Preparing Your Hospital for Market

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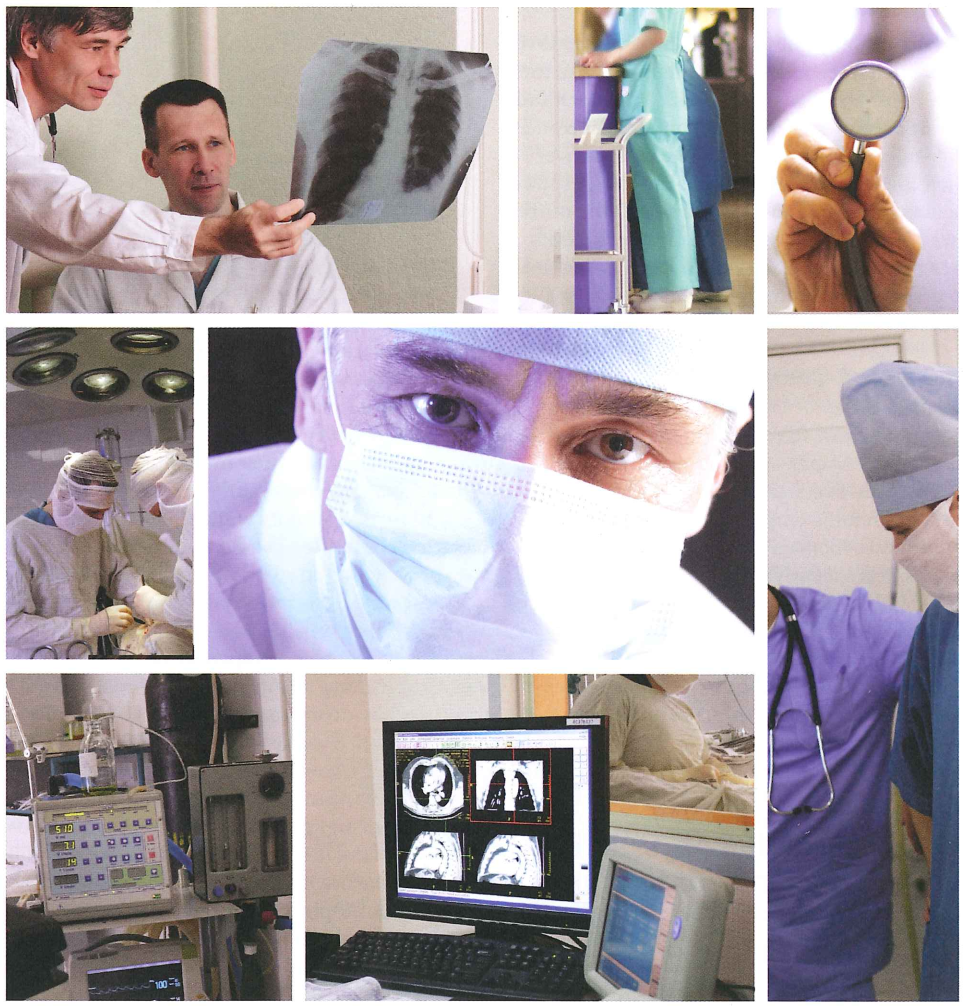
The specter of healthcare reform and challenges facing hospital operators have proven to be powerful catalysts for consolidation and integration in the hospital industry. Despite the trend toward consolidation, the hospital "market" is significantly more confused than at any time in the last 20 years. The hottest topic of discussion is business combinations. More systems are speaking with potential target hospitals and a large number of for-profit buyers are growing more active in the marketplace.



ONE CLEAR TREND IS THE increasing difficulty of completing transactions and the need for advance preparation. Advance preparation can ensure two things in a transaction. First, preparation can mitigate the risk that a transaction's closing will be delayed or sidetracked by the discovery of a regulatory issue during due diligence. Second, if issues are presented early in transactions and solutions for these issues are readily available, then the bidder's price for the company will have incorporated the risk of these issues. This avoids repricing a transaction later based on the discovery of an issue late in the due diligence process. Preparation can lead to swift closure of hospital transactions at attractive valuations, thereby maximizing community benefit.

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In preparing any hospital for market, the following key issues should be considered:

1. **Relationships with referral sources.** Large non-profit systems and for-profit consolidators alike tend to heavily scrutinize referral source relationships because they are highly regulated and the financial impact of non-compliance can be substantial. Federal enforcement agencies have closely watched compliance with the anti-kickback statute and Stark law in recent years. This has been demonstrated in a number of recently announced settlements including a $20 million settlement by Detroit Medical Center before it was acquired by Vanguard Health Systems. Similarly, in 2008, Condell Medical Center paid a $36 million settlement for violations of the False Claims Act that emanated from below fair market value leases and other improper financial relationships with physicians.

   In preparation for any transaction, hospitals should identify physician and institutional referral sources, consider whether a financial relationship exists, and assess whether the relationship is compliant with the anti-kickback statute and Stark law, as well as other applicable state laws. Relationships that should be examined include physician employment agreements, leases, medical director agreements, and supply agreements with physicians. Non-compliant relationships should be identified and corrected if possible.
2. **Billing and coding.** Billing and coding is an obvious area of interest, but one that could develop into a sticky issue among the parties. The importance of cleaning up old audits, both internal and external, cannot be overemphasized. A hospital must be able to demonstrate that issues identified in old billing and coding audits (whether internal or conducted by Medicare or Medicaid) have been addressed and remediated. To this end, a hospital may want to consider conducting a re-audit to demonstrate compliance. Even if exposure seems minor,

