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This newsletter is designed to inform you about new research and expert opinions in the area of hospital and health system governance, as well as to update you on services and events at The Governance Institute.

Building a Hospital Joint Venture: A Blueprint for Success

By Barry Sagraves, Juniper Advisory, and Ken Marlow, Waller

This is the third and final article in a series examining the uses of health system joint ventures, the process of developing a joint venture, and expected trends related to these transactions.

In the first two articles, we looked back into the history of joint ventures (JVs), the factors leading to their emergence, and the potential benefits of a JV to a non-profit hospital or health system. We then looked at emerging trends in JVs and speculated as to the future directions that these models could follow to solve for rapidly evolving healthcare challenges.

In this article, we will explore the "nuts and bolts" of considering and creating a hospital JV, which will allow us to bring the hypothetical and theoretical into the practical. If you are a hospital or health system considering forming a JV, there are some important factors to think through before embarking on this complex process.

Hold It Right There—Before You Even Get Started…

JV partnerships have the ability to address many challenges faced by hospitals and health systems today. However, it is easy to "default" to a joint venture structure without thinking deeply about whether that is in fact the best way to organize collaborative activities. On the surface, a JV may appear to represent the "best of both worlds"—it can bring together the strengths of two or more organizations to create a new "super organization" (for example, the capital and community hospital operating expertise of an investor-owned company with the clinical prowess and brand appeal of a non-profit system or academic medical center). It is, however, important to not lose sight of what is driving the exploration of a potential JV formation. What are you trying to achieve as an organization? What problems are you trying to solve, and what outcomes are you seeking for your community? Do these goals align with those of your potential partners? While it's possible (and maybe even common) for partners to seek different objectives, it's also important for the structure of the JV to flow from these objectives. Form should always follow function.

All too often, potential JV partners will get deep into collaborative talks only to discover that the organizations have fundamentally different goals for pursuing a partnership. One may want to become a preeminent hub for medical research, while the partner may be more focused on creating a regional system in order to create economies of scale. One organization may want to better fulfill its charitable mission by creating a large locally governed foundation, while another partner may want to leverage the branding of the partner in order to fuel new acquisitions outside of the market. It is important to be up front with all potential partners and to clearly outline:

1. What the JV will allow you to achieve that could not be achieved alone
2. What you are willing to commit as an organization in order to fulfill these goals
3. What you are expecting your potential partner to commit

Only then can a JV structure begin to emerge that can help all parties meet these goals within existing constraints. And, who knows, perhaps the delineation of goals, expectations, and commitments will make it apparent that another new, unanticipated party should also be involved, or that a different form of relationship may be preferable. The front-end exploration of goals and form are vital to laying the groundwork for a successful partnership that will thrive far into the future.

A JV Doesn't Always Mean 50-50

A common misconception is that a JV involves two parties in a traditional 50-50 split. From the outside, this seems like the path to least resistance and the structure that will guarantee fairness and equality for both participants. However, sometimes goals will dictate unequal ownership and governance splits. It's important to consider how the ownership split should be arranged. For starters, consider these questions:

- Is one party committing more capital, expertise, time, or effort?
- Is one party exposed to more risk than the other(s)?
- Is the JV more important to one party's overall business success than it is to the other(s)?

It's important that the structure of the JV follow the level of commitment from each participant. A less-committed party (financially or strategically) can lead to the weakening of a JV—or worse, can do real damage to the other involved parties. Everyone needs a proportionate amount of "skin in the game."

Cultural Alignment: All That It's Cracked Up to Be?

One of the biggest buzzwords in hospital and health system business combinations is "cultural alignment." While it is crucial that the two organizations are culturally *compatible*, this is not the same as having cultures that are *identical*. For example, it is possible for each organization to highly value quality and employee fairness, but approach them in different ways.

A health system JV can be conceived of like an all-star team in sports. These "super teams" are made up of the best-of-the-best players from what are, usually, rival teams. While the players need to cooperate effectively on the team, they do not need to be the best of friends off the court. It is important that they have a common purpose and agree on the plan for achieving success, and be committed to the shared goal.

The Nuts and Bolts of a JV

Once a hospital/health system decides this is the path it wants to pursue, the following is an outline of how to start the process of forming a joint venture. This is written with the assumption that the organization has not yet identified a partner. If a partner has already been selected, many of these steps may not be necessary.

1. Prepare the Board and Management Team for the Process

Select an investment banker and counsel. Management and boards typically work with an investment banker to assess the needs of the market, outline strategic objectives, lead the request for proposals, set timelines, assist the parties with their negotiations, and more. A transaction advisor with experience working in this area will allow the board to take a step back, think more broadly, and may also assist in maximizing the competitive process to ensure the best partner is identified. In addition, counsel can be helpful in advising the hospital on the negotiation of the definitive agreement, assessing the potential risks and benefits of a joint venture, and assisting with regulatory approvals and other review processes.

Define objectives and review options. The process, and ultimately the partner selected, will be guided by answering some fundamental questions early. At this point, it's important to also compare a range of strategic alternatives, practical implications, and successful models. The board, management team, and investment banker should discuss the preparedness for the new healthcare environment and the expectations for overall size and positioning.

