

Reproduced with permission from Mergers & Acquisitions Law Report, 15 MALR 1179, 08/13/2012. Copyright © 2012 by The Bureau of National Affairs, Inc. (800-372-1033) <http://www.bna.com>

HEALTH CARE

Determining Whether a Sale or Affiliation Is Appropriate For Your Hospital and How to Prepare for It



BY ROGER STRODE AND CARSTEN BEITH

The ever-changing landscape in health care continues to put significant strain on smaller hospitals and health care systems and their missions to provide high quality, reasonable cost health care to the communities and patients they serve. As a result, we've seen a tremendous number of affiliations of community

Roger Strobe is a partner with Foley & Lardner LLP, Chicago, where his practice focuses on health care business transactions, including mergers, acquisitions, corporate restructurings and joint ventures, general corporate matters and health care regulation. He is a member of the firm's Health Care Industry Team. Carsten Beith is co-head of Cain Brothers's Tax-Exempt M&A Group, and is a member of the firm's Executive Committee. He is responsible for mergers, acquisitions, sales and other strategic advisory engagements on behalf of hospitals and health systems, managed care organizations, ambulatory surgery centers, ancillary providers and physician organizations. He is based in Chicago.

hospitals and health care systems with larger systems and outright sales of these entities to regional and national nonprofit and for-profit provider organizations.

Before making any affiliation decision, organizations should consider, at a minimum, the various issues and questions outlined below.

1. What's the Objective and the Best Strategy?

A critical first step is to prioritize the objectives the organization seeks to achieve from an affiliation or sale. Today's leaders often grapple with issues such as a lack of management or governance experience to effectively compete in its marketplace and/or a lack of leverage with payers. Moreover, many of today's community hospitals are bereft of capital necessary to expand or to build out IT infrastructure. In addition, we see community hospitals finding it increasingly difficult to recruit physicians, leading to deficits in quality and service. Finally, we have seen many hospitals seek capital partners for fear that the organization simply will go out of business, leaving the community bereft of locally oriented care. This is hardly an exhaustive list, but it is illustrative of the many reasons we see for community hospitals to seek an affiliation or capital partner.

Once key objectives are identified, hospital leadership is free to consider the array of strategic alternatives available to the organization. Is a merger, sponsorship transfer, outright sale, or joint venture the absolute right thing for the hospital, its medical staff, and the community it serves? These days, there are many and varied affiliation or alignment strategies and a decision about the best path to take should be based upon the mission and needs of the institution and its ultimate objective, which is most often to assure the community maintains access to high quality, affordable health care.

Not only is a careful identification of objectives and strategic alternatives sound business practice, but undertaking a rigorous, thoughtful process will help protect the hospital's governing board from claims of breaches of duty, and, in those states where regulators have the right to approve or disapprove hospital "change of control" transactions, ease that process. The focus of regulators charged with reviewing proposed sale transactions often turns on questions of process and whether the board has been thorough in its deliberations. Outlining a set of key objectives and then systematically finding the structure and partner best suited to help reach those goals is critical to the process.

2. Who Is and How do We Find the Best Partner?

For many institutions, the list of possible affiliation or capital partners is as long as the range of transaction possibilities is wide. Is the best partner a local or regional nonprofit competitor? Is it a national for-profit chain? Is it an insurer? In today's market, the answer could be "yes" to each of the above, thus requiring a careful analysis of potential suitors.

Most organizations seeking a partner tend to engage a transaction financial adviser, such as an investment banker, to assist in ensuring an effective and efficient selection process. A well-qualified adviser will assist in prioritizing objectives, performing reverse business due diligence to uncover potential pitfalls and opportunities with the various prospective transaction parties, conducting a solicitation and evaluation of proposals and negotiating the key business terms of the transaction. In some cases, particularly when a nonprofit hospital is sold to a for-profit buyer, financial advisers will render a formal "fairness opinion" on the financial terms of the transaction. The most effective of these advisers have strong relationships with many of the potential bidders, which should allow for a robust bidding environment and an overall efficient process.

