

Successor Liability in Hospital M&A: Assessing and Mitigating Risk Exposure

Managing the Impact on Transaction Structure, Allocating Risk, and Addressing Medicare Issues

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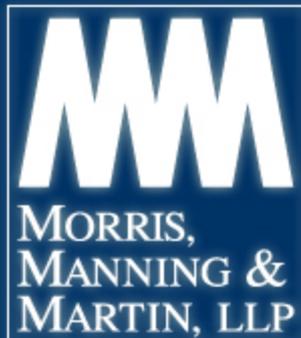
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SUCCESSOR LIABILITY IN HOSPITAL M&A: ASSESSING AND MITIGATING RISK EXPOSURE

**Robert C. Threlkeld, Esq.
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April 2, 2014





Successor Liability – The Basics

Basic Legal Doctrine of Successor Liability

The general rule of successor liability is that a purchaser is not responsible for the liabilities of a seller without an express agreement to assume liabilities. For this reason, hospital acquisitions, and acquisitions of health care providers in general, typically are structured as asset purchases where there is an express exclusion of liabilities.



Successor Liability – The Basics

The courts, however, have recognized a number of clearly defined exceptions to the general rule that can impose successor liability upon a purchaser of assets. Moreover, CMS has practically made it much more difficult for the acquirer of assets of a health care provider to avoid successor liability, by making it administratively burdensome to obtain a new Medicare provider number.



Successor Liability – The Basics

Elements/Theories – Four Principal Elements

- i. The successor entity expressly or impliedly assumes the predecessor's tort liability,
- ii. There was a consolidation or merger of seller and purchaser,
- iii. The purchasing entity is merely a continuation of the selling entity, or
- iv. The transaction was entered into fraudulently to escape such obligations.



Successor Liability – The Basics

Express/Implied Assumption of Liabilities

- If the Purchaser of the assets of health care provider expressly agrees to assume the liabilities of Seller, then the Purchaser will be liable for the liabilities expressly assumed.
- In determining whether a selling hospital's liabilities have been impliedly assumed by Asset Purchaser, courts generally will do the following:
 - Examine the language of the asset purchase agreement to determine whether there is an unambiguous assumption or exclusion of certain liabilities.
 - Review Asset Purchaser's post-acquisition conduct to determine whether such conduct implies an assumption of liabilities.



Successor Liability – The Basics

DeFacto Merger

Uniformly, the courts will hold that a purchaser of assets is subject to successor liability if there is a defacto merger.

Among the factors courts examine, these are paramount:

1. Continuity of ownership;
2. Cessation and prompt dissolution of the Seller;



Successor Liability – The Basics

DeFacto Merger

Continued –

3. Assumption by the purchaser of those obligations necessary for uninterrupted operation of business. For a health care provider, those could include trade debt, service contracts, licensing agreements (including licensing of electronic medical records and billing software), physician employment and service contracts, emergency department coverage and call coverage agreements, and a host of others.
4. Continuity of management, personnel, physical location, assets and general business operations. For a health care provider, many of these factors will be met, including physical location, employed physician and professional staff, use of identical assets to provide hospital services.



Successor Liability – The Basics

DeFacto Merger

Continued –

5. The continuity of ownership standard has been made more elastic and flexible in recent years. A plaintiff seeking to impose successor liability may only be required to show “some sort of proof”, than exchange of shares in the successor corporation.
6. This proof may include (i) successor’s assumption of debt (credit or lending) obligations and (ii) employment of Seller’s most important employees.



Successor Liability – The Basics

Mere Continuation of Seller

1. This theory of successor liability is a variant of the defacto merger. Under this theory an Asset Purchaser would be responsible for Seller's liabilities if it is merely a restructured or reorganized form of Seller.
2. To determine if Asset Purchaser is a "mere continuation" of Seller, the following factors are relevant:
 - Common ownership of Asset Purchaser and Seller
 - Common identity of officers and directors of Asset Purchaser and Seller
 - Similar function of officer and directors
 - Inadequate consideration paid for assets



Successor Liability – The Basics

Fraud Exception

- The fraud exception is a variation of fraudulent conveyance liability.
- The exception covers instances where there is payment for assets at less than fair value, or there is actual intent to defraud creditors of the Seller or the Seller's shareholders.
- In distressed hospital sales outside of the bankruptcy context, the purchaser must be particularly vigilant to ensure that a court would conclude that the transaction was commercially reasonable and at fair market value.
- The doctrine also has been applied if the transaction was structured to avoid liability, even if the consideration paid was at fair market value.



