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In it Together: Emerging Joint Venture Structures for Hospitals and Insurers

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Following the passage of the Affordable Care Act (the ACA), hospitals and physician practice groups, on the one hand, and health insurance and managed care companies, on the other hand, increasingly have focused on lowering health care delivery costs and better aligning their respective interests. These discussions have included, among other things, strategies for sharing profits (and downside risk) related to the utilization of health care services and improving quality of care and patient outcomes through better clinical integration and coordination.

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Two of the most recent innovative risk sharing arrangements involve joint ventures between health care providers and insurers. These arrangements may be referred to as contractual joint ventures and legal entity joint ventures. Although employing different contractual structures, both arrangements provide effective methods for sharing profits and losses and increasing coordination of care through the creation of new, branded health plan products and services that can be offered to the public at below-market insurance premium rates.

What Drives These Joint Ventures?

These types of ventures are most attractive to larger hospital systems (including their controlled or affiliated physician networks) with a significant share of a regional market (''hospitals'') and strong national or regional health insurance and managed care companies (''insurers'') that wish to quickly and significantly grow membership in competitive regional markets. For the insurer, these arrangements provide an opportunity to partner with a hospital possessing strong market share and name recognition. For the hospital, they provide an opportunity to diversify and significantly increase their revenue by sharing in the insurance profits generated from the joint venture health plan products (JV products) sold in the geographic area covered by the venture (the ''territory'').

Constructing the Joint Venture Products

The goal of each of these joint ventures is the creation of new JV products that can drive growth in membership and increased utilization of the hospital through competitive pricing and well-coordinated care. To achieve this goal, the hospital and (often) its controlled or affiliated physician network agree to provide

significantly reduced medical reimbursement rates (particularly in the commercial market and to a lesser extent in the Medicare Advantage market) for health care services used by the joint venture's health plan membership. Combined with the hospital's name recognition in the territory, the hospital's controlled or affiliated physician network and the insurer's national network (used for out-of-area services covered by the JV products), the competitively priced JV products can drive membership growth that would be difficult to replicate organically. For its part, an insurer might agree to contribute its existing membership in the territory to the joint venture by renewing customers onto the JV products (subject, perhaps, to certain exceptions including with respect to national group accounts) and to provide all of the joint venture's health plan administration services, IT systems, personnel, sales functions and other services at a competitive profit margin or at cost.

If created successfully, the pricing and marketing advantages of the JV products should significantly help drive customers to the JV products. Because profits and losses are shared by the hospital and the insurer under the joint venture structure, the impact of this membership growth and the benefits of improved care coordination will flow to both parties. In the end, this alignment of interests between insurer and hospital offers the possibility of transforming the relationship between insurers and hospitals from the typical, and sometimes acrimonious, vendor/vendee and/or fee-for-service relationship into a relationship of partners delivering efficient, high quality and profitable care to patients.

How are these Joint Ventures Structured?

Although each joint venture is unique, relationships of this type typically are structured in one of two ways. The first, the contractual joint venture , relies only on a contractual relationship between the parties. The second, the legal entity joint venture, involves the creation of a new risk bearing entity (either an insurance company, an HMO or both) that will be owned and controlled jointly by the parties and will issue the JV products. Each structure has benefits and some drawbacks.

Contractual Joint Ventures

In a contractual joint venture, no new legal entity is organized or otherwise owned jointly by the insurer and hospital. Rather, the joint venture is created solely by contract. Profits and losses are shared between the insurer and hospital through reinsurance transactions, typically between the insurer, as the entity writing and issuing the JV products, and a captive insurer or other authorized risk-bearing entity of the hospital, which reinsures a percentage of the risk of the JV products in return for a similar percentage of the premiums for the JV products. Many hospitals already own captive insurers that can be used for assuming such reinsurance, subject to regulatory approval. Alternatively, captive insurers and other authorized risk-bearing entities can be organized relatively quickly by the hospital.

The reinsurance percentage that the hospital will assume can vary depending upon, among other things, product line, geography and each party's respective contributions to the joint venture. The ability to easily adjust the reinsurance percentages provides flexibility to the parties' ability to fairly share in the profits of the contractual joint venture.

In addition to the reinsurance agreements, which may be subject to insurance regulatory approval, the parties will enter into an alliance or relationship agreement that will set forth, among other things:

- the nature, scope and objectives of the joint venture;
- the parties' respective support and contribution to the joint venture;
- the reduced medical reimbursement rates for health care services to be provided to the joint venture membership by the hospital and its controlled or affiliated physician network and access to the hospital and physician networks;
- governance and dispute resolution mechanisms;
- exclusivity and noncompetition obligations; and
- the term and termination of the joint venture, including run-off obligations for the JV products.

The parties likely will enter into a new, or modify an existing, network access agreement providing the insurer access to the hospital and its controlled or affiliated physician network at the agreed upon reduced medical reimbursement rates.

