Structuring St. Sebastian Health System's Acquisition of National Spinal Surgery Center

Huff, Huff & Doback, LLC

Table of Contents

I. Introduction **3**

II. Structure of the Deal **3**
A. SSHS Will Create A Purchase Subsidiary To Buy NSSC Stock From Whitehead 3
B. Acquiring Assets 7
C. Finance the Subsidiary 8
D. Transfer from Whitehead to C-Corp Likely to be Taxed 8

III. St. Sebastian Health System should acquire only Whitehead's 55% of National Spinal Surgery Centers. **9**
A. Less Capital Needed For The Acquisition 9
B. PBC Coupler Patent-Owners Remain Financially Invested 10
C. Ensure A Smooth Transition Process 11
D. Maintaining Tax-Exempt Status 12

IV. Financing the Acquisition **13**
A. Easily Liquidated Assets To Assist With The Initial Payment 14
B. Sources of Third Party Financing or the Initial Payment 15
C. Finance the Subsidiary 15

V. Risks and Liabilities **16**
A. Litigation Risks 16
1. Compensation Suits 16
2. Negligence Suits 17
3. NSSC "Pushing" the PBC Coupler 18
4. Products Liability Suits 19
B. Regulatory and Compliance Risks 20
1. UBI Taxation 21
2. Loss of Tax-Exempt Status 22
3. Corporate Integrity Agreement 24
4. Stark Law 26
C. Business Risks 27
1. Significant Investment 27
2. Control 28
3. Lack of Expertise 29

VI. Conclusion **30**

I. Introduction

St. Sebastian's Health System ("SSHS"), like many health systems operating today, is faced with a rapidly consolidating market that makes remaining a mid-sized regional corporation less viable. However, every acquisition and expansion is fraught with risks and challenges. The transaction contemplated here is whether SSHS should acquire a majority-share of National Spinal Surgery Centers ("NSSC")—a for-profit, multi-state surgical practice—and if so, how the transaction should be structured, and what risks are involved. This memorandum advises SSHS to Whithead Corporations' ("Whitehead") 55 percent stake of NSSC.

To begin, this memo will detail the way in which the acquisition should be structured. It is our conclusion that creating a wholly owned purchase subsidiary to acquire Whitehead's shares of NSSC is the best way to conduct this transaction. The purchase subsidiary would help ensure SSHS maintains its tax-exempt status, and to shield SSHS from potential liabilities incurred as a result of the acquisition. Next, we will discuss the implications of purchasing only 55 percent—rather than making a full acquisition of NSSC—and the reasons we conclude it to be the proper choice. Then, we will survey potential sources of capital that could be used to make the acquisition, detailing the structure in which the acquisition would be financed. Finally, this memo will address the various legal and business risks that may be incurred as a result of this transaction.

II. Structure of the Deal

A. SSHS Will Create A Purchase Subsidiary To Buy NSSC Stock From Whitehead

To acquire the NSSC stock, SSHS will first create a purchase subsidiary that will be controlled and wholly owned by SSHS. The subsidiary ("C-Corp") will be a C-Corporation incorporated in the state of Delaware. The creation of the purchase subsidiary provides two major benefits: (1) it will help SSHS maintain it's 501(c)(3) not-for-profit status, without needing to acquire 100 percent of NSSC and then merge it into SSHS, and (2) it provides a layer of liability protection between SSHS and NSSC.

In order to create C-Corp, SSHS will need to draft and file C-Corp's Articles of Incorporation with the Delaware Department of Financial Institutions. SSHS will also appoint a registered agent for C-Corp. SSHS will put its funds into C-Corp, and in return, C-Corp will issue 100 percent of its stock to SSHS. C-Corp will then transfer the funds to Whitehead in return for Whitehead's shares of NSSC. The sole purpose of C-Corp will be to hold the NSSC stock. When NSSC pays out dividends, it will pay those dividends to C-Corp. C-Corp will then distribute those dividends to SSHS. C-Corp will not have to file for its own 501(c)(3) designation from the IRS. Instead, the IRS will not treat C-Corp as a separate corporation for tax purposes.[1] In order to qualify as a subsidiary, 100 percent of the stock of C-Corp must be held by SSHS.[2]

C-Corp will help SSHS maintain its tax-exempt status. All revenue generated outside of the tax-exempt purpose of SSHS gets taxed at the corporate tax rate.[3] If too much of SSHS's revenue falls outside of its tax-exempt purpose, SSHS could lose its tax-exempt status. However, non-profit organizations are not taxed on any dividends they receive.[4] When C-Corp receives the dividends from NSSC, it in turn will pass the profits

[1] 26 U.S.C. § 501(c)(25)(E)(i).
[2] 26 U.S.C. § 501(c)(25)(E)(ii).
[3] Massachusetts Nonprofit Organizations § 11.1 (2013).
[4] *Id*., 26 U.S.C. § 513(1).

to SSHS as it is a wholly owned subsidiary. Therefore, under typical circumstances, SSHS would not be taxed on these dividends.

However, as this deal will need to be financed partially through debt — as will be discussed in Section III — the dividends paid to SSHS will be taxable up to the amount that was purchased with debt financing.[5] Additionally, this revenue will still constitute Unrelated Business Income ("UBI"). If too much of SSHS's revenue is UBI, it could jeopardize the company's non-profit status. There is no bright-line rule as to what is too much UBI, but it is commonly seen as more than 15 percent of the total revenue.[6] Last year, SSHS took in $12 Billion in revenue. If it took in more than 1.8 billion of UBI, it would reach the 15 percent threshold and put the tax-exempt status in jeopardy. We do not know how much of the $12 billion came from UBI last year. To avoid reaching the threshold, C-Corp should contract that no more than $900 million be paid out in total dividends to the shareholders of NSSC until the debt-financed loans have been paid off. Since NSSC is valued around $5.5 billion, it is unlikely that these revenues will reach that much. However, this contract ensures NSSC's dividends will not threaten SSHS's UBI threshold. If NSSC generates excess revenue that cannot be distributed to the shareholders due to this contract, that revenue will be re-invested in NSSC. There may be some pushback from the other 45 percent of the shareholders who would want to maximize their dividends, but given the low probability of this dividend cap actually being hit and because the reinvestment of any excess funds will help increase the total value of the company, it should be agreed upon.

