S-A-F-E Suggestions for St. Sebastian Health System

Team 8

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I. INTRODUCTION

St. Sebastian Health System ("SSHS") is a large, regional, Catholic, non-profit, tax-exempt health system. SSHS owns twenty-four hospitals, seventeen skilled nursing facilities and operates over two hundred care sites in eight states. The SSHS system has more than two thousand employed physicians, a number which is expected to grow. SSHS is one of the leading healthcare providers in each market in which it operates. SSHS's annual system revenue tops twelve billion dollars.

SSHS's board and management recognize that the consolidation wave in the current healthcare market is unlikely to abate and that SSHS needs to grow, substantially, if it is to thrive in the future market. For the past fifteen months, SSHS has been quietly seeking to expand into a new service line that would take SSHS outside of its core regional eight-state market and catapult it into a health care system having national breadth. SSHS has narrowed its search to National Spinal Surgery Centers ("NSSC").

NSSC is a for-profit, privately owned corporation founded by a trio of spinal surgeons and one of the largest management service organizations in the country, owning spine and neurosurgery practices in eighteen states. NSSC owns or 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 employed by NSSC Practice Corporation, P.C. ("P.C."). P.C. contracts with NSSC for management services and the practice infrastructure at each practice location.

NSSC's growth increased dramatically in large part due to the purchase of the exclusive rights to royalties connected with a new spinal device patented by its three founders, the "PBC

Coupler". Revenues also expanded significantly when the founders sold a 55% interest in NSSC to Whitehead Partners ("Whitehead"), a private equity firm.

NSSC's growth has not been without its challenges. Lawsuits 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. A variety of negligence actions have also been filed against some of the NSSC practices and other cases have been filed involving the PCB coupler, alleging premature failure of the device, causing pain and necessitating replacement surgery. Lastly, 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.

A broker has approached SSHS concerning Whitehead's interest in capitalizing on NSSC's success and selling its controlling stake. Whitehead is under no obligation to obtain the trio of surgeons' consent if Whitehead were to sell its interest. A nondisclosure agreement has been entered into between SSHS and Whitehead and preliminary due diligence materials have been shared. The parties have narrowed down the agreed upon market value of Whitehead's majority interest in NSSC to somewhere between \$2.35-\$2.55 billion.

II. Acquisition Structure

The first issue confronting SSHS is the vast array of acquisition structures at their disposal should they decide to follow through with their proposed acquisition of NSSC. Though the number of options is theoretically infinite, the central decision facing SSHS is which of the core acquisition structures can be shaped to meet their needs best: an asset purchase, a stock purchase, a joint venture or one of three tax-free reorganizations (A, B, and C). Taking this, along with SSHS's unique circumstances and objectives, into account, our firm would ultimately recommend a structure that is: simple, accurate, (tax) free and that contains as little exposure as possible. Stated another way, our firm would recommend a ***reverse subsidiary merger*** because it is the only structure that is "S-A-F-E."

i. *Simplicity:*

SSHS's immediate concern will likely involve the rate of speed, and level of complexity, regarding any subsequent integration. Though SSHS enjoys a strong organizational reputation, NSSC is one of the largest management service organizations in the country, and the consolidation wave currently hitting the healthcare industry shows that time is not on SSHS's side. Therefore, it seems only logical to begin with an examination of simplicity first.

While almost all of the potential structures present resolvable difficulties regarding this objective, two of them prove to be insurmountable: Type B and Type C Reorganizations. Under a Type B Reorganization, an acquiring corporation exchanges voting stock in their corporation for a controlling or complete interest in the target corporation.[1] In addition to containing a strict, voting-stock-only requirement, Type B reorganizations also require that the purchasing corporation possesses "control" of the target corporation immediately following the exchange.[2]

This creates a major hurdle for SSHS for two reasons. First, because SSHS is a tax-exempt, non-profit organization, it does not possess the ability to distribute stock. Therefore, in order to take advantage of this potential structure, SSHS would need to create a for-profit subsidiary company that they could then have to execute the deal. Though this would inconvenience SSHS to a certain degree, it would be manageable. The overarching issue,

[1] INTERNAL REVENUE CODE § 368(a)(1)(B).
[2] INTERNAL REVENUE CODE § 368(c) (control means at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock).

however, concerns the 80% control requirement since SSHS only has a current offer for 55%. While further investigation is certainly advised, the current facts are insufficient to conclude that any of the remaining NSSC shareholders wish to also sell their stake in the company. Therefore, absent any additional or unexpected information, this option appears ill advised to meet SSHS's immediate needs, especially considering any non-stock inclusions can dismantle the entire transaction and result in a taxable stock sale.

Much like the concerns discussed above, Type C Reorganizations present similar difficulties. Under this framework, a purchasing corporation exchanges a mixture consisting primarily of voting stock in their corporation, along with other non-stock contributions like cash or property, in return for 'substantially all' of the target corporation's assets.[3] The target corporation then liquidates itself almost immediately after the transaction. Though this structure provides more flexibility since it allows up to 20% of the overall consideration to consist of non-voting stock, this not only still falls well short of SSHS's 55% target, but it also creates an additional layer of complexity since not all assets are necessarily transferable. For example, permits—such as certain state licenses to operate a hospital—are not transferrable, even with consent.[4] Furthermore, many commercial contracts contain anti-assignment provisions that would likely be triggered under this approach, which could then increase the potential for holdouts, lengthy negotiations, and various other complications. SSHS would also lose the ability to arrange any pre-deal disposals of unwanted assets given the strict 'substantially all' requirement.

