Selling a Physician-Owned Hospital — 15 Key Concepts

By:

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The sale of a physician-owned hospital to a third party, often a national company, involves a number of key issues and concerns. This article highlights 15 specific areas that deserve particular attention as the sale moves forward and ultimately closes. This article focuses on the key areas relative to a transaction involving the sale of units or stock. Many of the issues will be the same if the transaction is structured as an asset sale.

1. *Developing a Plan.* A hospital that is examining a sale usually starts by considering its core long term options, for example whether it can simply remain in business and prosper or whether a sale is critical for one reason or another. Here, it must assess whether a sale is needed for purposes of seeking cash or liquidity, to bring in new management or to restructure ownership. Depending on the size of the hospital, the motivations for selling, and various complicating factors, it can take at least six to 12 months from the time a decision is made until the day that the transaction closes. A hospital must be prepared to operate through this process. Moreover, the hospital and its leaders must prepare for the length of time that the process requires.
2. *Identify the Hospital Leaders; Establish a Transaction Committee.* It is important to identify who on the part of the hospital will be the leaders during the sale process once it commences. These individuals will drive the transaction process forward by communicating regularly with counsel to discuss the core terms of the transaction, the transaction documents (discussed below), and issues of importance to the physician sellers. The leaders will meet and communicate regularly with the potential buyers. These individuals will organize meetings and communicate regularly with the selling physicians. They will work to facilitate agreement among the sellers on critical issues such as governance of the hospital after the sale and non-competition provisions. The hospital leaders may include the chief executive officer of the hospital or other officer or a member of the governing board of the hospital. Consider specifying at least three or five people who will be involved in the process from start to finish. It is a very time intensive process and the individuals identified will need to be prepared for the time commitment entailed. Throughout the process, the members of the hospital will need to be fully apprised of the situation so that consent and approval of the transaction is more readily attained. However, at the beginning stages of the process, three to five members of the governing board or specific officers should take the lead.
3. *Soliciting Potential Buyers.* There are several key considerations in the effort to negotiate with buyers.
   a. Determine who the likely buyers are and create a list of potential buyers. Advisors can help identify buyers and can create the list based on knowledge of the industry and contacts. The seller and its counsel should research the buyers if the list includes lesser known buyers. Buyers can often be categorized as either (i) industry or strategic buyers, or (ii) financial buyers. The typical management company or strategic buyers are parties already in the industry. They are often familiar and known within the industry and they may or may not present the highest or most attractive bid. In some situations, a financial buyer is the highest priced buyer. Here, it is important to assure that an unknown buyer (e.g., a "financial" or new entity investor) actually has the commitment and the capital to close the transaction.
   b. Determine who will help in developing a request for a proposal book (also referred to as a solicitation book or information memorandum), either a legal team or a specialized investment banking team. The

investment bank will likely charge a fee set as a percentage of deal proceeds and will focus on finding a buyer and offer. Alternatively, in many cases, the core team can work with outside counsel to put together the request for proposal. Outside counsel fees are charged on an hourly basis and fees will likely be, as a whole, lower than the fee charged by an investment bank. Legal counsel fees are generally paid whether or not a transaction closes. In contrast, an investment banker is generally only paid if a transaction closes.

4. *Request for Proposal.* The request for proposal is a critical component of the transaction process. The book essentially summarizes the hospital's key information and includes information that the buyer will use to evaluate whether the opportunity is one that is of interest. The book typically includes information relating to the hospital's market, payor mix, case volume and case mix, physician specialties and procedures performed, and history. The hospital leaders and counsel (or investment bank) work together to assemble the book into a format for potential buyers. It is intended to provide an overview of the hospital.

   When the request for a proposal book is complete, the next step involves calling potential buyers and asking them generally about interest in the project. Outside counsel or the investment bank typically handles this part of the process. If a prospective buyer is interested, the potential buyer executes a confidentiality agreement with the hospital. Pursuant to the typical confidentiality agreement, the parties acknowledge that they are entering into discussions regarding a potential transaction and that each party will be providing certain confidential information to the other. The parties agree not to disclose such information.[1] Once the potential buyer and seller execute the agreement, the proposal book is sent to the buyer.

   Once the buyer has had a chance to review the book, counsel or the investment bank will follow up to determine whether the interest is serious. Here, the initial call is to ask if the potential buyer received the book and if they have an interest in an initial discussion with the management of the hospital. If the potential buyer is interested, a call is set up with the hospital leaders. If the buyer or buyers are still interested, site visits with the seller are scheduled. Here, if multiple parties are interested, the seller may want to consider opening a data room where the potential buyers can work through the diligence the seller provides. The data room may be a room on site at the hospital or may be electronic. The seller's counsel will also have access to the data room. This step of the process is time consuming and in most cases, many of the potential buyers who express initial interest do not ultimately submit a bid.

