Ten Success Factors in Healthcare Affiliations

BY ROBERT L. SCHUCHARD, JD

As the healthcare industry consolidates, affiliations and mergers will continue to be a significant trend during the balance of the 1990s. Stand-alone hospitals will find it increasingly difficult to compete in an industry dominated by large healthcare systems and large multispecialty medical groups. Similarly, regional systems will also find it attractive to combine with other regional or national systems to enhance their competitive positioning. Merger or affiliation often makes sense as a strategic plan to respond to evolving market demands.

Before a hospital or system undertakes such a structural realignment, it is important to identify factors that can lead to successful negotiation and affiliation. An organization should consider these factors in the context of the four phases of a transaction:

Phase One: Preliminary Planning The organization determines whether a merger or affiliation makes sense.

Phase Two: Identification of an Appropriate Partner The organization decides what sort of partner to seek.

Phase Three: Courtship Leading up to a Deal The organization and prospective partner negotiate and resolve key deal points.

Phase Four: Closure The organization and prospective partner execute a definitive agreement, complete due diligence, and obtain all necessary governmental and other approvals.

The success factors are as follows:

The Strategic Plan

A merger or affiliation needs to be considered in the context of a well-thought-out and board-supported strategic plan. Peter Drucker wrote in *Managing in Turbulent Times* (Harper & Row, New York City, 1980, p. 1), "the first task of management is to make sure of the institution's capacity for survival, . . . to adapt to sudden change, and to avail itself of new opportunities."

Pressures for changes in our national healthcare policy, changing demographics, advances in technologies, a volatile economy, an increasing number of uninsured patients, and potentially decreasing governmental subsidies ensure a different healthcare climate for the rest of the 1990s.

Mr. Schuchard is an attorney with Musick, Peeler, & Garrett, Los Angeles.

Against this backdrop of turbulence and change, an organization must be able to identify issues it needs to address and adjust its long-range plan, and possibly its mission, accordingly. A facility or system must define its objectives and strategies clearly so that it can make a reasoned decision about whether an affiliation or merger will further these objectives. The governing board and management also must be able to articulate the mission and objectives and state why an affiliation can facilitate these objectives. This articulation may also be critical if the transaction needs to be "sold" to governmental agencies, such as the Department of Justice or the state attorney general. Furthermore, board members need to be conversant with the background and reasons for such a transaction in the event an action is brought asserting breach of a board member's fiduciary duty or the board is deposed in connection with a related legal challenge.

The Requirements of a Partner

As with any partnership or joint venture relationship, the identification of a partner with the appropriate strengths is critical. The strategic planning process can help identify such needs. A review of the potential affiliate's strengths and weaknesses is the logical next step. A hospital or healthcare system looking for an affiliation partner will find a variety of interested entities, and it will need to sort through the strengths and weaknesses of each. The strengths sought in a partner could include a strong balance sheet or credit rating, access to less expensive credit, a reputation for excellence of care, presence in a useful geographic area, management expertise, strong management systems, or strength in managed care.

The Negotiation Committee

The success of the courtship process also hinges on the quality and composition of the negotiating committee. In appointing this committee, the aim should be to find experienced businesspersons and forceful representatives of the various constituencies: The medical staff, administration, and board. The members of this committee must be able to make a significant commitment of time, in addition to their other commitments on the board or committees, and be able to work in a collaborative setting to achieve what is best for the organization.

Negotiating and compromising skills also need to be represented on the committee. It is unrealistic to expect that one side or the other will get all the terms and conditions it wants, in the manner it wants them. Persons experienced in the give-and-take of business negotiation need to participate in this process. Key management personnel will certainly participate, but this can be awkward if such persons are in effect negotiating with a future supervisor.

Cooperative Counsel

The tone set by a counsel can also be important to the success of the negotiations. A combative style is not preferred when one is trying to bring entities together. Prior successful dealings are one indicator of counsel's ability to work with other counsel and consummate a merger or affiliation.

Due Diligence Thresholds

The importance of due diligence cannot be underestimated. Governing boards are required by law to make informed judgments, particularly in anticipation of a decision as significant as an affiliation or merger. Thus the review of the proposed affiliates is of critical importance. Before starting this process, however, the organization should determine the types of issues that, should they surface in a due diligence review, might make the deal one that does not serve the organization's best interest. Examples are: a potential partner's financial condition that might cause the organization to fail to meet financial covenants in loan or bond documents; incompatibility of governing philosophy; large potential damage awards; or a history of problems with the Internal Revenue Service or Office of the Inspector General.

