ST. SEBASTIAN HEALTH SYSTEM
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NATIONAL SPINAL SURGERY CENTERS — Acquisition Memorandum

Team Nineteen Insights, LLC
225 Beazley Drive, Beazley, Loyola 12345
P: 123.456.1987 || E: info@team19insights.com

TEAM 19 INSIGHTS

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I. INTRODUCTION

Amid economic uncertainty, ongoing regulatory changes, and consolidation within the healthcare industry, a health system's strategic plan often demands creative ways for the business to grow and thrive. Expansion into new service lines has proven to be an effective strategy to stimulate that growth. Depending on the demographics and needs of a region, health systems, large and small, may take advantage of multidisciplinary approaches, subspecialties, or technological advances. However, the process is not without legal, financial, and regulatory hurdles. St. Sebastian Health System ("SSHS" or "the Health System") faces similar concerns while considering strategic options to expand outside of its core regional market, setting it on the path to national growth. To that end, National Spinal Surgery Centers ("NSSC") is an ideal acquisition and partner for SSHS. NSSC is one of the largest management service organizations ("MSO") in the country, owning spine and neurosurgery practices in eighteen states. With its strong reputation in the spinal field and explosive growth, SSHS is poised to benefit greatly from purchasing an interest in NSSC.

The current discussions between SSHS and Whitehead Partners ("Whitehead"), a private equity firm, would result in SSHS acquiring Whitehead's fifty-five percent (55%) controlling stake in NSSC. The additional possibility exists that the founders of NSSC may be interested in selling their remaining forty-five percent (45%) of the MSO to SSHS. Because of the progress made with the Whitehead negotiations thus far, SSHS's focus has narrowed in on several key issues essential to the transaction.

First, this memo will analyze and discuss how the potential acquisition of NSSC can be structured and the implications the acquisition structure will have on SSHS as well as its ownership of NSSC. This includes not only the optimal transaction structure for the acquisition

of NSSC, but the memo will also address whether SSHS ought to pursue an acquisition for the entirety of NSSC, or only the 55% interest held by Whitehead. This will include an analysis of the benefits and risks concerning the different stakes in ownership.

SSHS will also need to consider how to raise the significant amount of capital needed to purchase either the interest held by Whitehead or all of NSSC. The market value for the 55% held by Whitehead has been determined to be between $2.35 - $2.55 billion. Although SSHS's revenue tops at $12 billion annually, the Health System does not have the cash needed to complete the purchase and will need to explore financing options. Each option should be reviewed thoroughly and SSHS must consider the benefits and costs of each option to select the best financial route for the transaction.

Lastly, a certain amount of risk and liability exposure is inherent in most acquisitions, especially one of this size. However, by evaluating the risks and liabilities closely and early, SSHS can be confident in its decision to acquire NSSC, and understand how to mitigate these risks during the acquisition, and when NSSC is a part of the Hospital System. Issues dealt with in the memo include the actions NSSC is currently litigating, and compliance concerns related to the remaining three years of the Corporate Integrity Agreement ("CIA") NSSC entered with the HHS Office of the Inspector General. Additionally, there may be substantial regulatory and compliance risks may arise as further investigation is made into NSSC's compliance with federal laws such as Stark law and the Anti-Kickback Statute. The business risks involved with the acquisition need to be carefully considered before any further decisions are made to move forward with the deal.

II. ACQUISITION STRUCTURE & IMPLICATIONS

In determining how to structure its acquisition of NSSC, SSHS must consider a multitude of factors, including the respective legal, administrative, tax and business issues inherent in the acquisition. Most acquisitions, including the purchase of interest or a subsidiary, are typically structured as either (i) a statutory combination such as a merger or consolidation, (ii) a purchase of assets from the business, or (iii) a negotiated purchase of outstanding debt and equity from investors.[1] Should SSHS choose to move forward with its acquisition of NSSC, it is likely the final transaction will take one of these forms.

This section will discuss the benefits and disadvantages of the three potential acquisition structures—merger, asset purchase, and equity purchase—and their implications for both SSHS and NSSC. Additionally, while contemplating the final transactional structure, a question exists as to whether SSHS ought to pursue an acquisition the entirety of NSSC, or only the fifty-five percent (55%) interest held by Whitehead. The answer to that question is deeply intertwined with the acquisition structure, and so will be explored in this section as well.

A. Merger or Consolidation

Mergers and consolidations involve a vote of shareholders, resulting in the merging or disappearance of one corporate entity into or with another corporate entity.[2] In the most common type of merger (a "reverse triangular merger"), a buyer creates a new wholly-owned subsidiary company that will merge directly into the seller's company, with the subsidiary disappearing as a distinct legal entity following the completion of the merger.[3] The result is that the buyer owns

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[1] STEPHEN GLOVER ET AL., M&A PRACTICE GUIDE § 2.03 (2008).
[2] *See* Alabama Power Co. v. McNinch, 94 F.2d 601 (App. D.C. 1937); Phillips v. Cooper Laboratories, 215 Cal. App. 3d 1648, 264 Cal. Rptr. 311 (1st Dist. 1989).
[3] GLOVER, *supra* note 1, at § 2.05; *see also* F. HODGE O'NEAL & ROBERT B. THOMPSON, 1 OPPRESSION OF MIN. SHAREHOLDERS AND LLC MEMBERS § 5:6 (Update 2017).

100% of the merged company—i.e., the "surviving entity," which from a legal entity standpoint is identical to the original company. In the case of SSHS' acquisition, a reverse triangular merger would result in the NSSC MSO as a wholly-owned subsidiary of SSHS.

There are other types of statutory combinations, including forward and reverse forward triangular mergers, and direct mergers.[4] If the only goal is to expand its service lines, SSHS may even wish to consider acquiring NSSC only to dissolve it, and employ its surgeons and physicians directly.[5] However if a statutory combination is pursued in SSHS' acquisition of NSSC, a reverse triangular merger is recommended. This type of merger has a number of advantages, not the least of which is that it may qualify as a tax-free reorganization.[6] Additionally, to complete a merger, particularly this type of transaction, it is typical that only a majority of the stockholders need to provide consent.[7] As Whitehead already owns the majority share of interest in NSSC, its assent is enough to fully consummate the purchase by SSHS; it may not even be necessary to secure the consent of Drs. Pearson, Beazley and Corboy as minority owners. Their respective interest may be paid out through a variety of means, including interest in SSHS, cash, or a combination of the two.[8] If SSHS' goal is to pursue 100% ownership of NSSC, a reverse triangular merger would allow it to move forward with the acquisition with a minimum of conflict among owners.

