The COVID–19 Pandemic: Observations and Recommendations for Health Care Deals

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Introduction: Health Care Transactions Post–COVID–19

The novel coronavirus (COVID-19) pandemic continues to challenge U.S. hospitals and other health care providers to prepare for a massive influx of people infected with the virus and treat the patients already in their facilities. Higher-margin operations such as elective surgeries have been shuttered to make beds and resources available as the pandemic continues, as providers are prioritizing building their capacity to quickly and efficiently triage, test, and treat COVID-19 patients. They continue to fulfill their missions notwithstanding a rapidly deteriorating bottom line and shortages of beds, equipment, and supplies, and an exhausted and often at-risk workforce. These efforts are being managed by leadership teams often stretched thin by competing demands, who must continue to ensure their institutions comply with constantly evolving government mandates and regulations.

Even the manner in which care is being provided has changed dramatically in a very brief period, including (1) the exponential increase in the use of telemedicine in many areas and accompanying relaxation of regulations governing its use and reimbursement,[1] (2) the interest by some in concierge medicine and other "prioritized" access points to obtain tests and treatment (in some cases in a manner not otherwise available to the broader population), and (3) consideration of previously unimaginable measures such as ventilator rationing or sharing and universal "do not resuscitate" orders for COVID-19 patients.[2] These changes and the novel ethical, legal, and moral issues they present will necessarily have long-lasting implications for the way health care is provided in the future. For providers that possess the sophistication and resources available to handle the evolving needs of their patient populations and weather the crisis, the post-COVID-19 world will likely present new challenges and opportunities.

Current Trends

There is no doubt that the health care sector—from nonprofit hospitals and academic medical centers to large, publicly traded health care companies, to physician groups and ancillary service providers—will be hard hit by the pandemic. With no clear answer as to when life in the United States will normalize, industry experts are scrambling to evaluate the potential impact of the COVID-19 outbreak on the sector and speculate as to what the new world order post-pandemic might look like for financially strapped providers. Following a robust, yet slightly slower, year for hospital transactions in 2019, early 2020 looked to be starting out with a boom. Cash-rich hospital systems, private equity companies with vast "dry powder" to deploy in the health care sector, and successful physician groups were fueling a new wave of deal making—many in early discussion stages and not yet publicly announced—before this momentum crashed into the brick wall of the pandemic.

While some pending transactions already nearing the finish line closed in Q1 2020, including UPMC Western Maryland's sale of its nursing and rehab center; HCA Healthcare's acquisition of Frisbie Memorial Hospital in Rochester, NH; and Mayo Regional Hospital's merger with Northern Light Health in Maine, many have been placed in a holding pattern or indefinitely sidelined as hospitals attend to the imminent needs of communities impacted by the pandemic.[3] Industry advisors report anecdotally that there continues to be relatively robust activity in the identification and negotiation of transactions involving core hospital assets, including acquisitions, investments, and joint ventures involving strategically important hospital partners. Hospitals will likely continue to pursue large-scale mega-mergers and similar combinations and affiliations, strategic transactions with physicians, including physician acquisitions with hospital employment, competitively significant deals (meaning a competitor will usurp the opportunity if the provider does not act), arrangements

that provide access to beds and resources necessary to treat the anticipated increase in COVID-19 patients, and other mission-critical transactions, subject to delays and modifications as a result of pandemic variables, as discussed in more detail in this article.

For health care providers continuing to engage in strategic planning for the immediate and long-term success of their systems, several factors are impacting whether and how deals are getting done during the pandemic. An initial gating item has been the limited resources and staffing available to support transaction planning and execution. In the current crisis mode, hospital leaders are dealing with more immediate and pressing considerations such as accessing beds and space for current and anticipated COVID-19 patients, protecting and securing their physicians and workforce, obtaining supplies for testing and treatment, funding critical core activities and health care operations, evaluating medical ethics issues, and monitoring evolving rules and laws that impact how treatment can be provided and reimbursed. The unknown duration and economic impact of the crisis on the economy, and on health care enterprises specifically, creates uncertainty about the financial health and viability of potential transaction parties. Market volatility also calls into question the use and applicability of methodologies for valuation opinions to confirm reasonable and fair market consideration, which is especially relevant for health care transactions that may implicate Stark and anti-kickback rules. On March 30, 2020, the Centers for Medicare & Medicaid Services authorized waivers of certain Medicare, Medicaid and Children's Health Insurance Program requirements and conditions of participation under Section 1135 of the Social Security Act (blanket waivers) under the physician self-referral law for enumerated "COVID-19 Purposes."[4] How the blanket waivers will affect hospital and physician relationships, and any resulting changes in methodologies used for valuation opinions, will continue to evolve as the arrangements are put into place under these new rules.