---

[5] 26 U.S.C. § 512b(1).
[6] *See* Michelle Adams, *Defining "Excessive UBI,"* Nonprofit Law Blog (July 20, 2009), https://adamsnonprofitlaw.wordpress.com/2009/07/20/defining-%E2%80%9Cexcessive-ubi%E2%80%9D/

To avoid the IRS ignoring C-Corp's corporate existence, the board of directors of C-Corp will have to be different than the board of directors of SSHS[7]. This is an easy fix, as SSHS can designate a subsection of its own board to act as C-Corp's board. Further, with a subsection of SSHS' board acting as C-Corp's board the two boards will share the same vision of the company.

C-Corp also adds an extra layer of protection between SSHS and NSSC. Without C-Corp, creditors would only have to pierce one corporate liability shield to gain access to SSHS's assets in the event of a catastrophic judgment against NSSC. By creating a layer of protection, it makes it harder for a judgment to be entered against the hard assets of SSHS as discussed below in Section V.

Maintaining the NSSC founders as partial owners of NSSC and members of its board of directors has several benefits. The difference in the makeup of the board of directors of NSSC and SSHS will help ensure NSSC remains a separate entity from SSHS for tax purposes. Therefore, when NSSC enters into a business deal, it will be responsible for the decisions it makes, giving SSHS a layer of protection. The three physicians on the board also provide for other benefits listed below.

Despite being separate entities, SSHS must still be careful if it uses some of its own resources to assist NSSC. The Stark law and Anti-Kickback Statute ("AKS") both regulate hospitals self-referring and double-dealing to prevent a hospital system from emptying the coffers of Medicare and Medicaid. To avoid a Stark law violation, SSHS should ensure that the acquisition qualifies under an exception to the Stark law. One obvious exception is the Isolated Transaction Exception. The acquisition should qualify if

[7] *Id*.

SSHS and NSSC avoid additional transactions for at least six months following the acquisition.[8]

Another frequently used exception is the "Fair Market Value" exception. The Fair Market Value exception allows for SSHS to provide a service to NSSC (or vice-versa) so long as the compensation for the service matches the fair market value of the service rendered.[9]

Additional Stark law issues could arise if NSSC Practice Corporation, P.C., ("P.C.") is owned by NSSC itself. However, the record does not shed light on this relationship.[10] If NSSC does own P.C., then NSSC and PC will already have a plan to deal with these issues and SSHS should maintain the current structure to avoid any disruption. However, it is clear is that NSSC contracts with P.C. to employ doctors, then bills for the services on behalf of P.C., and charges a flat monthly fee and portion of the billings.[11] This gives rise to the belief that the two are separate entities that contract together. If so, NSSC should continue to contract with PC independently so long as both entities feel the relationship is beneficial. SSHS will want to avoid entering into any more transactions with NSSC in order to avoid violating the Stark and Anti-Kickback laws. The only exception would be if SSHS decides to buy the remaining 45 percent of NSSC.

B. Acquiring Assets

In order to pay Whitehead, SSHS will need to acquire sufficient assets for the payment. SSHS should acquire the necessary assets in three ways. First, SSHS likely has some cash on hand it can use to contribute to the payment. Second, SSHS should take out

[8] 42 CFR 411.357 (f) (2016).
[9] 42 CFR 411.357 (i) (2016).
[10] R. at 2.
[11] Id.

a loan from an investment bank to add to the balloon payment. Third, SSHS should structure the remainder of the payment over time using debt instruments. By utilizing more than one stream, SSHS is able to incentivize Whitehead to agree to the sale with an upfront payment while also making it easier for SSHS to finance the deal over a long period of time.

The smallest portion will come from cash available on hand. As SSHS is a non-profit, it does not likely hold enough liquid assets to finance a transaction of this size. Further, by dipping into its coffers too much, SSHS would expose itself should other cash flow issues arise. But using some cash does have a benefit. It will reduce the amount of debt SSHS will have to use, thus reducing the amount of interest it must pay, and fewer of the profits will be taxed as UBI when SSHS receives the payments as dividends.

The majority of the balloon payment will be financed through an investment bank. SSHS will then pay back the bank with interest. While major debt financing will be necessary, SSHS should limit this as much as possible because of its tax consequences.

C. Finance the Subsidiary

Once SSHS has secured the funding necessary to complete the transaction, it will have to transfer the assets to C-Corp. C-Corp will in turn transfer 100 percent of its own stock back to SSHS, giving SSHS full control of C-Corp. The transfer of assets from a parent organization to a subsidiary in exchange for stock in the subsidiary is tax-exempt under I.R.C. 351[12] or I.R.C. 1032.[13]

D. Transfer from Whitehead to C-Corp likely to be taxed

[12] 26 U.S.C. § 351.
[13] 26 U.S.C. § 1032.

