Real Estate Due Diligence Considerations for Health Care Merger and Acquisition Transactions

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Introduction

Within the past few years, health care mergers and acquisitions have repeatedly hit record-breaking numbers. Mergers and acquisitions allow health providers to increase access to care, improve quality of care, increase revenues thereby helping ensure long-term viability, enter new geographic markets, and retain or even increase market share. Additionally, recent shifts to value-based reimbursements have increased the financial pressures on health care organizations, requiring them to decrease their costs and become more efficient, thereby further incentivizing consolidation. No signs point to this trend slowing down. That is not to say, however, that mergers and acquisitions are without risks. Health care organizations understand this and regularly engage in comprehensive due diligence efforts to identify and assess the risks and benefits of transactions before they are consummated. Most mergers and acquisition transactions in the healthcare context, whether hospital-to-hospital transactions, hospital-physician practice acquisitions, or other similar types of transactions, involve the consolidation of real estate, not just in terms of the physical assets themselves, but also in terms of real estate strategies, real estate policies and procedures, real estate administration, and, perhaps most importantly, real estate compliance infractions. To that end, it is critically important for health care organizations’ due diligence efforts to include, in part, a real estate review, which, at a minimum, should focus on the following: (1) Compliance Considerations; (2) Strategic Considerations; and (3) Physical Considerations.

Despite these astronomical numbers, many health systems, and especially those that are being acquired, do not allocate adequate resources to create, implement, and administer effective compliance programs. Viewed by many organizations as cost centers, many compliance departments are not adequately funded and staffed, and they are not given the necessary authority within the organization to enforce and maintain a culture of compliance. In addition, many organizations view compliance as the responsibility of only the compliance and the legal departments and not of the entire organization.

One of the areas of health systems’ compliance programs that is often overlooked and neglected involves real estate lease arrangements between health systems and physicians. Although health care fraud lawsuits that stem from real estate lease arrangements with referral sources represent a relatively small percentage of the total annual recoveries referenced above, a recent study by a health care law firm of Voluntary Self-Referral Disclosure Protocol settlement data (published by the Centers for Medicare & Medicaid Services and Provider Self-Disclosure Protocol settlement data that is published by the Office of Inspector General) revealed that in the period between 2009 and 2016, the cost of settlement of a potential violation involving a real estate arrangement was 66 percent higher than the average settlement that did not involve a real estate arrangement. The study also found that “the average settlement involving a real estate arrangement was $731,654.17 compared to the average settlement amount of $439,097.43 for matters not involving a real estate arrangement.”

Even though real estate lease arrangements with referral sources pose regulatory risks for health systems and have a tendency to increase the average settlement amount health systems have to pay, compliance considerations often have less time and resources devoted to them during the due diligence process than other business considerations. Many health systems view compliance considerations as something that can be handled down the road instead of potential “deal killers” that can lead to large fines and even exclusion from federal health care programs. Health systems that are in the process of acquiring other health systems should conduct real estate compliance risk assessments as part of their due diligence analysis to ensure that they will not be inheriting noncompliant real estate arrangements or, if they will be, to adjust the business terms of the transactions to address the compliance infractions or walk away from the deal altogether. The real estate compliance risk assessment should be

Compliance Considerations

In fiscal year 2019, the Department of Justice obtained more than $3 billion in settlements and judgments from civil cases involving fraud and false claims against the government. Of the more than $3 billion, $2.6 billion involved the health care industry, including drug and medical device manufacturers, managed care providers, hospitals, pharmacies, hospice organizations, laboratories, and physicians, and $2.1 billion arose from whistleblower lawsuits, which are filed under the qui tam provisions of the False Claims Act. The recoveries in 2019 marked the tenth consecutive year in which civil health care fraud settlements and judgments involving the Department of Justice have exceeded $2 billion. Simply put, the health care industry is in the government’s crosshairs.