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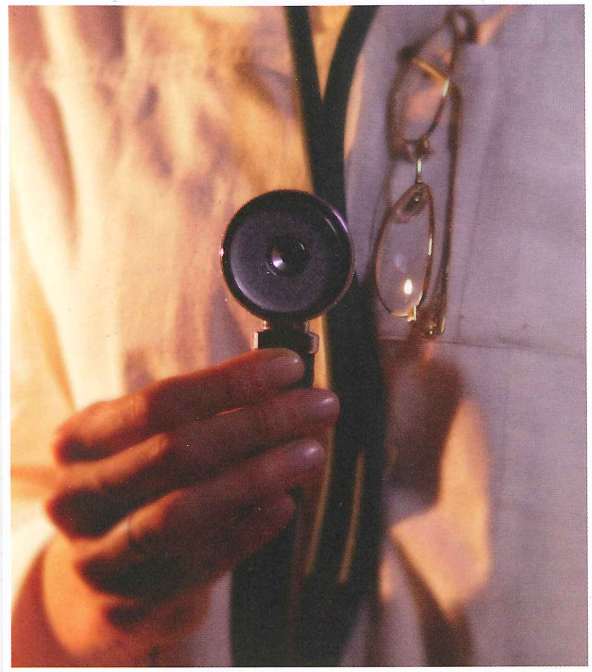
buyers will view any governmental billing and coding issues as significant.

3. **Licenses, permits, and accreditations.** Two key issues should be examined before a transaction with respect to licenses, permits, and accreditations. First, all of these governmental permits should be up-to-date and, if possible, unrestricted. Any recent suspensions or investigations by regulators should be closed out and the seller should have evidence available to the buyer that no restrictions are in place. Second, hospitals should be aware in advance of whether a change of ownership transaction will impact any healthcare licenses or permits. Most importantly, past licensure problems or survey hiccups should be fully remediated and the hospital should be prepared to explain how survey deficiencies were addressed and how the hospital has improved upon its business practices. Here, showing improved policies or successful follow-up audits can be great evidence to enable a potential acquirer to feel comfortable that a past problem has been fixed.

Before a hospital starts discussions with suitors, the critical issues of referral source relationships, contracts, culture of compliance, and billing and coding should be audited and any aberrations addressed.

4. **Bond and debt issues.** Unfortunately, some hospital transactions are motivated by recent bond covenant defaults and other issues related to debt. Non-profit health systems in particular will be keenly interested in the options for paying off or leaving in place a hospital target's bond obligations. This will focus attention on bond covenants and other debt-related issues. In preparation for a transaction, sellers should engage in a review of bond and debt issues with counsel to enable the full range of options to be discussed with buyers.
5. **Commercial insurance relationships.** Although many providers focus on Medicare and Medicaid, commercial insurers (i.e., Blue Cross Blue Shield, UnitedHealthcare) still pay for the majority of healthcare services provided in the United States. Therefore, sellers should ensure that contractual relationships with these insurers are in order. One key issue that healthcare services companies have faced is the waiver and discounting of patient co-payments and deductibles. Commercial insurers maintain out-of-network policies that apply to patients who visit out-of-network providers. In the case of non-compliance with an insurer's policy, a seller should consider a preemptive change since buyers will price compliance into a deal. In the case of a compliant policy, the seller should ensure that the policy is documented to the satisfaction of the buyer's counsel.



6. **Culture of compliance.** In this highly regulated industry, buyers will be interested in evaluating a target hospital's healthcare compliance plans, programs, and practices to ensure a "culture of compliance" exists. A seller should expect and be prepared to respond to certain inquiries including:
   - Does the compliance plan address all of the hospital's risk areas?
   - When was the compliance plan last updated?
   - Does the hospital have an active compliance officer and privacy officer?
   - Do key employees complete healthcare compliance training regularly?
   - Do hospital board minutes reflect senior management's attention to healthcare compliance issues?
   - Has the seller made a systematic attempt to solicit compliance issues from employees and partners through compliance hotlines and other approaches?
7. **Contracts.** Contracts are often a source of significant value for any seller. Core contracts may be with vendors, suppliers, customers, payers, lessors, or lenders. Consequently, a hospital must identify and review those contracts that will be the focus of the proposed transaction. Contract provisions that can cause challenges include those pertaining to assignment, change of control, liability, restrictive covenants (such as non-compete or non-solicit), and termination. The loss or suspension of payment under key contracts can translate to cash flow issues for the buyer.
8. **Patient privacy issues.** HIPAA, as supplemented by the Health Information Technology for Economic and Clinical Health (HITECH) Act, and the patient privacy obligations thereunder, must be a compliance focus for all hospitals. The Department of Justice requested over $24 million for privacy and security enforcement in fiscal year 2010 alone—demonstrating a renewed focus on patient privacy compliance issues. The failure to comply with patient privacy laws can result not only in significant civil monetary penalties, but also reputational harm. Accordingly, a hospital should have updated HIPAA and HITECH Act compliance plans, notices of privacy practices and breach protocols, and, just as importantly, have the ability to demonstrate effective implementation of such plans, practices, and protocols.

To position a hospital to capitalize on increased integration activity, hospitals considering a sale or integration with a system are urged to review these issues *in advance* of any transaction. Before a hospital starts discussions with suitors, the critical issues of referral source relationships, contracts, culture of compliance, and billing and coding should be audited and any aberrations addressed. This preparation and implementation of corrective actions will translate to fewer repricing events and obstacles to a timely closing, thereby enabling maximum value to be achieved for the community.

The Governance Institute thanks Barton C. Walker, associate, and Kristian A. Werling, partner, of McGuireWoods, LLP for contributing this article. They can be reached at bwalker@mcguirewoods.com and kwerling@mcguirewoods.com.