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REMAIN INDEPENDENT OR ALIGN?

Considerations for Choosing the Best Future for Your Hospital

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Independent community hospitals are facing increasing financial and other pressures. The federal government's threatened cutbacks for reimbursement under the Medicare and Medicaid programs, the need to upgrade aging facilities, the significant costs to keep pace with IT operational needs and the uncertainties of future health care reform are all factors that bear on a hospital's decision respecting whether to remain completely independent or to align with another hospital or hospital system. This article will address considerations important to a hospital deciding whether to remain independent or affiliate with another provider or system.

A. Consolidation Trends

Due to federal health law reform and other factors, hospitals are consolidating. In 2010, 77 domestic hospital merger and acquisition transactions were announced, marking a 33% increase over the number of transactions reported in 2009.¹ In the second quarter of 2011, 32 such transactions were reported, an increase of 78% over the number of such transactions reported in the second quarter of 2010.² This consolidation trend can be expected to continue due to likely reductions in reimbursement rates, the shift of risk for cost of care from payors to providers, expanded health care coverage and other factors.

Many hospitals are now considering whether to align with larger, better positioned organizations. Hospitals with limited borrowing capacity to replace aging facilities or to acquire IT capacity, hospitals with weak financial performance and hospitals facing significant strategic threats from competitors are all examples of hospitals that may desire to align with stronger partners.

In determining whether to align, the fundamental question that a hospital's Board needs to answer is: **"Which future course will ensure that our hospital is best positioned to continue to fulfill its mission of service to the community?"** In satisfying this fiduciary duty, a member of the hospital's Board needs to answer this question in determining whether the hospital should remain independent or align with another hospital or health system.

In answering this fundamental question, a hospital's Board can consider a range of options, from a strategic affiliation, joint venture activities (e.g., simple service agreement, surgery center or imaging center), inclusion in an "ACO like" organization or a merger.

B. Process to be Followed in Determining Whether to Align

In determining whether to align, it is important that a hospital follow a sound process so as to evaluate its options fully and carefully. The hospital's Board should think critically about its ability to continue down the path of independence. The Board should also consider all potential partners, not just those entities with which it has had the closest or best relationship in recent years.

¹ Irving Levin Associates' Deal Search

² Irving Levin Associates, the Health Care M&A Report

If the hospital desires to consider alignment options, it should formally adopt a specific process and then follow it. Steps in this process might include: i) identifying all health systems present and competitive in their market; ii) identifying key "decision criteria" by which to evaluate potential partners; iii) developing and distributing a formal partnership RFP to each potential hospital or health system partner; iv) establishing an explicit schedule and following it closely to avoid a protracted, ongoing effort to reach a decision; v) evaluating the responses to the RFP based upon the key decision criteria initially identified; vi) selecting a respondent that seems to best fit the decision criteria; vii) conducting a due diligence review of such potential partner; and viii) if the due diligence review is satisfactory, developing and executing definitive agreements.

In sum, it is important that the hospital desiring alignment sets its own process and follows it. Sticking to the process that the Board originally approved is important, especially given the pressure the aligning hospital often faces to comply with the processes of other systems with which it may be speaking.

C. Reaching the Final Destination

Once the independent hospital has identified a potential partner, the hospital should work out the key terms of the proposed transaction and reflect them in a letter of intent or term sheet. This letter or term sheet does not need to be legally binding except in certain limited respects typically concerning confidentiality, no public communications without both parties' consent and an exclusive negotiation or standstill period of several months. After a letter or term sheet is executed, the parties can then begin an extended due diligence review of each other. Whether the potential partner is a proprietary or a nonprofit entity, the prospective partner will be especially concerned about potential "big-ticket" liabilities of the independent hospital, including those relating to potential environmental problems, existing governmental investigations, Stark/AKS issues and unfunded pension liabilities. If the prospective partner is interested in structuring the transaction as an asset purchase, the partner will be less concerned about potential liabilities of the independent hospital since the partner will not assume those liabilities in the transaction.

In negotiating the key terms of the transactions, the following issues are often of critical importance to the parties: i) governing body composition including nomination, final selection and removal; ii) CEO approval and removal; iii) future capital allocation and budgets relating to operations and capital expenditures; iv) decisions respecting major transactions or changes in service lines; and v) retained powers respecting decisions which will require a super majority approval by the pertinent Board.

In resolving these critical issues, both parties are well served in following the motto "Be we." Often the most successful alignments are those in which the Board of the post-closing organization is constituted with individuals who do not represent a pre-merger constituency, but who view their responsibilities as fiduciaries to the new corporation as it exists after closing.

Before an alignment transaction can be closed, regulatory approvals are often required. These approvals may relate to certificates of need, state attorney general consents, Hart-Scott

Rodino Act filings and related approvals and other state agency approvals. In certain circumstances, the approval of a local court is also required.

D. Conclusion

Cutbacks in reimbursement and health law reform are driving many community hospitals to consider aligning with a financially stronger partner. Increasing financial risk and accountability for outcomes will also motivate providers to rethink current arrangements. Laboratory services, dialysis, rehabilitation services, home care, physical therapy, ambulatory surgery and imaging may all be future targets for consolidation. An independent community hospital should consider how best it can accomplish its mission of servicing the health care needs of the community. If it determines to investigate giving up its independence, it should establish a clear process and stick closely to it.