



Acquiring Pharmaceutical or Medical Device Manufacturers

Due Diligence and Risk
Reduction Strategies

Strong market and regulatory forces are causing healthcare companies to increasingly pursue M&A transactions. However, these companies operate in a complicated web of federal and state regulations. When acquiring a pharmaceutical or medical device manufacturer, industry-specific compliance issues should be at the forefront of due diligence investigations and risk mitigation strategies.

Author



MICHAEL M. MANNIX
PARTNER

HOLLAND & KNIGHT LLP

Michael's practice focuses on corporate law and corporate finance, and he is the team leader for the Business Law Section's Mid-Atlantic Region. He

represents public and private companies, including clients in medical devices, information technology, software, engineering, telecommunications, electronics, e-learning, defense products and other industries, in mergers, acquisitions and divestitures, securities offerings and technology transactions.

Author



MICHAEL M. GABA
PARTNER

HOLLAND & KNIGHT LLP

Michael is the federal policy leader of the firm's national Healthcare & Life Sciences Team. His practice focuses on counseling and representing medical device

and biotech companies before the Food and Drug Administration, the Centers for Medicare and Medicaid Services and the US Congress on a range of issues related to health care reform.

The business of health care is evolving, driven in part by increasingly sophisticated information technology, a shift in the method of delivery of health-related services and the aging of the soon-to-be retired baby boom population. In addition, the healthcare industry is bracing for an expensive, new federal regulatory scheme due to arrive in the next several years as a result of the sweeping health care reform legislation under the March 2010 Patient Protection and Affordable Care Act (PPACA), as amended by the Health Care and Education Reconciliation Act of 2010. In response to these strong market and regulatory forces, healthcare companies have increasingly pursued M&A transactions as part of their corporate strategy.

However, M&A in the healthcare industry is not without its challenges. The industry operates in a complex scheme of federal and state regulations. Failure to comply with these regulations can result in the loss of authority to deliver products and services. The stakes are especially high, as many industry participants have violated applicable laws or neglected their disclosure obligations. When considering an M&A transaction, industry-specific compliance issues should be at the forefront of the acquiror's due diligence investigation.

Performing high-quality due diligence is the best way for an acquiror to protect itself against the risks of an M&A transaction. If an acquiror discovers compliance failures and other material risks during the due diligence process, the acquiror must find a method to mitigate the risks or the deal is in peril. Once those risks have been identified, it is crucial for the acquiror to effectively negotiate transaction terms through which the risks between the acquiror and the seller or target are properly allocated.



This article explores selected legal and compliance issues for acquirors to focus on when pursuing an M&A transaction involving a target that is a manufacturer of pharmaceuticals or medical devices. In particular, this article:

- Reviews the preliminary goals of effective due diligence and provides guidance on the most important areas of investigation when acquiring a pharmaceutical or medical device manufacturer.
- Highlights some of the strategies acquirors can use to mitigate risks discovered through the due diligence process.

This article assumes that there are no distinctions between due diligence and risk mitigation between deals with simultaneous and non-simultaneous signings and closings.

>> For an overview of the signing and closing process in an M&A transaction, search [Signing and Closing M&A Transactions](#) on our website.

DUE DILIGENCE OF PHARMACEUTICAL AND MEDICAL DEVICE MANUFACTURERS

The preliminary goals of due diligence are to:

- Determine the existence of any “deal stoppers” in the transaction (for example, an ongoing governmental investigation).
- Identify and weigh any facts that require the revision of the original strategic rationale for the transaction.

>> For more information on due diligence in M&A transactions, search [Due Diligence for Public Mergers and Acquisitions](#) and [Due Diligence for Private Mergers and Acquisitions](#) on our website.

Due to the high degree of regulation in the healthcare industry, it is particularly important for the acquiror to confirm that the target has operated in substantial conformity with the statutes and regulations applicable to the target’s business. The starting point for this analysis is the review of the target’s business operations and compliance mechanisms. In particular, during the due diligence process acquirors should evaluate:

- The adequacy of the target’s compliance programs and systems.
- Risks stemming from the target’s fraudulent or abusive business conduct.
- Financial risks related to products liability claims, and product labeling and advertising potentially resulting in misbranding and US Food and Drug Administration (FDA) enforcement actions.
- The target’s policies and practices on protecting, exploiting and prosecuting its intellectual property.
- The impact of new, burdensome Physician Payment Sunshine Act disclosures.
- Whether the target has obtained and maintains all necessary licenses and has followed proper product approval processes.

