



# The Governance Institute's E-Briefings



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## Welcome to The Governance Institute's E-Briefings!

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. Please note that you are receiving this newsletter because you are a Governance Institute member or expressed interest at one of our conferences.

### News, Articles, and Updates

#### Community Considerations for Hospital Transactions

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When evaluating change-of-control transactions, hospital boards need to be cognizant not only of their fiduciary duties to the corporation, but also of how their decisions will impact the broader community. Selling a hospital, especially to an out-of-town buyer, is a politically charged issue that frequently brings emotional responses from the community. If not handled correctly, public concerns can gain momentum and derail transactions that boards have specifically structured to meet the long-term healthcare needs of their communities. There have been repeated public relations disasters in which communities rightly or wrongly concluded that their hospital was sold out from under them without adequate disclosure or community input. To ensure a successful outcome, it's important to design a transaction process that anticipates community concerns and addresses them proactively and transparently.

This article suggests a number of strategies to ensure that community concerns are appropriately addressed in the design and implementation of a process, before they put transactions at risk. Within the context of the board's fiduciary duties, we will review the role of community leaders (including the often conflicting objectives of boards, management, staff, local government, physicians, and business leaders), securing investments in the community, the provision of charity care, and local control. A well-considered anticipatory public relations strategy can defuse many of these issues before they gain momentum.

Conducting a thorough, exhaustive, and open process with the assistance of a public relations firm is one of the key elements of securing regulatory approval for the transaction. Ultimately, this supports the board's goal of ensuring the long-term provision of quality healthcare for its community.

#### Balancing the Concerns of Community Leaders

As our national economy continues to migrate from manufacturing to services, so too does the role that hospitals play within the economy. Thirty years ago community members typically saw hospitals solely as places of healing and would not have characterized them also as economic engines powering regional growth. Today, hospitals are often the largest employers in town. They can also attract independent physicians who support the local tax base and local businesses. Hospitals often have large contracts with local service providers (e.g., laundry, construction, food services, etc.), as well. Given hospitals' important role in their local economies, the list of community leaders that have a stake in their success and stability is long.

With a diverse set of stakeholders, each with his or her own vested interests, the risk of an organized campaign opposing a change in ownership is high. Unfortunately, while resistance is often couched in words of concern about community control, access to care, and services for the indigent, what is quite

often at play is concern over how a transaction might impact that individual's personal or business interests. It is the board's responsibility to keep the discussion on track and to ensure that it continues to serve the interests of its organization and long-term access to quality care for the community (or in the case of impending bankruptcy to also secure the interests of the creditors). In the face of community resistance, the board should clearly communicate its objectives in exploring a transaction and work with its advisors to directly address community concerns. When those concerns are legitimate, they can almost invariably be addressed through the transaction's legal structure, financial arrangements, or included in the contractual language with the selected partner.

### **Securing Investments in the Community**

The overarching goal of nearly all hospital transactions is to support and secure the long-term provision of quality healthcare for the community. The form that this support takes, however, can vary widely, and a given transaction can include a number of different forms of economic and non-economic consideration.

Types of economic consideration can include:

- Cash payment to the seller or existing related foundation
- Commitment that the buyer will assume long-term debt and other liabilities (e.g., pension obligations, out-of-the-money interest rate swaps, etc.)
- Capital commitment by the buyer to fund strategic projects (e.g., building construction, major equipment, specific new programmatic offerings)
- Agreements from the buyer to continue the same charity care policies in place at the time of closing
- Cash that the seller leaves behind or transfers to a foundation at the time the transaction closes

The financial proceeds created from the transaction are often placed into a locally controlled grant-making foundation that continues to support healthcare in the community.

The types of non-economic consideration are even more diverse and include organizational resources to recruit and retain physicians (e.g., connections to residency programs, recruiting infrastructure, etc.), agreement by the buyer to meet quality or patient satisfaction targets, or agreement by the buyer to retain all the employees with comparable

or improved salaries and benefits. If something can be measured it can be built into the contract.

These diverse forms of economic and non-economic consideration give boards a unique opportunity through the transaction process to identify what is most important to them (e.g., net proceeds, physician network, reputation, quality, patient satisfaction, etc.) and then to work with their advisors to maximize those outcomes through a competitive transaction process.

### **Change of Control and Charity Care**

Commitment to charity care is an important consideration and one that is often of primary concern to local leaders. This issue is also usually very important to state attorneys general and other regulators who may review the transaction. It is worth noting that much of the research into the continued provision of care to the indigent after hospital conversions has found little to no impact. The article "A Statistical Analysis of the Impact of Non-profit Hospital Conversions on Hospitals and Communities," published by The Commonwealth Fund, examined the impact of non-profit to for-profit conversions on several measures of hospital community benefits, including care to the indigent, and found no impact on charity care caused by conversion.<sup>1</sup> The Economic & Social Research Institute's report for the Kaiser Family Foundation titled "The Privatization of Public Hospitals" had consistent findings that hospital conversions do not lead to reductions in charity care.<sup>2</sup> In practice, most acquiring entities (regardless of tax status) will agree to maintain the hospital's charity care policies or at least adopt a comparable policy without resistance.

