Preparing a Hospital or Health System for Sale or Partnership Transactions

by Rex Burgdorfer and Jordan Shields, Juniper Advisory
and John Callahan, Megan Rooney, and Kristian Werling, McDermott Will & Emery

The consolidation trend in hospital and health systems continues. At this time, horizontal consolidation (hospital to hospital combinations) are keeping pace with vertical consolidation (hospital acquisitions of ancillary providers and physician groups). To address perceived inefficiencies and quality of care issues, hospitals are attempting to form larger enterprises to create scale, expand geographically, manage risk, access capital, contend with the changing regulatory environment and to more effectively manage the health of the populations they serve. Despite the trend toward consolidation, completing hospital consolidation transactions is more challenging than ever as demonstrated by an alarmingly high failure rate. Over the past several years, about 25 percent of announced partnerships have failed after the signing of a letter of intent and before close. A "busted deal" may cause economic harm and operating disruption to all involved.

One of the keys to assuring that a hospital transaction can be successfully completed is advance preparation. Advance preparation mitigates two key risks. First, preparation mitigates risk of delayed closing or a sidetracked deal due to the discovery of a regulatory issue during due diligence. Second, preparation can help mitigate against the risk of a "re-trade" on fundamental economic terms. Presenting potential issues (and their solutions) early helps to ensure that the terms of the transaction take into account all of the known risks associated with the operation of the hospital partners. Preparation can lead to a swift and more painless closure of hospital transactions at attractive valuations, thereby maximizing community benefit and the outcome for all stakeholders.

The following issues should be addressed before a hospital or health system begins discussions with potential partners:

1. Bond Issues

While hospital transactions sometimes are motivated by an actual or impending bond covenant default, bond covenants also often restrict the ability of health systems to enter into transactions with potential partners. In transactions in which a nonprofit health system is acquired by a for profit hospital management company, tax exempt bonds usually are fully discharged out of the transaction proceeds, making the bond covenants less relevant. However, in transactions between nonprofit health systems, it is common for tax exempt bonds to remain in place for some period of time post-closing. If the bond trustee has a right to consent to the transaction, the parties must plan early to seek the consent. If the bond trustee withholds consent, the parties may need to refinance the debt contemporaneously with the closing of the hospital transaction, even where there otherwise might be financial reasons to wait.

Nonprofit health systems which are acquirers also can face bond covenant issues. In many cases, bond indentures require the maintenance of certain financial ratios which can be violated if the balance sheet of the acquired hospital is consolidated. Bond covenants also often restrict health systems from assuming additional debt (such as the bond debt of the acquired hospital). In cashless member substitution transactions between nonprofit health systems (i.e., transactions in which the parent of one health system becomes the corporate member of the other health system's hospitals), the acquiring health system often makes commitments to fund routine or special capital projects on the acquired hospital's campus. Before committing to make these capital expenditures, the acquirer should ensure that its own bond covenants do not place restrictions on the amount of capital that can be spent on projects outside of acquirer's bond obligated group.

Regardless of the type of the structure of the transaction, all parties to hospital transactions should be aware of the restrictions imposed by their bonds before they consider potential transactions with partners. In addition to ensuring that there are not delays associated with the unanticipated bond approvals, the parties can develop transaction structures that account for the restrictions, or alternatively, account for the need to refinance.

2. Pension Plan Deficits

Underfunded pension plans present an issue when negotiating change of control transactions. Approximately 72% of the 460 not-for-profit hospitals that are rated by Moody's Investor Service offer defined benefit plans to their employees (referred to herein as "pension plans"). According to Standard & Poor's, the median funded status of defined benefit plans for hospitals was 69.4% in 2012, down from 72.6% in 2011. If a pension plan is significantly underfunded, that is to say that the benefit obligations under the pension plan exceed the assets held in trust to settle the accrued benefits, the pension plan represents a concern both from a liability and cash flow perspective. In many transactions, the affiliating party may adjust its financial commitment to reflect the negative credit impact of underfunded pension plans. In hospital transactions in which a hospital's assets are sold to a buyer, the buyer will likely exclude the underfunded pension plan from the transaction so that it is not legally obligated to maintain or fund the pension plan following the closing.

The seller may be required either to maintain the underfunded pension plan, or alternatively, to fully fund and terminate the underfunded pension plan (which can be expensive). From a buyer's perspective, the termination of these pensions may pose employee relations issues, or require a delicate negotiation with labor unions (potentially delaying the closing of the hospital transaction).

Prior to approaching buyers or partners, a selling hospital should have an actuarial study commissioned on the cost to fund-up or terminate the pension plan. A buyer must understand how pension liabilities will impact the preferred structure of a transaction and the operations of the acquired hospital post-closing.

3. Physician Referral Source Relationships

Large non-profit systems and for-profit consolidators alike heavily scrutinize physician referral source relationships because the financial impact of non-compliance can be substantial. In many situations, an acquiring hospital or system will require the target hospital to self-disclose any inappropriate financial relationships with physician referral sources to regulators prior to closing. This has been demonstrated in a number of recently announced settlements that preceded transactions. For example, Condell Medical Center in Illinois paid a $36 million settlement for violations of the False Claims Act that emanated from alleged below-fair-market-value leases and other alleged improper financial relationships with physicians prior to Condell's merger with Advocate Health Care.

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 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 and, if necessary, self-disclosed to the appropriate regulator.

