System Affiliation Discussions Require Carefully Structured Process

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The Governance Institute has fielded a number of inquiries lately from freestanding hospitals thinking about joining a multi-hospital system and asking how to engage the board in these discussions.

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A potential transfer of ownership to a system parent and the resulting loss of full autonomy involve the quintessential governance duties of care, loyalty, and obedience to charitable purpose. The transferring hospital board must be satisfied the transaction is fiscally sound and in the best, long-term interests of the hospital's primary stakeholders—patients and the community. Thus, the board's fiduciary responsibility suggests it should be involved early on, but in reality, that's not so easy.

Deals usually are born between a few top leaders who see that a system affiliation could enhance each organization's financial stability, access to capital, market share, operating efficiency, clinical quality, or patient access. Timing must be just right. The impending retirement of a hospital CEO, the need for capital to finance a major hospital expansion, or financial losses that create a CEO vacancy can briefly open a window.

However, leaders can become so focused on the potential bounties that they lose real world perspective. Potential partners must be candid from the outset about the deal-breakers that doom transactions. They include:

- How much autonomy the hospital must relinquish to the parent board (specifically, whether the system's reserved powers will include total or limited control over operating entities' budgets, strategic plans, CEO selection and evaluation, and local board composition)
- New management structure (and the fate of the hospital CEO and senior management team)
- New governance structure (and what happens to current hospital board)
- The desire to maintain treasured hospital programs and services (that are duplicative or losing money) after the deal

Such complexities are best resolved by small groups working out of the limelight. In the hospital arena, physicians, employees, the foundation, senior management, and others may fear loss of influence, jobs, and control. Religious sponsors may be concerned over maintaining their values and religious identity under new owners. Government owned entities answer to elected officials with political agendas. The saying "loose lips sink ships" applies: premature disclosure of discussions can jeopardize a strategic partnership by unleashing a host of negative forces.

As a result, we recommend the parties carefully structure a process to get tough issues on the table early and progress from small work groups to larger forums. Initial meetings between the two CEOs might be followed by bringing in the board chairs and then forming a small, confidential transaction committee to agree on the key principles of the partnership, draft a vision statement, and address potential deal breakers. The parties would sign a confidentiality agreement. Flexibility, candor, and subject matter experts in finance, law, human resources, and governance, are critical. An experienced facilitator is often of great help.

At an appropriate point, the full leadership of both parties should be educated and agree to a non-binding letter of intent, leading to a due diligence phase. Eventually the hospital board, and where appropriate the system board, should be educated and asked to approve the transaction. Strict time frames are important. When discussions drag on without resolution, morale suffers, anxieties spread, and opposing interests dig in.

Many of these concepts are also applicable to mergers and acquisitions. Making 1+1 = 3 requires creativity, vision, expertise, patience, and attention to detail. A carefully structured process that confronts reality and engages the best thinking of the board and senior management has the best chance of producing a masterpiece.