

Preparing your business for the scrutiny that comes during due diligence takes time, effort and money, but if you prepare for due diligence in advance and manage the process appropriately, you can ultimately save significant time, effort and money. By identifying issues early in anticipation of a potential transaction or at the beginning of a transaction, you will be able to more quickly and efficiently resolve the issues yourself or with the help of your advisors or work with a buyer to settle the issues in a manner satisfactory to all parties.

Now that you are on your way to getting your house in order and are ready to engage in and manage the due diligence process in anticipation of a potential transaction with a buyer or other partner, you are primed for our upcoming installments of **GOOD DEAL** that will examine various alternatives for structuring sale/merger transactions and that will begin to explore the key provisions of a purchase agreement.

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Health Care Transactions

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GOOD DEAL: RELIABLE GUIDANCE FOR TODAY'S HEALTH CARE TRANSACTIONS

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Due diligence, in the context of a company sale or other transaction, is generally defined as the research and analysis by the parties to the transaction on one another. In our first edition of **GOOD DEAL**, we started with the ABCs of LOIs and MOUs. But even before entering into a Letter Of Intent or Memorandum Of Understanding, both parties in a transaction will need to conduct initial due diligence on each other, and after entering into an LOI or MOU, both parties will perform more formal examinations of each other before definitive transaction agreements are finalized and signed.

In this edition of **GOOD DEAL**, we will address the due diligence process from a seller's perspective. Our **FOCUS** section discusses various health care regulatory and other issues that sellers should add to their due diligence checklist when preparing for a transaction. Our **FOUNDATION** section offers some practical suggestions for how a seller should prepare for and conduct due diligence.

Focus:

Before engaging in a health care transaction, sellers need to be aware of the health care regulatory landscape that may impact their business and the transaction. So before we review some of the foundational components of preparing for and conducting due diligence, we will discuss just a few of the specific health care laws that may need to be addressed during the sale of a health care business. Some of these laws may not be applicable to your business, but it helps to keep these laws in mind as you prepare for and navigate the due diligence process.

- **STARK LAW.** The federal physician self-referral law (often referred to as the Stark law) prohibits a physician from making referrals for certain designated health services payable by Medicare or Medicaid to an entity with which the physician (or a member of his or her immediate family) has a financial relationship, whether it is an ownership, investment or compensation relationship, unless an exception applies. Also, unless an exception applies, the Stark law prohibits the entity from presenting any claims for those designated health services. Designated health services include, for example, clinical laboratory services, physical therapy services, durable medical equipment and inpatient and outpatient hospital services.

The Stark law is a strict liability statute, which means that failure to meet an exception results in violation of the law. There are many available exceptions (e.g., bona fide employment relationships, rental of equipment and rental of office space), but an arrangement must be carefully structured to comply with all the requirements

of an exception. So, in conducting due diligence, a potential buyer will likely question whether a health care entity's arrangements with physicians who have an ownership, investment or compensation relationship with the entity meet a Stark exception.

- **ANTI-KICKBACK STATUTE.** Generally, the federal anti-kickback statute prohibits anyone from knowingly and willfully paying, offering, receiving or soliciting anything of value in exchange for the referral of any items or services paid by a federal health care program (Medicare, Medicaid, or TRICARE). The anti-kickback statute is very broad, and covers all sorts of arrangements that a health care entity may have with physicians as well as with any other person or entity. For example, when a vendor of medical supplies offers a discount on those supplies to a hospital, the anti-kickback statute is implicated. Also, when a nursing home provides free transportation to family and friends of nursing home residents, the anti-kickback statute is implicated.

The anti-kickback statute offers several safe harbors, and if an arrangement meets all the requirements thereof, the parties to the arrangement are protected from prosecution under the anti-kickback statute (which does provide for criminal penalties). However, compliance with a safe harbor is voluntary, and failure to meet the requirements of a safe harbor does not mean the arrangement is necessarily illegal. Examples of safe harbors include safe harbors for investments in ambulatory surgery centers, for compensation provided to employees and for

personal services arrangements. During due diligence, sellers should be aware of any arrangements that may implicate the anti-kickback statute.

- **HIPAA.** HIPAA governs the use and disclosure of protected health information by health care providers, health plans and health care clearinghouses (called covered entities) and by the business associates of those covered entities. A business associate is a person or entity that provides to the covered entity services that involve the use or disclosure of protected health information. For example, entities providing billing services, practice management services and legal services are often business associates of their covered entity clients.

HIPAA requires that covered entities and their business associates develop certain policies and procedures regarding the privacy and security of protected health information. HIPAA also requires that covered entities and business associates enter into business associate agreements that contain specific provisions. In addition, when a covered entity learns of any breach of unsecured protected health information, the covered entity must notify individuals, the U.S. Department of Health and Human Services and, in some cases, the media, of that breach. A covered entity or a business associate that is preparing for the due diligence process should be prepared to provide HIPAA policies and procedures and business associate agreements.

- **IRS.** Many health care entities are exempt from federal income taxes because they qualify as charitable organizations under section 501(c)(3) of the Internal Revenue Code. A health care entity that is exempt under section 501(c)(3) must be organized and operated exclusively for its exempt purposes, and none of its earnings may inure to the benefit of a private

shareholder or individual. Also, the lobbying activities of such an entity are limited.

