Mergers and Acquisitions: Minimizing Successor Liability

Focus on compliance in pre-transaction due diligence activities

By John Fisher, CHC, CCEP

An organization can get into a lot of difficulty with mergers and acquisitions. Your pre-transaction due diligence process should include the skill sets of compliance and internal audit professionals as part of the due diligence team. Put the mindfulness and focus of a compliance and internal audit to work as early as possible, and at each stage of a transaction, so that areas of special risk are identified and sufficiently reviewed. This article provides insight concerning how you can best undertake a productive effort in M&A transactions.

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The complex and shifting healthcare regulatory environment makes a proactive regulatory due diligence process critically important to minimize the risk to your organization in a merger or acquisition. Compliance and internal audit professionals add a critical perspective to the due diligence team.

Historically, legal counsel has been responsible for much of the due diligence process, but there has been a growing recognition of the unique focus and insight that a trained compliance/audit professional brings to the due diligence team. Most major entities now have a compliance professional involved in the due diligence/transaction team.

The compliance due diligence process

The compliance team should be involved in a potential transaction as early as possible. Although merger and acquisition transactions rarely progress in a linear fashion, each transaction usually includes:

- Early exploration (pre-transaction)
- Active acquisition (through closing)
- Integration

The compliance team plays a significant role at each stage of a transaction. Compliance issues may affect the deal structure, financial decisions and/or transaction course of action. In this article, we focus on pre-transaction activities.

Due diligence requests

During early exploratory stages, requests should be made for compliance program documents, information on past or pending government investigations, and other information necessary to develop a general sense of the state of the compliance program and to identify any known compliance problems. This information can affect the path the deal takes and the nature and scope of future and more detailed compliance due diligence activities. As the transaction progresses, the depth of the compliance review should increase.

Serious problems may require the selling organization to self-disclose to the federal or state government, reach a resolution with government regulators or make payments as a condition to the transaction moving forward. Other issues may be so significant that there is little choice but to recommend ending discussions. Early identification of these issues will optimize the ability to resolve possible compliance issues in a manner that keeps the transaction on track.

A typical due diligence request will call for documents necessary to analyze the target from a financial and legal perspective. Due diligence requests will include:

- Corporate documents
- Significant agreements
- Loan information
- Description of pending legal actions
- Other information regarding the target

If the transaction is structured as an asset purchase, documents will be requested that evidence potential liens or encumbrances or other items that could affect the value of the assets being acquired. All of these documents should be considered for their legal implications, and to determine whether they raise any compliance issues.

Compliance due diligence typically covers a host of additional required disclosures that become relevant for assessment of the unique successor liability issues involved in most healthcare mergers and acquisitions. Many issues that are important from a compliance perspective are not normally included in a typical legal/transactional due diligence request.

For example, if assets are being acquired, a transactional attorney may not be concerned about the details of agreements between the provider and physicians who have provided service to the target organization. These agreements are not likely to have a direct impact on the assets being acquired. However, from a compliance standpoint, these agreements may create violations of the Stark Law. Even if the violating agreement is not assumed, the past liability may be carried forward because of the Medicare successor liability rules.

Compliance due diligence will also identify areas where written agreements do not exist but should. Compliance will examine financial records for payments that are made to potential referral sources. Compliance will match each payment to a written agreement and examine the agreement for Stark Law and Anti-Kickback Statute compliance. This type of analysis is not normally addressed by transactional legal counsel.

Past liability may be carried forward because of the Medicare successor liability rules.

Compliance should work with legal counsel to assure compliance due diligence materials are included in the due diligence request. Have a list of items that must be obtained during each stage of the process. Be certain that disclosed material relevant to compliance is promptly made available to permit complete review, identification of deficiencies, follow-up information requests and potential corrective or remedial actions.

Pre-transaction due diligence

Determining the extent to which a target entity has complied with applicable regulations is an important step in a merger or acquisition. Failure to adequately explore the latent risks that may exist could lead to significant issues for the acquirer.

