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Healthcare REITs: Navigating Regulatory Challenges and Minimizing Liability Risk

Understanding Organizational, Operational and Tax Considerations When Dealing With REITs

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Healthcare REITs: Navigating Regulatory Challenges and Minimizing Liability Risk

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Overview

- **1) The role of REITs in healthcare transactions**
- **2) Evaluating whether to hold an operating license**
- **3) Regulatory due diligence**
- **4) Analyzing transaction structure issues & regulatory timing**
 - Variation in regulatory requirements depending on provider type, state, and transaction structure
 - Techniques for closing your transaction as soon as possible
 - Limiting disruption of reimbursement
- **5) Regulatory requirements for additional changes**
 - Change of management company
 - Internal reorganization
 - Sale of real estate

The Role of REITs in Healthcare

- Provide capital for a variety of transaction types
- The REIT's roll will vary based upon the objectives of the REIT and operator
 - Purchase from third-party owner; more complicated when operations are acquired
 - Monetization sale/lease-back
 - Lender (especially development/construction funds)
 - Joint venture opportunities
- REITs will act as a development partner to facilitate future capital improvements and growth

Evaluating Whether to Hold an Operating License

- RIDEA structure allows REITs to own healthcare operators.
- Advantages to holding an operating license:
 - Easier to replace management company/EIK
 - Easier to prevent license revocation if management company does not hold the license
 - Benefit from operator revenues
- Disadvantages to holding an operating license:
 - Regulatory risk (e.g. lawsuits, government investigations, etc.)

Due Diligence

- Level of regulatory due diligence varies depending on whether REIT will own only real estate or real estate and operations.
- Real Estate-only regulatory diligence: focus on Certificate of Need, licensure, Medicaid/ Medicare enrollment.
- Due diligence on Manager/EIK
 - Compliance history
 - Tax and structure

Regulatory Due Diligence-Operations

- Develop a customized due diligence request list
- Conduct preliminary interview with Seller
- Review key documents (issue spotting)
- Conduct management interviews
- Request and review additional documents

Regulatory Due Diligence-Operations

- Report material findings in real time
- Respond to regulatory questions from lenders
- Oversee correction of problems to be fixed prior to closing
- Review/revise regulatory representations and warranties and indemnification provisions
- Be available for last minute surprises
- CHOW process and timing

Regulatory Due Diligence: Sample Items

- State licenses
- State Medicaid provider agreements
- Accreditation information
- Physicians with financial interests in the providers
- Third party payor contracts
- Government investigations and audits
- Survey reports
- Most recent licensure and Medicaid filings
- All Medicare CMS-855s filed
- Description of any pending projects

Analyzing transaction structure issues: What constitutes a CHOW?

- Structure of transaction
 - Change of control v. change of operator
 - Asset sale v. Stock transfer
 - Mergers
 - Other transactions
- Medicare
- State Licensure
- Certificate of Need
- Medicaid

Transaction Structure: What constitutes a CHOW?

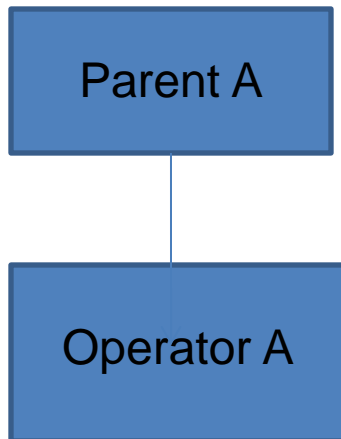
- Definitions of a CHOW do not always contemplate certain common transactions (e.g., internal reorganizations, real estate sales, stock sales of distant parent)
- Regulatory focus is often on the actual operating entity
 - If that entity (i.e., the entity that holds the license and provider numbers) is changing, then there most likely will be a full CHOW
 - If the transaction is removed from the operating level, certain agencies may not require full CHOW filings and may only require certain abbreviated filings, or no filings at all
 - Changes of officers/ directors can require CHOW filings in certain states.