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[3] INTERNAL REVENUE CODE § 368(a)(1)(C) (substantially all means assets representing at least 90% of the target corporation's net assets and at least 70% of the gross assets).
[4] Andrew L. Bab and Dmitriy A. Tartakovskiy, Health Care Mergers and Acquisitions Answer Book, 4(Kevin A. Rinker et al. eds., 2017th Edition. 2017).

The remaining structures, however, present little to no difficulty in this respect. Though asset purchases generally involve immediate inconveniences like multiple document transfers, and joint venture agreements can include reoccurring hassles such as continuous supervision, both of these difficulties are nevertheless manageable. Furthermore, other potential structures like stock purchases and mergers exhibit the highest degree of simplicity considering the following: they usually contain minimal requirements like filing or exchanging a merger/stock certificate(s); they generally won't constitute a change of ownership of a hospital for Medicare purposes,[5] and they typically require fewer third-party consents since the target's corporate identity and most of its regulatory permits and licenses remain unaffected.[6]

ii. *Accuracy:*

In addition to—if not more important than—providing overall simplicity, SSHS's ideal structure must also achieve its stated objectives without question. The SSHS Board's aim was to position the company as a provider with national breadth. Therefore, the next step in this analytical framework should be an evaluation of each structure in terms of SSHS's desired outcome.

While almost all of the remaining options might be able to satisfy SSHS's stated objectives, the potential for failure under an asset purchase remains the highest. In an asset purchase, the purchasing corporation receives the ability to strategically select assets and liabilities they want to assume from the target corporation.[7] Though this approach would appear to allow SSHS more flexibility, in terms of distancing itself from the NSSC liabilities noted earlier, a closer reading of the facts illustrates this is far from the case. In order to fit within the

[5] 42 C.F.R. § 489.18 (a transaction in which a new legal entity becomes the owner and operator of a Medicare-enrolled provider constitutes a change of ownership).
[6] Bab, *supra* note 4 at 12.
[7] *Id*. at 9.

Board's stated goal of national expansion, SSHS would ultimately need to acquire most—if not all—of NSSC's assets. However, as SSHS's percentage of assets increases, so too does its risk to de facto merger and successor liability labels.

As a general rule, it is true that a buyer in an asset purchase does not automatically assume the liabilities of the seller.[8] However, in certain situations, buyers can face liability under the state law doctrines of de facto merger and successor liability. De facto mergers are held to occur when transactions—which are clearly mergers in substance—are structured in ways that grant all the benefits of a merger, while simultaneously avoiding any assumption of liability.[9] In situations such as this, courts have shown a tendency to grant creditors relief under a state's successor liability doctrine, which generally allows creditors to seek recovery from asset purchasers for liabilities that were not assumed in an acquisition.[10] Therefore, though SSHS does have the ability—in theory—to structure this transaction in a way that could ensure the acquisition of all necessary assets without any of the accompanying risks, in all likelihood this outcome is extremely unrealistic.

Additionally, an asset purchase offers no solution to the transferability issue detailed in Type C reorganizations. As noted earlier, intangible assets like licenses and many commercial contracts tend to create assignment issues regarding their transfer. Unfortunately for SSHS, this would ultimately include the PBC coupler patent (along with any subsequent licenses arising from it), which accounts for most of NSSC's proposed value. Therefore, because this framework can prevent—or at the very least overly complicate—the transfer of the most valuable asset at stake here, it too, seems ill suited to meet SSHS's clearly defined needs.

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[8] *Id.*
[9] *See* De Facto Merger, BLACKS LAW DICTIONARY, https://thelawdictionary.org/de-facto-merger/
[10] *See* Successor Liability, U.S. LEGAL DICTIONARY, https://definitions.uslegal.com/s/successor/

iii. *Free:*

After establishing a solution that is both simple in its application and accurate in its design, SSHS will likely shift its focus to costs—at both the macro and micro levels. SSHS is a tax-exempt, non-profit healthcare system. The Internal Revenue Code provides that a non-profit organization does not pay taxes if it is organized and operated exclusively for a tax-exempt purpose.[11] The term "exclusively" has subsequently been defined to mean primarily, with courts allowing several tax-exempt organizations to receive unrelated trade or business income tax-free as long as they continued to carry out charitable programs that are commensurate in scope with the organization's financial resources.[12]

This benefits SSHS for two reasons. First, due to the massive consolidation wave currently hitting the healthcare industry, SSHS can argue that any of the three remaining transactions was executed in furtherance of its charitable (tax-exempt) purpose since its objective was to secure funding for both long and short-term survival. Furthermore, even if the income used to fund this transaction is found to be linked to non-tax exempt purposes—and thus taxable as unrelated trade or business income (UTBI)—it is generally taxed at a rate that is identical to the current corporate tax rate, which, as of this year, is at an all-time historic low. Moreover, the approximate cost of the proposed offer only represents about one-fifth of the company's annual revenue. Therefore, assuming no major deviations occur regarding SSHS's customary level of charitable activity, even if the income were held to be subject to taxation, the amount would, in all likelihood, represent an insubstantial—and permissible—allocation of resources.