3. What Are the Board's Duties When Considering a Transaction?

The members of a hospital's governing board are fiduciaries. As such, they owe established duties to the organization, which generally are referred to as the duty of care and the duty of loyalty.

In brief, the duty of care requires that a trustee act in an informed, good faith manner when participating in board decisions and that he or she exercise the care of an ordinarily prudent person in a like position. Trustees should be aware of the concept of the "business judgment rule," which protects a board's decision as long as the decision is sufficiently informed, is made in good

faith and in the honest belief that the action taken is in the best interests of the organization, and is made by disinterested trustees. The business judgment rule places the focus on the process followed by the board in reaching a decision, *not necessarily* on the substance of the decision.

All of this means that a board considering a transaction is well served to undertake a fair and unbiased analysis of the hospital's alternatives. The board should focus on the hospital's mission to the community and the preservation of its assets. Trustees should consider all alternatives, including those that might not necessarily lead to an affiliation or sale. And the board should be informed by the expert opinions of management and advisers, such as those of strategic financial or legal advisers with experience in multiple transactions.

The duty of loyalty requires a trustee to exercise his or her power in good faith and in the best interests of the hospital and its mission, *not* in his or her own interests or the interests of another person or entity. This means that a trustee must consider any conflicts of interest, such as offers of employment from the buyer, when reviewing a proposed affiliation or sale. Trustees also must maintain the confidentiality of the process and any decisions made by the board. For physician-trustees representing a hospital's medical staff, the duty of loyalty can be particularly challenging as the desires of the medical staff are not always aligned with the organization's objectives, which can result in pressure on physician trustees to vote in their own interests and that of their fellow physicians, rather than in the interests of the organization.

4. Will Government Oversight be Involved?

Increasingly, state governments have become involved in affiliation and sale processes, especially those involving the transfer of charitable assets to for-profit entities. Certain states have extensive processes for approvals of sales of assets by charitable entities to for-profit buyers. In those states, the attorney general is usually charged with the authority to approve the sale of the assets or, further, to bring a lawsuit to stop a transaction should the AG determine that public trust has been, or will be, violated by the transfer of those assets to a for-profit company. The power of the AG may be granted by specific statute, or simply can be a function of long-standing practice under a doctrine referred to as *cy pres* arising under the law of charitable trusts. A strong relationship with the AG and good communication before and during the transaction often are keys to gaining necessary and timely approvals.

As a general rule, state attorneys general are interested in several critical things when reviewing a transaction:

- The identity of the buyer and whether the buyer is the type of organization that will preserve the mission of the selling hospital and continue to serve the community.
- The process used to reach the ultimate decision to sell or affiliate. As noted above, the process used often is more important than the ultimate decision reached.
- The price, if any, to be received for the hospital and its assets, and whether the price is fair. A ro-

bust bidding process and a fairness opinion often will go a long way to satisfying an AG that charitable assets aren't being wasted or simply given away to for-profit use.

- How the net transaction proceeds will be used. Most state AGs will insist that proceeds be used strictly for charitable purposes and, often, only for those related to the health of the community served by the hospital. Often, the selling organization will establish a charitable foundation to maintain the proceeds and oversee their distribution.

In addition to exercising approval rights related to the use of charitable assets, government regulators may weigh in on, among other things, antitrust or certificate of need issues. If a transaction is large enough and its participants are of a certain size, the transaction may be subject to review under the Hart-Scott Rodino Antitrust Improvements Act (or HSR), which requires a set of filings from both the acquirer and the acquired entity and a waiting period prior to closing during which the Federal Trade Commission or the Department of Justice has the ability to review the transaction and its effect on competition in the relevant market or markets. A number of recent transactions have been stymied because of antitrust review. In addition, in those states where a certificate of need is necessary to operate a hospital or health care system, the approval of the transaction by the state health facilities planning board also may be required.