Successor Liability – The Basics

Fraud Exception

Continued –

- In states such as California, Georgia, Michigan, Vermont and others where there is Attorney General or other Governmental oversight of acquisitions of not-for-profit hospitals, there is typically a fair value process that will insulate the transaction.
- In other states, and in the context of the acquisition of for-profit hospitals, it is particularly important to obtain an independent third-party valuation of the transaction. That is true even if there is no argument that could be made that the Seller is a referral source for the hospital under new ownership.



Successor Liability – The Basics

Fraud Exception

Continued –

- In distressed asset sales, particularly in Certificate of Need states and other jurisdictions that impose restrictions on hospital permitting, it is important that the value of such permits and approvals be considered.
- Even where fair value is paid, under no circumstances should a purchaser assist the Seller in insulating proceeds of the sale from creditors, directly or indirectly.



Successor Liability – The Basics

Other Potentially Applicable Theories

- Continuity of Enterprise: Under the continuity of enterprise theory, successor liability can be imposed if (i) there is substantial continuity of the appearance of the entity, its management, employees, assets, and general business operations such as retention of the name and provision of same services; (ii) prompt dissolution of seller following asset transfer; (iii) there is an assumption of trade liabilities and other obligations necessary to the business. Other factors include purchaser's knowledge of liabilities and absence of responsible parties.



Successor Liability – The Basics

Product-Line Exception

- Typically the product-line exception applies where there is the purchase of a manufacturer of goods rather than a provider of services like a health care provider.
- Relevant factors are the continuation of the same general business, and the lack of an available remedy against the original manufacturer.



Successor Liability

Potential Liabilities in Hospital Transactions

There are myriad potential liabilities in a hospital sale context that a purchaser would seek to avoid.

- Healthcare regulatory liabilities arising from: Stark Law; Anti-Kickback Statute; False Claims Act; HIPAA; EMTALA; conditions of participation; overpayment or lack of entitlement to state upper payment limit funds; unlawful retention of overpayments; disproportionate share hospital funds or indigent care trust funds; under-funding of state mandated indigent and charity care support; cost-report liability; civil monetary penalties; etc.



Successor Liability

Potential Liabilities in Hospital Transactions

Continued –

- Other regulatory liabilities including: Environmental liabilities; Title VII liabilities; unfunded and under-funded employee benefit liabilities; breach of collective bargaining agreement liabilities; ERISA liability; unpaid tax at local, state and federal levels; tax liability for abuse of not-for-profit status; unpaid wage claims; others.



Successor Liability

Potential Liabilities in Hospital Transactions

Continued –

- Healthcare specific non-Governmental liabilities, including: repayment or breach of contract obligations to payors; malpractice liability including hospital liability and employed physician malpractice liability; general contractual liability for equipment, service contracts, supplies; medical staff disputes.
- Non-healthcare specific liability including: breach of contract, trade debt, general tort liability.
- Of these liabilities, the vast majority of non-Governmental liabilities may be excluded by the Purchaser and immunized from successor liability with proper transaction structure. However, liabilities associated with a Medicare provider number are difficult practically to avoid in a hospital sale.



Successor Liability

- **42 CFR 389.18(c)** provides that when there is a change of ownership, the existing Medicare provider agreement will be automatically assigned to the new author. A change of ownership includes the following for the following entities:
 - Partnership – The removal, addition or substitution of a partner.
 - Sole Proprietorship – Transfer of Title and property to another party.
 - Corporation – The merger of the provider corporation into another corporation, or the “consolidation” of two or more operations. However, transfer of corporate stock or merger does not constitute a change in ownership.
 - Leasing – The lease of all or part of a provider facility.



Successor Liability

CMS Encourages Assumption and Provides Disincentives to Rejection of Automatic Assignment of Provider Agreement

- Pursuant to 42 CFR 489.52, a new owner of a provider, including a hospital facility, is entitled to reject assignment of the Medicare provider number.
- If the Medicare provider number is rejected, then the traditional theories of successor liability still may be pursued by regulatory agencies seeking repayment of liabilities arising pre-transaction. However, in general, liability for pre-transaction regulatory liability attached to the rejected provider number should not flow to the Purchaser.



Successor Liability

CMS Encourages Assumption and Provides Disincentives to Rejection of Automatic Assignment of Provider Agreement

Continued –

- The caveat to this general rule is if the Purchaser acquires accounts receivable, these accounts receivable are subject to set-off and recoupment for pre-closing liabilities.
- However, in a September 6, 2013 policy memorandum, CMS imposed a policy making it burdensome and impractical to reject assignment of the Medicare provider number.



