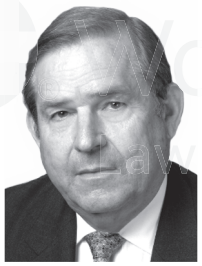
Richard P. Kusserow

Mergers and Acquisitions Due Diligence in Health Care

Key Focus Areas to Review *Before* M&A Closure with a Health Care Provider



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Hardly a day passes when the press doesn't report on a new merger or acquisition in the health care sector. The trend toward consolidation in creating larger systems with a wider array of services has been dramatic over the last decade. Some mergers and acquisitions (M&As) are monumental in scope, but most relate to individual hospitals, facilities, or entities. This continuing trend is evidenced by annual surveys of Hospital Mergers & Acquisitions, which in 2012 found the number of hospital deals climbing more than 18 percent to 109 in 2012, up from 92 deals recorded for 2011.[1] This trend is likely to continue and is stimulated by health care reform and the Affordable Care Act (ACA) that will likely result in more consolidation and integration among hospitals and physician practices.

The simple current reality is there will be relatively few hospitals that remain independent in the coming years. The vast majority will merge, be acquired, or enter into an affiliation or joint venture agreement. The driving forces include seeking economy of scale, better meeting new regulatory challenges, expanded capability in providing patient care, gaining from shared services, and expanding their market geographically.

Financial and Legal Due Diligence

Due diligence reviews are an integral part of all health care mergers and acquisitions. They provide a vital tool to help organizations assess the potential liabilities in M&A transactions. In most industries, there are two common types of due diligence: financial and legal. They generally focus on financial accountability and legal liabilities. The overall objective of due diligence is to understand the financial viability of the organization

or entity involved in M&A — and its compliance applicable laws, regulations, and disclosure obligations. This should be part of every acquisition in determining risks and exposures as well as establishing a future defence in case a problem emerges subsequent to closure on the deal. The fact that one out of four intended M&As did not take place, after letter of intent, can be attributed in large measure to the results of due diligence reviews.

Financial due diligence involves an independent accounting firm focused on reviewing and evaluating the balance sheets, income statements, audit reports, and cash flow statements and projections. This includes examination of property real and personal, as well as any other tangible and intangible assets. Along with this is valuation of debts. There are many very competent public accounting firms that specialize in this type of work.

Legal due diligence involves an extensive examination of the entity's structure; business permits and/or approvals; employment and labor law compliance; environmental law approvals, permits, and compliance; contractual rights and obligations; intellectual property rights and obligations; real property law compliance; securities and financing regulatory compliance; tax exposure risks; consumer protection law and exposure risks; international trade and export permits and/or licenses; previous and/or current litigation; media reports; and external consultants and/or advisors. This is a very labor intensive process, but there is an abundant number of law firms that provide high-quality services in this type of work.

Even after having highly competent accounting and law firms conducting financial and legal due diligence, a surprising number of transactions end with the acquisition also including unanticipated regulatory liabilities. What is missing is the failure to focus on the potential health care regulatory and legal compliance issues. Those financial and legal experts hired were limited in their health care regulatory expertise with the result that the scope was too limited to address these types of potential problems. In many cases, the due diligence was focused in other directions, not on regulatory compliance. As such the detailed and pointed questions that are part of due diligence did not extend to these types of issues.

Health Care Regulatory Due Diligence[2]

Regulatory due diligence is also needed for transactions in the health care space, as M&A is more complicated in the health care sector. This is due to the heavily regulated environment wherein health care facilities are subject to a tremendous number of state and federal laws and regulations that govern how business must be conducted. It requires subject matter expertise. The Centers for Medicare & Medicaid Services (CMS) alone produces annually thousands of pages of new instructions and regulations that create new obligations while at the same time adding prohibitions on how business is conducted that involve the Medicare and Medicaid programs. As such, there is significant risk that a purchaser can inherit serious regulatory liabilities without checking to see how the entity is complying with these rules.

The traditional financial and legal due diligence work often does not focus on this exposure. They will request all information pertaining to any investigation by any governmental authority regarding alleged violations of applicable law, as well as the resolution of those investigations, but not exposure that has yet resulted in regulatory or legal action.

Health care reform has already led to increased oversight and enforcement by the U.S. Department of Health and Human Services (HHS) Office of Inspector General (OIG), Department of Justice (DOJ), and Federal Bureau of Investigation (FBI) through legal enforcement initiative. In addition, CMS has been employing a

number of program integrity contractors, including recovery audit contractors (RACs), zone program integrity contractors (ZPICs), Medicare administrative contractors (MACs), Medicaid integrity contractors (MICs), and others to increase this effort. The anticipated or actual outcome of program integrity and oversight activities and being subject to government audit is a compliance risk that should be properly accounted for in any M&A transaction.

It is important to have health care compliance experts conduct a review, examining regulatory high-risk areas as part of verification of the provider's compliance with their regulatory and legal obligations. The review should identify any gaps in compliance with applicable health care-related laws and regulations as well as identify corrective action measures to mitigate liability exposure. Most of the problems that acquiring parties inherited dealt with physician arrangements, but in many cases there were also issues of proper claims development and submission. It is essential to include this in any due diligence effort prior to closing of a transaction with the provider.

