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

OFFICIAL PROBLEM

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Introduction

Your firm has been newly retained as legal counsel for Pearson Health System ("PHS"), the largest not-for-profit health care system in the state of Loyola. PHS has been caring for communities across three large counties in Loyola since the founding of its first hospital in 1880 and is intensely proud of its strong connection to the places where its community members live and work. In fact, its long-term strategic vision is unequivocally aimed at being Loyola's top-notch, comprehensive health system, growing from one Loyola county to the next, to become *the* health care organization of choice to serve all people across the state.

PHS has prioritized expanding its footprint into a fourth county, Tetra County, which borders the other counties where PHS currently operates its hospitals. Expanding into Tetra County would cement PHS's presence to serve the local communities that already cross the Tetra County borders for services at existing PHS sites of care. Operating out of Tetra County also would create a bridge to other geographies of potential long-term interest to PHS and scale and grow PHS's existing business units such as tertiary and quaternary referrals to its larger acute care hospitals.

Background

Loyola has developed several laws designed to protect the health and well-being of its citizens. For instance, hospitals in Loyola cannot deny patients access to care based on an inability to pay. The Loyola Charity Care Law requires that all hospitals develop charity care policies, procedures, and sliding fee schedules to ensure that all patients are able to obtain medically necessary inpatient and outpatient care that is free of charge or at discounted prices.

Starting January 1, 2023, hospitals, health systems, and many other healthcare providers must give notice to the Loyola Attorney General at least 60 days in advance of closing certain transactions, including all transactions that involve the provision of health care. Unlike the federal Hart-Scott-Rodino Act, which requires notice to the federal antitrust agencies for transactions valued over a certain dollar amount, the Loyola law has no minimum dollar threshold and will require reporting even for very small transactions that are unlikely to raise antitrust concerns. The legislative intent behind this new Loyola law is to create a review process to assess the impact of a transaction on cost, quality, and access to care.

Loyola also observes a legal doctrine known as the corporate practice of medicine and enforces a "mini" -Stark statute that addresses self-referral and physician conflicts of interest, as well as its own anti-kickback and fee-splitting prohibitions.

Strategy

PHS has worked closely with its trusted financial advisor to explore its options for expanding into Tetra County. PHS's financial advisor has recommended that PHS acquire an already existing Tetra County-based hospital, Tetra Medical Center ("TMC").

TMC Overview

TMC is a for-profit, 100 licensed-bed community hospital that serves patients mostly from Tetra County. In 2019, TMC had approximately 5,000 annual admissions, 20,000 emergency department visits, and $100 million in net patient service revenue. Like other smaller sized hospitals across the country, TMC had substantial declines in revenue due to Loyola's state-wide emergency declarations to suspend elective procedures and office visits. After a brief rebound in early- to mid-2022, TMC is now experiencing another significant decrease in revenue and patient volumes largely driven by patients delaying care and concerns about limiting out-of-pocket expenses during a much-anticipated economic recession. TMC's expenses also are much higher compared with pre-pandemic levels due to persistent supply chain issues, pandemic-spawned labor market challenges, and market inflation. Despite these challenges, TMC is ranked third in terms of customer preference with the second highest ranked staff of doctors in Tetra County, according to a third-party market insight report.

TMC is owned and operated by Tetra Medical Limited Partnership ("TMP"). The general partner of TMP, which owns 88% of its equity, is Vital Health, Inc. ("VHI"). The remaining 12% is held by a small group of physicians who are the limited partners (the "TMC Physician Owners"). The TMC Physician Owners hold their interest in TMP in their individual capacity, with no formal legal business entity tying them together. PHS and VHI have begun initial, informal discussions, but have not yet signed a letter of intent. It is unlikely at this time that the TMC Physician Owners are aware that PHS and VHI are in discussions.

Based on the initial discussions to-date and publicly available information, PHS has also learned the following:

- VHI provides management services to TMC via a management services agreement, including accounting, legal, budgeting, and group purchasing services. Senior management at TMC are employees of a VHI-affiliate and also provide their services to TMC under this agreement.

