

GREAT BOARDS

December 6, 2010

Governing Board's Role in Mergers and Alliances

Healthcare reform is expected to drive a new round of mergers, acquisitions, and strategic alliances among hospitals and other providers.

Consolidation in the healthcare industry is a trend dating back several decades. From 1995 to 2008, the number of hospitals in the U.S. declined by nearly 500, but the number of hospitals in systems grew from 2,040 to 2,488, and the number of hospital systems grew from 253 to 330, according to data from the American Hospital Association. Some 55% of hospitals are in systems today, up from 45% in 1995. The primary drivers for consolidation have been a desire for financial strength, access to capital, and the scale to leverage operating efficiencies across a larger organization.

The implementation of the Patient Protection and Affordable Care Act (PPACA) and related market forces will add new imperatives for providers to consolidate and use scale to drive out costs. If bundled payments supplant fees for service, and if the government can drive prices lower through Medicare rate setting and insurance exchanges, hospitals will face new demands to be accountable for value and outcomes across the care continuum. Marketing and branding will become more important to distinguish offerings to insurers, employers, and insurance exchange customers.

The implementation of the Patient Protection and Affordable Care Act (PPACA) and related market forces will add new imperatives for providers to consolidate.

As a white paper this summer from The Governance Institute noted, “Since the recent passage of healthcare reform, nonprofits have demonstrated much more interest in achieving scale. Also, a number of free-standing hospitals and small hospital systems are questioning whether they can thrive post-healthcare reform, without becoming part of a large system.”

A consolidation strategy goes to the core of a governing body’s fiduciary duty to preserve the organization’s long-term viability to sustain its mission. Directors should ask whether consolidation will strengthen the organization’s finances, operations, market position, growth potential, and core values, and thus support its mission. Or conversely, will consolidation dilute resources and damage stakeholder relationships?

For organizations “merging as equals” or being absorbed into a larger entity, consolidation also brings out a powerful emotional factor: loss of autonomy. As my colleague Ed Kazemek has written, “the decision to remain independent or join (or create) a larger system is the most profound decision a board can make, and a potential to change control requires the board to perform at its highest fiduciary level.”

Preparing for a Consolidation Strategy

Boards can take a number of steps to prepare for strategic decisions involving mergers and acquisitions (M&A) and strategic alliances.

1. **Build competence.** Recruit or add one or more directors with experience in M&A, as well as directors with healthcare experience from outside the community. Such individuals can add both expertise and objectivity.

A consolidation strategy goes to the core of a governing body’s fiduciary duty to preserve the organization’s long-term viability to sustain its mission.

2. **Build connections with target communities.** If the organization has its eye on a consolidation involving a facility in particular community, consider recruiting a director who can build ties to the area.
3. **Face the future.** Review candid projections extending out at least five years of the organization's profitability, capital capacity, competitive position, and ability to attract high-quality physicians and nurses. Rating agencies have suggested independent hospitals and small systems will be hard pressed to thrive in the PPACA environment. Kazemek cautions boards to avoid "rosy" scenarios and apply tough business discipline to long-term projections.
4. **Agree on a strategic affiliation strategy.** Engage the board, along with senior executives and physician leaders in a thoughtful process to explore and agree on the rationale and vision for joining with others. The full board should buy into what it hopes to achieve through a merger, acquisition, or strategic alliances, such as access to capital, critical economic mass, market strength, and improved quality.
5. **Form a "strategic affiliations task force."** Mergers and strategic partnerships require private talks—they can't be done in a fishbowl. A task force of the board's most influential leaders and strategic thinkers—its "A Team"—can be more closely informed and consulted about partnership discussions. The executive committee, strategic planning committee (if it's small and has no conflicted physician members), or an ad hoc task force can fill the bill.

The full board should buy into what it hopes to achieve through a strategy of merger, acquisition, or strategic alliances, such as access to capital, critical economic mass, market strength, and improved quality.

How soon and how to engage directors?

Merger and alliance talks occur mostly between the parties' CEOs and senior executives. Board leaders need to determine how soon and how much to inform and consult the strategic affiliations task force and the full board, respectively, before a final deal is consummated and ready for formal board approval.

It's tempting to keep knowledge of M&A discussions in a small circle, but surprising directors with a done deal is unwise. Pre-cooked mergers and alliances that trample on some stakeholders' turf can trigger a backlash from powerful directors, physicians, and other stakeholders—and could scuttle an otherwise sensible strategic partnership. It also deprives the executive team of the insights and experience that directors may have.

Conversely, fishbowl negotiations are a prescription for disaster. Getting a lot of directors enmeshed in the details of deal making or letting news leak out prematurely to stakeholders, especially medical staffs, will also kill a deal and embarrass the other partner.

The answer lies in finding the right balance, consistent with a board's unique culture. Some boards are accustomed to lots of involvement in strategic decisions, while others vest great discretion in their CEOs and board leaders. The best course is to give a board sufficient engagement so the final decision has strong support, but not so much engagement that a deal is weakened by too many hands on the steering wheel.

Pre-cooked mergers and alliances that trample on some stakeholders' turf can trigger a backlash from powerful directors, physicians and other stakeholders—and could scuttle an otherwise sensible strategic partnership.

Negotiating a Deal: The Seven Questions

In major transactions, the parties often sign a non-binding letter of intent and form a joint steering committee of the CEOs and 4-6 directors to oversee negotiations. Each steering committee member signs a confidentiality agreement.

Although every transaction has unique elements, there are seven governance questions, or deal points, that must be satisfactorily resolved by the parties to strike a deal for a sustainable relationship.