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[4] I.R.C. §§ 368(a)(1)(A), 368(a)(2)(D) (2017); *see also* 33 Am. Jur. 2d Fed. Taxation ¶ 5159.

[5] NSSC's physicians are currently employed by NSSC Practice Corporation ("PC"), which contracts with the MSO for management services, in order to avoid the corporate practice of medicine doctrine and Stark and anti-kickback laws. However, most states have carved out hospitals from the corporate practice of medicine prohibition. *See, e.g.,* 210 ILCS 85/1 (from the Illinois Hospital Licensing Act, stating only licensed hospitals and hospital affiliates may employ licensed physicians if they meet certain requirements). Nevertheless, it is not recommended that SSHS go this route, since it would necessitate negotiating new employment contracts with doctors at 120 practices in 18 states, an administrative headache.

[6] *See* Rev. Rul. 2001-25, 2001-1 C.B. 1291 (2001) (articulating section 368 of the Internal Revenue Code, which recognizes that a stock-for-assets acquisition as a tax-deferred reorganization).

[7] *See* DGCL §§ 141, 251 and 252.

[8] *See, e.g.,* Carl Marks & Co. v. Universal City Studios, Inc., 233 A.2d 63 (1967) (under Delaware statute shareholders of corporation being merged into another can be required to accept cash for their stock).

Furthermore, one of the key benefits of a reverse triangular merger structure is the impact it would *not* have on the licenses and other contracts of NSSC. After this type of merger is consummated, a contract between a third party and NSSC will remain a contract between the third party and NSSC.[9] Most clauses in contracts that bar assignment of a contract without the prior written consent of the third party are inapplicable because there has been no transfer of the contractual right from NSSC to SSHS, despite SSHS' status as a parent organization—the contract right never left NSSC.[10] Therefore, a reverse triangular merger is preferred when a buyer like SSHS is seeking to protect the value of contractual rights faster and with greater certainty than other types of mergers, where third parties may withhold consent to the assignment of the contract to the acquiring entity.[11]

This particular fact is crucial, given that the real value of NSSC is not in the MSO, but in the NSSC Practice Corporation ("NSSC PC") and its employment of the many physicians practicing at NSSC locations. Without the physicians that have bought into and built up NSSC as a broad-based and profitable service line, acquiring the MSO alone is pointless. Therefore, protecting the value of NSSC's management contracts with its physicians is crucial to the acquisition itself. A reverse triangle merger could permit SSHS to acquire 100% of NSSC, incorporating it fully into the health system, while equitably compensating Drs. Pearson, Beazley and Corboy, and maintaining the relationships that have made NSSC profitable in the first place.

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[9] TIMOTHY R. DONOVAN & JODI A. SIMALA, 2 SUCCESSFUL PARTNERING BETWEEN INSIDE AND OUTSIDE COUNSEL § 41:46 (2017) (articulating the finer points of assignment provisions and mergers).

[10] *See, e.g.*, Meso Scale Diagnostics, LLC v. Roche Diagnostics GmbH, 62 A.3d 62 (Del. Ch. 2013) (holding that absent explicit language in the anti-assignment clause prohibiting changes of control, a reverse triangular merger did not violate an anti-assignment clause in a license).

[11] Contrast with a forward triangular merger, where the surviving entity would be an SSHS subsidiary, and ultimately have to recreate and negotiate every contract NSSC held, without the benefit of NSSC's history with the third party in question.

There are some disadvantages to a statutory merger, both generally and specifically with regard to SSHS' acquisition of NSSC. Generally, a merger can be more complicated when compared to an equity purchase, as it often requires the creation of a merger subsidiary and the filing of a merger certificate with state authorities.[12] Since the number of stockholders in NSSC is small and assuming they are readily available, an equity purchase may be an easier and more efficient process than a merger. Additionally, because a reverse triangular merger maintains NSSC's existence as a legal entity, all NSSC's liabilities would vest in SSHS by operation of law.[13] These liabilities include NSSC's outstanding debt to Whitehead, pending litigation, and any other financial and regulatory liabilities currently being dealt with by NSSC.[14] While having NSSC as a subsidiary can shield SSHS from some of this exposure, it is not a perfect shield, and NSSC will retain these liabilities.[15]

Furthermore, a reverse triangular merger may not be the best solution for SSHS in acquiring NSSC particularly. A merger of this type necessitates SSHS purchasing of 100% of the interest in NSSC—however, SSHS is currently in conversation solely with Whitehead, which is only authorized to sell its 55% without consent of the remaining shareholders. The broker may be correct that Drs. Pearson, Beazley and Corboy would be open to selling their interest in NSSC for the right price, but this information is currently unverified. There is no indication as to what "the right price" is, or whether it is within SSHS' means. Worse, if the surgeons become dissenting shareholders, SSHS may find itself mired in another set of problems. It would not

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[12] GLOVER, *supra* note 1, at § 2.05
[13] *See* United States v. Best Foods, 524 U.S. 51 (1998) ("It is a general principle of corporate law deeply ingrained in our economic and legal systems that a parent corporation . . . is not liable for the acts of its subsidiaries.") However, in that selfsame case, the Court went on to enumerate the situations in which the corporate veil could be pierced, and shareholders or parent corporations would be liable for the activities of the subsidiary.
[14] *See infra* IV for more detail.
[15] Compare with asset purchase, *see infra* II.B.

ultimately prevent the merger from consummation, but the surgeons can potentially establish claims against SSHS if the valuation of their interest seems insufficient.[16] It would also be inadvisable from a business perspective—as the founders of NSSC and authorities on its operations, Drs. Pearson, Beazley and Corboy could be extremely valuable as advisors, and members of any transition team. Deliberately alienating them by forcing a merger despite their protests would not be in SSHS' best interest.

