



# Mergers, Acquisitions and Partnerships

*Lessons From the 1990s.*

During the 1990s, hospitals stampeded to affiliate with one another based on the assumption that capitation would soon be the dominant form of payment to providers. Field experience and literature review indicates there were at least as many failures as successes, with failures falling into three categories: hospitals that invested a lot of time, money and energy but never closed the deal; hospitals that closed the deal but subsequently came apart; and hospitals that closed the deal but still haven't achieved expected benefits.

Mergers and acquisitions peaked in 1998 with 287 hospitals participating

in 139 deals, according to the American Hospital Association's (AHA) 2009 *TrendWatch* Chartbook. (See chart on page 58.) Except for a blip in 2004 (and HCA's restructuring of 176 hospitals in 2006), transactions trended steadily downward until 2007 when it jumped to 149 hospitals participating in 58 deals. Based on conversations among The Governance Institute's advisors and other experts, most expect the upward trend to continue. But, before rushing into negotiations, prudent leaders should reflect on the lessons of strategy, structure and process used in the 1990s.

## Lessons of Strategy

A common business axiom is that structure follows strategy. Yet many affiliation discussions begin as if the opposite were true, with lawyers outlining complex explanations regarding antitrust law, displaying diagrams of corporate structures and developing requests for proposals.

Hospitals affiliate to better serve their communities and to either strengthen their position for the future or fix a problem they can't resolve independently. When I provide advice in an affiliation discussion, I ask the board and CEO to determine one to three compelling motivations for why the transaction should take place. Pinpointing compelling motivation requires the discipline to sort through rhetoric and the fortitude to confront practicality. Improving market share and upgrading facilities are not compelling motivations. The root causes in this case are more likely: Organizations need help recruiting physicians (to increase market share) and need access to capital (to replace antiquated facilities).

In AHA's 2003 Larson Lecture, Samuel O. Thier, MD, said the merger of Massachusetts General Hospital and Brigham and Women's

To help focus the discussion in this article, the following definitions are provided.

**Hospital:** a nonprofit, 501(c)(3) freestanding hospital or system-based hospital.

**Acquisition:** a transaction in which one hospital gains control of most or all of the assets of a second hospital.

**Merger:** a transaction in which two hospitals combine most or all of their assets to create a third entity, resulting in a change of control for both hospitals.

**Partnership:** a transaction in which two or more hospitals agree to cooperate for mutual benefit; not resulting in a change of control.

**Affiliations:** a term that encompasses mergers, acquisitions and partnerships.

Hospital to create the dominant Partners Healthcare System in Boston “...was neither a marriage based on love nor a shotgun wedding.” He went on to describe compelling motivations related to contracting and cost reduction.

Although recently terminated, it wasn't hard to find the compelling motivation for Johnson Memorial Hospital, Stafford Springs, Conn., in its negotiations with Eastern Connecticut Health Network (ECHN), Manchester, Conn., which was going to assume \$45 million in Johnson's debt and potentially invest \$20 million for capital improvements, according to a March 7, 2009, article in the *Hartford Courant*.

### ***Motivations for Mergers and Acquisitions***

In practice, the basis for a merger or acquisition typically comes down to four potentially compelling motivations: access to capital, physician recruitment, payor contracting and reduction in operating costs.

In the case of acquisitions, another motivation sometimes arises when hospital A acquires hospital B to prevent a potential loss of referrals. But be careful—physicians make referrals, not hospitals. Strengthening physician relationships at hospital B might be more effective and less expensive.

### ***Motivations for Partnerships***

Strong community hospitals may have a compelling motivation to enhance particular service lines but aren't interested in being merged or acquired to achieve it. Instead, they seek a partnership with a well-regarded tertiary hospital to provide

brand equity, clinical protocols and availability of specialist physicians.

### **Lessons of Structure**

Whether it's negotiating from a position of strength or weakness, when a hospital is clear about its compelling motivation, the structure almost defines itself. For this article, structure refers to the framework through which organizations affiliate: mergers, partnerships or acquisitions. In general, when determining structure, choices should be made regarding capital—who is supplying it and how the assets will be combined.

In almost all cases, if one organization is providing capital—which can be an

infusion of cash or assumption of debt—to another, an acquisition is taking place. In most instances, the capital recipient will relinquish substantial control of the hospital. When Addison Gilbert Hospital “merged” with Beverly Hospital to create Northeast Health System in Boston, governance of the new entity was dominated by Beverly, the stronger of the two hospitals. Again, the proposed transaction between ECHN and Johnson Memorial was frequently referred to as a merger. But when ECHN abruptly terminated discussions, the headline read, “ECHN Cancels Purchase of Johnson Memorial Hospital,” and referred to it as an acquisition. Many hospital mergers are actually acquisitions.



But mergers do take place, most often when two organizations of similar strength combine all their assets to create one stronger survivor. Arden Hill Hospital and Horton Medical Center in Goshen and Middletown, N.Y., respectively, now known as Orange Regional Medical Center, merged eight years ago with the compelling motivation to pool capital and create a new, state-of-the-art hospital. As the first new freestanding hospital in New York in more than 20 years, it will open in approximately 18 months.

Emerson Hospital in Concord, Mass., is a good partnership example. A 180-bed community hospital, Emerson faces world-class competition in every service line. To better compete, Emerson supplements its own clinical strengths in partnerships with Massachusetts General, Brigham and Women's Hospital, Tufts Medical Center and Lahey Clinic, which bring strong brand awareness, protocols and physicians to Concord.