- The target’s compliance with the requirements of the Health Insurance Portability and Accountability Act (HIPAA).

COMPLIANCE PROGRAMS

Many business practices that are acceptable in other industries are prohibited by regulations specific to the healthcare industry. For example, broadening the marketing and sales of a product beyond its current use may be ordinary course in the telecommunications industry, but marketing a pharmaceutical or medical device outside the specific use for which the item is approved by the FDA violates federal regulations (see *Box, Violations of Healthcare Industry Regulations*).

Moreover, drug and medical device advertising and labeling expose not only the manufacturer, but its officers and directors to potential criminal and civil liability under multiple legal theories. Additionally, there are specific requirements for drug advertisements, and FDA regulations spell out a long list of characteristics of advertisements which fail to meet the regulations. If advertising fails to meet the guidelines, it is deemed to be “misbranded.” Interstate commerce in misbranded products is a crime. Labeling is a separate problem for manufacturers. FDA labeling regulations are detailed and cover, for example, the proximity of some information to other information and type size.

Due diligence must focus on the adequacy of the target’s compliance programs and systems. These programs and systems are established to monitor the corporate behavior of the target in regulated areas. The success of these measures is critical. In particular, the acquiror’s due diligence review should include the assessment of:

- Codes of conduct, policies and procedures.
- Background and implementing documents.
- Relevant meeting minutes.
- Audit plans.
- Disciplinary measures and corrective action plans.

The acquiror should view the target’s failure to meet adequate thresholds in these critical areas as a potential indication that fraudulent or abusive conduct has gone unnoticed and unaddressed.

Standards of Effectiveness

Unlike many other industries, companies in the healthcare industry are required by federal and local governments to implement and maintain a sound compliance program. The Office of Inspector General (OIG) has issued compliance guidelines for many of the types of businesses that are involved in the healthcare industry. The existence of a program meeting minimum compliance standards allows the healthcare company to participate in federal health care programs (such as Medicaid and Medicare). Accordingly, the target’s compliance program must meet both the acquiror’s subjective standards of effectiveness, as well as

the more objective standards used by government programs.

During the due diligence process the acquiror should, at the least, examine the:

- Existence and comprehensiveness of the target's policies and practices, including the target's compliance with the requirements imposed by the:
 - Foreign Corrupt Practices Act (FCPA);
 - Federal False Claims Act (FCA);
 - Food, Drug, and Cosmetic Act (FDCA);
 - Public Contracts Anti-kickback Statute;
 - federal Anti-kickback Statute; and
 - state anti-kickback statutes and false claims acts.
- Target's procedures and resources for employees, independent contractors, distributors, suppliers or customers to disclose any concerns, allegations or factual evidence of any non-compliance with the applicable regulations and statutes.
- Function, authority and corporate visibility of the target's division(s) tasked with:
 - conducting internal audits;
 - facilitating external audits; and
 - coordinating the corporate response to any identified deficiencies in compliance programs or allegations of non-compliance.
- Scope and nature of management's control over the target's divisions.
- Nature of the relationships between the target's divisions. Federal regulators and prosecutors have focused investigations on pharmaceutical and medical device manufacturers that appear to have a corporate culture driven by the sales and marketing division.

Culture of Compliance

Compliance-related due diligence examines more than just the programs themselves. The acquiror should evaluate the target's culture of compliance, or the degree to which the target's senior management is involved with the implementation of the compliance program. A corporate culture that values ethics and compliance will help the target avoid incurring violations in the first place.

The acquiror should also assess whether the target's employees understand and respect its compliance program. Compliance with and documentation of the target's internal procedures can be a significant deterrent to fraudulent conduct. Good practices in recordkeeping and documentation can help the target's senior management to oversee and control conduct at the division level.

VIOLATIONS OF HEALTHCARE INDUSTRY REGULATIONS

Several years ago, makers of biliary stents began marketing them for uses for which they are not approved. A *qui tam* suit was filed accusing three companies of encouraging physicians to use the biliary stents to treat blocked blood vessels. The stents are designed to treat bile duct cancers and the FDA has not approved them for other uses. The whistleblower lawsuit allowed the plaintiff to file suit on behalf of the government and to collect one-third of any monetary judgment resulting from the case.

