2023

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.

STRUCTURING AN ACQUISITON

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I. INTRODUCTION

During the acquisition of a healthcare entity, there are many moving parts and aspects that need to be taken into consideration to ensure a successful transition. Pearson Health Systems ("PHS") has been meeting with Tetra Medical Limited Partnership ("TMP") concerning the acquisition of one of their hospitals, Tetra Medical Center ("TMC"), located in Tetra County. The following memorandum reflects a comprehensive business plan with recommendations for PHS to make this a smooth process for all parties involved.

II. STRATEGIC, CULTURAL, AND BUSINESS CONSIDERATIONS

The process of acquiring an entity within the healthcare system can be arduous, time-consuming, and quite costly. On the other hand, there are vast advantages to expansion and acquisition of healthcare assets. PHS should review the following strategic, cultural, and business considerations in light of their preliminary discussions with VHI.

A. Strategic Considerations

Expansion into Tetra County aligns with PHS's long-term strategic plan of becoming Loyola's top-notch comprehensive health-system. Such plan requires ample resources in locations of need, well-trained staff, and a loyal patient base. Per guidance from PHS's financial advising team, PHS is considering the acquisition of TMC to establish a presence in Tetra County in furtherance of its plan. Additionally, there is a demonstrated need for PHS to increase its presence in Tetra County to provide medically necessary care within the community as Tetra County residents currently cross county borders to receive the premier care rendered at PHS facilities. Furthermore, serving the Tetra County community will allow PHS to assess the need for additional clinical service specialties in Tetra County.

PHS's strategy moving forward should be to minimize the liability inherited from TMC, uphold operational standards, and maintain regulatory compliance. This memorandum will offer three strategic models (merger, asset purchase, and equity purchase) that will advance PHS's business interest and preserve its mission. PHS's goal is to become Loyola's comprehensive health system and the suggested models put PHS in the best position to succeed.

B. Cultural Considerations

To ensure a smooth integration into Tetra County, PHS must consider the contributing factors leading TMC to its current state of noncompliance, as well as any cultural issues that may be causing Tetra County patients to drive across county lines to seek the same level of care at PHS facilities. Tetra Medical Limited Partnership ("TMP") is the owner of TMC and consists of two shareholder groups: the majority shareholder, Vital Health Inc. ("VHI"), which owns 88% of TMP's equity, with the remaining 12% minority of shares owned by individual TMC Physician Owners.

Tax-exempt healthcare systems must annually report to the IRS their accountability towards improving the overall health of the communities they serve.[1] Additionally, a sizeable amount of expenses for tax-exempt healthcare systems are attributed to community well-being and health improvement services.[2] PHS's continued success in the state of Loyola is largely due to their mission to provide comprehensive care, and its tax-exempt structure allows the reinvestment of revenue back into the community. Tax-exempt medical centers are also required to engage in community benefit activities, such as community health needs assessments ("CHNA") and

[1] *Results from 2016 Tax-Exempt Hospitals' Schedule H Community Benefit Reports,* AM. HOSP. ASS'N, aha-2016-schedule-h-community-benefits-report.pdf (last visited Feb 19, 2023).
[2] *Id.*

community health implementation plans ("CHIP").[3] These community benefit programs ensure that the tax-exempt organization is focused on improving the care the community needs, as well as fulfilling its tax-exempt duties. PHS's commitment to the Tetra County community can help resolve potential cultural misalignments with TMC, and could assist with fostering a positive provider-patient relationship in Tetra County.

PHS's status as a tax-exempt organization could also be in serious jeopardy if it fails to maintain consistent and transparent financial reporting. News of a tax-exempt organization facing specific injunction rules due to Loyola Charity Care Law violations could raise concern amongst Loyola community members. The uncertainty of TMC's future to effectively operate a healthcare system should raise concern for PHS; however, these issues are best resolved by considering the circumstances surrounding this transaction and participating in risk mitigation practices. PHS must decide if it is willing to accept and take on any inevitable issues or if the issues may halt or completely preclude the acquisition from taking place.

C. Business Considerations

Ultimately, this is a business decision that will require PHS to weigh the risks and decide if moving forward is the right option. Entering a new territory can be daunting and although Tetra County patients currently cross borders to receive care at PHS facilities, it cannot be guaranteed that PHS can incur a sustainable patient volume in Tetra County solely on brand recognition. However, the patients who currently travel to utilize PHS's exceptional services will be delighted to receive the same quality of care under PHS within their own community. These loyal patients are also likely to recommend PHS to friends and family in the community. PHS can use this current

[3] Michael D. Rozier, *Tax-exempt Hospital Community Benefit in the U.S.: A Scoping Review From 2010 to 2019*, 8 Front Pub. Health 72 (2020).

patient base as a positive indicator that there will be established PHS patients who are familiar and eager to engage with a PHS location in Tetra County.

Despite their current regulatory issues, TMC is ranked third in terms of customer preference in Tetra County and boasts the second highest ranked provider group in the county, indicating that residents of Tetra County hold TMC in a high enough regard, which is an encouraging sign for PHS to capitalize on. PHS now has the opportunity to take the medical center to new heights, with the potential to make TMC the *most* preferred facility in the county. Exceptional provider care teamed with the PHS affiliation and culture of serving the community can surely turn this goal into a reality. If PHS can retain TMC's highly rated physicians, patients will likely continue to see their current doctors and choose PHS's new Tetra County Medical Center.

