System Focus

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Breaking Boundaries: Navigating Challenges to Expanding across Borders

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Consolidation across the healthcare industry continues to rise, despite legal and operational challenges, particularly in the hospital and health system sector. Driven by increased competition from private equity investors, strategic companies, and other large for-profit and non-profit health systems, many non-profit organizations are expanding beyond state borders to establish large regional systems. These systems seek to broaden their geographic footprint and compete more effectively in the changing marketplace. By extending their reach beyond state borders, health systems can capitalize on economies of scale, boost operational efficiency, and deliver more comprehensive and coordinated care to a wider patient base. This expansion allows organizations to offer seamless and holistic care experiences, benefiting both patients and providers.

This article examines the key legal and other risks and challenges for non-profit systems in a cross-border transaction.

The Board's Fiduciary Duties

A paramount consideration for the board in pursuing a cross-border transaction is its fiduciary duties. The board must be intimately involved in the consolidation process from inception to completion, addressing both corporate law and regulatory compliance.

For non-profit organizations, board members owe fiduciary duties of care, loyalty, and obedience. The duty of care mandates that board members exercise prudent judgment and act with the diligence of a reasonable person. Consolidation transactions often necessitate board approval per the health system's governing documents, typically

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secured through multiple phases, beginning with a steering committee tasked with exploring strategic options and reporting back to the full board.

Engaging third-party experts to conduct a thorough assessment of the organization's strategic strengths and weaknesses is essential. These experts can identify potential legal and compliance issues, while consultants can assist in identifying potential partners and evaluating offers.

The duty of loyalty requires board members to avoid self-dealing, necessitating early identification and management of conflicts of interest. The duty of obedience ensures that decisions are consistent with the organization's charitable mission, especially crucial when considering partnerships with for-profit entities.

The diligent exercise of fiduciary duties is vital for securing regulatory approval, particularly if mandated by state law. Accordingly, all board actions—from establishing a steering committee and engaging third-party consultants to approving potential partners and the terms of the transaction—should be meticulously documented in board minutes to reflect the board's thorough deliberative process.

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Structuring the Consolidation Transaction

Given the limited options available to structure a non-profit-to-non-profit health system consolidation transaction, most of these are structured as a member substitution. Under this structure, the "buyer" essentially steps in and becomes the sole member (or parent) of the "seller."

Due Diligence and Reverse Due Diligence

An essential facet of a board member's fiduciary duties involves ensuring that the organization has undertaken a meticulous execution of due diligence. For the buyer's board, it is imperative to ensure that comprehensive and exhaustive due diligence is performed on the seller's operations, financial status, legal and regulatory adherence, workforce, medical staff, facilities, and community reputation. Furthermore, a proactive board should extend this scrutiny onto itself, assessing the compatibility of both organizations and identifying potential liabilities that could impact the transaction.

Buyer's due diligence:

- The buyer should do an in-depth quality of earnings and financial review of the seller so that it has an in-depth understanding of any major financial issues.
- The buyer should analyze the seller's strategic plan and determine strengths and weaknesses.

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Seller's "reverse" due diligence:

- The seller should ask the buyer for confirmation of its ability to fulfill any financial commitments being made to the seller.
- The seller should ask the buyer for a description of its strategic plan and how the seller will fit in.
- The seller should ask the buyer for a description of any recent prior acquisitions and how those fared—successes or failures?

Due diligence not only protects the buyer, it also protects the seller and demonstrates that the seller's board has properly exercised their fiduciary duties. This "reverse" due diligence of the buyer by the seller is also important if the seller's 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.

Both parties' due diligence:

- Both parties should ask the other to describe any major government investigations, litigations, and compliance issues that could materially adversely impact the organization.
- Both parties need to explain key affiliations, joint ventures, research, and medical education programs.
- It is essential for both parties to have a comprehensive understanding of each other's relationships with unions, as well as with key community groups and stakeholders. This becomes especially critical for the buyer, who is stepping into a new community. For the buyer, gaining insight into the local dynamics, including established relationships and political nuances, is of utmost importance to ensure a smooth and informed transition. Understanding these elements will play a significant role in navigating and integrating into the community effectively.

During due diligence, parties must take precautions to ensure compliance with antitrust laws. Generally, they must withhold confidential and proprietary information from each other. If there is a compelling reason to exchange sensitive information, access is often limited to independent consultants and attorneys retained by the parties. For example,

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pricing information may require a "clean team" process (i.e., a client team that can see sensitive information but is limited and restricted from using that information in the normal course of business). Further, even if the parties do not compete for services, they may compete for employees, so wage information may need to be restricted. Additionally, antitrust laws require parties to act as separate and distinct entities until closing. Therefore, a buyer must avoid the appearance of influencing or attempting to influence the seller's normal business conduct. Nevertheless, the antitrust laws do allow for the "preservation of assets," so a buyer may require, in the definitive agreement, that the seller provide notifications of key events to ensure compliance.