Additionally, how SSHS deals with Drs. Pearson, Beazley and Corboy will likely send a signal to all the physicians employed by NSSC PC. If SSHS is seen as a hostile intruder, this may create additional problems that will affect the transaction and subsequent integration of NSSC into the SSHS system. There may already be some culture clash due to SSHS' nonprofit and Catholic status; adding interpersonal conflict is unlikely to improve the situation. Moreover, the status of the anti-assignment provisions in NSSC and NSSC PC's contracts is uncertain at this point in preliminary due diligence. As previously discussed, one of the primary attractions of a reverse triangular merger is the ability to retain contractual rights, even as NSSC becomes a member of the SSHS family. However, where anti-assignment provisions include specific "change of control" language, courts have held these to be enforceable.[17] Therefore, if the doctors and surgeons of NSSC PC have "change of control" provisions in their contracts, a reverse triangular merger is no longer an optimal transaction structure. Attaining the consent of every NSSC physician and renegotiating every employment, lease, and management agreement held by NSSC is at best a misuse of SSHS' resources, and at worst totally unfeasible.

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[16] In many jurisdictions, statutes that permit a company to merge without unanimous consent correspondingly give shareholders who "dissent" the right to have his stock appraised and to be paid its value, under certain conditions. 40 A.L.R.3d 260 (Originally published in 1971). "Dissenters rights" have been litigated at length.

[17] Meso Scale Diagnostics, 62 A.3d at 88, *supra* note 10.

Given the facts before us and the current status of the discussion between SSHS and Whitehead, a reverse triangular merger is not recommended at this time.

B. Asset Purchase

Generally speaking, an asset purchase differs from a statutory merger in that the agreement specifies the assets to be acquired and the liabilities to be assumed, rather than adopting them wholesale. For this reason, asset transactions are typically more complicated and more time consuming than statutory mergers or even equity purchases.[18] As the buyer in an asset transaction, SSHS would only acquire the assets described in the acquisition agreement; accordingly, the assets to be purchased must often be described with specificity in the agreement and the transfer documents.[19]

Not all the administrative burden of an asset purchase can be bundled in the same way; documentation and separate filings or recordings may be necessary to affect the transfer.[20] This can include separate real property deeds, lease assignments, patent and trademark assignments, and other evidences of transfer that cannot simply be covered by a general bill of sale or assignment. Moreover, these transfers may involve assets in a number of jurisdictions, all with different forms and other requirements for filing and recording. Given that NSSC has 120 different locations in 18 different states, an asset purchase could involve a substantial effort to ensure these regulatory requirements are met.

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[18] GLOVER, *supra* note 1, at § 2.05.
[19] *See* Cynthia Y. Reisz & Dawn R. Crumel, *Point/Counterpoint: Perspectives in the Negotiation of a Hospital's Acquisition of a Physician Practice,* AM. HEALTH LAWYERS ASS'N (2017). However, the usual practice is for buyer's counsel to use a broad description that includes all of the seller's assets, while describing the more important categories, and then to specifically describe the assets to be excluded and retained by the seller. DOUGLAS M. BRANSON, ET AL., BUSINESS ENTERPRISES: LEGAL STRUCTURES, GOVERNANCE, AND POLICY: CASES, MATERIALS, AND PROBLEMS 72 (3rd ed., 2016).
[20] DOUGLAS M. BRANSON, ET AL., BUSINESS ENTERPRISES: LEGAL STRUCTURES, GOVERNANCE, AND POLICY: CASES, MATERIALS, AND PROBLEMS 72 (3rd ed., 2016).

However, the above disadvantages are also an asset purchase's primary advantages. The primary attraction of an asset purchase is that a buyer like SSHS can dictate what, if any, liabilities it is going to assume in the transaction.[21] This limits exposure to liabilities that are either unknown or not stated by the seller.[22] The buyer can also dictate which assets it is not going to purchase. This is often advantageous if the seller has a lot of accounts receivable that the buyer does not believe will be collected. Given NSSC's pending litigation, the outstanding CIA for billing irregularities, the uncertainty of the preliminary due diligence, and the abrupt growth since 2012, limiting SSHS' liability for NSSC's faults should be a central concern.[23]

Furthermore, an asset purchase typically favors the buyer when it comes to tax considerations. For tax purposes, purchase price is allocated among the assets in accordance with their respective fair market values at the time. SSHS therefore acquires the various assets with bases equal to fair market values, a so-called "step up" in basis. SSHS then takes the assets with full basis and new holding periods, and where applicable, will get the benefit of depreciation deductions, thereby reducing the SSHS' taxes going forward.[24]

Despite these advantages, an asset purchase encounters the same central issue that plagued discussion of the merger: at this time, SSHS is solely in conversation with Whitehead regarding its 55% interest. Consent from Drs. Pearson, Beazley, and Corboy may be needed to purchase the assets that SSHS is interested in, such as the leases for the hard assets currently

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[21] Byron F. Egan, *Asset Acquisitions: Assuming and Avoiding Liabilities*, 116 PENN ST. L. REV. 913, 954 (2012) (reiterating that the most important factor in proceeding with an asset purchase is that the contract be very clear as to which liabilities the buyer is expressly not assuming).

[22] *Id.*

[23] It is important to note that even an asset structure cannot completely shield a health system from liability. *See* 79 Fed. Reg. 72499 (2014) (limiting Medicare enrollment by providers or suppliers with ties to providers or suppliers with an outstanding Medicare debt, including an overpayment.)

[24] David Burton & Anne Levin-Nussbaum, *Tax Considerations in M&A Transactions*, THOMPSON REUTERS BUS. L. CURRENTS (Jan. 24, 2012), http://cdn.akingump.com/images/content/5/2/v4/5297/Akin-Gump-Tax-Considerations-in-MA-Transactions.pdf.

owned by NSSC, or royalties for the PBC Coupler. Given that the purpose of this acquisition is to help SSHS grow, a piecemeal acquisition seems the incorrect way to go. Furthermore, an asset purchase triggers any anti-assignment provision embedded in NSSC's varied contracts. Renegotiating or obtaining consent or waivers from all third parties associated with NSSC would be an enormous burden on SSHS and misuse of resources.[25]

While an asset purchase is attractive from a risk perspective, it does not have a place within SSHS' strategic growth plan. An asset purchase is not recommended at this time.

