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Healthcare M&A

Mitigating Enforcement Risk and Closing the Deal

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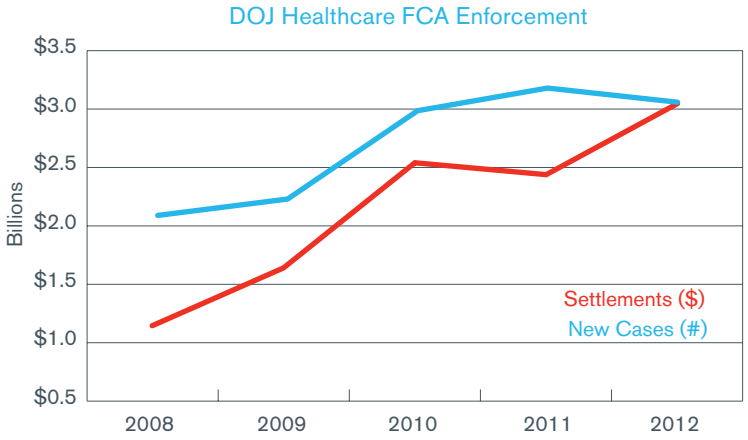
Introduction

Compliance, litigation, and regulatory enforcement are unpopular topics that elicit a coordinated groan from buyers and sellers alike in healthcare M&A. These issues add unwanted hair to a deal that may otherwise generate significant returns. In the healthcare market, these risks are all too real. Department of Justice (DOJ) healthcare enforcement has increased by 50%, with settlement amounts increasing by 172% over the past five years.[1] While the winds aren't changing anytime soon, there is a brighter side: middle-market healthcare M&A has seen a dramatic increase in deal flow despite these additional risks. "Notwithstanding the recent plateau, middle-market healthcare M&A activity has grown dramatically in the past five years with the number of transactions growing by 54%, and the dollar volume of transactions increasing by 66%," reports Jim Hesburgh, Head of Healthcare M&A at Duff & Phelps. This article will highlight the best practices to mitigate the risks of enforcement, close the deal, and reduce overall litigation costs in Healthcare M&A.



1. "Fraud Statistics – Health and Human Services," U.S. Department of Justice, October 2012.

A Common Approach

We have witnessed a common approach to litigation and regulatory risk in healthcare M&A transactions. At a high-level, the approach first involves a thorough due diligence to identify potential risks. Second, a preliminary analysis is conducted to quantify the risks identified. This approach typically yields two results:

- Negotiations ensue and additional discounts or indemnification are required to consummate the deal, with the assumption post-deal disputes are inevitable; or
- Negotiations fail and the deal is scuttled due to uncertainty or significance of the risks.

Given this framework, we find that many deals are cancelled prematurely or discounts and indemnifications may not be accurate or appropriate. This outcome often results when discounts are quantified by due diligence professionals unfamiliar with the complexities of the healthcare enforcement environment. As a result, parties may make investment decisions using inaccurate or incomplete information.

The Preferred Approach

A third and more favorable outcome occurs when incorporating litigation attorneys and dispute professionals in the preliminary stages of due diligence. Dispute professionals, such as fraud experts and forensic accountants commonly have enforcement experience with DOJ, FBI, and HHS and provide a wealth of technical enforcement expertise. Although due diligence professionals are adept at detecting and exposing risk factors, litigation and dispute professionals can address those factors using a deep understanding of the techniques for mitigating enforcement risk. When paired together, these professionals provide an in-depth knowledge of the true risks and opportunities offered by each deal.

Case Study

This case study is based on a recent deal in which we were involved with a leading healthcare services provider. Several details have been altered to maintain confidentiality. The deal, valued at approximately $300 million, lies in the middle-market sweet spot where we observe a growing number of deals involving clinic networks and provider practices. In the weeks prior to closing, a False Claims Act (FCA) suit was unsealed by the Government, alleging a variety of ongoing Medicare billing fraud resulting in over $30 million of allegedly false claims. While litigation is not an uncommon M&A consideration, the unique nature of the FCA statute dramatically increases its impact on healthcare M&A. In addition to treble (3x) damages, the FCA also contains a qui-tam or whistleblower provision which greatly increases the appeal of lawsuits by sharing up to 30% of recoveries with whistleblowers.