### **Addressing Concerns about Local Control**

Hospital boards have a tendency to identify "local control" as an issue of primary importance when considering business combinations. When arguing the merits of local control, board members often cite the uniqueness of their communities and the need for their continued oversight in ensuring that services are not reduced. Focusing on local control, however, misses the point.

<sup>1</sup> Jack Hadley, Bradford H. Gray, and Sara R. Collins, "A Statistical Analysis of the Impact of Non-profit Hospital Conversions on Hospitals and Communities," The Commonwealth Fund, May 2001.

<sup>2</sup> Mark W. Legnini et al., "The Privatization of Public Hospitals prepared for the Henry J. Kaiser Family Foundation," Economic and Social Research Institute, Washington, D.C., 1999.

Local control is not the same thing as securing the long-term provision of quality healthcare for the community. In fact, it can be the opposite. For example, boards and management teams routinely continue to support services at their hospitals despite recurring problems with low quality, high cost, or volumes below the minimum thresholds considered necessary for the safe provision of care. It is the rare board that proactively closes its open heart program due to safety concerns from a lack of volume (e.g., fewer than 100 open heart surgeries). By confusing local control with the long-term provision of quality healthcare in the community, boards can miss opportunities to partner with strong operators that have the financial resources to invest capital, the organizational breadth to recruit and retain the highest quality practitioners, and the management resources to identify and disseminate best practices.

Another factor that is often included in the shorthand of “local control” is concern about the breadth of services that the acquirer will continue to provide. Hospital change-in-control contracts almost invariably include a commitment by the acquiring organization to maintain and/or expand services at the hospital that is selling for a given period of time. While these terms are difficult to enforce through the courts, they are rarely violated. This is because buyers have a significant reputational risk any time they fail to live up to the promises made in the definitive agreement. For example, HCA is not going to risk the system-wide national reputation of its 165 hospitals by failing to act on a small (by comparison) commitment in any given community. Acquirers need to maintain their reputations as vigilant operators if they hope to be able to grow their companies and acquire additional hospitals in the future.

### **Communicating the Board’s Fiduciary Duties**

Regardless of the type of transaction, state attorneys general always ask two questions of hospital boards:

- 1) Why is the board considering a change of control?
- 2) Why did the board select this particular suitor and structure?

The first question depends on whether the board conducted a thorough, fact-based, and well-documented assessment of alternatives. The answer to the second question must invariably be that the board approached a broad market of

buyers, arrived at a fair market value, and selected the suitor and structure for clear reasons that satisfy the board’s fiduciary obligations to the hospital organization and, if applicable, the community at large.

At the core of the board’s responsibilities in this context are the fiduciary duties imposed by state law. In general, a board of directors will have a duty of loyalty and a duty of care with respect to their conduct and decision making on behalf of the organization. These specific duties can vary from state to state, but some common principles emerge almost universally.

The duty of loyalty most commonly relates to conflicts of interest. In other words, is the board acting in the organization’s best interests, or is the board acting in furtherance of some other personal or profit-seeking motive? For example, does a particular director stand to benefit personally from the transaction? Unlike a for-profit corporation, the board’s job in this context is not to maximize profitability or a return for shareholders. In most 501(c)(3) organizations, the primary goal must be serving charitable purposes.

The duty of care is more generally focused on process and requires the board to gather all of the relevant information before making a decision. The amount of due diligence that is required can vary, depending on the circumstances. In all cases, the board should ensure that it has engaged in a full investigation of the relevant details. In the context of a hospital sale, the duty of care would usually require the board to consider other alternatives, to justify the ultimate purchase price in light of fair market value, and to evaluate any competing offers.

In addition to ensuring that the board is satisfying its fiduciary duties, it is important that the board explicitly communicate this to the public. This reassures the members of the community that the board is working in their best interests.

Breach of a fiduciary duty is a serious matter for the organization and can also result in individual liability for the breaching director. The risk of breach is heightened when boards or management teams pursue a change of control with what they believe to be the “right” partner without exploring other options. This can result in the board failing to realize significant economic (often in the hundreds of millions of dollars) and non-economic consideration for its organization

and failing to maximize the value of what is inherently a community asset.

## **Conclusion**

Because of the role that hospitals play in their local communities, change-of-control transactions are

once-in-a-generation, highly emotional, stress-laden events for their directors. This can result in boards being distracted from their responsibility to ensure the best outcome for their organizations. Boards that effectively stay focused on the underlying organizational realities of the transaction maximize value for their communities.

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