Hospital Mergers & Affiliations: Legal & Regulatory Considerations

Presented to

WA/AK HFMA

October 12, 2017

Presented by

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Agenda

• Consolidation Drivers
• Forms of Integration
• Recent Trends
• Legal Barriers and Cautions
• The Transaction
• Compliance Tips
To swim with the fishes, that is the question . . .
Consolidation Drivers

• Market reform will outpace legislative reform
• Reimbursement will be increasingly tied to quality and outcomes
• Cost reduction pressures will increase
• Shift from inpatient to outpatient
• Restrictions on physician self-referral will continue
• Data will be king
• Reductions in Medicare/Medicaid reimbursement to hospitals and physicians
• Shortage of physicians as boomers age
• Hospitals will still need doctors and doctors will still need hospitals
Forms of Integration

- Administrative
- Operational
- Governance
- Legal
- IT
- Financial
- Clinical leadership
- Quality
- Contracting
- Marketing
The Range of Integration Options

- Affiliation
- Joint Ventures
- Joint Operations
- Merger
- Acquisitions
Continuum of Structural Integration Forms

- **Clinically Integrated Network**: The parties create a clinically integrated network (potentially also with some level of financial integration).
- **Joint Operating Company**: The parties retain ownership of their hospitals and other facilities but create a joint operating company to manage them.
- **Whole Hospital or System Joint Venture**: The parties contribute the assets of one or more of their hospitals into a joint venture.
- **Antitrust Single-Entity**: The least structurally integrated form.
- **Management Agreement**: The parties enter into a contractual relationship for one to manage the other’s services.
- **Service Line Joint Ventures/Mergers**: The parties contribute the assets of discrete service lines into a joint venture.
- **Merger or Consolidation**: A full merger of the assets and liabilities of the two systems into a single entity.
Consolidation Models and Trends

- Consolidation of medical practices/IPAs
- Clinically integrated networks
- Physician practice acquisitions
- AMCs and clinical integration
- Virtual mergers and the JOA Model
- Hospital – Physician co-management
- Hospital – Physician joint ventures
- Recovery care
- Integrating behavioral health & primary care
Legal Barriers to Consolidation

- Laws aimed at preventing collaboration:
  - Anti-Kickback Statute
  - Stark Law
  - Civil Monetary Penalties
  - Antitrust Law
  - Tax Exempt Status
Quick Legal Primer

- Anti-Kickback Statute = payment in exchange for referrals is criminal
- Stark Law = financial relationship with referring physicians (or family members) prohibited unless exception applies
- Civil Monetary Penalties Statute = cannot pay physician to reduce services
- False Claims Act = liability for submitting claims that do not comply with law
- Antitrust = prohibits price fixing or market control
“Look, I’m not saying it’s going to be today. But someday—someday—you guys will be happy that you’ve taken along a lawyer.”
Purpose Driven Transactions

• Legitimate Business Purpose
  – Reasonably calculated to further the health system's business/charitable purposes
  – System or hospital needs...intends to use...does use service or item in furtherance of commercially reasonable business objectives

• Fair Market Value of Goods/Services
  – Should be independently determined

• Commercially Reasonableness
  – The arrangement would make commercial sense even if there were NO potential referrals
Finding the Right Purposes

• What are things to consider?
  – Mission and vision
  – Strategic planning
  – Continued viability and ability to respond to the needs of the community with appropriate and quality health care services
  – Charitable purposes
  – Quality
  – Population management
  – Development of a multi-specialty medical group
Favorable Features

- Expand or improve scope of services to the community
- Improve quality of services to the community
- Respond to the needs of the community
- Raise investment capital for needed services or equipment
- More effective and efficient care
- Safeguard the provision of medically necessary services
- Commercially reasonable and fair market value payments
- Integrity of legal structure
- Improve access to care for patients
Be Careful with Communications

"We have worked with the ____ group in the past in an attempt to partner with them and to acquire their referrals for MRI."
Protect the Revenue Stream

Q. It's fair to say that the purpose of the noncompete agreement was to protect that revenue stream [referrals from Dr. Saleh and Dr. Vaccaro].

A. The purpose of the noncompete, from my point of view, was to make sure that Drs. Vaccaro and Saleh didn't have a financial incentive to refer away from the hospital.

Q. Because if they didn't have a financial incentive to refer away, they would refer it to you?

A. We could hope that they would, yes.

Q. You did more than hope. You expected they would refer to you?

A. Expected they would refer a good bit of it to us, yeah.

-- Deposition of George Leonhardt, CEO, Bradford Regional Medical Center
Increased Referrals

"Halifax tracked the referrals generated by each medical oncologist. In February 2010, [The Chief Financial Officer] of Halifax Hospital, questioned why Dr. Sorathia generated a **comparatively low dollar value** of referral services when he saw **more patients** than any of the other medical oncologists."

