# MOTIVATIONS & MODELS FOR HEALTH SYSTEMS FORMING CAPTIVE VENTURE CAPITAL FUNDS

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**U.S. Health Care and Asset Management and Investment Funds Alert**

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In the context of a rapidly evolving health care industry, there is a growing trend for health systems to establish and experiment with their own captive venture capital investment funds as an adjunct to more traditional innovation, growth, and investment strategies. If anything, the COVID-19 pandemic is accelerating the rate of change in health care. Some of the motivating factors that have prompted health systems and academic medical centers to create proprietary venture capital funds include the uncertainties of changing reimbursement models and shifting industry alignments. As the march towards value-based payment advances, vertical mergers between payors and ancillary providers (*e.g.,* pharmacies) continue, and non-traditional entrants to the provider market emerge, health systems may see the creation of their own venture capital fund as a means to more nimbly participate in new health care lines of business. This strategy is intended to create diversified revenue streams to mitigate downward pressures on reimbursement and better position systems for evolving health care delivery models.

Key advantages to health system-owned venture capital funds also include local and often direct control over these strategic investments, as well as the ability to co-develop innovations. Opportunities are identified based on the real world perspective health systems have about their own needs for innovative solutions and investments are often made in ideas that are promising for implementation in the health systems' own service delivery model. Ideally, the assets can be deployed to support the health system itself, as well as be scaled for external commercialization. For state-owned and nonprofit academic medical centers, creating an affiliated venture capital fund can provide much-desired flexibility to direct mission-driven investments into for-profit service lines. Proprietary venture capital funds are further able to leverage the ingenuity and talent of academic faculty and other health system innovators through start-up support that may spur additional investment. Overall, the innovations that may result from health system-sponsored venture capital funds can enhance a system's reputation, in addition to promoting clinical, economic, governance, and risk mitigation goals.

However, we also take lessons from the fact that some health systems have established and later suspended their venture capital programs. To promote the sustainability and longevity of such proprietary venture capital funds, it is important to ensure that the activities of the fund are fundamentally rooted in, aligned with, and in service of the sponsoring health system's overarching priorities and core business objectives. This client alert outlines various models for structuring, organizing, and operating a captive venture capital fund currently in the marketplace and provides illustrative examples of health systems that have adopted some form of these approaches.

## KEY TAKEAWAYS

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1. Many health systems have elected to establish and experiment with their own captive venture capital investment funds.
2. Such funds identify investment opportunities based on the real world perspective these health systems have about their own needs, and the funds often make investments in ideas that align with the health system's own service delivery model.

## COMMON CAPTIVE VENTURE CAPITAL FUND MODELS

Recognizing that it obviously takes capital to form a venture capital fund and health systems have experienced severe economic impacts as a result of COVID-19, we nonetheless posit that pursuit of proprietary venture capital fund investment may still be a strategic priority to help plan for the future and influence innovation in a manner calibrated to meet the health systems' most acute needs. If a health system desires to sponsor a proprietary venture capital fund, there are multiple models available, each with its own pros and cons. Described below are several of the most frequent models seen in the current market.

### Direct Investment

A health system may elect to invest directly in portfolio companies or other assets. Under this model, the health system creates a new internally-managed subsidiary entity to invest in such companies or assets. Prospective investments are identified either internally by the system itself or by a third party engaged for that purpose. Initial start-up costs are minimal and, because there is no management fee or carried interest payable, all portfolio company returns accrue to the system.

On one hand, under this approach there is greater efficiency in launching and only a brief go-to-market period. The health system retains a high degree of ownership and control over the management of its investments, as well as when and how to publicize and market such investments publicly. Upon building a strong track record, it may be possible to “spin out” such direct investments (or assign the right to invest in later rounds of fundraising) to a future external fund, if desired. Because the system itself is acting directly as the investor, there is a relatively low degree of reputational risk as compared to, for example, relying on an external manager. On the other hand, the system faces increased administrative burdens and internal capacity, legal, and regulatory constraints (e.g., the need to create an internal investment and compliance infrastructure, address staffing matters, and engage internal or external counsel as needed). These difficulties are especially acute if the sponsor is creating a small program, since the costs, including administrative costs, may not be commensurate with the size of the investments. As a result, individual deals may take longer to source and consummate. Because this model does not involve leveraging external capital, it may be more challenging for the system to publicize the success of its approach. Finally, the system presumably has only limited financial or operational capacity to individually support portfolio companies.

