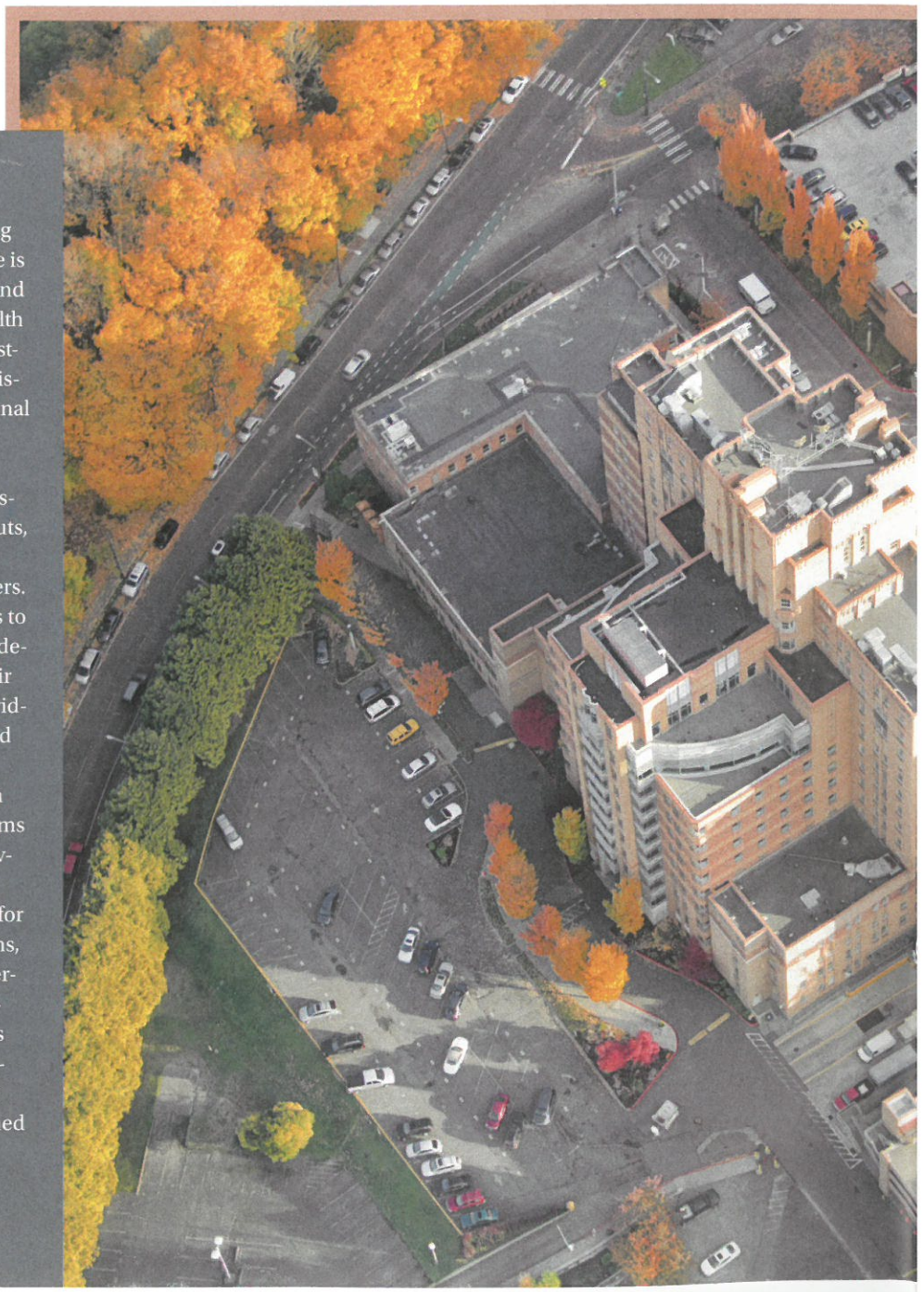
PUBLIC HOSPITALS AND PARTNERSHIPS

By Jordan Shields and Ken Marlow

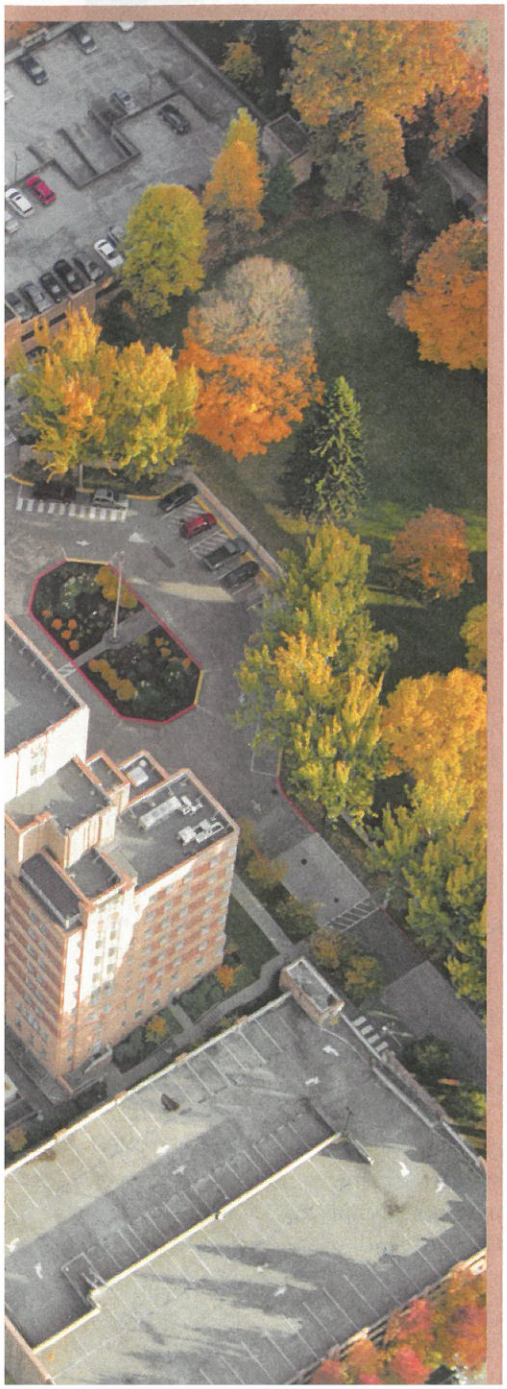
Government-affiliated hospitals face distinct challenges when collaborating with other organizations



Hospitals and health systems face an array of compounding pressures. Chief among these is a shift to population health and value-based care models that require health systems to not only continue to make investments in information technology, administration and care, but also take on additional financial risk.

At the same time, other challenges abound: slowing revenue growth, increasing expenses, outright reimbursement cuts, migration from inpatient to outpatient services, yawning pension gaps and others. As a result, hospitals are examining ways to position themselves to improve quality, decrease costs, increase scale, improve their position relative to vendors, service providers and payers, and become the preferred health system in their respective region.

Although these pressures are common to virtually all hospitals and health systems regardless of ownership or tax status, governmental hospitals often perceive that these pressures are perhaps more acute for them because of their patient populations, restrictions on capital, complicated governance structures and disclosure requirements. As a result, many public hospitals are participating in discussions with prospective partners, whether they be other governmental, 501(c)(3) or investor-owned health systems.



The range of governmental hospitals and partnership options is broad and includes hospitals that have some form of state, city, county, district, hospital authority or public trust involvement. This includes 501(c)(3) organizations that lease their facilities from governmental units, as well as quasi-governmental facilities with lingering public oversight. Related to partnerships involving these organizations, this article will address certain predominant structures when relevant but use the terms partnership and combination to include the full array of structural alternatives including leases, asset purchase agreements, membership substitutions, joint operating agreements and joint ventures.