Though structures such as stock purchases or mergers can generally be organized in a way that avoids the dreaded "double-tax" at the corporate level, corporate joint ventures,

[11] INTERNAL REVENUE CODE § 501(c)(3); *See also* Reg. 1.501(c)(3)-1(c)(2).
[12] Rev. Rul. 64-182, Internal Revenue Service (1964).

unfortunately, cannot. In a corporate joint venture, two or more independent entities come together to form a commercial collaboration for purposes ranging from a single project to continuing a business together for the foreseeable future.[13] Here, this would involve SSHS either entering into a contractual relationship with NSSC—commonly referred to as a 'strategic alliance'—or SSHS creating a separate legal entity with NSSC (i.e. corporation, partnership, limited liability company, etc.). The issue presented by this structure is two-fold. First, there is a very high probability that either the new entity or the contractual relationship with NSSC, will subject SSHS to USTB taxation. Therefore, any revenue put into or derived from such an arrangement is likely to be subject to USTB taxation. Furthermore, the creation of the new entity could result in organizational and public relations issues. Specifically, SSHS could face a whole smorgasbord of problems spanning from internal culture disruptions to external donor misrepresentations—each containing their own unique set of repercussions. Therefore, because this framework appears to leave SSHS with more problems than solutions, it is ultimately ineffective under these circumstances.

iv. *Exposure:*

Given the fact that the two remaining structures—stock purchase and Type A Reorganizations—share a high degree of similarities with one another, SSHS's ultimate decision is likely to hinge on which structure minimizes its overall exposure the best. Stated another way, SSHS's ideal structure will likely be the one that provides the Board with more sleep at night.

While both options can be structured in a way that can insulate SSHS from external threats such as unknown or undisclosed NSSC liabilities, only one option provides SSHS with protection from internal issues as well: Type A reorganizations. Under a Type A reorganization,

[13] *See* Joint Ventures: Tax Issues, Practical Law Practice Note 8-502-5303.

more commonly referred to as a merger, an acquiring corporation exchanges a mixture consisting primarily of either non-stock contributions like cash or property, or voting stock in their company, in return for a controlling or complete interest in the target corporation. This framework is most commonly used for shareholder buyouts given that it—unlike both Type B and Type C reorganization—permits up to 60% of the overall consideration to consist of non-voting stock. Here, because SSHS currently only has a 55% controlling interest offer, this is the only structure that would provide SSHS with enough flexibility to buy out the remaining 45% of the company from the minority shareholders.

Though it is true that SSHS could obtain 100% control of the company (and internal security) via a stock purchase as well, that approach ultimately leaves SSHS vulnerable to too much exposure. Stock purchase agreements generally require individual purchase orders from each and every shareholder and, as noted earlier, the current facts are insufficient to conclude that any of the remaining NSSC shareholders wish to also sell their stake in the company. Therefore, this framework not only creates simplicity issues, but it also leaves SSHS exposed to many of the same holdout and renegotiation issues detailed in asset purchases or Type C Reorganizations.

Therefore, our firm would ultimately recommend SSHS engage in a reverse subsidiary merger with NSSC. This approach involves two simple steps. First, SSHS creates a for-profit subsidiary company ("SubCo") to accept Whitehead's offer—pending a potential reevaluation given the due diligence findings. Next, SSHS orchestrates a merger between SubCo and NSSC using its controlling interests in both companies (with NSSC surviving). After the smoke clears, SSHS emerges with a controlling interest in NSSC 2.0, and a multitude of options for reaching its stated objective depending on what the future holds.

III. Financing the Acquisition

The financing sources for business acquisitions are as varied as the structure and motivations for the acquisitions themselves. The most efficient source depends on several factors, including the cost of raising capital, prevailing interest rates, flexibility desired and any anticipated need for future financing. Potential sources of financing generally can be divided into equity financing and debt financing. Per our suggestion that SSHS acquire Whitehead's fifty-five percent share in NSSC, SSHS will need to raise enough capital necessary to complete the purchase, including the purchase price itself and various fees and closing costs.

A common mistake buyers make is to focus on an attractive purchase price, rather than the strategic importance of the company's present and future growth plans.[14] Securing capital and the best financing terms for an acquisition can be daunting and challenging.

A key to the type and availability of funding is the structure of the company that is being acquired. The type of business being acquired, the valuation of assets and cash flow, perceived market risk as well as growth plans, are the characteristics that determine which capital sources and financing structure is the most appropriate.[15] Each type of transaction will have its unique set of evaluation criteria, cost of capital, expectations, deal terms, and covenants.