Responding to regulators requires planning, time, and money. A poorly executed strategy for dealing with government review or approvals can derail or significantly delay a transaction.

5. How Will Important Constituencies Respond?

Critical to any decision to undertake change is the reaction of certain important groups of stakeholders in the organization: payers, the community served by the hospital, employees, and the medical staff. Missteps in gauging the reactions of these groups can cause a transaction to slow down or, worse yet, fail.

Payers, for example, can raise concerns over the impact of a transaction on prices. If payers make credible claims that a particular transaction will harm competition due to market consolidation, regulators may be persuaded to attempt to halt the deal or slow it down in order to carefully scrutinize the potential impact on price competition. Any organization considering an affiliation or sale is well advised to consider the wisdom of discussing and advocating for the transaction with major payers in order to address possible negative reaction to the deal.

Closely related to payer reaction is that of the community, both patients and employers. Will they perceive the transaction as one that will foreclose, maintain, or expand provider choice? Will the deal help keep a critical community provider, and employers, in place? Will vital services, such as secular women's services, be lost, or will the transaction involve the loss of a religious-based provider, such as a Catholic hospital? Negative reactions from these groups are extremely important as regulators and payers pay close attention to these constituencies and their responses.

Considering the impact on physicians also is critical. Patients follow physicians, and payers follow patients. Physicians often find themselves very concerned with their futures in the event of an affiliation transaction or sale. Physicians who are "on the fence" may seek reinsurance that they won't be pushed out and that they and their patients always will continue to be welcome. For example, physicians who are affiliated with community hospitals that are considering affiliations with larger academic medical centers often express concern that academic medical center faculty practice plan physicians may "poach" their patients or try to usurp their standing in the community as the preferred provider.

6. What Don't We Know About Our Compliance Issues?

Compliance issues that typically arise are those related to the hospital's relationships with referring physicians. It isn't unusual for a hospital to have hundreds of financial relationships with physicians, many of which may be decades old. Moreover, it is possible that no one has done a thorough compliance review of the arrangements in many years, if at all, and, as such, the compliance aspects of certain of those relationships may have been neglected. For example, agreements may have lapsed or compensation currently being paid to a physician may not be reflected in the agreement. There may have been changes to the law that were never incorporated or, worse yet, one or more arrangements now may be illegal.

Any potential partner will engage in a rigorous due diligence process and, if compliance issues are uncovered, will insist that the purchase price be reduced or that some level of self-disclosure be made to the appropriate regulatory agency (which, usually, is accompanied by a significant payment to the government), or both. Engaging legal counsel early in the process can help uncover these issues and make them easier to deal with, as opposed to having them raised by a potential capital partner or buyer.

7. How Will the Transaction Impact Material Agreements and Vice Versa?

Proper planning for a transaction includes gaining an understanding of how the deal will impact material agreements, including financing arrangements, payer agreements, physician contracts, leases of facilities and equipment, and other similar arrangements and contracts.

Many arrangements, such as financings, may need to be restructured or—in the case of a tax-exempt debt maintained by a hospital to be sold to a for-profit buyer—paid off or defeased. Other arrangements, such as physician employment contracts, may require renegotiation. For example, many physician contracts contain provisions that allow for the assignment of the arrangement to the purchaser of all or substantially all of the assets of the employer.

Each hospital has a core set of agreements that are critical to its ongoing operations, and those arrangements should be considered early in the process in order to ensure that they either can be maintained or discussed and, if necessary, renegotiated.

Conclusion

In summary, hospitals or health systems contemplating potential sales or affiliations should clearly articulate up-front what they seek to achieve from a transaction, conduct a thorough process to identify and select a partner, communicate with key constituencies includ-

ing regulators, and identify regulatory and compliance issues—as well as material contracting concerns—that may slow or halt the transaction. Careful attention to these matters will give the organization the greatest chance of concluding the transaction in a way that has the most advantages for the hospital, its physicians, and the community it serves.