Dealmaking Implications of California's New Healthcare Cost Monitoring Law

August 19, 2022

On June 30, 2022, Governor Gavin Newsom signed California's $308 billion state budget, which included, as a budget trailer bill,[1] the California Health Care Quality and Affordability Act ("SB 184" or "the statute"). The statute, among other things, establishes the Office of Health Care Affordability ("OHCA" or "the office"),[2] whose portfolio is to collect and report data that are informative to the legislature and the public regarding healthcare expenditures and cost trends in order to develop data-informed policies and enforceable cost targets. California joins a number of other states, including Massachusetts and Oregon, in the establishment of a healthcare cost commission. Although the statute does not grant OHCA authority to block or challenge healthcare transactions, it could nonetheless have a significant adverse effect on healthcare dealmaking in California.[3]

Because OHCA has the authority to analyze healthcare mergers, acquisitions, affiliations and other transactions, with few exceptions,[4] healthcare entities[5] will be

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1 Trailer bills are used in California to implement the main budget act outside the normal, lengthier legislative process, and they typically take effect immediately with a majority vote and the signature of the governor. They have been criticized by some as a means of making policy changes outside the normal legislative process.

2 Gov. Newsom's approval of the $308 billion state budget includes $30 million allocated to the establishment and administration of OHCA.

3 As discussed here, the California Assembly this year also considered Assembly Bill 2080 ("AB 2080"), which, among other things, would have subjected any $15M+ healthcare transaction to the California Attorney General's review and approval. The bill failed to be timely heard before the Senate Committee on Health and the Senate Committee on Judiciary before the July 1, 2022, deadline and, therefore, did not move to the Senate for a vote during the August session.

4 For example, the statute exempts agreements or transactions involving healthcare service plans that are subject to review by the Director of the Department of Managed Health Care for cost impact or market consolidation under the Knox-Keene Health Care Service Plan Act of 1975.

5 Although SB 184 defines "health care entity" as "a payer, provider, or a fully integrated delivery system," the statute provides that OHCA shall examine transactions involving "health care service plans, health insurers, hospitals or hospital systems, physician organizations, providers, pharmacy benefit managers, and other health care entities."

required to provide written notice to OHCA of any potential agreement or transaction that will "occur"[6] on or after **April 1, 2024**, that involves:

- the sale, transfer or other disposal of a material amount of a healthcare entity's assets; or

- the transfer of control or governance of a material amount of the assets or operations of a healthcare entity.

The statute does not define "material amount of assets" for these purposes,[7] nor does it limit the notice requirement to healthcare entities that have significant market share, to transactions with a certain threshold value, or by any similar measure.[8] Further, the statute purports to require notice to be made regardless of the jurisdiction of the transacting parties, so long as the transaction involves a healthcare entity that has healthcare operations in California.[9]

As written, SB 184 raises concerns over timing of transactions, premature disclosure, confidentiality and cost:

Timing. Written notice must be made to OHCA 90 days prior to entering into a transaction agreement (as opposed to 90 days prior to closing). The office then has 60 days to determine whether the transaction is likely to have a risk of a significant impact on market competition, the state's ability to meet cost targets, or costs for purchasers and consumers. If it determines in the affirmative, it must conduct a cost and market impact review, considering a variety of factors, including cost, access, quality and "equity," and may also consider the benefits of the transaction. No transaction for which OHCA conducts a review may close for 60 days following its delivery of a final report.

While OHCA has no express authority to block an agreement or deal, the timeline would in many cases be unworkable in practice; rarely do parties know 90 days in advance of signing that they actually have a deal. If the transacting parties deliver the notice shortly before they are prepared to sign, even where the office decides not to prepare a report, the signing would nonetheless be held up for 90 days, during which

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6 It is not entirely clear what it means for an "agreement" to "occur" at some point in time, but presumably the language is intended to refer to the signing of the transaction governed by the agreement.

7 Similarly, California Health and Safety Code Section 1399.65 (which provides the Department of Managed Health Care with the right to approve or deny a plan transaction involving a "material amount of assets") does not define the term. However, the California Corporations Code Sections 5914 and 5920 (which provide the Attorney General with the right to approve or deny transactions affecting a nonprofit corporation) define "material" as (i) 20% of the target's total assets or (ii) a transaction value of $3M.

