



Global FINEX - Mergers and Acquisitions
Global Transactional Risks
review and outlook

February 2022

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Introduction and outlook

2021 saw an upsurge in global levels of Merger & Acquisition (M&A) activity, with record transaction levels fuelled by the economic bounce-back as the first grip of the COVID-19 pandemic began to loosen.

According to figures from Refinitiv, M&A activity in 2021 was up 64% on the previous year with total deal value reaching USD 5.9 trillion¹.

This was underlined by the fact that the same number of large global deals were completed in Q1 2021 as in the whole of 2020 (58 deals in the range of USD 1billion-10billion). This was the highest Q1 result since 2008 and one which set the tone for what proved to be the most active ever recorded.

Activity in the WTW Global Transactional Risk team followed this trend, as they advised on a combined total of over 1,500 Warranty and Indemnity (W&I) / Representations and Warranties and Tax / Contingent risk policies (which we group together as Transactional Risks insurance (TR)) in 2021.

It is expected that deal activity will continue to be strong into the first half of 2022 driven by a combination of macroeconomic factors, significant unspent investor dry powder and corporates refocussing following the ongoing impact of the pandemic.

We have assembled this review with contributions from our TR experts around the globe demonstrating:

1. The broader themes at play.
2. Patterns and trends seen in 2021.
3. Expectations for 2022.

Expected features 2022

Warranty & Indemnity (W&I) / Representations and Warranties insurance (RWI)

Transactional Risks insurances – expected to be utilized on a higher proportion of M&A deals.

Stabilisation of premium rates – market pressures experienced in Q4 2021 are expected to ease.

Cyber – continued scrutiny on cyber risks and thorough due diligence is required.

ESG – increased focus on advice and diligence relating to ESG matters.

Tax insurance

US Internal Revenue Service (IRS) momentum - driving focus on transfer pricing matters, valuations and IRS no-rule areas.

2022 / 23 Global minimum tax rate - implications on restructuring risks.

Private Equity (PE) concerns - substance and valuation risks.

1. <https://www.refinitiv.com/perspectives/market-insights/dealmakers-ring-out-2021-as-the-year-of-ma/>



Warranty & Indemnity / Representations & Warranties insurance

Global Themes



Market growth

W&I / RWI insurance market activity grew across all regions in 2021 with volumes seen by the WTW M&A team increased by an average of 50%.



Insurance capacity

North America saw three new Managing General Underwriters (MGU's) launch in the second half of 2021 while the UK saw several new entrants to the market.

Record-breaking deal volume led to some constraints – particularly in Q4 of 2021 – in terms of both underlying capital capacity as well as bandwidth of underwriting staff, which in turn led to insurers becoming more selective about which risks, industry sectors and transactions they were willing to underwrite.



Pricing

A consequence of this was upward movement in pricing, which was more severe in some regions; North America notably saw larger – transactions >\$350M – commanding rates 15-20% higher on average than lower middle market transactions, with carriers reducing their appetites for what they perceived as more complex risks. North American insurers also demonstrated a reduced appetite for smaller transactions which were broadly considered to be deals with Enterprise Values (EV's) lower than \$100m. Asia saw primary rate increases of 20-50% through 2H2021 and up to 100% on select larger transactions in certain jurisdictions. Australasia was similar for larger deals in terms of primary layers, seeing nearly 50% increases, although emerging earlier in the year. The UK and Europe saw rate increases of 10 – 20% for operational targets with smaller transactions particularly affected by reduced appetite and increased minimum premiums. For UK real estate transactions, premium rates increased to around 0.6% to 0.9% having previously been around 0.5% - 0.7%.



Limits of liability

Despite the above mentioned capacity constraints, the typical insured policy limit of liability has on the whole remained consistent throughout 2021 at between 10% and 30% of the target's enterprise value. While large policy limits are available, the UK and Europe have seen a trend in insurers seeking to reduce both primary and standalone policy limits and instead ventilate capacity as part of a programme (or tower) or W&I insurance. A typical primary layer in the UK/European markets is now typically GBP 20 million to GBP 30 million with additional excess layers up to the desired policy limit. This follows the approach which has been adopted historically in the US.



Retention levels

Retention levels in North America held firm at 1.0% of the enterprise value across most deals, though for deals above \$300M carriers were often willing to offer lower retentions (generally between 0.75% -0.8% but as low as 0.5%) given the healthy retention in terms of absolute dollars. In Asia and Australasia, retention levels were between 0.5% to 1% but notably some insurers were less willing to offer lower retentions through 4Q2021. In the UK and Europe, retention levels remained largely unchanged as against previous years at between 0.25% to 0.5% for operational target businesses and nil retentions applying to real estate transactions and renewables assets.