Violations of applicable laws and regulations can result in significant whistleblower and other civil suits and criminal sanctions. For example, in May 2012, a prominent pharmaceutical company pled guilty and agreed to pay \$1.5 billion to resolve its criminal and civil liability arising from the company's unlawful promotion of a prescription drug for uses not approved as safe and effective by the FDA. The fine is the second largest payment by a pharmaceutical company in history. It is comprised of a criminal fine and forfeiture totaling \$700 million and civil settlements with the federal government and the states totaling \$800 million. The company also will be subject to court-supervised probation and reporting obligations for its chief executive officer and board of directors.

Corporate Integrity Agreements

The acquiror should also analyze any claims or proceedings brought by government agencies or private individuals against the target company, whether for deficiencies in compliance programs or misconduct that compliance programs are intended to prevent. Many pharmaceutical, medical device and biotechnology manufacturers have been subject to inquiries by the OIG, the Department of Justice, or other enforcement authorities, and have resolved those inquiries by entering into Corporate Integrity Agreements (CIAs) with the government. CIAs can impose a variety of expensive, time-consuming and restrictive requirements and obligations on a company, such as:

- Limitations on certain business operations and actions.
- Increased oversight.
- Third-party monitoring and auditing.
- Reporting, certifications and attestations.

When evaluating a CIA, the acquiror should analyze:

- The nature and term of the CIA requirements and obligations.
- Any requirements imposed by the CIA on the transaction.
- Its impact on future business operations and the residual effects on the resulting entity.

The due diligence team should also review any reports previously provided by outside consultants to the target which evaluate the establishment or operation of the compliance program.

FRAUD AND ABUSE

Due diligence should assess the risk to the target of private or government legal actions stemming from fraudulent or abusive business conduct. The acquiror should also review the nature of

FRAUDULENT OR ABUSIVE CONDUCT

The recent acquisition of a well-known pharmaceutical company provides a cautionary tale for potential acquirors. After closing the transaction, the acquiror voluntarily disclosed to federal officials potential violations of federal statutes by the target company it had acquired. The target allegedly violated the Anti-kickback Statute by offering to make improper payments on a distribution contract to a subsidiary of a pharmacy benefits manager. The payment was made with the expectation of obtaining improved positioning for the products and improved ancillary benefits from that pharmacy benefits manager for the target's drug products.

A pharmacy benefits manager often acts as a middleman between pharmaceutical companies and health insurers and recommends pharmaceutical products to health plans. In this case, the target offered to make payments under a drug distribution contract with the expectation that the pharmacy benefits manager would recommend the target's drug products to certain of its health plan clients.

The acquiror's due diligence should include a review of material contracts of the target. The acquiror's team might have reviewed the target's contract with the pharmacy benefits manager if it were a material contract. If so, the due diligence team might have uncovered the improper payment as outside the ordinary terms of the contract prior to closing. However, generally, acquirors cannot review all material contracts and to some degree can rely upon the presence of a robust compliance program. An effective compliance program at work in the target would raise the acquiror's comfort level on matters relating to the compliance and monitoring of fraud and abuse and other prohibited business conduct.

the target's relationships with third parties. This area of due diligence is especially important (see *Box, Fraudulent or Abusive Conduct*).

Existing or Threatened Legal Proceedings

Pharmaceutical and medical device manufacturers are subject to several broad, overlapping federal and state statutes that prohibit fraudulent or abusive conduct, particularly where the manufacturer sells its products directly or indirectly to the federal health care programs. Even if the manufacturer does not directly serve as a health care provider under the federal health care programs, courts have interpreted the statutes to cover conduct that improperly influences the use of medical services by beneficiaries of the programs.

The acquiror's due diligence team should determine the existence of any investigations, such as:

- Civil investigative subpoenas by federal prosecutors under the FCA.
- Requests by current or former employees under the Freedom of Information Act.
- Threatened enforcement proceedings by federal regulators and prosecutors.

Most frequently, lawsuits and enforcement actions against manufacturers allege violations of the FCA, the FDCA, the Anti-kickback Statute and the FCPA.