PHS's interest in expanding their business to TMC will ultimately boil down to financial costs and benefits associated to the acquisition. Currently, TMC is experiencing a sharp decrease in patient volumes due to financial concerns, and additionally, operating costs are worsening TMC's bottom line. Tetra County community members fear an economic recession is around the corner and PHS should also keep these concerns in mind when deciding to expand into Tetra County. PHS should approach this expansion opportunity with caution because while this may align with PHS's vision for the future, if not executed correctly the transaction could potentially bail out TMC and its limited partners from their financial woes and put PHS in a worse off position.

A deal of this magnitude with varying levels of uncertainty might deter other health systems looking to expand their patient outreach. Fortunately, PHS's ample resources and financial separate them from other potential buyers and gives enough cushion to feel optimistic, regardless of whether the deal goes through or not. Being the largest tax-exempt health care system in Loyola allows PHS the advantage of financial stability and stable ground to expand on. TMC is facing problems with inflation and supply chain instability that a system like PHS may not particularly feel due to their overwhelming presence and connections in three counties surrounding Tetra County. PHS has the financial and administrative support to run a comprehensive health system, and their 143 years of serving Loyola should be a testament that people in the state will support and work with Pearson Health Systems. PHS has a solid foundation in which they can expand and build on. In closing this deal, PHS should consider whether their stability as a health system translates to stability in Tetra County.

III. ACQUISITION STRUCTURES

There are several contributing factors PHS will need to consider when selecting a business structure to proceed with the acquisition of TMC. From a regulatory perspective, PHS will need to consider any CMS change of ownership implications and successor liabilities. From an administrative and operational standpoint, PHS will need to consider the integration strategy of TMC into PHS. Furthermore, PHS will need to ensure the protection of their tax-exempt status when acquiring a for-profit hospital.

The following section illustrates three of the most common means to acquire a business in the order of recommendation based on PHS and TMC's current circumstances: merger, asset purchase and equity purchase. At this time, we recommend PHS to pursue TMC via a *reverse triangular merger* in order to safeguard PHS's CMS credentials and tax-exempt status, and to be shielded from further unanticipated liabilities incurred by TMC. An asset purchase or an equity purchase may also be viable solutions for PHS under the right circumstances, however it will be critical for PHS to understand the associated benefits and risks of each strategy.

A. Merger

Rather than directly purchasing the assets of another business, a merger entails the combination of two or more businesses. While there are many different merger structures, the options are narrowed when one business entity is tax-exempt while the other business entity is for-profit. When deciding the optimal merger structure for PHS, it is crucial to ensure that PHS does Not enter into an agreement in which they would be exposed to successor liability from TMC's current regulatory infractions with CMS and the Loyola Charity Care Law.

One merger strategy which aligns with the existing circumstances for PHS is a reverse triangular merger with TMC (Figure 1A). A reverse triangular merger is a structure by which a parent company acquires a target company through a parent company subsidiary. The subsidiary is then absorbed by the target company, which continues to operate as a separate legal entity under the parent company. Here, PHS could create a limited-liability subsidiary to integrate into TMC, and TMC would finally become a subsidiary of PHS (Figure 1B). This acquisition structure could be an advantageous strategy for PHS for the following reasons.

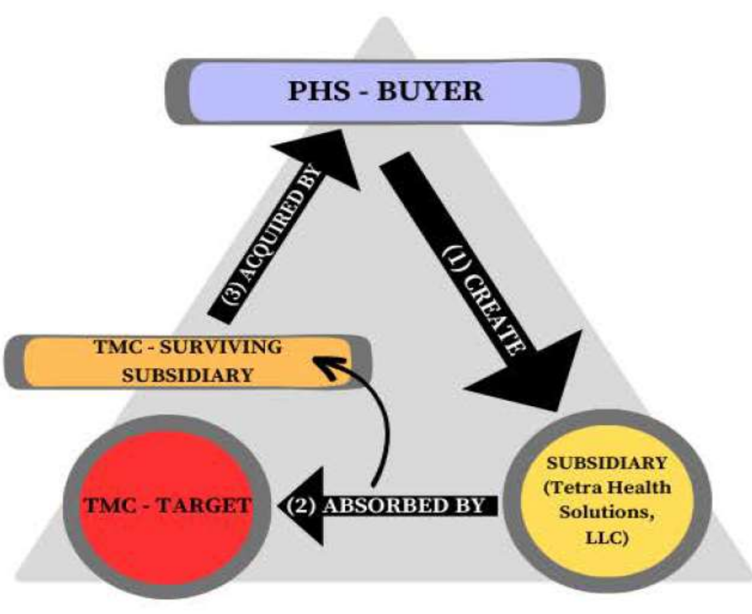

Figure 1A: Reverse Triangular Merger Acquisition Strategy

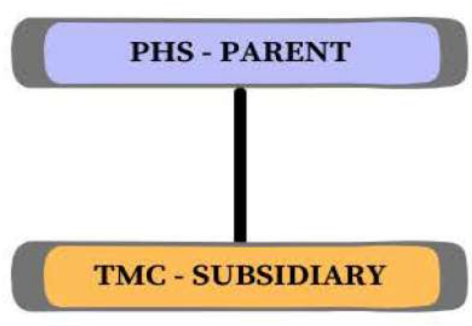

Figure 1B: Final State

1. Expedited Process

TMC currently has several existing agreements with multiple stakeholders to operate. TMC's owner, TMP, is owned by VHI, a general partner (88%), and TMC Physician Group limited liability shareholders (12%). TMC also leases assets from NBT. A direct merger strategy would require for TMP, VHI, NBT, and Physician stakeholders to align with the PHS merger. An unpredictable alignment with many moving pieces could significantly delay the acquisition process with each company who may not agree to a direct merger. Such drawn out negotiations could become very costly for PHS to afford counsel to formulate a new agreement with each company currently involved with TMC. In contrast, a reverse triangular merger would allow for a cleaner transaction as TMC would remain a separate legal entity as a subsidiary of PHS. As a result, TMC may maintain its existing management agreements with VHI, its building and land lease with NBT, and its highly ranked physicians employed by the Physician Group.