Transaction Structure:

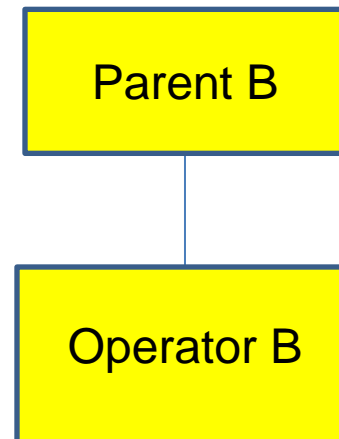
Diagram #1: What constitutes a CHOW?

- Change in operator (Traditional CHOW)

Before



After

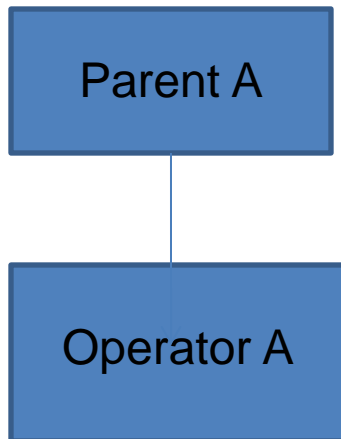


Transaction Structure:

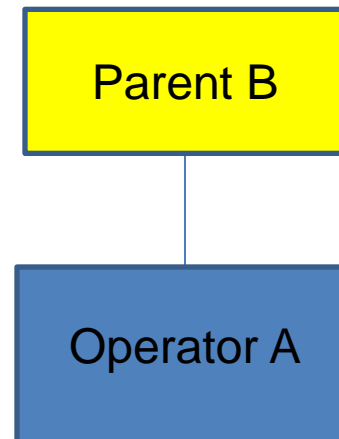
Diagram #2: What constitutes a CHOW?

- Change in immediate parent (often considered a CHOW)

