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The importance of healthcare due diligence in healthcare transactions

by Randi E. Seigel and Michael J. Herrmann

Due diligence is a vital step in all types of mergers, acquisitions, and other transactions, including making large investments in a company (collectively referred to in this article as “transactions”). While due diligence is done in various areas (e.g., financial, tax, operations) in most transactions, healthcare transactions require special attention to healthcare regulatory compliance due diligence—which often is where the greatest risks to the buyer may be. Ultimately, buyers and/or merging parties use their healthcare regulatory compliance due diligence to assess risks, inform the purchase price and any reserves, determine the closing conditions, negotiate definitive agreements, and prepare for the integration of the parties post-closing.

Importance of due diligence

Asset purchase versus stock purchase

While due diligence is important for all transaction types, certain transactions make due diligence more significant than others. Accordingly, it is essential to understand the transaction structure—whether it is an asset purchase transaction, merger, or stock purchase transaction—to determine the materiality and impact of any noncompliance identified during due diligence. For example, there is a stark difference in the assumption of liabilities between asset purchase transactions and stock purchase transactions.

- **Asset purchase.** The buyer obtains certain assets and liabilities but does not acquire the “legal entity” of the seller (i.e., does not “step into the shoes” of the seller). This allows the buyer to avoid incurring certain liabilities associated with the seller, such as noncompliance with state healthcare licensure requirements and generally protects the buyer. We note that even in an asset purchase transaction, most buyers assume Medicare and/or Medicaid provider agreements and do become responsible for any overpayments owed to the Medicare and/or Medicaid programs by the seller (although the buyer can seek reimbursement or use other terms in the purchase documents to be made financially whole for historical noncompliance).
- **Stock purchase.** The buyer purchases the seller’s stock and thus “steps into the seller’s shoes,” meaning the buyer is now responsible for all the seller’s known and unknown liabilities.

General purpose of due diligence

Due diligence is vital for the following reasons in almost all transactions.

- **Transaction structure.** Understanding the seller's potential historical and future liabilities may inform the transaction structure; a buyer may decide after due diligence to change from a stock to an asset purchase or even some other kind of transaction structure (e.g., merger, joint venture, services agreement).
- **Mitigation of exposure.** In addition, due diligence allows the buyer to perform an overall assessment of the seller's key compliance areas, enabling the buyer to plan mitigation activities upon completion of the transaction, regardless of transaction type. For example, if the seller identifies through due diligence certain arrangements likely to implicate the Anti-Kickback Statute (AKS)^[1] and that are unlikely to meet an AKS safe harbor, the buyer may require mitigation measures to be taken prior to or after closing.
- **Definitive agreement preparation and purchase price determinations.** In relation to mitigation of exposure, due diligence provides the buyer a basis for certain negotiation points when negotiating the transaction's definitive agreements and purchase price (as discussed later in this article). Due diligence may also inform what conditions to closing are set forth in the agreements, such as obtaining necessary healthcare regulatory approvals or submitting a Stark Law disclosure. It also may inform provisions regarding how the seller's business must continue operating between sign and close, e.g., not surrendering or terminating a license or continuing key payer agreements.
- **Integration of the parties.** Lastly, understanding the seller's compliance posture and licensure structure is critical for developing an integration plan to ensure compliance post-closing. For example, if HIPAA risks were identified, the buyer may want to immediately transition the seller to be subject to the buyer's HIPAA policies and procedures and provide a training program and IT security infrastructure.

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