Each party should consider whether and why this partner is the right one.

1. Why are we doing this? The steering committee begins by learning about each party's mission, values, culture, facilities, programs, and people. It defines the rationale for a partnership, which must have a strong fit with each party's strategic vision and core values. A potential transaction must fill the parties' respective critical needs, such as capital, geographic scope, clinical integration, and administrative efficiencies. The benefits in terms of mission, finances, clinical care, operations, and market share should be quantified, not just rhetorical.

Each party should consider whether and why *this* partner is the right one. Have other options been considered? Mergers with Catholic organizations must address the impact of the Ethical and Religious Directives of the Catholic Church and the values of religious sponsors.

2. What's the best corporate structure? A range of structures, from full asset mergers to joint operating

companies and shared services arrangements to clinical affiliations and more can be used to gain the benefits of combining organizations. The steering committee should be educated on the range of options and agree on the structure best suited to achieve the strategic intent of a deal.

3. How will the authority of each board be affected?

Hospital boards often don't want to sacrifice autonomy but consolidations fail when the governance structure impedes a tough but necessary strategic or final decision (case in point—the recent breakup of Health Alliance in Cincinnati). Failure to choose a sustainable governance model can doom a new system from the start.

4. Who will be the CEO? Boards understandably want to protect their CEO, but co-CEO models rarely work. The management succession process should be clearly laid out in advance. Current executives should be treated fairly, and the resulting organization should have strong leadership to get the job done.

5. Who will be on the new organization's board, and how will directors be chosen?

Current board members may want to preserve their seats but the most successful systems minimize representational governance in favor of competency-based board composition. Getting directors with the “right stuff”—objectivity, vision, and leadership experience in large and complex systems can make or break eventual success.

The steering committee should be educated on the range of options and agree on the structure best suited to achieve the strategic intent of a deal.

6. What will be the financial and strategic impacts of a consolidation? Financial considerations obviously are key to eventual performance, beginning with whether assets are being valued at the right price. Boards should examine the projected impact on the parties' balance sheets, profitability, and bond ratings. They should know how existing debt will be treated and what will happen to foundation assets.

Boards often ask: "What will happen to our most treasured facilities or programs?" To secure agreement, the parties may have to agree that a super majority of the new board will be necessary for certain decisions, such as closing facilities, integrating clinical services, or divesting assets.

7. Is it legal? The Federal Trade Commission is displaying renewed interest in the anti-trust potential of hospital mergers. Boards will want to know in advance if there's a good case to be made for community benefit, quality, and cost reductions to federal and state regulators.

The steering committee should reach agreement on the key deal points. All the key issues must be addressed, not left hanging. Potentially controversial issues such as the governance structure and the management succession process should be settled here, not left to due diligence.

Finalizing an Agreement

The steering committee should brief each board at one or more appropriate "plateaus" in the negotiation process. The leaders on the steering committee can't get so far ahead that other board members feel they have no voice—but again,

A recent study by Health Leaders magazine found that transactions talks break down most often over these issues:

- * Agreement on valuation,*
- * Access to capital,*
- * Political considerations,*
- * Community considerations,*
- * Medical staff issues*

everyone can't be involved in the negotiations. Through executive sessions, the board chairs should update their boards, seek feedback if appropriate, and ensure the board is still behind the partnership efforts.

The deal points will form the basis of a written document, sometimes called a memorandum of understanding, which generally states that the parties have agreed to merge or align, and will enter a period of due diligence to iron out final financial and legal aspects of the deal. Since MOUs are often made public, the steering committee should ensure that a communications plan to key stakeholders and the public is ready to go. The plan should stress the vision and benefits of the proposed arrangement.

Each board, through its committee structure, should thoroughly review the results of the due diligence process and the proposed affiliation agreement before giving its final approval.

Trust Building, not Just Deal Making

Successful mergers, acquisitions, and alliances are built on a foundation of trust and relationships far more than formal rules and structures. By engaging their board leaders and executives in a candid exploration of a potential strategic partnership, the parties will test the merits of a deal and begin building the communications and trust that can enable post-deal governance and management to succeed.

Barry S. Bader is the Publisher of the *Great Boards* newsletter and the President of Bader & Associates, governance consultants.

Earlier versions of this article appeared on the Great Boards blog on August 24 and August 31, 2009. © Copyright 2010, Bader & Associates

Great Boards
*The Online Governance
Newsletter*
www.GreatBoards.org

Published by :
Bader & Associates
10050 East Calle de Cielo
Scottsdale, Arizona 85258

Phone: 480-614-0422
GreatBoards@gmail.com

Additional Resources

Hospital Consolidation Trends in Today's Healthcare Environment

A Governance Institute White Paper, by James Burgdorfer and Juniper Advisory LLC, Summer 2010

One is a Lonely Number

By Edward A. Kazemek, Chair/CEO ACCORD Limited, *Trustee*, September 2009

Hospital Mergers & Acquisitions: Opportunities and Challenges

By Karen Minich-Pourshadi, *Health Leaders Media*, November 2010

To Stand Alone or Seek a Partner: A Question ... or an Imperative?

By Ryan A. Gish and Kit A. Kamholz, Kaufman, Hall and Associates, *Trustee*, September 2009

Engaging a Strategic Hospital Partner: A Proven Approach to Achieving Success

By Kit A. Kamholz and Stephen E. Sellers, White Paper available from Kaufman, Hall and Associates

Look Before You Leap

By Barry S. Bader, *Trustee* magazine, March 1997

Simple Rules for Making Alliances Work

By Jonathan Hughes and Jeff Weiss, *Harvard Business Review*, November 2007