Negotiating the Definitive Agreement

Concurrently with the due diligence process, the parties will negotiate the definitive agreement. Key areas of focus include:

- **Financial terms:** The seller should ensure the buyer's financial capability to fund the capital commitments requested by the seller, as well as allocate funds for specific projects, growth strategies, and infrastructure investments. The buyer may be hesitant to pre-commit to specific projects without fully assessing operations until after closing, to avoid being "stuck" with initiatives that are either financially unfeasible or not aligned with its strategic plan. Therefore, the buyer may make general capital commitments to maintain flexibility among various projects. The impact of the transaction on the buyer's bond ratings should also be carefully considered.
- **Governance rights:** Governance issues are often heavily negotiated. The seller's legacy board members may wish to have a voice on key decisions for a period post-closing. The buyer, however, may be cautious about granting these rights, especially regarding initiatives that may not align with the buyer's financial goals. Additionally, the seller's board should negotiate representation on the buyer's board for a period post-closing.
- **Keeping healthcare local:** Many selling hospitals in cross-border transactions emphasize maintaining key services in the seller's community. This ensures that patients, regulators, and other stakeholders are confident that the buyer will not shut down or relocate services.
- **Employees and unions:** It's crucial for the buyer to understand the seller's history with its unionized workforce and for both parties to reassure employees that their jobs and benefits will not be adversely impacted by the transaction.
- **Understanding and managing local culture:** The buyer should work with the seller and their advisors to understand and communicate with key stakeholders

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about the transaction's benefits for the community. A well-developed communication plan early in the process can prevent local political issues that might threaten the successful completion of a cross-border transaction.

- **Enforcement rights:** A mechanism to enforce commitments and covenants in the definitive agreement should be established. This may involve creating an independent entity governed by the seller's legacy board members or assigning voting rights to the legacy board members who remain post-closing. The seller should also allocate sufficient funds for legal and advisor expenses to enforce the buyer's commitments.
- **Termination rights:** The parties should discuss "walk-rights" between the signing of the definitive agreement and closing. These rights may be limited to material adverse events or the inability to secure regulatory approvals, depending on the circumstances.

The buyer should work with the seller and their advisors to understand and communicate with key stakeholders about the transaction's benefits for the community.

Navigating Regulatory Approvals

Once the definitive agreement is signed, the focus will turn towards obtaining the necessary state, federal, and other third-party consents and approvals required for the parties to go to closing. 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.

State Laws

A member substitution transaction may require consents from state regulatory bodies, like the department of health. The approval process varies by state and, in cross-border transactions, may involve multiple states with unique requirements. In some states, it may be a straightforward notification or application, while in others, it could be a more complex process involving public hearings and community input from various stakeholders.

In many states, the transaction may require approval from the state attorney general under a "conversion statute" or common law jurisdiction. Some states apply this statute only if the non-profit hospital is selling to a for-profit buyer, while others apply it regardless of the buyer's status. The attorney general reviews the transaction to ensure it is fair and reasonable for the non-profit seller, scrutinizing the board's actions and decisions to verify that directors fulfilled their fiduciary duties.

Antitrust Laws

The transaction may trigger federal antitrust laws. A transaction requires Hart-Scott-Rodino (HSR) Act notification if it meets the "size of transaction" and "size of person"

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tests. The HSR notification informs federal antitrust agencies, allowing them to review and determine if the transaction could harm competition. But even if the transaction is below the dollar threshold for an HSR filing, it may trigger antitrust scrutiny. Other market participants (such as customers, competitors, or a state attorney general) may alert the federal antitrust agencies to a transaction. Alternatively, those private parties or the state attorney general may file an antitrust case themselves. The board should note that, in recent years, the federal government has been very active in its antitrust enforcement against healthcare providers. In light of this, when considering a transaction, the seller's board may want to evaluate the potential anticompetitive effects or market consolidation impact when evaluating potential transaction partners.

Other Approvals and Notifications

There may be other approvals, notifications, and consents that must (or should) be obtained, including with the party's bond financing or debt documents, under the standards of any accreditation organizations, the regulations of applicable permits or licenses, the Catholic Church (if applicable), or the provisions of key third-party contracts and leases.

Key Board Takeaways

- **Keeping healthcare local:** The seller's board should anticipate that cross-border transactions may create apprehension among regulators and community stakeholders who may fear the relocation of essential healthcare services away from the seller's service area. Thus, the board should consider this concern when evaluating prospective buyers.
- **Understanding and managing local culture:** Formulating a comprehensive and community-specific communication and public relations strategy at the outset of the process should be a paramount concern for all parties involved.
- **Rising federal antitrust enforcement:** Due to the heightened activity of federal agencies, parties should anticipate additional time and expenses for each transaction to address potential inquiries from antitrust authorities. Furthermore, the antitrust agencies have signaled potential changes to the HSR filing notification process, which may require more information than is currently mandated, thereby imposing an additional burden on the parties involved.

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Conclusion

The ongoing trend of cross-border consolidation transactions involving hospitals and health systems is anticipated to continue in the near future. These transactions encompass cultural, societal, and regional elements, along with legal and regulatory considerations. Thus, it is essential for board members of both the seller and buyer to understand how their fiduciary responsibilities align with these regional factors and legal issues so that they and their organizations can effectively navigate this intricate environment.

TGI thanks Anjana D. Patel and Patricia M. Wagner, Members of the Firm in the Healthcare and Life Sciences practice, Epstein Becker & Green, P.C., for contributing this article. They can be reached at adpatel@ebglaw.com and pwagner@ebglaw.com.

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