C. Equity Purchase

In an Equity Purchase Agreement, one or more equity holders agree to sell their ownership interests in a company, and the purchasing company pays the proceeds to the equity holders.[26] An equity purchase is often easier and quicker than an asset purchase or a merger, since no transfers of title to assets are required and there is no need for third party consents.[27] However, any liabilities or risk incurred by the previous owner of the equity automatically carry over to the new owner, without the benefit of a subsidiary's liability shield.[28] Additionally, unlike with an asset sale, a buyer cannot cherry pick the assets it wants to acquire and avoid the assets it does not want.[29]

Nevertheless, at this time an equity purchase of the 55% interest owned by Whitehead is best and surest means for SSHS to acquire NSSC and integrate it into its network. First and foremost, this is closest in structure and scope the proposed transaction; it does not rely on uncertain opinions of other shareholders or consent. Second, one of the biggest advantages for an

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[25] E. THOM RUMBERGER JR., THE ACQUISITION AND SALE OF EMERGING GROWTH COMPANIES: THE M&A EXIT § 5:15 (2nd ed. 2017)
[26] GLOVER, *supra* note 1, at § 2.05.
[27] Paul R. DeMuro, *Structural Issues for Mergers and Affiliations*, AM. HEALTH LAWYERS ASS'N (Jun.5, 1996).
[28] *See supra*, II.A.
[29] DeMuro, *supra* note 27.

equity purchase is that NSSC continues the operation of the company in the same corporate form; there is no new entity operating the business of the company. The name of the company stays the same, the principal place of business of the company stays the same, employees continue to work for the company; everything stays the same except for the identity of the owner. As with the reverse triangular merger discussed in II.A, *supra*, this retains the important contracts and licenses held by NSSC MSO and PC, including physician employment. The continuance of the company means that third party consent for the transfer of contracts is typically not required unless there is a "change of control" clause. It is in this way an equity transaction can provide a seamless transition, while keeping physicians integrated and involved.

From a business perspective, an equity purchase brings is very little disruption to the business, and maintains the goodwill earned by NSSC's past performance. NSSC has experienced significant growth in the last decade; SSHS should capitalize on this success, not curtail it. Furthermore, by only purchasing the 55% interest from Whitehead, SSHS has the benefit of keeping Drs. Beazley, Pearson and Corboy on as advisers and operational authorities, as well as firmly invested in the growth of NSSC. From SSHS' subsequent position as majority shareholder, it may also provide a stepping stone to a later merger, once SSHS and NSSC have developed a firmer partnership with one another.

Depending on subsequent due diligence and developments, SSHS may want to consider revising the proposed acquisition structure. If Drs. Pearson, Beazley and Corboy are interested in selling their shares, or if SSHS wants to immediately begin integrating NSSC fully into its system; if few third party consents are required, or if the anti-assignment provisions have no "change of control" clause, a different structure may further SSHS' goal of growth towards a

larger market. However, until such new information becomes available, it is recommended that SSHS opt for an equity purchase of the 55% interest currently owned by Whitehead.

III. FINANCING THE ACQUISITION

SSHS needs to raise a significant amount of capital in order to purchase Whitehead's 55% interest in NSSC. The market value for Whitehead's majority shares is currently somewhere between $2.35-$2.55 billion. Furthermore, since Whitehead purchased 55% of NSSC in 2012, it has loaned approximately $400 million to NSSC. If the Board chooses to purchase NSSC's debt to Whitehead from the private equity firm, SSHS may also need to consider raising an additional $400 million for the transaction. Each option to raise the capital is explored for its benefits and consequences regardless of if SSHS chooses to purchase the 55% from Whitehead or all of NSSC.

A. Bond Financing

An option that SSHS can choose to pursue is financing the acquisition through tax-exempt bonds. While tax-exempt bonds may not be issued directly from the health system, the state and local government can issue the tax-exempt bonds on behalf of the health system and act as a conduit.[30] Through this conduit financing system, the health system is able issue the bonds to the public and private market.[31] By issuing bonds to the public and private market, SSHS would receive the money from those purchase the bonds.[32] These bonds are more favorable to the public and private market because the investors would receive tax breaks from purchasing the

[30] R. Todd Greenwalt, *Primer on Bonds*, AMERICAN HEALTH LAWYERS ASSOCIATION (2001).
[31] *Id.*
[32] James Monacell, *Overview of Bond Financing for 501(c)(3) NonProfit Organizations*, SMITH, GAMBRELL, RUSSELL, LLP http://www.sgrlaw.com/briefings/459/ (last visited Feb. 16, 2018).

bonds than if they purchased other corporate bonds[33]. Once the bond matures, SSHS would have to pay the principle amount back plus interest.[34]

Both fixed rate bonds and variable rate bonds would be available to SSHS.[35] The primary difference between the two types of bonds is in how the interest rate is determined. In a fixed rate bond, the rate is determined when the bond is issued and remains the same until the bond matures.[36] This allows "bond holders to determine their effective investment yield up front."[37] The other type of bond, variable rate bonds, are issued with an interest rate that varies until it matures.[38] The interest rate may vary based on several factors, such as the public index; it could be reset by a remarketing agent, or adjusted in an auction procedure where current and future bondholders identify the rate at which they are willing to buy, sell, and hold the bonds.[39] Since SSHS' bond rating is double A (AA), the interest rates on the bonds will not be extremely high. Ultimately, SSHS will owe less money back to the government when the bond matures than if they had a lower bond rating.[40]

Both types of bonds have benefits and consequences that SSHS should consider before choosing which to issue. Fixed rate bonds will keep the same interest rate until maturity. This is advantageous for SSHS because its AA bond rating ensures that the interest rates would be low.[41] However, the consequence to this is that the interest rate cannot change. If SSHS's bond rating increases sometime in the future, it could receive a better interest rate at that time—

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[33] Quinton Harris, *Tax-Exempt Municipal Bonds: Are They Still the Structure of Choice for Hospitals?*, AM. HEALTH LAWYERS ASS'N 19,19 (2014).
[34] R. Todd Greenwalt, *Tax Exempt Bond Basics*, AM. HEALTH LAWYERS ASS'N (2007).
[35] Greenwalt, *supra* note 34.
[36] *Id.*
[37] *Id.*
[38] *Id.*
[39] *Id.*
[40] *Id.*
[41] *Id.*

however, with fixed bonds, the Health System could not take advantage of the lowered interest rate, because it would be locked into the rate initially issued for the bond. The interest rate on a variable rate bond fluctuates, which may lead to lower interest rates than SSHS would receive from purchasing fixed rate bonds. However, since variable rate bonds' interest rate is influenced by several factors, this means that the rate could also rise, which would result in high interest rates that may be costly for the Health System.

