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L. EDWARD BRYANT, JR.
NATIONAL HEALTH LAW
TRANSACTIONAL COMPETITION

OFFICIAL PROBLEM

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Introduction

Your firm has been newly retained as legal counsel for Pearson University Health System ("Pearson"), a major academic medical center located in the City of Beazley, State of Loyola. You are one of the Associates assigned to the team working on the Pearson representation.

For many years Pearson has found itself financially challenged, but the last three years have been devastating, with losses rising to an unsustainable level. For eighteen months Pearson's Board worked with a consultant to explore its options, and has now reached a Letter of Intent ("LOI") with Caring Health System ("Caring" or "CHS") (described below). Even though due diligence has only begun, Caring has already identified a number of concerns (the "Due Diligence Findings"). Pearson is seeking your counsel on how to respond to the Due Diligence Findings, and also guidance on how the Findings might impact the transaction with Caring. Pearson has retained specialty antitrust counsel, so issues in this area need not be considered by your firm.

Background

1. Pearson University Health System

Pearson is an urban non-profit, tax-exempt health system governed by a self-perpetuating Board of Directors. It is the sole corporate member of a 500-bed tertiary level hospital ("PMC") and a 150–bed rehabilitation and skilled nursing facility ("PSNF"). Pearson has a variety of owned or managed clinics scattered throughout its primary and secondary service area. It also has an academic affiliation with Magis Medical School ("Magis"), providing residencies in internal medicine, pediatrics, general surgery and orthopedics, among others. As part of this academic affiliation, Pearson conducts pharmaceutical and medical device clinical research.

PMC is one of five (5) hospitals serving Beazley and its surrounding metropolitan area. Its medical staff is a mixture of employed physicians and independent physicians. Of the medical staff's approximately 650 physicians, 150 are employed by Pearson through Pearson Medical Associates ("PMA"), a wholly-owned non-profit, tax-exempt subsidiary of Pearson. Most of the PMA physicians have faculty appointments at Magis.

While well thought of within Beazley, PMC is a distant second, and perhaps even third, in reputation compared to other hospitals serving the Beazley communities. Its facilities are somewhat dated, impacting its ability to draw the younger, more affluent population attracted to Beazley's city-center. PMC's high debt load ($400M) has also impacted its ability to invest in plant and equipment, causing it to fall behind several of its competitors. Further, even though it has moved aggressively to become more "physician friendly," it has failed to truly develop an integrated delivery model with its doctors. As such, its costs continue to be much higher and its quality lower than the market leading Caring Health System ("CHS") hospitals. These deficiencies, along with its poorer payor mix compared to other Beazley hospitals and significant leadership turn-over the past ten years, have caused the hospital to experience significant financial stress. PMC has gone through two cycles of "right sizing" within the past 18 months, and seen its bond rating drop to "A" with a negative outlook.

2. Caring Health System

CHS, a large, non-profit/tax-exempt multi-state system operating two hospitals (one 275 beds and the other 225 beds) in Beazley, is the clear market leader. Caring's Beazley facilities are relatively new and located in the most financially advantageous areas of Beazley. Further, Caring is a nationally renowned health system, highly regarded for its superior quality, financial strength and sophisticated leadership. Caring's Beazley facilities have strong partnerships with physicians in the Beazley community, offering market leading ACO and narrow network insurance products. Caring's hospitals are viewed as "essential" providers by the insurance companies, meaning that the rates they receive from private payors tend to be higher than those offered to other systems. Consequently, the hospitals enjoy a strong reputation within the Beazley medical community.

While Caring has historically not employed the physicians on its medical staffs and has relied upon independent physicians to staff its hospitals, with the tightening of the Beazley physician market and Pearson's growth in employed physicians, Caring has begun to respond with aggressive physician employment. Currently, Caring employs more than 115 physicians, but it has made its intentions clear that it will offer the largest employed medical group in Beazley within five years. Given Caring's reputation and capital resources, there is no reason to believe that this will not occur.

The Transaction

Pearson has reached the following LOI with CHS:

1. The transaction will be structured as a membership transaction, with CHS becoming the sole corporate member of Pearson.

2. Pearson's Articles of Incorporation and/or Bylaws will be amended to provide that all strategic, operational policy and financial decision-making will be reserved to CHS ("reserved powers").

3. The Articles of Incorporation and Bylaws of PMC and PSNF will be amended so that all strategic, operational policy and financial decision-making will be reserved to Pearson.

