# Health Care Real Estate Litigation: RIDEA and Securities Risk

By Clare McCarrick

## Is your health care real estate company at risk for securities litigation? Will your directors and officers policy offer protection in the event of a claim?

Securities class action suits have been filed at a historic pace throughout 2017. Organizations and their directors and officers face increased financial and reputational risk as this record rate of litigation develops, which not only exposes the assets of the entity, but also – more alarmingly – amplifies the personal liability of the management team. If the year-end total of class action filings reaches the projected 450, Cornerstone Research predicts that one in 11 companies listed on a major U.S exchange will be the subject of a class action. These suits, aside from the tremendous financial burden they present in an environment of unprecedented defense costs, serve as a major distraction for management teams and deploy resources that could be better used elsewhere.

Industry classes previously less prone to class action filings are no longer immune. The increased filings have affected all major industries – from financial institutions to media to health care companies. Equity REITs, in particular, saw few filings over the past few decades until 2016 when securities litigation against REITs were filed in multiples of the average year. While each filing was unique, a growing trend in shareholder litigation was action against health care-specific REITs, specifically those that employed the RIDEA structure. This niche industry sub-sector has heightened exposure to securities litigation due to regulatory attention. Companies should ensure that they have critical protection provided by directors and officers liability (D&O) insurance.

## How are health care REITs structured?

Since the establishment of the health care real estate investment trust business model, health care REITs (Real Estate Investment Trusts) have been able to deliver outsized shareholder returns based on a straightforward business model: buy quality health care properties in good locations and form cohesive partnerships with the top operators.

Serving as landlords to the medical world, health care REITs combine the investment opportunities of both real estate and health care. The variety of investment possibilities ranges from hospitals to medical office buildings to senior housing.

Senior housing has been an enormous driver of growth – many health care REITs have substantial stakes in senior housing. With the impending retirement of baby boomers providing a new generation of medical real estate needs, REITs are capitalizing on senior housing and skilled nursing opportunities.

Senior housing leases are generally structured two ways. The traditional structure was a triple-net-lease arrangement, where the REIT owned the building and the tenants paid leases, taxes and upkeep. Alternately, REITs can employ a RIDEA structure. The RIDEA structure poses specific executive risks for health care REIT executives, as outlined below.

**RIDEA: acronym for the REIT Investment Diversification and Empowerment Act, enacted in 2007 to reform how REITs accounted for health care real estate income. The RIDEA act allows legal structure of taxable REIT subsidiaries (TRS), with an in-place lease between the landlord and tenant entities so that REITs can participate in the net operating income, as long as there is an involved third-party manager. Previously, health care real estate investments had to be structured as traditional leases.**

## What are some of the biggest D&O exposures presented by the RIDEA structure?

### *1. Operational (financial performance) risk*

Under a traditional landlord/tenant triple net lease agreement, the operational risk is assumed by the tenant — the third-party company that manages the senior living community on behalf of the REIT landlord. The only risk that the landlord (REIT) takes on is for payment default

The RIDEA structure permits the REIT to participate in the upside, allowing the opportunity capture of increased annual income growth as operations improve. It opens the door to broader investment opportunities, where REITs underwriter shifts in operations and income as opposed to merely the credit risk of the tenant and the standard 2 – 3% annual escalations. Under the structure, REITs can benefit from not only market rent increases, but things like increased occupancy and operational efficiencies. The tenant/operator benefits from this structure because they are not assuming the long-term operational liability, instead collecting management fees that often include incentives for excellent performance.

Conversely, the non-stable assets investment also presents a downside risk along with the upside opportunity. Decreased operational performance and declining occupancy could result in decreased income — there is no credit guaranteed rent. The REIT's FFO and GAAP measures could be heavily impacted by a partnership with an operator with performance issues. Poor financial performance and associated poor stock performance are key drivers in securities litigation.

### *2. Legal (regulatory) risk*

Under a RIDEA structure, the REIT assumes additional potential legal liability by participating in the operations. Lawsuits, regardless of substance materiality, generally name the REIT along with the management company. This increased litigation frequency simultaneously has a negative financial impact as defense costs rise and serves as a distraction for the legal team and named executives.

The uncertain regulatory environment surrounding health care under the current administration contributes to increased regulatory and legal risk for the management teams and landlords. Changes in government regulation combined adjustments to the Department of Justice agenda can seriously affect the legal risk exposure of health care properties. One of the best examples of this is the detrimental impact on skilled nursing facilities from strategic enforcement of the False Claims Act.

