PRINT

20 Best Practices for Healthcare Mergers & Acquisitions

Written by Kathleen Roney | January 03, 2013

The current healthcare environment is creating one of the most active hospital and health system consolidation markets in decades. This is partially driven by provider responses to the challenges and opportunities created by national and state healthcare reform. In addition to complex business considerations, hospital and health system transactions implicate a vast body of state and federal laws, which complicate a transaction process, leaving many opportunities for missteps or complications.

Here are 20 best practices to help hospital and health system executives navigate the transaction process from beginning to end.

1. Conduct a preplanning process. Preplanning allows hospital executives to consider problems and issues before meeting with potential partners or undertaking a transaction.

"The biggest factor I see is hospital executives saying they talked to a potential partner and all they need is advice on how to move forward. At this point, they are already a mile down the road…You need to know where you are before you know where you're going," says Max Reiboldt, CPA, president and CEO of healthcare consulting firm Coker Group.

In order to avoid moving too quickly, Mr. Reiboldt advises hospital executives to ask the following questions.

• What do you want to accomplish?
• What are your main goals?
• Do you want to maintain healthcare in the community?
• Do you want a partner to invest in the community?
• Do you want to maintain jobs at the hospital?
• Do you want to minimize ongoing losses?

"[Hospital executives] need to understand what their hospital needs to derive from a transaction. This is one of the biggest, most often missed points," says Mr. Reiboldt.

2. Be systematic. According to Mr. Reiboldt, a hospital transaction can be an emotional process, so conducting a systematic process can help executives understand and pursue the outcomes the hospital needs in order to remain operational — without getting caught up in the emotion that may accompany a transaction. "Although emotion may play a role regardless, keeping the process as technical as possible will help. Just check things off the list," says Mr. Reiboldt.

3. Use experienced advisers early. When hospitals get ahead of themselves, they may overlook opportunities that could be beneficial. For this reason, Geoffrey Cockrell, JD, partner at McGuireWoods, recommends that hospitals engage experienced transaction advisers in the preplanning phase.

"A hospital may think [it has] considered all potential options, but an experienced adviser could expand the choices the hospital may consider. For example, I was working on a transaction in the Midwest with a fairly rural non-profit hospital. The hospital was eventually acquired by a large East Coast health system. This transaction was not on the hospital's horizon initially, and it ended up being the best choice," says Mr. Cockrell.

What may feel like the most obvious candidate may be wrong for reasons that are not obvious initially. Taking a step back to think more broadly is critical.

4. Build a strong team. Once hospital executives make the decision to move forward with a transaction, they need to build a strong transaction team. In order to maximize the potential of the deal, Mr. Cockrell and Mr. Reiboldt recommend choosing a few key people for the beginning of the transaction, and then adding others into the process as it develops.

"At the beginning, you may build your transaction working group with members of the executive team, members of the board and the hospital's legal counsel. Then, you'll need to bring in someone who manages the transaction process for a living. You need that person in there especially for the regulatory and/or health department review process. The final person in the group should be a finance expert or investment banker who knows how to run a competitive process," says Mr. Reiboldt.

While a hospital may need a specific and small team for the beginning stages of the deal, later on in the process executives may want to bring in other stakeholders. "Different constituencies of the transaction — medical staff, the nurses union, joint venture partners or local government members — may have different thoughts and views on what is going on. While they aren't part of the working group, keeping an eye on them will help. The last thing an executive team wants is to get bogged down with material that can cause delays and could kill a deal," says Mr. Cockrell.

5. Slow down, spend time on partner selection. While it is logical for an executive team to want to keep momentum in the transaction process, nothing can substitute for applying due diligence and a systematic method when selecting a partner.

"There are a variety of entities that could be a great partner — for-profit, non-profit or private equity fund. It goes back to the planning aspect of the process and laying things out," says Mr. Reiboldt.

Mr. Cockrell agrees. "You do not know who the right suitor will be. There is a lot of benefit to a systematic process. You may think one hospital is a perfect match, but it is hard to gauge which hospital will really be the right partner without a systematic, diligent process," he says. "Make sure you understand the issues or all the skeletons in the closet so to speak. They don't come out of nowhere. Running due diligence brings them to light at the front end."

6. Allow decision making to evolve through the process. Ideally, a hospital board will allow the transaction decision making to be gradual and comparative. "We advise boards to simultaneously explore their options — all the strategies they can pursue and the range of partnership models they can undertake," says Rex Burgdorfer, vice president at Juniper Advisory. "With all the options hospitals have at their disposal, a common thing we hear is that boards feel overwhelmed by the obligation or duty to understand all their options. This can be an important and difficult time."

For this reason, the hospital board should refrain from finding only the best partner, but instead accept alternative proposals, refining objectives during the process instead of before.

"It may be counterintuitive to folks on the board. They may think it is best to start the [transaction] process with a clear expectation of where the transaction will end. However, you can also make mistakes by starting a process zeroed in on one affiliation partner or one structural idea," says Mr. Cockrell.