### Co-Investment or Side Car

A health system may elect to co-invest directly alongside a primary, established venture capital fund (a “main fund”). In this model, the health system and the main fund together as co-investors capitalize a particular portfolio company or asset. The main fund bears the burden of identifying and selecting prospective investments, subject to the health system's approval. A variation of this model includes involving additional co-investors, such that other entities or funds are invited to co-invest alongside the health system and the main fund. This model involves

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slightly higher start-up costs (e.g., fund formation expenses and use of legal counsel) and it is likely that a management fee and carried interest will need to be negotiated.

Advantages of this approach include outsourcing to the main fund primary responsibility for investment sourcing and compliance activities, thus alleviating much of the administrative burdens due to the above-mentioned internal capacity, legal, and regulatory constraints. There is also reduced upfront complexity in identifying and consummating individual deals and the health system retains a high degree of control and ownership with respect to each investment. However, disadvantages are that it may be prohibitively challenging to identify a suitable main fund that is aligned with the system's investment focus and reputation and that will be responsive to the system's preferences. Involvement of a main fund will require additional time to be devoted to negotiation of applicable terms (particularly economic terms, such as a management fee and carried interest) and, given the presence of a co-investor(s), there is not necessarily a direct link between the health system's investment and any positive outcome, which may be less effective in signaling a market opportunity to other investors. Further, taking advantage of co-investment opportunities requires quick action in many cases (since the window for investment is often a short time period). This may be difficult to implement without dedicated staff.

In addition, the right to make co-investments with a fund is often sought after by a number of investors. A significant investment in a fund may be necessary to secure these rights. Thus, competition with other investors of all sizes may cause only a few of these opportunities to be available.

### Hosted Fund or Fund-of-One

In this model, a health system selects an existing venture capital fund (a “host fund”) to create a stand-alone fund vehicle (a “fund of one”) specifically for the system, in which the system is the sole investor. A subset of the host fund's existing employees is charged with making and managing investments on behalf of the health system, subject to the system's overall direction and oversight as desired. Whereas the prior model involves a main fund identifying and selecting prospective investments and taking on significant administrative burden, this model, given the system's role as the sole investor, has slightly higher start-up costs and it is likely that a management fee and carried interest will need to be negotiated.

On the plus side, this model results in even further reduced administrative burdens, because the system is able to rely on the internal capacity, legal resources, and regulatory expertise of the host fund's designated employees. By selecting the appropriate host fund, the system can seek to ensure mission and value alignment and reliance on a successful financial track record. However, it may be challenging or time-consuming for a health system to identify and select a host fund with a brand, values, and investment philosophy that align precisely with what the system envisions. Further, the host fund will have fiduciary duties to allocate prospective investment opportunities among the system's fund-of-one and the main fund's other existing vehicles.

### External Model

Here, a health system contributes capital to an entirely new venture capital fund (a “new fund”) and serves as the new fund's anchor investor. The health system then selects and brings in a third-party manager or group of employees to run and make investments for the new fund. This model has the highest start-up costs due to the need to engage a third-party manager and the associated administrative and legal costs, and will require payment of a management fee and carried interest to any manager selected.

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On one hand, this approach almost completely outsources responsibility for identifying, conducting due diligence, executing on, and managing investments. It also has the benefit of attracting and then leveraging commitments of outside capital as additional investors are admitted. The system retains a high degree of control through the new fund's governance structure (*e.g.,* a board of directors). On the other hand, this approach requires the management team, as well as the health system itself, to recruit other external investors to contribute capital to the new fund. Administratively, this model constitutes a more complex structure from a legal and regulatory perspective (*e.g.,* the formation and operation of an external entity) and requires additional time to be devoted to negotiation with other investors.