Tax-exempt hospitals can choose to divide the transaction between fixed rate bonds and variable rate bonds.[42] SSHS could choose to divide its bonds among both types in order to manage risks associated with either type of bond. The Health System could purchase a number of fixed rate bonds to ensure stability with a consistent interest rate, but also diversify its profile by purchasing variable rate bonds in order to optimize the eventual yield.

Another concern about financing the purchase through bonds is that SSHS would need to comply with IRS Revenue Procedures 97-13 and 2016-44, which discuss tax-exempt bond financing by a 501(c)(3).[43] SSHS needs to be mindful of how the transaction is structured and supported to ensure that the bonds do not lose their tax-exempt status.[44] Private inurement risk can arise if SSHS purchases Whitehead's interest of NSSC for over fair market value.[45] SSHS must also structure the transaction to avoid private inurement issues, though an equity purchase would likely not trigger any undue benefit.[46] Further due diligence should be done in order to

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[42] *Id.*

[43] *See* IRS Rev. Proc. 97-13; *See* IRS Rev. Proc. 2016-44. Though the facts do not state it explicitly, we are assuming that a tax-exempt, nonprofit health system is properly identified as a 501(c)(3). However, while this assumption is a logical and pragmatic leap, it nevertheless remains an assumption.

[44] Paul A. Gomez and Travis Jackson, *Dealmaker's Corner: Physician Practice Acquisition, Bloomberg BNA Law Reports* (June 26, 2017), www.bloomberglaw.com (search in search bar for "Nonprofit Hospital Acquisitions").

[45] *Id.*

[46] *Id.* The private inurement prohibition requires that a 501(c)(3) charity operate so that none of its income or assets unduly benefits any of its board members, trustees, officers, or key employees. These types of individuals are commonly referred to as "insiders." Unless some member of SSHS' Board is also among the NSSC physicians or shareholders, the undue benefit is unlikely to manifest.

ensure that SSHS would be purchasing the interest at fair market value and to avoid private inurement issues.

Under the IRS Code, a 501(c)(3) will lose the tax-exempt status on its bond if more than 5 percent of it is used for "private business use."[47] IRS Revenue Procedure 97-13 provides requirements for which a nonprofit organization, such as SSHS, can comply with in order to use a tax-exempt bond for private business use purposes.[48] Additionally, IRS Revenue Procedure 2016-44 clarified IRS Revenue Procedure 97-13 by outlining more specific requirements for a safe harbor to allow a nonprofit organization to use tax-exempt bonds for private business use.[49] SSHS should retain bond counsel to ensure full compliance with the IRS Revenue Procedures and avoid liability. If this is accomplished, the tax-exempt bonds would be the ideal financial option for SSHS to finance the equity purchase of Whitehead's interest in NSSC.

B. Leases

The property that SSHS owns could be leased out to other practice groups in order to raise capital. SSHS owns 24 hospitals, 17 skilled nursing facilities, and operates over 200 care sites, so the health system could do further due diligence to determine if property is available to lease out to other medical groups. If further due diligence is done and it is determined that there is not property that SSHS already owns and could lease out, SSHS could invest in smaller, less expensive properties to lease out. The option of providing leases to physician practice groups would be a good long-term investment to raise capital, however the consequence is that the money profited from this option would take several years to accumulate and potentially pose a violation Stark Law.[50] While there is a statutory exception for renting out office space to

[47] Monacell, *supra* note 32.
[48] IRS Rev. Proc. 97-13.
[49] IRS Rev. Proc. 2016-44.
[50] *See* 42 U.S.C. § 1395nn(a)(1) (2017).

physicians, which would allow SSHS to avoid violating the law, SSHS would need to meet all eight requirements of the exception at all times. This option still comes with a large risk of facing liability of violating the Stark law because the consequence for not complying outweigh the amount of capital raised from the investment.[51]

C. Grateful Patient Philanthropy

Another option to finance the acquisition is through a grateful patient philanthropy program. Philanthropy is one of the major sources of financial support for a medical center.[52] Grateful patient philanthropy typically occurs when a prior patient is grateful for treatment received from a medical center, and the medical center subsequently solicits that patient for donations.[53] Medical centers create and implement grateful patient philanthropy programs out of a need to raise funds and finance needs mundane as equipment, staff, services, or the facility maintenance.[54] SSHS could develop or take advantage of an existing grateful patient philanthropy program, creating a campaign around expanding the excellence of SSHS and fundraise the money needed. If SSHS currently does not have a grateful patient philanthropy program, the Health System could take this opportunity to develop one—it will probably be needed beyond this transaction. Grateful patient philanthropy programs are mostly beneficial for the hospital to gain more funds for its needs.[55] "The Association of Healthcare Philanthropy (AHP) reported that healthcare organizations received $8.9 billion in charitable contributions in

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[51] 42 C.F.R. 411.357(a).
[52] Scott M. Wright et al., *Ethical Concerns Related to Grateful Patient Philanthropy: The Physician's Perspective*, 28 J. GEN. INTERNAL MED. 645, 645 (2013).
[53] *Id.*
[54] Donor Research, *Grateful Patient Programs: Breaking Down the Basics* https://www.donorsearch.net/grateful-patient-program-basics (last visited October 31, 2017).
[55] Jesse Roach and Elizabeth A. Jacobs, *Grateful Patient Philanthropy: Is What's Good for the Goose Good for the Gander?*, J. GEN. INTERNAL MED., 608, 608 (2013).

