TWISTS AND TURNS OF A HOSPITAL SALE
The Anatomy of a Deal

Beverly Hills Bar Association
Health Law Committee

DATE: March 9, 2016
TIME: 12:00 PM to 1:30 PM

PRESENTERS:
Michael J. Sarrao, Esq.
Craig B. Garner, Esq.

This Program Offers One Hour of MCLE Participatory Credit
EVENING BEFORE CLOSING
11:59 p.m.
While Everyone Sleeps

In the two minutes just before and after midnight on closing day, a hospital transaction nears completion.

- Seller terminates all employees just before midnight.
- Buyer hires (substantially) all employees just after midnight.
- Patients transition seamlessly from seller to buyer.
- What could go wrong?
While Everyone Sleeps – the Employees

- State and federal W.A.R.N. Act concerns
- Union issues
- Final paychecks from sellers and treatment of PTO
- Employee personal and trust assets
- Overtime and/or shift differentials overlapping at midnight
- Employees on a leave of absence or disability leave
While Everyone Sleeps – the Patients

- Right to bill for patient charges
- Patient belongings
- Payer contracts
- Length of stay issues (Medicare, Medi-Cal, other insurance)
- Patient expirations and claims for professional negligence
While Everyone Sleeps – Vendors and Valuables

- Liability to third parties before and after midnight
- Pre and post close reconciliations and treatment of accounts payable
- Assumed and rejected contracts
- Third party (patient, employee and vendor) equipment and valuables
While Everyone Sleeps – Other Considerations
SIX MONTHS EARLIER
Is It Time To Sell?

- Between 2004 and 2013, 28 hospitals in California closed and 20 opened.

- Hospital consolidations and closures continued at record-breaking levels in 2014 and throughout 2015.

- Consolidation also extended to medical device companies, pharmaceuticals and insurance companies.
Is It Time to Sell? continued

- The number of acute care hospitals in California declined by 4% between 2004 and 2013.

- The top eight hospital systems account for 40% of California hospitals.

- More California hospitals were profitable in 2013 than in 2014.

- The cost of uncompensated care (charity care and bad debt) increased by 45% between 2004 and 2013.
Necessary Ingredients

- **Hospital** – Preferably financially distressed or in trouble with state or federal government. Active license and/or patients optional.

- **Seller** – Willingness optional. For non-motivated sellers, see Title 11, United States Code.

- **Buyer** – Money and experience optional.

- **Regulatory Approval** – For certain transactions only.*
Recommended Ingredients

- **Management Company** – Recommended with certain buyers.

- **Broker/Investment Banker** – Recommended, especially with financially distressed hospitals or buyers limited experience.

- **Lender** – Recommended for buyers without money and those with unlimited cash.

- **QAF** – Offer limited while supplies last.

- **Regulatory Approval** – Lawsuit possible alternative.*
Pre-Sale Checklist (theoretical for seller)

- **Step 1** – understand your market
- **Step 2** – identify your target buyer
- **Step 3** – clean up your mess
- **Step 4** – come to terms with your price / value
- **Step 5** – realize the futility of steps 1 to 4
Pre-Sale Checklist (theoretical for buyer)

- **Step 1** – understand your target market
- **Step 2** – identify your target
- **Step 3** – your target is a mess
- **Step 4** – dictate terms for price / value
- **Step 5** – wait for seller to realize the futility of steps 1 to 4
Pre-Sale Checklist (practical for seller)

- **Step 1** – draft an NDA and BAA
- **Step 2** – find a good broker and/or lender
- **Step 3** – don’t tell anyone
- **Step 4** – always smile
- **Step 5** – include some but as few key employees as possible
Pre-Sale Checklist (practical for buyer)

- **Step 1** – sign seller’s NDA and BAA; it earns trust and both documents are useless
- **Step 2** – find a better broker and/or lender
- **Step 3** – pretend to care about confidentiality
- **Step 4** – always smile
- **Step 5** – identify the key employees as quickly as possible
FIVE MONTHS EARLIER
Letter of Intent

- Short version vs. long version: What kind of road map do the parties prefer to follow throughout the transaction?

- Typically non-binding, but serves as a test of the integrity of each party.

- What provisions can be binding?

- How should the parties approach valuation?
Confidentiality Concerns

Confidentiality can be an integral part of any hospital transaction.

Information about a possible sale can disrupt operations, cause physicians and employees to seek work elsewhere, and ultimately have a negative impact on a hospital’s bottom line.

At the same time, information about a possible sale can attract other potential buyers and drive the price of a possible sale, and maybe even create a “bidding war.”
Valuation– What Is the True Value of a Hospital?