Another advantage for PHS as a parent company is the ability to separate from TMC if PHS finds the parent-subsidiary relationship to be ineffective.[4] This could be advantageous for PHS to pilot a business relationship with TMC in a controlled environment if PHS is unsure of entering into a permanent integration with TMC. In contrast, if the parent-subsidiary business model is successful for PHS and TMC, then PHS will have the ability to fully merge with TMC in the future once TMC rectifies existing infractions and PHS has the chance to further understand incurred liabilities should the entities fully integrate.

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[4] Willard L. Boyd III, *Mergers, Acquisitions, and Affiliations Involving Tax-exempts: Not Typical M&A Transactions,* (June 22, 2014) ABA https://www.americanbar.org/groups/business_law/publications/blt/2014/06/02_boyd/.

2. CMS Change of Information

Next, a reverse triangular merger would be advantageous to PHS as it would allow PHS to maintain its existing and separate CMS license. Because TMC would continue to be a separate legal entity and have the same for-profit status, a formal Medicare Change of Ownership (CHOW) would not be required under 42 C.F.R. §489.18.[5] A CHOW occurs when a Medicare provider is purchased by another organization,[6] which results in the transfer of the seller's Medicare identification number and provider agreement to the new owner.[7] As opposed to re-applying for a new CMS license, TMC would simply need to file a Change of Information notifying CMS of an update in enrollment since TMC survived as the target entity after absorbing PHS's subsidiary in the reverse triangular merger.[8] Additionally, PHS would need to report its indirect ownership interest in TMC to CMS. [9] This transaction would also protect PHS's CMS licensure from being affected by any further CMS infractions by TMC.

3. Protection of Tax- Exempt Status

Maintaining TMC as a separate taxable subsidiary would also protect PHS as a 501(c)(3) tax-exempt organization to prevent intermingling of for-profit and tax-exempt funds. Similarly, to comply with the Loyola Charity Care Law, having TMC as a subsidiary to PHS would allow for both entities to operate their own separate Charitable Organizations. In order to protect PHS's tax-exempt status, it would be imperative for PHS to maintain clear accounting records, management,

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[5] *Medicare Enrollment Application,* DHHS, https://www.cms.gov/Medicare/CMS-Forms/CMS-Forms/Downloads/cms855a.pdf (last visited Feb. 19, 2023).
[6] 42 C.F.R § 489.18.
[7] U.S. v. Vernon Home Health, Inc., 21 F.3d. 693 (5th Cir.); *see also* Provider Reimbursement Manual, Part I, §1500.7. [2013_MMI] W. Healthcare Transactions and Medicare's Change of Ownership Rules, healthlawyers.org; *see also* 42 C.F.R. §§ 489.18(a)(4) & (e).
[8] *Medicare and Medicaid Change of Ownership Considerations in Healthcare Industry M&A,* LEXISNEXIS https://plus.lexis.com/api/permalink/ec5df749-2693-4508-9e98-6a6f6994ea9c/?context=1530671 (last visited Feb 19, 2023).
[9] *Medicare Enrollment Application,* DHHS, https://www.cms.gov/Medicare/CMS-Forms/CMS-Forms/Downloads/cms855a.pdf (last visited Feb. 19, 2023).

board, and officer responsibilities to refute any claims that the TMC is a mere continuation of PHS, which may blur the lines between the business structures of the two separate entities.[10]

4. Ownership Considerations

A reverse triangular merger is an administratively efficient strategy; however, it is also crucial for PHS to anticipate possible roadblocks. Although TMC would remain a separate legal entity after the reverse triangular merger, TMC will still be a subsidiary of PHS, meaning PHS may still assume liability for TMC's past, present, and future acts and omissions. For instance, if TMC continues to violate of the Loyola Charity Care law and CMS guidelines under PHS parent ownership, and if there is substantial continuity of the predecessor operations leading to the infractions, the PHS may be required to fulfill certain required obligations as a result.[11] However, PHS can protect themselves from this liability by contracting with TMC to require implementation of a new sterilization program for purposes of rectifying existing CMS infractions.

Furthermore, to effectuate the establishment of PHS as a parent company over TMC as the target, PHS will need to have a controlling interest in TMC. To obtain this controlling interest, once the subsidiary created by PHS is absorbed by TMC, the TMC shareholders will need to trade out their stock for shares of the absorbed subsidiary.[12]

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[10] Nationwide Mut. Ins. Co. v. Eagle Window & Door, Inc, 424 S.C. 256 (2018).

[11] Fall River Dyeing & Finishing Corp. v. Nat'l Labor Relations Bd., 482 U.S. 27, 43 (1987); The substantial continuity test is applied to determine whether a successor entity, PHS, must satisfy the obligations of a predecessor, TMP. Courts would essentially look to whether the business while under the successor entity has the same management, consumer population, and business operations as the successor entity and is still conducting the same infractions when under the predecessor. Here, PHS would need to ensure best practices are implemented to shield from substantial continuity application if there are any further infringements with CMS and the Loyola Charity Care Law.