Underwriting scrutiny

All regions reported greater scrutiny in underwriting particularly around the areas which we feature below, where preparedness, sound diligence and active negotiation were key to securing levels of cover required. North America, Australia and Asia saw a marked increase in carrier focus on the representations and warranties wording within the transaction agreement, the impact of which can be material to coverage for clients. This focus on the drafting of the warranties is consistent with the historic UK/European market practice where insurers typically prepare the so-called warranty spreadsheet which is attached to the policy (the warranty spreadsheet sets out the scope of coverage for each of the individual warranties provided for within the transaction agreement).



Industry sector focus

Our regions all reported their industry sector activity with the most active areas being Technology, Manufacturing, Healthcare, TMT, Infrastructure and Real Estate. Notably, we saw increased appetite for sectors which insurers have historically shown less interest, in particular Financial Services, Business / Corporate Services and Logistics. We anticipate that the mix of Industry sector activity could change in 2022 due to a range of considerations.



SPAC's / de-SPAC's

Finally, the range of transactional risk insurance solutions offering continues to evolve and grow to meet our clients' needs. In that vein, the WTW transactional risk team advised on several de-SPAC transactions, take-private transactions, and secondaries transactions, in particular where transactional insurance has become a solution to providing indemnification recourse.

Key global underwriting themes



COVID-19 exclusions

Despite an initial spate of blanket COVID-19 exclusions, this eased during the course of 2021 as most insurers took a more commercial position and approached COVID-19 risks through enhanced underwriting.

Key areas of underwriting focus are:

- Use and potential clawback of government grants or support schemes (e.g. Coronavirus Job Retention Scheme).
- Impact of COVID-19 on customer and / or supplier contracts, in particular any concerns around the target's ability to fulfil contracts and supply chain issues.
- Financial stability of the target (including any solvency concerns).
- Business continuity and disaster recovery plans.
- Impact of COVID-19 on the valuation of the target.

Australia, Asia, Europe and the UK are, however, seeing COVID-19 exclusions re-emerge in some W&I policies for deals with longer interim periods. This will be an area to monitor closely.



Accounts, valuations and multipliers

The frequency of claim notifications and size of claims, coupled with the impact of COVID-19 on business performance, has led to an increased focus from certain insurers on the accounts and / or financial related warranties as well as the buyer's multiples in valuation of the target. Robust financial diligence to support the financial related warranties remains crucial to obtaining comprehensive cover. Where a particularly high multiple has been applied, some insurers previously sought to cap the multiple for targets operating in certain sectors, though the vast majority of insurers are able to get comfortable with valuations during the underwriting process and avoid the need for any caps.

In the Nordics following on from two claims, one insurer imposed their own definition of loss excluding multiples in 2021 which was not adopted by the rest of the market.

We expect this to become an increased area of focus for both insurers and buyers alike in 2022 and a matter which should be addressed as early as possible in the W&I process.



Cyber

We have seen an increase in sensitivity in cybersecurity issues as a result of:

1. Insurance regulators raising concerns about the scope of 'silent cyber' cover in policies.
2. Insurers' general concern around cyber issues given the frequency, potential severity and often high-profile publicity surrounding cyber-attacks and data breaches.

We have seen an increase in the level of diligence insurers are requiring in relation to the cybersecurity arrangements of the target business. In addition, where issues are identified in the target's cybersecurity arrangements, WTW have seen an increase in insurers seeking to exclude warranties relating to cybersecurity and, depending on the nature of the target and due diligence carried out, data protection matters.

On the assumption that the target has existing cyber insurance arrangements with a clean claims history, insurers are often willing to provide cover "in excess of and no broader than" that underlying insurance cover depending on the industry sector.



Employment Warranties

Due to the higher prevalence of employment related claims, W&I and Representations and Warranties insurance insurers (in particular in Australia and the UK) continue to focus on employment matters (such as classification of the workforce, correct application of modern awards and other industrial instruments, employment tax, etc.) and the extent of due diligence conducted by the insured on the target's compliance with industrial relations laws. Insurers continue to require sufficient sampling work to be conducted by the insured's advisors (even in instances where the seller has conducted due diligence investigations on these risks as part of seller due diligence). We expect this focus to continue into 2022.