5. *Letter of Intent.* Once the potential buyer field is narrowed, the buyers' proposal reviewed and the lead buyer or buyers identified, the seller will negotiate and enter into a letter of intent with the buyer. The letter of intent will include binding and non-binding provisions. For example, the letter will set forth the broad outlines of the deal that will be non-binding, such as what percent ownership the buyer will purchase and the purchase price. The letter of intent will also include certain covenants that are binding, including a confidentiality provision and in most cases, an exclusivity provision. An exclusivity provision provides that the parties will work only with one another until a specific time. For example, a typical exclusivity provision drafted by the seller would provide as follows:

   > During the period beginning January 1, 2006 and ending on the first to occur of 5:00 pm on March 30, 2006 or termination in accordance with Section___ of this letter, the Hospital shall not, directly or indirectly, through any representative or otherwise, solicit or entertain offers from, negotiate with or in any manner encourage, discuss, accept or consider any proposal of any other person or entity, including any company, hospital, or management company, but excluding any physicians, relating to acquiring any portion of the membership interests or business of the Hospital, other than the Buyer or one of its affiliates.

[1] The obligations under a typical confidentiality agreement survive termination of the discussions related to the transaction. Sometimes there is a limit on the survival period but often there is not. This is to protect the seller in the event that a transaction either does not take place or does not ultimately close.

Sellers typically desire short exclusivity provisions; buyers desire longer exclusivity provisions. Typically, the letter of intent includes a 30–90 day exclusivity period with the ability to extend the period.

6. *Due Diligence.* Once the letter of intent has been signed, the buyer will typically continue its due diligence of the hospital. Seller's counsel will also continue its due diligence. The buyer will want to see all agreements, legal documents, licenses, and financial documents. The hospital should be organized and ready for a request for information. In addition, the hospital's counsel will request a copy of all information and documents provided to the buyer.

7. *License, Provider Number, and Permit Issues.* Depending on the percentage of ownership interests sold (i.e., 30%, 50%, 70%, etc.) and a number of other factors, the transaction may require a number of actions with respect to the licenses, provider numbers, and other permits held by the hospital. Once the letter of intent is signed (if not earlier), counsel should request a copy of all licenses and permits. In addition, counsel should make contact with someone in each of the agencies where the hospital has a license, permit or provider number. There will be extensive communication and contact between the hospital and agency relating to the change of ownership and confirming what actions need to be taken.

Early in the transaction process (e.g., once the hospital decides to move forward with the transaction), counsel should typically research state and federal laws and regulations related to change of ownership, notification requirements under state and federal law related thereto and the impact of such change on the licenses and permits. The results of such research can heavily impact the timing and process for closing. In some situations, it can also impact the percent ownership that the hospital decides to sell.

a. *Medicare Provider Number.* Under federal regulations, a transfer of stock often does not constitute a change of ownership.[2] Here, it is critical to call the Centers for Medicare and Medicaid Services ("CMS") regional office to confirm and determine exactly what action is needed. For example, certain intermediaries may deem a 51 or 100 percent stock transfer to be a change of ownership. If the transaction is deemed a change of ownership, a new provider number may be required and CMS Form 855 will have to be completed in its entirety.[3] This may also result in a new survey, which can be a lengthy process.

If the transaction is not a change of ownership (which is most often the case with stock sales), it will only be deemed a change of information. This generally requires filling out the section of the CMS 855 Form related to changes of information. This should be confirmed with each transaction.

b. *Hospital Licensure.* Hospitals, in most states, require a state license to operate.[4]

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[2] 42 CFR § 489.18(a) defines what constitutes a change of ownership for partnerships, sole proprietorships and corporations. 42 CFR § 489.18(a)(3) states as follows with respect to corporations:

> 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.

In comparison, 42 CFR § 489.18(a)(1) states as follows with respect to a 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.

Thus, the corporate structure of the selling entity may determine whether the transaction constitutes a change of ownership.

[3] 42 CFR § 489.18(b) ("A provider who is contemplating or negotiating a change of ownership must contact CMS."). The rules related to the change of ownership and CMS notification requirements recently changed. In commentary in the April 21, 2006 Federal Register, CMS states as follows:

> In the case of a provider or supplier undergoing a change of ownership as described in part 489 subpart A, we would require at Sec. 424.550(b) that a CMS 855 be completed and submitted by both the current owner and the new owner before the completion of the ownership change. Failure of the current owner to submit the CMS 855 prior to the change of ownership may result in sanctions and penalties, after the date of ownership change, in accordance with Sec. 424.520, Sec. 424.540, and Sec. 489.53. Failure of the new owner to submit the CMS 855 prior to the change of ownership may result in the deactivation of the Medicare billing number until the CMS 855 has been submitted. 71 FR 20762 (April 21, 2006).