7. Run a competitive process. In order for a hospital to have a basis of comparison, it needs to create a competitive process and use that competition in its decision.

"The hallmark of good decision making is a basis of comparison. Competition helps a board evaluate transaction options outside of a vacuum — in an academic, hypothetical way. It helps them understand and learn from the market of companies they might work with," says Mr. Burgdorfer.

A competitive process will help accelerate the timetable to the selling or target hospital's advantage, maximize its negotiating leverage and help it evaluate alternatives on a relative and absolute basis.

8. Focus on fundamental goals of the transaction. When there is a clash within the hospital's board and/or with the potential partner's board, Dale Van Demark, JD, partner at EpstienBeckerGreen, recommends putting the issues in perspective by focusing on the fundamental goals of the transaction.

"Does the issue impact the possibility of achieving those fundamental goals? If the answer is no, then it becomes less of an issue. If the answer is yes, then there can still be a path forward but perhaps with more compromise," says Mr. Van Demark.

9. Write a detailed letter of intent. According to Craig Garner, JD, independent attorney and healthcare consultant and former CEO of Coast Plaza Hospital in Norwalk, Calif., it is important to emphasize detail in the letter of intent when beginning transaction discussions.

"Even though it may not be binding, it provides an outline of the transaction. If you are dealing with individuals who honor their word, they will use it as a template for developing the deal," says Mr. Garner.

For instance, when Mr. Garner negotiated the sale of Coast Plaza Hospital to Avanti Hospitals in 2011, the letter of intent between Coast Plaza Hospital and Avanti Hospitals included:

• Acquisition structure (asset versus stock purchase or merger)
• Parties to agreement
• Assets and liabilities to be purchased and excluded
• Regulatory considerations
• Valuation
• Payment terms
• Confidentiality
• Diligence

10. Do not get distracted by peripheral issues. According to Mr. Cockrell, board members need to keep the core issues of a transaction in mind instead of letting peripheral issues dominate the discussion. For instance, if a larger hospital is partnering with a small, community hospital, the community hospital's board would need to stay attuned to the larger hospital's vision for providing services. "Making sure the acquiring hospital is committed to a suite of services at the acquired hospital is a core issue to keep an eye on," says Mr. Cockrell.

11. Look to the hospital's mission for inspiration. When an issue comes up during discussions or preparation for a transaction, the board should think back to the hospital's principles and/or mission.

"Whatever the issue happens to be — does it impact your organization's mission?" asks Mr. Van Demark. "My experience is that very few issues really come down to that fundamental point of mission, but it is always a good question to ask because it focuses individuals on why they are [conducting transaction discussions] in the first place," he adds.

12. Keep lines of communication open. It is important to keep appropriate and clear lines of communication open at the board level so if issues come up during the course of the transaction, there is already a great foundation for productive discussion. "If you are very clear on your hospital's mission and goals with respect to a transaction, and they are communicated very clearly and consistently to the other party throughout the course of discussions, then it is less likely for misunderstandings to arise," says Mr. Van Demark.

13. Keep the interests of stakeholders in mind. According to Mr. Van Demark, it is important to stay aware of stakeholders' interests when dealing with transaction issues among hospitals' boards.

"I find this is sometimes ignored. However, whether the stakeholders are the hospital staff, physicians, lenders, regulators, patients or the political community, they may influence the ability to complete a transaction," says Mr. Van Demark. "It is always important when dealing with board clashes to understand how constituent groups might look at the issue," he adds.

Mr. Cockrell agrees. "Some stakeholders can get worked up about the wording of a contract," he says.

14. Use competition as leverage to negotiate price and terms. Competition during a deal becomes beneficial when negotiating the best price and terms during a transaction. According to Mr. Cockrell, there are various structures and types of considerations that have significant value implications. For instance, community hospitals associate considerable value to non-price matters (e.g., programmatic support, working capital, interim capital expenditures and commitment to services).

When a board allows competition in its transaction process, it may have more leverage with the potential partners to negotiate for a structure that allows for these non-price matters or a structure that has market value as well as value to the community.

For instance, competition during the process can help a selling hospital encourage an acquiring hospital to agree to softer issues that may be of particular importance to the community. The competition will help the hospital find the partner that appreciates and agrees with the soft issues.

15. Expect to give and receive full disclosure during due diligence. According to Mr. Garner, the due diligence process between Coast Plaza and Avanti Hospitals moved quickly because the work group was small and efficient. Although there were a couple of phases of due diligence — initial diligence prior to the letter of intent, from LOI to definitive agreements and from definitive agreements to close — the process was streamlined by cooperation from both sides.

Avanti Hospitals' diligence requests were more substantial than Coast Plaza's. For example, Avanti requested information on Coast Plaza's financials, corporate organizational documents, employees and ERISA, third-party vendors, real and leased property, tax and environmental compliance, intellectual property, inventory and joint ventures, to name a few. Coast Plaza diligence focused primarily on information relating to the financial viability of Avanti and its retained liabilities.