In the healthcare context, whether hospital-to-hospital transactions, hospital-physician practice acquisitions, or other similar types of transactions, involve the consolidation of real estate, not just in terms of the physical assets themselves, but also in terms of real estate strategies, real estate policies and procedures, real estate administration, and, perhaps most importantly, real estate compliance infractions. To that end, it is critically important for health care organizations’ due diligence efforts to include, in part, a real estate review, which, at a minimum, should focus on the following: (1) Compliance Considerations; (2) Strategic Considerations; and (3) Physical Considerations.

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split into three major focus areas: (a) real estate compliance program assessment, (b) real estate arrangement testing, and (c) post-closing operational compliance risk assessment.

Real Estate Compliance Program Assessment

The real estate compliance risk assessment should begin with the assessment of the health system’s real estate compliance program, assuming one even exists. The due diligence review should focus on the following:

- General review of the health system’s current approach to negotiating and maintaining real estate arrangements with potential referral sources;
- Obtaining an understanding of the individuals in key roles, the various departments, the responsibility of each department, their interdependence on other departments, and the role of external partners as it relates to real estate;
- Review and assessment of the health system’s real estate policies and procedures, including, but not limited to, policies for obtaining real estate FMV valuations in support of health system’s real estate arrangements with referral sources;
- Obtaining an understanding of the real estate arrangement approval process for different types of real estate arrangements (e.g., new leases, lease renewals, leases with referral sources, leases with nonreferral sources, master leases, subleases, income leases, expense leases, timeshare leases, timeshare licenses, ground leases, real estate purchase and sale agreements, etc.);
- Review and assessment of the health system’s standard real estate contract templates;
- Review and assessment of current systems used to track real estate information and processes supporting those systems;
- Obtaining an understanding of key regulatory compliance risk areas including documentation for fair market value and commercial reasonableness opinions for real estate transactions;
- Becoming familiar with the health system’s compliance and audit functions and how they interact with real estate;
- Review and assessment of the health system’s real estate compliance training and education for its employees; and
- Becoming familiar with health system’s compliance investigations and remedial measures processes.

The primary goal for the reviewing entity should be to determine whether the entity has established a robust real estate compliance program that is designed to prevent real estate compliance violations. If no real estate compliance program exists, it is highly likely that at least some real estate arrangements from the entity that is to be acquired are in violation of the applicable regulations, which could in turn have negative financial consequences for the acquiring entity if the transaction is consummated. Careful consideration should be given to the financial contingencies that should be included in the deal if there is an increased likelihood of there being real estate compliance violations as a result of the acquired entity’s poor or non-existing real estate compliance program. Additionally, the reviewing entity should think about the efforts that will need to be undertaken to identify potential real estate compliance infractions and, if any are found, to resolve those issues after the deal is consummated.

Real Estate Arrangement Testing

After determining whether the health system that is to be acquired has a real estate compliance program and assessing its effectiveness, the next step in the review should be selecting a sample of real estate arrangements to test. Sampling criteria should be established to ensure that a cross-section of the arrangements is chosen that are illustrative of the portfolio as a whole; if the entire real estate portfolio can be reviewed in a cost-effective and timely manner, this is the best option. A variety of lease types should be sampled—income leases, expense leases, full-time leases, timeshare leases, master leases, ground leases, subleases, etc. In addition to lease arrangements, the sample should include purchase and sale real estate arrangements between the health system and referral sources as well as any joint-venture arrangements between health systems and referral sources related to the development and ownership of real estate projects. As part of the real estate arrangement testing, the following questions should be asked to assess whether any compliance concerns exist or could arise in the future:

- Do the lease arrangements and other real estate arrangements have fair market value support? If not, are there other ways to show that the terms of the arrangements are consistent with fair market value?
- Do the lease arrangements and other real estate arrangements have business justification memorandums or other types of documents illustrating that the arrangements are consistent with industry practices and are commercially reasonable?
- Do the lease arrangements and other real estate arrangements have some method for determining and documenting whether the arrangements are with referral sources?
- Have the OIG Exclusion List of Excluded Individuals and Entities (OIG LEIE) and GSA System for Award Management (SAM) searches been conducted to ensure that the contracting parties are not excluded from participating in federally funded health care programs?
- Do the lease arrangements and other real estate arrangements contain all documentation required under the other entity’s existing policies?