-- *U.S. ex rel. Baklid-Kunz v. Halifax, United States' Complaint in Intervention*
Increased Referrals

"A strategic goal was achieved to affiliate Northside Clinic with Diagnostic & Medical to stop leakage to Springhill via referrals to Cardiology Associates and Pulmonary Associates. Diagnostic and Medical successfully established Cardiology outreach to Monroeville, increased referrals to [Mobile Infirmary]."

--Email from Senior Management of Infirmary Health System, Inc.
Getting from A to B
Merger/Acquisition of Hospital/Health System
What Does Merger Look Like?

A will merge into B and B will be the surviving entity
Effects of Merger

- No separate corporate identity of non-surviving entities
- No separate Boards of Directors
  - Former directors may participate in department governance
Effects of Merger

- Surviving entity assumes all contracts and leases
- Surviving entity assumes all assets
- Surviving entity assumes all liabilities and obligations
Effects of Merger

• Combined insurance coverage
  – Professional coverage
  – Unemployment/worker's compensation
  – Property

• Combined financial accounts
  – Accounts payable and receivable
  – Bank accounts
Letter of Intent

• Nature of Proposed Transaction
• Definitive Agreement
• Conditions to Closing
• Negotiating
• Binding Provisions
• Term and Termination
• Confidentiality
• Publicity
• Non-Solicitation
Nature of the Proposed Transaction

• Creation of the New Parent Corporation
• Proposed Transaction Structure
• Each Separate Hospital to be Maintained
• Capital Commitments
• Reserved Powers
• Human Resources and Benefits
Definitive Agreements

• Affiliation Agreement
Conditions to Closing

- The obligations of the Parties to consummate the Proposed Transaction are conditioned, among other things, upon the following:
  - The preparation, and the execution by each Party, of the mutually acceptable Definitive Agreements;
  - Completion of all regulatory filings and the receipt of any and all applicable required regulatory and/or judicial approvals;
  - Receipt of any approvals required under any loan agreements, leases or other contracts or documents by which one (1) or more of the Parties, or any entity affiliated within the Parties, may be bound; and
  - Approval by the Boards
Negotiating

For a period of eight (8) months following the date first set forth above, the Parties agree to meet, negotiate and work with each other to define the scope, terms, conditions, objectives, economics and other matters pertaining to the Proposed Transaction, and to negotiate and prepare the Definitive Agreements. In doing so, the Parties agree that they shall not, without the prior written consent of the other Party, enter into discussions with any third party regarding any asset sale, membership interest transfer, lease, merger, consolidation, joint operating agreement or any other similar arrangement outside the ordinary course of business, which could result in the Party transferring a significant portion of its assets or operations to, or coming under the control of, any person or entity other than a Party hereto.
Binding Provisions

• Except for the obligations set forth under Sections 4, 5, 6, 10, 12 and 15 of the Letter of Intent (collectively the "Binding Provisions"), which the Parties agree are legally binding upon them, the Letter of Intent is not legally binding and represents solely an expression of the intent of the Parties to further explore and develop the Proposed Transaction.
Term and Termination

• The term of the Letter of Intent shall commence on the date first set forth above (the "Effective Date"), and shall continue until the earlier of:
  – The effective date of the Definitive Agreements executed by the Parties;
  – The termination of the Letter of Intent, at either Party's sole discretion, upon the delivery of ten (10) days prior written notice, which may be delivered by facsimile or hand-delivery to the individuals who have executed the Letter of Intent; or
  – Eight (8) months from and after the Effective Date, subject to any written extension of the Letter of Intent executed by the Parties.
Additional Terms

• Confidentiality
• Publicity
• Non-Solicitation
## Merger/Integration Timeline

- **Letter of Intent**
  - Meeting of Hospital Board of Incorp.  
  - Board Approvals  
    - Starting date  
    - 1 week

- **Affiliation Agreement**
  - Board Approvals  
    - 1 month

- **Creation of New Parent Organization**
  - Articles of Incorporation  
    - 2 months
  - Corporate Bylaws  
    - 2 months

- **Due Diligence**
  - Due Diligence Checklist  
    - 2 weeks
  - Due Diligence Completed  
    - 3 months

- **Draft Corporate Documents**
  - Restated Articles of Incorporation  
    - 4 months
    - Hospital 1
    - Hospital 2
  - Amended Corporate Bylaws  
    - 4 months
    - Hospital 1
    - Hospital 2

- **Final Board Approvals**  
  - 5 months

- **Final Approval by Hospital Board of Incorp.**  
  - 6 months

- **Closing**
  - File Restated Articles of Incorporation  
    - 7 months
  - First Meeting of New Boards  
    - 7 months
Merger/Acquisition of Physician Groups
Requirements for Group Practice

