Top 5 Potential Pitfalls in Health Care M&A Transactions

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Health care companies in the United States function within an intricate regulatory scheme which can pose significant risks in health care transactions. Counsel to health care companies (and their lenders and equity sponsors) must be prepared for potential transaction traps to avoid significant exposure.

In addition to the typical pitfalls and traps of corporate deals, health care transactions give rise to further risks related to compliance with the specific laws and regulations that govern this complex industry. Health care businesses in the United States function within an intricate regulatory scheme, the requirements of which are brought to the fore when contemplating a transaction. The role of these issues is of increasing importance as the United States experiences a notable increase in health care provider merger and acquisition (M&A) activity, which some have attributed to the passage of health care reform legislation and related alignment initiatives. Failure to fully comprehend the scope of these matters in health care business transactions is a recipe for potential deal disaster.

The following represent but five of the many pitfalls counsel and business leaders may encounter in health care transactions.

1. Importance of In-Depth Due Diligence and Increased Regulatory Scrutiny

No industry in the United States is as heavily regulated as the health care industry, making the operation or acquisition of a health care company fraught with risk. As a result, corporate transactions in the health sector call for a level of diligence that exceeds that of corporate transactions in other business areas. Noncompliance with health care laws can lead to the imposition of crushing financial penalties and operational restrictions on noncompliant entities. In addition to the general function of permitting acquirors to identify material financial risks that may affect price, due diligence in health care transactions provides an opportunity for acquirors to assess regulatory compliance risks. Therefore, use of a “standard” corporate due diligence request list is not sufficient in health care transactions, as these forms typically do not contemplate the spectrum of documents and information relevant in health care due diligence.

Enforcement of health care laws is anticipated to increase moving forward, both as part of the Patient Protection and Affordable Care Act of 2010, better known as the health care reform legislation, and as part of general government efforts to crack down on fraud and abuse in the health care arena. Both sellers and buyers in this context are advised to carefully prepare for and approach due diligence in any health care corporate transaction—sellers from the perspective of anticipatory preparation and buyers from the perspective of determining both a “go/no-go” with the deal and thoroughly evaluating risks to be abrogated or compensated as part of the transaction.

Enforcement activity in health care has been on the rise in recent years, with the government taking an active role in enforcing the complex laws applicable to health care providers and suppliers, including the Anti-Kickback Statute and Physician Self-Referral Law (referred to collectively herein as the Fraud and Abuse Laws). The Fraud and Abuse Laws make illegal certain business, referral and financial arrangements that are ordinary course in other business sectors. Complicating matters, the activities that constitute violations of the Fraud and Abuse Laws may be subtle and difficult to discern. As certain of the laws are strict liability statutes, even the smallest infraction without intent is on par with a flagrant violation, weighing the ability and basis for enforcement in the government’s favor. Violation of the Fraud and Abuse Laws can result in the imposition of severe penalties, including fines and civil monetary penalties (or costly negotiated settlements in lieu thereof), and restrictions or prohibitions on participation in federal health care programs.

Accordingly, due diligence of health care businesses and operations must necessarily include a thorough review of compliance with health care laws, including the Fraud and Abuse Laws, to assist in identification of noncompliance and give the parties an opportunity to address any issues. So-called “defensive diligence” by potential sellers in advance of undertaking a bid process or otherwise entering the M&A marketplace is becoming more common, and health care regulatory counsel increasingly recommend potential sellers undertake such proactive reviews before permitting a potential acquirer or partner access to information.

In the transaction context, addressing noncompliance with health care laws has increasingly taken the form of self-disclosure to the government in anticipation of undertaking a transaction after internal “defensive diligence” or hand-in-hand with a potential acquiror or partner, either during the negotiation of or prior to closing of a transaction. Other disclosures may occur under the real or perceived threat of disclosure from a *qui tam* relator (whistleblower) who has knowledge of the noncompliance.

In addition, health care transaction due diligence must involve areas of risk unheard of in other industries, such as Health Insurance Portability and Accountability Act (HIPAA) (health information privacy) compliance and research program compliance, to fully evaluate these sources of additional potential risk.

2. Complexity of Governmental Regulation, Licensing and Accreditation Matters

Health care businesses are highly regulated and typically require numerous local, state and federal licenses, permits, accreditations and approvals in order to operate. Licenses, permits and accreditations are often nontransferable, or require significant paperwork and lead time in order to complete transfers within the deal timeline. Ensuring health care providers and suppliers who participate as providers in federal and state health care programs are appropriately enrolled in these programs is vital to the smooth transition of operations post-closing. As health care businesses require licensure and sometimes accreditation to treat patients —and bill for patient care, particularly through the federal health care programs that are the lifeblood of most hospitals and other health care facilities—the threat to interruption of operations, revenue and reimbursement if these matters are not carefully handled as part of a health care transaction cannot be overstated.