Companies generally elect to include debt in their capital structure in part because interest on debt is usually tax deductible whereas dividends usually are not. In addition, in the

[14] Linda L. Curtis & Andrew Cheng, *Introduction to Acquisition Financing*, LEXISNEXIS, https://advance.lexis.com/api/permalink/1ecab257-1e01-4812-9128-1f9e05f3efbe/?context=1000522.
[15] *Id*.

acquisition context, the inclusion of debt financing as well as equity financing helps to diversify the potential sources of financing.[16]

Negotiations of acquisition financing have become increasingly complicated, with the seller typically reviewing the buyer's financing commitment papers and the lenders reviewing the acquisition agreement. Binding commitment letters setting forth the structure of the financing, the terms of the financing, and the conditions that will need to be satisfied before the lenders are required to fund are typically negotiated.[17]

Since the financial crisis, it has become rare for an acquisition agreement to condition the buyer's obligation to close on obtaining debt financing.[18] Accordingly, the buyer is assuming significant risk if the financing were to fall through. However, buyers are often successful in negotiating a sharing of the risk with the seller, through limitations on specific performance remedies and/or damages for a financing failure. It is customary to ask the buyer to make certain representations to the seller in the acquisition agreement relating to its financing commitment.[19]

In addition, acquisition agreements almost universally contain a mutual covenant to the effect that after signing, the parties will all make reasonable efforts to consummate the transaction.[20] In the case of steps required to consummate the buyer's acquisition financing,

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[16] Linda L. Curtis & Andrew Cheng, *Acquisition Finance Sources: Equity and Seller Financing*, LEXISNEXIS, https://advance.lexis.com/api/permalink/59de0e20-5bd4-4ba0-8cc3-be39e2df1b6e/?context=1000522.
[17] *Id*.
[18] Linda L. Curtis & Andrew Cheng, *Key Acquisition Agreement Financing Terms*, LEXISNEXIS, https://advance.lexis.com/api/permalink/5632d0f2-68b4-4bfe-88a0-1c1967469457/?context=1000522
[19] *Id*.
[20] *Id*.

these reasonable efforts provisions have become very extensive and detailed, for both buyer and seller, especially since the end of the 2008 financial crisis.[21]

i. *Purchase Price*

An issue in any transaction, purchase price is key in healthcare transactions in the current market. Because of how robust the healthcare M&A market has been, purchase price multiples seem to be at an all-time high.[22] The surge in activity has been primarily driven by strategic acquirers seeking economies of scale as they face the impact of healthcare reform.[23]

The purchase price provisions are among the most critical terms of an acquisition agreement. The value of the consideration to be paid by the buyer to the seller will be affected not only by provisions setting forth the amount of the consideration, but also by the form of consideration, the timing of payment, potential adjustments to the amount to be paid, and any rights of set-off that the buyer may assert against outstanding payments. The buyer can finance the transaction, or give the seller a promissory note if it does not have the cash on hand to pay the full purchase price.[24] Regardless of the transaction's structure, the negotiated letter of intent often includes a detailed purchase price provision. If the parties negotiated such a document, it should be used as a starting point in drafting the purchase price provision in the acquisition agreement.

In the acquisition of a private business, the acquisition agreement also may provide for deferred payments. Deferred payments are usually structured as installments to be paid after

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[21] *Id*.
[22] Steven Glover, *Purchase Price Provisions in Acquisition Agreements*, LexisNexis, https://advance.lexis.com/api/permalink/36580052-87e0-47d3-abd2-def5b155b354/?context=1000522.
[23] *Id*.
[24] *Id*.

closing, either at set intervals or upon the occurrence of certain events.[25] Deferred payments that become payable upon the meeting of certain post-closing performance benchmarks are often referred to as "earn-outs". The buyer may demand a set-off right against deferred payments to support the seller's indemnification and other post-closing obligations. Likewise, a portion of the cash consideration may be placed in an escrow account or retained as a holdback so that there are readily accessible funds to cover indemnification claims or other specified contingencies. Most often, cash is paid in the form of immediately available or "same day" funds sent by wire transfer.

It is commonplace to request a fairness opinion concerning acquisition purchase price.[26] We should seek a fairness opinion from a third party considering the due diligence findings regarding all of the liabilities of NSSC to renegotiate the purchase price.

The parties to an acquisition agreement may agree to include certain provisions in the agreement to preserve the transaction value between signing and closing. Purchase price adjustments are included in acquisition agreements to preserve the benefit of the parties' bargain during the interim period, and sometimes post-closing as well.

It is important to remember that getting financing usually increases the closing costs of the deal. These closing costs, which include the buyer's contribution to the purchase of the business, come from the buyer. The amount the buyer needs to budget for closing costs varies based on the size and type of business that is being acquired.

ii. <u>*Debt Financing*</u>

A senior secured creditor is the prototypical type of debt financing for an acquisition.[27] If a senior secured creditor is being used to fund an acquisition, such a creditor usually provides

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[25] *Id.*
[26] *Id.*

most of the debt financing used to fund the purchase price of the acquisition. In practice, term loans are typically drawn in a single draw at the closing of the acquisition to fund the payment of the purchase price. Revolving loans may be drawn in part at the closing of the acquisition to help fund the payment of the purchase price, but they are primarily used for ongoing working capital needs of the acquired company.