Assess the target's compliance efforts

An initial assessment of the effectiveness of the target's past compliance efforts is a necessary step. The initial assessment should include examination of compliance plan documents, a review of past audits and written evidence of active compliance program operation.

The target's compliance officer, department staff and senior management should be interviewed to identify past commitment to compliance. These interviews can serve an important secondary role of introducing the target to the compliance culture of the acquiring entity to facilitate later integration efforts.

Analyze identified risk areas

Based on the initial assessment, judgments can be made regarding the potential impact on the structure of the transaction and additional risk areas that may require further assessment. Decisions about the scope of the pre-transaction compliance review require the perspective and judgment of an experienced compliance professional working with legal counsel and the acquisition team.

The information collected will form the beginning of a compliance work plan for the new entity.

Due diligence goals – successor liability

One of the central reasons to engage in due diligence is to prevent the assumption of liabilities attributable to past operations of the target, commonly known as successor liability.

> Medicare successor liability attaches even if the transaction is structured as an asset purchase.

In general, in a non-healthcare transaction that is structured as a purchase of assets, the purchaser will not assume liabilities arising from the past operations of the target. Due diligence will generally be focused on liabilities that could attach to the assets that are being acquired.

Medicare successor liability rules

Where an acquisition involves a Medicare provider, special Medicare successor liability rules apply and potentially expose the acquiring party to a much broader scope of liabilities attributable to the past operations of the target. This makes it necessary to perform much broader due diligence than would be performed in other types of transactions.

Under Medicare's successor liability rules, an entity that acquires the Medicare provider agreement can be exposed to all of the past Medicare related liabilities of the target. Medicare successor liability attaches even if the transaction is structured as an asset purchase.

> If the acquiring entity does not assume the existing provider agreement, a new Medicare provider status must be obtained.

The Center for Medicare and Medicaid Services (CMS) takes the position that purchasing a provider's assets constitutes a "change of ownership" (also known as CHOW). The Medicare provider agreement of the selling provider is automatically deemed to be assigned to the acquiring organization. All penalties and sanctions arising from previous operations attach to the provider agreement and become the obligation of the acquiring entity.

A series of federal court cases have upheld the Medicare successor liability rules and have extended them to liability for accrued overpayments and civil monetary penalties. The government has taken the position that successor liability includes liability under the Federal False Claims Act (FCA).

An acquiring entity can avoid successor liability by giving proper notice to CMS in advance of the transaction. However, if the acquiring entity does not assume the existing provider agreement, a new Medicare provider status must be obtained. New provider status cannot be requested until after the transaction is completed. Delays can lead to significant loss of revenue, making rejection of the existing provider agreement impractical in many cases.

Successor liability effect on scope of due diligence

Potential successor liability exposure necessitates robust due diligence that goes beyond the scope normally provided by transactional attorneys. The extent of further due diligence may be influenced to some extent by the sophistication of the target's past compliance efforts. However, reliance on past compliance efforts will not exempt the acquiring company from financial exposure.

Decisions regarding the necessary scope of due diligence are highly subjective. These decisions require the seasoned judgment of professionals with consideration for the specific risk areas of the organization being acquired. When assessing acquisition risk, compliance should use the process that it uses to identify its own internal risk.

The transaction team should balance the potential risk exposure against available resources and the transaction timeframe. Generally, the compliance team should consider the acquirer's compliance risk tolerance for existing business operations, and apply the same standards to its due diligence assessment of the target. Areas of special risk should be identified and reviewed.

If the target has operated a robust compliance effort, including audits of identified risk areas, less robust due diligence might be reasonable. When risk areas are identified but have never been audited, due diligence may need to include an audit of the identified areas. Areas of past problems or high levels of payment denials should be examined closely.

Due diligence issues need to be brought to the forefront of the transaction as early in the process as possible. While business members of the transaction team may be focused on completing the transaction on schedule, compliance needs to make certain compliance risks are properly addressed.

It is important the transaction team understands that compliance issues can have significant business implications. In some cases, serious compliance problems may be identified that require significant modification to the transaction, possible self-disclosure, or termination of the transaction.

