

Remain Independent or Align?
Considerations for Choosing the Best Future for Your Hospital

August 11, 2011

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Welcome



Remain Independent or Align?

Considerations for Choosing the Best Future for Your Hospital

- We will begin shortly
- Audio Dial-In: **1-470-200-0300**
- Audio Passcode: **670-633-999**
- If you are experiencing technical issues, please contact Patricia Lee: **1-215-599-2464**
- Phone lines *will* be muted during the presentation.

Submitting Questions



- You may submit questions during the presentation using the “Chat” feature on the side of your screen.
- Questions submitted via “Chat” will be fielded at the end of the presentation as time permits.
- If we do not get to your question(s) in the time available to us today, we will follow-up with you individually offline.
- Phone lines *will* be muted during the presentation.

Today's Speakers



Howard Peterson
Managing Partner
TRG Healthcare



Douglas Long
Shareholder
Hall Render

Howard Peterson, MHA

Mr. Peterson is the Founder and Managing Partner of TRG Healthcare, LLC. He has more than 30 years of healthcare experience developing progressive strategic, financial and operational solutions for a broad range of healthcare clients. His consulting expertise includes: strategic transactions, strategic and financial positioning, as well as operational and financial performance improvement. He has worked extensively with hospitals, health systems, academic medical centers, as well as physician and faculty group practices.

Douglas Long, Esq.

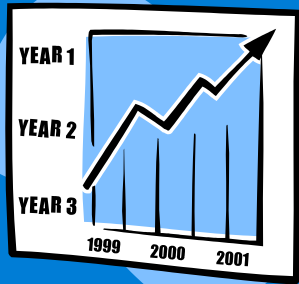
Mr. Long passed the CPA examination in Indiana in 1976 and graduated from Harvard Law School in 1979. At Hall Render, he concentrates his practice in corporate and tax issues relating to hospitals, health care systems and other health care entities. He is admitted to the bars of Indiana, Illinois, the United States Tax Court and the Seventh Circuit Court of Appeals. He has published articles in The Tax Lawyer, Journal of Partnership Taxation, The Tax Executive, Insurance Law Journal, Proceedings of the NYU Institute on Federal Taxation, Drake Law Review and other journals. He serves as the Treasurer of the principal election campaign committee of a United States Senator.

Agenda



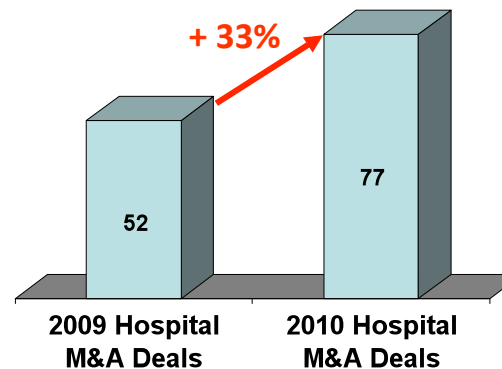
- Consolidation Trends
- Options for Independent Hospitals
- Getting to the Right Decision
- *A Case Study on Process and Outcomes: The Road to Partnership for “Washington Health System”*
- Lessons Learned
- Important Legal Considerations
- A Look Ahead
- Questions and Answers

Consolidation Trends



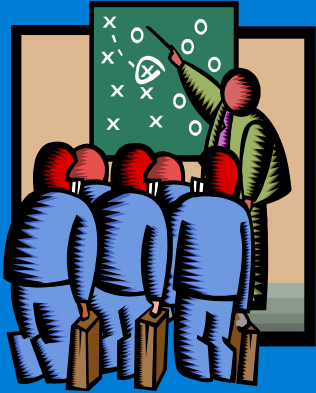
Approximately 800 independent hospitals (> 100 beds) remain in the U.S. today.