2011, an amount that has steadily increased over the last decade."[56] In 2011, not-for-profit healthcare organizations contributions came primarily from grateful patients and philanthropists, with 85% of contributions made by individuals.[57] In 2013, individual donations to health care organizations increased to $31.68 billion.[58]

The benefit to raising funds through a grateful patient philanthropy program is that the money is coming from patients in the form of donations, which means that SSHS will not have to pay it back. The hospital will be able to obtain the funds required for the acquisition and not be in debt from it. However, the consequences of grateful patient philanthropy programs are that it would potentially take a long time to raise the enough money for the transaction and it involves many ethical concerns.[59] SSHS needs to raise at least $2.35 billion and donations made to the health system are not in large amounts enough to cover that cost quickly. Furthermore, if the Health System does not have a grateful patient philanthropy program already, it would take even longer for it to create and implement the program.

Additionally, grateful patient philanthropy programs raise ethical concerns, particularly because of the role physicians have within the program: soliciting the donations from its patients.[60] Grateful patient philanthropy programs recruit physicians to assist their efforts in raising funds in many ways, ranging from simply signing donation request letters drafted by development officers to directly asking patients, sometimes while they still at the hospital

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[56] Dan Lowman, Grenzebach, Glier & Assocs., *Grateful Patients: Critical Success Factors for Navigating Healthcare's Fastest Growing Donor Segment 3* (2013).
[57] *Id.*
[58] Adam Wilhelm, Engaging Physicians in Philanthropy, Campbell & Company (posted July 18, 2014) http://www.campbellcompany.com/news/bid/107679/Engaging-Physicians-in-Philanthropy.
[59] *See* Julian Prokopetz & Lisa Lehmann, *Physicians as Fundraisers: Medical Philanthropy and the Doctor-Patient Relationship*, PLOS MEDICINE (2014).
[60] *See Id.*

receiving care.[61] Physicians engaging in philanthropy poses three main ethical concerns.[62] First, patients may feel pressured to donate when asked because the physician who is treating them is the one who is soliciting the donation.[63] Second, patients who donate may expect to receive better care from the hospital because they donated.[64] The last issue is that patients may be concerned to learn that because the HIPAA privacy rule allows for certain PHI to be disclosed or used for fundraising purposes since it is a health care operation, their wealth has been assessed or their information may have been shared with staff that is not involved in their treatment.[65]

D. Federal Programs

Lastly, since SSHS is a charitable organization, the Health System could apply for grants available through the federal government.[66] The benefit to applying for the grant is a large sum of money at once, and as a grant, would not be later owed back to the government. The consequence to relying on grants as the option to financing the acquisition is that there is an application process and could take a long time before SSHS would hear back from the federal government. There is also a possibility that the Health System will not receive the grants that it applies for, since this option is highly competitive and funds are limited.[67] The Health System could apply for federal loans through the federal government, such as the FHA 242 Insured Mortgage. Further due diligence needs to be completed to determine if SSHS meets the requirements for the grant or loan. The option of financing through federal grants and loans is

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[61] Frank A. Chervenak et al., *Ethics: An Essential Dimension of Soliciting Philanthropic Gifts from Donors*, 203 AM. J. OBSTETRICS & GYNECOLOGY 540e.1, 540e.1 (2010)
[62] Prokopetz & Lehmann, *supra* note 59.
[63] *Id.*
[64] *Id.*
[65] *Id*; *See* 45 C.F.R. § 164.514(f)(1).
[66] U.S. DEP'T OF HEALTH AND HUM. SERVS. https://www.grants.gov/web/grants/learn-grants/grant-making-agencies/department-of-health-and-human-services.html (Last visited Feb. 16, 2018).
[67] Steven W. Kennedy, *Financing Options for Large Hospitals and Multi-Hospital Systems*, BECKER'S HOSPITAL REVIEW (Dec. 7, 2010), https://www.beckershospitalreview.com/hospital-management-administration/financing-options-for-large-hospitals-and-multi-hospital-systems.html.

likely not a viable option because neither is a guaranteed source of finance for the Health System.

E. Recommendation

The best option for SSHS to raise the amount of money needed to purchase either 55% or 100% of NSSC would be to finance the acquisition through tax-exempt bonds. It is the most stable option, in that it provides the most amount of money with the least risk to the Health System. Although bond rates may not initially be as high as SSHS would want, there is opportunity that they will rise. It is recommended that SSHS diversify its portfolio and fund the transaction with both fixed rate bonds and variable rate bonds to achieve the most optimal interest rate.

If SSHS does decide to pursue this route, it is highly recommended that the Health System retain bond counsel—their expertise will assist SSHS maintain compliance with IRS Revenue Procedures so that the bonds do not prompt the Health System lose its tax-exempt status. The other options for raising capital for acquisition of NSSC involve potentially violating federal laws such as Stark Law, which could lead to significant legal problems long-term. In addition to the risk of violating federal laws, the other options would require more time and administrative effort, and it is not guaranteed that the amount of money needed will be raised. Thus, the recommendation would be for SSHS to finance the acquisition with tax-exempt bonds.

IV. RISKS & LIABILITIES

The acquisition of NSSC by SSHS is a major transaction which necessarily brings with it substantial risks in many areas. However, so long as the risks and liabilities are thoroughly examined prior to the transaction, they can be properly handled to ensure the acquisition

progresses smoothly, and that any risks in acquiring NSSC will be managed correctly moving forward.

A. Litigation Risk

Whether SSHS decides to purchase 55% or 100% of the interest in NSSC, several risks associated with litigation may exist for SSHS as the majority or full owner of NSSC. The acquisition of NSSC will also bring the costs associated with the lawsuits currently filed against NSSC as well as the possibility of future claims being filed.

The costs associated with the negligence claims filed against some of the NSSC practices that do not involve the PBC Coupler will likely not cause great concern. Spinal surgery and its associated conditions often carry with them higher risk of treating complex patients which can often result in negligence claims being filed against the practice. The first reason these claims should not concern SSHS through the acquisition is because only a few of them exist currently. Of the claims that do exist, the damages sought are not significant compared to the risks as discussed previously. Additionally, it is likely that these practices would have medical malpractice insurance to help cover the cost of litigation and any settlements or awarded damages which may occur.

The next group of lawsuits, which may generate some concern, deal with the acquisition of three practices in 2015. The claims alleged that the physician's compensation was not equivalent to the amount offered to the physicians at the time of acquisition through the proforma. These claims will also likely result in small costs and risks because there are only three, and the damages involved did not raise to significant level. What could be of some concern in these claims are the hints concerning NSSC exerting influence on physicians to use the PBC Coupler. It may be beneficial to try to settle these claims as quickly as possible so that the issue

of the PBC Coupler does not become the focal point of these lawsuits. This issue of the PBC Coupler will be discussed in further detail below.

