Hospital and Health System Mergers and Acquisitions: Key Legal Issues for the Board

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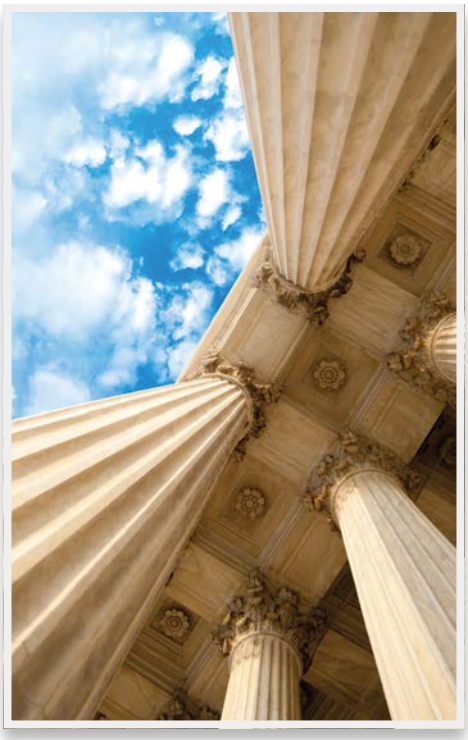
The healthcare industry has been transformed in the last five years since the passage of the Affordable Care Act (ACA) as more and more organizations merge, acquire, or consolidate with others. Under the ACA, the shift in focus from keeping patients out of the hospital and increasing preventative care has led to a decline in hospital revenues, while at the same time the cost of doing business has risen due to increased government regulations and heightened enforcement against providers.

Add to this the ACA's reward/penalty system aimed at incentivizing better quality of care and care coordination amongst providers, and the result is increased pressure on hospitals and health systems to "grab" a larger geographic footprint and scale to better compete in this evolving marketplace. The rise in post-ACA mergers, acquisitions, consolidations, and affiliation transactions ("consolidation transactions") have, in large part, been driven by these challenges as hospitals and health systems seek to more effectively manage larger patient populations, better align physician incentives, assume and manage risk, expand service lines, and invest in information technology and other infrastructure.

While horizontal consolidation transactions continue amongst hospitals and health systems, also on the increase are vertical transactions among hospitals, physicians, and insurance companies as healthcare organizations position themselves to access products and services such as data analytic systems, telemedicine, mobile apps, and other digital technologies to support their population health management and risk assumption initiatives.



Whether your organization is a standalone community hospital or a multihospital health system, consolidation transactions present unique legal and regulatory risks that board members should be cognizant of in connection with the exercise of their fiduciary duties to the organization. This article discusses some of the key legal and regulatory issues for the board's consideration in pursuing a consolidation transaction.

In addition, it is important for board members to understand how these transactions work in order to effectively manage timelines and expectations. Thus, for example, if an organization is contemplating a consolidation transaction for primarily financial needs, the board should have an understanding of how quickly (or not so quickly) these transactions can be consummated and the impact on the institution if the transaction will not be completed within a certain timeframe.

Key Board Takeaways

Hospitals and health systems continue to merge both horizontally and also vertically with physicians and other healthcare providers and health plans. Consolidation transactions present unique legal and regulatory risks that board members should be cognizant of in connection with the exercise of their fiduciary duties to the organization. Some issues for the board to consider when pursuing consolidation transactions include:

- Properly exercising the board's fiduciary duties is important from a regulatory perspective, especially if state law requires the transaction to be approved by the state attorney general. Board actions will be scrutinized to determine if it properly exercised its fiduciary duties to approve a transaction that is fair and reasonable.
- A proactive board will not only conduct due diligence on the target, but also on themselves to ensure that both organizations are a good fit for each other.
- "Reverse" due diligence by the seller on the buyer can help minimize board scrutiny by the state attorney general or other regulators, as well as community interest groups.
- Do not wait until late in the negotiations to discuss management succession planning. Many transactions have died late in the game because the parties did not tackle this sensitive issue early on.