- **Hospital consolidation is active in the industry** and gaining momentum due in large part to Federal Health Reform.
- **77 domestic hospital M&A deals were announced in 2010**, marking a 33 percent increase over deals reported in 2009. *(Source: Irving Levin Associates' Deal Search)*



- **Second quarter 2011 is an acceleration of the 2010 market**, with hospital deals up 78%, (32 vs. 18 deals) from the same period last year. *(Source: Irving Levin Associates, The Health Care M&A Report)*

Perspective on Consolidation



- Consolidation will likely dominate strategic agendas over the next 3-5 years due to underlying trends triggered by the prospect of Health Reform:
 - ✓ Expanded health care coverage
 - ✓ Reductions in reimbursement rates
 - ✓ Shift in risk for cost of care from payers to providers
 - ✓ Emphasis on value and alignment of provider payment with quality
 - ✓ IT mandates too costly for a solo organization
 - ✓ Greater oversight and demands for cost and quality reporting

- Consolidation will shift focus away from traditional strategy.

- Hospitals struggling to address mounting challenges must ask the fundamental fiduciary question:

“Which future course will assure that my hospital is BEST positioned to continue to fulfill its mission of service to the community?”

What Options Exist for Independent Hospitals?

Range of Options

- Pursue initiatives to enhance position as an independent:
 - FHA financing strategy
 - Leveraging balance sheet
 - Clinical service initiatives
 - Academic affiliation
 - Contractual agreements
 - Establish connections with health agencies and other local resources
- “Test-the-Water” relationship with similar hospital
- Merger with similar hospital or group of hospitals
- Merger with an established system
- Align with a proprietary hospital company
- Create a unique system structure

What is the Best Option for My Hospital?
How Do I Make the Right Decision?

Getting to the Right Decision



Adhering to the following **KEY PRINCIPLES FOR SUCCESS** helps position an organization to make and execute the right decisions.

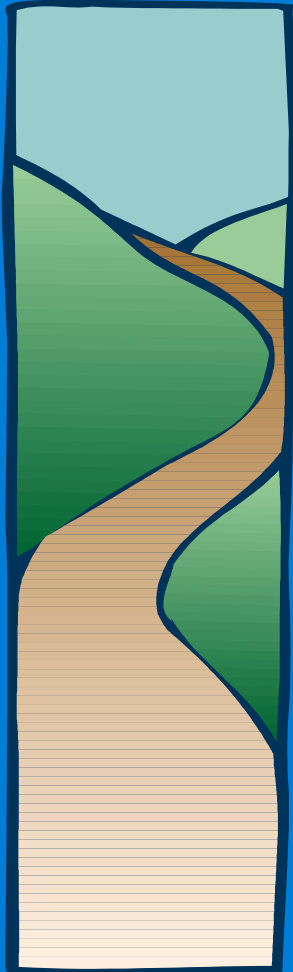
- ❖ Independent hospitals have significant value and can control the affiliation process on their terms.
- ❖ Focus on continuing your mission, not just finding the best immediate financial solution.
- ❖ Don't wait to contemplate the future until you have lost leverage and available options in the market.
- ❖ Identify areas of particular importance *early on* to serve as “decision criteria” to aid in an objective evaluation of alternatives.
- ❖ Consider *all* reasonable options, including competitors with whom you may have had a negative history.
- ❖ Start with independence and keep it “on the table” throughout.
- ❖ Establish a competitive dynamic to enhance your negotiating leverage and the ability to close under your terms.



A Case Study on Process and Outcomes:

*The Road to Partnership for
Washington Health System (“WHS”)*

Starting Down the Road to Partnership



- **WHS** was approached by another local health system (“System A”) to respond to their partnership process.
- Intrigued by this possibility and the potential to create something of greater significance for both parties.
 - Opportunities for coordination
 - Cost reduction with fewer redundancies
 - Large economies of scale
- Signed a confidentiality agreement to enter into a two-party integration evaluation process with System A.
- While involved in discussions, WHS made no decision to end its independence at this time.

Taking the Wheel

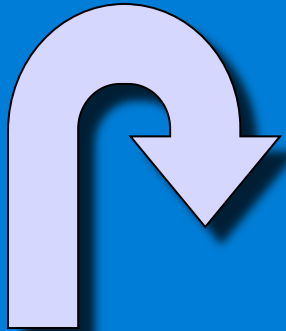


Take Control.

The organization should control its options and evaluation process and the choices it makes regarding its future.

