

Reps And Warranties Insurance Rises In Health Care Deals

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Merger and acquisition deal activity during 2013 saw an increase in the general use of M&A insurance policies, specifically representations and warranties insurance. RWI provides coverage for losses arising from unintentional and/or unknown breaches of representations and warranties made in an acquisition or merger agreement. In the context of a health care transaction, RWI presents an interesting solution to some of the common hurdles to closing a deal.

One of the more challenging types of issues in any transaction are liability issues that combine high magnitude with low probability. The high magnitude component makes buyers nervous in ways that are not easily bridged with escrowed funds. The low probability makes sellers reluctant to fund escrows sufficient to pay the liability or absorb meaningful price adjustments to account for the risk.

In the health care context, these sorts of issues arise on a regular basis. Some companies operate in more gray areas of the law, particularly in certain subsectors, where formal governmental guidance is not always available and industry practices tend to gravitate toward more aggressive interpretations.

Residing in these gray areas often carried significant liability for being wrong. Some health care statutes (like the Stark Law) can impose enormously strict liability for mistakes, and other statutes can present equally daunting potential for claims with no practical way to grade the exposure beyond the experience of the industry and one's advisers.

RWI can be a bridge across these concerns.

Use of RWI

A standard buyer-side RWI policy provides buyers with an insurance product to call upon in the event of a breach of seller representations and warranties. Buyers and sellers are now utilizing RWI to replace or supplement an escrow and to bridge gaps between parties in indemnification negotiations.

Additionally, sellers look at RWI as a way to achieve a “clean exit” and keep more of the deal proceeds. Deal professionals have also seen that RWI policies can mitigate concern about the financial ability of sellers to meet indemnification obligations, provide solutions when indemnification is not available, and provide buyers’ lenders additional collateral and protection.

Costs — Premiums, Retention and Fees

Much of the increased use of RWI can be explained by a decrease in both premium pricing and retention/deductible levels. As little as 10 years ago, premium pricing generally ranged from 5 to 6 percent of the insured amount. Today, premiums are generally in the 2 to 4 percent range. Retention (or deductible) levels have also fallen, currently approximately 2 to 3 percent of the transaction amount.

When considering the financial feasibility of a policy, a policyholder should factor in the above along with any fees or other charges that might apply. For example, many carriers will charge an underwriting and/or diligence fee in the range of \$15,000-\$50,000.

Structure of Coverage

RWI can be structured to offer creative solutions to indemnification exposure. Perhaps the coverage is set up as a “first dollar” policy intended to protect the seller’s escrow. Alternatively, the coverage could kick in after the escrow is depleted to effectively extend the coverage of the escrow. Alternatively, the insurance could have a very large deductible intended to cover catastrophic claims. Obviously, all of these alternatives impact underwriting and pricing.

Deal Process Impact

RWI policies are not a substitute for a buyer conducting its usual process and its own diligence, nor are the policies a diligence shortcut. Underwriters will carefully review the underlying acquisition agreement and the accompanying diligence. Additionally, the sellers’ financial statements are reviewed and considered. Known breaches are not generally covered; other M&A and/or contingent liability policies are available for such breaches.

RWI policies are generally based on the representations and warranties made in the underlying acquisition agreement, but in some cases, underwriters will exclude certain representations and warranties from coverage.

Exclusions

One area to focus on in an RWI policy is the types of losses covered. In the health care context, the exposure can be both the liability to write a check to someone on account of the breach and the going-forward impact on the business of having to change one’s business to operate in a compliant manner.

The first exposure generally falls within the scope of RWI policies. The second measure of loss can be more problematic.

A policyholder must read the fine print and understand the limitations of an RWI policy. In addition to the exclusion of a specific representation and warranty in an acquisition agreement, a common exclusion in many RWI policies is for “any damages calculated by using the multiple on which” the purchase price is based. While it is possible to structure coverage for losses that reflect a diminution in value, a potential policyholder should take great care to ensure such coverage is included.

Going Forward

As more insurers enter the market, M&A insurance policies will likely continue to rise in both popularity and use. As insurers develop a longer claims history for these types of products, they become more capable of underwriting a broader array of risks.

In addition to RWI policies, other types of coverage used in the M&A context include tax liability policies, litigation/contingent liability policies and environmental insurance. Any party contemplating an M&A transaction should consult with experienced counsel concerning the desirability of these forms of coverage.

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