Ideally, the buying company would come out on the other side of the acquisition with as little debt as possible. Using debt to finance part or most of an acquisition will allow the buyer to use less capital of its own, however, there will then be a new obligation to pay off the creditor that could become a huge liability down the road.

iii. <u>*Equity Financing*</u>

Equity financing for a business acquisition can take many forms and is highly dependent on the structure of the acquisition. A merger, for example, may be funded all or in part by equity issued by the purchaser. Because the value of a buyer's stock may fluctuate, the purchase price becomes less certain than a pure cash or debt deal. Equity financing is also highly dependent upon the type of equity being issued as consideration for the acquisition. Private company securities may be used, however, whenever the buyer issues equity securities as part of the acquisition consideration, it should carefully consult counsel regarding issues relating to compliance with applicable federal and state securities laws. Typically, the buyer seeks equity from such sources as private equity firms, venture capitalists, and angel investors.[28]

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[27] Linda L. Curtis & Andrew Cheng, *Acquisition Finance Sources: Debt*, LexisNexis, https://advance.lexis.com/api/permalink/499de759-6eb3-4bc3-b8d7-a6a3fb5eaf57/?context=1000522.
[28] Carolyn M. Brown, *How to Finance an Acquisition* (Jan. 20, 2011), https://www.inc.com/guides/201101/business-acquisition-financing.html.

A buyer will not have any debt, but the buyer is going to have to give up equity for the cash infusion. There is no guarantee that the buyer will be able to find investors to buy the equity interests or investors that are willing to pay the buyer's chosen rate for the interests.

iv. *Seller Financing*

Seller financing allows the buyer to defer part of the purchase price for a pre-negotiated period of time. The buyer pays a cash down payment to the seller, and the seller, acting like a bank, finances the remainder of the purchase, with payments made to the seller over time. Often, seller financing will be combined with some other sort of consideration to bridge the gap in purchase price negotiations between what the buyer is offering and what the seller is demanding.[29] In many ways, this is the simplest form of financing a business purchase. The down payment, in this case, is purely negotiable, ultimately it is whatever is agreeable to the buyer and the seller.[30] The remaining amount to be paid to the seller can simply be in the form of a promissory note with equal payments for a set period, or an earn-out, where payments are tied to the performance of the business going forward. Either way, this benefits the buyer because the seller has a strong interest in seeing the business succeed under the new ownership. Seller financing is a flexible option because terms are fully negotiable between buyer and seller. It can also be the fastest route to a closing. However, there is no guarantee that the seller will be interested in financing the acquisition. The seller may want to be done with the deal as soon as the agreement is finalized or may not have the funds necessary to loan to the buyer.

v. *Cash on Hand*

While it is unclear without having been able to look over SSHS's balance sheet, with a billion-dollar revenue it can probably be presumed that SSHS has a fair amount of cash on hand

[29] *Id.*
[30] *Id.*

to finance a portion of this acquisition. Combined with other sources of financing, cash is a good option for an acquisition because the buyer would not be taking on a substantial amount of debt or giving away too much equity in their own company or any subsidiary companies. Using only cash to finance an acquisition is possibly not as common as other strategies which use multiple methods, but can be an effective strategy given the particular structure of an acquisition.

vi. *Proposed Financing Strategy*

Concerning the proposed acquisition of the 55% interest in NSSC currently owned by Whitehead, we suggest financing the purchase with the combination of cash of SSHS for this particular deal, and issuance of equity stock in the new subsidiary to outside investors in exchange for capital for the capital required in the future acquisition of the entirety of NSSC.

With the information of SSHS having a twelve-billion-dollar revenue stream in the most recent year, there should be enough cash on reserve that can be utilized as necessary to complete the transaction. SSHS should move $2.5 billion in cash to the new subsidiary company to finance the acquisition of Whitehead's interest. While this is an enormous amount of money, SSHS is running out of options business-wise. The only way to achieve their stated goals is to make this move.

To do this, the new chief officers at the subsidiary, people of SSHS's choosing, will be on the other end of a deal giving SSHS a 55% stake in the new subsidiary in exchange for SSHS's capital. We will then offer up the other 45% interest in the new subsidiary to outside investors in the form of equity stakes in exchange for more capital to be used in the long-term acquisition of NSSC in its entirety. SSHS should attempt to give away the other 45% of their equity to outside investors and donors at a value identical to the equity of NSSC.

If SSHS ultimately decides that it does not want to finance the acquisition in cash alone to cover the cost of Whitehead's interest, then SSHS should seek financing in the form of a secured creditor to help bridge the gap in the chance that a financing disparity arises. A thorough review of the most recent balance sheet will be necessary for SSHS to make this decision. While taking on a large amount of debt is not our recommendation, it may be unavoidable if SSHS is not comfortable with the only-cash method. If this does become necessary, SSHS should have no problem's acquiring a loan from a lender for the new subsidiary given the substantial revenue amount in the most recent year and the company's reputation as one of the leading providers.

SSHS should use the due diligence findings about NSSC to negotiate the purchase price to the most favorable amount as possible. Given the nature of the findings, SSHS should be able to avoid paying the maximum amount of $2.5 billion. SSHS should also negotiate a portion of the cash consideration at the signing of the acquisition agreement be put into an escrow account for the purposes of paying any penalties that arise in the interim period of the deal.