**False Claims Act: Effected in 1863 and sometimes called the Lincoln law, the FCA is a U.S. federal law that imposes liability on individuals and companies that defraud governmental programs. While its application has evolved, this law is the primary federal litigation tool for governmental fraud.**

**In 2010, the *Affordable Care Act* made four amendments to the FCA — the most relevant redefines "obligation" under the Act to include "retention of overpayments," which the DOJ has used to target certain health care facilities.**

Several reports over the past six years from the U.S. Department of Health and Human Services Office identified significant problems related to skilled nursing facility management and related Medicare payments. The establishment of the Health Care Fraud Prevention and Enforcement Action Team (HEAT) initiative in 2009 evidenced renewed emphasis on combating health care fraud. Alleging an industry pattern of inflating Medicare reimbursement amounts by administering unnecessary levels of therapy to patients, the DOJ launched several lawsuits against skilled nursing facilities.[1]

Over the past few years, the DOJ's invigorated Medicare reimbursement investigations have resulted in enormous settlements to resolve False Claims Act allegations. Between 2009 and 2016, the DOJ recovered $19.3 billion for the federal government in FCA settlements related to health care fraud, inclusive of both settlements and judgments.

While the FCA settlements are not against the Health Care REITs themselves, the reputation and financial wellbeing of the real estate landlord is intimately tied with the operator. Shareholders can file securities claims against the landlords for breaching their fiduciary duty to vet the operators, or to stop the fraudulent patterns in the skilled nursing or senior housing facilities.

### *3. Reputational (stock drop) risk*

The effects of DOJ investigations across the health care industry have not been limited to financial repercussions but can also spread to reputational risk. While the investigations have been focused on the operators, not the property owners – the RIDEA structure implicitly brings in the REITs by association.

When REITs have a large relationship with operators/tenants, any unfavorable news about the tenant is almost always associated with a stock drop for the REITs. Large stock drops over a short period of time generally lead to securities class actions, which have colossal financial and reputational implications if not dismissed.

Unique nuances of the RIDEA structures also require REITs to attach the financial statements of the operators if they make up a certain revenue percentage of the company when they file with the SEC. These financial restatements and misrepresentation allegations have recently added substance to securities class action claims against health care REITs.

## How can health care REIT executives mitigate these additional risks?

- Partnering with best-in-class operators:
  - The RIDEA structure creates a symbiotic relationship between the operator and landlord. Given the degree of interdependence, health care REITs should only partner with those they view as best-in-class operators, with historical operating performance and a strong balance sheet.
- Management agreement – credit enhancements
  - Credit enhancements (including guarantees) should be a specific provision in the management agreements to hedge credit risk.
- Asset management platform
  - Health care REITs should utilize a strong, industry targeted asset management platform to avoid any surprises. An experienced senior housing operations team should be constantly monitoring both the individual property operating metrics and overall market fundamentals.
- SEC filing vigilance
  - Specific retention should be paid to both GAAP and non-GAAP measures, especially those specific to REITs (NOI, same-store NOI, FFO).
  - Any operator filing attached to REIT financial statements should be thoroughly reviewed to avoid any misrepresentation allocations.

## How can your D&O policy address these issues? Health care REITs should consider the following coverage enhancements to best protect management and the company.

- Subsidiary coverage
  - Your policy should have the broadest definition of subsidiary as available in the marketplace, not just limited to the 50% ownership threshold. This is sometimes alternately defined as “management control” or “controlled entity.”
- Partnership liability
  - Given the number of joint ventures and partnerships that health care REITs participate in, partnership liability is an imperative part of the D&O policy. This is generally not available on public D&O forms but can be found on REIT-specific forms or added by endorsement.

- Pre-claim inquiry costs
  - The purpose of pre-claim inquiry cost coverage is to pick up costs incurred by informal regulatory investigations before an actual claim has been made. (Historically, D&O policies only covered formal investigations.)
- Entity investigation costs
  - Entity investigation coverage is increasingly available for additional premium amounts. For companies with increased regulatory risk exposure, this policy enhancement should be considered.
  - What about co-defendant language for upstream REIT entities not named on RIDEA policy?

## What happens when a claim comes in?

In the event that an investigation, written request, demand or lawsuit is made, keep the following in mind. Your broker is not only a resource for policy placement and pricing, but for managing claim scenarios.

## What questions should you ask your broker in the event of a claim?

- Noticing requirement for applicable insurers. Who should be noticed and when?
- Claim developments. What constitutes a material development?
- When to incur defense costs. How does the company obtain consent?
- Consent to settle. Who needs to be notified before making an offer to settle or to counter a settlement demand?
- Coverage disputes. What is technically covered by the policy, and how can coverage disputed be avoided? When should the company involve mediation or arbitration?

## Source

[1] FACT SHEET: SIGNIFICANT FALSE CLAIMS ACT SETTLEMENTS & JUDGMENTS (2009 – 2016)." *www.justice.gov,* The United States Department of Justice, 2017, www.justice.gov/opa/press-release/file/918366/download

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