- WHS leadership and Board quickly felt that the interests of WHS were not being served by the initial process.
- The decision at hand was of the *greatest importance*; they had to get it right!
- Realized that comparing what they knew (independence) to something more abstract (being aligned) was unfair.
- Found it critical to understand the *specific details* of our alignment options to make a sound judgment in the end.
- TRG recommended WHS reorder the logic and structure of the process to comply with WHS timelines and objectives.

Changing Direction



“If we don’t change direction, we are likely to end up where we are going.”

(Chinese Proverb)

- TRG facilitated a Board Retreat focused on WHS’s strategic direction and decision making.
 - Large, diverse Board membership
 - Strong sentiment to continue as an independent entity
- Really began to think critically about its ability to continue down the path of independence.
- Ongoing independence would require, *at a minimum*, enhanced strategies to mitigate risk and remain relevant.
- Obtained guidance from the Board as to their willingness to consider potential partners *other than* System A.

Identifying Alternate Routes



Consider *All* Reasonable Options.

Considering all options will offer the very best opportunity for the organization to reach its objectives and eliminates the risk of second guessing your selected strategic path later on.

- With TRG, WHS initiated a formal process to actively explore and evaluate our alignment options.
- It began by identifying all health systems present and competitive in the WHS market area.
- Made judgment about which to include/exclude for further consideration.
- There was no compelling reason to include for-profit systems or not-for-profit systems outside of the area.
- Three potential partners remained for further evaluation along with independence .

System A

System B

System C

Independence

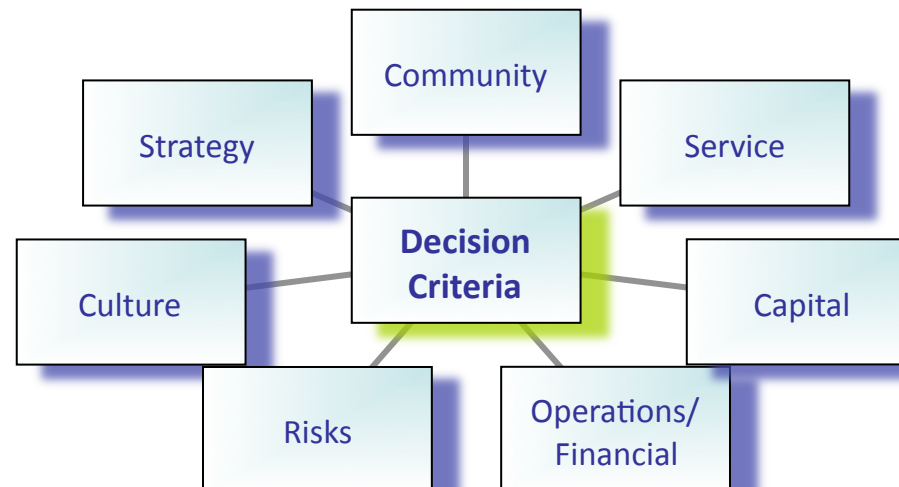
Establishing Criteria to Guide Decision Making



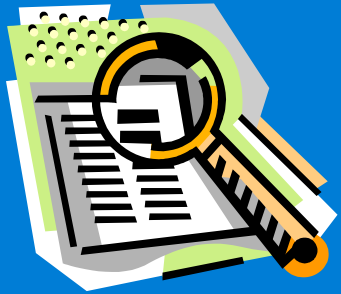
Establish “Decision Criteria” Early On.

Defining areas of particular importance up front will help ensure an objective process and strategic decisions or partnerships that address the organization’s critical issues.

- WHS developed its *own* set of terms for alignment based on WHS mission, vision and values.
- Seven elements emerged which WHS believed were of the greatest importance when evaluating its future options.
- These became known as the “DECISION CRITERIA” to guide WHS’s decisions going forward.