4. Errors and Omissions (Malpractice) Coverage and Tail Insurance

Most buyers of hospitals will require that a target obtain an insurance policy (or an endorsement to an existing policy) that provides coverage for past known and unknown medical malpractice claims. This type of policy is commonly known as a "tail insurance" policy. The cost and structure of a tail insurance policy can vary widely. One of the key influencing factors on the cost of such a policy is the cost of errors and omissions insurance in the state in which the hospital operates. If the hospital's malpractice coverage (also known as "errors and omissions coverage") was expensive, the tail insurance policy will likely also be costly. If a hospital that is being acquired maintains its own captive malpractice insurance or is "self-insured" it may complicate the approach to tail insurance and there will be a need to purchase tail insurance for the captive's re-insurer. Finally, different features of the tail insurance policy itself (such as whether the policy includes demand or incident triggers) can influence its cost. Hospital management that is preparing for a consolidation transaction should be aware of the structure of its coverage and options for obtaining tail insurance.

5. 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. 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 and/or clinical practices. A hospital should be able to demonstrate improvements to policies or successful follow-up audits to enable a potential acquirer to feel comfortable that a past problem has been resolved in a reasonable manner.

Hospitals also should research in advance how a change of ownership transaction will impact any of its licenses or permits. Certificate of Need approvals or exemptions, state department of health notices, DEA notices, FCC licenses and Joint Commission or other accrediting body issues should be understood so that acquirers and the hospital's leadership can accurately convey the timeline to stakeholders.

6. Program Integrity Contractor Audit

All hospitals are dealing with the rash of Medicare and Medicaid program integrity contractors such as Recovery Audit Contractors (RAC) and Zone Program Integrity Contractors (ZPIC). Billing and coding is an obvious area of interest for potential acquirers because it impacts not only compliance, but also the quality of the hospital's earnings and cash flow. The importance of cleaning up old program integrity 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 by an outside professional or consultant to demonstrate compliance. Even if exposure seems minor, buyers often view any governmental billing and coding issues as significant.

7. Commercial Insurance Relationships

Commercial insurers (i.e., Blue Cross Blue Shield, United Healthcare, etc.) 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. Specifically, major payor contracts that are expired or near expiration should be re-contracted so as to mitigate against future reimbursement risks. One key issue that health care services companies have faced is the waiver and discounting of patient copayments 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, rather than waiting for the acquirer to later reduce its financial commitment when it discovers that the hospital's revenues are inflated due to non-compliance with an insurer's policies.

8. Compliance Program

In the highly regulated health care industry, acquirers will be interested in evaluating a target hospital's healthcare compliance plans, programs and practices to ensure that a "culture of compliance" exists. A seller should expect and be prepared to respond to questions about the compliance plan and the leaders of the hospital's compliance program.

Typical questions may include:

- Does the hospital keep a log of reported compliance issues and how they were addressed?
- Has a recent risk assessment been conducted and has the compliance plan been updated following the risk assessment?
- When is healthcare compliance and privacy training completed for employees and physicians?
- Do hospital board minutes reflect senior management's attention to healthcare compliance issues?

Involving the hospital or health system's compliance professionals early is the key to successfully preparing for these inquiries.

9. HIPAA and Patient Privacy

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 Office of Civil Rights of the Department of Health and Human Services has begun to audit and fine hospitals for HIPAA violations. For example, Shasta Regional Medical Center in California recently paid a $275,000 fine and agreed to implement a costly corrective action plan due to alleged violation of the HIPAA security rule. To avoid potential HIPAA enforcement issues, 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. Buyers and potential partners will conduct due diligence on these critical patient privacy issues to avoid successor liability issues.

10. Real Estate Restrictions

Hospital real estate may have been donated many years earlier and can be subject to restrictions on operation and/or transfer. This is of particular concern in transactions where nonprofit hospitals are converted to for-profit status. In many cases, deed restrictions can limit the use of land or buildings to charitable or non-profit uses. These restrictions also can include reversionary interests which direct that the land or buildings be returned to the original donor or to the state if the hospital is no longer used for charitable purposes. In other cases, zoning restrictions, non-competition covenants, easements and encumbrances on the title to real property can impact the ability to sell the property, to change the current use of the property, or to use the property as collateral for future hospital financings.

Consequently, a hospital must identify and review all real estate restrictions (including restrictions in lease agreements) to understand their potential impact on transactions. Where there are material restrictions on the use of the hospital's main campus, the hospital may select potential transaction partners based upon their ability to comply with the restrictions, or alternatively, may petition a court to loosen or remove the restrictions before the transaction with a partner is consummated. If a hospital is unaware of the restrictions at the time they select a partner, however, it may be unpleasantly surprised when the real estate restrictions come to light during the due diligence process, potentially delaying or derailing the transaction.

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, patient privacy, and billing and coding should be audited and any aberrations addressed. Management should have a strong understanding of pension and bond obligations and options for tail insurance coverage. 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 all stakeholders.

Juniper Advisory is an independent investment banking firm dedicated to providing its hospital industry clients with M&A and other strategic financial advice. McDermott Will & Emery is a global law firm with internationally recognized corporate and health practices. Juniper bankers Rex Burgdorfer and Jordan Shields co-authored this article with McDermott Will & Emery attorneys John Callahan, Megan Rooney, and Kristian Werling.