2022

Health Care Transactions

Resource Guide

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AMERICAN HEALTH LAW ASSOCIATION

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Successful corporate transactions and business arrangements in the heavily regulated health care environment require the right combination of experienced lawyers who understand the intricacies of the health care industry and its governing laws and regulations. Crowell & Moring's health care practice has a long track record of guiding its clients from the initial stages of complex health care business transactions through their completion. Our experienced health care transactional team provides guidance on M&A, joint ventures and commercial contracts and our regulatory teams advises on the array of government contracts and programs, fraud and abuse, permits and licensing, privacy and security, antitrust, and other regulatory constraints affecting health care organizations today.

To learn more about how Crowell's Health Care Practice can help your organization's needs visit our website or reach out to one of our transaction experts below:

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Representation and Warranty Insurance in Health Care Transactions

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Overview of Representation and Warranty Insurance

Representation and warranty insurance (R&W Insurance) is an increasingly popular type of insurance policy that is purchased in connection with private company mergers and acquisitions. A standard acquisition agreement will contain representations and warranties made by the seller about the target company, and such representations and warranties are usually heavily negotiated by the parties. The seller generally agrees to indemnify the buyer (subject to certain limitations) for breaches of such representations and warranties. The seller's indemnification obligation has historically been (and sometimes still is) backed by a portion of the purchase price payable at the closing being held back or held in escrow for a specific period of time. The emerging use of R&W Insurance is modifying this traditional indemnification structure. R&W Insurance provides protection against financial losses for certain unknown and unintentional breaches of the representations and warranties in the acquisition agreement. The American Bar Association's 2021 Private Target M&A Deal Points Study (the 2021 Deal Points Study), which analyzed the acquisition agreements of publicly available transactions from the year 2020 and the first calendar quarter of 2021 involving private companies, indicated that the percentage of acquisition agreements expressly referencing R&W Insurance increased from 29% in the 2017 study to 52% in the 2019 study to 65% in the 2021 Deal Points Study.

R&W Insurance is available to both buyers and sellers in a transaction. Under a buy-side policy, the buyer would look directly to the insurer for coverage for breaches of the seller's representations and warranties. Under a sell-side policy, the insurer would reimburse the seller for indemnification claims paid by the seller to the buyer. The use of buy-side R&W Insurance policies has far outpaced the use of sell-side R&W Insurance policies. The 2021 Deal Points Study indicated that 95% of the acquisition agreements that referenced R&W Insurance provided that the buyer would acquire the R&W Insurance policy. The other 5% of acquisition agreements did not specify which party would acquire the R&W Insurance policy. None of the acquisition agreements provided that the seller would acquire the R&W Insurance policy.

R&W Insurance can benefit a buyer in a variety of ways. For example, a buyer can purchase R&W Insurance to cover higher amounts than the cap that the seller is willing to accept, and with longer survival periods. Additionally, if recovery against the seller(s) is expected to be difficult (e.g., because there are several sellers, foreign sellers, or financially distressed sellers), R&W Insurance can provide an alternative, streamlined mechanism for recovery. R&W Insurance can also make a buyer's bid more attractive in an auction process by reducing the amount of the purchase price that is held back or held in escrow. It can also help preserve relationships by mitigating the need for a buyer to pursue claims against management sellers who will remain in place as management personnel following the closing of a transaction.

R&W Insurance can benefit sellers in a variety of ways as well. As previously mentioned, R&W Insurance can be used to eliminate or reduce the portion of the purchase price that is held back or held in escrow, which allows a greater portion of the purchase price to be distributed to the sellers right away at closing. The 2021 M&A Deal Terms Study by SRS Acquiom found a stark difference in escrow sizes between transactions with R&W Insurance and transactions without R&W Insurance—a majority of deals with R&W Insurance had an escrow amount that was 0.5% or less of transaction value, while transactions without R&W Insurance had an escrow amount hovering in the traditional range of 10% to 15% of transaction value. A R&W Insurance policy can also protect passive sellers and provide a "clean" exit for sellers, with fewer contingent liabilities, which is particularly beneficial for private equity companies or venture capital funds at the end of their life cycle. In addition, with a R&W Insurance policy, the seller may feel more comfortable giving more fulsome or broad representations and warranties, which could lead to a faster negotiation of the acquisition agreement and lower legal costs for all parties.

Process and Cost

To begin the process of obtaining a R&W Insurance policy, either the buyer or the seller approaches an insurance broker (e.g., AON, Lockton, Marsh, Willis, or Woodruff Sawyer) to solicit quotes from insurers. The insurer generally will provide an initial "non-binding indication" or "NBIL" and will then undergo an underwriting and due diligence process. The insurer will want to review the data site for the transaction, the due diligence report prepared by the buyer, and the key transaction documents, including the acquisition agreement and the disclosure schedules. Once the insurer completes its diligence process, the insurer and the party seeking the R&W Insurance policy

will negotiate the specific terms of the policy. The party seeking a R&W Insurance policy should plan on actively negotiating the policy and should begin such negotiation early in the process. While carriers may not be open to negotiating certain provisions and the insurance market may influence the success of the negotiations, the party may be able to obtain more favorable provisions by negotiating the provisions early in the process. There are standard exclusions under R&W Insurance policies, including, for example, with respect to covenant breaches, purchase price adjustments, pension underfunding/withdrawal, or breaches of representations and warranties of which the buyer had knowledge, and there may also be specific exclusions based on the insurer's due diligence. The party seeking the R&W Insurance policy should plan on exclusions wherever there are diligence gaps or specifically identified diligence risks, but because the policies are not bound until either the signing or the closing of the transaction, there is the possibility of removing such exclusions with additional diligence. However, because additional diligence raises legal costs and requires more time, the decision to seek removal of exclusions will be transaction-dependent.