The resulting partnerships involving public hospitals include special governance, political, legal, business and regulatory considerations, which are relevant to boards because they affect how governmental hospitals can come together with partners. This article explores the unique attributes of public hospitals and the resulting restrictions and nonhealth care responsibilities they face when considering partnerships. Key considerations include ownership and governance, approvals, sunshine laws, political considerations, sovereign immunity and antitrust protections.

Ownership and governance

Unlike community 501(c)(3) hospitals that typically have self-perpetuating boards, public hospitals have distinct, identified owners. The state, county, city, district, hospital authority and public trust entities exert their ownership control in different ways. This can range from tight control, with the governmental entity appointing the hospital board and approving all decisions, to loose control, with the governmental entity fairly removed from a semiautonomous 501(c)(3) entity. Regardless of how they assert their control, the objectives of the governmental entities may differ from those of public hospital boards.

For state, county and city hospitals, differences include the governmental entity's broad mandates to serve its constituencies beyond health care. For example, capital requests from the hospital can compete directly with capital requests for roads, public safety, prisons or schools. Also, some government authorities may face constraints in accepting covenants that bind the actions of subsequent boards, whether they be service commitments, capital improvement commitments or other specifically negotiated covenants.

Districts, hospital authorities and public trusts have narrower mandates, generally focused on health care. They do not, however, escape the divergence in objectives faced by their governmental-entity cousins. The same tax, service and divergent board priorities surface here as well.

Approvals

Governmental ownership may mean that the hospital board does not have ultimate authority to partner without approval. These approvals can take different forms, including a vote of the commissioners, a referendum or statutory approval. These approval processes are complex, require a number of coordinated efforts of the parties, may have

TRUSTEE TALKING POINTS

- Public or governmental hospitals are seeking partnerships to address changes in the health care landscape.
- Partnerships can take place with other governmental, nonprofit or for-profit organizations.
- Such partnerships carry their own special and often complicated governance and regulatory restrictions.
- Board members need to be educated and prepared to bring these partnerships through to completion.