Some potential claims might not be apparent on the first review. For example, manufacturers may hire physicians to

market the off-label uses of a product, which is a violation of FDCA and FDA regulations, or may provide an unrestricted grant to a physician group in exchange for prescribing the product, which violates the Anti-kickback Statute.

However, this same conduct can also serve as a cause of action under the FCA for private individuals, serving as *qui tam* relators (whistleblowers that file suit under the FCA), or the federal government. Some courts have found that the improper conduct of a manufacturer caused the physicians to submit false claims to the federal government. In other words, the manufacturer caused the physicians to misrepresent in their claim for reimbursement that the physicians were in compliance with federal law.

Therefore, the acquiror should carefully review with its counsel all complaints threatened or filed against the target alleging fraudulent or abusive conduct.

Third-party Relationships

The scope of risk under the fraud and abuse statutes will be determined not just by a review of current federal investigations and civil actions, but also by careful due diligence of the target's corporate conduct. The acquiror should assess the business

practices of the target regarding its contractual relationships with third parties. The due diligence team can begin by reviewing the contracts between the target and third parties that pose potential risks, including:

- Physicians.
- Clinical researchers.
- Hospitals.
- Managed care organizations.
- Group purchasing organizations.
- Distributors and independent contractors.
- Federal health care programs (in some cases).

However, the contracts may not explain the true extent of the relationship between the target and a particular third party. The acquiror should also interview the target's employees about the nature of the target's relationship with referral sources and match any payments made by the target to the payment requirements set out in the contract.

Under the federal fraud and abuse statutes, the requisite intent to defraud may be found even where a manufacturer has reasons other than obtaining or inducing referrals to pursue a contractual relationship with the health care provider. Therefore, if any purpose of the transaction is to induce Medicare or Medicaid referrals, the position of the OIG and of the federal courts is that the company has violated the federal statutes. Where there is a purpose by the manufacturer to induce referrals, liability



will be found regardless of the nature or importance of the manufacturer's other legitimate purposes.

However, there are a number of safe harbors under the Anti-kickback Statute that protect certain arrangements from prosecution even if the arrangement otherwise might technically constitute a statutory violation. The safe harbors identify arrangements that the OIG, under Congressional authorization, has determined will present little or no risk of fraud or abuse. Under these narrowly circumscribed fact patterns, the OIG will not treat certain conduct as violations of the Anti-kickback Statute.

For instance, certain sales commission agreements, although illegal under a literal reading of the Anti-kickback Statute, are permissible. Where the conduct does not satisfy each element of the safe harbor, the OIG will employ an analysis to determine whether there is an "improper nexus" between the remuneration in question and the referral of federal health care program business.

PRODUCTS LIABILITY AND FDA ENFORCEMENT

Pharmaceutical and medical device manufacturers must also comply with the labeling and manufacturing standards imposed by FDA regulations and state law-based duties. The FDA can suspend distribution of a product as well as recall the product or, in rare cases, seize or ban "restricted devices" that do not comply with FDA regulations. More significantly, as an alternative to basing a claim on a violation of a state law-based duty, private individuals can claim strict liability and negligence against the manufacturer for harm caused by a drug or §510(k) medical device (§510(k) of the FDCA requires the medical device manufacturer to register with the FDA) where the manufacturer violated the FDA regulations or the FDA's Current Good Manufacturing Practices (CGMPs).

In estimating the financial risk of the M&A transaction, the acquiror should closely examine the target's compliance with these federal statutory and state law-based obligations. In particular, the acquiror should assess the degree to which the target has:

- Implemented CGMPs.
- Maintained its obligations under the FDA's applicable reporting obligations.
- Promptly disclosed to the public any adverse findings by the FDA in an administrative hearing. This includes any FDA suspensions or recalls of its products and any adverse administrative determinations by the FDA (such as a notice or warning letter).

Due diligence should also identify which of the target's products are §510(k) medical devices, as opposed to Class III devices. State law-based tort claims that allege harm caused by Class III devices are not preempted by the FDA's statutes and regulations. Class III devices are usually those which support or sustain human life or pose a risk of injury.

In evaluating the risk of future liability, the due diligence team should review the:

- Frequency of adverse events reportedly caused by the target's drugs and medical devices.
- Level of communication between the operations managers for each division and the target's compliance staff.