Initial compliance due diligence review

These are some questions that should be answered through initial compliance review regarding the effectiveness of the target's compliance program:

1. Does the organization reflect a "culture of compliance"?
2. Does the compliance program contain all elements required under CMS model compliance guidance and federal sentencing guidelines?
3. Is there evidence that the compliance program is actively operated to affirmatively identify and address areas of significant risk?
4. Is compliance included in employee education and training?
5. Is there a well-publicized anonymous compliance reporting system in place? Are complaints made and investigated?
6. Is there an anti-retaliation policy that is effectively communicated to employees?
7. Is the board actively engaged in compliance?
8. Is there a compliance officer with a direct communication to the board? Are regular compliance reports made?
9. Are audits of significant risk areas being performed regularly?

The effectiveness of the target company's compliance program is one consideration affecting the scope of future requests.

Identifying risk areas

Due diligence requests for specific risk areas are affected by the type of provider, the industry segment, areas of billing, and contractual arrangements that have been entered by the provider.

> Legal documents should specifically permit the acquiring entity to conduct audits in identified risk areas.

Compliance and internal audit professionals should use normal processes to identify potential risk areas. The OIG Industry Specific Guidance, OIG work plans and industry updates are a good place to start. Risks that are specific to the provider can only be identified by studying and understanding the business and contractual relationships of the provider.

Compliance impact on transaction documents

Working with legal counsel, you should confirm that compliance issues are appropriately addressed in legal documents. The initial letter of intent should provide for disclosure of basic compliance program documents. The asset purchase agreement should include specific obligations of the target to produce due diligence materials requested for compliance review.

M&A due diligence check list			
Document	**Exists**	**Copied**	**Indexed**
Standards and oversight			
Code of Conduct	YES NO	YES NO	YES NO
Compliance budgeting process/line items	YES NO	YES NO	YES NO
Compliance committee structure	YES NO	YES NO	YES NO
Compliance officer appointment	YES NO	YES NO	YES NO
Compliance officer job description	YES NO	YES NO	YES NO
Compliance plan document	YES NO	YES NO	YES NO
Compliance reporting structure	YES NO	YES NO	YES NO
Education of board on compliance duties	YES NO	YES NO	YES NO
Historic compliance reports to board/compliance committee	YES NO	YES NO	YES NO
Initial baseline audits	YES NO	YES NO	YES NO
Process for communicating code of conduct	YES NO	YES NO	YES NO
Records relating to the development of a compliance program	YES NO	YES NO	YES NO
Risk-scoring process	YES NO	YES NO	YES NO
Statements from administration re: compliance	YES NO	YES NO	YES NO
Hotline/compliant process			
Alternative communication of hotline (i.e., newsletters, etc.)	YES NO	YES NO	YES NO
Call logging process & forms	YES NO	YES NO	YES NO

You should be permitted to meet with management and staff to ask questions about compliance program operation, and about past and potential compliance problems. Once the transaction appears to be proceeding, you should prepare and present a detailed, risk-area-specific document request to the target. A compliance work plan for the transaction should also be prepared and signed by the parties to avoid ambiguity regarding the scope of compliance due diligence.

Legal documents should specifically permit the acquiring entity to conduct audits in identified risk areas. The seller should be required to permit access and lend assistance in this process. Conditions should be placed in the agreements that permit the purchaser to back away from the transaction based on identified compliance issues. The agreements might also address the need to self-disclose and otherwise remedy past compliance problems before closing.

The asset purchase agreement should contain specific and detailed representations and warranties regarding compliance issues. The value of the representations and warranties after closing will vary based on the nature of the transaction and whether there are significant assets to back up the indemnification obligation. Make certain that limitations on post-closing indemnifications do not include compliance-related liabilities.

Conclusion

Healthcare mergers and acquisitions present a great deal of potential risk. The acquiring entity can get stuck with the bill for pre-closing obligations in numerous ways. A robust compliance due diligence process can greatly reduce the risk and potential exposure to pre-transaction liabilities. Because many of the potential risks involve compliance issues, compliance officers need to take an active role in these healthcare transactions. **NP**