Before



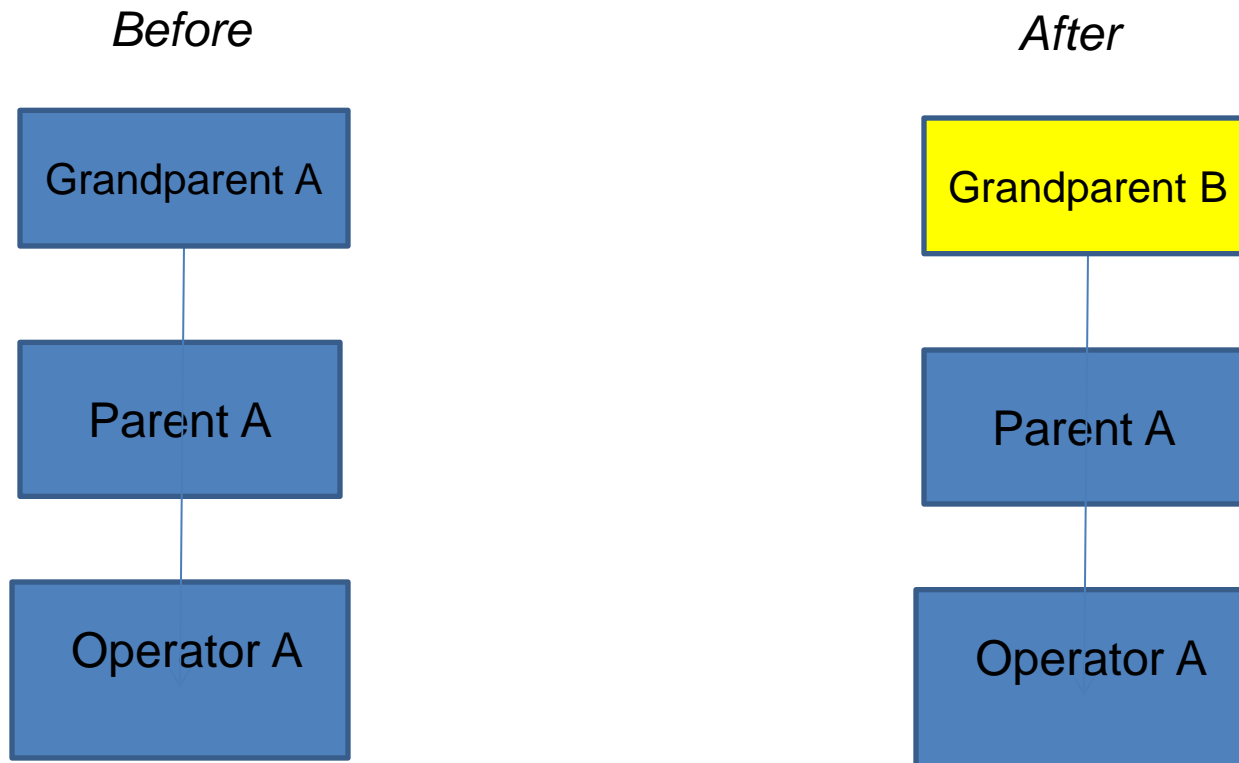
After



Transaction Structure:

Diagram #3: What constitutes a CHOW?

- Change in grandparent (sometimes considered a CHOW)



Transaction Structure:

What constitutes a CHOW for Medicare purposes?

(a) *What constitutes change of ownership—*

- (1) *Partnership*. In the case of a partnership, the removal, addition, or substitution of a partner, unless the partners expressly agree otherwise, as permitted by applicable State law, constitutes change of ownership.
- (2) *Unincorporated sole proprietorship*. Transfer of title and property to another party constitutes change of ownership.
- (3) *Corporation*. The merger of the provider corporation into another corporation, or the consolidation of two or more corporations, resulting in the creation of a new corporation constitutes change of ownership.
Transfer of corporate stock or the merger of another corporation into the provider corporation does not constitute change of ownership.
- (4) *Leasing*. The lease of all or part of a provider facility constitutes change of ownership of the leased portion. 42 CFR 489.18

Transaction Structure:

What constitutes a CHOW from a state perspective?

- State licensure, CON, and Medicaid agencies vary in their positions with respect to whether a transaction constitutes a CHOW and whether any filings are required for various transactions
 - State licensure agencies typically look to whether there is a change in the entity or individuals that control the operations
 - Medicaid agencies often defer to whether there is a change in Tax ID or NPI
 - Certificate of Need agencies vary, and may defer to licensure in their determination

Tax Issues Relating to REIT Operation

- “Good income” from real estate
- Taxable income from operations
- Selecting the EIK Manager for the RIDEA structure
 - Qualifications of EIK Manager
 - When qualifications are tested
- No employment of facility employees

Transaction Timing: Techniques for Closing Your Transaction Quickly

- Use of management agreements as a workaround when regulatory approvals cannot be obtained within desired timeframe. May be coupled with RE change.
 - Certain states require approval for a change in management company.
 - Pay attention to regulatory requirements for management agreements.
 - Colorado example: “If the owner of a health care entity enters into a lease arrangement or management agreement whereby the owner retains no authority or responsibility for the operation and management of the health care entity, the action shall be considered a change of ownership that requires a new license.” 6 CCR 1011-1 § 2.7.3(E).

Transaction Timing: Techniques for Closing Your Transaction Quickly (cont.)

- Use of divestiture agreements
 - Some states allow these agreements. If you are not approved, you agree to divest the facility.
 - These policies change often (e.g. Rhode Island).
- Fines for closing your transaction before regulatory approval has been granted.
 - West Virginia: penalty for closing without CON approval.
 - Rhode Island: substantial fine for closing without Change in Effective Control approval.
- Some states will allow you to close without regulatory approval, but prior operator remains liable for licensure issues.

Analyzing Reimbursement and Cash Flow Implications: Medicare Automatic Assignment

- Buyer must affirmatively reject automatic assignment to avoid it.
- Unless the automatic assignment of the Medicare agreement is rejected, buyer is responsible for successor liability.
- Most buyers accept automatic assignment in order to avoid gap in Medicare reimbursement.

Analyzing Reimbursement and Cash Flow Implications: Rejecting a Medicare Provider Agreement

- New owners have the option to reject automatic assignment, resulting in the termination of the prior Medicare provider agreement.
- If the new owner rejects assignment, the new provider is treated as an initial applicant and will experience a period of time without Medicare payments.
- Generally, rejecting assignment precludes the new owner from having successor liability for Medicare overpayments.
- Purchaser must affirmatively reject the assignment of the provider agreement by notifying the Regional Office in writing at least 45 days in advance of the CHOW's effective date.