The contractual joint venture has been used effectively by certain insurers for purposes of participating in state procurement opportunities, particularly with respect to dual eligible populations. For example, using the contractual joint venture structure, an insurer can partner with a health-care services provider (usually a hospital system) that may have expertise in a particular health-care service or services required by the state procurement opportunity. Partnering under the contractual joint venture allows the parties to submit a stronger and more targeted bid for such state procurement opportunities and to share profits and losses generated thereunder through reinsurance. The combination of an insurer's strong reputation in the industry and administrative expertise and a strong provider's unique health care delivery capabilities and regional penetration create a more compelling bid than either party could submit individually.

Legal Entity Joint Ventures

In a legal entity joint venture, the insurer and hospital either organize a new insurer and/or managed care company or acquire an insurer and/or managed care company (usually as a so-called shell company) (collectively, the new JV insurer) to be owned and controlled jointly by the insurer and hospital. Profits and losses are shared between the insurer and hospital through their respective ownership interest in the new JV insurer rather than through reinsurance relationships.

The alliance or relationship agreement in a legal entity joint venture will have many of the same provisions summarized above that are included in a contractual joint venture agreement, but also will contain:

- the obligations of the parties with respect to organizing and licensing a new JV insurer (or acquiring an existing new JV insurer);
- the obligation to meet initial and on-going capital requirements;
- the allocation of responsibility for the administration of the new JV insurer;

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- the selection of the chief executive officer of the new JV insurer;
- the branding of the new JV insurer and JV products;
- sales channels of the JV products and the obligation of the parties to exclusively offer JV products in the territory;
- if needed, the temporary use of reinsurance (similar to a contractual joint venture), until such time that the new JV insurer is licensed, and has the policy forms and rates on file, to write the JV products directly in the territory.

Similar to a contractual joint venture, the insurer's and hospital's respective ownership interests in the new JV insurer can vary based on the value of each parties' contribution and other factors. For example, adjustments to the respective parties' ownership interests in the new JV insurer can be triggered by reaching certain performance targets or failing to contribute additional capital. Furthermore, an insurer's contribution of initial capital to the new JV insurer also can include (in addition to cash) the agreed upon value of existing membership of the insurer in the territory which is successfully renewed onto the JV products.

Like the contractual joint venture, the legal entity joint venture will require a network access agreement. In addition, administrative services agreements will be needed between the joint venture parties and the new JV insurer to provide administration services on behalf of the new JV insurer. The legal entity joint venture also will require a shareholder or similar agreement that will cover governance and deadlock resolution procedures. Most importantly, because terminating a legal entity joint venture is not as simple as terminating reinsurance agreements, one of the most negotiated provisions in a legal entity joint venture covers the termination of the parties' joint venture relationship and the disposition of each party's respective ownership interests in the new JV insurer.

Hybrid Joint Ventures

A hybrid model of these two structures also can be used. Indeed, we recommend considering at the outset a two-step relationship, with the parties first entering into the contractual joint venture, and if certain agreed upon targets are met (i.e., a minimum number of members covered, or premiums earned, under the JV products by a certain date), the parties then will enter into the legal entity joint venture. The benefit of this hybrid model is that the parties have the opportunity to gauge whether or not the joint venture can be successful before embarking on a more permanent relationship with its accompanying incremental costs, expenses and capital obligations.

What are the Advantages and Disadvantages of the Different Structures?

Contractual Joint Ventures

The primary benefit of a contractual joint venture is speed to market, assuming each party has the existing authority to write (and reinsure) the JV products. Because no new or existing legal entity will be owned jointly by the parties and because the insurer may be able to use existing licenses and approved policy forms and rates, fewer regulatory approvals usually are required. Other advantages include the absence of initial or ongoing capital requirements and the relative ease with which the venture can be terminated.

On the other hand, in a contractual joint venture there is no entity that can increase in value over time, and it is more likely that the parties will perceive it as a short-term relationship. Also, reinsurance may be unfamiliar to a hospital, making it more difficult for a hospital to evaluate the business case for the relationship. This difficulty may be accentuated where a hospital does not have a captive insurer or other authorized risk-bearing entity.

Legal Entity Joint Ventures

A legal entity joint venture, as compared to a contractual joint venture, entails significantly greater regulatory approvals, costs and expenses, and generally takes longer to bring to market. However, compared to the contractual joint venture, a legal entity joint venture may be perceived as a longer-term relationship by the insurers and hospitals and, due to the independently branded profile of the new JV insurer, can be a more powerful vehicle to increase market share in the territory. The ability of the new JV insurer to increase in value also can be a significant benefit.

On the other hand, there are certain distinct disadvantages to a legal entity joint venture. Most obviously, the regulatory approvals necessary to launch such a venture increase both the organizational costs and the time to market. Owning a risk-bearing entity also brings with it the obligation to capitalize the entity (and maintain capital going forward) and can make it substantially more difficult to terminate and unwind than a contractual joint venture.