Transaction Financing Concerns

Quickly dwindling cash reserves and lack of access to capital can hamper a potential acquiror's ability to finance transactions, both to pay an upfront purchase price and to support the capital and operating commitments that often replace outright cash consideration in member substitutions, joint operating arrangements, or similar transaction structures. Insecurity regarding the availability of capital can jeopardize the integration that is often necessary when systems combine or partner to execute on a transaction, such as funding electronic health record and other technology platform migrations, capital expenditures that are deferred during the crisis, and other identified joint strategic objectives. The impact of sustained revenue loss and increased expenses resulting from the pandemic may be potentially ameliorated by hospitals' access to future government-designated funds and other support for COVID-19 care, including as a result of new

legislation such as the Coronavirus Aid, Relief, and Economic Security (CARES) Act, which creates a $100 billion fund for providers.[5] The fund includes reimbursement of lost revenue attributable to COVID-19, although there is some question as to whether lost revenue for procedures that have been delayed, but will be performed at a later date, are eligible for reimbursement given the fund is not intended to cover losses and expenses that have been or will be reimbursed from another source. This uncertainty regarding availability of capital and access to government funds in the future may cause transaction parties to question their viability on both a standalone and combined basis.

Regulatory and Third–Party Approvals

Because the health care industry is highly regulated, transactions often require governmental entity approvals, including from licensing agencies, state and federal antitrust authorities, government programs, attorneys general, and other public agencies and health care regulatory bodies. In some cases, regulators are actively prioritizing COVID-19-related approvals, such as recent guidance by the Department of Justice Antitrust Division and the Federal Trade Commission providing for expedited antitrust review (within seven calendar days of receiving all necessary information) of "collaborations of businesses working to protect the health and safety of Americans during the COVID-19 pandemic."[6] Some agencies have been able to move forward with their processes notwithstanding shelter-at-home and similar limitations, in particular to facilitate transactions that result in immediate solutions to pandemic challenges such as leasing shuttered hospital space to increase COVID-19 treatment capacity. These include the state of California leasing Seton Medical Center in the Bay Area, which is already open as a COVID-19 hospital,[7] and shuttered St. Vincent Medical Center, though it is not clear yet whether St. Vincent's will be used for housing COVID-19 patients or for other purposes.[8] However, there has been some slowing and delay in governmental responses to non-urgent matters, including those that may be necessary for a deal to move forward or close.

Significant transactions that involve a change of control of an enterprise typically require consents to assignment and other accommodations by third parties such as lenders, contract parties, payors, suppliers and vendors, landlords, and labor unions. Major deals involving nonprofit health systems and academic medical centers entail coordination and buy-in from many stakeholders within the organization, such as boards of directors or equivalent governing bodies, physicians, employees, and faculty. In the current period of crisis, the attention of these stakeholders is often being diverted as these parties address the more pressing matters of the health and safety of patients, employees, and constituents, and the stability and viability of their own businesses.

The coordination and resource-intensive process and commitment involved in executing on a major transaction can be challenging, and in some cases may prove to be impossible, in a pandemic situation. Hospital transactions may not completely come to a halt during this time; deals that are already close to completion, that involve distressed assets, or that create solutions for the diagnosis and treatment of COVID-19 patients may go forward in the coming weeks and months. However, there may be a delay in the announcement and implementation of less developed and non-critical transactions, which may result in a surge in hospital M&A and other deal activity once the pandemic is over.

A Potential Shift in Transaction Targets

After the immediate push for ICU beds and COVID-19-related care passes, potential transaction parties may be looking for new types of partners and deal structures. The trend for the last few years has been a move away from standard M&A or "marriage" by merger or acquisition towards more creative non-M&A structures. The COVID-19 crisis will likely propel that trend forward at an accelerated pace. In addition, the pandemic may create interest in certain types of targets, such as ambulatory surgery centers (ASCs), telemedicine companies, or urgent care centers, depending on how services are restructured and how reimbursement shifts during the next few months. For example, on March 20, 2020, the Ambulatory Surgery Center Association published guidance stating, "[t]raditional hospital services may soon lead to federal and state government decisions to use ambulatory surgery centers to support the healthcare system in expanded surgical use and new ways during the pandemic."[9] Further, the Association published on its website a list of scenarios in which ASCs could be "activated to help handle surgical overflow from hospitals that are at treatment capacity due to COVID-19."[10]