[12] Elaine D. Ziff, *The Effect of Corporate Acquisitions on the Target Company's License Rights*, 57 BUS. L. 767, 775 (2002); Joshua. G. Graubart, *Unintended Consequences: State Merger Statutes and Nonassignable Licenses* https://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=1094&context=dltr (last visited Feb. 19, 2023).

B. Asset Purchase

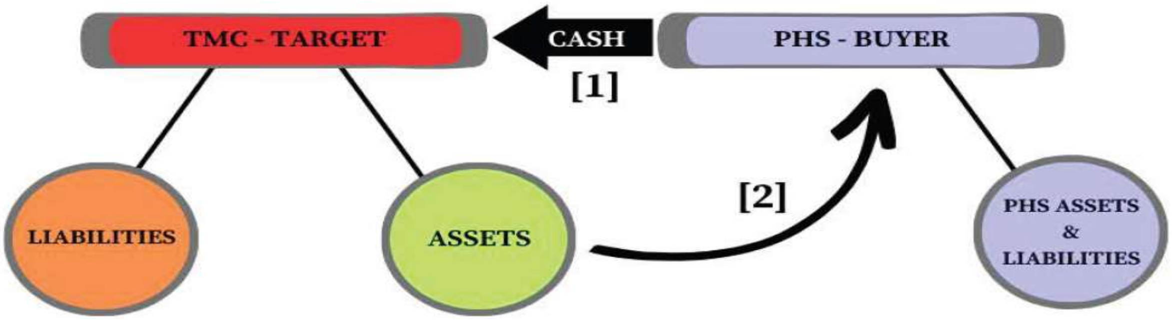

Figure 2A: Asset Purchase Strategy

An asset purchase provides that the acquirer buys only the assets and certain specified liabilities agreed upon in the purchase agreement. Upon closing, the buyer will thereby take on any agreed upon risks and rewards of the asset or assets purchased (Figure 2A-2B). Asset transactions can be as simple as purchasing machinery, and as substantial as purchasing entire businesses.

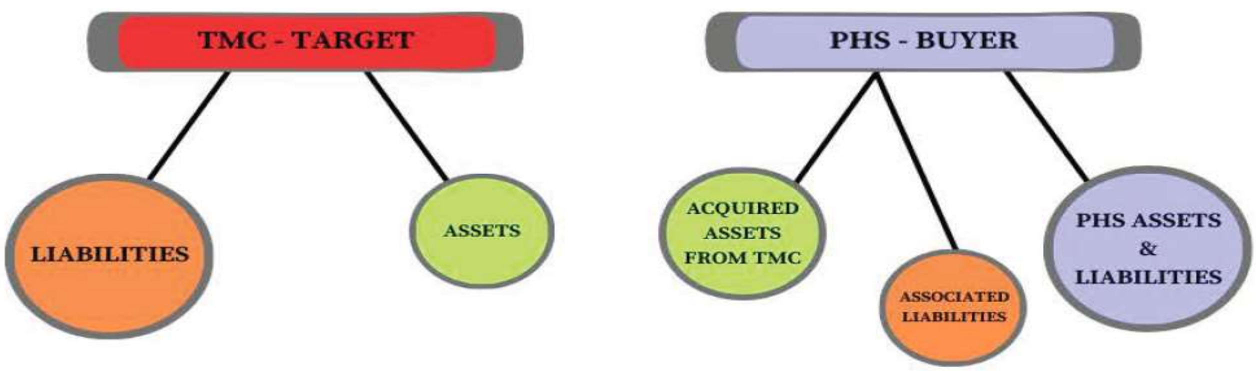

Figure 2B: Final State

1. Operational Considerations

An asset purchase may initially appear to be an attractive option for PHS as it would allow PHS as a buyer to specify which assets and liabilities are to be included in the purchase of TMC. This can include the TMC hospital itself, the equipment and hospital staff. However, due to the granular nature of all transactional parties identifying and agreeing upon the specific assets and liabilities that will be involved, asset purchases tend to take longer as opposed to wholesale agreements which involves multiple stages of negotiation and intense review of the terms of the contract. If PHS were to purchase all TMC hospital assets outright, then PHS would have to evaluate the contract agreements of every applicable staff member, medical device, or any other asset therein, which could be a significant added expense for PHS resources to effectuate these agreements under PHS. Another administrative consideration is the role TMC shareholders play. In an asset purchase, the management services provided by VHI would not be retained. This could pose a problem, considering VHI's majority ownership interest in TMP, the company who owns TMC. Additionally, TMC senior management is unlikely to agree with this asset purchase agreement if it would mean their replacement by PHS officers.

2. CMS Change of Ownership

From a regulatory standpoint, PHS conducting an asset purchase of TMC or leasing TMC assets would require a CHOW process. With TMC's CMS license currently at risk if the infractions with their sterilization department are not corrected by April 30th, it is not recommended that PHS assume responsibility for TMC's at-risk existing provider agreement with CMS. During a CHOW process, the new owner may reject the seller's existing provider agreement during the sale, terminate the old agreement, and file for a new Medicare identification number as a new applicant. Because TMC is currently a functioning hospital, purchasing TMC's assets without an active Medicare identification number could leave the hospital uncovered. Although it could be possible for TMC to operate under PHS's Medicare enrollment if certain standards are met[13], it is not recommended as PHS's own Medicare enrollment could be put at risk if TMC is penalized for additional CMS infractions.

