

How to Navigate a Warranty & Indemnity Claim



Introduction

Warranty & indemnity insurance is a popular transactional risk management tool relied upon by dealmakers and clients as they become more familiar with the way the insurance works. In the last three years alone, Aon placed warranty & indemnity insurance policies on over 100 transactions in Australia and New Zealand, representing almost \$5 billion in policy limits.¹

With an increase in warranty & indemnity insurance policies being placed, this has resulted in an upward trend in the number of claims, with Aon receiving an average of one notification per month during 2020 and 2021.²

Based on Aon's market experience, this article provides Insureds with guidance on making a warranty & indemnity claim; an overview of claims trends; and insights on the claims process.



Section 1: Key Considerations When Making A Warranty & Indemnity Claim

When Should I Notify?

Each matter will be fact specific but generally speaking:

- Third Party Claims³ should be notified as soon as possible
- For a First Party Claim⁴, whilst it is prudent for a policyholder to put Insurers on notice, it is often beneficial to liaise with Insurers first as to what information they are likely to need and provide further details when available thereafter

It is important to have a clear and concise strategy before presenting the claim to insurers. Where possible, engage management and internal stakeholders as early as possible in the claims process.

^{1,2} Aon proprietary data

³ Third Party Claims are liability claims brought by persons allegedly injured or harmed by the Insured.

⁴ The Insured is the first party, the insurer is the second party and the claimant is the third party.

What Should a Notification Include?

It is essential to notify the insurer correctly. Where possible, involving the sale transaction lawyers can be helpful. The notification should include:

- Background information/timeline (i.e. when the matter was discovered and how)
- Details of breach (i.e. which warranties the policyholder considers have been breached and how)
- Detail addressing knowledge, if applicable (e.g. warranties qualified by seller knowledge)
- A breakdown of loss (see “Quantum”)
- Documentary evidence in support of the claim (where available)

It is always helpful to provide a fulsome claims notice, including supporting evidence, at an early stage and to be open and transparent with insurers with the claims information. This ensures that insurers are engaged earlier and enables a quicker resolution.

Quantum

Generally, if a claim is covered, ‘loss’ under the policy is determined by calculating the difference between:

- The fair market value of the target company with the warranty being true, and
- The fair market value of the target company with the warranty being false

Calculating loss is complex. The appointment of forensic valuation experts by the Insured who will consider several methodologies to determine loss, can greatly assist in bringing a claim to a timely resolution.

“Warranties will, of course, typically cover a wide range of often technical areas. For example, tax, compliance and financial statements. We often need advice on such issues. For this reason, we frequently have to retain external legal, accounting and other experts to advise us. The fact that we have taken this step should not be interpreted as implying that we have any concerns.”

We often ask Insureds to agree to allow experts we have retained to liaise directly with the Insured’s or target’s relevant in-house or external experts, as we have found this to be an effective way of expediting the claim process. We therefore recommend facilitating such contact whenever possible.”



Carlos Fane, Claims Manager, Financial Lines & Transaction Risk, Tokio Marine HCC

What to Expect

Insurers will provide initial comments on the notification. It is likely they will request further information and documentation. Insurers may appoint a law firm to assist with their coverage investigation; this is common and no cause for alarm. Depending on complexity, although the process is quicker and more straightforward than pursuing the seller, assessment of the claim (including quantification of loss) can take time.



“Provide early notification to the Insurer to enable the claims process to commence as soon as practicable. We understand that the claims process can take time, so early notification means that the claims process can commence sooner, to enable the insurer to start engaging with you on understanding your claim as well as discussing any particular requirements you or they may have. The earlier that relevant information is provided to the insurer, the more efficient the claims process. Sometimes the claims process can involve several exchanges of questions and responses between Insured and Insurer, in light of the complex nature of the circumstances surrounding a claim and the nature of the losses experienced. It is beneficial to engage with the Insurer to enable an efficient claims process.”



