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HEALTH LAW
ASSOCIATION

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HEALTH CARE TRANSACTIONS

RESOURCE GUIDE

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From removing deal-breaking risks from a merger or acquisition to covering a balance sheet reserve requirement, insurance capital has become an effective tool to facilitate M&A transactions and improve deal and business outcomes. Aon knows every transaction is unique, so we deliver personalized service to our clients. We are experts of the complex and can bring certainty to your specific situation to unlock value.

More Health Systems Leveraging Representation and Warranty Insurance to Support M&A Activity

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Recent years have presented a host of unprecedented challenges for health systems across the country, including large increases in costs for labor and supplies, rising interest rates, tighter credit, difficulty recruiting and retaining providers, and regulatory uncertainty. According to Kaufmann Hall's M&A Quarterly Activity Report: Q3 2023, 39% of the health system transactions announced in Q3 2023 cited these kinds of financial challenges as drivers.

Despite the challenges, health system executives are optimistic heading into 2024 and expect to engage in significant M&A and strategic partnership transactions. According to **VMG's Health Survey of Health System Leader Expectations for 2024**, 59% of executives expect health system financial performance to improve in 2024. With the improved financial performance, 85% expect the same or more M&A activity compared with 2023. Transactions are anticipated to remain hot in all major service lines, including outpatient surgery, behavioral health, post-acute care, imaging, physician services, urgent care, hospital-at-home, and laboratory.

Trends Driving Dealmaking by Hospitals and Health Systems

Healthcare is a dynamic industry with unique characteristics that support dealmaking in the sector. Not only is spending less discretionary, leading to a counter-cyclical and recession resistant industry, the long-term tailwinds underlying healthcare demand include an aging population and an increase in the incidence of chronic diseases. Hospitals and health systems continue to be highly fragmented despite the amount of consolidation that has taken place—especially when compared to payors—supporting strategies designed to achieve geographic and revenue diversification and operational scale efficiencies; ensuring success of value and risk-based based care models; and improving positioning in the negotiation of reimbursement rates. The consolidation of providers to bend the cost curve with better patient care coordination and expand the continuum of care from the clinic to the home has also been supported by this environment. As a result, consolidation activity continues to occur across provider types, from physician practices to ancillary services, home health, hospice, and hospital networks.

There continues to be a shift from traditional fee-for-service revenue models to value and risk-based care models to decrease the cost of patient care, especially with primary and chronic care providers. The Centers for Medicare & Medicaid Services has been pushing healthcare cost containment efforts and shifting patients away from traditional fee-for-services towards these models. As a result, health systems are engaging in significant transactions involving both direct patient care and technological capabilities. Investment in healthcare information technology (HCIT) is now critical to achieve cost efficiencies, coordinate patient care, and maximize revenue. Health systems are investing in technology and data analytics companies to support these goals, driving M&A activity across the HCIT landscape, including operations management, electronic health records, and revenue cycle management.

While the strategic use of representation and warranty insurance (RWI) capital to transfer risk away from buyers is being widely used by healthcare private equity firms and strategic acquirers, adoption by health systems has been slower. The insurance market for deals involving health systems is now deeper and more robust than ever before. Insurer risk appetite to cover unknown breaches of the representations and warranties made in connection with deals in the healthcare space has significantly increased due to the insurers' need to put significant amounts of capital to work, favorable historical claims data, and improved familiarity by underwriters of issues unique to healthcare transactions.

RWI is available for plain vanilla mergers and acquisitions, as well as acquisitions of minority interests, joint ventures, affiliations/membership substitutions (protecting the capital commitment/assumed seller debt), and it provides insurance capital to backstop any seller indemnities for unknown breaches of the representations and warranties made by a seller or other counterparty (depending on deal structure). An 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. In an uninsured transaction, the seller generally agrees to place a portion of the purchase price in an escrow account, commonly for 12-18 months, to indemnify the buyer (subject to certain limitations) for breaches of such representations and warranties. RWI provides a compelling alternative whereby a buyer can purchase a RWI policy and have recourse against an insurance company in the event of a breach rather than against the individuals who—in the healthcare context—are likely providing healthcare services on behalf of the buyer, either as an employee or independent contractor. By using RWI, sellers can achieve a clean exit and buyers receive greater levels of protection than via traditional indemnification. In member-substitution and affiliation transactions (where there is no cash purchase price) and other transactions where the seller-side does not commit proceeds to an indemnity escrow, RWI can provide true recourse to buyers for any breaches discovered after closing.