A Closer Look at the Decision Criteria



1. **COMMUNITY.** Produces a resilient orientation to understanding and acting on the health needs of Southwest Washington.
2. **SERVICE.** Establishes the ability to provide the broadest set of services economically viable within Southwest Washington.
3. **CAPITAL.** Results in substantially improved access to capital to make investments required to better serve community needs.
4. **OPERATIONS/FINANCIAL.** Produces sustainable operating and financial benefits (e.g., access, quality, service, safety, etc.).
5. **RISKS.** Creates a structure that mitigates exposure to any material risks and could perform well under Health Reform.
6. **CULTURE.** Ensures a cultural fit that is probable to advance the historical mission and values of Southwest.
7. **STRATEGY.** Accomplishes something strategic that Southwest could not accomplish without the partnership.

Understanding the Alignment Options



Establish a Competitive Dynamic.

Without a competitive dynamic your negotiating leverage is diminished and the ability to close under your terms is jeopardized.

- WHS developed a formal partnership RFP and distributed it to Systems A, B, and C.
 - Fostered a competitive dynamic
 - Provided leverage to drive time frames and results.
 - Established clear terms for partnership.
 - Helped in collecting consistent information.
- Established an explicit schedule and followed it closely to avoid a protracted, ongoing effort.
- Had multiple discussions and data exchange with each potential partner organization.
- Received comprehensive proposals from Systems A, B, C.

“System B” Response

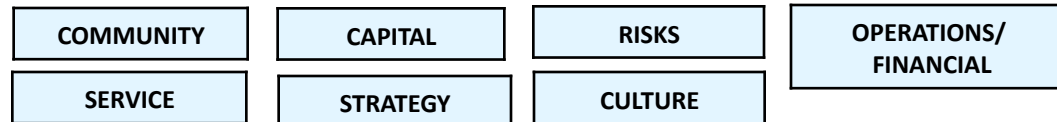


- This was a crucial decision for System B; merging the assets of WHS would be a significant addition.
- System B did their homework to fully understand WHS and its “goodness of fit”:
 - ✓ Start with Mission and Values
 - ✓ Fit with Regional Network Strategy
 - ✓ Assessment of Strategic Fit (i.e., working on similar things?)
 - ✓ Administrative/Board Fit
- System B invested a great deal in addressing the decision criteria identified as important to WHS in its proposal.

Evaluating the Alternatives



- WHS evaluated the alternatives against the decision criteria.



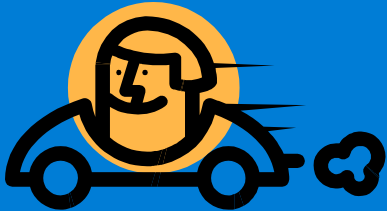
- Assigned a relative ranking related to each potential partner.
 - 3 = best satisfies the criteria
 - 2 = next best at satisfying the criteria
 - 1 = least satisfies the criteria

