Healthcare Insights

9 Core Considerations for Boards of Directors Considering a Hospital or Health System Affiliation

KEY TAKEAWAYS

> Business and regulatory demands may cause a hospital or health system board to consider affiliating with another organization.

> Before deciding on an affiliation, the board should select seasoned advisors, establish firm decision criteria, and practice ample due diligence.

> Throughout the affiliation process, the board should engage in community and physician outreach, board member education on fiduciary duties, and the identification and mitigation of liabilities and regulatory concerns.

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As acute care providers have responded to the recent challenges and opportunities created by healthcare reform, consolidation continues to emerge as an important option for hospital and health system boards to consider. As regulatory demands and business realities continue to change within the industry, hospitals and health systems will need to continually adjust their financial and operational plans in order to succeed and meet market demands. Such adjustments may necessitate that the board move the organization toward an affiliation transaction. To the extent a board determines that an affiliation transaction is necessary, there are many procedural and substantive issues to navigate. This article describes nine core legal, strategic, and financial issues for boards of directors to consider when deciding whether to affiliate with another hospital or healthcare system.

1. DECIDING WHEN TO AFFILIATE

The most common forces that drive the affiliation process for hospitals and health systems are generally financial and operational, and include: (1) lack of access to capital, (2) declining reimbursement, (3) limited ability to recruit physicians, and (4) decreased inpatient utilization of services. Of course, these forces are not new to boards, however, healthcare reform has exacerbated the negative consequences of these forces while also creating a sense of urgency, because it is expected that inpatient utilization and reimbursement declines will not recover. As a result, we are seeing the proverbial melting ice cube at struggling hospitals and health systems. Boards should be wary of recommended solutions that include (i) anticipated

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increases in commercial reimbursement and (ii) "build it and they will come" ideas. If the operational dashboard indicates challenges regarding the four forces listed previously, consider negotiating to find a partner while the organization is still relatively strong financially and does not need an affiliation transaction merely to survive.

Boards should reflect on their organization's mission, values, and role in its community when evaluating a potential affiliation. Boards should also question whether "staying the course" is a legitimate long-term option. In evaluating these complex issues, boards should consider their constituents and the potential impact of an affiliation on these stakeholders, including physicians, community groups, and employees, even if those groups are not involved in the early planning stages. Spending time identifying key concerns and setting organizational goals before undertaking a transaction or meeting with potential partners is a crucial step that boards can take to prevent problems and confusion down the road.

2. SELECTING CORE ADVISORS FOR THE AFFILIATION PROCESS

Forming a strong team of advisors at the outset of an affiliation is critical because it helps boards (1) develop a sound understanding of their organization's needs and goals; (2) consider a broad range of potential partners under a competitive process; (3) oversee a well-organized due diligence process and respond to regulatory concerns; and (4) cultivate support for an affiliation among key stakeholder groups and their communities. Selecting key internal leaders is the first step to a successful affiliation, because they are well versed in the organization's history, needs, and goals. Next, selecting legal, financial, and communications experts can help the board maximize its negotiating power, avoid regulatory roadblocks, and maximize the likelihood of a transaction that's supported by physicians in the community.

3. ESTABLISHING DECISION CRITERIA TO EVALUATE OFFERS

Once the board establishes that it is time to affiliate, the next important step is to create decision criteria, which is a list of criteria that will assist the board in identifying the right partner. While each entity may create its own specific decision criteria for choosing a partner, a good framework should include certain key considerations, including:

> Responding to healthcare reform

> Improving access to capital

> Increasing/maintaining services

> Assisting in maximizing return on past and current investments

Do not underestimate the value in creating a united board mission and vision during the affiliation process. It is advantageous to hear opinions and perspectives early, while there is still time to debate.

> Attracting physicians to the market

> Aligning incentives within the health system

Decision criteria serve as guide posts for the board. It is the old saying, "If you do not know where you are going, any road will get you there." As the process of finding an affiliation partner develops, there are inevitable distractions, including the demands of the process and day-to-day board responsibilities. decision criteria keep the board grounded and focused. Additionally, and possibly more importantly, decision criteria established early in the process help all of the board members get on the same page and aligned in the same direction from the beginning. Do not underestimate the value in creating a united board mission and vision during the affiliation process. It is advantageous to hear opinions and perspectives early, while there is still time to debate.

