A Healthy Market:
Representations and Warranties Insurance for Healthcare Transactions

By Brian Thede,
Senior Vice President, Healthcare, Ethos Specialty Insurance Services LLC

and David Kuffler,
Partner, Kaufman Dolowich & Voluck, LLP
Representations and warranties insurance is firmly ensconced as an important tool to facilitate mergers and acquisitions. One leading insurance broker in the space estimates that, in the target North American market of private company transactions between $25 million and $10 billion in enterprise value, 45% employed R&W insurance in 2018, up from 34% in 2017\textsuperscript{i} and 20% in 2016.\textsuperscript{ii} Buyers, sellers and their advisors have clearly recognized the benefits that R&W insurance brings to the table. Among other things, R&W insurance can: (1) reduce or eliminate a seller’s need to indemnify the buyer; (2) reduce or eliminate the need to hold back a portion of the sales price in escrow to fund any such indemnification from the seller; (3) extend the survival period of the sellers’ representations and warranties to provide for a longer period in which a breach can be discovered and pursued; (4) reduce the risk that the buyer will pursue the sellers for indemnification for a breach, particularly where the sellers remain with the acquired company post-closing; and (5) reduce collection risk where there are numerous sellers, foreign sellers or sellers of questionable solvency.

Notwithstanding this dramatic overall growth for R&W insurance, certain industry sectors have lagged behind in terms of adaptation of the product as an attractive alternative to traditional seller indemnification. One such field, healthcare, has experienced a shift in underwriting appetite in response to demand over the last 12 to 24 months. R&W insurance is now available for many participants in the healthcare industry on attractive terms approaching the coverage available to the M&A market at large.

**Risks Unique To Healthcare**

While the healthcare industry encompasses a large and diverse body of businesses, in general they compete in a highly regulated environment. Federal and state Medicaid and Medicare programs are giant payors for many in the industry. Complex statutes and regulations must be followed in order to receive valid payments from these bodies. In the event of errors, violations of the False Claim Act can give rise to stiff penalties.

Marketing and sales of products and services is also subject to regulation and scrutiny and presents risk under the FCA, the Stark Law and the Anti-Kickback Statute among others. The FCA incent lawsuit by promising whistleblowers bounties out of any recoveries.

Manufacturers of medical products and pharmaceuticals face heightened risk of product liability exposures. Medical service providers must always be concerned with malpractice claims. Compliance with complex HIPAA patient privacy requirements is also a fundamental risk for service providers.

**The Insurance Market Responds**

The healthcare sector is about 20% of the U.S. economy and generated over 780 M&A transactions valued in excess of $120 billion in 2018 alone.\textsuperscript{iii} Private equity investors are said to be seeking out funds which invest in healthcare opportunities due to strong growth, inherent protection from recession and excellent historical returns.\textsuperscript{iv}
As demand for R&W insurance has grown, insurers have allocated resources to assess and understand the special risk profiles of this class of business. The expansion of underwriting expertise, whether through the hiring of underwriters or external advisors, has allowed insurers to provide the consistent and predictable underwriting process along with commercial terms that has become the hallmark of the rest of the R&W insurance market.

Today, healthcare submissions are approaching 20% of overall requests for quotations based on the number of deals. This is consistent with healthcare’s overall macro position in the economy and suggests that, at least on the buy side, healthcare has caught up with the rest of the market for R&W insurance. Certainly for private equity buyers, the adoption rate appears to be equivalent. Corporate buyers have generally been slower to take up the product overall and seem to be lagging a bit further behind in healthcare transactions.

**What Is Getting Covered?**

The fundamental fulcrum upon which R&W insurance depends is the quality and extent of diligence performed by buyers and the communication of that diligence to underwriters. As a result, areas of the healthcare industry where insurers have gotten comfortable with the diligence process show the most growth in terms of issuance of policies.

Most patient service providers can currently obtain coverage. This is a vigorous area of M&A activity as private equity firms have focused on physician practice roll-up strategies. Insurers have become comfortable with third party diligence providers for billing/coding risks. Insurers will also write medical product manufacturers and IT companies on a selective, risk by risk basis. Several insurers will write policies for pharmaceutical, pharmacy and pharmacy benefit manager targets.

Insurers have shied away from certain risks that are currently drawing a lot of attention from regulators such as pain management facilities that deal with soft tissue injuries who tend to generate questions of medical necessity from payors as well as anyone involved with opioid medications. Drug treatment facilities, medical transport and certain areas of in-home care providers are proving difficult to write. Finally, pharmaceutical companies whose value is based primarily on patents due to limited historical sales can also be challenging.

Insurers are paying close attention to product liability exposures and existing, traditional insurance coverage maintained by targets. For privacy risk, insurer typically require the maintenance or purchase of adequate cyber coverage.

**What Terms Are Available?**

There is likely capacity in the marketplace of up to $500 million depending on the risk. With demand from the healthcare industry high, more insurers are writing policies in this space. Generally, the cost is higher for deals with high levels of government billing exposure, such as hospice, home health and some areas of behavioral health, particularly those that are Medicaid-funded. The market has become more aggressive, particularly on deals considered “healthcare-
“lite” such as medical products which are FDA-regulated, and frequently offers rates that are generally in line with the R&W insurance market as a whole. Finally, some markets are pricing higher risk deals as if they are lower risk in an apparent effort to win business.

It is unclear if the more recent drop in rates is sustainable for an industry with such heavy regulatory oversight. Regulatory enforcement, along with financial statements, contribute a significant percentage of claims in R&W generally. The current competitive nature of R&W may have pushed some carriers to offer terms below a sustainable long-term level for certain provider types.

**What Does the Future Hold?**

Robust demand and intense competition will likely continue to push insurers to expand into previously underserved industries. Thus, we anticipate that healthcare will remain a growth sector for R&W insurance underwriters. Insurers may be incentivized to seek competitive advantages by finding and retaining persons with expertise in areas of the healthcare industry that, to date, have not drawn attention. In the event of a downturn in the overall economy, healthcare may become an important niche for market participants for the same reasons private equity investors have sought it out. Given the lag in claims and the typical 3-6 year policy periods, everyone will, of course, be keenly following loss developments on the policies written over the last 12 to 24 months to determine whether the current pricing and terms environment is sustainable.

*Brian Thede is a Senior Vice President, Healthcare on the Ethos Specialty Insurance Services LLC Mergers & Acquisitions team. Ethos is a U.S. managing general agency dedicated to the development and acquisition of underwriting platforms in both the standard market and E&S arenas.*

*David Kuffler is a partner at Kaufman Dolowich & Voluck, LLP where he has been at the forefront of the rapid changes and market expansion of representations and warranty insurance in the U.S. He assists clients with claims, policy drafting and underwriting due diligence in connection with representations and warranty insurance and other transactional insurance.*

---