The Letter of Intent

Reaching agreement on a comprehensive letter of intent, sometimes referred to as a memorandum of understanding, is also important. Critical issues need to be dealt with up front. In this category are the amount of money to be infused by one party into the other, a decision on who will be the CEO, who will control the board, and what commitments can be made with respect to continuation of facilities or services. Other important questions, depending on the parties in the transaction, include: What will be the structure of the affiliation? Who will chair the board? What decisions will be made at the local level, versus the parent level? How will compliance with the terms of the merger or affiliation agreement be monitored?

Working on a common vision or plan is one way to determine whether the parties will be able to work together in the future to resolve other issues.

If the central or critical issues are not addressed early on, a lot of time and expense can be expended before the parties realize they have no common ground. Affiliations require the input of experienced consultants, accountants, and lawyers, who generally charge by the hour. Often these consultants are brought in to expeditiously close the deal. Consultants' fees can quickly hit $15,000 to $25,000 per month. To allow such resources to be expended without agreement on central deal points is not acting in the organization's best interest. Thus initial agreement on certain preliminary and general structural issues needs to be set forth in a letter of intent. This document will then frame subsequent discussions, which, if all goes well, will lead to closure.

A Vision and Plan for the Future

Early on, both parties need to agree on the plan and direction of the consolidated system to be created by the merger or affiliation. If the parties cannot agree on a common vision or plan, many of the other discussions will also fail to fall into place. Working on a common vision or plan is one way to determine whether the parties will be able to work together in the future to resolve other issues.

Expediting Closure

The courtship must not drag on. Once the organizations have decided to merge or affiliate, they should agree on and push for an aggressive time line, no more than four months. The transaction will be a significant source of concern and distraction to all the hospital's constituencies, and the shorter the period between agreement and closure, the better. The longer the period, the more time there is for the surfacing of tangential issues or questions that may lead the parties into distractions and possible damaging discussions. If the strategic planning and identification process is conducted positively, and if institutional support for the transaction is present, closure should be expeditiously achieved.

Continued on page 16

HEALTH POLICY

Continued from page 12

Glenn Melnick, found that hospitals in highly competitive markets provided more charity care than those in less competitive markets, but that the level of care declined over the decade as the competitive pressures increased.[5] Also, on average, hospitals could not keep up their levels of charity care. "In 1980, the average private hospital in California provided $1.2 million of uncompensated care. By 1989, the average hospital provided $2.1 million of uncompensated care. Had hospitals been able to provide uncompensated care at the same rate in 1989 as they did in 1980, the average hospital would have provided $2.9 million in such services. This difference represents a shortfall of 36 percent." The researchers attribute nearly half of this shortfall to pressure from MediCal, the state's public healthcare program; 27.6 percent to "competitive pressure"; 21.4 percent to for-profit ownership; and 2.8 percent to pressure from Medicare's prospective payment system.

These findings are particularly telling since California has experienced explosive growth in managed care and selective contracting by both private payers and MediCal. It thus may serve as a "harbinger of trends likely to appear in other parts of the United States," note the researchers. All providers committed to a mission orientation should pay attention to it. □

NOTES

1. *AHA News*, September 19, 1994.
2. "Health Care Barometer," *AHA News*, September 12, 1994.
3. "Slower Growth in Hospital Expenses, Revenues: AHA," *AHA News*, December 5, 1994.
4. Joan Pickett, "A Decade of Health-Care Ratings: Past is Prologue," *Standard & Poor's CreditWeek*, October 1994, pp. 17-18.
5. Joyce Mann, et al., "Uncompensated Care: Hospital Responses to Increased Price Competition and Payment Reform," *Health Affairs*, Spring 1995.

LAW

Continued from page 15

Public Relations and Constituent Support

Communications with various constituencies is vital. A communications consultant can help with press releases and communications to the medical staff and employees. An entity's constituencies will have a variety of concerns: Will services be terminated that affect my medical practice? Will there be layoffs? Will I have a different supervisor? Issues like these should be actively addressed in meetings conducted by management and in written correspondence.

The surrounding community may also have concerns: Will the facility we have supported for many years be shut down or sold? Will certain services no longer be available? Will we have to drive to another facility to receive services? Will we continue to have an emergency room or a cardiac center?

Medical Staff Support

Obviously, the medical staff is a key driver to the success of a hospital. If, early on, key medical staff leaders do not support a transaction, it will be difficult for the institution to rally behind it. Political or tangential issues will soon surface and become an impediment to resolving or reaching agreement on key issues. Spending time early on with medical staff leaders is important in determining and garnering medical staff support.

Not all negotiations lead to consummation of a merger or affiliation. Nor do all mergers and affiliations lead to successful partnerships. However, careful planning and attention to the factors described above will increase the likelihood of success—or, equally as important, lead to the termination of discussions when the transaction is not in the organization's best interests. □