[13] 42 C.F.R § 413.65.

3. Protection of Tax-Exempt Status

Furthermore, PHS will need to consider the tax implications of purchasing select TMC assets as TMC is currently a for-profit hospital. To protect PHS's tax-exempt status, it will be critical for PHS hold separate accounting records and bank accounts with the for-profit assets and liabilities. This also includes holding separate charitable organizations for PHS and TMC. An asset purchase permits the buyer to elect the assets and liabilities it would incur, however it also presents unpredictable administrative concerns between VHI and NBT, as well as the regulatory burdens on PHS to either process a CHOW or re-apply for CMS coverage. While an asset purchase is a viable option, it may not be the best option when considering the totality of the circumstances.

C. Equity Purchase

PHS can also pursue an equity purchase, which is when the buyer assumes control of a business by purchasing voting stock in a company.[14] Here, PHS would purchase at least 50% of TMP shares to have a majority voting control over TMC operations (Figure 3A). This strategic model can be beneficial to PHS for several of the following reasons.

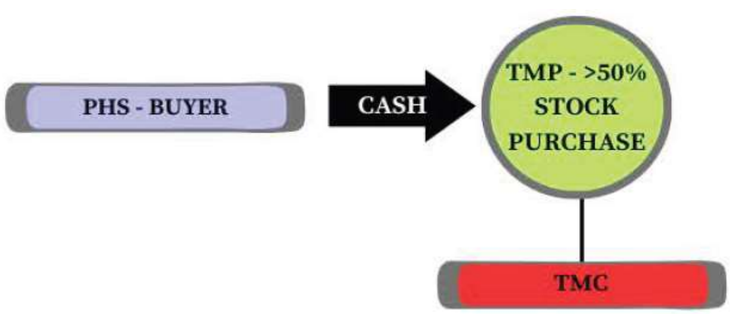

Figure 3A: Equity Purchase Strategy

Figure 3B: Final State

[14] STEPHEN GLOVER ET AL., M&A PRACTICE GUIDE § 2.03 (2008).

1. Ownership Considerations

Once PHS acquires the majority of controlling stock, PHS would have significant voting power regarding organizational decisions (Figure 3B). Additionally, this model is one of the fastest strategies for PHS to have ownership over TMC. This can be advantageous for PHS to have better oversight of TMC operations and strategies to rectify its current regulatory infractions and any future potential risks. Although this is one of the fastest options to obtain control over TMC, it is also important to consider that as a majority shareholder PHS would assume all past, present, and future liabilities associated to TMC.

2. Protection of Tax-Exempt Status

As discussed in section IIA and IIB, PHS would need to carefully monitor all financial activity to avoid jeopardization of their 501(c)(3) status. Furthermore, as shareholders of TMC, any profits incurred by PHS from their investment of TMC would qualify as unrelated business taxable income (UBTI).[15] This federal tax liability could be very costly for PHS. Because PHS and TMC would need to keep separate financial records, and separate Charitable Organizations, PHS would not be able to offset any of the UBTI incurred from their for-profit business ownership against reported tax-exempt losses.[16] Therefore, if PHS were to purchase ownership of TMC, PHS will need to anticipate yearly UBTI expenses throughout the entirety of the ownership.

3. Ownership Considerations

Although the majority stock purchase would quickly effectuate ownership over TMC and would allow PHS increased oversight into completing action plans to rectify TMC's regulatory infractions, PHS's CMS license may still be at risk in the event of TMC infractions during the

[15] *Private Equity Funds Investor Tax-Exemption Guidance,* NAT L. R., https://www.natlawreview.com/article/irs-issues-interim-guidance-applicable-to-tax-exempt-investors-private-equity-funds (last visited Feb 19, 2023).
[16] *Id.*

CHOW application process.[17] PHS would also need to navigate the acquisition agreement with TMP to have a majority interest in TMP. The most apparent roadblock with obtaining majority ownership is if VHI, which owns 88% of TMP, does not sell enough shares for PHS to obtain over 50% of TMP shares. However, TMP shareholders may be inclined to sell their shares at current fair market value to PHS as there is a much-anticipated economic recession, which would likely decrease the share value. While this option may be advantageous to the seller, PHS would likely experience a loss if the share value decreases in the event of a recession. Additionally, PHS can offer fair market value prices to any of TMP's minority dissenting shareholders prior to acquiring TMC as a subsidiary despite minority shareholder dissent.

D. Acquisition Recommendation

While an asset purchase is an attractive option which allows PHS to specify the liabilities they are willing to assume, and an equity purchase may provide PHS with the ability to quickly obtain controlling ownership of TMC, both alternatives increase the risk of jeopardizing PHS's tax-exempt status and CMS licensure. Therefore, due to the totality of PHS and TMC's circumstances and the operational, financial and regulatory benefits mentioned in IIIA, a reverse triangular merger is the recommended strategy for PHS to acquire TMC.

IV. POTENTIAL LIABILITY EXPOSURE

Liability exposure in transactions such as mergers and acquisitions can be inherent and inevitable. However, it is important to mitigate risks to liability to minimize the effects they will have on PHS and its future operations. This section will first discuss preliminary steps PHS can take prior to closing to minimize the risk of liabilities attaching post-closing. Second, we will review the key risks of this transaction that could potentially expose PHS to liability, the severity

[17] This concern is similar to the Asset Purchase strategy.

of those risks, and the suggested course of action PHS should take to minimize the effect those risks will have on future operations.