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immunity from liability, and may result in having the partner entity absorb the liability. Working with counsel is important to understand what types of partnerships may trigger what types of approvals, as well as the regulatory, statutory or other approval processes.

As a result of the approval processes and the time it takes to work through them, along with the fact that input from constituents may cause further review and negotiation of the definitive agreements, it is not uncommon for the transaction timeline to be extended significantly and for the parties to find an increase in the number of issues to resolve. Approvals and timing can be further complicated by sunshine laws that apply to governmental hospitals. These issues create increased opportunities for a transaction to fail before completion.

The potential for long timelines is one reason that many governmental hospitals pursue management contracts and leases, even when their internal reviews have found that a membership substitution transaction or outright sale might meet their objectives better. Because management contracts and leases typically trigger fewer approvals than mergers and outright sales, they can be achieved more quickly, lowering the risk of transaction failure.

Sunshine laws

While regulations vary by state, governmental hospitals often face such daunting disclosure requirements as providing public access to books, records and planning documents; holding most meetings in public; and maintaining open-bidding procedures. Further, it is not atypical for competitors to review copies of public hospital strategic plans, attend board meetings and gather all manner of competitive intelligence, potentially anticipating and reacting to public hospital strategies before decisions are finalized. In a time of rapid change, the competitive and operational overhang of these disclosure requirements adds momentum to combination discussions.

As part of the governmental review process, sunshine laws can require that the definitive agreement be made available to the public for review and, often, comment. This can make for difficult negotiations between the parties when the covenants and commitments are available for public scrutiny, particularly because outside constituents do not have the same responsibilities to the health of the community and hospital that the fiduciaries hold. Disclosure also can make partners less willing to make certain financial and nonfinancial commitments, because they worry that a public agreement quickly will become their de facto starting position for all future partnership negotiations. Boards may wish to seek expert advice to help reduce the impact of disclosure requirements on partnership outcomes.

Politics

Nonprofit hospital boards focus mainly, if not exclusively, on how partnerships will affect health care delivery. The governmental owners of public hospitals, however, balance a wider range of considerations. It is not uncommon for a city to sell its hospital and use the proceeds to buy police vehicles or build a new high school. Understanding the motivations of the owner — and how to work toward a partnership that meets all parties' needs — is an endeavor that cannot start too early in the process. In addition, health system partners should be aware going into the partnership that the governmental hospital may have enjoyed certain benefits, like access to tax-supported revenue bonds or exemption from certain employment regulations, and that those benefits may go away post-transaction.

Similarly, tax issues can flare up in governmental-hospital partnerships. Tax support of public hospitals is not uncommon and has implications for a partner likely to lose this support. Less common

are successful public hospitals that transfer earnings back to their governmental owners. Additionally, the prospect of a tax-supported hospital flipping to become a property-tax-paying entity occasionally has resulted in governmental entities advocating for investor-owned buyers.

> "Education and preparation can help boards to avoid costly and time-consuming mistakes."

Other considerations

In any partnership, the entities need to review pension, labor and liability issues. Treatment of public hospitals, however, requires special consideration of these topics. Governmental hospitals can enjoy certain protections that traditional nonprofit hospitals do not. It is important for nonprofit hospitals to understand these protections up front to ensure that their expectations for the partnership are valid.

Like religiously sponsored systems, governmental hospitals are exempt from Employee Retirement Income Security Act requirements. The loss of this exemption when a public hospital joins a system that is subject to ERISA can result in increased pension liabilities over and above what is recorded on the public hospital's balance sheet. Further, if the pension plan is still active, there may be specific steps needed prior to closing beyond meeting the ERISA actuarial funding requirements. Governmental entities also enjoy immunity from certain state and federal employee protections, which may be triggered at closing. Sovereign immunity protects public entities from certain tort claims, including particular medical-malpractice actions, thus lowering the cost of insurance.

Other implications after closing include the statutory inability of many public hospitals to indemnify their partners. Public hospitals may have immunity from liability, requiring the partnering entity to absorb these potential liabilities or insure against them. Nonprofit boards should seek advice on tail insurance and other protections to shield their organizations from liabilities not formerly faced by a governmental partner.

Certain state, county and city hospitals have benefited from their exemptions to the federal antitrust statutes. While it is important to receive early input from experts regardless of ownership of the partner, the nuances of governmental-hospital antitrust protections and their implications for the partnership deserve a board's special consideration. On the business side, nonprofit hospitals also should consider the impact of the combination on future growth. These are both examples of the limited areas in which governmental ownership can be an asset to the partnership.

Be prepared

When public hospitals and health systems actively engage in discussions with potential partners, it is important to recognize the hospitals' special governance, regulatory and political features. Understanding the related issues early in conversations is key, allowing both parties to limit distractions and achieve outcomes that meet their needs. Education and preparation can help boards to avoid costly and time-consuming mistakes. We expect to see more historically slow-to-partner public hospitals pursuing transactions as the field rewards nimble, integrated systems of high quality and low cost. T

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