The last group of lawsuits which may contain risk moving forward are the claims alleging negligence based on a premature failure of the PBC coupler. These claims could be a significant liability moving forward after the acquisition. If the allegations are proven to be true, it may lead to further liability from future device failures. Because the device is one of the contributing factors to the growth and success of NSSC, an inquiry should be conducted to determine the cause of these failures. One of the best scenarios would be if it was a simple manufacturing error that caused the failure. Hopefully, this would be something that could be fixed the use and licensing of the device could continue without major interruption. The more unfavorable situation would be if a problem with the design of the device existed.

A few solutions exist in order to manage the risk and liabilities involved with these lawsuits. One option available to SSHS would be to use an escrow or holdback account. In either case, an agreed-upon percentage of the purchase price would be held by a third party in escrow to handle any adjustments that may need to be made as a result of litigation expenses.[68] Another option would be to ensure Whitehead indemnifies SSHS and or NSSC for the appropriate amount of the cost of these lawsuits.[69] Such indemnification could be written into the purchase agreement, perhaps with Whitehead only indemnifying 55% of any costs incurred because that was the percent of the interest owned by Whitehead at the time.

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[68] Richard J. Zall, *Managing Risk in Today's Healthcare M&A Transaction*, HEALTHCARE FIN. MGMT. ASS'N (Apr. 1, 2016), http://www.proskauer.com/files/News/4f7e2e2d-51f7-4e46-8af3-2115e57f2a52/Presentation/NewsAttachment/f4b13c59-f81c-41ad-8e37-dae53a31d5f3/0416_HFM_Zall.pdf.
[69] Zall, *supra* note 68.

B. Regulatory Compliance Risks

1. Stark

The federal self-referral prohibition law is generally known as the "Stark Law." Stark is a strict liability statute which prohibits a physician from referring patients covered by federal programs (such as Medicare and Medicaid) for "Designated Health Services" ("DHS") to an entity with which the physician (or an immediate family member) has a "financial relationship."[70] A financial relationship is defined by the statute to mean an ownership or investment interest in the entity, or a compensation arrangement with the entity.[71] Penalties for Stark violations can be significant including a denial of payment for billed DHS or refunding of payments already made.[72] Continued violations or non-refunded amounts may implicate the False Claims Act ("FCA") or additional Civil monetary penalties, both of which carry significant financial penalties and possible exclusion.

MSO arrangements with providers generally constitute a referral relationship and a "financial relationship." Therefore, it is critical that the arrangements between NSSC providers satisfy the requirements of one of the applicable Stark exceptions. A major exception which would work for these relationships would be the Personal Service Arrangement exception.[73] Any provision of services from physician to the MSO should comply with the personal services arrangement exception which allows compensation arrangements between a physician and an entity if the physician not an employee of the entity. The exception has several requirements, most notably a written agreement for a year or longer.[74] Other exceptions may exist as well in

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[70] 42 U.S.C. § 1395nn(a)(1).
[71] 42 U.S.C. § 1395nn(a)(2).
[72] 42 U.S.C. § 1395nn(g).
[73] 42 U.S.C. § 1395nn(e)(3); 42 CFR 411.357(D) et seq.
[74] *See* 42 U.S.C. § 1395nn(e)(3)(A) (explaining all of the requirements for the personal service exception: "(i) the arrangement is set out in writing, signed by the parties, and specifies the services covered by the arrangement, (ii)

order to ensure compliance with Stark law. Further due diligence should be conducted to determine whether any Stark violations have occurred in recent years at NSSC. Because a CIA is in place on NSSC, it is likely any recent violations were addressed in the CIA and continued compliance with the CIA will keep NSSC in compliance with Stark.

Another possible Stark concern could be if NSSC's management decides to acquire a large physical therapy provider. If NSSC decides to purchase a therapy provider, any referrals to the therapy provider could be a violation of Stark law if NSSC has a financial relationship with that provider. Generally, most physical therapy is considered a DHS, however, physical therapy often falls under the in-office ancillary services exception.[75] The exception applies to services provided while in the physician's office, but also to physical therapy so long as the therapy is billed by the practice which employees the physical therapist, and not the therapist themselves.[76]

2. AKS

Another relevant federal law concerning referrals is the Anti-Kickback Statute ("AKS"). AKS contains criminal penalties for knowingly or willfully soliciting, receiving, offering to pay, or paying, any remuneration to induce referrals for items or services which are then billed to a federal healthcare program.[77] An AKS violation carry criminal penalties including fines of up to

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the arrangement covers all of the services to be provided by the physician (or an immediate family member of such physician) to the entity, (iii) the aggregate services contracted for do not exceed those that are reasonable and necessary for the legitimate business purposes of the arrangement, (iv) the term of the arrangement is for at least 1 year, (v) the compensation to be paid over the term of the arrangement is set in advance, does not exceed fair market value, and except in the case of a physician incentive plan described in subparagraph (B), is not determined in a manner that takes into account the volume or value of any referrals or other business generated between the parties, (vi) the services to be performed under the arrangement do not involve the counseling or promotion or a business arrangement or other activity that violates any State or Federal law, and (vii) the arrangement meets such other requirements as the Secretary may impose by regulation as needed to protect against program or patient abuse.")

[75] 42 CFR 411.355(b).

[76] 42 CFR 411.355(b).

[77] 42 U.S.C. § 1320a-7b.

$25,000 and imprisonment for up to five (5) years.[78] Similar to Stark law, AKS and its related regulations grant several safe-harbors which have been determined not to constitute unlawful remunerations under AKS.[79]

In the acquisition of NSSC, due diligence should continue to be conducted to ensure that NSSC did not have any AKS previous violations. Any possible violations may fit within one of the commonly used safe-harbor for MSO's such as Space, Equipment, or Personal services and Management Contracts. These safe-harbors all contain analogues requirements including: a written agreement; a term of at least one year; that the payment and the consideration for payment be stated in advance; and a few more additional requirements as to the specific terms. Additionally, the compensation must be equivalent to fair market value and cannot be adjusted based on the number of services or amount billed to the federal payers including Medicare or Medicaid.[80] The need to look back at any potential AKS violations is just as import as the continued compliance of NSSC of the Anti-Kickback Statute to prevent any future risk arising.