Ami Kalmath, International Head of M&A Claims, General Insurance, AIG

Broker Support

Many Insureds, although familiar with warranty & indemnity insurance, have limited experience navigating a claim. Due to the nature of these claims, the process can be both complex and involved. Brokers can assist at all stages of the claims process:

- Assist with early consideration of whether there is a claim, including which warranties may have been breached in the SPA and how the policy might respond
- Help draft the claim notification and put in place a claims strategy to suit individual business needs
- Represent Insured's interests in all dialogues with the insurers
- Provide guidance in the investigation of losses
- Ensure requests for further information and documents from insurers are relevant and proportionate to the claim

Section 2: Claims Trends

Claims Frequency and Size

Claims notifications are increasing throughout Australia and New Zealand. Transaction sizes, limits placed and claim values have increased proportionately over the past several years. Aon's claims book suggests a claims frequency of approximately 1 in every 5 policies.⁵

Timing of Notifications

Most notifications occur within the first year and approximately 2/3 of claims are notified within the first year post-completion.⁶

Common Breach Types

The most common breach types in the Australia and New Zealand region are in the areas of tax, accounting and financial, compliance with laws/regulatory matters, material contracts and employment related.⁷

Section 3: The Claims Process

The length of time it takes to settle a claim varies widely, based largely upon the complexity of the claim, but also the availability of supporting information.

There is generally a period of investigation by the Insurer following receipt of the claim notice. It takes time to gather and provide ample supporting documentation as well as conduct calls and meetings to explain the details of the breach and validate the loss (similar to what is required when dealing directly with a seller in an indemnity claim). Hence, it is no surprise that during this time the Insurer will make requests for additional documents or information.

There may also be other matters, such as evaluating the quantum and the Insurer's subrogation rights to the extent that a payment is made (including against the seller in cases of fraud), which can add complexity to the claim negotiation.

^{5, 6, 7} Aon proprietary data

A typical claims process for a warranty & indemnity insurance claim is set out below.



“Third-Party Claims (as are typically defined in a policy) can be delicate in the M&A claims world because they often produce a scenario in which the Insured and insurer alike necessarily must wait for a determination as to the merits of certain alleged underlying issues. The most common mistake in this process is for the communication flow between the Insured and insurer to cease following the initial notification, only for the conversation to pick back up just when an Insured is nearing a settlement.

Assuming the insurer’s consent is required (as is typically the case, depending on the amount of a settlement), this can put both parties in a difficult position if an active dialogue about the status of the third-party claim has not been maintained.

Additionally, Insureds often place too little emphasis on requirements contained in the policy such as obtaining consent to hire certain advisors that are not pre-approved and consent to incur fees past certain thresholds. We always recommend, therefore, that Insureds err on the side of disclosure and provide insurers with frequent updates as to the status of any claims, the amount of fees incurred, and the potential for resolution at a minimum.”



**Simon Radcliffe, Head of GTS Claims,
Liberty GTS**



Section 4: Claims Case Studies

It is important for an Insurer to understand the valuation methodology and multiples applied when the Insured purchased the target. If this is clearly documented, the claims verification process is simpler.

Case Study 1: Australian Financial Services Company Accounts Misstatement



The Claim

An Insured made a claim for material misstatements in the target's historical financial statements. The target was in the financial services sector and the Insured alleged that certain line items within the financial statements were materially misstated. The Insured/Buyer had factored this into their valuation model which then led to a large loss once the EBITDA multiple was applied. The Buyer claimed for loss suffered for defence costs.



Initial Declinature

The Insurer initially denied the claim on the basis there was insufficient evidence to suggest that the Buyer had factored this into their valuation model. The Insured was also cautious about sharing their entire valuation model which it considered commercially sensitive.

Correspondence between the parties had also led to a stalemate on moving the claim forward, particularly due to the complex issues involved that the Insurer had to work through, including determining the ultimate EBITDA multiple to apply to the 'loss' being claimed by the Insured under the policy.



Successful Outcome

After the initial declinature, Aon was able to solve this through a staged approach and process for an amount acceptable to both parties.

- Aon was able to establish a direct line of communication with the Insurer to talk them through the sensitive nature of the valuation model. Under a confidential process the Insurer gained access to certain parts of the initial model and Aon facilitated discussions between the parties and their advisors who assisted with the model
- An independent forensic accountant was appointed who opined specifically on the misstatements of the financial statements
- The Insurer was able to verify the appropriateness of the multiple used, confirming it was within an acceptable range

The parties were able to settle the claim at an agreed level which also factored in a portion of defence costs.