The sale of NSSC stock from Whithead to C-Corp is unlikely to fall under a tax exemption. In order to fall under the IRC 1032 exemption, the exchange would have to meet several criteria, including: (1) the stock must be acquired directly from the organization, (2) it must be acquired with a pass-through basis, and (3) it must be immediately exchanged.[14] In this transaction, Whitehead likely satisfies the first two criteria, since it acquired the stock directly from NSSC and it then was done with a pass through basis. However, since Whitehead did not immediately turn the stock over to C-Corp, and instead held it for a number of years before selling it, it is unlikely to qualify as an exemption under regulation 1.1032.[15] However, that doesn't mean it's not worth applying for, because if the transaction can become tax free, Whitehead could pass on part of its tax savings to SSHS in the form of a lower negotiated price.

III. St. Sebastian Health System should acquire only Whitehead's 55% of National Spinal Surgery Centers.

SSHS should acquire only Whitehead's 55 percent of NSSC, because: (1) it will cost significantly less capital than purchasing all of NSSC's stock while still allowing SSHS to control the company, (2) it will help ensure that the owners of the PBC Coupler patent are financially invested in continuing the license to NSSC, (3) and it will smooth the transition process when SSHS takes control of NSSC. Additionally, proper structuring and financing of this transaction will limit risks to SSHS's non-profit status that may otherwise appear in a 55 percent acquisition of a for-profit entity.

A. Less Capital Needed For The Acquisition.

[14] *Id.*
[15] *Id.*

While it may seem like an obvious point, it is vitally important for SSHS's fiscal health to find a way of executing its stated desire to expand into a national market,[16] while doing so at the lowest possible price. Purchasing only Whitehead's share of the company will allow SSHS to establish itself as a national player at approximately half the cost of purchasing 100 percent of NSSC's stocks. Financing a $2.5 billion acquisition will already put a strain on SSHS's resources, and will require extensive financing schemes and fundraising efforts to execute. Doubling that figure would significantly increase the time, energy, and resources needed to finance the acquisition, which could leave SSHS in a financially vulnerable position. Additionally, while there are risks involved in choosing to acquire only a majority share in the company—such as the possibility that the minority shareholders could obstruct SSHS's efforts to make certain decisions for NSSC—SSHS will also have less at stake in the company, should the investment prove to be deleterious.

B. PBC Coupler Patent-Owners Remain Financially Invested

NSSC derives a significant portion of its profits from the royalties connected with the PBC Coupler.[17] Thus, it is critically important to ensure the patent-holders are committed to maintaining the license between themselves and NSSC, giving NSSC exclusive rights over the royalties. At this point, we are unaware of the specific terms of that license. We do not know how long the license to NSSC lasts, or if there are any provisions that would void it. If the contract has to be renegotiated, it would be extremely beneficial to keep the patent-holders on as minority shareholders, as they benefit financially from a friendly license to NSSC.

[16] R. at 2.
[17] R. at 3.

C. Ensure A Smooth Transition Process

Acquiring only a majority share in NSSC, helps ensure that the day-to-day operations will continue normally, thereby mitigating many of the financial risks that often come with a full takeover of a target entity. A 2005 case study found that 30 percent of corporate mergers and acquisitions fail within three years, and the overriding reason for failure tends to be "disparities in organizational culture."[18] Acquiring all of NSSC, would bring a new corporate culture to that company—a culture that may or may not sit well with its long-time employees and contracted physicians. Further emphasizing the differences between the two corporations is SSHS's nonprofit status and NSSC's for-profit nature.[19] The underlying goals of each company are markedly different: SSHS is interested in providing healthcare for healthcare's sake, whereas NSSC is, by nature, concerned about profit. This could easily translate into a managerial disparity, which could potentially disrupt the day-to-day operations of the surgical practices, and thereby negatively impact profitability or general appeal to would-be investors.

However, acquiring only Whitehead's 55 percent, will retain the founders of NSSC as partial owners of the corporation.[20] Their experience and knowledge of NSSC will help smooth the transition process as SSHS acquires Whitehead's majority shares. As the majority owner of NSSC, SSHS would still be able to consolidate redundancies and mold the corporation into something more fitting its vision, but it could do so with the guidance and expertise of those who know NSSC best. Most important, keeping three surgeons on as minority owners of NSSC could potentially reduce any anxieties among

---

[18] Isaac Dixon, *Culture Management and Mergers and Acquisitions,* Society for Human Resource Management (March 2005).
[19] R. at 2.
[20] R. at 3–4.

contracted physicians NSSC will be headed by persons unfamiliar with medical practice. This could reduce physician defections that might otherwise occur in a full-acquisition, thus reducing the time, cost, and effort of recruiting replacement physicians.[21]

D. Maintaining Tax-Exempt Status.

As a tax-exempt nonprofit, perhaps the most important consideration facing SSHS in this proposed transaction is how purchasing this for-profit subsidiary could affect SSHS's tax-exempt status. While acquiring 100 percent of the corporation could potentially insulate SSHS from losing its tax-exempt status by allowing NSSC to be reorganized as part of SSHS under its existing 501(c)(3) status and purpose —and thereby ensuring revenue generated by NSSC would be untaxed—it would require a massive and complicated reorganization of NSSC,[22] and it is certainly not guaranteed that the IRS would allow the reclassification to occur. However, purchasing 55 percent of NSSC with any amount of debt will cause the dividends distributed by NSSC to C-Corp (and in turn, to SSHS) to be classified as UBI.[23] This means SSHS will be taxed on the dividends up to the amount the acquisition was financed with debt.[24] The courts have promulgated rough standards stating that a non-profit that receives a "substantial" amount of UBI could be reclassified as a for-profit organization.[25] There is no bright-line rule for what "substantial" ultimately means, but tax-experts have suggested that anywhere from 10 to 15 percent of a nonprofit's annual revenue being UBI is "substantial."[26]

