A Great Boards Briefing Paper

GOVERNING BOARD'S ROLE IN MERGERS AND ALLIANCES: ADDING VALUE AND FINDING THE RIGHT BALANCE

Just as in the early 1990s, hospitals and health systems are seeking advantages of size and scale to prepare for the uncertain but undoubtedly difficult aftermath of healthcare reform. *Modern Healthcare* reports 28 deals were announced in the first half of 2009, according to Irving Levin Associates, Norwalk, Conn.—but "a spate of announcements" has come since July 1, signaling heightened interest.

Sometimes alliances rather than mergers are the best match to achieve strategic goals. In May, 19-hospital Banner Health, the largest not-for-profit system in Arizona, announced a partnership with the prestigious University of Texas M.D. Anderson Cancer Center in Houston, to build a $90 million outpatient clinic and cancer hospital at one of Banner's suburban hospitals.

The 7 questions boards always ask

Approval of a merger or major alliance is clearly a governance responsibility. I've had several clients ask about the best approaches to facilitating the board's involvement in a partnering process. I advise them that there are seven questions that boards always ask, and which require their engagement to reach the best answers:

1. Why are we doing this? The rationale must have a strong fit with the mission and the strategic vision. It must fill critical gaps – e.g., capital, geographic scope, clinical integration, administrative efficiencies. The financial and market share benefits should be quantified, not just rhetorical. In addition, why is this partner the right one? Have we looked at all the options?

2. What's the best corporate structure? A range of structures, from full asset mergers to joint ventures to clinical affiliations and more –can be used to gain the benefits of combining organizations. Boards should be educated in the range of options and weigh in on the one that's best suited to achieve the strategic intent of a deal.

3. How will the authority of our board be affected? Hospital boards often don't want to sacrifice autonomy but consolidations often 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. How will board members 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 the "right people on the bus" can make or break eventual success.

5. 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.

6. What will happen to our most treasured facilities or programs? Sometimes specific protections are appropriate to include in an affiliation agreement, sometimes not, and sometimes it's agreed super majorities will be necessary to close facilities, integrate clinical product lines, or divest assets. It all depends and requires candid discussion.

7. Is it legal? FTC 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 to federal and state regulators.

Of course, there will be other many other issues specific to each deal. Mergers and alliances with Catholic systems pose particular challenges. But these seven questions must always be addressed up front.

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How soon and how to engage directors?

Executives and board leaders face the challenge of determining how soon and how much to engage the board in discussions before a final deal is consummated and ready for formal approval.

It's tempting to keep information about a potential merger or strategic alliance in a small, management-driven circle, but surprising the whole board with a done deal is a never a good idea. 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 a sensible strategic partnership. It also deprives the executive team of the insights and M&A 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, also will kill a deal and embarrass the other partner.

The answer is finding the right balance, consistent with a board's unique culture — some boards are accustomed to having a lot of involvement, while others vest great discretion in their CEOs and board leaders. The CEO and board leaders should clearly think through the right process for engagement of directors so the final decision has broad stakeholder support and benefits from the insights and experience of directors.

Whether an organization is joining a larger system, engaging in a merger or alliance of equals, or adding a new member to its existing system, the board's involvement in the negotiation process usually involves these steps:

1. Get general consent from the full board to look at strategic alliances. This is best done as part of the ongoing strategic planning process. Directors may ask, "Why do we need to engage in a merger or alliance – can't we do well just as we are?" A five-year, strategic financial projection can help answer whether status quo is an advisable course. The full board should buy into the rationale for why the organization needs to grow and what it hopes to achieve through a merger or strategic alliance – e.g., access to capital, critical economic mass, market strength, and improved quality. The strategic planning process may involve directors in broadly analyzing a number of potential strategic partners to determine who would be the ideal fit. The amount of detail the full board gets into at this early, pre-negotiation stage, will vary and requires careful judgment by the CEO and board leaders.

2. Choose a small group of the board's leaders to be more closely informed about merger and alliance discussions. This could the board's executive committee, strategic planning, or an "ad hoc strategic partnerships task force." The group should draw from the board's most influential leaders, including the chair and the board's best strategic thinkers in terms of mission, strategy, business, finance, culture, and quality. Although merger and alliance talks occur mostly between the parties' CEOs and senior executives, this committee or task force is the CEO's "Governance A-team" for the board's engagement in merger and alliance discussions.

3. Form a steering committee of leaders from both or all parties. The steering committee will include some of each board's "A-teams." The steering team should be small, probably 3-4 directors from each party plus the CEOs. Each member must sign a confidentiality agreement. It's this group that addresses the key questions common to all partnership discussions, such as who will be the CEO and who's on the board. It will identify and then answer questions specific to each deal, such as, will all parties be part of an obligated financial group, what will happen to existing foundation assets, and will a specific amount of capital be invested in particular facilities? Mergers with Catholic organizations must address the impact of the Ethical and Religious Directives of the Catholic Church and the values of religious sponsors.

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4. Prepare the committee to address the key questions. The steering committee should be briefed on the range of structural options for joining organizations, and the pro's and con's of each option. It should also examine the case for a merger or alliance, including a strategic and financial analysis projecting what a combined organization might look like. And of course, the parties should learn about each other's mission, values, culture, facilities, programs and people. If a partnership is the right thing to do, trust and a sense of cultural compatibility should build during the course of the steering team's learning process.

5. Candidly explore the key questions (deal points) and options. This is the steering committee's major work, to explore options and reach agreement on a vision and the key "deal points," including the most appropriate type of corporate structure to achieve the strategic and financial aims, governance structure and authority, board composition and selection method, management succession plan, and other key issues.

6. Go back to each board at appropriate "plateaus" in the process. The leaders on the steering committee can't get so far ahead that other board members feel they have no voice – but again, everyone can't be involved in the negotiations. So, at one or more key places in the negotiation process, the board chairs should update their boards, seek feedback if appropriate, and ensure the board is still behind the partnership efforts.

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

8. Sign an MOU. The deal points form the basis of 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.

9. Review the results of the due diligence. Each board, through its committee structure, should thoroughly review the results of the due diligence process and the proposed affiliation agreement.

10. Grant final approval. Each board votes final approval of the combination.

Outside experts in three areas – law, finance, and governance — generally make valuable contributions to a merger or alliance process. The governance consultant often also serves as a facilitator for the process.

If the negotiation process strikes the right balance of governance input but not meddling, it will build trust and a positive culture for successful governance and operation of the emergent organization.

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