In addition, the reviewing entity should review and analyze payment information for the selected real estate arrangements by focusing on the following:

- Rent collection;
- Rent reconciliation;
- If appropriate, late fee charges;
- Operating expense reconciliations; and
- Enforcement actions that have been taken in the event of non-payment under the selected real estate lease arrangements.
Detailed summaries of the observations, assessments, and findings at this stage will allow the reviewing entity to assess any existing compliance concerns and determine how they should be remedied if the transaction is consummated or if the concerns present too great a risk to allow the transaction to proceed. If the real estate arrangement testing reveals compliance violations, the reviewing entity should determine whether these concerns should be remediated as a condition of consummating the transaction, whether the reviewing entity is comfortable with remediating these concerns once the transaction is consummated, or whether another course of action is warranted.

It is also important to remember that if only a sample of the acquired entity’s real estate arrangements are reviewed instead of all of the arrangements, a prudent health system would be wise to assume that a similar percentage of issues would be found in the remaining arrangements. For example, if a sample of the reviewed real estate arrangements represents 10% of the entity’s total real estate arrangements, and 25% of the arrangements in that sample have potential compliance issues, the total number of potentially affected arrangements needs to be determined by multiplying the number of affected arrangements in the sample by ten. Operating under this assumption will give the acquiring health system a better understanding of the financial implications of the potential compliance violations it could be inheriting if the deal is consummated.

**Post-Closing Operational Compliance Risk Assessment**

The final component of the compliance risk assessment should focus on gaining an understanding on the feasibility and ease of transitioning the acquired entity’s real estate practices to those of the acquiring entity. All due diligence conducted here is focused on the reviewing entity’s ability to effectively and efficiently adapt to the acquiring entity’s real estate policies and procedures to ensure future consistency across the acquiring entity’s real estate portfolio.

The first goal for the reviewing entity at this stage should be to determine the efforts that will need to be undertaken post-closing for the real estate compliance programs of the two entities to come together and operate as one. All of the aforementioned items will need to be modified to some extent. At a minimum, real estate policies and procedures will need to be changed, responsibilities of various individuals and departments may need to be shifted, and certain jobs and positions will likely need to be consolidated. All of this will result in additional costs, but the amount of those costs will depend on how similar the real estate compliance programs of the two joining entities are. Those real estate compliance programs that are similar should require less effort and cost to consolidate than those that are completely different.

Additional work and effort will be needed if the two entities have completely different approaches to real estate. For example, one health system may internalize all of its real estate functions, while the other may outsource it to third-party providers. If a decision is made to internalize the real estate functions post-closing, significant efforts and financial investment will need to be made to create an internal real estate department, including, but not limited to, hiring qualified individuals and conducting the necessary real estate compliance training as well as training on the new real estate policies and procedures.

The second goal for the reviewing entity at this stage should be to determine whether the entity that is to be acquired has and practices a culture of compliance. If an organization takes compliance seriously, the implementation of many of the items outlined above can be achieved with less effort and cost. Conversely, if an organization that is to be acquired does not take compliance seriously or, worse, has a culture of noncompliance, serious considerations should be given about whether the deal should be consummated at all. Not only will it be more difficult and costly to implement many of the items outlined above, but the culture of noncompliance could inadvertently infect the acquiring organization as well.

All of these factors should be taken into account when conducting the real estate compliance risk assessment. Only after it has been determined that there are no compliance concerns that will derail the transaction, or once it has been determined how the identified compliance concerns will be addressed, should the acquiring entity proceed to performing real estate due diligence related to strategic and physical considerations.