- Enterprise value v. price per hospital bed
- Cash flow analysis
- Market value

- **EBITDA** (earnings before interest, taxes, depreciation and amortization); **EBITDAR** (earnings before interest, taxes, depreciation, amortization and rent/restructuring costs); **EBITDARM** (earnings before interest, taxes, depreciation, amortization, rent and management fees)
Transactions in Bankruptcy Court

- What happens to the hospital sale process in bankruptcy court?
- What is the scope of the bankruptcy court’s authority?
- Does the Office of the Attorney General play a role?
- What is a “Stalking Horse” bidder?
- How can a creditors’ committee impact the sale process?
Offers You Can’t Refuse

Sometimes a potential buyer has more to offer than just a sales price.

- Bridge loans
- Management services
- Inclusion in a larger system
- Assistance in avoiding bankruptcy
- May include exclusivity or no shop clauses
What the Government Needs to Know

A provider who is contemplating or negotiating a change of ownership must notify CMS. 42 C.F.R. § 489.18(b)

What can constitute a change of ownership?

- Removal, addition or substitution of a partner
- Transfer of title and property to another party
- Merger or consolidation (but transfer of corporate stock does not constitute change of ownership)
- Lease of all or part of a hospital (change of ownership for the leased portion)
FOUR MONTHS EARLIER
Buyer Due Diligence

- Corporate structure
- Financial information
- Litigation / insurance
- Licensing / regulatory
- Human resources
- Real estate / environmental / seismic
- Information technology
Seller Due Diligence

- Buyer’s financial stability
- Corporate structure, the scope of which may depend upon guarantees in the transaction
- Ability to close (regulatory approval or other non-financial contingencies)
- Interim management agreement (due diligence may expand)
- Knowledge qualifier
Using Public Information

- OSHPD reports (http://www.oshpd.ca.gov/HID/DataFlow/HospMain.html)
- HospitalCompare (https://www.medicare.gov/hospitalcompare/search.html)
- UCC filings
- Court filings
- Community / public opinion
- SEC filings
THREE MONTHS EARLIER
Asset or Stock Purchase Agreement?

- **APA**: Buyer may not acquire all assets
- **APA**: Focus on excluded assets and assumed liabilities
- **APA**: Schedules take center stage
- **APA**: Used for mergers and acquisitions
- **SPA**: Transfer of company shares title
- **SPA**: Less flexibility than an asset purchase agreement
- **SPA**: Potential for easier/faster regulatory process
Purchased Assets (APA)

- Real and leased property
- Quality assurance fee payments
- Furniture, furnishings and equipment (FF&E)
- Accounts receivable
- Information systems / proprietary rights
- Inventory
Assumed Liabilities (APA)

- Accounts payable
- Quality assurance fee obligations
- Assigned contracts
- Past Medicare obligations
- Lease obligations
Excluded Assets (APA)

- Personal articles
- Cash and cash equivalents
- Prepaid loan fees
- Employee-owned assets
- Seller’s organization and governing instruments / irrevocable licenses
Retained Liabilities (APA)

- Employee wages / PTO
- Reserve / extended sick leave banks
- Historical Medicare claims
- Broker fees
- Past tax obligations
- Tail policy
SCHEDULES, SCHEDULES, SCHEDULES
Real Estate

- Often the most valuable asset in a transaction
- Value may be inextricably connected to the hospital license
- Existing mortgage—friend or foe?
- Consider scope of any appraisal
- Hospital campus and/or medical office buildings—consider in proper context
- Environmental concerns
What Goes Into a Purchase Price?

- Deposit
- Holdback
- Adjustments (assumed liabilities or acquired assets)
- Outstanding obligations on assigned contracts
- Prorations
- Items payable at closing
- Transition services
Representations and Warranties

- Organization and good standing
- Necessary consents
- Corporate records
- Financial statements
- Disclosure of liabilities (known or should be known)
- Net working capital
Contracts

- Material contracts
- Assumed and assigned contracts
- Types of consent required
- Payer contracts
- Employee contracts
- IT contracts
TWO MONTHS EARLIER
California Department of Public Health

- Issues hospital licenses in California
- Primary regulatory agency for hospitals
- Oversees hospital administrative penalties
- Licenses hospital ancillary services, units and outpatient facilities
- Licensing forms: https://www.cdph.ca.gov/pubsforms/forms/Pages/HealthFacility-GACH.aspx
Centers for Medicare & Medicaid Services (CMS)

- Oversees the Medicare and Medicaid programs in the United States
- Hospital inpatient and outpatient prospective payment system, as well as inpatient psychiatric facilities
- Hospital value based purchasing program
- Hospital readmissions reduction program
- CMS 855A (application for hospitals)
Assignment of Medicare Provider Number

Upon assignment of Medicare provider number, buyer retains data to calculate Medicare DSH payments (42 C.F.R. § 412.106), charge-to-cost ratios for outliers (§ 412.84(i)(3)(i)), IPPS “base period” for payment and cost report history, wage index (§ 412.230) and E.H.R. incentive payments (§ 495.105(c)).