Once decision criteria have been established, the hospital or system should include them in any marketing materials or outreach materials designed for the purposes of attracting proposals from potential partners. As part of the affiliation process, a good financial advisor can organize marketing materials in an "offering memorandum," which should include decision criteria. Closely defining expectations tends to weed out those potential partners that would not be truly interested in pursuing the hospital's or system's interests. However, the current status of a hospital, especially its financial situation, will usually determine how particular and aggressive a board can be in creating, sticking to, and achieving preferred decision criteria. Unfortunately, some hospitals' situations are dire and less flexible, requiring immediate action to salvage needed services in the community, while other situations are better timed and offer more bargaining power to achieve decision criteria. Creating decision criteria early will pay off once the difficult job of evaluating proposals begins.

4. EVALUATING AFFILIATION MODELS

Next, we will address, at a very high level, various types of affiliation models. While there are lots of names and structures for affiliation models, they typically center around two variables: control and potential incremental increases in efficiencies. The more control retained by each hospital seeking a partner, the less potential for the achievement of increases in efficiencies through the partnership. For example, let's define, in order of more control to less control by a hospital seeking to partner, the range of affiliation model options: (1) stay the course (maintain independence), (2) joint operating agreement (JOA), (3) joint venture (JV), (4) merger, and (5) asset sale or membership substitution.

Joint operating agreements (JOAs) and joint ventures (JVs) are not always easy to negotiate, because often the two parties have to negotiate the divorce before consummating the marriage, so to speak.

Of course, staying the course will allow a hospital to retain the most control, but, as expected, will yield the least incremental efficiencies. On the opposite end is an asset sale or membership substitution, which gives up complete control while likely creating the most potential for increasing efficiency. JOAs and JVs are sometimes seen as a first step toward establishing a longer-term, more closely structured transaction (i.e., merger, asset sale, or membership substitution). JOAs and JVs, however, are not always easy to negotiate, because often the two parties have to negotiate the divorce before consummating the marriage, so to speak.

Somewhat related to JOAs and JVs, in many states, we are seeing a growing number of purchasing-power and clinical hospital affiliations—those that provide enhanced contracting abilities (e.g., managed care and supplies), but preserve strong independent governance for each affiliated hospital. These agreements will yield some savings, but at some point the ability to influence managed care programs and truly integrate operations and best practices will likely require more closely structured transactions, again more fully yielding control for a higher level of efficiency. A good example of this type of affiliation can be found at the BJC Collaborative, which covers Illinois, Missouri, and Kansas through a loose affiliation between BJC Healthcare, St. Luke's Health System, CoxHealth, and Memorial Health System. In total, BJC Collaborative will command about $7 billion in net patient revenue, but each participant will retain its own unique board.

5. COMMUNICATING THE AFFILIATION PROCESS WITH PHYSICIANS AND THE COMMUNITY

Because an affiliation typically involves many stakeholders, communication about the process is key to better ensure physician and community involvement and support.

> **Physician Communication.** Involving physicians should be relatively straightforward, as most boards have a physician representative who usually has some stature within the physician community. As a basic guideline, the physician representative should be tasked with communicating key developments to the medical staff during the affiliation process and gathering physician input when necessary. To enhance buy-in, it is also important to ensure that any potential affiliation partner be given the opportunity to meet with the physician community. A potential affiliation partner will be sure to address (or should be asked to address) the following items:

- Success stories working with employed and non-employed physicians
- ACO strategies
- Technology solutions
- Governance inclusion
- Rationale (big picture) for affiliation

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Depending on the ratio of employed to independent physicians, the interaction with the physician community will vary. However, the affiliation process is typically geared to enhance physician recruitment, so it presents an opportune time to influence independent physicians who may make ideal employed physicians.

> **Community Coordination.** Community involvement requires a balance between encouraging transparency, while also ensuring the affiliation process is not compromised due to a lack of confidentiality. Community involvement is especially important when the community is represented on the board or where a hospital is county-owned. It is not uncommon for boards to hire public relations firms to help prepare a message indicating that a process is (or is about to be) underway to identify a partner. The board may want to include its decision criteria (discussed previously), or the guidelines for how the board will make its affiliation decision. At a minimum, the community should understand the rationale for wanting to find a partner, with reasons usually being to: (i) improve access to capital, (ii) increase access to services, (iii) enhance physician recruitment ability, and (iv) provide strategies for responding to healthcare reform.

The purpose of including both physicians and the community in the affiliation process is to garner more support along the way and avoid any surprises once the affiliation is final. As a general rule, the more communication, the better.

