The Governance Institute's E-Briefings

Volume 9, No. 1, January 2012

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

Protecting Corporate Value during an Ownership Transition

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Much has been written about the fiduciary responsibilities of hospital board members that are considering business combinations. Another important issue that has received less attention is *leadership continuity* throughout the transaction process. Increasingly, there has been harmful senior management and board member turnover during the consideration and pendency of transactions.

Hospitals typically have rolling terms for board members, along with employment contracts and policies for their executives. However, these are often inadequate in the context of transactions involving ownership change. The elephant in the room for most boards exploring a transaction concerns only the post-closing impact of the transaction on the executive team. Juniper has observed the serious disruption that board and management dislocations during the transaction process can have on transaction outcomes. While this is a sensitive topic, failing to address it can diminish value. Management and board turnover has frequently led to lost partnership opportunities, lost vision for the future of local healthcare, lost consistency of organizational objectives, lost time (which is never good for sellers), and, on occasion, millions of dollars in lost consideration.

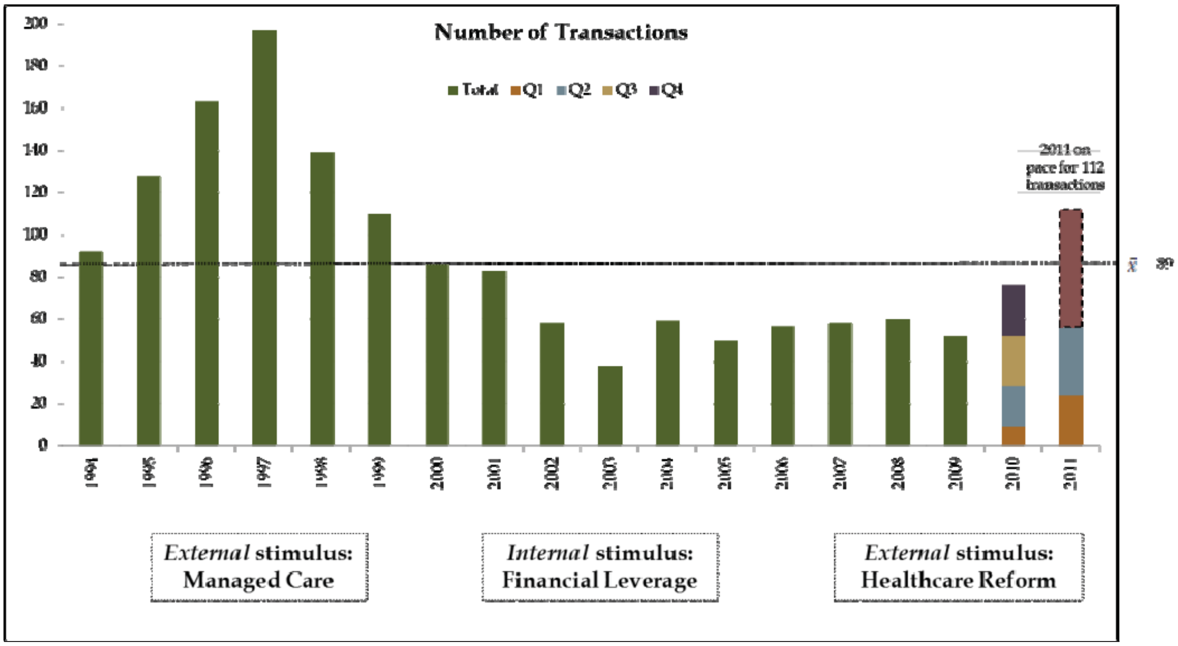
Background

This topic is increasingly relevant as consolidation pressures mount in the healthcare industry. More hospitals, both independents and systems, are (or will be) considering fundamental decisions regarding their futures. Management teams and boards are actively assessing the likely impact of health reform, including the adequacy of organizational resources to effectively implement ACOs, respond to market competition, and increase physician interest in employment models. As a result, they are evaluating affiliations, sales, and mergers as tools to be used to meet their organizational needs. Given that these are always substantive and often anxiety-provoking conversations, organizations require management and board leadership stability to thoughtfully reach consensus on the long-term direction of the organization.