The insurer charges a premium to issue the policy, which generally is paid up front and is usually 2% to 4% of the coverage limits, and an underwriting fee. There may also be an insurance broker fee. The deductible or retention amount of a R&W Insurance policy is typically based on a percentage of the transaction value (e.g., 1% of the transaction value) and often correlates to the size of the indemnification escrow or holdback amount. As discussed below, the cost of obtaining a R&W Insurance policy for a health care transaction was inflated at the end of 2021 due to the state of the market.

Health Care Transactions

Historically, obtaining a R&W Insurance policy for health care transactions (and, in particular, for health care provider transactions, as opposed to adjacent industries such as health care technology or life sciences) was challenging. Insurers did not want to assume the risk for violations of health regulatory laws, including with respect to Medicare and Medicaid billing and reimbursement practices (False Claims Act violations), Anti-Kickback Statutes and the Stark Law. Insurers would categorically exclude these types of health care compliance-related representations and warranties from coverage, making R&W Insurance policies of little value for health care provider transactions. In 2014, there were only one or two insurers providing R&W Insurance for transactions involving health care providers. Accordingly, the use of R&W Insurance for these types of transactions has lagged behind other industries.

Several factors have led to the expansion of R&W Insurance in health care transactions, including a growing demand for R&W Insurance products for health care transactions, partially due to the increased involvement of private equity firms in health care acquisitions; insurer's improved ability to perform efficient health regulatory due diligence; and the relative stability of the health care industry, despite general times of unpredictability or unprecedented disaster.

There are many more insurers willing to provide R&W Insurance for health care transactions than in the past. Currently, there are approximately seven to nine insurers that can underwrite a health care provider deal. Insurance broker AON indicated that it has brokered R&W Insurance on more than 75 health care provider transactions since 2015. As depicted on the table below, whether an insurer is willing to underwrite a health care provider transaction is based on a number of considerations, including provider type, size of provider and scope of operations, government payer exposure, availability of audited financial statements, and compliance history.

Provider Characteristics

» Consolidated (one-location) billing operations » Limited number of health care services provided (i.e., small number of CPT codes billed) » Capitated-rate billing model (fee/month)	» Bills sent from up to three locations » Health care services performed in the field » Cost report-based billing	» More than three locations billing government insurance » Many different services provided (i.e., high variation in number of CPT codes billed) » Fee-for-service billing model » Multiple billing models (e.g., cost report and fee-for-service)
← Easier to Underwrite		**Harder to Underwrite →**

» Medicare/Medicaid Health Maintenance Organizations
» Accountable Care Organizations
» Benefit Management Companies
» Specialist Providers, such as:
  » Radiology / Medical Imaging
  » Durable Medical Equipment
  » Labs
  » Physical Therapy
  » Single Specialty Physician
	» Home Health / Hospice
	» Urgent Care
	» Physician Practices
	» Multi-Specialty / Ancillary
	» Nursing Homes
	» Hospitals (one to three locations)
		» Large Integrated Hospital and Health Systems (e.g., more than three hospitals)
		» Multi-State Providers

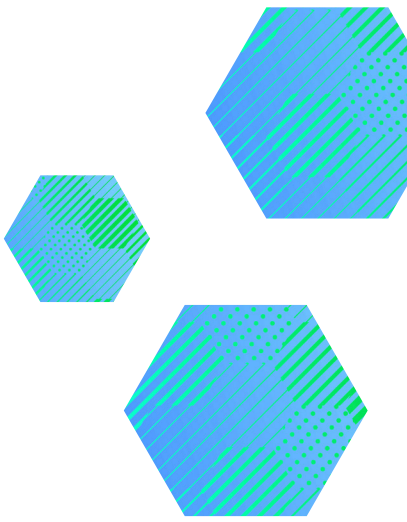
Example Provider Types

In order to underwrite a health care provider transaction, insurers expect to conduct fulsome diligence on health care regulatory matters. Insurers will typically perform diligence with respect to financial arrangements and referral sources; employment, physician and independent contractor arrangements; real estate leases; sales and marketing activities; the compliance program and internal and external compliance audits; privacy and data security compliance, including compliance with HIPAA; payer contracts; and corporate practice of medicine.

2021 Issues and 2022 Outlook

In 2021, the issues with obtaining R&W Insurance related to bandwidth, as it was a record-breaking year for mergers and acquisitions. The challenges varied by industry, but the health care industry was particularly impacted. Towards the end of 2021, insurers were able to cherry-pick the transactions they wanted to underwrite and, accordingly, steered away from health care provider transactions involving increased health regulatory due diligence and risk. Additionally, parties who obtained R&W Insurance for health care transactions in the last quarter of 2021 paid significantly higher premiums than usual.

As we have moved into the new year, the R&W Insurance market has reset, and pricing has begun to return to more normalized rates. However, pricing for health care transactions is not resetting as quickly as other industries. Premiums for transactions involving complicated health care providers still appear to be around 6% of the coverage limits, and, in general, premiums for health care provider deals are expected to stay in the range of 4% to 6% of coverage limits. As 2022 progresses, parties to health care transactions should be prepared for tightening of the R&W Insurance market if mergers and acquisitions have another record year. R&W Insurance has increased in popularity in private company mergers and acquisitions over the past decade, and its usage in health care transaction is only expected to rise. As private equity companies continue to pursue health care transactions and the volume of health care transactions in general continues to increase, R&W Insurance may become entrenched in health care transactions like it has in many other industries. Both buyers and sellers should consider whether a R&W Insurance policy could be beneficial on their next health care transaction.



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