Deal Process and Due Diligence

Doing deals during the pandemic creates challenges in the transaction process and execution. Predictably, shelter-in-place and stay-at-home orders have resulted in increased reliance on virtual meetings. Providers have skeleton legal teams, if any, at their facilities. Zoom, Webex, FaceTime and other platforms are being used to connect people in an unprecedented volume. Because many systems and providers had already migrated towards virtual meetings even during normal business operations, employees are more familiar and quicker to embrace virtual meetings, which can offer convenience and flexibility. Technology, however, will never fully replace in-person connections, so strategic leaders may not be able to easily ascertain whether there is cultural compatibility with a potential transaction partner. In-

person meetings can be essential to establishing trust, and when negotiations hit a standstill, in-person meetings can pave the way to resolve key issues. Parties, however, will make do with virtual options for now and re-engage in person when it is safe to do so.

For many potential acquirers, use of virtual datarooms in M&A has been the norm for years, but for nonprofit, safety net, or other hospitals with less capital available for investment in new technology, the move towards virtual negotiation and due diligence for transactions may have lagged. Some target hospitals and providers, especially older or more rural facilities, may not currently have their contracts and other documentation online in an easily available or organized manner. When that hospital becomes a target of an acquisition and undergoes due diligence, someone at the facility often must locate, scan, and upload all of their contracts to virtual datarooms for the first time. For some targets, this may slow down or preclude the due diligence processes if staff are preoccupied with COVID-19 issues or are not in the office due to stay-at-home orders.

Providers of virtual dataroom services, including Merrill Corporation, Donnelley Financial, and Intralinks, are seeing an increase in the creation of online datarooms to anticipate a surge in M&A once the market stabilizes.[11] These companies report that their M&A clients are starting to use virtual datarooms to store and share files among dispersed employees because of security concerns.[12] An upside of this trend is that it may make it easier to organize and undergo due diligence later if relevant contracts and documentation are already stored in a repository. One virtual dataroom executive optimistically predicts that the "volatility will end and the deal market will come roaring back, and what we're seeing is that our companies are preparing for that."[13]

In addition, buyers may need to shift their due diligence focus to assess the risk of COVID-19 on the target business. This includes, of course, long- and short-term impact on the target's financial and operational viability, but also a more thorough review of insurance policies related to business interruption, plans to address crisis management, supply chain risk (ranging from potential availability of face masks and scarce ventilators, to production or shipment for new COVID-19-related equipment), effective protocols for high-risk employees, and Health Insurance Portability and Accountability Act and other privacy concerns.[14] Provisions addressing inventory assessments, monitoring, and sufficiency may take on increased importance in the negotiation of purchase agreements. Performing due diligence related to the ability of a target to conduct operations remotely may also become a new area of focus.

On the other hand, COVID-19 challenges may force some buyers to do less robust and more "high-level" diligence. Buyer and seller workforces are stretched thin, sellers may be becoming distressed to the point of insolvency, and buyers may not be able to undertake a deep a dive into due diligence materials. This may result in adjustment of the amount of risk buyers are willing to take on and could potentially impact transaction structure. In light of the uncertainty and increased risk, transaction parties may modify deal structures to streamline processes, prioritize quick timing, or re-allocate post-closing risk.

Representations and Warranties

In a typical transaction, each party will make representations and warranties to the other about matters such as its due authorization to enter into the transaction, compliance with health care laws and other applicable regulations, the condition of its assets, operations and finances, and many other areas that relate to the well-being of the enterprise and its existing and potential liabilities. The representations and warranties are often qualified by knowledge and materiality and are accompanied by disclosure schedules that elaborate on or clarify the representation (such as a list of owned assets and properties) or disclose exceptions (such as known compliance problems). These terms are highly negotiated because they can shift risk from the disclosing party to the other party and require the disclosing party to indemnify the other party for costs and damages related to any failure of the representation and warranty to be true.

As transactions continue to be negotiated in the current pandemic environment and its aftermath, it is likely buyers and other transaction partners will seek to modify traditional representations and warranties or create new ones to address areas impacted by the COVID-19 outbreak, such as solvency, sufficiency of inventory and assets, liabilities not disclosed in financial statements, absence of changes to the business since the last audited financial statements, and the like. Given that these provisions are subject to negotiation by the parties and are impacted by the parties' relative leverage and other variables, the terms may vary substantially until standard terms are developed and adopted as "market" by the sector.