The rules related to change of ownership notification requirements became effective on June 20, 2006 and can be found at 42 CFR § 424.550.

[4] *See e.g.,* IN. CODE § 16-21-2-10 (providing that any person . . . must obtain a license from the state health commissioner before establishing, conducting, operating, or maintaining a hospital. . . .); CO. REV. STAT.

parties, expense, and the number of issues to resolve.

d. Once the documents are close to fully negotiated and the key issues discussed between and among the parties, the summary memorandum of the key provisions is updated by the hospital's counsel. The summary and each of the key documents is circulated to the hospital's board of managers or directors and to each individual selling some or all of his or her units or stock in the transaction. These individuals should read the documents and summary so that they can vote knowledgably on the transaction when consent is sought.

10. *Ancillary Agreements.* There will be a number of other agreements, in addition to the key transaction documents, that the parties will enter into. In many cases, the buyer will want the hospital chief executive officer and other key leaders to remain employees. The buyer will want such leaders to enter into an employment or consulting agreement. There may also be other agreements, related to management, billing and collecting, or lease arrangements that may need to be negotiated. Each of these arrangements will need to be fully negotiated and disclosed to the members of the hospital.

11. *Real Estate.* The extent of any real estate considerations will depend on whether the hospital owns or leases the building in which it operates. If the hospital leases the building and land, it will likely need to seek consent of the landlord. The hospital should also consider addressing issues related to future growth and expansion, if relevant. If the hospital or a related party owns the real estate, the owner will have to determine whether it wants to sell the real estate too. If the owner decides to sell the real estate, there are related issues, such as whether the real estate will be kept separate from the hospital, whether the buyer of the hospital will also buy the real estate, and if the same parties are involved, whether the purchase of the hospital will be tied to purchase of the real estate. Often the buyer and seller want to close the real estate and operations simultaneously and the closing of one can be conditional on the closing of the other. This can have an impact on the timing of the closing. If there is a hold up on the hospital side, the real estate side will often be held up as well.

12. *Building Consensus.* As noted, the process should start with the core leaders. However, soon after the first draft of the documents has been sent back to the buyer (if not sooner) the core leaders should begin discussing the deal with all parties involved. The pre-transaction governing documents will govern what consent is required for the members to approve the transaction, i.e., a majority of the members or two-thirds of the members. However, there is a risk that those members who object to the transaction may bring litigation or will not desire to participate in the operation of the hospital on a going forward basis. For this reason, it is advisable to obtain a much higher vote for approval of the sale, i.e., ideally, close to 100 percent of the physician members will support the sale. By bringing the members into the process early, it gives them an opportunity to note concerns and also time to have the documents reviewed by separate counsel if they desire.

13. *Securities Disclosures.* There are state and federal rules and regulations with which the sale may need to comply. Depending on the number of investors selling, the conflicts of the buyer and whether the investors are transferring, receiving or reclassifying stock in the sale, a formal disclosure document may need to be circulated to all investors to apprise them of the transaction and related risks and to make proper securities laws disclosures.

14. *Buyer/Seller Communication.* In situations where the buyer and seller will be partners post-closing, it is important that each communicate often and regularly with one another regarding the transaction and critical issues related thereto. It is also important that the hospital's attorneys are in regular communication with the buyer's attorneys to help assure that all parties are on the same page.

15. *Closing.* Although a closing date can be tentatively agreed to in the letter of intent, the closing date is often moved back. This can be a function of delayed consents or lengthier negotiations than anticipated. The buyer and seller can agree to either sign the documents and close (i.e., wire the money) simultaneously or sign and close

separately (i.e., sign the documents on one day and wire the money a different day). From a seller's perspective, there is often a desire to expedite closing and it may be preferable to sign and close simultaneously in order to mitigate the risk that something negative could happen between signing and wiring the money. During the period of time before closing, if something negatively impacts or happens to the hospital, the seller generally bears the risk. Sometimes, however, it is necessary to sign and then delay the actual closing. This delay can be due to regulatory reasons (i.e., waiting for the state to issue a new license and surgery or determine whether the transaction is deemed a change of ownership) or financing (i.e., the bank documents are not processed in time for closing). A seller may desire this type of closing if the buyer will not waive conditions for closing and the necessary consent and approvals needed in order to close have not been obtained. Here, it may be preferable for the seller to obtain a commitment to close by the buyer by signing the documents and closing later rather than risk either breaching the conditions to closing or having the transaction fall apart entirely. In either case, both parties should be prepared to work together to agree on a closing date and meet that date.