---

[21] Larry Senn, *Cultural clash in mergers and acquisitions*, Heidrick & Struggles (2014).
[22] *See generally Life Cycle of a Public Charity*, IRS.gov, https://www.irs.gov/charities-non-profits/charitable-organizations/life-cycle-of-a-public-charity.
[23] 26 U.S.C. § 514(a)(1).
[24] *Id.*
[25] *Christian Stewardship Assistance, Inc. v. Commissioner*, 70 T.C. 1037, 1042 (1978).
[26] *See* Michelle Adams, *Defining "Excessive UBI,"* Nonprofit Law Blog (July 20, 2009), https://adamsnonprofitlaw.wordpress.com/2009/07/20/defining-%E2%80%9Cexcessive-ubi%E2%80%9D/

In a transaction of this scale, it will be realistically impossible to avoid debt-financing altogether. However, if SSHS can raise approximately $500 million of capital up-front, and contract with NSSC to limit total dividend distributions to $900 million per year—an amount more than NSSC is likely to distribute, regardless—the dividends SSHS receives from NSSC should not cause SSHS to exceed the 15 percent guideline on "substantial" UBI. If structured and managed correctly, the threat of SSHS losing its tax-exempt status is minimal.

After SSHS has received dividends from NSSC in an amount equal to the amount of debt it used to finance the acquisition, then the dividends will cease being classified as UBI.[27] Other forms of "passive" income (e.g., rent) paid to SSHS by NSSC will, however, still be classified as UBI.[28]

IV. Financing The Acquisition

Although an ideal option to finance the acquisition for SSHS may be to acquire Whitehead's shares of NSSC using only a long-term financing model, the reality is that Whitehead will need at least a portion of the payment up front. Financing part of the acquisition with debt will cause the dividends SSHS receives from NSSC to be treated as taxable income.[29] However, debt financing is realistically necessary in a transaction of this size. There are ways to limit the damaging effects of this IRS rule. One of the primary ways to limit the UBI will be for SSHS to raise significant capital for an initial payment. This memo has identified several potential sources of liquid capital that can be tapped for this initial payment—including unrestricted endowment funds, investments in

[27] 26 U.S.C. § 512(b)(13)(A).
[28] 26 U.S.C. § 512(b)(1).
[29] 26 U.S.C. § 514(a)(1).

publicly-traded stocks, and retained revenue (i.e., "cash on hand"). However, the majority of the capital used to acquire the stocks will have to be debt-financed.

A. Easily Liquidated Assets To Assist With The Initial Payment

As a large, established non-profit that makes around $12 billion in annual revenue, SSHS likely has a certain amount of cash on hand it can put towards financing the initial payment. Although the amount of unused revenue SSHS has at its disposal is unknown, SSHS should consider dedicating at least a portion of any retained revenue to this payment, as it will lower the amount it needs to secure through debt financing.

Another potential source of capital is part of SSHS's unrestricted endowment. Funds SSHS has received from donors may be tapped into as a source of liquid capital, so long as the funds were not restricted to a particular use by the donor. It is important to recognize the distinction between restricted and unrestricted funds: if a donor designates the donation to be used for a specific purpose, then the funds are restricted. Also, if SSHS designated a purpose for the funds when the funds were solicited, then the funds are restricted.[30] However, if the funds were not designated for a particular use by the donor, or the fundraising campaign, then those funds are eligible for unrestricted use.[31]

Finally, SSHS can sell stock it may have in any publicly traded corporation, and use the proceeds from the sale as capital for the initial payment. Gain derived from selling stocks will not constitute taxable income to SSHS.[32] While information detailing the total number of stocks held by SSHS is unknown, any stocks held should by SSHS should be seriously considered for sale so long as they have been held by SSHS for at least one

[30] *See generally* Unif. Prudent Mgmt. of Inst. Funds Act (Nat'l Conference of Comm'rs on Unif. State Laws 2006).
[31] Id.
[32] 26 U.S.C. § 501(a).

year, because maximizing our amount paid up front will limit the debt-financed portion of the acquisition.

B. Sources of Third Party Financing or the Initial Payment.

In addition to the on-hand or easily liquidated sources of capital, it will be necessary to finance a portion of the initial payment with investment. The amount of capital needed for the initial payment depends on negotiating with Whitehead, but considering this is a $2.5 billion transaction, the initial payment may be upwards of $500 thousand. The majority of this amount will likely come from an investment bank.

To induce an investment bank to lend SSHS the funds necessary to finance the acquisition, SSHS would be required to pay significant interest on the loan. SSHS may be able to reduce the risk involved with the loan and thus the interest rate by securing it with certain assets. However, this would put those assets at risk.

Another incentive SSHS could offer an investment bank would be a seat on NSSC's board of directors. This would incentivize the investment bank to provide the loan because it would give them influence in how their money is used, but it should not affect SSHS's control of NSSC.

C. Long-term financing.

A majority of SSHS's funding must be long term. Raising $2.3 to $2.5 billion in the given timeframe to finalize this deal is virtually impossible. Thus SSHS must examine its options for long-term financing. One method that may be available is a "loan agreement," in which SSHS agrees to pay Whitehead for the value of the stock at a standard interest rate for a term of a select number of years. A loan agreement will be more appropriate than a simple promissory note, because the extent of the payment deferred is quite substantial, and loan agreements—unlike promissory notes—must be signed by both parties, and generally include more extensive governing clauses.[33] The particularity with which the loan agreement is drafted will likely provide a level of confidence and reassurance to Whitehead that the debt will be satisfied. Moreover, the loan agreement can be secured by the NSSC stock, which provides greater assurance that SSHS will not default on its repayment obligations.[34]

V. Risks and Liabilities

As a result of this transaction, SSHS could potentially incur several types of liability and risk, including: incurring liability in multiple different types of lawsuits, failing to maintain compliance with current regulatory schemes, developing the need to comply with new regulations, and exposing itself to new business risks.