Regulatory due diligence effort should be equally focused and directed as are the financial and legal due diligence efforts. This type of review needs its own detailed set of protocols. With the right kinds of experts, a regulatory due diligence can be performed quickly, efficiently, and at a fraction of the cost of legal and financial due diligence. It should not be intensive in documentary review. Experts can quickly identify areas of risk and vulnerability, focusing on the 10 specific high-risk areas highlighted in OIG compliance guidance documents for hospitals.[3] They can examine the effectiveness of the compliance program, evaluation of internal monitoring of high-risk areas, claims audits and extrapolations, and the ongoing auditing processes of the health care organization.

High on the list for any reviews should be all the various types of arrangements with referral sources, particularly physicians. This has been the highest enforcement priority of both the DOJ and OIG for many years and represents the majority of cases litigated and/or settled. The claims processing system and controls also should be examined to ensure that there are not regulatory issues waiting to be discovered by CMS contractors or enforcement agencies. It is surprising the number of cases wherein an acquisition is made only to find within a matter of months a need to make disclosures of overpayments of millions of dollars.

Another high-risk area with significant liability exposure involves protected health information under the Health Insurance Portability and Accountability Act (HIPAA) and Health Information Technology for Economic and Clinical Health (HITECH) Act. Not maintaining proper controls, policies, and procedure with training of covered persons can result in substantial financial, reputational, and operational harm to covered entities, business associates, and subcontractors.

Regulatory Due Diligence Scope of Work

Prior to M&A closure with a health care provider, the following should be included in the scope of due diligence review, beginning with the Compliance Program effectiveness review[4]:

- evidence of an effective compliance program;
- role, job description, and standing of the compliance officer in the organization's structure;
- Compliance Office budget and process for approval;
- degree and evidence of active board and executive-level oversight of corporate compliance;
- Compliance Office records;
- Compliance Office policies and procedures as well as high-risk areas that are compliance-related;
- sanction screening process and results;

- determine if any excluded parties have been engaged or are part of a business arrangement;
- adequacy of ongoing monitoring by all high-risk area program managers;
- effectiveness of ongoing auditing of high-risk areas;
- review of the hotline log and other compliance communication channels;
- code of conduct; and
- compliance training materials and evidence of its effectiveness in communicating compliance.

In addition, special attention should be given to specific high-risk areas, including:

- organization, management, and policies relating to HIPPA privacy and security program;[5]
- cost report development and reporting processes;
- all processes and controls related to any arrangements with referral source;
- claims development and submission;
- EMTALA compliance;
- PATH compliance;
- laboratory services;
- Medicare bad debts;
- credit balances; and
- one-day stays and outpatient services.

If the right experts with experience in doing this kind of work are selected, the time and costs for the due diligence review should be only a small fraction of either a financial or legal review. The reason is simple: the financial due diligence is transaction analysis intensive in going over all the books and records of the organization. The legal review also involves detailed examination of a large number of agreements, contracts, and other legal documents. Regulatory compliance experts know exactly where to look for any weaknesses without having to do a "deep dive."

It is difficult to imagine why a party looking to make an acquisition would not want a regulatory due diligence. In virtually all cases, problems will be identified that in very few cases would interfere with the decision to acquire but is very likely to not only avoid a future liability but puts on the table additional tools to improve the negotiation terms and conditions.

Mock Regulatory Reviews

Compliance officers of an entity in the process of being acquired or merged may find themselves in a very vulnerable position. The results of the due diligence reviews can have serious consequences for their continued employment after the transaction is completed, or if it fails due to deficiencies within their areas of responsibility. It may be advisable to have an independent evaluation or "mock review" performed of the compliance program before those engaged to do due diligence work enter the scene. Any deficiencies noted in the "mock" review report should be addressed and evidenced as such. It is advisable to have this report be certified so that it could be used in evidence of an actual due diligence review.

For those hospitals considering seeking to be acquired, it is highly advisable to undertake "mock" due diligence reviews to identify and address those issues identified that might impact negatively if found in an actual set of reviews. It is never a sound business practice to have outsiders learn more about a hospital's business than those who own and manage it. The results of such a review can identify (1) gaps in policies and internal controls; (2) weaknesses in executive and board oversight; (3) compliance program deficiencies; and (4) regulatory risk exposures. This will allow remedial actions that will mitigate exposures at the time of due diligence review. In addition to identifying gaps and deficiencies requiring attention, there are other benefits of doing this. Going through the process will better prepare the organization to the real thing and reduce the expenses associated with actual review. It will also better prepare employees for the real thing and reduce the stress associated with it.

Endnotes:

1. *Modern Healthcare*, January 26, 2013, www.modernhealthcare.com/article/20130126/MAGAZINE/301269951.
2. For more information see www.compliance.com/services/compliance-program-services/mergers-and-acquisitions-ma-assistance-and-due-diligence-reviews.
3. OIG Compliance Program Guidance for Hospital, 63 CFR 8987 February 23, 1998, oig.hhs.gov/authorities/docs/cpghosp.pdf. OIG Supplemental Compliance Program Guidance for Hospitals (70 *Federal Register* 4858) Supplemental Compliance Program Guidance for Hospitals.
4. www.compliance.com/services/compliance-program-services.
5. HIPAA Compliance: Knowledge Center for Health Care Entities at www.compliance.com/hipaa-compliance.

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