8 SB 184 does, however, require OHCA to adopt regulations regarding material changes that would warrant a notice filing.

9 Whether the long-arm aspect of the statute is enforceable has not yet been tested.

time facts material to the deal could change. While deals could be structured to account for the risk, many deal participants may nonetheless be unwilling to accept it.

Although the statute specifies that transacting parties cannot "implement"[10] an agreement or transaction for 60 days following delivery of OHCA's final report, it does not set a limit on the length of time the office may take to investigate and prepare the report. Transacting parties should plan for particularly lengthy pre-closing periods.

Premature Disclosure. If OHCA determines that the conditions exist to conduct a review, it is required to make the transacting parties' written notice to OHCA (including all materials submitted to the office for review) publicly available. That means that the public will likely become aware of a transaction before signing—a circumstance buyers and sellers alike generally try to avoid, especially, but not exclusively, if the target is a public company. The risk of premature disclosure may be sufficient to chill some dealmaking.

Confidentiality. OHCA is authorized to obtain data and documents from healthcare entities and other relevant market participants, including by subpoena. Sponsors and corporations invested or investing in healthcare businesses would likely qualify as market participants, which means that they may be forced to turn over any documents and materials OHCA deems relevant. While OHCA is bound by confidentiality constraints with regard to nonpublic information and documents, there is an exception for information included in the preliminary or final report to the extent the office believes disclosure is in the public interest. OHCA must take into account privacy, trade secret and similar considerations, and it must give the source of the nonpublic information the opportunity to explain why disclosure is damaging and why the public interest is served by withholding the information.

Despite the protections afforded, there is a real risk that buyers may be forced to disclose publicly their investment theses, predictions around the market, investment committee decks and many other documents that no investor would want to see in the public domain.

Cost. The statute requires reimbursement by the transacting parties of costs incurred by OHCA for outside contractors to assist in the preparation of the report. While the costs must be "reasonable," the broad authority of OHCA as to what the report should consider and cover could subject transacting parties to significant, unpredictable costs.

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[10] It is not entirely clear what it means for a transaction to be "implemented" but we presume the language is intended to refer to the closing date.

Looking Ahead. SB 184, a budget trailer bill sponsored by the Senate Committee on Budget and Fiscal Review, is based on Assembly Bill 1130, originally introduced by Assemblymember Jim Wood in February 2021. Assemb. Wood has advanced a legislative agenda targeted at aspects of the healthcare sector, including AB 2080, a bill that would have granted the California Attorney General broad approval authority over healthcare M&A transactions but was defeated earlier this summer.[11] Although SB 184 may appear innocuous and less explicitly prejudicial towards healthcare transactions in California than AB 2080 and its predecessors, it may have an equally chilling effect for the reasons set forth above.

As noted above, SB 184, as written, broadly captures even minor transactions that would pose *de minimis* anticompetitive risk. Importantly, however, the statute requires OHCA to adopt regulations regarding "material changes that would *warrant* a notice filing"; in adopting such regulations, the statute requires the office to "*consider appropriate thresholds*, including, but not limited to, annual gross and net revenues, as well as market share in a given service or region." Setting appropriate thresholds would reduce OHCA's administrative burden and allow the office to focus its efforts on transactions that pose a risk of significant impact on market competition.[12] The statute also allows the office to adopt regulations that expedite review timelines, as warranted, depending on the nature of the agreement or transaction at issue. OHCA may, therefore, promulgate an expedited review process or grant early termination of the statutory waiting periods on a case-by-case basis. In the coming months, affected stakeholders are likely to press OHCA to adopt reasonable regulations that provide guardrails on its review process, as well as push for certain provisions of the statute to be amended, including with respect to the disclosure of nonpublic information.

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Please do not hesitate to contact us with any questions.

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[11] Assemb. Wood has indicated that he will reintroduce legislation similar to AB 2080 in the 2023-2024 session.

[12] For context, the 2022 size-of-transaction threshold under federal antitrust law is $101M+.

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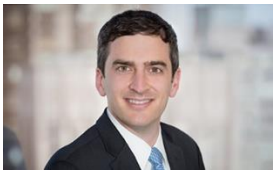
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