A. Litigation Risks

First, SSHS may incur liability in at least four different types of lawsuits, including: (1) suits relating to PC's compensation of its physicians, (2) potential negligence by NSSC in caring for patients, (3) failures of the PBC Coupler, and (4) NSSC possibly "pushing" providers to use the PBC Coupler.

1. Compensation Suits

The risk from the suits relating to PC's compensation of its physicians is relatively minimal for two reasons. First, these suits appear most naturally directed at the physician's corporate employer, PC, rather than NSSC. If PC is not a subsidiary of NSSC but rather simply a vendor of physician services, then NSSC may escape all liability relating to these compensation suits; assuming that there is no contractual mechanism in

---

[33] *Commercial Loan Agreements*, CGAP, p. 2 (2006) **https://www.cgap.org/sites/default/files/CGAP-Technical-Guide-Commercial-Loan-Agreements-Oct-2006.pdf**.
[34] *Id.*

place between PC and NSSC that extends liability otherwise confined to PC to NSSC. Furthermore, these suits are relatively small in number, occurring at only 3 of NSSC's 120 clinics. The small number of these suits limits NSSC total potential liability, should these suits ultimately result any liability at all for NSSC.

There are several steps SSHS can take in order to further minimize this risk. SSHS could require that NSSC move to have the court hearing these cases remove NSSC as a defendant, prior to the finalization of the acquisition. Knowing the results of these motions would allow NSSC and SSHS to more accurately assess their liabilities. Additionally, SSHS could require that NSSC avoid any contractual language that may extend liability from PC to NSSC for any future suits of a similar nature. Finally, SSHS could require that NSSC include notifications and disclaimers in future deals between NSSC clinics and PC physicians (or any physician group) highlighting the use of "proforma" financial statements and the fact that they may differ from the formal GAAP-compliant financial statements that will be used for physician compensation.

2. Negligence Suits

The risk from the suits relating to the alleged negligence of NSSC in treating patients is more substantial but not overly concerning. Nearly every medical practice faces some suits of this nature.[35] This is even truer in specialty practices that treat particularly high-risk patients, such as surgical centers.[36] The number and dollar value of suits against NSSC is not abnormal. Furthermore, all medical practices should have

---

[35] C. Krupa, Medical liability: By late career, 61% of doctors have been sued, American Medical News (2010)

[36] Anupam B. Jena et al., Malpractice Risk According to Physician Specialty, 67 Obstetrical & Gynecological Survey 73-75 (2012).

insurance that provides coverage for these types of suits,[37] which further reduces NSSC's exposure to unexpected or large payments and normalizes NSSC's expenses and cash flow. This should aid SSHS in appropriately valuing these suits, NSSC as a whole, and ultimately calculating the cost of these suits into the purchase price of the NSSC shares.

SSHS can further reduce the risks they face from these suits by including in the transaction a requirement that NSSC warrant that all NSSC practitioners and contractors have a specified level of insurance and that NSSC indemnify SSHS from any damages SSHS suffers if any NSSC practitioner is uninsured. SSHS could further require NSSC to hold a specified amount of "umbrella insurance" to further insulate it from this risk.

3. NSSC "Pushing" PBC Couplers

The risk stemming from NSSC potentially exercising undue influence over physicians to use the PBC Coupler is remote and somewhat unclear — as no actual allegations have been made to that effect — only "hints" of allegations in somewhat unrelated civil complaints. If those "hints" were to develop into actual allegations of undue influence on the part of NSSC, one potential source of liability related to such allegations would be the Anti-Kickback Statute ("AKS").

If the undue influence NSSC would be accused of using involved any type of value exchange to providers in return for ordering the PBC Couplers, or other benefits, then the AKS could be triggered. The AKS is a criminal statute and its penalties include significant fines and incarceration, so the potential liability is extreme.[38] There is no private cause-of-action in the AKS.[39] Thus, a private civil complaint could not trigger this liability. However, there is a "whistle blower" provision in the AKS that allows private

[37] Rachel Silverman, So Sue Me: Doctors Without Insurance, Journal of Medicine (2016).
[38] 42 USC § 1320a–7b (2016).
[39] *Gaalla v. Citizens Med. Ctr.*, 407 F. App'x 810 (5th Cir. 2011)

citizens to report violations of the AKS to authorities empowered to pursue charges and even provides financial incentives for them to do so.[40] Therefore, even though the "hints" are currently speculative and remote, the risk may be significant.

One way that SSHS could mitigate this risk would be to determine internally if NSSC believes its action could give rise to any AKS liability. If NSSC may be at risk, SSHS should include in the acquisition a requirement that NSSC settle these lawsuits prior to finalizing the acquisition and that those settlements include a non-disclosure agreement that could help limit NSSC's exposure. If NSSC does not believe that its actions could potentially give rise to liability under the AKS, SSHS should require that NSSC warrant that their actions have not violated the AKS and indemnify SSHS for any damages relating to the AKS.

4. Products Liability Suits

The risk from the suits relating to the potential failure of the PBC Coupler is the most concerning of the suits NSSC is currently facing. Suits alleging the premature failure of medical devices are typically structured as "product liability suits."[41] Lawsuits of this nature often evolve into class action lawsuits, which can greatly increase the value of the suit. This is escalated to a greater level when the damages resulting from the medical device failure include physical pain to patients and additional invasive surgeries. Under standard tort law, NSSC would likely be liable for these damages, even if the issue with the PBC Coupler occurred during manufacturing or other activities completely outside of

[40] John Nisbett, The Three-Headed Monster of Healthcare Fraud Enforcement: The False Claims Act, Stark Law, and the Anti-Kickback Statute, American Bar Association (2018).
[41] Judge (ret.), Medical Device Product Liability Lawsuits Injury Claim Coach (2018), https://www.injuryclaimcoach.com/medical-device-liability.html (last visited Feb 15, 2018).