In addition, many states restrict the employment of licensed professionals (most commonly physicians, but sometimes others) by corporations, which corporations are thereby viewed as undertaking the practice of that profession in contravention to state law requiring licensure for such activities. These "corporate practice" issues arise frequently in health care transactions where a post-closing corporate structure or the merger or other reorganization of the corporate structure contemplates a corporation's employment of licensed providers.

3. Increasing Antitrust Scrutiny

Health care transactions with competitive implications are subject to increased scrutiny by the U.S. Federal Trade Commission (FTC) and Department of Justice (DOJ). Health care transactions that meet certain thresholds require filings with and clearance from these agencies before the transactions can be consummated.

The FTC has recently linked its enforcement efforts to the desire, as expressed in health care reform legislation, to improve quality and control health care costs through careful management of the market. Moreover, the Obama administration has identified merger enforcement for certain health care entities as a top priority. Where a proposed transaction may adversely affect competition, the FTC and DOJ analyze the efficiencies identified by parties and consider whether the efficiencies outweigh the transaction's potential anticompetitive effect (to avoid presumed harm to patients, *i.e.*, through price increases). A comprehensive review and analysis of the potential efficiencies of a proposed health care transaction is an absolute must in the early stages of transaction planning for those deals that have competitive implications.

Accordingly, an up-to-date understanding of relevant antitrust guidelines and their potential impact on a deal is essential to appropriately executing health care corporate transactions.

4. Special Considerations for Nonprofit Health Care

A significant amount of hospital and health care operations in the United States is owned and operated by nonprofit corporations. Knowing the client's business and anticipating traps in this context includes an understanding of the role of mission, vision and values inherent in such operations and an appreciation of the many differences between nonprofit and for-profit health care deals. For example, the true "bottom line" for nonprofits is often tempered by mission over money.

In order to maintain their tax-exempt status, nonprofit health care business entities must comply with the regulations and requirements of the Internal Revenue Service. These requirements affect many aspects of nonprofit health care transactions, including, by way of example, the need for nonprofits to obtain valuations to substantiate that, as a buyer, it pays fair market value in acquisitions from for-profit entities, or the need to use proceeds only for exempt activities. In addition, nonprofit health care assets are viewed as "charitable assets" of the relevant state in which they are located, and in many states the sale or other disposition of charitable assets to a for-profit enterprise is subject to the approval of the state attorney general. More and more, states' attorneys general are intervening in nonprofit health care transactions, particularly those where a nonprofit entity sells some or all of its businesses to a for-profit enterprise. Even where state law does not provide a specific right of intervention, an attorney general may invoke his or her role as protector of charitable trusts generally as a basis for such scrutiny. Of additional concern, states that have historically recognized nonprofit health care facilities as exempt from property taxes have started to scrutinize, and in some cases revoke, that status upon a change of ownership or control of the property—even if the change results in continued nonprofit ownership.

5. Additional Concerns for Catholic Health Care

A significant segment of nonprofit health care operations in the United States is affiliated with the Catholic Church. According to the Catholic Health Association, there are more than 600 Catholic hospitals and 1,400 long-term care and other health care facilities operating in the United States (*see* Fast Facts, last visited November 1, 2010). Health care entities affiliated with the Catholic Church must obtain the approval of the Holy See, the headquarters of the Catholic Church in Rome, before entering into certain transactions. This approval, called an "indult," is issued after the party selling or otherwise transferring property prepares an intricate application to the Holy See, usually under the guidance of an expert in Canon (Catholic church) law. An indult can take weeks or even months to obtain, potentially affecting the timing of a deal if not thought out in advance.

In addition, Catholic health care sellers or buyers may require an acquiror to retain, or an acquired entity to follow, the *Ethical and Religious Directives for Catholic Health Care* (the Directives), specific guidance promulgated by the U.S. Council of Catholic Bishops applicable to business operations and patient care and treatment at Catholic health care facilities (*i.e.*, provision of spiritual care and prohibition of certain procedures). In the context of a transaction, the Directives may have a business impact on facilities that are sold or acquired by Catholic entities, and sometimes result in community concern regarding the future availability of certain services in the community.

Conclusion

Counsel to health care businesses and health care business leaders must be prepared for potential transaction traps to avoid significant liability and transaction risks. Involvement of counsel experienced in health care early in deal planning and throughout the life cycle of the transaction is key to successfully navigating these issues.