The target may be subject to more potential tort or regulatory risk where the target's employees know of adverse events, but acting independently from the target's compliance officer, have determined that those events did not require disclosure under the statute and associated regulations.

Any misrepresentations by the target to the FDA in connection with the drug or medical device approval process may serve as a basis for a relator's claim under the FCA. However, these violations of the FDA labeling requirements could also serve as a basis for individuals claiming tort liability due to harm caused by off-label use of the target's drugs or medical devices. The acquiror should examine the target's disclosures to the FDA during the pre-market approval processes to determine if the target made any misrepresentations about the potential use of its products.

INTELLECTUAL PROPERTY

When conducting due diligence on pharmaceutical and medical device manufacturing companies, which operate in a sector marked by rapid technological change and high margins, the acquiror must review the target's documentation, policies and practices related to protecting, exploiting and prosecuting its intellectual property. A review of the target's portfolio of trade secrets and issued patents will reveal the rights of the target in its patent assets and the target's competitive advantage within the relevant market. An understanding of the target's patents and related disclosures will also allow the acquiror to value the target's patent portfolio.

As part of a comprehensive plan to protect a company's intellectual property, the target should have in place:

- Assignment agreements with its employees and consultants who are inventors of important company technology and know-how.
- Processes for maintaining the confidentiality of its trade secret information.

Documentation of the target's patent portfolio may reveal weaknesses in its competitive advantage. Therefore, the acquiror should review:

- The validity, exclusivity and enforceability of the issued patents.
- The policies and practices of the target in disclosing its patent rights, prosecuting its patent portfolio and licensing its technology.
- The extent of the target's efforts to create contractual safeguards (whether through confidentiality or

non-competition agreements) to prevent the disclosure of its trade secrets and to ensure the assignment of patent ownership rights.

- Any exploitation and infringement of the target's patents by third parties or by the target regarding the patents of third parties.

>> For a Checklist of issues to consider when conducting intellectual property due diligence for an M&A transaction, search [IP Due Diligence Issues in M&A Transactions](#) on our website.

PHYSICIAN PAYMENT SUNSHINE ACT DISCLOSURES

As part of the PPACA, Congress included the Physician Payment Sunshine Act which directs the Centers for Medicare and Medicaid Services (CMS) to adopt rules implementing the transparency provisions of the PPACA. On March 31, 2013, companies will begin reporting under these new, burdensome disclosure requirements, including pharmaceutical, medical device, biotechnology and other medical supply companies. In anticipation of these requirements, acquirors should determine the impact on the target's compliance program and the heightened enforcement risk posed by the target's business relationships.

CMS has proposed that the statute should cover entities that sell products in the US which require pre-market approval by the FDA (as well as manufacturers that license the applicable products for production, distribution and sale). Where a covered entity transfers to a physician, group of physicians or teaching hospital anything of value above a nominal threshold, the covered entity must publicly disclose:

- The identity of the recipient.
- The nature of the transfer, for example:
 - cash or cash equivalents;
 - in-kind services or goods;
 - ownership interests;
 - stock;
 - dividends; or
 - profits and other returns on investment.
- The purpose of the transfer, including:
 - research;
 - clinical investigations;
 - grants; or
 - charitable contributions.
- The covered entity's product that is "reasonably associated" with the transfer.

These new disclosure requirements pose significant risks for covered entities. Non-compliance with the disclosure requirements can result in civil monetary penalties up to \$1 million per year. The covered entity must also pay for the cost of a compliance audit conducted by the Department of

Health and Human Services. However, most concerning is the heightened risk of liability under the Anti-kickback Statute and the FCA, especially in cases where the manufacturer discloses questionable financial relationships with physicians and teaching hospitals.

The acquiror should therefore review:

- The enforcement risks posed by material financial relationships with physicians, particularly those that sponsor pharmaceutical products or medical devices or serve as principal investigators in clinical trials funded by the manufacturer.
- The technical ability of the manufacturer to meet the requirements of the proposed rule, which will require the aggregation of information that is likely not shared between divisions of the company.

