2018

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NATIONAL HEALTH LAW
TRANSACTIONAL COMPETITION

OFFICIAL PROBLEM

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I. Introduction

For the past fifteen months St. Sebastian Health System has been quietly seeking to expand into a new service line that would take the System outside of its core regional 8-state market and catapult it into a health care system having national breadth. A variety of options have been reviewed, and the System is now narrowing in on an acquisition of National Spinal Surgery Centers ("NSSC"). NSSC is one of the largest management service organizations in the country, owning spine and neurosurgery practices in 18 states. Your firm has been retained to represent St. Sebastian Health System through Closing of the acquisition.

II. Description of St. Sebastian

St. Sebastian Health System ("SSHS") is a large, regional, Catholic, non-profit, tax-exempt health system. SSHS owns 24 hospitals, 17 skilled nursing facilities and operates over 200 care sites in eight states. The system has more than 2000 employed physicians, a number which is expected to grow. SSHS enjoys a AA bond rating and is the leading, or secondary, health care provider in each market in which it operates. Annual system revenue tops $12B.

Despite its size, SSHS Board and management recognize that the consolidation wave hitting health care is unlikely to abate, and that SSHS needs to grow, substantially, if it is to thrive in the future. Through an intensive, 15-month process, SSHS has been looking at a variety of acquisition strategies, and targets, to position the system as a provider with national breadth.

III. Description of National Spinal Surgery Centers

National Spinal Surgery Centers is a for-profit, privately owned corporation. NSSC was founded by Drs. Pearson, Beazley and Corboy, a trio of spinal surgeons, in 2003. Pearson, Beazley and Corboy continue to operate their surgical practice, and enjoy a strong reputation in the spinal field.

NSSC is the largest management services organization ("MSO") in the U.S. focusing on spinal treatment. It has grown from managing a single spinal surgery practice at its founding to today, managing over 120 spinal care and surgery practices in 18 states. The NSSC business model is that NSSC owns/leases the hard assets of the practices it acquires and operates, and manages the practices, including employing all personnel except the physicians. The physicians working in the practices are, in turn, employed by NSSC Practice Corporation, P.C., a professional corporation ("P.C."). P.C. contracts with NSSC for management services and the practice infrastructure at each practice location. Services are billed in P.C.'s name by NSSC personnel. NSSC charges each practice it manages a monthly flat management fee, plus a percentage of billings. Under the compensation model that P.C. has with each physician, monies remaining after these expenses are paid to NSSC are then devoted to compensation for the physician.

NSSC's growth first exploded in 2008 when it purchased the exclusive rights to royalties connected with a new spinal device patented by its three founders. Implantation of the "PBC Coupler" is now widely used within all NSSC practices, generating significant royalties to NSSC. In fact, NSSC's standard practice is to include a one hundred percent (100%) markup on the cost of PBC Couplers used by the practices.

Revenues next expanded significantly beginning in 2012 when the founders sold a 55% interest in NSSC to Whitehead Partners ("Whitehead"), a private equity firm. At the time of the acquisition, Whitehead valued NSSC at $700M. Since making this acquisition, Whitehead has since loaned NSSC over $400M to acquire surgical practices throughout the United States. NSSC continues to enjoy strong growth. Twenty more spinal practices are slated to be acquired in the first quarter of 2018, with many more potential targets in sight. Further, management has been looking at the acquisition of a large physical therapy provider to capture the revenue from therapy referrals made after spinal surgery. While discussions are still preliminary, NSSC and the therapy company have begun drafting a letter of intent to move the acquisition forward.

NSSC's growth has not been without its challenges. Law suits involving three practice acquisitions in 2015 have been filed against NSSC, each alleging that physician compensation was not consistent with the proforma performance presented to the physicians at the time of the acquisition. Further, while not directly alleged in the complaints, each of the pleadings hint that a claim might be made that the physicians believe that NSSC exerted undue influence on them to deploy the PBC Coupler, even in cases where its use may not have been appropriate.

A variety of negligence actions have also been filed against some of the NSSC practices, although the frequency of litigation and the dollar amount sought is not alarming given the heightened risk involved in treating sensitive patients, such as those in spinal pain. Still other cases have been filed involving the PBC Coupler, alleging premature failure of the device, causing pain and necessitating replacement surgery.

Perhaps most serious, in 2016 NSSC entered into a Corporate Integrity Agreement ("CIA") with the HHS Office of the Inspector General to resolve issues involving billing irregularities from some of its owned spinal practices. The length of the CIA is for five years; three years remain.

IV. The Proposed Transaction

About eight months ago, a broker approached SSHS with an interesting option: Whitehead Partners, a private equity firm, is interested in capitalizing on NSSC's success and selling its controlling stake in NSSC. While the broker only represents Whitehead, it believes that the three surgeons who founded NSSC (who, together with Whitehead, constitute the owners of all of NSSC's shares) could be persuaded to sell their interests if the price were right, though Whitehead is under no obligation to obtain the surgeons' consent if Whitehead were to sell its interest.

Discussions with Whitehead have moved quickly, to the point that a nondisclosure agreement has been entered into and preliminary due diligence materials shared. Further, the parties have narrowed down the agreed upon market value of Whitehead's majority interest in NSSC to somewhere between $2.35 – 2.55B.

V. Transaction Planning/Preliminary Due Diligence Issues

As your work begins with SSHS, several issues have arisen, with SSHS management seeking your counsel on the following:

1. How should a potential acquisition of NSSC be structured, and what implications does the choice of approach have on SSHS as well as its ownership/control of NSSC?

2. Should SSHS acquire 100% of NSSC, or only the interest held by Whitehead? In discerning this issue, advise SSHS on the implications of this choice.

3. Regardless of whether it purchases 55% or 100% of NSSC, SSHS needs to raise significant capital to complete this acquisition. What options are available to it to raise this money, what are the pros and cons associated with each, and what do you recommend?

4. Analyze the liability and risk exposure that would be potentially assumed by SSHS as a result of the acquisition, including but not limited to litigation, compliance and regulatory issues, and business risk. Describe the seriousness of the exposure/risk, and advise how these are best minimized and contained, both at acquisition as well as in the future when NSSC is part of the SSHS "family."