

As Disruption Drives Healthcare Deals, a Massive Sector Transforms Itself

► **Akin Gump's Gene Elder and Daniel Graver take a look at the political and economic trends reshaping M&A and transactions in the healthcare industry.**

CCBJ: Private equity (PE) investors are highly active in segments of the healthcare market, such as pediatric services and therapies. What involvement are you seeing?

We have seen a significant amount of interest by private equity investors in various aspects of the healthcare industry. This is both from PE investors looking to invest in specific segments of the industry and PE investors who are looking to exit from investments made within the last decade or so. Like other investors in the current low-yield environment, PE investors are looking for places to put capital to work in general. But they are also attracted to the healthcare industry because of broad ongoing changes in the industry, such as the administration's changes to the ACA [Affordable Care Act], efforts to develop new payment mechanisms and the ongoing implementation of healthcare technology. These changes are not necessarily attractive in themselves; they are attractive because they have the potential to be disruptive. They can change winners into losers and losers into winners. Timing these shifts is what some PE investors are trying to do. As far as where the funds are focusing, we've seen significant activity and interest in the hospital and pharma sectors, but we may not be able to generalize our experience across the spectrum of PE activity in the healthcare industry.

Bankruptcy filings among hospitals and medical centers more than tripled in 2017, according to Bloomberg. Some believe the political battle over the ACA will spawn even more debt restructuring and bankruptcy filings in healthcare. What are you seeing?

Even though the opponents of the ACA haven't succeeded in their stated goal of completely repealing the ACA, they have made some progress in weakening the interconnected parts of the law that would add to the population that has health insurance. The more difficult question is what negative effect this may have on particular hospitals. Hospitals that did not

see much of an increase in revenues associated with the ACA may not experience a negative impact from the administration's actions. But other hospitals may have negative fallout from declining numbers of insured, or from having expanded in ways that depended on an increased population of insured patients that may not show up after all.

Fraud and abuse are constant concerns in the healthcare arena. What influence does this have on M&A, joint ventures, restructurings and other transactions?

Fraud and abuse risk is a significant issue for a number of reasons. Because of the dollar amounts involved, the complicated regulations governing the industry and the relatively long lag time between the creation of a compliance or overpayment problem and the discovery of the problem, transactions can involve very substantial unknown liabilities. The potential liabilities are substantially increased by the mechanism of the False Claims Act, which allows fraud claims to be filed under seal and provides for bet-the-company-sized penalties, including potential exclusion from federal healthcare programs.

The major influence these unknown liabilities have on transactions is to increase the importance of conducting



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thorough due diligence and paying careful attention to the contractual provisions governing undiscovered liabilities. In addition to taking a close look at any known or suspected, but as-yet-unresolved, compliance investigations or issues, and trying to cabin the potential liabilities associated with them, buyers should thoroughly review and evaluate the sellers' compliance systems and culture. There are a wide variety of operations that go under the name of compliance programs, but not all are created equal or operated with the same organization, thoroughness and integration into the fabric of the entity involved. The more comprehensive and professional an entity's compliance operations, the greater a buyer's confidence can be that it will not get any material fraud and abuse surprises following closing. Moreover, the buyer's comfort level can benefit sellers in the form of higher purchase prices or less onerous indemnity or escrow provisions.

There are a variety of ways that M&A participants can handle predecessor or successor liability issues, ranging from leaving all liabilities with the seller to transferring all liabilities to the buyer and various forms of indemnities and escrow to implement the intended allocation of risk. There is no standard answer to how such liabilities should be treated in transactions. The approach typically depends on unrelated issues, such as who or what kind of buyers and sellers are involved, whether selling entities will continue to exist or have assets to meet indemnity obligations, the relative bargaining power of the parties involved and other variables. In any case, it is important to address the allocation of these contingent fraud and abuse liabilities as clearly as possible in the transactional documents and to make sure the parties understand this allocation in their negotiations.

Gaining scale and broadening scope may be necessary for some as healthcare moves from facility- and acute-care-focused models to broader population health and chronic-care models. What's your take on this broad trend?

We've been seeing healthcare companies looking to do exactly what you're talking about – expand the scope of their services into areas that might be closely related to their historical core business, but not something they have previously had much experience with. Managed-care companies are looking to acquire physician practice-management companies, and insurance companies are looking to invest in point-of-service healthcare businesses, such as pharmacies and clinics. Some of this is driven by an old-fashioned desire to reduce expenses by having more control over suppliers, and some of it is companies trying to hedge their bets in anticipation of new value-based or bundled-payment models or other holistic payment approaches. The impact for M&A and restructuring is that it puts a premium on working with financial and legal advisors who are familiar with a variety of health-industry sectors. A company that is broadening its scope beyond its historical business may not have substantial in-house expertise or

experience in the new area and will need guidance from specialists to avoid potential potholes or mistaken assumptions.

There seems to be a crisis brewing in unpaid medical bills. How serious is this?

The administration's efforts to chip away at the ACA – such as expanding the discretion of states to implement work requirements for Medicaid, reducing the amount of government outreach to get people to sign up for health insurance, and eliminating the individual mandate – seem likely to reduce the number of individuals who have health insurance. This generally means there will be fewer paying patients getting care at hospitals than there would otherwise be, and more people who need care will not have insurance to help them pay for it. The growth of high-deductible plans and bigger co-payments is also likely to increase the amount of unpaid medical bills for providers. The ACA systemically reduced disproportionate share hospital (DSH) payments for uncompensated care under the theory that as more people were insured, there would be less uncompensated care. Both the inconsistent expansion of Medicaid and these recent pressures are likely to drive uncompensated care levels back up without a corresponding increase in DSH payments (lacking a statutory change). While our clients are clearly experiencing increasing levels of unpaid deductibles and other cost-sharing amounts, it is not clear to us yet that it is a full-blown crisis.

Healthcare continues to be a prime target for cyberattacks. Is this having an impact on your clients and your practices?

In some ways, the healthcare industry has lagged behind the finance industry in its awareness of cybersecurity risks, and many health industry entities have been playing catch-up as they work to harden their systems to protect against vulnerabilities. In terms of M&A, more resources are being devoted to diligence focused on technology security issues over the past few years. IT systems review is a significant diligence issue for specialists, and it is also becoming common for some purchasers to develop specific plans for allocating staff and resources to improving cybersecurity at a target company post-closing. Predictably, the costs associated with these steps sometimes affect negotiations around purchase price. Identifying gaps and managing risk going forward (and assigning risk for undetected and undiscovered data breaches that may have occurred pre-closing) is a routine negotiation for parties to health industry transactions. Once risks are identified, parties can seek to mitigate the risks through improved management and systems, investing in updates and covering the remaining risk through cybersecurity insurance policies. Whereas in the past we might see transactional documents with few, if any, reps and warranties around cybersecurity, we now see these issues more comprehensively addressed in purchase and merger agreements. ■