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Mergers and Acquisitions

Catholic Health Initiatives Pursues New Deal After Governor Blocks Three-Hospital Merger

A decision by Catholic Health Initiatives, announced Jan. 6, that two CHI-affiliated Kentucky hospital systems will complete a merger without the state-owned University of Louisville Hospital exposes the tension between consolidation pressures and regulatory obstacles in the health care industry, health care attorneys told Bloomberg BNA.

The merger, announced after Kentucky Gov. Steve Beshear (D) Dec. 30, 2011, rejected the state-owned hospital's participation in the deal, brings together Jewish Hospital & St. Mary's HealthCare in Louisville and Saint Joseph Health System in Lexington to form KentuckyOne Health, CHI said.

CHI said the new entity creates the state's largest health system and that the two were moving ahead without University of Louisville Hospital and James Graham Brown Cancer Center despite the fact that the original three-way deal had been approved by federal government antitrust agencies and the Catholic church.

Attorneys said the development shows that the need to form consolidated hospital and health care delivery systems among former competitors will continue in 2012 and that these deals will need to clear a range of hurdles—some that are obvious and others that may be hidden or unexpected. The governor's decision to reject the deal also is a reflection of heightened scrutiny by state and local regulators, they added.

Loss of Control Cited. Beshear, supported by state Attorney General Jack Conway (D), rejected the deal because he was concerned that the state would lose control over the hospital after the merger. He also signaled concern that the ability of University Hospital to continue offering reproductive health services might be affected by the CHI affiliation.

A report issued by Conway cited financial and practical concerns related to a new academic affiliation agreement and lease, the use and protection of charitable assets, and unwind provisions that might adversely affect the state-owned facility. It also cited "constitutionality" concerns about restrictions on access to reproductive health services if University Hospital was controlled by CHI.

"The proposed consolidation . . . to create a statewide network health care entity sponsored by Catholic Health Initiatives, Jewish Hospital Healthcare Services Inc. and the University of Louisville, raises unprecedented and complex legal and policy issues. While

some of the legal and policy issues have been addressed by the parties, many remain unresolved," the report said.

Lessons Learned? According to Douglas Ross, with Davis Wright Tremaine, Seattle, the merger is a reflection of a larger trend in health care requiring hospitals to merge and affiliate with others in order to survive. "The extraordinary regulatory burden, costs, and business risks imposed on hospitals can only be absorbed when hospitals are part of a system," Ross told Bloomberg BNA.

Ross said that the action by the state, however, provides important lessons.

"It exposes the reality that an antitrust hurdle is not the only significant governmental barrier to a hospital merger and, in some deals, it's not even the most important one," Ross said. "States have a variety of ways to get involved and sometimes can attach conditions to a merger or, in rare circumstances such as this one, block it outright."

"While some might look at this decision as limited to state reviews of transactions involving state-owned facilities, this just as easily could have involved an AG's review of a transaction involving any nonprofit hospital."

MICHAEL W. PEREGRINE,
McDERMOTT, WILL & EMERY, CHICAGO

"It also demonstrates that it's important to approach anyone who may be have the ability to say 'no' early in a deal and not spring it on them late in the day," Ross continued. "The Kentucky AG's report suggests he may have been miffed not to have been involved earlier."

Michael W. Peregrine, with McDermott, Will & Emery, in Chicago, said the governor and AG viewed the deal as a complex transaction that had not been fully vetted with the state, and that the AG's report gave Beshear "a number of credible legal reasons to say 'no.'"

Part of Trend. Regardless of the governor's decision, the state's review of the transaction "is consistent with the states taking a more active role in supervising M&A transactions involving nonprofits, and I think may embolden elected officials in other states to similarly in-

volve themselves more aggressively in scrutinizing such deals,” Peregrine told Bloomberg BNA.

“Attorney General Conway said the proposed transaction was unique and that it was the first of its kind in the country to raise a host of legal and public policy issues,” Peregrine noted. “It was these issues that attracted the attention of the state and ultimately led Gov. Beshear to reject the deal.”

“While some might look at this decision as limited to state reviews of transactions involving state-owned facilities, this just as easily could have involved an AG’s review of a transaction involving any nonprofit hospital,” Peregrine continued.

“The concerns identified in the report could be raised by any state charity official reviewing a transaction involving the use of charitable assets of a nonprofit hospital that are under most states’ laws held for the public’s benefit,” Peregrine said. “So, while the immediate impact may only be on transactions involving governmental entities, I think there will be a broader spillover effect.”

Detailed Objections. The AG’s report focused on a series of concerns, ranging from how the University of Louisville handled its potential participation in the deal to what the deal would mean to the state, to University Hospital, and to the patients who depend on it.

Conway’s report specifically pointed to:

- concerns over how ethical and religious directives for Catholic Health Care Services might be applied to University Hospital in the face of constitutional restrictions on the ability of a state to establish or endorse religious beliefs that might be imposed by CHI;

- the way the deal was handled in the face of the state’s obligation to approve transactions that involve the disposition of property owned by the state and that raise procurement issues;

- concerns about requirements that the new system created by the merger distribute payments to the system’s participants and the related, and potentially im-

proper, use of charitable assets belonging to the university and state by the new entity;

- substantial changes to the preexisting affiliation and lease agreements with University Medical Center (UMC), the entity that manages the hospital, and the terms and conditions of a requirement that the university repurchase University Hospital and certain other assets if the deal is ultimately unwound;

- the effect of restrictive covenants and limitations on services contained in the new agreements that could improperly limit the types of health care services University Hospital could provide outside the umbrella of the new system;

- issues involving the terms of new academic affiliation agreement and lease involving UMC and University Hospital and the state’s ability to terminate the contract; and

- the effect CHI’s control of UMC would have on the latter’s duty to comply with Kentucky laws granting public access to records relating to publicly owned property and assets.

New Entity Created. KentuckyOne, a nonprofit charitable organization, said in a statement it will continue to honor “the rich Jewish and Catholic heritages of its two sponsors, Jewish Hospital HealthCare Services and Catholic Health Initiatives” and that “historically Jewish facilities will remain Jewish [and] historically Catholic facilities will remain Catholic.”

The deal is designed to help the hospital systems better serve Kentucky and its residents and respond to problems concerning “access to preventive and advanced medical care and a severe shortage of physicians,” the statement said. “The system will collaborate with all health care providers, enhancing existing relationships and developing new partnership.”

BY PEYTON M. STURGES

The attorney general’s report is at <http://op.bna.com/hl.nsf/r?Open=psts-8q9rf2>.