The Board's Fiduciary Duties

From both a corporate law perspective, as well as regulatory compliance perspective, it is important that the board is intimately involved in the consolidation transaction, not only from the beginning, but throughout the entire transaction.

From a corporate law standpoint, board members owe fiduciary duties to the entity they serve. These fiduciary duties are typically characterized as the duty of care, the

duty of loyalty, and in the case of non-profit organizations, the duty of obedience. The duty of care requires a board member to exercise prudent judgment and act in the same manner as a reasonable person would in like circumstances.

A consolidation transaction will also likely require board approval under the hospital's corporate governing documents (i.e., its article of incorporation and/or bylaws). Very often board approvals in connection with consolidation transactions are obtained in multiple phases. Thus, for example, the initial decision to pursue a consolidation transaction may involve the establishment of a steering committee comprised of some board members, as well as hospital management. The steering committee is usually tasked with exploring possible strategic transactions and identifying prospective suitors. The steering committee then reports to the larger board with its recommendations of whether a consolidation transaction should be pursued and with whom.

The exercise of the duty of care may require the board to consider engaging third-party experts to independently assess the organization for its strategic strengths and weaknesses. This type of "pre-consolidation transaction" assessment may help surface any major legal and compliance issues that could be a deterrent to potential buyers. In addition, the hospital may wish to engage a consultant to assist the board with identifying potential partners, the potential synergies, advantages, and disadvantages of each partner, as well as helping the board with evaluating competing offers from multiple buyers or strategic partners.

The duty of loyalty is generally characterized by a board member not engaging in self-dealing, meaning that the board member does not put his or her interests before the interests of the organization. Thus, it is very important that any potential conflicts of interest are vetted out early on in the process. The duty of obedience requires the board to ensure that its decisions are faithful to the mission of the organization. For example, the board of a non-profit hospital considering a consolidation transaction with a for-profit buyer may have to consider what mission-oriented "must-haves" it should negotiate and obtain from this type of buyer.

The board should keep in mind that the proper exercise of its fiduciary duties is also important from a regulatory perspective, especially if state law requires the consolidation transaction to be approved by the state attorney general. To that end, all decisions and actions of the board, from establishing a steering committee and selecting third-party consultants to actually approving potential suitors and the terms of the transaction, should be reflected in reasonable detail in the board minutes to demonstrate the board's deliberative process.

Structuring the Consolidation Transaction

A threshold legal question that will need to be answered is how to structure the transaction. The typical transaction structures are a stock purchase, an asset purchase, a merger, or a consolidation of two organizations. A stock purchase/sale or merger transaction will result in the buyer assuming all of the assets and liabilities of the seller. An asset transaction enables the buyer to cherry-pick the assets and liabilities of the seller that it will assume.

One important consideration from a buyer's perspective that may affect the structure of the transaction is successor liability (i.e., the extent to which the buyer inherits a seller's liabilities). In the healthcare industry, this could be a major area of concern if there are significant financial obligations of the selling hospital to the government through its participation in federal and state healthcare programs. In this scenario, a buyer is likely to be more comfortable with an asset transaction rather than a stock purchase or merger transaction.

Sometimes, however, the parties will have limited flexibility to determine the structure of the transaction. For example, if the buyer is not already participating in federal and state healthcare programs and will need the selling hospital's government participation agreements and provider numbers post-closing, then it will inherit any healthcare program liabilities of the seller if it assumes those participation agreements. In addition, if the selling hospital is a non-profit entity and the buyer is a for-profit entity, most states' laws will not permit a stock/membership interest purchase or merger transaction and the parties will have no choice but to structure the transaction as an asset purchase.

Lastly, other concerns such as debt structure may drive the structure of the transaction. This concern is common in consolidation transactions between two major non-profit health systems with multiple provider facilities, where each system has an existing bond-financed debt structure that may be too complicated to restructure quickly. In this scenario, the transaction structure may involve combining the two systems by creating a super-parent above the existing health systems to preserve and keep intact their respective debt structures.