In closing, keep in mind that it is common to use more than one source of funding to acquire a business. There are many considerations that go into making the decision on how to finance this acquisition of Whitehead's share.

IV. ACQUISITION EXPOSURE

Healthcare industry transactions are generally very unique as they are likely to be affected by various commercial, legal, regulatory, and tax considerations. Adopting a reverse subsidiary merger as the structure of this transaction will shield SSHC from the multitude of risks that are generally associated with these types of transaction. Reverse mergers are commonly used and recognized in healthcare transactions, as an effective risk-mitigating structure. The primary advantage of this type of merger is that liabilities remain with the target company (NSSC). Additional advantages are also the facts that anti-assignment provisions will not be triggered under this type of merger and, the transaction will not result in a change of control of the NSSC.[31] Yet, despite the numerous advantages of S.A.F.E, completing an extensive due diligence review before acquiring NSSC as a subsidiary will be an integral part of this transaction. In addition, due diligence reviews will need to be conducted periodically to ensure, the ongoing regulatory compliance of these two entities.

i. *Legal Exposure*

SSHS's immediate concern will likely involve the various lawsuits pending against NSSC. Though the facts indicate that the negligence actions signal no cause for alarm, the compensation related suits present much higher concern considering there are indications that the disgruntled physicians might allege an undue influence lawsuit as well. While NSSC is sure to receive their day in a court of law to contest these allegations, the court of public opinion might not be so patient. Therefore, SSHS's initial focus should concern devising solutions to these legal exposures or, at the very least, allocating some of their inherent risks.

While the negligence actions and physician allegations can be resolved rather efficiently (under the right circumstances), the product liability exposure presents a greater concern. The facts currently indicate that isolated cases have been filed around the country alleging issues stemming from NSSC's most valuable asset. This creates a risk for SSHS in two ways. First, because our recommended structure results in SSHS's subsidiary assuming all of NSSC assets and liabilities, SSHS's separate immunity appears to be at risk given its parent relationship. Additionally, because the facts give no indication that these claims are completely without merit,

[31] Bab, *supra* note 4 at 4.

any subsequent judgment(s) favoring the petitioners would ultimately be enforced indirectly against SSHS.

In order to combat, or at the very least mitigate, these risks, our firm would recommend a two-prong solution. First and foremost, SSHS's subsidiary should require that both the Whitehead purchase and subsequent shareholder buyout, involve an escrow-structure. Stated another way, before SSHS begins to make its strong case for any price reductions, it should first ensure they can obtain the most advantageous structure. Under an escrow payment framework, a buyer can place an agreed upon percentage of the purchase price in an account to insure against any unresolved liabilities they ultimately assume. Following the final resolution of the issue, if liability existed, then the judgment is fulfilled by the funds in the escrow account, and if not, then the funds in the escrow account are released to the seller—thereby resulting in satisfaction of the entire purchase price. Though both Whitehead and the minority shareholders are likely to oppose such a structure of financing, SSHS can respond in two ways. First, because contract law stresses the importance of contracting parties receiving what they bargained for, SSHS can argue that this modified payment is not a reduction at all, but rather a simple deferral it included to ensure the reliability of NSSC's alleged value. Furthermore, because this framework would result in a structured, rather than lump sum, payment, the taxes both Whitehead and the minority shareholders ultimately pay on these cash receipts could be much less.

Additionally, SubCo should argue for a purchase price reduction given these recent due diligence findings—or at the very least require an independent fairness audit. This could benefit SSHS not only because an overall price reduction may occur regarding both the Whitehead purchase and the shareholder buyout, but also because this ensures both the SSHS and non-SSHS shareholders in SubCo receive exactly what they contracted for. Nothing more. Nothing less.

ii. *Business Risk*

After devising amicable solutions to insure against any legal exposure, SSHS will likely shift its concern to any business risk arising from this transaction. As noted earlier, SSHS is a tax-exempt organization that must adhere to special restrictions in order to avoid USTB taxation and preserve its tax-exempt status. Though our recommended structure does result in SSHS owning a controlling interest in a for-profit company, this should not pose a major threat to SSHS's tax-exempt status for two reasons. First, SSHS can argue that the transaction was committed in furtherance of its charitable—tax-exempt—purpose, and second, the overall transaction likely represents a permissible allocation given its insubstantial nature.

Additionally, because our recommended framework results in a parent-subsidiary relationship being created, this conclusion necessitates the existence of at least two separate legal entities. This 'organizational shield' not only strengthens SSHS's arguments for separate tax analyses, but it also provides protection in various other areas such as successor liability, public relations, and internal culture.

Retaining NSSC's exclusive rights to the royalties of the new spinal device is imperative. The record does not mention the existence of any anti-assignment provisions in connection with this patent, but it would be prudent to be mindful of this risk. Here, this will thankfully not be a concern as an additional advantage of this type of structure is the mere fact that reverse mergers do not constitute an assignment under the target's contracts and will not trigger anti-assignments provisions that restrict an "assignment by operation of law."[32] In fact, some of the uncertainties as to whether an IP license that either explicitly prohibits assignment or is silent would be violated as a result of a reverse triangular merger of the license have been recently laid to rest. In

[32] Bab, *supra* note 4 at 4.

a recent case, the court has ruled that a reverse triangular merger does not constitute an assignment by operation of law as to the surviving entity.[33] Though contract laws may vary from one jurisdiction to another, this conclusion has generally been accepted.[34] Consequently, NSSC will continue to receive the royalties associated with the spinal device patent. However, it may be prudent to verify contract laws that are applicable to the state of Loyola and to require that consents be obtained from third parties.