Cast Plaza's willingness to respond to all of the requests for information about Coast Plaza helped the deal conclude successfully. "I wanted to make sure that we made all disclosures. I wanted to do this only once, and do it right," says Mr. Garner.

16. Document transaction steps so the deal is defensible. A hospital and its board can never predict the reaction of the community when they propose a transaction. In addition, the length and intensity of an attorney general or Federal Trade Commission review is unpredictable. In order to have a strong defense for the rationale behind the transaction, the board needs to document its strategic goals and objectives as well as the extent to which the board and any advisors conducted a competitive process. Barton Walker, JD, attorney with McGuireWoods, recommends documenting the following:

- The board's strategic needs and objectives including management updates from the past 12 months.
- The extent to which the board and its advisors conducted a competitive process.
- The comprehensiveness and rigor of the market-clearing process (e.g., how many partners were contacted and what ownership forms were considered).
- The fairness and openness of the transaction as viewed by regulators and other stakeholders (e.g., competitors, lenders and payors).
- The responses that were requested of these partners (e.g., what financial and non-financial issues were addressed and how the responses were documented in instruction letters and proposals).
- The extent to which a detailed comprehensive analysis of the proposals was reviewed with the board.

17. Manage confidentiality. One of the most important objectives for a board is to manage the confidentiality of transaction discussions. The board and the hospital will benefit from a broader search, which it will have time for under confidentiality. When there is a risk of a confidentiality breach, a broader consideration of partners is not as feasible.

According to Mr. Burgdorfer, a strong confidentiality agreement is important for the following reasons:

• To protect sensitive information from competitors.
• To preserve management's focus on business.
• To manage employer perceptions.
• To avoid erosion of admissions by physicians.
• To avoid third-party interference with the transaction (e.g., state agencies, competitors, payors and unions).

"A transaction may be a decision made once over a 100-year life cycle that involves hundreds of millions of dollars of community value," says Mr. Burgdorfer.

Risking the confidentiality could jeopardize the whole deal.

18. Design an integration strategy. Once due diligence is completed, hospitals need to plan an integration strategy, which helps to capture the positive synergies identified early on in the integration process. According to Bill Baker, partner and head of transaction services for healthcare at KPMG, this is a key driver for financial success.

"[KPMG's] history with transactions tells us that [a hospital is] much better served by quickly working on the integration. Many times we work with our client to immediately begin integration planning once they are comfortable that a transaction will occur. This will help you start executing integration the day after closing," says Mr. Baker.

The ultimate goal is to accomplish strategic objectives as well as reach a financially stronger position post-transaction. According to Diane Hueter, senior knowledge leader with Greater Yield, a change management consulting company, multiple integration details — such as culture, medical staff, support needs, board structure roles and responsibilities and change management — have to be addressed to reach that goal.

19. Prepare for questions from regulators. In many cases, regulatory review cannot be avoided in a healthcare transaction. For this reason, hospital officials need to practice pre-transaction diligence in order to be prepared for potentially lengthy and in-depth reviews, especially when the FTC or a state attorney general can halt a transaction. According to Jim Riley, JD, healthcare attorney at McGuireWoods, state attorneys general tend to ask four main questions. Among others, hospital officials should address the following questions:

• **Why is the board considering this transaction?** According to Mr. Riley, the answer should be that the board conducted a thorough and well-documented options assessment, and the board concluded this transaction is the best way — if not the only way — for the hospital or health system to survive. In addition, the board should show that this transaction is the best method for the hospital to position itself for success in the future.
• **Why did the board pick the particular suitor and structure?** When officials are asked this question by an attorney general, they should be prepared to show that the board went to a broad market of buyers, arrived at a fair market value and selected the suitor and structure for clear, well-documented reasons that satisfy the board's fiduciary obligations.
• **Is the value to be received "fair market value?"** According to Mr. Riley, the answer should be that through independent valuation and the transaction process the board achieved fair market value for the transaction.
• **If the hospital is tax-exempt and if there will be proceeds from the transaction retained by the seller, how will it be used?** "The answer should be that the board will ensure the funds are used in furtherance of the hospital's mission," says Mr. Riley.

20. Craft transaction message carefully, have proper documentation. Proper documentation will not only help with FTC and regulatory review but with community and stakeholder communications. Mr. Riley recommends that hospitals tightly control messaging and clearly present the transaction to the community and stakeholders as a solution or path forward. On the other hand, sellers should not minimize the severity of the situation or hide any information, such as information they failed to document properly or effectively evaluate. In order to document properly, a hospital board should follow these three steps to arrange documentation:

• Ensure board and committee minutes are complete.
• Ensure all policies and procedures are up to date.
• Gather anticipated diligence materials and governance documents.

Although the structure of a healthcare transaction can take many forms, the best practices for successful partnership searches, negotiations, due diligence and final agreements apply to each situation. The above 20 best practices may help hospital and health system executives as they explore and pursue transaction opportunities.

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