**Strategic Considerations**

Although it is easy to get bogged down in the details while performing real estate due diligence activities, it is imperative for health systems to remember the strategic objectives of the transaction and real estate’s role in achieving those objectives. Viewing real estate as simply a place to put more patients and doctors vastly undervalues its importance and forecloses the strategic advantages that real estate can provide to health systems. An effective real estate strategy can help eliminate costs and create value at a time of increased financial pressures that result from the numerous and constant changes that occur in the industry. When a real estate strategy works to further a health system’s core organizational and clinical missions, the strategy can reduce costs, create value, increase efficiencies, and, most importantly, create a better patient experience. To that end, for those transactions involving, in part, the acquisition of real estate, the role of the real estate to be acquired in achieving the objectives behind the transaction should always remain top of mind.

The first step in the real estate due diligence process as it relates to strategic considerations is for the acquiring entity to create a summary of the real estate portfolio, both owned and leased, that is to be acquired. The real estate portfolio summary should include the following property information:

- Property Name
- Tax Parcel
- Address
- Acreage
- Square Footage
- Year Built
- Parking
- Owned vs. Lease Considerations
- Fee Owner
- Fee Owner Affiliations (if available)
• Lease Abstracts of Material Terms (if applicable)
• General Property Description / Class
• Current Vacancy Rates in Owned Buildings
• Lease Expirations
• Rent Rolls for Owned Buildings
• Costs of Ownership
• Property Use / Tenant Mix
• Aerials and Parcel Maps
• Photographs of facilities
• Demographic Reports for the Market

Once the real estate portfolio summary has been developed, entities should conduct a portfolio analysis to determine whether the real estate that will be acquired as part of the transaction will meet the strategic objectives of the transaction. Specifically, the analysis should be guided, in part, by the following questions:

• Will the real estate allow the entity to expand its service offerings?
• Will the additional real estate help satisfy the demand for increased space for a growing service offering?
• Will the real estate allow the acquiring entity to offer services in desired geographic areas?
• Can the acquired real estate be sold to generate capital to reinvest into the organization?
• Will the real estate compliment other strategic objectives behind the transaction?

If the aforementioned questions are answered in the affirmative, the acquiring entity can focus its portfolio analysis more specifically on the buildings that are to be acquired. One of the key parts of the due diligence surrounding the strategic considerations phase should be title review. The goal during a title review should be to determine first whether there are any issues with title currently and secondly whether there are any restrictions on title that could impede the long-term strategic goals for the real estate to be acquired in the transaction. The reviewing entity should assess whether there are any restrictions on title that could impede the transaction, certain acquired buildings will serve duplicative functions to those that are already part of its portfolio, it should determine whether those buildings can be repurposed or whether they can be sold. The acquiring entity should also examine the vacancy rates, the rent rolls, and operating expenses in the buildings to determine their profitability. Buildings with high vacancy rates, high outstanding receivables, or high operating costs could potentially be excluded from the deal, sold after the transaction is consummated, or improved in their operations following the transaction.

An effective real estate strategy that aligns with a health system’s overall strategy can be a market differentiator within the competitive health care landscape. To that end, a health system’s decision to merge with another health system is presumably motivated, in part, by the real estate aspects of the transaction. Therefore, when conducting real estate due diligence, it is important to check and confirm that the acquired real estate will in fact help the acquiring health system achieve the desired objectives and, if not, to create a plan of action on how to deal with real estate that fails to achieve those objectives before or after the transaction is consummated.