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Due Diligence

Another important aspect of a board member's exercise of his or her fiduciary duties arises in connection with due diligence. As a board member of a buyer, it is critical to ensure that extensive and detailed due diligence is conducted into the seller's operations, financial condition, legal and regulatory compliance, workforce, medical staff, facilities, and community standing. Moreover, a proactive board will not only conduct due diligence on the target, but also on themselves to ensure that both organizations are a good fit for each other and to ensure that both organizations are not bringing major liabilities to the transaction.

Due diligence not only protects the buyer, it can also protect the seller. Very often, the seller will conduct "reverse" due diligence on the buyer. This is especially true if the board's actions will be scrutinized by the state attorney general or other regulators, as well as community interest groups. By engaging in a review of the buyer, including its financial wherewithal, strategic direction, past acquisitions, and its successes and failures, the seller's board will also have a better sense of whether

the buyer is a good fit, both operationally and culturally.

Particular care should be taken when conducting due diligence with respect to sharing sensitive and potentially competitive information. For example, sharing pricing information could raise antitrust concerns that may be alleviated through the use of "clean teams" to facilitate the disclosure being sought by the buyer. Another example is sharing information about potential or actual fraud and abuse violations could be used by would-be whistleblowers. One strategy to deal with these issues may be for the seller to voluntarily self-disclose and attempt to resolve the fraud and abuse violations in order to avoid the buyer walking away from the transaction. These types of compliance issues, which may be discovered in due diligence by the buyer, highlight the reason why the board may wish to engage a third party, prior to entering into a consolidation transaction, to independently review the hospital's financial relationships with physicians and other vendors for fraud and abuse violations, as well as other major legal and regulatory compliance areas, such as billing and coding, HIPAA, privacy and security, lax employment practices, joint employer liability concerns, etc.

The scope and thoroughness of the due diligence conducted will be critical in helping to assess potential liability and risk areas for the buyer and how the transaction is structured and risk allocated between the parties in their definitive agreement.

Negotiating the Definitive Agreement

Concurrently with the course of the due diligence, the parties will be negotiating the definitive agreement. Among the major areas of focus for these negotiations are:

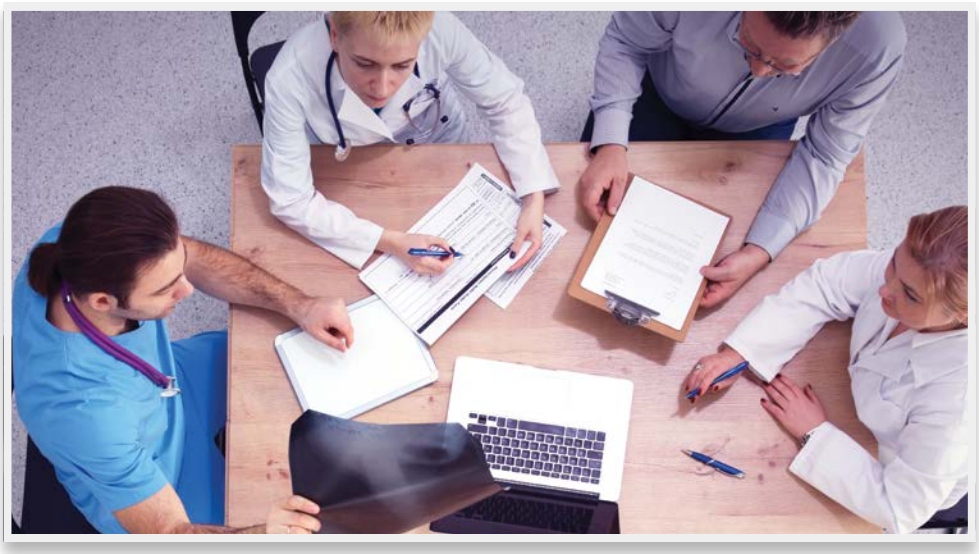
- **The financial terms**, including whether the transaction will be contingent on the buyer obtaining financing and whether the seller will finance any portion of the purchase.
- **The governance rights of the seller (if any) following the closing**. Governance issues may be hotly negotiated if the board of a selling hospital demands representation on the buyer's board for a period of time following the closing, or in a consolidation transaction between two health systems where a new "super-parent" is created to combine the systems.
- **Management structure**. One area that is very sensitive and thus not dealt with early on is the fate of the seller's C-suite executives following the closing. Many transactions have died late in the game because the parties did not tackle this sensitive issue early on.
- **The seller's representations and warranties**. The board should understand that the majority of the definitive agreement will be devoted to the seller's representations and warranties. From a seller's perspective, the fewer statements it makes about its business, the better, as it is less likely that a buyer can call out a breach post-closing. Conversely, from a buyer's perspective, the seller should make broad, comprehensive representations about the business it is selling. A seller will also want to negotiate a finite "end" date by which it is no longer responsible for its representations and warranties—usually between 12 to 24 months—and after which the seller's liability to the buyer is released. A buyer on the other hand will seek to extend this period for as long as possible in order to keep the seller at risk for breaches of its representations and warranties.
- **Indemnification**, which is a risk allocation mechanism between the parties for breaches of representations and warranties and non-compliance with other provisions of the definitive agreement. This provision is often very heavily negotiated. From the buyer's perspective, indemnification can be effectively used to mitigate successor liability, especially for healthcare-related liabilities if the buyer has to assume the seller's government participation agreements for other reasons. Indemnification can be useful, but sometimes it's either not available (for example, the liabilities arise many years after the closing and the seller is long gone) or it's not applicable (for example, in transactions where the buyer will take over an entire hospital or health system and there will be no seller or assets left behind after the closing), in which case, it is even more important that the buyer's due diligence is thorough and identifies potential risk areas.
- **Escrow, holdbacks, and guarantees**. Also common is for the buyer to require that a portion of the purchase price be set aside in escrow or held back for a time period (usually between 12–24 months) following the closing to fund any liabilities that arise after the closing. Alternatively or in addition to an escrow or holdback, the buyer may also insist a corporate guaranty of the seller's parent (if applicable).
- **Restrictive covenants**. Restrictive covenants such as non-competes in favor of the buyer, and "take-back" provisions or rights of first refusal in favor of the seller, are also sometimes heavily negotiated.

Regulatory Approvals

Once the definitive agreement is signed, the focus of the parties will turn towards obtaining the necessary state, federal, and other third-party consents and approvals required for the parties to go to closing. At the state level, these approvals may include approval by the state department of health to transfer licenses and certificates of need, and approval of the state attorney general to transfer the charitable assets of a non-profit hospital. It is imperative that the board understand what notifications and approvals are required and the timeframes that each may take in order to ensure that the timing for obtaining these approvals does not become a major setback.

The transfer of a hospital's acute care and other licenses and certificates of need (if applicable) may involve a simple notification and/or application to the state department of health, or a more lengthier process involving public hearings and input from the community and various stakeholders. In some states, the department of health may also require the buyer to submit "track record" information about itself from any other state where it operates hospitals or other licensed healthcare facilities, as part of the application and approval process.

In a number of states, the transfer by a non-profit hospital of its assets requires approval of the state attorney general under what is known typically as a "conversion statute" or under the attorney general's common law jurisdiction. In some states, the conversion statute only applies if the non-profit hospital is selling to a for-profit buyer; while in other states, the statute applies regardless of whether the buyer is non-profit or for-profit. Further, in some states, if the buyer is a for-profit, the review process may be more heightened than if the buyer is a non-profit, and the selling hospital may be required to obtain an independent valuation, appraisal, or fairness



opinion to comply with the attorney general's requirements.