Results

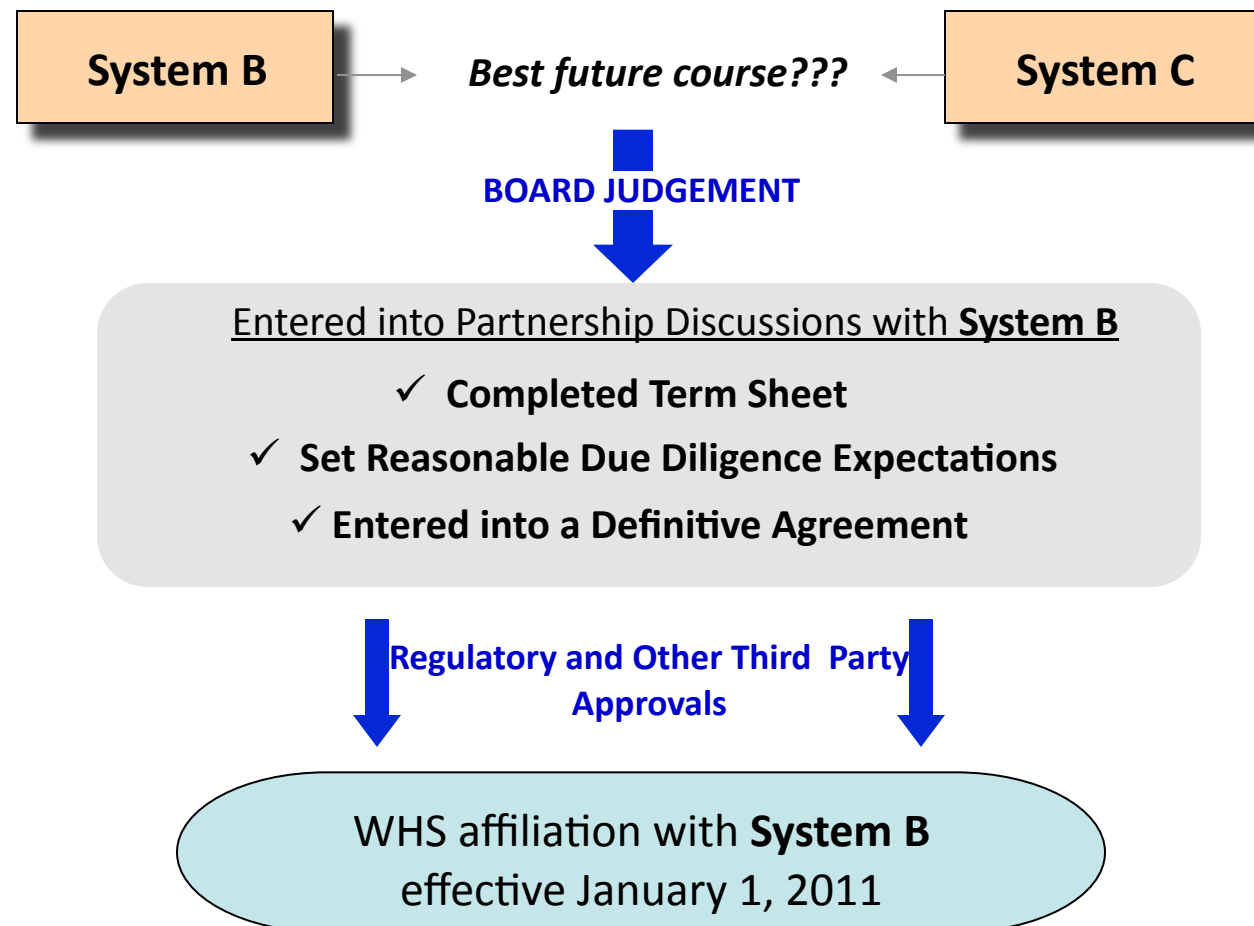
	<u>Alternative</u>	<u>Average Ranking</u>
Best ↓ Least	System B	2.6
	System C	2.0
	System A	1.4

System A, with whom WHS had EXCLUSIVE discussions early on, was the LEAST attractive when measured against the Decision Criteria.

Moving Ahead to a Final Destination



WHS gave formal consideration to its two preferred alternatives:



Factors in Selecting “System B”



- Well-tailored proposal; best at advancing the decision criteria.
- Great willingness to invest in governance and leadership interaction to build a strong relationship early on.
- Positions WHS as a regional tertiary referral center.
- Demonstrated commitment to the region with plans to locate headquarters and shared services center near WHS.
- Shared values and strengths that would position WHS for continued growth in the quality/range of services it provides.
- Less risk of becoming reduced or moderated as it might be if plugged into a larger, more established health system.
- Best choice based on intuitive insights.

Lessons Learned – Hospital Perspective



- ❖ **Take control of your process.** Avoid wasting time in another party's process and focus on creating your own process with your own objectives and timelines.
- ❖ **Focus on mission.** A process focused on preserving mission, rather than immediate financial gain will lead to the best results long-term.
- ❖ **Consider a range of options.** By considering *all available options* you avoid overlooking the one that may turn out to be the very best.
- ❖ **A competitive dynamic is critical.** Competing parties will put their best offers forward including items that would never arise from a two- party process.

Lessons Learned – System Perspective



- ❖ **Build Trust.** Get senior leaders and a few key board members together early to begin building trust.
- ❖ **Establish fundamental principles.** ALWAYS get to agreement of fundamental principles first.
- ❖ **Address key questions up front .** Deal with governance, structure, and leadership questions early in the process.
- ❖ **Focus due diligence.** Keep due diligence focused on items needed to satisfy basic questions to get to agreement.
- ❖ **Communicate often.** Senior leaders should talk every week.
- ❖ **Stay humble.** Neither party has all the answers.