6. EDUCATING BOARD MEMBERS ON FIDUCIARY DUTIES

Before the affiliation process, board members should be familiar with applicable state law fiduciary duties that govern their actions in transactions undertaken on behalf of their hospital or health system. First, directors must understand their duty of care, which requires them to investigate all relevant details of a proposed transaction, ensure that the organization receives fair market value, and fully evaluate alternative proposals and competing offers. Next, directors must understand their duty of loyalty, which involves detecting and avoiding conflicts of interest as well as maintaining confidentiality in the context of the transaction. This confidentiality with respect to informing the hospital or health system's surrounding community does not extend to the boardroom: directors must be open and honest with others about any actual or potential interests they or their immediate family members may have in an affiliation. For example, a board member might also be a supplier, distributor, or hospital property owner. This type of information must be disclosed as soon as possible to ensure that the board, and each director as an individual, is acting in the organization's best interest.

Finally, the duty of obedience to purpose, which requires directors to act in accordance with the primary goal(s) of their organization, also applies to board members of nonprofit hospitals and health systems. In general, board members of

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501(c)(3) organizations must act to further their organization's charitable purposes (in addition to acting in its financial best interest). Engaging legal help if necessary to understand these duties will both ensure that directors meet their fiduciary obligations during the transaction and are protected from potential liability.

7. IDENTIFYING AND AVOIDING POTENTIAL LIABILITIES AND ROADBLOCKS

As part of the transaction process, hospitals will identify and quantify key liabilities, such as deficits in employee pension funding and benefit programs; restrictive bond covenants or real estate restrictions; relationships with employee unions and physicians; malpractice and other insurance relationships; restrictions on land use or licenses; and regulatory compliance issues. These and other issues can significantly impact a transaction by causing timing issues or resulting in concessions in negotiations.

Comprehensive planning and process documentation are also important, because they allow boards to stay focused during the affiliation process. As the board and its team go through the affiliation process, they should keep standardized documentation of their activities. At a minimum, hospitals and health systems should ensure that (1) all board and committee minutes are complete; (2) all policies and procedures are up to date; and (3) all diligence materials, records, and governance documents are as well organized and recorded as possible. This process makes documentation easier and allows for a unified presentation to partners during diligence and to government regulators after closing.

8. ADDRESSING REGULATORY COMPLIANCE CONCERNS

With the severity of potential penalties for violations of the federal physician self-referral law (the Stark Law), the False Claims Act (FCA), and federal and state anti-kickback statutes, affiliation partners now commonly require that selling hospitals disclose and/or otherwise resolve instances of regulatory noncompliance as a condition to closing a transaction. What this often means is that a partner will require a seller to self-disclose instances of noncompliance with the Stark Law, including unintentional, technical issues (such as unsigned or expired physician contracts) to government regulators. These violations are not uncommon among hospitals and healthcare centers. Boards considering an affiliation should be prepared to undertake comprehensive reviews of their physician service arrangements, lease arrangements, and other contractual agreements with physicians and be prepared for potential interactions with regulatory agencies.

Having clear records of a board's preplanning process, goals, and objectives; the search for potential partners; and the level of competition

Having expert help to conduct this diligence and navigate regulatory processes is crucial for hospitals and health systems to streamline the review process and avoid potentially costly errors. Experienced legal advisors can help the board alleviate risks by (1) mitigating harm from noncompliant arrangements, (2) disclosing instances of noncompliance to regulators and navigating the settlement process, and (3) ensuring that regulatory noncompliance issues do not derail an affiliation.

9. AVOIDING PROBLEMS WITH GOVERNMENT REGULATORS

Boards need to consider the impact a given affiliation might have on their organization's state and federal regulatory approvals, including their certificates of need, if applicable, and participation in government healthcare programs. Boards must also be prepared for scrutiny from the Federal Trade Commission and Department of Justice under the Sherman Act and other federal antitrust laws, particularly where the organization already holds a significant market share.

Boards of directors of not-for-profit hospitals considering an affiliation with a for-profit entity will need to take special care in properly structuring the transaction with respect to their tax-exempt status and obtaining approval for the transaction from the state attorney general. Attorneys general are tasked with protecting the interests of the hospital's or healthcare system's community (and tax-exempt assets). In general, an attorney general review of a transaction that transfers charitable assets from a not-for-profit hospital or healthcare system to a for-profit entity is more stringent than a comparable review of a transaction between two not-for-profit organizations.

In dealing with attorneys general and agencies like the Federal Trade Commission, boards must be prepared to defend the rationales and reasoning behind their transactions. For example, a board must be able to show that it conducted a thorough options assessment and concluded that its chosen transaction was the best way for its hospital or health system to survive and succeed in the future. A board must also demonstrate that its process was fair and open and that it satisfied its fiduciary obligations by going to a broad market of buyers, selecting a partner for clear, well-documented reasons in the organization's best interests, and obtaining fair market value in the transaction. Having clear records of a board's preplanning process, goals, and objectives; the search for potential partners; and the level of competition and rigor of its market-clearing process provides significant support for its affiliation decisions.

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