The attorney general will be tasked with reviewing the transaction from the perspective of whether it is fair and reasonable for the non-profit seller. Specific scrutiny will be focused on the board's actions and decisions during the entire transaction timeline to determine if the board properly exercised its fiduciary duties to approve a transaction that is fair and reasonable for the selling hospital. Hence the need for the board to demonstrate its deliberative process and diligence in selecting the particular buyer.

The attorney general's review will also focus on any restricted gifts that the selling hospital or any affiliated foundation holds. Depending on the nature of the gift and the restriction, the board should be prepared if the attorney general requires that such gifts be submitted to a court in a *cy pres* hearing to determine their ultimate disposition.

There may also be approvals and consents required at the federal level. A threshold concern is whether the transaction triggers the application of the antitrust laws. Transactions in excess of certain dollar thresholds will require a mandatory notification filing under the Hart-Scott-Rodino (HSR) Act. But even if the transaction is below the dollar threshold for an HSR filing, it may trigger antitrust scrutiny if it is between competitors. The board should note that the federal government has been very active in its antitrust enforcement against healthcare providers in recent years.

In addition to antitrust concerns, the parties should assess whether any filings are required to be made to Medicare and Medicaid. Depending on the structure of the transaction, a "change of ownership" (or CHOW) filing, and corresponding approval from Medicare, may be required to transfer ownership of the selling hospital. Alternatively, some transactions merely require a "change of information" (or CHIN) filing, which is a notification to and not an approval from Medicare.

For buyers that are not already participants in Medicare, the easier pathway is to assume the selling hospital's participation agreement because a *de novo* Medicare enrollment application requires a lengthy survey and certification process. Buyers that will be assuming a seller's Medicare participation agreement need to understand how a CHOW approval works because it may have a significant impact on cash flow following the closing. This is because there may be a period of time following the closing, while the CHOW is being processed, during which Medicare will continue to pay the seller for services that the buyer is providing. Once the CHOW is approved, it will be retroactive to the closing and Medicare will start paying the buyer. However, for this interim period, it is important that the buyer negotiate provisions in the definitive agreement obligating the seller to turn over its funds. Conversely, the seller should likewise ensure protections in the definitive agreement for itself relative to any payments received by the buyer after the closing for services provided by the seller pre-closing, including any overpayments or payments from closing cost reports.

Other Approvals, Notifications

Consolidation transactions often involve a myriad of other approvals, notifications, and consents that must (or should) be obtained. Some other key approvals or notifications include:

- Reviewing debt documents, such as bond financing documents to determine if the selling hospital needs to obtain lender or bondholder approval to release any liens on its assets and/or to consummate the transaction
- Distributing any notifications required under the federal Worker Adjustment and Retraining Notification Act of 1988 (WARN) and/or any state equivalent, which may or may not be identical to federal WARN and thus have different or additional obligations
- Notifying all applicable accreditation organizations such as The Joint Commission
- Obtaining any necessary consents under various third-party contracts and leases that a buyer may be assuming
- Filing any requisite applications for transferring miscellaneous licenses, permits, registrations (e.g., radiology, pharmacy, CDS, DEA, CLIA, blood bank, medical waste, boilers, elevators, etc.)
- Approvals from the Catholic Church (if applicable)

Conclusion

The upward tick in consolidation transactions is likely to continue in the near future. As noted above, not only are hospitals and health systems consolidating horizontally, but they are also engaging in vertical transactions with physicians and other providers and health plans, and these types of transactions are likely to substantially increase in the near future. There are many interrelated legal and regulatory aspects to the various components of these transactions. Board members who have an understanding of the juxtaposition of the exercise of their fiduciary duties with the legal and regulatory issues arising in these transactions will be better positioned to help their organizations navigate these transactions.

The Governance Institute thanks Anjana D. Patel, a Member of Epstein Becker & Green, P.C., for contributing this article. She can be reached at adpatel@ebglaw.com. Ms. Patel would like to acknowledge Tristan Potter-Strait, a Law Clerk with the firm, for her assistance with this article.