## HEALTH SYSTEM EXAMPLES

We are grateful to the following healthcare organizations for agreeing to share insights from their experience managing a captive venture capital fund.

### Rex Health Ventures and UNC Health

Rex Health Ventures (RHV) is a limited liability company wholly owned by Rex Hospital, Inc. (Rex), an affiliate of The University of North Carolina Health Care System (UNC Health). Rex leadership, with the support of UNC Health, had a vision to form RHV nearly ten years ago to both foster a culture of innovation within the system and to present a differentiated funding option for health care and life sciences companies on the eve of commercialization. RHV makes direct investments in companies in exchange for equity pursuant to the funding decisions of its internal investment committee. Importantly, in conducting due diligence for potential investments, RHV seeks to ensure that the investment opportunity is not only projected to meet financial goals, but also that the products or services of the supported company could solve a health care service or clinical care need of the system. As is increasingly common, RHV investments are structured as strategic partnerships in which RHV is more than a contributor of capital and often is involved in the governance of the portfolio company. Whether or not formal governance rights are negotiated as part of the investment, RHV seeks to leverage its health care provider perspective to strategically advise the portfolio company on its product development and service model. In doing so, RHV brings the informed perspective of a health care provider within the market to which the company is seeking to commercialize its offerings. This symbiotic relationship differentiates RHV from traditional institutional investors, and has the potential to accrue mutual benefit to the company, the fund and the overall health care system.

### Winter Street Ventures and Commonwealth Care Alliance

Winter Street Ventures® (WSV) is the healthcare investment affiliate of Commonwealth Care Alliance® (CCA), a not for profit healthcare organization based in Massachusetts dedicated to improving care for individuals who are dually eligible for Medicare and Medicaid that live with complex medical, behavioral health, and social needs, including disabilities. In 2016, CCA leadership established WSV as an investment vehicle to identify, accelerate, and bring to scale innovations that advance CCA's core mission of improving the health and well-being of the individuals CCA serves. In researching potential investments and entering into strategic relationships, WSV first considers CCA's business needs and operational priorities and then evaluates how the work of supported companies may further those goals. WSV's investment decisions are grounded in CCA's broader strategic, operational, research, clinical, and service delivery priorities, to ensure that CCA can continue to innovate in its role as a healthcare payor and provider. To this end, WSV is deliberate in its due diligence process about

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pursuing mutually beneficial and collaborative relationships in which WSV and company leadership work together to advance initiatives that may be deployed in service of CCA's membership and its broader organizational and operational priorities.

## CONCLUSION

As a complementary strategy to overall innovation initiatives, many health systems have established proprietary venture capital funds to support and guide the development of promising new health care products and solutions. These funds enable the systems not only to have a direct voice in innovation that they want to implement in their own care delivery models, but also serve to diversify revenue streams. The funds that have been maintained over time tend to be those most closely aligned with the clinical and operational needs of the system itself. Having interest as a customer in the product or solution a portfolio company develops helps the system's heart to be in it through longer returns on investment, and serves as reasonable assurance there is a use case for the innovation in the marketplace.

K&L Gates LLP has one of the largest and most experienced investment management groups in the United States and globally. More than 150 lawyers in offices in the United States, Europe, Australia, and Asia spend the majority of their time providing legal services to the investment management and professional investor communities. In addition, K&L Gates' health care practice is listed in Modern Healthcare as one of the largest dedicated health care practices in the United States, and is recognized with a national first-tier ranking in Health Care Law in the 2019 edition of U.S. News-Best Lawyers “Best Law Firms.” With an exceptional depth of knowledge and experience, the lawyers of K&L Gates are leading the way in assisting clients in the investment management and health care sectors and continue to offer fully-integrated and multi-disciplinary solutions to clients.

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