Claims notices that clearly identify which warranties are breached and exactly quantify the loss being claimed for are usually settled quickly. Be clear in the notice that loss claimed does not include matters insurers would not cover, such as consequential loss or internal labour costs. Finally, anticipate what documents the insurer will need to verify loss and make the claims payment.

Case Study 2: Manufacturing Plant Operating Outside of Local Government Approvals



The Claim

The Insured purchased a target with a manufacturing plant. After the acquisition, the Insured was notified by the local council that certain structures at the plant had not received approval and must be removed. Management of the target, in consultation with the local council, undertook a number of steps to mitigate damages including removing the unapproved structures. The Insured claimed for the loss of profits from reduced hours of operation and loss to remove the unapproved structures.



Initial Declinature

The Insurer was aware of the target's initial engagement with the local council and steps taken by the Insured to mitigate damages, but management had not notified the Insurer of its ongoing discussions with the local council. The Insurer was not convinced initially of the process management followed to rectify council's concerns and authorisations processes followed. As there were several limbs of the claim, some of which required additional expert opinion and documentation for verification, the claim reached a stalemate and did not progress for a substantial amount of time.



Successful Outcome

Aon was able to assist the parties by discussing with the Insurer their concerns and addressing these by providing the Insurer with the requisite additional information to progress the claim.

The Insurer conceded there was a breach of warranties including compliance with laws and authorisation warranties.

As loss was suffered due to the target's inability to operate to full production capacity and this was quantifiable and verified, this portion of the 'loss' was promptly paid out by the Insurer.

The Insured was then able to continue to work with experts to document the quantification of 'loss' relating to the removal of unauthorised structures.



Section 5: Aon's Claims Capabilities – the Aon Advantage

Claims Support

Aon Asia Pacific has a dedicated team of claims advocates including dedicated transaction liability claims specialists who work to pursue positive outcomes for our clients when claims arise. The significant premium volume that Aon places into the market also affords Aon considerable market leverage to assist our clients in achieving resolution for their claim. This is particularly crucial for this specialised line of business as Aon can call on larger insurer relationships to realise results for our clients. Transaction liability insurance policies frequently extend as far as 7 years in the future and require claims advice and support over the long lifespan of the policies.

Leading Technical Expertise

Aon's claims team is a national team with offices in Sydney, Melbourne and Perth comprising more than 50 consultants. We have numerous subject matter experts specialising in all classes of insurance and insurance litigation having gained experience within insurance divisions of law firms and underwriters.

With the assistance of the brokerage team, Aon claims specialists partner with clients and their advisors to navigate the claims process from issue identification through to claim resolution, assisting with notification, facilitating discussions with insurers, and leveraging knowledge gained from past experience.

Claim Solutions

The Aon claims advocate is the focal point for starting the initial claim for indemnity, followed by progress payments or the timely resolution of the claim.

We are able to leverage our relationships with insurers and legal counsels to avoid any potential bottlenecks and to seek the best claims solution.

All claims handling and advocacy costs are included in Aon's initial placement fee. There is no additional fee for Aon to assist our clients with the claims advocacy and claims handling process.

About Us

Aon M&A and Transaction Solutions is a leading provider of specialist due diligence services to the Private Equity, Infrastructure and M&A industry. Its capabilities extend across a broad suite of services from Risk & Insurance, Human Capital, Cyber Security, and Intellectual Property. Clients also benefit from its expertise as the largest and most innovative broker for transaction insurance instruments in Australia and New Zealand including Warranty & Indemnity, Tax, Litigation, Credit and Surety solutions.

For further information on how we secure investments and enhance returns for our clients, please visit: aon.com.au/m&a

Aon Contacts

Sam Thomas

Client Director – M&A
and Transaction Solutions
Aon Australia

t 02 9253 8452

e sam.thomas@aon.com

Anita Vivekananda

Client Manager – M&A
and Transaction Solutions
Aon Australia

t 02 9253 8443

e anita.vivekananda@aon.com

Alexandra Morison

Technical Advisor and
Claims Advocate
Aon Australia

t 03 9211 3251

e alexandra.morison@aon.com

Jonty Vavasour

Executive Director – M&A
and Transaction Solutions
Aon New Zealand

t 09 362 9029

e jonty.vavasour@aon.com

aon.com.au/m&a