NSSC.[42] The actual liability these suits would generate for NSSC and thus SSHS is unclear, as these suits may have the potential to develop into high liability class action products liability suits, but have not yet reached this point.

There are several steps that SSHS could take to mitigate this liability. The most basic step is for SSHS to create a corporate subsidiary that would actually own the shares of NSSC. This step is included in the recommended structure of the acquisition. This structure adds a layer of corporate liability shielding between SSHS and NSSC, which could protect SSHS's own assets from claimants in the event that these suits, or others, result in catastrophic judgments. In such a situation, claimants would be required to "pierce" through two separate corporate liability shields to access SSHS assets. While this step helps to protect assets retained within SSHS itself, it does nothing to protect the substantial assets SSHS will invest in NSSC. In order to mitigate risks to those assets, SSHS could include in the transaction a requirement that NSSC obtain insurance coverage for these types of suits, if such insurance is available and feasible. Alternatively, or additionally, SSHS could include a requirement that NSSC settle these suits prior to finalizing the deal. SSHS should also include the cost of any insurance and the potential liability from these suits into their calculation of the value of the acquisition price of the NSSC shares.

B. Regulatory and Compliance Risks:

Additionally, SSHS may risk failing to comply with regulatory schemes under which it is already burdened as well as exposing itself to new requirements under other regulatory schemes. Specifically, SSHS may have income fall outside of its tax

[42] Christopher Thompson, Imposing Strict Products Liability on Medical Care Providers, 60 Missouri Law Review 711-730 (1995).

exemption, risk losing its tax-exempt status altogether, risk penalties under NSSC's CIA, and risk penalties under the Stark law.

1. UBI Taxation

As a result of the recommended structure of the acquisition, SSHS will likely have significant income fall outside its tax exemption. As discussed in Section I supra, SSHS will be a controlling organization with respect to NSSC for tax purposes.[43] Therefore, any passive income that SSHS derives from NSSC, other than dividends, will be taxed as UBI.[44] However, as SSHS will fund much of its acquisition of NSSC stock via debt, discussed in Section II supra, dividends paid from NSSC to SSHS will be taxable UBI for SSHS; until the cumulative amount of dividends taxed as such equals the amount of debt funding used by SSHS in the acquisition.[45] Thereafter, NSSC dividends paid to SSHS will return to their tax-exempt status.[46] Therefore, SSHS will almost certainly incur a cost it typically does not have to deal with as a tax-exempt organization.

There are several steps SSHS can take to mitigate the challenges presented by the tax on NSSC dividends. First, SSHS can factor the cost of this tax into the acquisition price of the NSSC shares, defraying some of the cost onto Whitehead. Additionally, SSHS can include in the acquisition a requirement that all NSSC dividends be cash dividends, as opposed to stock dividends, to help ensure that SSHS will always have the cash needed to pay the tax on the NSSC dividends. SSHS can also minimize the amount of UBI tax that it pays by avoiding additional transactions that would generate more passive income from NSSC that is taxable as UBI.

---

43 IRC § 512(b)(13)(D)(i)(I) (2016).
44 IRC 512(b)(1) (2016).
45 IRC 514(a)–(c)
46 Id.

Additionally, there is a risk that the IRS could ignore NSSC's corporate existence, for tax purposes, if there is too much of an overlap of ownership and control between SSHS and NSSC. Typically, this occurs when a non-profit organization owns an extremely high percentage of a pro-profit corporation and there is a large amount of overlap between the boards of directors for each company.[47] If the IRS were to ignore NSSC's corporate existence, all of NSSC's operations would then be attributed to SSHS, causing SSHS to recognize a large amount of UBI.[48] Limiting the acquisition to only 55 percent of NSSC's stock will help to reduce this risk. SSHS can further minimize this risk by avoiding excessive overlap between their own board of directors and NSSC's board.

2. Loss of Tax-Exempt Status

This acquisition will create two key ongoing concerns that could result in SSHS losing its tax-exempt status. However, if the risks are managed properly, that result is highly unlikely. First, SSHS could lose its tax-exempt status if too large of a percentage of its total revenue becomes UBI. If UBI comprises more than 10 to 20 percent of a tax-exempt organization's revenue on a regular basis, the organization is at risk of having its tax-exempt status revoked.[49] Given SSHS's annual revenue of 12 billion dollars, those percentages correspond to approximately $1-2 billion of "allowable" UBI per year.

There are steps that SSHS can take to reduce the risk that they will accumulate enough UBI in any year to threaten their tax-exempt status. First, it is unlikely that NSSC would distribute dividends anywhere near that large, given that the total value of the company is estimated at only $5.5 billion. It would be highly unusual for a large company to distribute a dividend worth more than 10 percent of its total corporate

---

[47] See Priv. Ltr. Rul. 86-25-078 (Mar. 27, 1986); Also See Gen. Couns. Mem. 39,326 (Jan. 17, 1985)
[48] Massachusetts Nonprofit Organizations § 11.4.1 (2013)
[49] Id. at § 11.3.16

value.[50] Additionally, if a situation arose where NSSC would distribute such a large dividend in a single year, the recommended structure would prevent NSSC from distributing more than 500 million dollars in any one year to SSHS. Five hundred million dollars is only approximately 6 percent of SSHS's annual revenue. Therefore, the fact that the NSSC dividends will be taxable UBI should not threaten SSHS's tax-exempt status, unless SSHS already receives a large amount of UBI from other sources. In order to help manage the risk of losing its tax-exempt status as a result of excessive UBI, SSHS should avoid further transactions that may generate significant amounts of UBI during the period of time that the NSSC dividends are taxable. SSHS will need to carefully monitor and manage the amount of UBI it receives each year, and focus on keeping the percentage of its total revenue that comprised by UBI to no more than 15 percent. Finally, SSHS could apply for a private letter ruling with the IRS, to have the viability of this plan confirmed by the IRS prospectively.