Key Considerations in Healthcare Deals

Buyers of healthcare provider targets face a myriad of unique risks. The healthcare industry is highly regulated because a significant source of revenue for healthcare providers are government payor programs, such as Medicare and Medicaid. For healthcare providers to treat these patients, they must adhere to multiple regulations including compliance with healthcare fraud and abuse laws—such as the False Claims Act and Anti-Kickback Statute—as well as government billing and coding requirements. Whistleblower and *qui tam* actions are also common in the healthcare industry given the government's involvement. Violation of such requirements can subject buyers to treble (3x) damages.

In addition to the above regulatory risks, healthcare providers are exposed to cyber breaches and data privacy risks given the amount of patient data they manage; they must therefore comply with both general data privacy regulations and regulations protecting health information, such as the Health Insurance Portability and Accountability Act (HIPAA). Adding to the risk landscape, independent contractors are very common in the industry, leading to risks related to misclassification and wage and hour matters. Accounting and financial risks vary across revenue models. Risk-based arrangements are more complicated from an accounting standpoint than the standard fee-for-service model.

These unique risks are in addition to the standard risks inherent in any acquisition, such as historical financial performance and accounting, suppliers, tax, litigation, and environmental risks. The confluence of these risks makes healthcare provider transactions more challenging compared to most other industries. Dealmaking in the healthcare space requires successful risk allocation for goals to be achieved post-closing. While comprehensive due diligence can mitigate risks by uncovering known risks, the way in which unknown risks associated with acquisitions are allocated and transferred needs to be considered. Representations and warranties insurance is a common tool used to achieve successful risk transfer of unknown exposures to the insurance markets. Shifting this risk allows parties to successfully negotiate and consummate a transaction while protecting both sellers and buyers against the unknown. Though RWI is no substitute for comprehensive due diligence, it provides an additional layer of protection against unanticipated complications that could materialize later.

While a robust market exists for deals in the healthcare space, carrier interest will depend on several factors, including:

- Type of healthcare provider or service
- Percent of revenue from government payors
- Revenue model
- Size and scope of the operation, and
- Target's healthcare regulatory compliance history and infrastructure.

Specialist providers, such as ophthalmology, gastroenterology, dermatology, cardiology, and other specialty physician practices and ancillary service providers, including urgent care, surgery centers, medical imaging, labs, and physical therapy are more attractive given the focused set of healthcare services and limited set of billing codes. While still insurable, providers with a higher level of regulatory oversight, such as home health and hospice, are more challenging. Hospitals and health system targets fall on the more challenging end of the spectrum given the number of services they provide and the related difficulty in assessing such broad operations. Value and risk-based models are also more challenging given the more unique financial and accounting aspects compared to standard fee-for-service revenue models. Carrier appetite for hospital and health system targets has increased in recent years, to the point where carriers are frequently willing to provide coverage for representations related to regulatory compliance, joint ventures, data privacy, and many others. As a result, Aon has seen a sustained uptick in health system buyers exploring and utilizing RWI.

Conclusion

The underlying industry dynamics continue to support deal-making by hospitals and health systems, and the industry is positively positioned in light of its unique characteristics. A diverse buyer universe, shifting business models, a fragmented industry, and demographic tailwinds are factors underpinning this positive environment. The RWI market has proven resilient and carrier appetite for healthcare deals is expected to continue to increase. As carriers broaden their risk appetite and gain experience and expertise in underwriting healthcare transactions, RWI will continue to serve as a risk shifting and mitigation tool and improve deal outcomes.

Educating and Connecting the Health Law Community

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