• Requirements for Group Practice Exception under Stark
  – Single legal entity
  – At least 2 physician members
  – Each physician member must furnish substantially the full range of medical services physician routinely furnishes
Requirements for Group Practice

• Overhead expenses and income must be distributed according to methods determined before receipt of payment for services giving rise to the expenses or providing services
Requirements for Group Practice

• Unified business
  – Centralized decision making by representative body
  – Consolidated billing, accounting and financial reporting

• No physician member directly or indirectly receives compensation based on volume/value of referrals
Requirements for Group Practice

• Members of group must personally conduct 75% of physician patient encounters
• Physician members may be paid a share of overall profits of group or productivity bonus based on personally performed services
Background of Transaction

• Creation of multi-specialty group practice
• 11 clinical groups composed of:
  – Nonprofit taxable corporations
  – Nonprofit tax-exempt corporations
  – For profit taxable professional corporations
  – For profit tax-exempt professional corporations
Background of Transaction

• Multiple Ownership Structures
  – Membership
  – Directorship
  – Shareholders
  – "Unknown"
Statutory & Legal Framework

• State Nonprofit Corporations Act
• State Business Corporations Act
• Professional Services Corporation Act
• Internal Revenue Code
Key Challenges

• Political
• Scope of Due Diligence
• Corporate Authorizations
• Potential Tax Liability
• Filing Requirements
• Attorney General Approval
• Consent/Notification
Overall Consolidation

• Merger
  – Tax-exempt corporations
• Transfer of substantially all assets
  – Taxable corporations
Solutions to Challenges

• Political
  – Issues of control
  – Protection of assets
  – Ongoing

• Scope of Due Diligence
  – Level of protection necessary
  – Impact to operations
  – Representations and warranties
Solutions to Challenges

• Corporate Authorizations
  – Meeting statutory timeframes
  – "Moving targets"
  – Clarification of structure/identification of members
  – Board/member/shareholder meetings
  – Written consents
  – Board approval
Solutions to Challenges

• Potential Tax Liability
  – Transfer of assets
  – Accounts receivable
  – Responsibility for pre-transfer liabilities
Solutions to Challenges

• Filing Requirements
  – Certificate of merger
  – Plan of merger
  – Identification of entities
  – Timing
  – Merger of professional corporations
Solutions to Challenges

- Attorney General Approval
  - Constant communication
  - Final identification of entities
Solutions to Challenges

• Consent/Notifications
  – Hospital Boards
  – Real property leases
  – Mission critical agreements and licenses
  – Other contracts
Allocation of Goodwill

- Individual vs. Corporate
- Tax liability to seller
- Total price within FMV
- Ensure personal goodwill being purchased
Applying the General Rule of Thumb

- Legitimate Business Purpose
- Fair Market Value
- Commercially Reasonable
Legitimate Business Purpose

• Lawful purpose
• Reasonably calculated to further the hospital or health system's business/charitable purposes
• Hospital needs the service or item
• Hospital intends to utilize service or item
• Hospital does utilize service or item in furtherance of commercially reasonable business objectives
Fair Market Value

• Stark definition/tax-exempt guidelines
• Burden of establishing "fairness" of an agreement generally rests with the parties involved
• Burden of establishing FMV rests with the organization
  – Internal governance and documentation
• Be careful with reliance on comparables that involve entities and physicians in a position to generate business
• Be careful with comparables if lack of competition in marketplace – look for alternative valuation methodologies, such as cost plus reasonable rate of return on investment
• Document beforehand! Internally and externally!
Commercially Reasonable

- **Centers for Medicare & Medicaid Services**: An arrangement will be considered "commercially reasonable" in the absence of referrals if the arrangement would make commercial sense if entered into by a reasonable entity of similar type and size and a reasonable physician (or family member or group practice) of similar scope and specialty, even if there were no potential referrals.

- **Burden of establishing CR rests with the organization**
  - Internal governance and documentation

- **Stark exceptions** – commercially reasonable even if no referrals are made

- **Deal should be able to stand on its own**
Actions to Avoid

• Providing physicians with items or services for free or less than fair market value
• Relieving physicians of financial obligations they would otherwise incur
• Inflating compensation paid to physicians for items and services
• Undocumented "arrangements"
• Arrangements that don't match the documents
• Arrangements without independent fair market value
• Any consideration of volume or value of potential referrals
Actions That Can Be Taken**

• Acquiring physician groups to expand or add new service lines
• Recruiting, employing and/or contracting with physicians to increase patient care capacity
• Entering into joint ventures or affiliation agreements with other providers to provide essential services in the community
• Paying fair market value for goods or services

** Proper structure of each relationship is key!!
Please visit the Hall Render Blog at http://blogs.hallrender.com for more information on topics related to health care law.

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