REQUIRED LICENSES AND APPROVALS

Depending on the particular business involved, healthcare companies are regulated by a broad range of both federal and state agencies (for example, Medicaid, state regulatory boards and state public health agencies). There are also professional and accrediting organizations which have authority over some healthcare companies. Many of these organizations require licenses, permits, registrations or accreditations for companies (and for individuals) to conduct certain activities. During the due diligence review, the acquiror must identify all of the necessary licenses required of the target. The acquiror must then determine:

- Whether the target maintains the most current versions of the required licenses.
- Whether there have been any lapses in licensure during times in which claims were submitted.
- What actions are necessary to transfer any licenses before or after the M&A transaction.

Medical devices and pharmaceutical products go through a rigorous approval process that requires clinical trials, including human testing and publication of results. Counsel should focus (sometimes with the help of a clinical auditor) on the manufacturer's efforts from the period of drug discovery through FDA approval.

Of special note for due diligence purposes is the §510(k) approval process applicable to medical devices. Under this process, companies can request a shortcut to approval if the product is deemed "substantially equivalent" to another product which already has FDA approval. It is inexpensive and does not require testing which might identify material flaws in the product. The process was created for products which are identical to those previously approved to enhance FDA efficiency in reviews but it is up to the medical device manufacturer to claim substantially equivalent status.

Any shortcuts could result in a large financial burden on the acquiror if there is a recall, removal from the market by the FDA or some other regulatory action by the FDA that limits the prescription of the products being purchased. Additionally, if any mistakes were made in the medical device approval process and individual patients are harmed as a result, the acquiror could face significant financial liability.

HIPAA REQUIREMENTS

Under the HIPAA Privacy Rule for “covered entities” and “business associates” (such as independent contractors of covered entities), the Department of Health and Human Services Office of Civil Rights (OCR) regulates the corporate procedures for the use and corporate response to the misuse or mishandling of certain Protected Health Information (PHI).

The acquiror should therefore identify whether the target has:

- Experienced any security breaches of PHI, especially with respect to unencrypted laptops and other portable media, and, if so, has disclosed the form and type of PHI.
- Promptly notified the appropriate government entities, individuals and, in some cases, the media after experiencing a security breach.
- Promptly corrected either the cause of any security breach or any deficiencies identified by the OCR in connection with select post-breach audits.
- Recovered any PHI prior to misuse.
- Developed and maintained appropriate systems for documentation of:
 - the target’s compliance with HIPAA and the Health Information Technology for Economic and Clinical Health (HITECH) Act;
 - any security breaches; and
 - corporate responses to breaches.

RISK MITIGATION STRATEGIES

After risks are identified through the due diligence process, the acquiror’s counsel must determine an appropriate risk mitigation strategy. In cases of substantial risk, the conclusion may be that the proposed transaction should be abandoned. Most often, the parties will consider changes to the transaction structure or to the terms in the definitive documentation to mitigate the risks.

TRANSACTION STRUCTURE

The transaction might be restructured into an asset purchase in which the acquiror does not purchase the higher risk portion of the target’s business. This alternative is only feasible if the parties can achieve their goals on the tax and accounting aspects of the deal and if the target’s key contracts and other rights can be effectively transferred at the closing to the acquiror.

>> For more information on asset purchases, search [Asset Acquisitions: Overview](#) on our website.

RISK ALLOCATION PROVISIONS

The acquiror’s counsel may also try to mitigate the risks of expensive or indeterminate post-closing liabilities by using some of the risk protection provisions commonly available in transaction documents related to the purchase of private companies, such as:

- Indemnification provisions.
- Acquiror escrows.
- Holdbacks.

Of special note for due diligence purposes is the §510(k) approval process applicable to medical devices. Under this process, companies can request a shortcut to approval if the product is deemed “substantially equivalent” to another product which already has FDA approval.

Special indemnifications provide for more extensive liability for the target for known risks which are considered by the acquiror to be above the normal business risk in operating the target. For example, terminated employee litigation is frequently considered routine while litigation over the FDA approval process or intellectual property is probably not considered routine and would be the subject of special indemnification provisions.

The indemnification provisions are among the most important covenants in the transaction documents because they are most often the sole remedy for breaches of the purchase agreement. However, there is a delicate balance to be struck when negotiating these provisions. When a party perceives that the other side is attempting to disproportionately shift the risk in the transaction documents, the negotiations may become strained and the deal may fail to close.

>> For more information on indemnification provisions, search [What’s Market: Indemnification Provisions in Acquisition Agreements](#) on our website.

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