Another potential hurdle faced by healthcare entities during mergers might be the cumbersome regulatory constraints that are triggered if a change of control of the target occurs. It is likely that NSSC holds several licenses. Thus, during its due diligence review, SSHS will need to first review the licenses and permits to ensure that they are valid to ensure continuous operation of NSSC following the closing of the transaction.[35] The review will also help them identify additional risks of liabilities resulting from any business operations conducted without proper authorizations. The due diligence review will also include a review of NSSC's Medicare and Medicaid status. It is absolutely critical to determine whether the transaction will result in a change of ownership (CHOW) for medical purposes as CHOW application must be submitted before closing.[36] In a corporation, a change of ownership (CHOW) for Medicare purpose occurs as the result of a merger of the provider corporation into another corporation or the consolidation of two or more corporations, resulting in the creation of a new corporation.[37] If a transaction

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[33] *See Meso Scale Diagnostics, LLC v. Roche Diagnostics GmbH, C.A.* No. 5589-VCP (Del. Ch. 2013) (confirming that a reverse triangular merger does not result in an assignment by operation of law).
[34] *See Id.* at 49 (court acknowledging that leading commentators have noted that a reverse triangular merger does not constitute an assignment by operation of law).
[35] Benjamin M. Daniels and Melesa A. Freerks, E. Fundamentals: Avoiding Transaction Pitfalls-Licensing and Regulatory Compliance, AHLA, May 17-18, 2016, at 11.
[36] Daniels, *supra* note 41 at 11.
[37] 42 C.F.R. § 489.18.

results in a CHOW for certification and Medicare provider agreement purposes, the Medicare provider agreement is automatically assigned to the new owner.[38] The new owner takes the provider agreement subject to all terms and conditions and assumes all penalties and sanctions under the Medicare program.[39]

The nature of the transaction is important because the Center for Medicare and Medicaid Services' guidance on what constitutes a CHOW primarily relates to the nature of the particular transaction. Here, this transaction will most likely not result in a CHOW as CMS has consistently found that the transfer of stock or the merger of a corporation of another corporation into the provider corporation does not result in a CHOW.[40] However, what constitutes a CHOW may vary from state to state, thus SSHS will review the laws that are applicable to the state of Loyola. Generally, state agencies will consider whether there is a change in the entity or individuals that control the operations, whether there is a change in the tax identification number of the entity or a change in the control of the organization as the benchmarks to trigger various regulatory obligations such as applying for a new license or providing notice.[41]

iii. *Regulatory Compliance*

Regulatory due diligence reviews are an integral part of all health care transactions because of the heavily regulated environment of health care entities. Conducting a comprehensive due diligence review will provide a vital tool to help SSHS assess the potential current and future risks associated with this transaction. Activities that should be included in the scope of regulatory due diligence review include, but are not limited to, the following: assessing the effectiveness of the Compliance Program, determine all liabilities, review management and

[38] 42 C.F.R. § 489.18(c).
[39] Daniels, *supra* note 41 at 11.
[40] *Id.*
[41] *Id.*

policies of high-risk areas, including: HIPPA privacy and security program, all processes and controls related to any arrangements with referral sources and claims submission. Regulatory due diligence may be conducted at a different time.[42] In this case, SSHS will conduct thorough pre and post-closing due diligence reviews to ensure continuous compliance with the Stark Law, Anti-Kickback Statute, False Claim Act and any other federal or state regulations.

a. Stark

The Stark law, also known as the federal physician self-referral law, forbids physicians from referring for designated health services payable under Medicare or Medicaid to health care entities with which they or an immediate family member have a financial relationship unless an exception exists.[43] Financial relationship covers a wide array of arrangements**.** A prohibited financial relationship includes both an ownership or investment interest and any compensation arrangement. Designated health services include, but are not limited to, clinical lab services, physical therapy services, and occupational therapy services etc. Any violation of this law may result in severe monetary sanctions against that entity.[44] Fortunately, this law also includes a series of exceptions in order to accommodate legitimate business arrangements.

The most useful exception is the exception for fair market value compensation. Under the terms of this exception, "if a compensation arrangement is in writing, specifies the timeframe for services, specifies the compensation that will be provided, involves a commercially reasonable transaction, meets a safe harbor under the federal anti-kickback statute, and the services to be performed do not involve the counseling or promotion of an illegal business activity, then the

[42] Michael Anthony, AHLA Seminar Materials (2016).
[43] 42 USC § 1395nn(a).
[44] *Id.*

compensation made under such arrangement will not be treated as creating a "financial relationship" between a physician and an entity.[45]