3. Tax-Exempt Status

SSHS's tax exempt status is a major benefit to the system financially and the benefits as a result of this status will likely allow SSHS to raise the capital it needs to complete this acquisition. Purchasing a large for-profit entity could put that tax-exempt status at risk. In order to maintain the hospital system's 501(c)(3) status, any membership transaction needs to be "organized and operated exclusively" for a charitable purpose.[81] Additionally, no private benefit should be provided to NSSC or any other private entity or individual during or as a result of the acquisition of NSSC or the majority interest in the corporation. In the future, while NSSC may

[78] 42 U.S.C. § 1320a-7b(b).
[79] *See* 42 C.F.R. § 1001.952.
[80] 42 C.F.R. § 1001.952(b); 42 C.F.R. § 1001.952(c); 42 C.F.R. § 1001.952(d).
[81] 26 U.S. Code § 501(c)(3); 26 CFR 1.501(c)(3)-1.

continue to operate as a for-profit corporation, any benefits received by SSHS as a result of its ownership of NSSC must still go to SSHS's charitable purpose. Because NSSC will continue to operate as a for-profit corporation, it will not need to comply with all of the requirements to become a 501(c)(3) entity including the Internal Revenue Service's requirements that each facility establishes written financial assistance and emergency medical care policies; create limits for how much to charge needy individuals; and take time to determine whether an individual qualifies for financial assistance before initiating extraordinary collection actions.[82] Additionally, even though it is recommended that SSHS purchase only the 55% of NSSC owned by Whitehead, it should be clear that SSHS, as the non-profit entity, should be in control of those operations, even more so if it were decided that it would be beneficial to purchase 100% of NSSC.

4. Corporate Practice of Medicine

Another regulatory issue which would need further investigation would be the allegations that NSSC has been exerting influence on its physicians to use the PBC Coupler. The corporation exerting influence on how physicians practice medicine may verge on a violation of the relevant jurisdictions Corporate Practice of Medicine ("CPM") prohibition laws. Generally, state CPM statutes prohibit or strictly regulate a corporation from practicing medicine or employing practicing physicians. These laws stem from the public policy concern that physicians need to practice medicine in the best interests of their patients, without any financial motivations influencing their decisions when treating a patient.[83] Almost all jurisdictions have certain

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[82] New Requirements for 501(c)(3) Hospitals Under the Affordable Care Act, Internal Revenue Service, (last updated Aug. 27, 2017) https://www.irs.gov/charities-non-profits/charitable-organizations/new-requirements-for-501c3-hospitals-under-the-affordable-care-act.

[83] *Corporate Practice of Medicine*, THE AMERICAN HEALTH LAWYERS ASSOCIATION, https://www.healthlawyers.org/hlresources/Health%20Law%20Wiki/Corporate%20Practice%20of%20Medicine.aspx (last visited Feb. 12, 2018).

exceptions, most importantly that physicians may practice medicine through professional corporations and other related entities when the entity is solely comprised of physicians. In this case, all of the physicians which work at NSSC practices are employed by NSSC PC. This arrangement most likely is acceptable under all of the relevant CPM laws. However, if it is determined that NSSC the corporation is exerting influence over the physicians and influencing patient treatment for the corporation's benefit, this could violate CPM laws. During the acquisition and due diligence, it will be important to discover if this influence rises to a significant level. Moving forward with SSHS' interest in NSSC, it will be important to make sure no NSSC employees are pressuring physicians to change their treatment of patients by using the PBC Coupler more often than is medically necessary.

5. Anti-Trust

Because this is potentially such a large acquisition within the healthcare market, antitrust issues could become a concern. Without a thorough analysis early in the acquisition process, the transaction may incur unexpected costs or delays if required to make adjustments because of any antitrust violations. It would be important to assess any current markets where SSHS and NSSC would be operating in a similar region. Generally, if the new market share will exceed 30 to 40 percent, a merger or acquisition will likely raise antitrust concerns.[84] Because NSSC contains spinal surgery practices and SSHS is a large health system with different entities conducting different services, there will likely not be major antitrust concerns. Additionally, the large regional markets involved means that even a system as large as SSHS likely does not have too high of a market share when spread out across so many states. Nevertheless, it is important to verify no issues will arise in areas where both parties have a large presence currently.

[84] Zall, *supra* note 68.

C. Business Risk

As discussed previously, the CIA currently in place on NSSC will likely incur significant costs to NSSC for the next three years. Depending on the terms of the agreement, significant costs to look out for could include: requirements to hire additional compliance employees, regular reports to the Department of Health and Human Services, and increased auditing and monitoring. Further investigation into the CIA and its precise requirements will be needed in order to determine the overall estimated costs associated with it.

Another business risk associated with the acquisition for NSSC is the debt NSSC owes to Whitehead. The $400 million owed to Whitehead is a significant liability which needs to be considered prior to any acquisition. The capital seems to have been used well by NSSC with its rapid growth in recent years. A business decision should be made as to whether it may be beneficial to structure the acquisition so that the amount owed to Whitehead could be included in the purchase agreement. If not, it is a major liability NSSC will have on its books moving forward.

Physician retention after the acquisition could also be a business risk to consider. Although the physicians are employed by the NSSC PC, they may not want to be affiliated with a large health system such as SSHS. Additionally, some physicians may want to retain more independence, while others may not want to work under the umbrella of a Catholic hospital system for personal or ideological reasons. All these concerns must be considered as part of the risk of doing business.

V. CONCLUSION

While SSHS is facing a number of financial and compliance challenges in its acquisition of NSSC, the Health System should take advantage of this opportunity for strategic growth.

SSHS' next steps should to be focus its negotiations with Whitehead on those options that further its goal of growth towards a national market, while preserving SSHS' tax-exempt status and avoiding risk of regulatory sanctions or legal action. Large health systems and providers have the means to invest in clinical care improvements and incentive to invest in community health as well as increased administrative efficiency and have greater leverage to negotiate with payors. Through its acquisition of NSSC, there seems little doubt that SSHS can join these ranks, and worked towards becoming a leader in the healthcare market.