Customer and supplier contracts

Across all regions, claims relating to material contracts – in particular customer contracts and / or supplier contracts – continue to increase in frequency and are often relatively high value. For this reason, insurers are looking at customer and supplier contract warranties and representations a lot more closely as part of the underwriting process. Insurers are particularly sensitive to situations in which the target is reliant on one or a small number of customer and / or supplier contracts. We are seeing insurers requiring enhanced due diligence on those customer/supplier contracts (and related contracts) and relationships.



Global operations

As a global TR team, we are seeing an increasing number of deals involving global target businesses which span multiple regions and many jurisdictions. Insurers are increasingly focussed on ensuring there has been adequate advice and diligence done into every jurisdiction in which the target has material operations or risk.

Expected features 2022



Premium rates

We are expecting to see premium prices stabilise in 2022 (albeit likely lower than the spike in 4Q 2021) as (i) the pressure on insurance capital capacity eases; (ii) existing insurers increase their team sizes in 2022; and (iii) new entrants expected to enter the market.



Environmental, social and governance (ESG)

ESG factors are likely to have a significant impact on the W&I market – and insurance market more generally – in 2022.

WTW has already seen an increase in clients seeking cover for environmental matters whether by way of affirmative cover under a W&I insurance policy or a standalone environmental policy.

In the same vein we have seen a marked increase in buyers conducting in depth specialist anti-bribery and corruption (ABC) due diligence as well as seeking cover for ABC matters in jurisdictions which were previously perceived a high-risk.

With the high-profile nature of ESG matters coupled with an increase in regulations focussed on transparency and social issues (e.g. health and safety; modern slavery; gender pay gap reporting; payment practices and performance reporting) we expect to see an uptick in buyers seeking contractual and / or specific warranty protection for ESG related matters and further innovation in the W&I market as buyers look to mitigate ESG risks.

Tax risks

Global Themes



Market growth

In 2021 WTW saw strong client interest in Tax insurance solutions in all regions.



Insurance capacity

The aforementioned market growth in Representations and Warranties insurance led to some insurers reducing line sizes for tax insurance policies in order to manage their capacity constraints.

Coverage positions have generally increased and we have seen increased appetite from insurers on previously difficult to insure risks (e.g. valuation, secondary liability and detection risks).



Pricing

Rates for tax risk coverage are on the rise but at a slower pace than other lines of transactional risk. Rates in the range of 2% are still attainable in the UK and Europe for low level tax risks that come with strong tax advice from a reputable tax advisor while rates in North America were typically anywhere between 1% to 5.5%. In Asia and Australasia, premium rates for tax risks was broadly spread between 2% to 8% depending on the nature of the underlying risk with a significant number of placements relating to double tax treaty matters, indirect transfer tax and utilisation of exemptions / reliefs.



Outlook

The tax insurance market's appetite for unique and complex tax risks is robust and there is enough capacity in the market to cover up to USD 1 billion in limits in certain jurisdictions. We expect insurance market appetite for tax risks to continue in 2022, evidenced by existing insurers increasing their team sizes in 2022 and new entrants expected to enter the market; this may drive downward pressure on premium rates.

Expected features 2022



US tax upsurge in demand associated with IRS

As the IRS rebuilds and adds thousands of tax enforcement agents to specialized divisions focused on auditing corporations and high-earning individuals, it increases the likelihood that the IRS will challenge a return filing position involving some degree of independent judgement or tax law uncertainty. As a result, we expect there will be a high demand for policies covering issues such as transfer pricing matters and valuation issues which are inherently subjective in manner.

We also expect to see a high demand for coverage of tax risks associated with issues subject to the IRS “no-rule” areas, including:

- Renewable energy related tax credit qualification (related to claiming investment tax credits (ITCs) and production tax credits (PTCs).
- Spin-offs under Section 355² (including “plan” and “non-plan” issues, “five-year active business” requirement, and “active trade or business” requirement); and
- Repurposing surplus VEBA trust assets (a more recent addition to the IRS “no-rule” list).



Private Equity

Substance and valuation risks will continue to be key concerns for Private Equity

The Global minimum tax rate³ to be implemented in 2022 / 2023 may see restructuring risks become more of a concern for PE's on both acquisitions and disposals.

2. <https://www.accountingtoday.com/opinion/the-basics-of-a-tax-free-spin-off-transaction-in-a-corporate-restructurin>

3. <https://www.weforum.org/agenda/2021/11/global-minimum-tax-rate-deal-signed-countries/>

Contingent risks

We have seen a continued increase in the use of contingent risk policies in 2021 on M&A and other investment or financing transactions. Contingent risk policies can cover a very broad range of risks for which neither party to the transaction will accept financial responsibility. Contingent risks can also be utilised across any number of sectors and jurisdictions as evidenced by WTW placements in 2021 which included cover for loss of feed-in-tariff payments (both historic and future) in Italy; cover for loss of subsidy revenues (both historic and future) in Spain; cover for potential challenges to a construction project in Spain; and cover for potential claims and / or challenges against directors of a bank in Portugal.