First, SSHS will evaluate whether there are any potential financial relationships between NSSC's physicians and SSHS. Since this type of merger does not automatically create a financial relationships between the physicians and SSHS, NSSC's physicians will be able to continue to use the hospital for designated services if need be. Because NSSC functions as a separate entity, as long as its physicians do not have an ownership interest or receive any compensation for services not meeting one of the exceptions, it will be in compliance with Stark. In addition, it is worth noting that under this type of subsidiary model, many institutions do require that physicians utilize the hospital for services.[46] In addition, to avoid any compliance issues, it would be prudent for SSHC not to make it a requirement that physicians make referrals to their hospital. Greater scrutiny may occur if sums of money are transferred from the hospital to the subsidiary to provide funding.[47] However, under the fair market exception, as long as it is shown that the physicians are not paid more than fair market value, there are several avenues justifying the funding given to its subsidiary.[48] As a result, SSHS will not have any immediate issues with complying with Stark, but it will need to monitor any financial relationships between NSSC's physicians and SSHS.

b. Anti-Kickback Statute

The federal Anti-Kickback Statute is a criminal statute, which prohibits the exchange or offers to exchange of anything of value made with the intention to encourage the referral of

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[45] 42 CFR 411.357.
[46] Scott Becker, Bart Walker and Sarah Abraham, Hospital-Physician Integration Models: An Alternative to Joint Ventures, Health care law monthly, July 2007 at 6.
[47] *Id.*
[48] *Id.*

federal health care program business.[49] Severe penalties may result from a violation of this statute. In 2002, a federal district court, addressing a motion to dismiss in a qui tam action, referenced the 1992 OIG letter and stated that "the Anti-Kickback Act does not prohibit hospitals from acquiring medical practices, nor does it preclude the seller-doctor from making future referrals to the buyer-hospital, provided there are no economic inducements for those referrals."[50] To comply with the statute, the SSHC must simply pay fair market value to acquire the practice.[51] In addition, the U.S Department of Health and Human Services has promulgated safe harbor regulations that establish practices that are not subject to the anti-kickback statute because these practices would be unlikely to result in fraud or abuse. SSHC should review all provider contracts to determine, if there are referrals from providers, that the relationship fits into one of the statutory exceptions.

c. Anti-Trust

Federal and State antitrust laws serve as safeguards to ensure that markets remain competitive. Therefore, healthcare transactions involving competitive implications are generally subject to increased scrutiny by both the U.S. Federal Trade Commission (FTC), and the Department of Justice (DOJ).[52] The central concern underlying these extensive examinations, however, is ultimately not present in SSHS's scenario. Here, the facts not only reveal that SSHS is currently not—nor ever has been—involved in the spinal industry, but they also note that SSHS is seeking to gain national expansion, thereby making any threats of potential industry monopolization exponentially more difficult.

[49] 42 U.S.C. § 1320a-7b.
[50] Shane Gross and Catherine T. Dunlay, Legal and Valuation Concerns in Hospital Acquisition of/Association with Physician Practices (2009).
[51] *Id.*
[52] Jeff Miles, *Healthcare Antitrust Mergers and Merger Guidelines Revision: What Might It Mean for Healthcare Firms*, 22 Health Law. 36, (2009).

Furthermore, SSHS is not without options when it comes to allocating some of this risk. Notable recommendations our firm would advise include adding an anti-trust clearance closing provision on the transaction, and taking industry competitors' input into account during price negotiations, in order to help alleviate the concern that the merger will lead to increased prices.[53]

d. Corporate Integrity Agreement:

The fact that NSSC entered in into a Corporate Integrity Agreement ("CIA") with the Health Human Services Office of the Inspector General ("OIG"), while cumbersome, is not necessarily alarming. CIA agreements are generally negotiated into settlement agreements with health care providers following investigations arising under a variety of civil false claims statutes. In exchange for not excluding their participation in federal health care programs like Medicare and Medicaid, the offending providers agree to various administrative requirements.

Here, the facts reveal that NSSC entered into this five-year agreement in 2016, and no indication exists for concluding they have had any concerning issues with the OIG to date. Though this is unlikely to provide the SSHS Board with the level of sleep they are likely now envisioning, SSHS is, again, in a position that provides it with mitigating options. First, SubCo could argue for a restructuring of the purchase price pending completion of the CIA—or at the very least, completion of an independent SSHS investigation into their current CIA compliance. Additionally, SSHS could argue for a further purchase price reduction, using their assumption of NSSC's remaining two-year commitment (and the inherent complexities they necessarily accompany it) as evidence for their position.

[53] Market Matters: How Major Hospital Mergers Have Avoided Antitrust Issues, VMG Health, https://www.beckershospitalreview.com/hospital-transactions-and-valuation/market-matters-how-major-hospitals-mergers-have-avoided-antitrust-issues.html.

V. Conclusion

In summary, it is our recommendation that a potential acquisition of NSSC be structured as a reverse subsidiary merger. This unique structure not only creates an ancillary revenue source capable of funding future SSHS growth, but it removes virtually all-risk to SSHS's tax-exempt status, while simultaneously providing as much protection as possible against any uninsurable risks.

SSHS should not be concerned by the impending liabilities associated with this approach, but should be proactive in allocating risk when possible. By securing concessions in the form of escrow agreements, purchase price reductions and various other pre-closing conditions, our firm sees no reason why SSHS cannot maximize this exceptional opportunity.