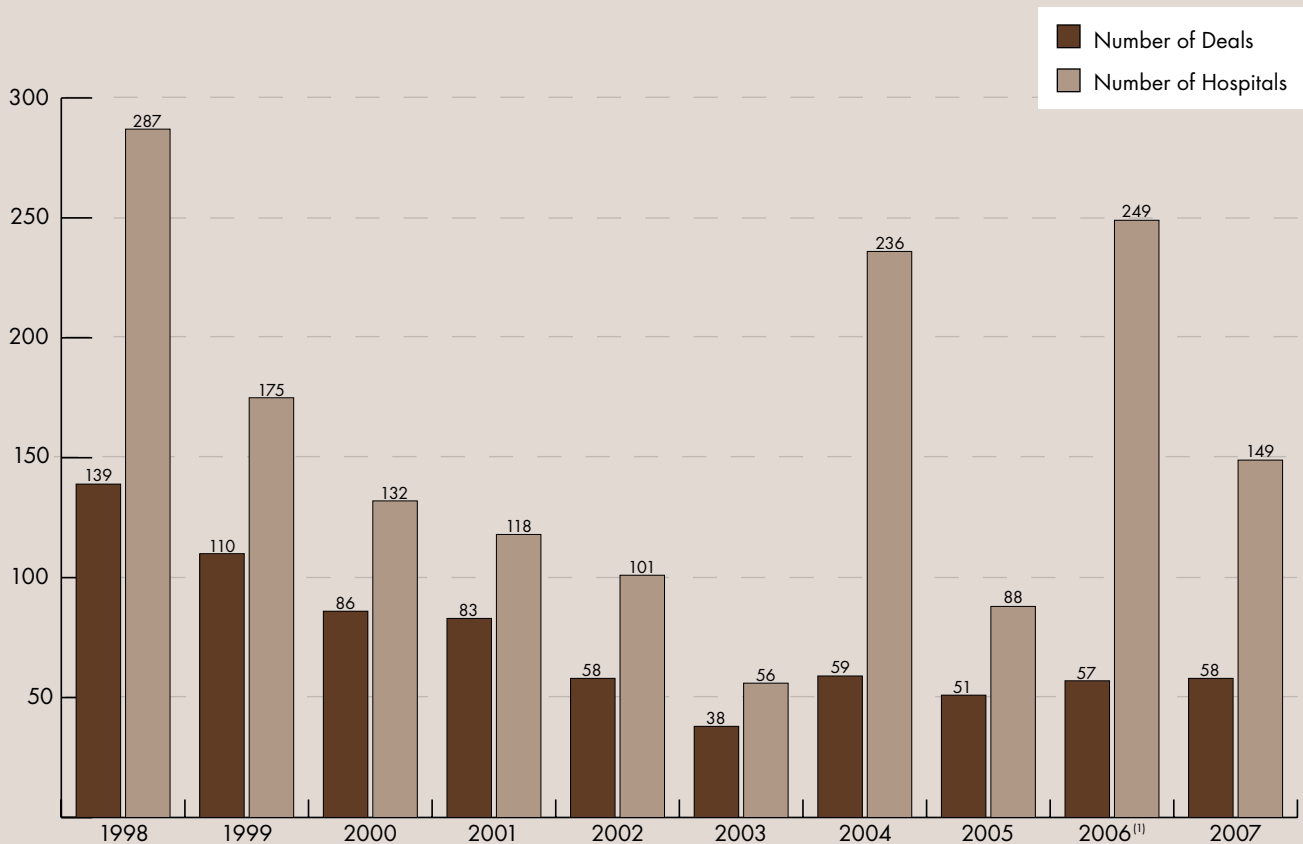
**Lessons of Process**

Strategic clarity, achieved through specifying goals and narrowing

options, makes the process of selecting a partner and successfully negotiating a deal much easier. For the transaction to go smoothly, the people involved and the sequence of events are important.

Hospital affiliations are not, at their core, financial transactions driven by maximization of financial gain for shareholders and executives. Many tenets of corporate America merger and acquisition transactions don't apply. While negotiation is important, hospital affiliations are typically more collegial than adversarial.

Announced Hospital Mergers and Acquisitions, 1998–2007



Source: Irving Levin Associates Inc., *The Health Care Acquisition Report*, Thirteenth Edition, 2008.

<sup>(1)</sup> In 2006, the privatization of HCA Inc. affected 176 acute-care hospitals. The acquisition was the largest healthcare transaction ever announced.

Step one in the process is to determine with whom to affiliate. The object isn't to sell the hospital to the highest bidder; it is to select the best potential partner based on strategy, structure and values.

Step two is to structure a confidential process, where the principles (strategy and structure) are discussed during a 30- to 90-day period in two to four meetings, each approximately three hours in length. This may seem overly prescriptive, but experience underscores the importance of moving quickly and keeping the dialogue at a high level. These discussions should involve three to five senior leaders from each organization and appropriate legal

counsel. Most often, one law firm serves as antitrust counsel to the transaction, while each hospital retains its own attorneys for contract review and due diligence. If these negotiations are successful, they should be documented in a memorandum of understanding.

Step three is a combination of business planning and legal due diligence. Assuming both have positive results, a definitive agreement document can be developed and the transaction completed. This should take 90 to 180 days.

There is always a question of who should be informed of what and when during these discussions. But

the less that is known outside the boardroom until a milestone has been reached, the better. The transaction should not be negotiated in the media, within the community at large, in the medical staff lounge or on the floors of the hospital. Communication outside the boardroom, however, is important. When a milestone is reached and documented, it is usually a good time to inform employees, physicians and the public. ▲

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