Important Legal Considerations: Which Legal Structure Best Effectuates The Parties' Intent?

MOST
INTEGRATED

SPECTRUM OF OPTIONS

LEAST
INTEGRATED

How Can Corp A and Corp B Combine?

- Merger
 - Corp B combines into Corp A
 - Eliminate Corp B and its separate governing body. Corp A is the only surviving corporation.
- Change of Corporate Member
 - Corp A becomes the sole member or Parent of Corp B.
 - Alternatively, NewCo becomes the sole member or Parent of both Corp A and Corp B. The Board of NewCo includes representatives of both Corp A and Corp B.
- Assets-Only Transaction
 - Transfer assets to an existing entity, or
 - New entity created to operate assets
- Joint Operating Agreement
 - Corp A and Corp B remain legally separate
 - Terms of an agreement govern their coordinated operation
- Other Affiliation
 - No specific legal definition
 - Could be management contract, purchased services, limited joint venture
 - Because affiliates are still competitors, watch antitrust compliance

Important Legal Considerations: What are the Key Control Issues to be Negotiated?



- Governing body composition, nomination, final selection, and removal
- CEO approval and removal
- Budgets / capital allocation
- Major transactions / service lines
- Retained powers – Certain decisions in addition to those noted above require super majority approval of Parent’s Board – e.g.,
 - Amendment of governing documents
 - Major borrowings

Important Legal Considerations: Non-Profit Partner



Form of Alignment

- Membership substitution is the most common method.
 - Preserves licenses and tax I.D. numbers.
 - Contracts continue and many do not require third party consents.
 - Liabilities can be kept separate.

- Merger is sometimes used if:
 - One party has more favorable provider contracts.
 - Operating as a single hospital with one tax I.D. number on two campuses is advantageous.

- Asset acquisition is utilized if one party views the risk of being held responsible for the other party's liabilities as too great. E.g., Corp A worries about contingent Stark/AKS/billing liabilities of Corp B.

Important Legal Considerations: Non-Profit Partner



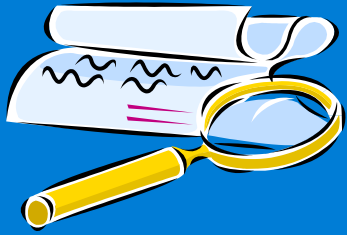
Board Structure

- Governance is often a difficult issue.
- If Parent is the sole member of Hospital Corp A and Hospital Corp B, some alternatives are:
 - *Non-representative* parent board, with representative hospital boards.
 - *Representative* parent board, with representative hospital boards.
 - 50% - 50% boards carry the risk of potential deadlock.

Reserved/Initiation Powers

- Reserved and initiation powers are often used by a parent board to exercise control over “subsidiary” hospitals of which the parent corporation is the sole member.
- Reserved/initiation powers often apply to:
 - Appointment/removal of hospital board members.
 - Appointment/removal of CEOs.
 - Approval/initiation of budgets, borrowings and major transactions.
 - Approval/initiation of amendments to articles and bylaws.

Important Legal Considerations: Non-Profit Partner

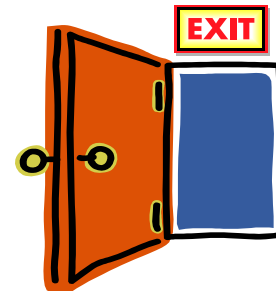


Due Diligence

- Thorough legal, financial and environmental due diligence by both parties is essential.
- Important lessons to keep in mind:
 - Do not assume you know everything about your partner.
 - Avoid last minute surprises.
 - Do not cut corners.
 - Results may influence form of alignment.
 - Representations and warranties are often meaningless after closing.
- Subjects: financing covenants, underfunded pension plan liability, environmental issues, Stark/AKS/billing, litigation, key contracts

Exit Strategy

- Limited unwind provisions?
 - Misrepresentations.
 - Alignment goals not fulfilled.
- Burn the boats?