WTW expects the contingent risk market to grow significantly in 2022 as insurer appetite and specialism expands and clients look to manage risks in a clean and efficient manner.



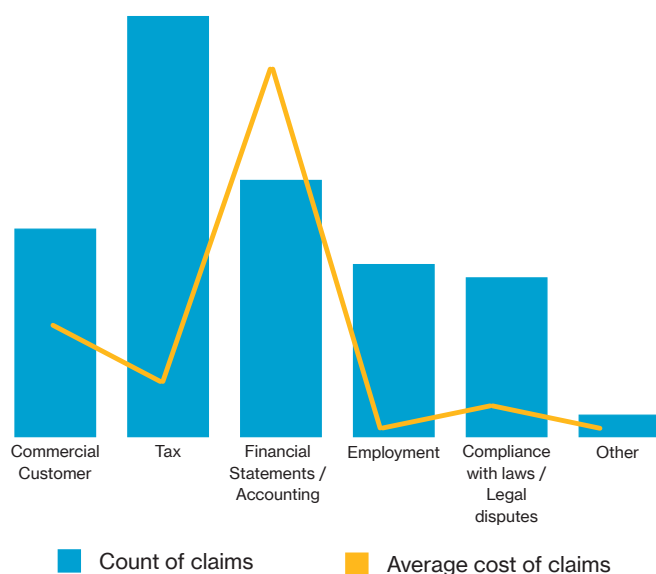
Claims review

Our review is based on a dataset of claims notified by clients under UK, European and US policy placements over a 10 year period up until December 2021. The charts and graphs below are all based on these claim notifications.

Additionally, WTW advises on W&I claims locally via our international teams. For example, a significant number of claims were managed in Australia and Asia in the last 3 years.

These claims are not included in the dataset, but the trends seen do not significantly vary from those seen within the UK and US claims data.

UK, European and US M&A 2021 claims analysis (by type)



This graph demonstrates the frequency and severity of the reported claim types in the UK, Europe and the US.

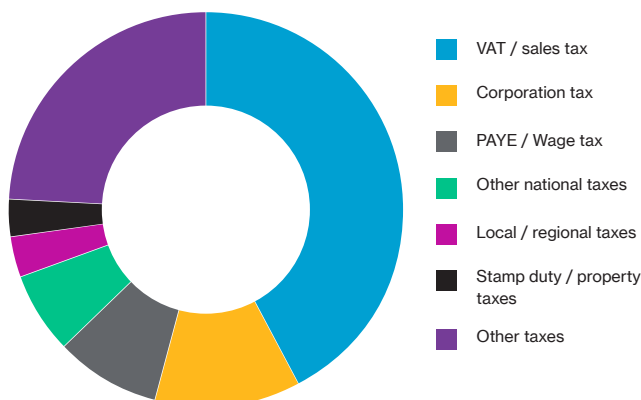
Financial statements / accounting have the largest total event cost and the second most frequently notified claim type - a common scenario relates to adjustments in EBITDA, which in turn affects purchase price if this was a multiple of EBITDA resulting in potential overpayment by the purchaser.

Tax events are the most frequently occurring event type. We see some large incurred amounts associated with them (2 of our top 10 claims related to tax), however these are generally less costly than commercial or accounting categories.

Commercial / customer events relate to day-to-day running of the target companies' business – subcategories within this area reflect that events relating to products / services are the most frequently notified and claims related to customers of the target are the most severe.