- TMP owns and operates a separate medical group: Tetra Medical Center Primary & Specialty Physicians, LLC (the "Physician Group"). The Physician Group employs primary and specialty care physicians who are credentialed for privileges at TMC. Affiliation through the Physician Group is required for medical staff membership at TMC – a relatively new strategy in response to labor market challenges and an effort to draw more patients to TMC. The Physician Group receives financial support from TMC to stay solvent; it also receives resources from TMC to recruit physicians to relocate to Tetra County to join the Physician Group and establish privileges at TMC. The Physician Group is known for requiring strict restrictive covenants of its employees tied to geography and time. TMP has made it clear to the employed physicians that the Physician Group strives to be "self-sufficient" and patients should be referred to other physicians employed by the Physician Group; and each physician's compensation is tied to the profitability of the inpatient and outpatient hospital services that their patients receive at VHI-hospitals, including TMC. According to a sample offer letter recently reviewed by PHS as part of its due diligence process, the Physician Group (in PHS's view) may be offering compensation beyond the bounds of fair market value.

- TMP leases the building in which TMC operates from National Buildings Trust ("NBT"); thus neither TMP, VHI, nor the TMC Physician Owners own the facility or the land upon which TMC sits. PHS's financial advisor is familiar with NBT and knows that NBT was a partner in select real estate holdings with VHI's corporate predecessors before VHI's most recent merger. The last time that the financial advisor consulted with a hospital client on a real estate transaction involving NBT, the lease required NBT's consent to replace the management company. In that situation, VHI's predecessor was providing management services to the hospital, just as VHI provides to TMC here. It remains unclear whether NBT is aware of the proposed venture between PHS and VHI, but PHS's financial advisor is wary of working across from NBT based on past experience.

- In May 2022, the Loyola Attorney General and TMC entered into a Consent Decree with a principal judgment amount of $1,000,000 and a set of injunctions based on TMC's alleged violations of the Loyola Charity Care Law. Based on the unsealed Consent Decree, TMC is required to continue compliance with the Consent Decree and may request that the injunction requirements be terminated only after three years from the entry of the Decree. Material violations of any of the injunctions could subject TMC to a civil penalty of up to $30,000 per violation.

- At the last meeting between the parties, VHI disclosed that TMC very recently received notice from the Centers for Medicare and Medicaid Services ("CMS") that it no longer meets several CMS' Hospital Conditions of Participation. Specifically, a recent surprise survey found that there are major safety concerns with TMC's central sterilization department, which is used to sterilize its reusable equipment, instruments, and devices. Consequently, TMC's participation in the Medicare program is at risk of terminating on April 30, 2023, if the identified deficiencies are not corrected. PHS's financial advisor has requested real-time updates about this matter, but VHI is not comfortable providing any further information without entering into a binding letter of intent which would expressly contemplate a process for closing over this issue with CMS.

Assistance Required

PHS is seeking your counsel to develop and sort through options available for, and legal risks associated with, acquiring TMC.

In the course of providing your advice, PHS has asked that you to specifically address the following questions.

1. Briefly discuss the strategic, cultural, and business considerations that PHS should keep in mind as it continues conversations with VHI.

2. Analyze the potential liability exposure that could be assumed by PHS as a result of a transaction to acquire TMC, including but not limited to litigation, compliance and regulatory issues, and business risk. For each key risk, identify the seriousness of the exposure and advise how these risks can be addressed, both at the transaction stage as well as in the future should TMC become a part of PHS.

3. What options are available to structure a transaction to acquire TMC? Which approach do you recommend, and why? Please define the strengths and weaknesses of each option from a legal and business perspective and recommend how PHS should proceed with the proposed acquisition.

4. Based on the information that PHS has collected to-date, please identify the areas that you deem as high-priority versus low-priority for supplemental due diligence. Please explain your priority designations and the goals you aim to achieve with your supplemental requests.

If your analysis is dependent upon facts of which you are unaware, please explain how your analysis may be impacted by those facts. Please limit your response to twenty-five (25) double-spaced (normal margin) pages in total. The memorandum is due February 20, 2023. PHS will reserve a date and time for your firm to visit with the PHS Board and members of its administration to present a summary of your conclusions and answer questions.