Second, SSHS could lose its tax-exempt status if the IRS determines that the relationship between SSHS and NSSC provides an impermissible private benefit to NSSC. Private benefit is a broad concept that applies whenever any individual or corporation reaps a benefit that is not within keeping of the exempt purpose of the tax-exempt organization.[51] The private benefit does not have to be financial.

There are numerous precautions that SSHS could take, in order to minimize the risk that the IRS would make such a determination. Above all, SSHS should avoid any appearance of impropriety in their relationship with NSSC. For example, SSHS should

---

[50] Shauna O'Brien, Comparing Average Dividend Yield by Sector Dividend.com (2018), http://www.dividend.com/how-to-invest/comparing-dividend-stock-sectors-by-yield/ (last visited Feb 15, 2018).
[51] OVERVIEW OF INUREMENT/PRIVATE BENEFIT ISSUES IN IRC 501(c)(3), (1990).

avoid any agreements that would either compensate SSHS itself or any of its physicians based on number of patients that they refer from SSHS to NSSC. Additionally, SSHS should have documented policies specifying that physicians should only refer patients to NSSC if that is medically appropriate and that physicians are allowed to refer patients to other surgical centers, if necessary. SSHS should document that they train their staff on these polices. Additionally, SSHS should minimize the number of NSSC board members, shareholders, or other individuals who benefit from NSSC's financial status that become key decision makers or board members at SSHS. Finally, SSHS should apply for another private letter ruling with the IRS, requesting a determination that this acquisition structure and management plan will not violate private benefit rules.

3. Corporate Integrity Agreement

As a result of this acquisition, SSHS may be required to comply with the terms of NSSC's Corporate Integrity Agreement ("CIA"). CIA's are simply contracts between regulated organizations and the Health and Human Services ("HHS") division Office of the Inspector General ("OIG"),[52] and thus the language and rules of each individual CIA controls can differ. However, there is typically significant standardization between the CIA's to which the HHS agrees.[53] Typically, a CIA specifies that it will apply to any organization that is a "Successor Organization" to the organization burdened by the CIA.[54] A CIA typically specifies that a burdened organization will only be released from the CIA if it has completely divested itself from the business to which the CIA was

[52] Department of Health and Human Services Office of Inspector General, Corporate Integrity Agreement FAQ | FAQs | Office of Inspector General | U.S. Department of Health and Human Services Oig.hhs.gov (2018), https://oig.hhs.gov/faqs/corporate-integrity-agreements-faq.asp (last visited Feb 15, 2018).
[53] Id.
[54] Id.

directed.[55] Thus, it is unlikely that this acquisition will release NSSC from its CIA, as NSSC ad its founders will retain a 45 percent ownership. Whether SSHS would also be bound by the CIA would turn on whether acquiring a 55 percent ownership interest in NSSC qualifies SSHS as a "Successor Organization." It is unclear if SSHS would qualify, as a CIA does not typically define the term.

However, even if SSHS is bound by the CIA as a "Successor Organization" to NSSC, the regulatory burden may not be significant. Typically, CIA's are not intended to be punitive nor are they meant to significantly increase an organization's regulatory burdens,[56] the express goal of a CIA is to promote compliance with existing requirements. Therefore, even if the CIA binds SSHS, it is possible that it would not incur any new significant regulatory burdens or costs. However, this would depend on the language and requirements in that specific CIA. Additionally, even if the CIA did not add significant regulatory burdens to SSHS, it would increase the risk for SSHS if it should violate those requirements. The typical damages for violating a CIA include a monetary penalty that can be assessed on a "per day basis" for smaller violations, as well as complete exclusion from federal CMS programs such as Medicare and Medicaid for larger "material" violations. SSHS, as an apparently CMS-compliant organization, may be unlikely to incur these penalties. However, if SSHS did incur these penalties, the consequences would be catastrophic and would threaten the viability of the entire organization.

There are several steps that SSHS could take to reduce the risks involved with this CIA. First, SSHS could include in the acquisition a requirement that NSSC warrant that it

[55] Id.
[56] Michael Rosen, The Chilling Effect of the New CIAs (2017), https://www.racmonitor.com/the-chilling-effect-of-the-new-cias (last visited Feb 15, 2018).

in compliance with the CIA and indemnify SSHS for any damages it suffers as a result of any violations of the CIA by NSSC. Further SSHS could include a provision that empowers it to unilaterally change any NSSC business practices that violates the CIA. Finally, SSHS could apply with the HHS Office of the OIG to have the CIA lifted, with respect to itself and/or NSSC. The OIG does have a formal process for these requests, and SSHS's request may be approved if it can satisfy the OIG with its own compliance procedures. If this request was granted it would completely remove the risks and costs associated with the CIA from both NSSC and SSHS, however, such action is at the discretion of the OIG.