Successor Liability

CMS Encourages Assumption and Provides Disincentives to Rejection of Automatic Assignment of Provider Agreement

Continued –

- Rejecting the automatic assignment constitutes a termination of the Medicare provider agreement.
- Pursuant to the Policy Memorandum, if a new owner rejects assignment, not only is the facility treated as a new applicant, but CMS' policy ensures substantial delay in the provision of a new Medicare provider number.



Successor Liability

CMS Encourages Assumption and Provides Disincentives to Rejection of Automatic Assignment of Provider Agreement

Continued –

- The Policy Memorandum requires that the initial survey cannot take place until after the sale.
- The survey must be a full standard survey.
- The survey cannot take place until the MAC has issued a recommendation for approval of the Purchaser's new enrollment application.



Successor Liability

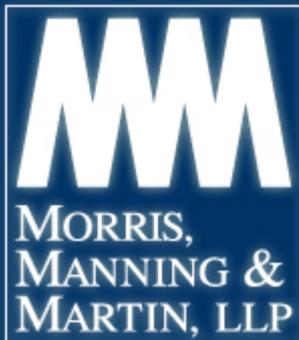
CMS Encourages Assumption and Provides Disincentives to Rejection of Automatic Assignment of Provider Agreement

Continued –

- Survey must be unannounced.
- Any survey within 14 days of the acquisition will bear closer CMS scrutiny.
- *Most tellingly*: CMS directs state survey agencies to complete all higher priority workload, and the initial survey is lowest priority.

Thank You

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Successor Liability in Hospital M&A - Assessing and Mitigating Risk Exposure - Deal Structure Implications

April 2, 2014

Paul F. Lawrence

- Stock Transactions / Certainty of Successor Liability
- Member Substitution Transactions / Certainty of Successor Liability

- The legal entity's liabilities remain unchanged
- Variants include:
 - Assignment of specified assets/liabilities to another entity
 - Arrange how specified liabilities would be handled

- Merger Transactions / High Risk of Successor Liability

- Closure Transactions
 - Cessation of Operations prior to acquisition
 - Limited to particular circumstances

- Strategic Transactions are typically Asset Transactions
- Structured to Avoid Pre-Closing Liabilities
- See Potential Liabilities from first portion of presentation

- Assumed Liabilities
 - Assumption of Specified Categories of Liabilities
 - All Contracts and Leases vs. Picking and Choosing
 - Trend in Certain Deals to Assume all Liabilities

- Liabilities Associated with Special Categories of Assets
 - Medicare Provider Agreement
 - Overpayments
 - Stark Act liabilities
 - False Claims Act liabilities
 - Accounts Receivable
 - Privileged Materials Considerations

■ Excluded Liabilities

- Liabilities Not Otherwise Expressly Assumed
- Typically liabilities relating to pre-closing operations
- Contracts/Leases with Compliance Issues
- Unlisted Referral Source Agreements
- Acquirer's obligation to make adequate provision for payment of liabilities not assumed by the acquirer

- Mitigation through Due Diligence
 - Diligence of various liabilities categories described above
 - Referral source diligence
 - Review of referral source contracts
 - Identifying payments made to referral sources
 - Made not in accordance with applicable contracts
 - Made without any contract in place
 - Non-monetary benefits
 - Time period to evaluate
 - Billing and Coding Review
 - Policies and Procedures Review

- Self-disclosure of potentially problematic arrangements
 - Content of self-disclosure
 - Who makes the self-disclosure
 - Choice of agency
 - Timing of making the self-disclosure
 - Timing of resolving and settling the self-disclosure
 - Interaction with indemnification obligations/rights

- Mitigation through contract provisions
 - Purchase Price
 - Representations and Warranties
 - Substantive Categories of Representations
 - Disclosure vs. Risk Allocation
 - Disclosure Schedules/Updating Issues
 - Knowledge Qualifiers
 - Materiality Qualifiers
 - Sandbagging Provisions
 - Associated Condition to Closing

- Mitigation through contract provisions (cont'd)
 - Indemnification
 - Breaches of Representations and Warranties
 - Breaches of Covenants
 - Excluded Liabilities
 - Specific Concerns of Note that Arise in a Particular Transaction
 - Damages
 - Baskets
 - Damage Caps
 - Survival periods

- Securing Performance of Contractual Obligations
 - Holdbacks
 - Escrows
 - Net Worth Requirements
 - Guaranty of Outstanding Obligations by Principals of Seller
 - Setoff Rights
 - Representations and Warranties Insurance
- Post-Closing Change of Name of Seller
- Exceptions to this structure in the case of lock/stock/barrel deals

- Question and Answer Period
- For any questions after the presentation, please contact:
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