2. Arrange the Joint Venture

Sign a confidentiality agreement. By signing a confidentiality agreement, all parties involved ensure that all information exchanged will be kept quiet.

Execute an information memorandum. In the event the hospital decides to pursue the process and needs to identify the best joint venture partner, it will need to prepare an information memorandum. This document will set forth key information regarding the hospital and some basic guidelines as to the needs of the hospital and the potential strategic alternatives it is considering.

Issue a request for proposals. In order to solicit information from potential partners, the hospital (via the investment banker) will issue a request for proposals. This is an opportunity to find out the level of capital investment the prospective partner is willing to commit, its commitment to quality of care, and its historical financial performance or patient satisfaction information. In addition, assuming the hospital has identified its goals, the organization can ask specific questions to gauge the potential partner's ability to meet or enhance its goals.

Negotiate the term sheets and sign LOI. Once the hospital has identified its joint venture partner, the parties will want to work on a letter of intent or term sheet. The purpose of the document is to provide the prospective partner a chance to focus on the goals of the joint venture and make sure the partners are on the same page. Some of the following themes should be considered:

- **Leadership and governance**: The parties will need to determine what each organization will contribute to the joint venture and the ownership percentages of each. They will also want to determine which entity will control the day-to-day operations of the joint venture. Will there be equal representation on the board or will one party have majority control? Put impactful people on the board and into the management of the JV.
- **Charitable purpose**: In the event the hospital is a tax-exempt 501(c)(3) organization, it will want to ensure that its charitable purposes are being fulfilled through the joint venture's operation of the hospital. The hospital will want to confirm that the joint venture will conduct a community health needs assessment, adopt an implementation plan, and take other actions in order to comply with 501(r) requirements.
- **Financials**: An investor-owned hospital company likely will require that the financial statement of the joint venture be consolidated with the financial statements of the hospital. As a result, there may be tension between the goals of an investor-owned entity and those of a tax-exempt hospital.
- **Performance expectations**: The parties will want to identify key decisions that require approval of the parties or the governing body. If there were ever a deadlock, how would the partners resolve the dispute? For example, if the partners have made a good faith effort but cannot reach an agreement on capital or operating budgets or an additional capital contribution that may be required, do they want to have the ability for one partner to buy out the other?

3. Tell Your Story

Leadership must agree upon and communicate a well-planned, consistent, and truthful series of messages to all affected parties (employees, physicians, patients, elected officials, and payers) that accurately describes the hospital's operating environment and conditions, the available alternatives being considered, and, ultimately, the actions to be taken to accomplish the organization's goals. This step is crucial to execute prior to going to regulators, as you will want people behind you in this decision, not against you. Opposition can be your worst enemy as you head to regulatory bodies for approvals—particularly if you are considering a conversion from non-profit to for-profit in a state that has never done so.

4. Negotiate and Execute a Definitive Agreement

The partners will want to memorialize their understanding by entering into a definitive agreement, which will involve the following:

- **Contribution agreement**: This agreement provides for the contribution of capital to the joint venture. It also sets forth the ongoing capital commitments, continuation of services and requirements to maintain certain levels of indigent care, and includes the conditions required to consummate the transaction (e.g., regulatory approvals and no material adverse effect), as well as allocation of liabilities and obligations of the parties.
- **Joint venture governing document**: This agreement sets forth the rights and responsibilities of the partners. This agreement also sets forth the governance structure of the joint venture, key decisions that require approval of the members, and unwind events should the partners find themselves in a deadlock.
- **Management agreement**: In the event that the joint venture appoints a manager to run the day-to-day operations of the hospital, it will enter into a management agreement with the manager, defining their responsibilities and those of the governing body of the joint venture.

5. Gain Necessary Third-Party Approvals

The change of ownership of the hospital to the joint venture could be subject to state and/or federal approval processes, including state attorneys general for joint ventures involving a conversion from non-profit to for-profit, the Federal Trade Commission for transactions exceeding the Hart-Scott-Rodino thresholds, and Certificates of Need by the applicable Department of Health.

6. Close the Transaction

Once the previous steps are complete, the organizations will work towards a closing, which will finalize their new partnership. At this point, this is when the real work begins.

Conclusion

The successful execution of a JV begins in the planning stages. A JV's form must always tie back to its function. Only then can the mechanics outlined above properly solve for the challenges of tomorrow's healthcare landscape. Remember that while a JV can appear to be an easy solution on the exterior because it represents the "best of all worlds," its ultimate success will reside on clear vision and commitment from all participants.

The Governance Institute thanks Barry Sagraves, Managing Director at Juniper Advisory, and Ken Marlow, Partner at Waller, for contributing this article. They can be reached at bsagraves@juniperadvisory.com and ken.marlow@wallerlaw.com. Juniper Advisory is an independent investment banking firm dedicated to providing its hospital industry clients with M&A and other strategic financial advice. Waller is a law firm specializing in healthcare transactions and regulations.