The currently high volume of hospital merger and acquisition activity has not been seen since the 1990's. Then, the emergence of health management organizations drove hospital consolidation as a way of addressing underlying costs (see **Exhibit 1** on the next page). Today, the key factors leading boards to consider business combination transactions center upon:

- An increased need for scale to cope with declining prices and higher costs
- Vertical integration and regional coverage to strengthen contracting and quality
- Access to capital is increasingly dependent on size as a result of the growing sophistication of the municipal bond markets and a "size penalty" imposed on small providers by the rating agencies
- The need to develop "systems of care" as the reimbursement environment shifts from fee-for-service to "fee-for-health"

Exhibit 1: Number of Transactions (1994–2011)



Change-of-control transactions may or may not be the right answer for organizations. They do, however, merit serious consideration as both healthy and struggling organizations face a dynamically altered future for the industry. These sorts of transactions represent a *material professional risk for senior management*. Successful evaluation and execution of transaction opportunities also demands increased attention from both senior management and volunteer boards. For these reasons, it is important for organizations to have the right measures in place to foster a thoughtful and unbiased assessment of how best to secure the long-term provision of quality healthcare in the market.

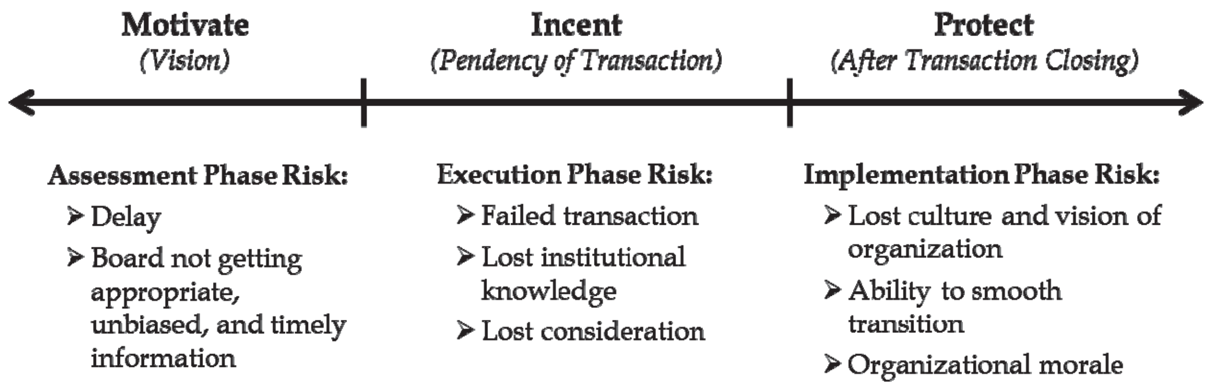
Juniper regularly encounters CEOs who have no contractual protections and yet have advised their boards on the need to consider strategic alternatives. It should be noted that they do this based upon an overriding concern for the future of the organization, but at great personal risk. Boards often fail to recognize that the lack of protections for management under these circumstances might result in *de facto* incentives for management teams to avoid transactions. Change-of-control represents both significant additional work for executives over the course of the transaction, and the potential end of their role with the organization. Contractual protections for executives help relieve management of potential conflicts. Furthermore, financial incentives for senior executives can relieve inherent biases related to the additional effort required of those managers in the event of a transaction.

As described below, the costs associated with failing to secure the continuity of organizational leadership throughout the transaction process can have material negative financial and organizational implications. With industry-wide hospital CEO turnover ranging from 14–18 percent per year for the last 20 years, there is a significant risk of management turnover at all times. When this turnover occurs immediately preceding, during, or immediately after the pendency of a transaction, the negative repercussions can be large.

The Importance of Continuity throughout the Transaction Process

The need for management continuity and unbiased, thoughtful input from the board exists throughout the transaction process, and takes on distinct forms within each phase of a transaction. Below, we break transactions into three major segments—assessment, execution, and implementation—and discuss the role of continuity within each.