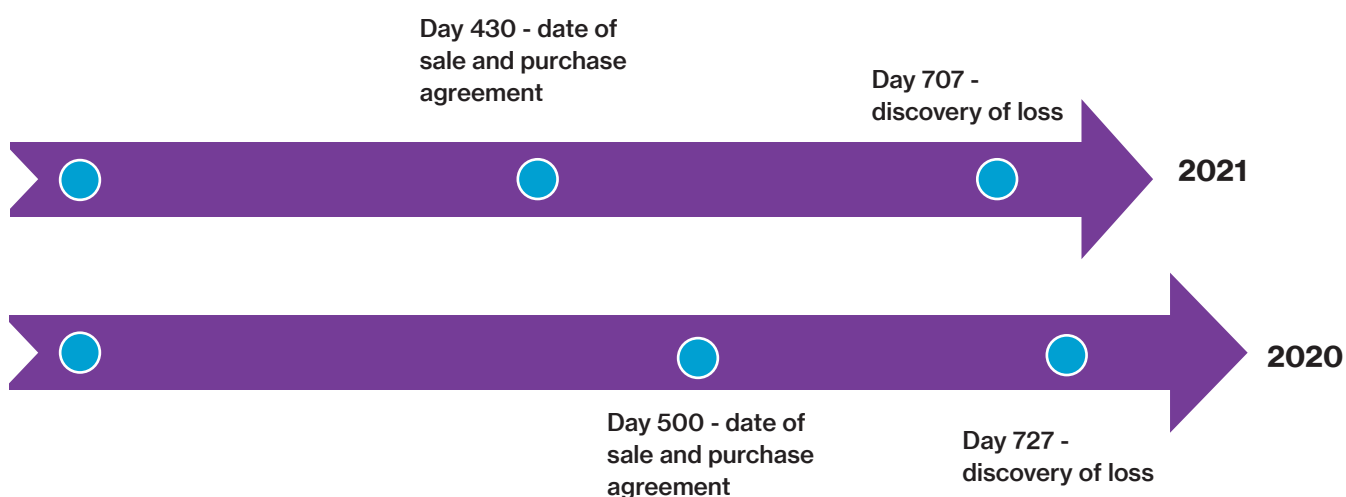
It is interesting to break down Tax events further, where VAT / sales tax and Corporation tax together account for 65% of all notifications.

UK, European and US M&A tax claim notifications 2021



Reviewing timelines

The average timeframe between an event occurring and acquisition reduced in 2021 to 430 days (from 500 days 2020). However the time taken by insureds to discover the event post completion increased from 217 days to 277. Overall, the average timeframe for an event occurring to discovery fell by 20 days to 707 i.e. just under two years in 2021.



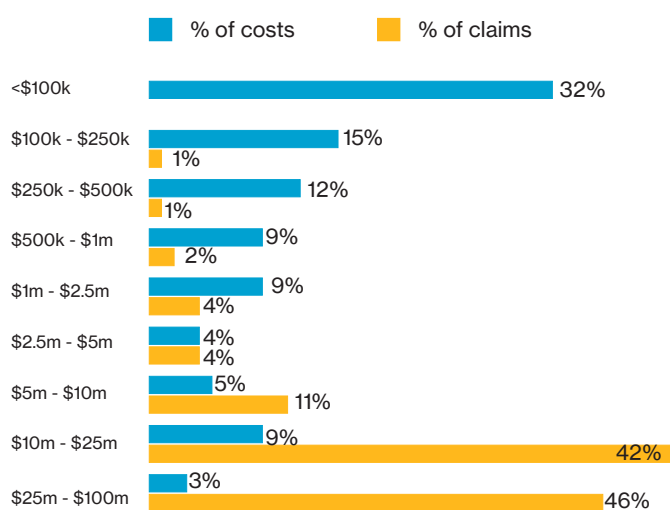
Typically, employment related events occurred shortly before the acquisition date, whereas in contrast events leading to claims concerning legal disputes / compliance with regulations often occurred years beforehand.

Claims costs / breakdown

Our data shows that a significant number of UK, European and US claims were precautionary, i.e. do not involve a loss and/or the loss suffered falls within the retention. This is evidenced by 79% of claims notified being relatively “low” in severity (USD 2m and below) and therefore such claims accounting for only approximately 8% of the aggregate amount of loss payments. These “low” severity claims point to an increased familiarity of, and use by, policyholders of transactional risk insurance policies and the importance of an appropriate policy retention threshold.

In contrast, claims of “high” severity (USD 10m plus) accounted for 12% of notifications though resulted in 77% of the aggregate amount of loss payments. Given the importance of these “high” severity claims, policyholders should consider carefully the level of cover required to ensure that they are not left with a significant uninsured loss by virtue of the fact that losses exceed the policy limit.

UK, European and US M&A 2021 claims paid distribution



About WTW M&A practice

A market leading team of 150+ M&A practitioners, many of whom are qualified in either Corporate Law, Tax and Accountancy principles or insurance, working together to help our clients navigate M&A transactions safely. We draw on the full resources of WTW to bring Sector expertise, analytics, risk evaluation and insurance placement (where required) to each transaction, in other words delivering the firm and focusing on our client's strategic objectives on a deal-by-deal basis.

We help solve complex risk issues, regularly working to tight deal timeframes. Our transaction related advice and insurance knowledge is valued by our clients, who often use this tactically buy-side and sell-side to enable a successful outcome to an acquisition or divestment.

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