However, buyer becomes responsible for any past Medicare liabilities and overpayments. 42 U.S.C. § 1395g(a).
Board of Pharmacy

- The California Board of Pharmacy ("BoP") licenses pharmacies located within any licensed hospital, institution, or establishment that maintains and operates organized facilities for the diagnosis, care, and treatment of human illnesses to which persons may be admitted for overnight stay and meets all of the BoP regulations.

- Biggest timing issue in most hospital transactions.
Other Licenses / Approvals

- Board of Equalization
- Business licenses
- CLIA
- Radiology
- FCC
- EDD
A FEW DAYS BEFORE
Transactional Closing Items

- Escrow instructions
- Bill of sale
- Closing certificates
- Assignments and assumptions
- DEA power of attorney
- Deed(s) of trust
- Closing statement
- State and county documentation
- Title policies
- Wire instructions
Logistical Closing Items

- 11:59 p.m. to 12:01 a.m.
- WARN Act considerations
- IT systems
- Badges and keys
- Patient valuables
- Medical staff
- Patients and the community
- When is it really over?
What Could Go Wrong?

- Most transactions do not end at closing
- Most transactions do not close as originally planned
- Certificates of good standing have a shelf life
- Lenders
- Title concerns
- Certifications and opinion letters
TWO MONTHS LATER
Adjustments After the Closing

- Found money
- Hidden liabilities
- Holdback
- Indemnification issues
- Tail coverage
- Periodic true ups
Access to and Retention of Records

- Buyer should provide reasonable access to all patient records relating to purchased assets (if needed by seller in the future).

- For how long should buyer retain hospital records?

- Application of “60 Days to Pay” regulation.

- What records should seller retain?
Management-Leaseback Agreement

- Buyer = Manager
- Seller = Licensee
- If Manager has not obtained an acute care license from CDPH for the continued operation of the hospital by the closing, a management agreement may be necessary.
- Licensee leases hospital facilities and equipment from Manager.
Medicare Reassignment Prohibition

- **General Rule**: No payment which may be made to a provider of services under Medicare for any service furnished to an individual shall be made to any other person under an assignment or power of attorney. (42 U.S.C. § 1395g(c); 42 C.F.R. § 424.73(a).

- **Exceptions**: (1) Payment to a government entity; (2) Assignment by court order; and (3) Payment to a billing and collections agent, subject to certain conditions.

- **Lock box agreements**
Michael J. Sarrao
Law Offices of Michael J. Sarrao

Mike Sarrao, a healthcare and business lawyer, is a senior executive with Alecto Healthcare Services, a California based healthcare company which owns, operates, and/or manages acute care hospitals in 3 different states including Olympia Medical Center in Los Angeles.

Mike previously served as General Counsel at Prime Healthcare. In addition to representing hospitals in a variety of legal matters, Mike has served as lead counsel for the buyer in the acquisition of 23 hospitals.

For additional information please email msarrao@sarraolaw.com.
Craig B. Garner
Garner Health Law Corporation

Craig is an attorney and health care consultant, specializing in issues pertaining to modern American health care and the ways it should be managed in its current climate of reform.

Craig’s law practice focuses on health care mergers and acquisitions, regulatory compliance and counseling for providers. Craig is also an adjunct professor of law at Pepperdine University School of Law, where he teaches courses on Hospital Law and the Affordable Care Act.

Between 2002 and 2011, Craig was the Chief Executive Officer of Coast Plaza Hospital in Norwalk, California. Craig is also a Fellow Designate with the American College of Healthcare Executives and a Vice-Chair of the State Bar of California, Business Law Section, Health Law Committee.

Additional information can be found at www.garnerhealth.com.
Thank You

Michael J. Sarrao
Law Offices of Michael J. Sarrao
16310 Bake Parkway, Suite 200
Irvine, CA 92618
(949) 783-3976
msarrao@sarraolaw.com

Craig B. Garner
Garner Health Law Corporation
1299 Ocean Avenue, Suite 450
Santa Monica, CA 90401
(310) 458-1560
craig@garnerhealth.com/
www.garnerhealth.com