Exhibit 2: Common Risks in Each Transaction Phase



Assessment Phase: Motivating Management

Before transactions get underway, management wields significant influence over what opportunities organizations consider and how those opportunities are perceived. Without appropriate managerial safeguards, boards are effectively incenting management teams not to consider the full range of strategic options open to their organizations. Managers have the ability to thwart transactions before they are even considered by not educating their boards, moving slowly when opportunities present themselves, or by subtly steering their organizations away from partnerships. Additionally, if senior managers decide to leave as the board moves toward considering a transaction, they can be hard to replace because it is difficult to hire strong executives to fill positions at organizations considering transactions.

Typical management employment contract terms that boards should be discussing with their advisors:

- ✓ Change-of-control payout
- ✓ Termination clause
- ✓ Retention bonus

For these reasons, boards are encouraged to consider incentives aimed at eliminating unintended biases inherent in standard executive contracts. By including change-of-control payout, termination, and buyout clauses in executive contracts, boards can ensure that the financial disincentives are removed. These encourage executives to bring information forward to the board and allow the board to complete its fiduciary duty and assess its full range of options.

Execution Phase: Incenting Management

From a financial standpoint, the execution phase of a transaction, which includes the period between the hospital going to market and closing the transaction, represents the greatest risk to executive retention. Suitors seek stable organizations and departing executives can damage employee morale, create uneasiness amongst physicians, and become distracted and less likely to anticipate and address competitive threats. Depending on when they occur during the execution phase, departures can also significantly slow down the process, which is generally not good for sellers.

Executive continuity is especially critical during this phase, however, it is a period when executives often feel most vulnerable. While it is routine for suitors to maintain executive leadership, this varies widely and is difficult to enforce unless explicitly included in the definitive agreement, which does not come until late in the transaction. Additionally, recruiters and rival systems are aware of this vulnerability and often increase their courtship of managers at organizations considering transactions.

The impact on value of losing executives is not limited to the CEO. For example, if a CFO departs, the organization can lose an important knowledge base related to significant terms in the transaction (e.g., the calculation of working capital, paid time off, and receivable activity). As a result, the organization could potentially miss opportunities to most-effectively negotiate alternative offers and fully represent its value to the market. With the loss of management, organizational history and implicit policies and procedures can also be lost. Even when this knowledge can be recovered, it typically slows the process, creating risk for the seller.

Implementation Phase: Protecting Management

After the transaction closes, management's institutional memory can help ensure a smooth transition to new ownership. They can help maintain the culture and vision of the organization and foster employee and community morale. While retention clauses are generally offered for this phase of the transaction by the acquiring organizations, they are only relevant for executives who have been retained up to this point. If executives expect to be released immediately after closing or have limited confidence in the purchaser to retain their positions, they are at risk of leaving, even when they have execution phase incentives. These execution phase incentives can be "bought out" by recruiters taking advantage of vulnerability before the transaction closes. Therefore, it is important to have safeguards. Ideally, these would be in place before the assessment phase to protect management after a transaction closes so as to incent their retention throughout.

Board Continuity

Like management turnover, board turnover during the transaction can damage the organization. This can occur for a variety of reasons, including board members deciding to roll off as time demands increase through the transaction process, board members who leave during the normal board cycles, and board members who decide they are not interested in serving in an advisory capacity vs. fiduciary capacity if the role of the board changes post-acquisition.

During the assessment phase, board members—especially board leadership—should apprise themselves of the demands of the transaction process and, if they decide to stay on, commit to remaining in their positions throughout the transaction. This is typically a one-year commitment but can vary depending on individual organizational circumstances.

Continuity of executive and board leadership throughout the transaction process is critical to ensuring effective outcomes and maintaining organizational value. These issues should be discussed openly *before* organizations begin considering transaction alternatives in order to minimize inherent biases and maximize outcomes. Boards that effectively ensure continuity preserve value and are more likely to make the best long-term decisions for their organizations.

The Governance Institute thanks David C. Gordon, principal, and J. Jordan Shields, vice president, of Juniper Advisory, LLC for contributing this article. They can be reached at (312) 506-3000 or kmaloney@juniperadvisory.com.