Other Important Factors to Consider

Trust

As with any joint venture, trust between the parties is the foundation for a successful and long-term partnership. Coming from opposite sides of the traditional fee-for-service model, hospitals and insurers often have an adversarial relationship, particularly in connection with their provider contracting negotiations. Each business team needs to cultivate and earn the other's trust early on. The parties should approach the discussions as an opportunity to become partners, rather than simply parties to a services agreement. In addition, because the joint venture structures are significantly more sophisticated than traditional capitation and similar risk sharing arrangements, it is critical that the parties carefully discuss and explore the various joint venture structures and mutually decide which one is optimal for their shared goals.

To avoid conflict later in the process, candid discussions of all material aspects of the proposed joint venture should take place between the parties at the outset. It may be helpful if this discussion leads to a detailed term sheet so that the more material terms are already vetted and agreed to before negotiating the definitive agreements. Not doing so can cause significant delays and angst during the middle of the negotiations and increase the potential that the joint venture relationship may not move forward.

Other Legal Issues

In addition to applicable insurance laws, the parties also should consider the following legal issues in selecting the optimal joint venture structure:

- *Tax consequences of the joint venture.* In particular, where the hospital is a nonprofit charitable organization, each party will want to carefully analyze the joint venture to make sure that no element of the arrangement will imperil the nonprofit and federal tax-exempt status of the hospital. Contractual protections can be built into the joint venture agreements to mitigate this risk and to provide paths to resolution where possible, particularly in the event of changed circumstances in connection with the venture;
- *Applicable antitrust laws.* As with any venture involving parties that may be in a competitive position with one another (and where one party may have significant geographic market share), joint ventures between hospitals and insurers may raise antitrust and competition issues that need to be reviewed by legal counsel;
- *Prohibited physician referral laws.* In the event that the hospital's controlled or affiliated physician network is part of the joint venture, the parties will need to carefully review the federal and any applicable state physician self referral laws including the federal Stark law to confirm that the structure and contractual arrangements do not implicate these laws or if these laws are implicated, to structure the venture in compliance with an applicable exception;
- *Anti-kickback laws.* If the joint venture will include a Medicare Advantage health plan or other federal health care program, the parties should carefully review the arrangements and any referrals between the parties and other providers including physicians to determine whether the federal anti-kickback law will be implicated by the venture. In addition, many states have payer anti-kickback laws that will need to be reviewed, if applicable. If the analysis identifies risk under such laws, the parties should carefully evaluate the risk and structure the venture to comply with a safe harbor to the extent necessary and appropriate or to otherwise minimize such risks;
- *Privacy laws.* In any such joint venture, the parties generally will desire and have a need to share protected health information for a number of reasons, including treatment, payment and health-care operations purposes, such as for population health. The sharing of protected health information requires compliance with the federal Health Insurance Portability and Accountability Act (HIPAA) Privacy and Security regulations and with applicable state laws, given that the joint venture and both parties are likely to be covered entities under HIPAA. The parties should consider how they will be sharing health information and for what purposes, and then will need to conduct an analysis of whether and to the extent to which protected health information can be shared under these laws and what protections or authorizations are required, if any;
- *Other contractual obligations of the Hospital.* The hospital and its controlled or affiliated physician network will have existing contractual relationships with other insurers covering medical reimbursement rates and, in certain cases, capitation arrangements (e.g., global capitation arrangements). The hospital should carefully review these contracts to determine if any of those existing arrangements will compete with the joint venture or restrict the hospital from delivering the agreed upon reduced medical reimbursement rates for health care services to be provided to the joint venture membership; and
- *Narrow networks.* Another area of growing concern that should be considered relates to proposals by the federal government, the National Association of Insurance Commissioners and certain states (such as California and Oregon) to strengthen regulations regarding the adequacy of insurers' networks, including narrow networks. Such proposals could have a significant impact on the hospital-controlled or affiliated physician networks utilized by these joint ventures.

Examples of Joint Ventures[1]

The following is a nonexhaustive list of recent, publicly announced joint venture transactions and other arrangements between health care services providers and insurers that appear from public sources to incorporate features of the transactions described in this paper:

- Anthem Blue Cross and several hospital systems (including UCLA Health and Cedars-Sinai) forming Vivity, an integrated health plan in Southern California;
- Florida Hospital Healthcare System and Health First Health Plans forming a commercial health plan in central Florida;
- Aetna and Inova Health System Foundation forming Innovation Health, a stand-alone health plan serving Virginia; and
- DaVita Health Partners and Independence Blue Cross forming Tandigm Health, a primary care delivery platform in the Philadelphia region.

Conclusion

As the health care industry continues to evolve, health care services providers and insurers will be challenged by the need to deliver health care services more efficiently while at the same time improving the quality of care. We believe the joint venture structures described above provide participants with a strong platform to build lasting and profitable partnerships in a challenging environment.

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[1] Disclosure: Locke Lord LLP has represented parties in certain of these transactions.

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