In the case of transactions that have been signed, but not yet closed, one or both parties will need to "bring down" the representations and warranties as of closing, meaning those provisions must still be true, or true in all material respects, as of the closing date as a condition of the other party's obligation to close the deal. However, as a result of the COVID-19 outbreak, representations regarding operations, financial viability, or even data privacy, may no longer be accurate due to the massive changes in hospital operations resulting from the pandemic. In bringing down representations and warranties to closing, the parties will need to carefully review each one to confirm whether additional disclosures or

exceptions will be necessary, and how newly identified liabilities and risk will be allocated. In addition, a failure to bring down representations and warranties sufficiently to meet negotiated conditions to closing could trigger a termination or walkaway right.

Representations and Warranties Insurance

Use of representations and warranties insurance for transactions with target health care providers, especially nonprofit health system and hospital transactions, has been growing due to increased availability of such insurance over the past decade.[15] However, representations and warranties insurance for health care company transactions can be more expensive as compared to other industries because of the heavy regulatory involvement and government payment implications of a potential breach of a representation or warranty. For example, Navine Aggarwal, the head of M&A Insurance at Ethos, a provider of representations and warranties insurance, has stated that while representations and warranties insurance rates "amount to between 2.5 percent and 3 percent of the limit purchased for deals in manufacturing, they will be usually 0.5 percent higher for health care companies."[16] Post-COVID-19, obtaining such insurance may become a more palatable option due to the unprecedented market conditions, uncertainty, and resulting risk to buyers. According to industry experts, there is a trend towards representations and warranties post-COVID-19 carving out risks such as business interruption, operations disruption, supply chain disruption, and resulting losses. Some representations and warranties insurance carriers are currently creating lists of specific industries and classes of businesses where the insurer would require an upfront exclusion for business interruptions related to COVID-19 to provide insurance. Other insurance carriers may require a blanket COVID-19 exclusion to provide coverage, though this may change as the pandemic continues its course and may be subject to negotiation on a case-by-case basis.

Another trend is the carveout of COVID-19-related losses from the definition of insurable "Loss" such that the burden shifts to the buyer to show that the loss was significant enough to trigger indemnification. It is unclear at the moment if there will be additional due diligence required by insurers for the purposes of obtaining such insurance. Some in the market caution, however, that those buyers relying on representations and warranties insurance should not fully rely on such insurance to cover all downside risks related to COVID-19.[17]

Material Adverse Effect and COVID–19 Carveouts

A material decline in a target's business prior to the closing of a transaction can trigger the termination of the transaction through a material adverse effect (MAE) or material adverse change clause. These clauses are often highly negotiated and can allow a buyer to walk away from its obligations under a purchase agreement or other definitive agreement, with little or no compensation owed to the seller. An MAE termination provision requires that the event or change be unforeseeable at the time the parties entered into the agreement and must exist over a long period of time (such as years).

An MAE definition typically includes a change or effect that would have or would reasonably be expected to have a material adverse effect on the target's business, finances, or assets. Parties often negotiate other specific exclusions to the MAE concept, meaning the buyer cannot walk away if a material adverse change results from the excluded circumstance. Depending on the timing of current transactions and whether definitive agreements have been entered into prior to the pandemic, there is a possibility that COVID-19 may trigger contractual walkaway rights under an MAE. Going forward, sellers may insist on carving out the effects of COVID-19 and anything related to it from the definition of an MAE, or insist on including the impact of COVID-19 only if it disproportionately impacts the target compared to similarly situated businesses. This would result in a walkaway right for a buyer if, for example, a hospital target (for whatever reason) has been disproportionately affected by COVID-19 as compared to other hospitals in its demographic/service area between signing and closing.

Despite the widespread use of MAEs in M&A and other corporate contracts, no Delaware court prior to 2018 had allowed a buyer to terminate a transaction based on an MAE.[18] In the recent landmark decision *Akorn Inc. v. Fresenius Kabi AG*,[19] the Delaware Supreme Court in a unanimous decision upheld the lower court's decision to allow Fresenius, a German pharmaceutical company, to declare an MAE to terminate a $4.8 billion merger with Akorn.[20] The lower court did not clarify the standards for finding when an MAE allowed a termination, though it "observed that in most cases, where decreases in profits were 40% or higher, a MAE existed."[21] The court, however, found that Akorn sustained both (1) a "general MAE under the agreement because it experienced a severe decline in business performance over time that a reasonable buyer would find material," and (2) a "regulatory MAE" based on breach of the regulatory representations and warranties, where Akorn misrepresented its compliance with regulatory requirements.[22] Further, despite widespread regulatory compliance problems, Akorn failed to "adhere to its promise to use 'commercially reasonable efforts' to operate in the ordinary course of business 'in all material