Physical Considerations

The final aspect of the real estate due diligence should focus on the physical considerations of the buildings that are to be acquired, which will ultimately have a financial impact on the transaction. The acquiring entity should perform environmental and facility condition assessments for the properties to be acquired, which should generally consist of the following activities:

• Conduct walk-throughs/site inspections of all hospital facilities, office buildings, residential buildings and parking facilities.
• Photograph existing conditions.
• Meet with facility staff to discuss known building conditions.
• Conduct a limited review of maintenance records to determine type and scope of routine and unforeseen maintenance work.
• Review all mechanical, electrical, plumbing (MEP) engineering systems and determine whether a more in-depth study of those systems is necessary.
• Review The Joint Commission’s Statement of Conditions and determine status of outstanding issues, if any.
• For each building, review existing conditions of:
  » Roof
  » Interiors
  » Structure
  » MEP systems and mechanical rooms
  » Elevators
  » Parking Lots / Structures
• Review of budgeted capital repairs and improvements for next fiscal year.
• Develop order of magnitude pricing for deferred maintenance items, if any.
• Develop order of magnitude pricing for significant capital improvement items, if any.
• Prepare a final comprehensive report detailing findings and recommendations.
• Conduct environmental site assessments.\(^\text{9}\)

The facility site condition assessments should help the acquiring entity project future financial costs that will be incurred in connection with the acquired buildings. The acquiring entity will then need to determine whether the need to acquire the buildings is outweighed by the cost to improve the buildings to a certain standard. If not, an adjustment will need to be made to the ultimate price of the transaction because of the investment that will still need to be devoted to improving the real estate being acquired. Rough plans should be created at this stage to address any of these necessary repairs and/or updates and factor their costs into the overall strategy for the transaction.

**Conclusion**

For those mergers and acquisition transactions that involve, in part, the acquisition of real estate, it is critically important for health care organizations’ due diligence efforts to include, in part, a real estate review. Although compliance is often not a major component of a real estate due diligence analysis, it should be because compliance violations could have significant financial impacts on the acquiring organization, not just in terms of compliance infractions that may be inherited but also in terms of future compliance infractions that could arise if the acquired entity has difficulties transitioning to the real estate policies and procedures of the acquiring organizations. Similarly, strategic and physical considerations should also be carefully analyzed because even if they are not necessarily deal-breakers for the transaction, they can impact the ultimate purchase price for the transaction. As mergers and acquisitions continue to occur in the health care industry, prudent health care organizations would be wise to invest time, money, and energy into conducting comprehensive due diligence reviews, as failure to do may very well result in a “penny wise and pound foolish” scenario following the consummation of the transaction.
HEALTHCARE REAL ESTATE TRANSACTIONS HAVE COMPLEX CHALLENGES. WE DELIVER SMART SOLUTIONS.

Since 1998, we have helped health systems save money, manage risks, and enhance delivery of care by implementing innovative and compliant healthcare real estate strategies.

Many of our clients find it an ongoing challenge to balance the tactical nature of healthcare real estate transactions, or the "how", with the overall strategy set by the client, or the "why" a transaction should be considered. Each of these elements must be addressed, while also balancing healthcare compliance considerations. We believe careful, precise management of transactions can align existing real estate assets and future real estate investments with the crucial strategic, operational, and financial goals of the organization.

RTG acts as an extension of healthcare leadership teams and their counsel and provides a full spectrum of healthcare real estate transaction support services. From evaluating the structure for a new transaction, conducting a feasibility analysis, or helping with real estate due diligence efforts, our team has you covered.

Leveraging our deep healthcare experience, we have the right team of experienced healthcare real estate advisors to assist with these physical, legal and financial aspects of the due diligence processes, helping you mitigate risk and close a successful transaction. We provide highly experienced, independent, and objective representation for transactions related to acquisition or disposition of properties, and landlord and tenant representation. After all, your healthcare real estate should be a strategic asset, not just a cost of doing business.

HOW WE HELP YOU

RTG's Healthcare Transaction Services Include, But Are Not Limited To:

- **Real Estate Due Diligence**
  - Feasibility Analysis
  - Zoning/Entitlement
  - Compliance, Financial, and Physical Due Diligence

- **Landlord Representation**
  - Transaction Management
  - Financial Analysis
  - Compliance Oversight

- **Tenant Representation**
  - Site Selection
  - Financial Analysis
  - Lease Negotiation

- **Acquisition/Disposition**
  - Land / Building Transactions
  - Investment Sales