Hospitals that qualify as tax-exempt under 501(c)(3) must comply with the community benefit standard, which involves operating a full-time emergency room, having an open medical staff, ensuring community representation on the governing board, providing charity care and other requirements. Such hospitals must also ensure that compensation to individuals who provide services to the hospital is “reasonable”. During due diligence, a buyer of a health care entity exempt from federal income tax is likely to question whether the activities of the entity have been consistent with the requirements of section 501(c)(3).

- **STATE LAW.** Finally, during due diligence, potential buyers will also be examining the implications of applicable state law. For example, a state’s certificate of need and licensure laws must be considered, as such laws could impact the transfer of assets from one party to another. Also, many states have their own self-referral and anti-kickback statutes which must be considered along with their federal counterparts. Most states have laws governing the privacy and confidentiality of medical information, and many states have a security breach or data breach law that may require individual notification in the case of a breach.

Keep in mind that the laws described above, as well as others that may apply to your business, may be frequently updated and modified. HIPAA, for instance, has changed significantly in the past few years and is expected to change even more in the near future. If you are considering selling a health care business, be sure that you and your advisors have an understanding of the current law and an understanding of how the law is expected to change, as that may impact the sale.

A good place to get started with the due diligence process is to contact your company’s accountant and lawyer. They can provide you with due diligence checklists and sample copies of purchase agreements that contain standard representations and warranties about various aspects of your business that you would be required to make to a buyer. The checklists and representations and warranties will serve as good guides for gathering and evaluating the information necessary to prepare your business for a sale or comparable transaction. Also, by

Foundation:

If you are considering selling your business now, or at any time in the future, it is never too early to begin preparing for the due diligence process. While getting your house in order can be a daunting task, if done timely and properly, it can help mitigate business risks and increase value. Slapping a fresh coat of paint on the business and sprucing up the landscaping around the front entrance may get you started, but it will be the roll-up your sleeves, grit and grime scrubbing of the financial and operational basements and attics of your business that will count the most.

alerting your advisors early in the process, they may be able to provide you important information about your business and help you identify and resolve issues before they become material problems.

In this article, we are not able to cover all the areas of your business that you will need to take into account in preparing for due diligence, but here are a few categories and issues you should consider.

- **ORGANIZATION AND GOOD STANDING.** Are your company’s organizational documents (i.e., articles of incorporation/organization, bylaws/operating agreements, shareholder/buy-sell agreements, meeting minutes and written consents and other documents) current and in good order? Have you made the necessary company filings with federal, state and local governmental agencies? What board/manager, shareholder/member or other approval requirements do you need to authorize and complete a potential transaction?
- **FINANCIAL INFORMATION.** Can you produce financial statements for at least the last three years that have been reviewed, compiled or audited by your accountant? Do you have copies of tax returns for the same time periods? Do you prepare a budget annually, and periodically compare your actual performance to your budget? Have you prepared projected financial statements with detailed assumptions that can be supported?
- **ASSETS AND LIABILITIES.** Do you have a listing of all assets of the company? Does the company have good title to all assets, or are some owned individually (e.g., intellectual property) or by another entity (e.g., real estate or equipment that might be held in a separate company)? What existing or pending company liabilities and obligations are there? Are there any liens, judgments or other encumbrances on the assets, including any pending or threatened lawsuits against the company? Are there any environmental issues associated with real estate that is owned or leased? A search of publicly available records (such as UCCs) can provide a good starting point for addressing some of these matters.
- **MATERIAL CONTRACTS.** Do you have copies of all final, signed contracts relating to the company, particularly those that are material to the operations and governance of the business (including all provider, payor, customer, vendor, shareholder/member, employee, loan and other

contracts as well as leases and other agreements)? Have any contracts expired or are they about to expire? Can the agreements be assigned or transferred to a buyer without notice to or consent of a third party? Are there any non-disclosure, non-compete or other restrictive agreements, covenants or provisions that exist?

- **EMPLOYEES AND EMPLOYEE BENEFITS.** Are your employees at-will employees or do employment, consulting or other contractual agreements exist with certain employees? Have you identified the employees that would be key to a successful transition to a new owner of the business? What employee benefits and retirement plans do you provide? Have you implemented any stock option or stock purchase plans, rights of first refusal or other stock ownership arrangements with employees? Are there any existing, pending or threatened lawsuits or claims by or against any employees, or does any reasonable basis exist for which such lawsuits or claims could be made?

In addition to making sure you address all aspects of your business when preparing for and engaging in the due diligence process, how you conduct and control the due diligence process when you are in discussions with a potential buyer is equally important. You should control the flow of information – how much, to whom, when and in what manner. If you did not include a confidentiality provision in your LOI or MOU, you should require the potential buyer to sign a confidentiality or non-disclosure agreement before providing any non-public information. The confidentiality agreement should cover not only the company information being disclosed but also the fact that a transaction is being discussed and the terms and conditions of the transaction being negotiated or agreed upon. You will also need to control the potential buyer’s access to your company and its employees, customers, vendors and other constituents. Carefully managing the flow of information and access to people connected with the company will be important in protecting the confidentiality of the potential transaction and company information and in preventing potential adverse consequences that could arise if information about the company or transaction were to be disclosed. Managing this process will also be critical to allowing you to continue to successfully operate your business while you are engaged in transaction discussions. A declining business in the course of a transaction can quickly erode the business’ value and reduce or impair the purchase price and other material terms of the deal.