Important Legal Considerations: Non-Profit Partner



Regulatory Approvals

- Certificate of Need?
- State Attorney General approval?
- Hart-Scott-Rodino Act federal antitrust filing?
- Other state agency approval? (DMH, OASAS, etc.)

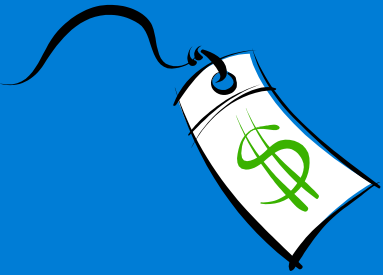
Important Legal Considerations: For-Profit Partner



Form of Alignment

- Transactions with for-profits are almost always structured as asset purchases.
 - For-profit buyers do not want to assume any unknown liabilities.
- All liabilities, except for accounts payable (if accounts receivable are purchased) remain with seller hospital.
 - Pension plan liabilities (these are usually most problematic).
 - Audit liabilities (for billings prior to sale).
 - Malpractice cases.
 - Employee severance.
 - Unassumed contracts.
- Asset Purchase Agreement contains other important promises of buyer.
 - Capital expenditures for purchased hospital.
 - Physician recruitment.
 - Restrictions on resale of hospital; right of first refusal held by entity representing local community.
 - Restrictions on closing of hospital.
 - Continuation of key clinical programs.
 - Continuation of charity care policy.

Important Legal Considerations: For-Profit Partner



Purchase Price/Community Benefit Foundation

- Need to assure that price to be paid for purchase of seller hospital's assets is sufficient to satisfy all liabilities of seller hospital corporation and fund a "community benefit foundation."
- Community benefit foundation often created:
 - Administers donor-restricted funds and net proceeds from sale.
 - Can help enforce promises made by for-profit buyer in APA.
 - Can help cause liabilities of seller hospital to be paid.
 - Manages conflicts between community needs and outstanding liabilities.
 - Carries out mission of foundation by supporting local health and wellness initiatives.

Other Considerations

- Due diligence by for-profit is extensive; but due diligence of for-profit buyer is usually limited if publicly traded.
- Remaining local hospital board may be merely "ceremonial" without real powers.
 - As a practical matter, apart from enforcing promises made in the APA, control is ceded to for-profit buyer.
- Only exit strategy is potential, but very unlikely, repurchase of hospital.

A Look At What Lies Ahead...

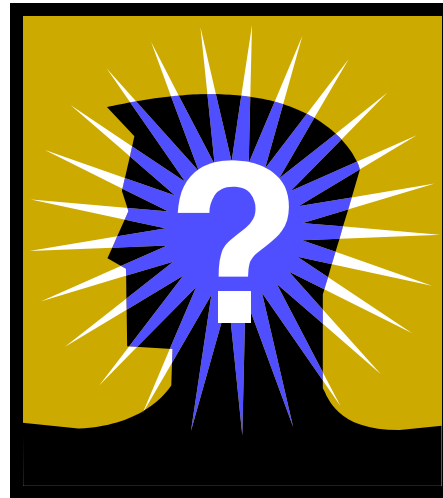


- Consolidation will likely spur a subsequent wave of “local market roll-ups”.
- Growth from consolidation will bring new economies and enhanced negotiating clout that may change the business case for providing certain services currently being outsourced.
- Increasing financial risk and accountability for outcomes will also motivate providers to rethink current outsourcing arrangements.

Likely Targets for Local Market Roll-Up

- Laboratory Services
- Dialysis
- Rehabilitation Services
- Home Care
- Physical Therapy
- Ambulatory Surgery
- Imaging

QUESTIONS?



Howard Peterson
TRG Healthcare, LLC
Philadelphia, PA
Managing Partner

Doug Long
Hall Render
Indianapolis, IN
Shareholder

Thank You!

For remaining questions please contact:

Howard Peterson

Managing Partner
TRG Healthcare, LLC
267-256-0726

hpeterson@trghealthcare.com

Doug Long

Shareholder
Hall Render
317-633-4884

dlong@hallrender.com