4. Upon closing of the transaction, Pearson will get 5 out of 15 seats on CHS' Board of Directors; each appointee will serve a 3-year term. Thereafter, these five Board members will be treated as all other CHS Board members, with any subsequent appointment following established Board appointment protocols.

5. CHS' President/CEO will remain the President CEO of the expanded health system. Pearson's President/CEO will retire upon closing of the transaction.

6. CHS will make $125M in capital commitments to PMC, and $10M in commitments to PSNF, within three years of the transaction closing. In addition, CHS will contribute $25M to a newly formed foundation to be created by Pearson. The foundation will be wholly independent of CHS and Pearson.

7. The transaction will close by July 31, 2017.

8. The LOI is non-binding, but for provisions regarding confidentiality of information, payment of attorneys' fees, no third party beneficiaries and choice of law being the State of Loyola.

Due Diligence Findings

To date, CHS has identified the following Due Diligence Findings:

1. PMC does not seem to have a well-maintained contract management system, especially when it comes to leases with physicians in PMC's medical office buildings. A review of the 80 leases outstanding between PMC and its physician tenants reveals 35 that are problematic. The issues with these leases fall into the following categories:

    a. Holdover leases: The lease has expired and there is no evidence of renewal, even though lease payments pursuant to the now expired lease continue to be paid.

    b. No signed lease: There is evidence that a lease was sent to the physician for signature but never returned. Payments, however, were made pursuant to the proffered lease.

    c. In three instances, payments under the lease began but then stopped. Review indicates that in one instance payments stopped because the physician group was experiencing financial difficulty—only three monthly payments out of twelve owed to date have been made. In the other two instances, the reason for non-payment is unclear: there is a note in the file from a former CEO indicating that the two medical groups need not pay, but there are no supporting details provided to explain this directive.

2. There is a growing concern that meaningful administration or controls over the clinical research enterprise at PMC are lacking. PMC has 240 pharmaceutical and device research protocols underway. In each of the research studies, Magis-affiliated faculty serve as principal investigators and the research site is in PMC licensed space. Many of the Magis faculty principal investigators are physicians employed by PMA. For some clinical research studies, Pearson is a party to

clinical trial agreements signed by Magis, Pearson, and the study sponsor. In other clinical research studies, the clinical trial agreements are solely between Magis and the study sponsor. For 200 clinical trials, the agreement designates Magis as the recipient of the research funds and responsible for paying the providers (including Pearson) for research-related clinical services. For 40 clinical trials, the agreement designates PMC as the recipient and manager of the research funds responsible for paying providers. Two key issues uncovered so far reveal the following:

a. In Calendar Year ("CY") 2014, approximately $18 million dollars in research funds were paid from Magis to Pearson for research-related clinical services at PMC. But in CY2015, Magis transferred only $500,000 in research funds to Pearson despite the volume of research at PMC remaining the same. The transfer amounts for CY2016 have been requested in due diligence but not yet received.

b. An internal audit report dated February, 2015 criticized PMA for having a poor mechanism to notify the PMC billing systems that a patient was enrolled in a research study. The internal audit report tested 10 random studies with a cumulative enrollment of 32 research patients and identified that the billing systems had been informed of only six (6) of the patients being enrolled in a research study. The report speculated that the balance of the research patients that were not "flagged" in the billing system may have resulted in the patients' insurers being billed for research studies that should have been paid by study funds. The audit report also noted that no process existed between PMC and Magis to reconcile their lists of research patients.

3. The compliance hotline recently received a complaint that a high referring physician owns a home health agency and PMC discharge planners are steering patients to the physician's agency. The physician is identified as a full-time employee of PMA. PMA and PMC have not established a formal conflict of interest process. Upon investigation, the compliance office has identified that the list of home health agencies that the discharge planners provide to PMC patients lists the physician's home health agency first on the document. This is the only home health agency listed on the sheet that is based in Beazley. The three other home health agencies on the list are based in the suburban or rural areas of the Beazley metropolitan community. The compliance office has not yet decided how to handle the results of its review.

4. As part of the preparation for due diligence, the physician compensation at PMA was reviewed. It appears that a component of the compensation package for the oncologists relates to the profitability of the hospital service, both inpatient and outpatient.

Your Assignment

1. Please address the legal and business implications associated with the Due Diligence Findings and provide your counsel on actions, if any, that Pearson should take.

2. Discuss the impact that the Due Diligence Findings may have on Pearson's transaction with Caring.

3. In light of the Due Diligence Findings, what types of modifications to the LOI or other terms might you expect Caring to seek in a definitive agreement, and how might Pearson best respond to counter these demands?