4. Stark Law

As a result of the recommended structure for this acquisition, SSHS will be required to comply with the Stark law. SSHS will need to comply with the Stark law because NSSC will have physician ownership, due to the fact that the founding members are physicians and will retain 45% ownership in NSSC under the recommended structure. Therefore, referral from NSSC to SSHS would be a referral from a physician (NSSC) to an entity with which it has a financial relationship. Any such referral for Designated Health Services ("DHS"), which would inevitably be a common occurrence, would trigger the Stark law.

Penalties for violations under the Stark law involve monetary penalties for each violating referral as well as the possibility of exclusion from CMS programs such as Medicare and Medicaid. While these penalties could be catastrophic if SSHS incurred them, the risk of CMS assessing such strict penalties under the recommended structure is remote.

One exception to the Stark law is Isolated Transaction Exception.[57] The recommended structure should fit into this exception, and thus the acquisition would not result in a financial relationship between SSHS and NSSC for purposes of the Stark law. To ensure that the acquisition qualifies for this exception, SSHS must absolutely avoid any additional transactions with NSSC for at least 6 months, unless those transactions fit into the exceptions in 42 CFR 411.357. Additionally, as has been discussed previously in other sections, SSHS also must absolutely avoid structuring any aspect of the acquisition to depend on the volume of referrals it receives from NSSC. Ensuring any additional transaction that would need to occur between SSHS and NSSC is included in the acquisition itself should minimize any risk from the Stark law.

C. Business Risks

Finally, SSHS may face risks as a result of the size of the investment required for this acquisition, the lack of total control over NSSC, and their expansion into new geographic regions.

1. Significant Investment

This acquisition requires an investment from SSHS that is beyond what they have typically invested in other transactions. As a result, SSHS will likely need to utilize much of their on-hand capital as well as debt to fund the acquisition, as discussed in Section 3 supra. The reduction in on-hand capital and the imposition of new debt obligations will thus reduce the liquidity of SSHS. A reduction in liquidity will make SSHS more sensitive to volatility in their cash flow.[58] As a result, SSHS could be unable to take advantage of future opportunities, if those opportunities require liquid capital for

---

[57] 42 CFR 411.357 (f) (2016).

[58] Heitor Almeida, Murillo Campello & Michael S. Weisbach, *The Cash Flow Sensitivity of Cash*, SSRN Electronic Journal (2003).

investment. In a worst-case scenario, reduced liquidity combined with volatility in cash flow could result in SSHS being unable to meet some of its short-term debt obligations.

To mitigate these risks, SSHS should consult with their accountants and financial experts to ensure that they maintain sufficient on-hand liquid capital, considering their expected cash flows, to cover their short-term debt obligations. Additionally, SSHS could ensure that it has available lines of short-term credit with local banks, so that it can quickly access additional liquid capital, if necessary.

2. Control

It is not clear exactly how much corporate control SSHS will have over NSSC following this acquisition, as SSHS will only own 55% of NSSC's stock and it is unknown if there are any super-majority requirements either in NSSC's articles of incorporation and/or in the corporate laws of the states in which NSSC is incorporated or operating. Any super-majority requirements would almost certainly result in SSHS being unable to exercise unilateral control with respect to those actions that require a super-majority. It is most likely that SSHS could encounter this issue with respect to extraordinary actions, such as a sale of NSSC, a merger, or entering into a completely new line of business, as these are the types of actions most commonly burdened with super majority requirements.[59] However, NSSC's articles of incorporation could add super-majority requirements for any type of action.

SSHS could understand and limit the risk they face from their limited control of NSSC by fully researching any super-majority requirements that are currently in NSSC's articles of incorporation as well as the requirements in applicable state laws. If SSHS

[59] Valdimir Rossman, Commercial Contracts: Restraint of Trade 19-45 (2 ed. 2018).

finds any super-majority requirements that burden a power they would prefer to hold unilaterally, they could negotiate with NSSC to amend their articles of incorporation as part of the acquisition.

3. Lack of Expertise

As a result of this acquisition, SSHS will become involved in relatively new lines of business and in new geographic areas, via their majority ownership and relationship with NSSC. SSHS risks making ineffective operational decisions for numerous reasons relating to its lack of expertise in these areas, including: its lack of expertise in the new lines of business, its lack of relationships with vendors and other organizations in new geographic areas, its lack of knowledge of NSSC's own internal operations and personnel, and its lack of direct control over some of NSSC's key business resources such as the PBC Coupler patent. The potential liability from ineffective operational decisions is significant, as they can finically damage NSSC and threaten its viability.

There are several steps that SSHS can reduce the risks from their lack of expertise. The most effective step is retaining involvement and ownership from the founders of NSSC, via the acquisition of only 55% of the ownership of NSSC, as recommended above. This will retain the knowledge and expertise of the founders in NSSC, and financially incentivizes them to continue making effective operational decisions. SSHS can further reduce the risks of ineffective decision making by fully leveraging the expertise of the NSSC founders, by providing them with significant control over the day-to-day operations of NSSC and including them in higher level decision making bodies, such as the NSSC board of directors, even though the NSSC founders do not actually control more than 50% of the NSSC stock. Having the NSSC founders maintain a significant ownership stake in NSSC also financially incentives them to maintain, renew (if necessary), and renegotiate (if necessary) the patent license for the PBC Coupler, which is a key asset for NSSC's viability and cash flow.

VI. Conclusion

The partial acquisition of NSSC provides a great opportunity for SSHS to make itself a player on the national stage. But the acquisition does come with risks that must be properly managed in order to make the acquisition successful long-term, the most important of which are: (1) the potential for SSHS to lose its tax exempt status (2) potential violations of the AKS and the Stark law, and (3) business risks that come from making a significant investment in new markets. Huff, Huff & Doback believes acquiring a 55 percent stake in NSSC provides the safest path while still giving SSHS a fantastic opportunity for future growth.