With $90 million of value at risk, walking away may certainly have seemed prudent. However, the seller recognized the unique workings of risk in the healthcare market and confronted the issue directly. The seller worked with outside counsel to involve the law firm's healthcare litigation team and retained a dispute expert specializing in healthcare billing fraud and forensic accounting. Among the goals of this team was to efficiently and expeditiously answer several questions:

- Does the suit have merit?
- Does the suit pose additional risk? (derivative suits, future obligations, etc.)
- What are the potential outcomes? (settlement, litigation, etc.)
- What is the true financial exposure of these allegations?

In just a few days, the team of litigation and dispute professionals was able to narrow the allegations in the suit and quantify a variety of likely outcomes. In short, the risk was estimated to be in the range of $1 - $5 million. More importantly, the experts were able to articulate their analysis to both buy-side advisors and Government representatives, resulting in a clear understanding of the issues by all parties, with a minimal expenditure of time and resources. Despite the untimely exposure of enforcement risk, the deal closed smoothly with no significant discounts.

Healthcare M&A Risks

While the case study highlights the False Claims Act, which has gained increasing notoriety recently, it is also worthwhile to discuss the larger landscape of risks in the healthcare market. A heightened focus on fraud and abuse make healthcare transactions a particularly risk-prone endeavor. Below is a sampling of healthcare regulations that may pose unique risks for M&A transactions:

- False Claims Act; Involves false claims to the government (Medicare, Medicaid, etc). Statutes include whistleblower provisions;
- Anti-Kickback Act; Involves any form of remuneration (consulting fees, research agreements, etc.);
- Stark Law; Limits physician referrals to facilities in which they or their family have a financial interest;
- Health Insurance Portability and Accountability Act (HIPAA); Involves privacy and security of individual health records;
- Recent Regulatory Amendments; Amendments to statutes noted above;
  - > Patient Protection and Affordable Care Act (PPACA)
  - > Fraud Enforcement and Recovery Act (FERA)
- Industry Codes of Conduct; AdvaMed, PhRMA, etc.

Although not a comprehensive listing, it is clear that healthcare M&A presents a vast landscape of distinct risks. More importantly, exposure to these risks is rapidly increasing. In fiscal year 2012, DOJ opened 1,131 new criminal health care fraud investigations involving 2,148 potential defendants. The department also opened 885 new civil investigations.[2]

Best Practices

Aggressively confronting the risks of healthcare enforcement allows boards and advisors to manage risk and maximize returns. We have seen a variety of best practices to confront such risks. Foremost, include a rigorous regulatory review during the initial stages of due diligence. This should include a focused review of healthcare enforcement risks to ensure identification as soon as possible. If your due diligence team does not possess expertise in this unique area, identify and involve an industry expert who does.

Accordingly, ensure your advisor maintains a strong network of healthcare industry experts including litigators, fraud experts, and forensic accountants. These experts should have significant expertise in the healthcare industry, along with a working knowledge of the regulatory bodies leading the enforcement (DOJ, FBI, HHS). These relationships are significant, and it is best to establish them before being faced with a healthcare dispute.

For example, at Duff & Phelps, our Investment Banking, Due Diligence, and Dispute Consulting practices work together in our Integrated Healthcare Group. This unique group greatly increases our ability to understand and mitigate healthcare enforcement risks.

For too long, acquirers have shied away from the risks of litigation and enforcement in favor of a cleaner deal or dramatic discounts. Participating in today's active healthcare M&A market requires boards and advisors to shed that mentality and embrace the reality of litigation risk. Companies and M&A professionals choosing to avoid these risks will increasingly exclude themselves from the growing healthcare market. Instead, we propose that these risks can often be mitigated by involving experts who regularly deal in these matters: litigation and dispute professionals.

2. "Annual Report for Fiscal Year 2012," The Department of Health and Human Services and The Department of Justice Health Care Fraud and Abuse Control Program, February 2013.

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As a leading global financial advisory and investment banking firm, Duff & Phelps leverages analytical skills, market expertise and independence to help clients make sound decisions. The firm advises clients in the areas of valuation, M&A and transactions, restructuring, alternative assets, disputes and taxation – with more than 1,000 employees serving clients from offices in North America, Europe and Asia. For more information, visit www.duffandphelps.com.

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