

## Improving the Health of Community Hospitals: Is Affiliation an Option?

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In today's healthcare industry, community hospitals face unprecedented challenges. From problems with physician retention and recruitment, to increasing technology and compliance costs, to the lack of negotiating power with vendors and suppliers, many community hospitals are at a severe disadvantage. In order to ensure their survival in this difficult economic climate, community hospitals around the nation are reviewing possible merger or affiliation with health systems. While affiliation involves the loss of a community hospital's independence and

local control, it can also provide substantial benefits. But is affiliation the answer for all community hospitals? What key benefits and considerations should a community hospital analyze before agreeing to an affiliation?

### **Benefits**

Access to capital is perhaps one of the most important benefits that affiliation with a health system provides to a community hospital. Many community hospitals are forced to put off promising expansion opportunities because they simply do not have the necessary

capital to complete the projects. The capital resources available to a large health system are numerous and can allow a community hospital to achieve its expansion goals.

Information technology resources are another benefit to community hospitals that choose the affiliation route. The up-front costs of information technology investment are enormous, and notwithstanding the cost savings that such technology may offer in the future, the initial investment is often unreasonable for a smaller hospital. Affiliating with a larger health system allows the cost of new information technology investments to be spread out among a greater pool of hospitals, physicians, clinics, and patients, and lead to greater savings.

Affiliating with a large health system is likely to provide community hospitals with better leverage when negotiating contracts and purchasing agreements. Suppliers and vendors want the increased business of larger entities and may be more willing to agree to concessions to ensure the entity's business.

Finally, affiliation can help community hospitals spread risk among many more clinics, physicians, and patients. Partnering with a large

health system that has the financial resources to absorb unexpected events reduces the risk that a large malpractice claim or other lawsuit could destroy a community hospital's financial reserves. Additionally, a community hospital may also be able to take more chances with promising endeavors that require up-front investment, such as new accountable care organizations.

### **Preliminary Considerations**

In order to ensure that a community hospital can take advantage of these and other benefits of affiliation, the hospital must consider a number of factors when deciding whether to partner with a health system.

First, a community hospital should conduct a thorough internal review of its current business operations and structures and the goals of affiliation. What type of health system partner is needed for the hospital to materially improve its access to capital? Will an affiliation really help with information technology and other investments?

After this internal review, the community hospital should send a request for proposal to potential health system partners. The request should include a list of requirements for a potential partner and questions about how the affiliation will help the financial and patient care concerns of the community hospital.

### **Negotiating the Affiliation Agreement**

Once an affiliation partner has been found, the parties should enter into a letter of intent and confidentiality agreement, and commence negotiations on the terms of a final affiliation agreement. These negotia-

tions should cover the governance and corporate structure for the affiliation, the financial and budgetary obligations, and the timelines and issues surrounding the transition of control of the acquired hospital's personnel and clinics.

During these negotiations, each party should also conduct intensive due diligence review of the other party's corporate documents, including business and financial operations, pending litigation, past and current compliance issues, and third-party contracts. The purpose of this due diligence is to discover any possible concerns or risks that could lessen the benefits of the affiliation.

Given the importance of the medical staff, coordination with the medical staff leadership is essential. Lack of support from the medical staff could be fatal to the affiliation.

### **Regulatory Concerns**

No matter how much the potential affiliation partners like each other, nothing can happen without government review and in some cases approval. The Federal Trade Commission (FTC) and Department of Justice (DOJ) can be significant barriers to a potential affiliation. These federal agencies have challenged a number of hospital mergers in the last few years on the grounds that they present anticompetitive concerns and may raise costs for patients and payors. Under the Hart-Scott-Rodino Act, the parties to certain mergers must submit a "Hart-Scott-Rodino Form" and filing fee that provides the FTC and DOJ with information about the proposed merger. FTC and DOJ review is needed only if the affiliation meets certain

monetary thresholds.

In addition to federal requirements, the parties must work with state regulatory agencies to ensure compliance. The State Attorney General will review the proposed affiliation for anticompetitive concerns. In Washington State, a public hearing is required if the affiliation involves a for-profit entity's acquisition of a nonprofit entity.

In many states, including Washington, the Certificate of Need Program of the Department of Health must be notified of the affiliation. The Department will conduct a review and ideally, issue a letter of nonreviewability. In Washington, such a letter will be granted if the affiliation does not involve a sale or lease of a licensed hospital and the affiliation does not expand either party's current operations under the Certificate of Need regulations. If the affiliation plan does involve an expansion of the current services offered by the parties, and that expansion is subject to Certificate of Need, approval can take several months.

Finally, the parties must ensure that both state and federal authorities are notified of the change in ownership of the acquired hospital's license. On the state level, the parties must notify the Department of Health, and on the federal level the parties must inform the Centers for Medicare and Medicaid Services of the change of ownership.

### **Other Items on the Affiliation Checklist**

In addition to obtaining approval from the regulatory bodies, the parties will likely need appropriate lender approval for the change of control for any tax-exempt bonds, mortgages, loans, or lines of credit

of the acquired hospital. The acquired hospital should also review and, as needed, obtain any necessary consents from third parties that have contracts or leases with the acquired hospital.

### Community Involvement

In order to achieve a successful affiliation, a community hospital must keep a finger on the pulse of community opinion as well as that of the medical staff. Many patients will be concerned with the thought of a large health system's takeover of their community hospital and the loss of local control. Some will ask why an affiliation is needed. Instead of ignoring these real concerns, a hospital must take the initiative to educate the public about why partnering with a larger entity is a good idea. Current healthcare services will typically be maintained, and the affiliation may allow for an increase in the scope and quality of those services. A properly executed public relations campaign from the outset can prevent the spread of misinformation and undesirable public backlash down the road.

### Conclusion

In today's healthcare industry, the review and analysis of the positives and negatives of affiliation or merger with a health system is one of the most important and challenging duties of the officers, board members, and senior management of a community hospital. The benefits of affiliation must be weighed against the loss of independence, local control, and flexibility that community hospitals now enjoy.

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