A. Pre-Closing Mitigation of Liabilities

There are a couple steps PHS can take during the pre-closing stage that would help shield itself from liabilities after the transaction is finalized, including compliance with the corporate practice of medicine doctrine, which precludes corporations from the practice of medicine or employing physicians for out-patient work, which does not have a non-profit exception. These steps include contracting for indemnification and representations and warranties insurance. Both recommendations require contractual negotiation, and PHS should be prepared for a lengthy negotiation process.

1. Indemnification

It is of high priority for PHS to shield itself from liabilities with indemnification. Indemnification provisions often make up the most heavily negotiated parts of an agreement due to the nature of transactions of this type and the desire of the parties to limit post-closing exposure to liabilities.[18] Indemnification provisions allow parties to protect themselves from breaches in representations and warranties, and breaches of the purchase agreement or binding elements of the letter of intent. PHS should create an "indemnification framework" based on the risks below to determine what limitations should be placed on this agreement, and how such limitations should be funded.[19]

Due to the nature of TMC's incurred liabilities and VHI's unwillingness to provide information, it is recommended that PHS tries to include a sandbagging provision in their

[18] Carly Eisenberg Hoinacki & Anjana D. Patel, *Navigating Indemnification Obligations in a Health Care Transaction: Managing Health Care Liability*, AHLA Connections, Nov. 2018, at 11.
[19] *Id.*

negotiations. This provision would preserve PHS's right to seek indemnification from VHI regardless of whether PHS learned of violative conduct before or after the transaction is completed. Thus, this provision will allow PHS to seek indemnification for information VHI does not feel comfortable disclosing until a binding letter of intent is issued, including fees issued by CMS.

However, while indemnification covers the financial aspect of TMC's sanitation violations issued by CMS, the regulatory problems are still best addressed by structuring the acquisition as a reverse triangular merger. Regardless, indemnification provisions are of the highest degree of importance in the pre-closing stages of the transaction, and we recommend PHS makes it a priority in its talks with VHI.

2. Representation and Warranty Insurance

Additionally, PHS should contract for representation and warranty insurance. Representations and warranties are made by both parties for the purpose of providing confirmation of facts and circumstances surrounding the operation of the parties' businesses and compliance with regulatory requirements.[20] PHS should cross-reference VHI's representations and warranties to ensure and confirm the accuracy of their own due diligence inquiries, as TMC's representations and warranties should reflect an effort to remedy the liabilities that they have incurred to prepare for a smoother transfer of interest to PHS. For example, PHS should try to obtain a compliance plan from TMC detailing how they plan to keep their provider status with CMS and how to prevent losing it in the future.

Accordingly, PHS must contract for a system that holds the other parties accountable for any violations of representations or warranties that may place PHS in a vulnerable position. The recommended way of doing this is purchasing representation and warranty insurance. This

[20] *Id.*

insurance provides a way for PHS to cover losses in the event of breach of representation or warranty by TMC. However, this insurance only covers losses resulting from *unknown* liabilities.[21] Thus, it would be an effective way for PHS to cover losses that may occur because of liabilities which stem from information VHI does not disclose. Furthermore, it is recommended that PHS reserve funds for both indemnification and representation and warranty insurance by holding over part of their purchase price in escrow to be accessed in the event either of these events are triggered.

B. Key Risks

PHS should be aware of the key risks they face in acquiring TMC. The risks to PHS and any liability exposure that may occur are listed below in order from most to least severe. Additionally, we have included recommendations for PHS to implement both pre- and post-closing to minimize the risk that such liability is incurred.

1. TMC's Medicare Privileges at Risk

The highest risk to PHS in this transaction is likely to be that TMC's status as a Medicare provider will be revoked, thus affecting PHS's eligibility to serve as a provider post-acquisition. PHS has diligently complied with regulatory and administrative requirements set forth by CMS for years since the inception of the program. Thus, this issue is vital and should be contemplated by PHS with the highest degree of care. Should PHS fail to proceed with caution, their status as a provider will be threatened as well.

Prior to executing the transaction, PHS should try to get as much information as possible regarding TMC's noncompliance with sanitization standards before a letter of intent is exchanged and the due diligence stage of the transaction begins. We understand that VHI may not be comfortable with sharing real-time updates regarding the matter; however, this information is

[21] *Id.* at 12.

valuable when determining the potential liability PHS may be exposed to upon completing this transaction with VHI. For that reason, PHS should negotiate with VHI and explore the potential of disclosing limited information regarding TMC's Medicare status under the protection of a nondisclosure agreement.

Furthermore, a letter of intent is not typically binding unless agreed upon by both parties. Thus, if VHI would like to execute a binding letter of intent, PHS must also intend for it to be binding. We would further recommend that PHS insist against a completely binding letter of intent. Should PHS receive further pushback from VHI, we may recommend that PHS agree to make some, but not all, parts of the letter of intent binding based on what VHI is willing to disclose about the CMS violations to PHS under a nondisclosure agreement.

Should PHS and VHI follow through with the transaction in a way that does not shield them from this liability, we recommend that PHS moves for reversal of revocation of provider status post-closing. To do this, PHS must confer with VHI about what specific parties were responsible for the violation and receive an update immediately if TMC's Medicare status is revoked. This will be difficult information for PHS to receive prior to closing but may be possible through the use of an NDA as referenced above. The revocation may be reversed if PHS can provide proof to CMS that the business relationship with the adverse party who caused the violation in the first place is terminated.[22]

2. Violation of the Loyola Charity Care Act

PHS must comply with the Loyola Charity Care Act in this acquisition to avoid the risk of having to settle for infractions. Effective January 1, 2023, and thus, applicable to this acquisition, the Loyola Charity Care Act will require PHS to give notice to the Loyola Attorney General at

[22] 42 CFR §424.535(e).

least sixty (60) days in advance of closing on any transaction. PHS should make this a top priority once they move into the final stages of the transaction, as failure to comply with this Act yields a high risk to incur liability, such as fees, injunctions, and a consent decree.

