transaction Liability's new Intangible Asset and Contingent Risk (IACR) team. The IACR group is dedicated to helping our clients use insurance to achieve their financial objectives, which often results in a far more efficient use of capital for our clients.

Overview of market developments

This past year has seen significant growth in the use of IACR products. Many new market entrants have either entered or signaled their intent to enter this space. As certain sectors of traditional financial markets have hardened, the creative and strategic pairing of insurance and debt capital has particularly gained interest and momentum. We have seen this increase in appetite across the board, from prospective borrowers to lenders; operating companies; insurance capacity providers and specialty underwriters; financial market intermediaries, boutiques and specialists; law firms; and in some cases, equity financiers. We anticipate significant growth in 2024 across all of the foregoing areas.



Product updates: Old & new

While the IACR team helps our clients to place a multitude of bespoke insurance policies, there are four products that constitute most of our submissions to the markets: (i) judgment preservation insurance (JPI), (ii) adverse judgment insurance, (iii) specific contingent insurance, and (iv) intellectual property collateral protection insurance (IP CPI). Out of these products, judgment preservation insurance and adverse judgment insurance are the two mature offerings and generally can be bound quickly when compared to other IACR products.

Judgment preservation insurance is a policy where the legal team can insure the value of a judgment to keep it from being diminished or reduced on appeal. Companies that obtain these insurance policies to “lock in” a plaintiff verdict can unlock the value of the award using an insurance-backed lending solution. The IACR team has significant experience negotiating and binding these policies. Historically, these policies have been purchased for between 9% and 15% rate on line. However, given recent adverse claim activity we expect that (i) the insurers will be more selective in the matters they bind and (ii) the price of these policies will increase. We also expect that markets will begin requiring greater retentions and/or coinsurance to better align the interests of the policyholders and insurers.

Our clients frequently request that the IACR team help them evaluate and place adverse judgment insurance policies. An adverse judgment insurance policy helps ring fence active pieces of litigation to cap a company’s exposure. Adverse judgment insurance is intended to be used for low-risk, high-severity events. This type of insurance is used to protect a company from remote but potentially catastrophic litigation exposure. Generally, these policies cost between 12%-17% rate on line and oftentimes will have significant self-insured retentions. Adverse judgment insurance remains one of the more challenging placements in the IACR space due to a high prevalence of adverse selection risk in submissions sent to the markets. Similar to judgment preservation insurance, we anticipate rates will increase for these policies and that the carriers will continue to demand significant retentions.

Outside of these two established products, the IACR team continues to lead the way in placing bespoke policies designed to help our clients value their contingent assets. Lockton’s IACR team has been a trailblazer in helping our clients to structure and place insurance policies to more efficiently leverage their contingent legal assets. These policies frequently will be combined with a financial transaction to help the client recognize the value of its contingent legal assets immediately. By combining insurance with appropriate risk-adjusted capital, our clients are able to better monetize their contingent legal assets in a way that materially helps our clients’ finances. Given these products are newer, rates for these specific contingent policies have remained in excess of judgment preservation insurance policies. However, since these policies generally insure a portfolio of contingent legal assets and the entrance of newer markets into the space, we expect that the cost of these policies will decrease over the next year.

Lockton’s IACR team has also devoted significant internal resources to building out our capacity to service our clients’ request to procure intellectual property collateral protection insurance (IP CPI). IP CPI is a novel risk transfer solution that facilitates debt financing for growth-stage companies. By backstopping a portion of the company’s principal and interest payments to a lender, an IP CPI policy can unlock investment/funding opportunities that might not otherwise be available between debt capital providers and growth-stage borrowers. We believe this product will have explosive growth in the coming year.

Case studies

Lockton helped bind a judgment preservation insurance policy for a corporate client in under three weeks to meet our client's desire to "lock in" their financial result before a significant development in the case. The matter involved a substantial piece of commercial litigation with damages. Lockton worked with senior management at both the client and carriers to streamline the underwriting process and bind the insurance policy before the client's deadline.

Lockton worked with a large, multinational corporate client to use an insurance policy to help monetize its pending legal claims against multiple defendants at favorable economic terms. Lockton worked with the insurer to structure a bespoke insurance policy that was designed to accommodate the needs of the client. Lockton also worked with the client's capital provider to help facilitate the transaction and respond to the needs of our client. Ultimately, our client was able to use its insurance policy to more efficiently monetize its contingent legal assets and drive substantial revenue to the company, while still maintaining a significant potential future recovery from those contingent legal assets.

UNCOMMONLY INDEPENDENT

If you have any questions or comments, please don't hesitate to reach out to Lockton TL's Head of Marketing, Hannah Haley Young: hannah.haley@lockton.com