Analyzing Reimbursement and Cash Flow Implications: September 2013 CMS Memorandum

- On September 6, 2013, CMS issued a policy memorandum to State Survey Agency (SA) Directors regarding the CHOW process and the assignment of Medicare provider agreements to new owners. The memorandum emphasized policies meant to encourage automatic assignment of the prior Medicare agreement.
- CMS focused on survey timing in particular, stating that if an initial survey of an applicant that rejected assignment is conducted shortly after the CHOW date, it raises significant doubts that the survey was unannounced.
- CMS also stated that SAs must not conduct initial surveys until they are able to complete their higher priority workload. Also, CMS clarified that the last day of an initial Medicare survey conducted by the SA or accreditation organization will not necessarily be the effective date of the new Medicare provider agreement.

Analyzing Reimbursement and Cash Flow Implications: State Reimbursement Issues

- State requirements vary regarding whether claims must be held for interim period while new owner is applying for enrollment.
 - Medicaid enrollment applications often require a copy of the new license, meaning that enrollment cannot be completed until after the transaction closing date.
 - New owners should be aware of possibility of cash flow disruption (although claims can often be retro-dated).
- Some states impose successor liability whether or not providers choose to accept or reject the provider agreement.
 - Best practice: address this issue in purchase agreement.

CON CHOW Process

Certificate of Need (CON)

- Notice and filing requirements vary among states with CON laws
- Some states require simple notification which may entail minimal review
- Others may have more detailed notice requirements, possibly including public notice requirements, and detailed application review

Other CHOW Requirements

- **Other facility-specific permits and authorizations may be required and may impact timing, including, but not limited to:**
 - Food Service
 - Pharmacy Permits
 - Accreditation
 - Certificate of Occupancy
 - General business license
 - Fictitious name registration
 - Beautician/barber permit
 - Radioactive materials permit
 - Solid waste handling permit
 - Passenger elevator operating permits
 - Boiler permits

CHOW Implications and Timing if REIT Must Terminate Relationship With Operator

- Landlord cannot bring in a new Operator without regulatory approval
- If Operator refuses to vacate, a court order may be necessary for regulators to approve replacement Operator
- Regulators may expedite review process so that resident care is not impacted
- Exiting Operator Cost Reports
- Transaction documents evidencing transfer

Implications for Change of Manager

Management Agreements

- Some states explicitly regulate the management entity for the facility and subject this entity to the same review process as the operating entity
- Accordingly, when such management entity changes, some states may require CHOW filings similar to that seen for operating entities
- If Operator relinquishes all operational authority, change in manager could trigger a CHOW
- For example: If the governing body of a health care facility does not retain the "immediate authority and jurisdiction" to do the following, Rhode Island considers there to be a "change in operator"—
 - Hire or fire the chief executive officer of the health care facility;
 - Maintain and control the books and records of the health care facility;
 - Dispose of assets and incur liabilities on behalf of the health care facility;
 - Adopt and enforce policies regarding operation of the health care facility.

Implications for Internal Reorganizations

Internal Reorganizations

- Example – presuming that the operating entity is Corp A, its parent is Corp B, the grandparent is Corp C, and the great-grandparent is Corp D, which is owned by individuals, and both Corp A and Corp B are transferred to a related entity owned by Corp D, regulators tend to view this as not constituting a CHOW, as the direct parent of the operating entity is not changing
- Nonetheless, because certain previously disclosed information is changing, states may require an update filing to its application, most likely the submission of a new ownership disclosure

Implications for Sale of Real Estate

Sale of Real Estate

- In the event of a sale of the real estate (i.e., bricks and mortar), there may be filing requirements.
- Usually the state CON agency is the agency most concerned with sale of real estate and may consider it a CHOW under the CON regulations
 - CON is often tied to the land, and the owner of the real estate may hold the CON and leases the right to the property as well as the right to operate to the operator
 - Often formal notification / request for exemption from CON review will be required
- State licensure often views these transactions as not triggering CHOWs. However, they may require formal notification and submission of transaction documents (i.e., bill of sale, new lease agreements)
- Medicare and Medicaid typically require little to no action under these circumstances

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