Additionally, it is vital that PHS does not conflate the requirements of the Loyola Charity Care Act with the Federal Hart-Scott-Rodino Act, which PHS must also comply with by submitting premerger notification to the FTC and DOJ.[23] The Loyola Act is stricter as there is no minimum purchase amount required for notice to the Attorney General. Thus, PHS should be advised that *any* transactions, no matter how small and unlikely to raise antitrust concerns, should be reported to the Loyola Attorney General at least 60 days before closing. PHS should also ensure that TMC and its affiliates are meeting notice requirements under this Act and that all parties comply with the Act at least 60 days before closing.

PHS should also be advised that violations of the Loyola Charity Care Act are likely to have consequences with steep costs. In its acquisition of TMC, PHS should be advised of TMC's violations of the Act to decide which of the three proposed business models would be suitable based on the liabilities TMC has incurred, as it is a potential liability for PHS. As a result of TMC's violations of the Act, they have entered into a consent decree with the Loyola Attorney General with a principal judgment amount of $1,000,000 and several injunctions. A consent decree is essentially a settlement between the Loyola Attorney General and TMC that contains several injunctions to prevent antitrust issues.[24]

Accordingly, PHS should move for post-acquisition modification of the existing consent decree. PHS should be advised that a party may request modification of a consent decree when it

[23] *Premerger Notification Program*, FTC https://www.ftc.gov/enforcement/premerger-notification-program (last visited Feb. 19, 2023).
[24] Hawkins v. Dep't of Health & Human Servs. for N.H., Comm'r, 665 F.3d 25, 30–31 (1st Cir. 2012).

is no longer equitable to apply the judgment previously issued.[25] PHS may do this by filing a motion for relief from judgment; according, PHS must only establish that a "significant change in circumstances" has occurred, such that modification is necessary. If PHS can show effective and consistent compliance with the Loyola Charity Care Act prior to the acquisition, the court may approve modification to reflect the necessity and equity of the consent decree aimed at the infringing party, TMC, which is to be taken over by PHS, a compliant party. This is likely to effectively mitigate some of the post-acquisition liability regarding TMC's consent decree with the Loyola Attorney General.

3. Shareholder Derivative Suits

In acquiring TMC, PHS should be aware of the possibility of potential shareholder actions that may be taken by shareholders on behalf of the corporation. In transactions involving shareholders, such as the one PHS and VHI have been discussing, PHS must be aware of certain shareholders rights, and how lack of opportunity to exercise those rights may lead to future derivative lawsuits and liability. Minority shareholders have a bundle of dissenter rights that they can exercise in the event they feel the company they hold interest in is going in a direction they are not interested in pursuing.[26] Shareholders not only have the right to be notified of an impending merger, but also have the right to vote on it and sell-out at fair market value prior to the close of the transaction. Accordingly, the fact that the TMC Physician Owners likely do not know about PHS and VHI's discussions may be contrary to their rights as minority shareholders of TMP and may subject PHS to derivative shareholder suits in the future. While the severity of this risk is moderately low so long as notice is given to minority shareholders, it is highly recommended that

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[25] FED. R. CIV. P. 60(b)(5).
[26] LEE HARRIS, MASTERING CORPORATIONS AND OTHER BUSINESS ENTITIES 246 (Russell L. Weaver eds., 2nd ed. 2016).

PHS negotiate with VHI to require notification to the TMC Physician Owners prior to closing to prevent any future liability.

4. Anti-Kickback Statute, False Claims Act, Stark and Mini-Stark

The federal Anti-Kickback Statute ("AKS") prohibits the knowing and willful solicitation, receipt, offer to pay, or payment of any remuneration to induce referrals for items or services paid at least in part through a healthcare program funded by the government.[27] PHS must ensure that they are complying with the federal and Loyola AKS and fee-splitting provisions. Failure to comply with AKS statutes may result in fines, exclusion from federal healthcare programs like Medicare and Medicaid, and criminal penalties. Some AKS violations are protected by satisfying the requirements of safe harbors, which include but are not limited to payments to bona fide employees and service or rental agreements.

Another relatively low risk that PHS should generally watch out for in conducting business and other transactions in the healthcare setting is liability incurred as a result of a violation of the False Claims Act ("FCA"). The FCA imposes civil penalties against any person who "knowingly submits false claims to the government."[28] These claims are set forth by independent parties or whistleblowers that bring "*qui tam*" suits on behalf of CMS. PHS is advised to make accurate claims to CMS regarding spending under Medicare and Medicaid, as any information reported with actual knowledge of its falsity or reckless disregard of the truth may be punishable in a *qui tam* action.