respects.'"[23] This was evidenced by the fact that, "[a]fter signing the merger agreement, Akorn cancelled regular audits at four sites in favor of audits that would not search for deficiencies, and Akorn senior management instructed its IT department to halt spending on data integrity projects and submitted fabricated data to the FDA."[24] Akorn is an extreme example, but Delaware's upholding of an MAE to support a buyer's right to terminate a merger contract is a potentially significant development relevant to hospitals and health systems considering entering into agreements in a precarious economic environment. Parties should include clear language addressing any MAE terms and corresponding rights related to COVID-19 circumstances.

Force Majeure

Another contractual concept that is receiving increased attention during the pandemic is the force majeure provision, which can excuse performance of a contract in the event of extreme circumstances. The provision typically requires the occurrence of unforeseen events like natural disasters, terrorism, or war, and the event itself must be a direct cause of the party's inability to perform. Some force majeure clauses explicitly list pandemics as a qualifying event for nonperformance, whereas as others contain more vague descriptions that could encompass the COVID-19 outbreak, such as "events beyond a party's control" or "acts of government." In the event of a force majeure, a party may have an actual or implied duty to mitigate its effect or seek alternate means of performance. Careful drafting and negotiation of force majeure provisions that specifically include (or exclude) medical pandemics will take on greater importance in health care transactions that are negotiated going forward.

Other COVID–19–Related Agreement Terms

Transaction agreements often include an outside date or "drop-dead date," defined as some date in the future which, if the closing has not occurred by such date, triggers a right to terminate the agreement. The intent is to give parties an incentive to move quickly to close the transaction or to allow a seller to move on and seek alternative buyers or partners if the transaction does not occur in a timely manner. If parties have entered into a transaction agreement prior to the pandemic, they may need to revisit the drop-dead date; parties entering into new agreements may want to include automatic extensions or extremely generous (i.e., very far in the future) outside dates to allow time for the pandemic to resolve.

Other potentially evolving terms include requiring the seller to identify and convey new or additional assets (outside of the originally contemplated assets) that could or would need to be transferred to handle the virus' effects, such as alternative work sites or technology contracts to provide for remote work. Parties may also consider adding pre-closing operating and other covenants specific to COVID-19 risks and operational impact on the business. These could include a duty to mitigate the impact of the virus using commercially reasonable efforts (or another agreed upon legal standard) or promise to cooperate with third parties in the provision of COVID-19 care. Buyers may request that the seller continue to adequately support target operations through closing and potentially thereafter until business continuity functions can be transferred to buyer. Parties may also negotiate for an optional transition services agreement which, depending on the status of target operations and levels of the pandemic's impact on the target at closing, allows a buyer to opt in for transition services for some set or renewable period of time. The parties may also choose to negotiate specific provisions regarding contingency plans depending on various anticipated enumerated scenarios relating to the pandemic's trajectory and resolution.

It may become increasingly common to see a hospital or health system negotiate and request these protective and risk-mitigating provisions as a buyer. It is too soon, however, to tell which concepts will become standard in health care M&A in the post-COVID-19 era, and what language will become "market" remains to be determined.

Conclusion

It is impossible to predict the ultimate impact the COVID-19 pandemic will have on health care providers and transactions in the hospital sector, given (1) the volatility of the market; (2) uncertainty regarding access to capital; (3) unpredictability regarding the spread of COVID-19 (including any resurgence if the virus is contained) and timing for a cure or vaccine; (4) unknown consequences of widespread disruption to hospital operations, supplies, and finances; and (5) the potential scope and limitations of the government's response and availability of committed funds. It is extremely likely that many hospitals and their transaction partners will hit the pause button on transactions as they attend to their missions to treat and protect their patients and communities. It is also possible that deal making will vary on a market-by-market basis as the conditions and impact of the COVID-19 pandemic differ across geographies and political, social, and economic circumstances. In the meantime, as COVID-19 transforms the way health care is accessed, provided, and reimbursed, there may be new and unique opportunities for health system growth and partnership in the future. Once the dust settles, we can expect that doing health care deals, like the provision of health care itself, will never be the same.

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