Finally, the physician self-referral law, or Stark Law, prohibits physicians from referring recipients of "designated health services" to entities that the physician or an immediate family

[27] 42 U.S.C. § 1320a-7b.
[28] 31 U.S.C. §§ 3729-3733.

member has financial ties with.[29] In its practice, PHS should be aware that they must comply with the federal Stark Law and the Loyola mini-Stark that governs self-referrals locally. While this may be a low risk, as no current circumstances point to Stark or mini-Stark issues in this transaction, failure to comply with such statutes at any time may expose PHS to liability in the form of civil monetary penalties, and PHS should conduct due diligence into the physicians they are employing in the new entity, whether from PHS or TMC.[30]

V. SUPPLEMENTAL DUE DILIGENCE

Before PHS confirms its next steps to acquire TMC, PHS must exercise reasonable care and perform the necessary due diligence which can be achieved through requests for supplemental information. The information gathered in the due diligence process will help PHS identify potential risks and will be the basis for how PHS will approach the acquisition. The following section illustrates the ideal goals for PHS to achieve during the supplemental due diligence process by general priority order. While there is higher-priority information that PHS will need to confirm prior to moving forward with any deal, there is also information which, although a lower-priority, should be taken into account.

A. Higher-Priority Considerations

1. CMS Licensure

One of the most pressing issues TMC is facing is its participation in the Medicare program which may be terminated by CMS on April 30, 2023 if its deficiencies are not corrected. There are serious regulatory and safety concerns regarding TMC's sterilization department, and it is important for PHS to understand the root cause of the concerns in addition to any action plans that

[29] 42 U.S.C. § 1395nn.
[30] 42 U.S.C. § 1320a-7a.

may be in place to restore TMC to compliance. Currently, VHI does not wish to provide details regarding this matter without first entering a binding letter of intent to close this deal. VHI can rightfully assume that PHS's willingness to proceed in discussion depends on CMS's decision and the circumstances surrounding it. The best case scenario is the information provided by TMC in an NDA will show that the deficiencies have been acknowledged and an action plan has been created and begun implementation to meet CMS compliance. However, the information provided by TMC may also show that TMC is unlikely to rectify the deficiencies by the April 30, 2023, and there are no opportunities for extensions. PHS's perspective on this deal will shift according to the information received surrounding this issue as PHS might be tasked with revamping an entire sterilization system with no guaranteed continuance of participation in the Medicare program if the targeted deadline is not met.

2. Consent Decree

Another area of concern requiring TMC documentation is the Consent Decree which TMC must operate under to avoid costly civil penalties. Obtaining additional information regarding the Consent Decree is a more manageable task because the consent decree is unsealed, meaning it is open for PHS to view without requesting the court to unseal files. The second prong of the Consent Decree issue is obtaining additional information from TMC to further understand the violations and the decree's effect on TMC operations. TMC may be unwilling to divulge any further information regarding the alleged violations, however implementing a confidentiality agreement will raise TMC's level of comfort to further discuss the situation with PHS. It is imperative for PHS to understand the injunctions set forth within the consent decree because there is a possibility that PHS may operate under the consent decree depending on PHS's acquisition strategy of TMC.

3. Labor Market Shortages

Due to its widespread success across several counties and communities in Loyola, PHS has many reputable and established connections that can be leveraged. Before PHS can serve an influx of new patients in Tetra County PHS will first need to ensure there are sufficient resources to meet the anticipated patient volume. TMC is currently facing labor market challenges because of the COVID-19 pandemic. PHS should perform a due diligence analysis to understand whether the labor market issue is specifically attributed to TMC operations or if it is widespread problem experienced by Tetra County. It will be beneficial for PHS to understand if the labor market challenges are due to the lack of qualified candidates to fill critical positions, employee satisfaction at TMC, the geographical location, or whether the salaries offered are not competitive enough for the area. If PHS wants to expand in Tetra County, whether through this deal or another, it would be beneficial for PHS to further understand how it might be able to attract employees in or near Tetra County to fill critical positions.

B. Lower-Priority Areas

During the due diligence process, all areas which may impact the transaction must be considered, even if not particularly pressing at this time. PHS should strive to obtain all relevant and potentially relevant information from TMC. While the below areas may not be as critical as the CMS deficiencies or compliance with the Consent Decree, PHS should also consider the following circumstances when arriving to a business decision.

1. NBT Breach of Contract

As previously discussed, National Buildings Trust (“NBT) owns the facilities TMC operates from in addition to the land on which the facility is located. Despite anecdotal discussions with PHS’s financial advisor team, it is unclear whether NBT will need to approve this deal with PHS. It is recommended that PHS obtains additional clarification regarding any provisions or change of control clauses from the TMC-NBT leasing agreement to confirm whether NBT must first provide approval of the transaction. If approval is not required, then PHS can proceed with the next due diligence finding. However, failure to identify this information could lead to breach of contract claims from NBT. The scope of the due diligence should include the process in which TMP entered into business with NBT to open TMC, as well as TMP's experience of operating a health system using NBT owned facilities. NBT will eventually be notified of the ongoing discussions, and it would benefit PHS to understand how to ensure an ideal a working relationship with NBT.

2. Time Sensitive Closing Deadlines

A Loyola law implemented in 2023 requires hospitals, health systems, and other healthcare providers to provide at least 60-days advanced notice of closing transactions involving the provision of healthcare. PHS should keep this in mind during discussions of next steps and acquisition timelines. The timing is important as PHS should first understand the extent of the CMS deficiencies before effectuating any agreement and notifying the Loyola Attorney General. Due to the reporting requirement, the closing process and subsequent acquisition of TMC may be delayed.

VI. CONCLUSION

PHS should consider the business, strategy, and cultural considerations when forming the plan to acquire TMC, while also considering the various acquisition structures, potential liability risks, and due diligence concerns. The benefits of expanding greatly outweigh the risks so long as PHS duly complies with the recommendations made above.