AHLA

2015 Health Care Transactions
Resource Guide

Choosing the Right Affiliation Structure

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Signing an agreement with another health care system doesn't have to be a merger or an acquisition. There are other options for joining forces.

It used to be that M&A in health care stood for mergers and acquisitions. But many innovative affiliation models exist that do not require fully giving up independence to create organized health care systems capable of delivering value-based care. Thus, M&A in health care has morphed to mean mergers and *affiliations*, which encompass the full spectrum, from loose clinical or administrative agreements to full asset combinations through traditional mergers or acquisitions.

In our previous article, *Rethinking Independence: Is it Time to Affiliate?,* we described the critical factors to consider when you're evaluating whether to seek an affiliation transaction. The first step is to assess the characteristics needed to remain independent. A baseline assessment of strategic, financial and operating strengths—as well as gaps and organizational needs—can identify the key objectives in an affiliation, define what success might look like and match organizational needs to the competencies and values of potential affiliation partners.

The Benefits of Change-in-Control Transactions

In financially troubled, strategically disadvantaged or capital-constrained circumstances, many of the benefits of independence are illusory. The realities of an organization's economic and competitive circumstances often dictate its ability to maintain or expand clinical services and can significantly reduce flexibility regarding day-to-day operating matters.

It may be the correct choice in many circumstances to pursue an outright sale or merger, which has been the most prevalent form of affiliation transaction. These change-in-control transactions, which are generally predicated on the need to access capital, can result in improved facilities, newly recruited physicians, expanded clinical services and enhanced information technology. In addition to capital access, full integration of organizations through mergers or asset sales also can reduce cost and provide "system" benefits by using corporate expertise in billing, human resources, quality, outcomes, population health, human resources and more.

Perhaps most importantly, a sale or merger can create an income stream for, and capitalization of, a newly formed foundation that can use its assets consistent with the organization's mission and values. This can be particularly important in preserving the value of the assets for the community, as the foundation does not bear the economic uncertainties (and risk of loss) associated with being a direct provider of health care in a rapidly changing environment.

Affiliation Without Merger

Alternatives to traditional mergers and acquisitions may be appropriate for health care leaders who wish to integrate operationally but do not want to sacrifice control over their assets:

Joint ventures. Joint ventures allow nonprofit organizations to secure capital and operating expertise while maintaining some measure of control. The assets and business of a nonprofit are contributed to a newly created joint venture, and a partner organization (generally for-profit) contributes capital sufficient to provide it with a majority ownership interest (typically 80 percent) in the joint venture. Sometimes, there is a distribution from the joint venture back to the nonprofit to satisfy remaining debt obligations or establish an independent foundation. Day-to-day operations of the joint venture often are managed by the for-profit entity pursuant to a management contract, while the nonprofit provides clinical and physician development services to the joint venture.

This joint venture model has two unique and important features:

1. For any distributions to the nonprofit partner to remain tax-exempt, the joint venture must generally operate according to IRS nonprofit guidelines.

2. Governance of the joint venture is disproportionate to the equity ownership, with 50 percent block voting established between the nonprofit and for-profit entities, allowing the minority partner to retain control over major corporate decisions.

These factors allow the "selling" hospital or health system to retain some of the key attributes of independence while attracting needed capital to support the business and enhance the sustainability of health care services in the community. Examples of this increasingly popular model include joint ventures between Duke University Health System and LifePoint Hospitals, Community Health Systems and the Cleveland Clinic, and LHP Hospital Group and Hackensack (N.J.) University Medical Center.

Clinically integrated networks. Organizations can collaborate in developing networks that support effective care coordination and allow the partners to share in the considerable cost of infrastructure needed to manage population health (e.g., medical homes, care management resources, claims management, predictive analytics and others). There is no merger of assets or change in ownership or control.

Members retain their independence, local governance and assets, but create an alliance that brings multiple health care organizations together to work in new ways and share clinical expertise, infrastructure and IT costs related to participating in new accountable care payment plans, and prepare for population health management. The network often will have its own board members and managers responsible for promoting clinical integration and improved clinical and operational efficiency.

There is a growing number of these alliances or collaboratives, including the University of Iowa Health Alliance, the BJC Collaborative in Missouri, Integrated Health Network of Wisconsin, the Granite Healthcare Network in New Hampshire and AllSpire Health Partners in New Jersey and Pennsylvania, as well as other less well-defined combinations like the Park Nicollet and HealthPartners affiliation in Minnesota. Each of the parties in this arrangement remains a distinct corporate entity and maintains separate budgetary and margin goals.

Joint operating agreement. An affiliation option that is closer to a traditional merger yet allows the partners to retain separate identities, as well as a certain amount of autonomy, is the joint operating agreement.

In a JOA, the assets and overall governance of the partners are not merged. Each entity retains the powers vested in it in its own bylaws. However, considerable management and financial authority is delegated to the joint operating entity, including budgeting for the entire organization. This contractual arrangement allows the affiliating entities to integrate operations and financial results. It is sometimes referred to as a "virtual merger," but it protects the individual partners' rights with respect to religious directives and to making decisions over such things as the sale of assets or other major corporate events.

These complex arrangements can combine operations of multiple organizations, allowing them to establish new models of integrated care, capture economies of scale, improve care coordination, reduce redundancies and allow for joint borrowing to support the joint operating entity's capital needs. From a Federal Trade Commission standpoint, the JOA is not deemed anticompetitive and allows the partners to contract jointly as well. JOAs can be a preclusion to a full merger. Recent examples of JOAs include Hoag–St. Joseph in Southern California and the University of Louisville–Catholic Health Initiatives in Kentucky.

Other arrangements. In addition to the alternatives described, there are many other options for affiliation that allow the parties to maintain autonomy, including clinical relationships like the Mayo Clinic model, which provides branding and assistance with quality and physician support, but involves no ownership change or capital commitment; joint governance agreements (such as was created with Froedtert Health and the Medical College of Wisconsin); and creation of a common parent (a model employed by the University of Colorado for its system affiliations).

Balancing Independence and Organizational Need

Many options for affiliation exist today, and the market continues to evolve in new and creative ways. Affiliating often means sacrificing some measure of organizational independence; however, an affiliation may be the best available strategy to sustain and advance your organization's mission, vision and values. The optimal transaction structure will be the one that best manages this trade-off between maintaining the attributes of independence most important to stakeholders and securing the financial strength and other benefits that joining a larger organization can provide. This legacy decision requires a complete understanding of the options that are available for hospitals and health systems to match strategic and financial needs with the right partner in the right transactional structure. ◆

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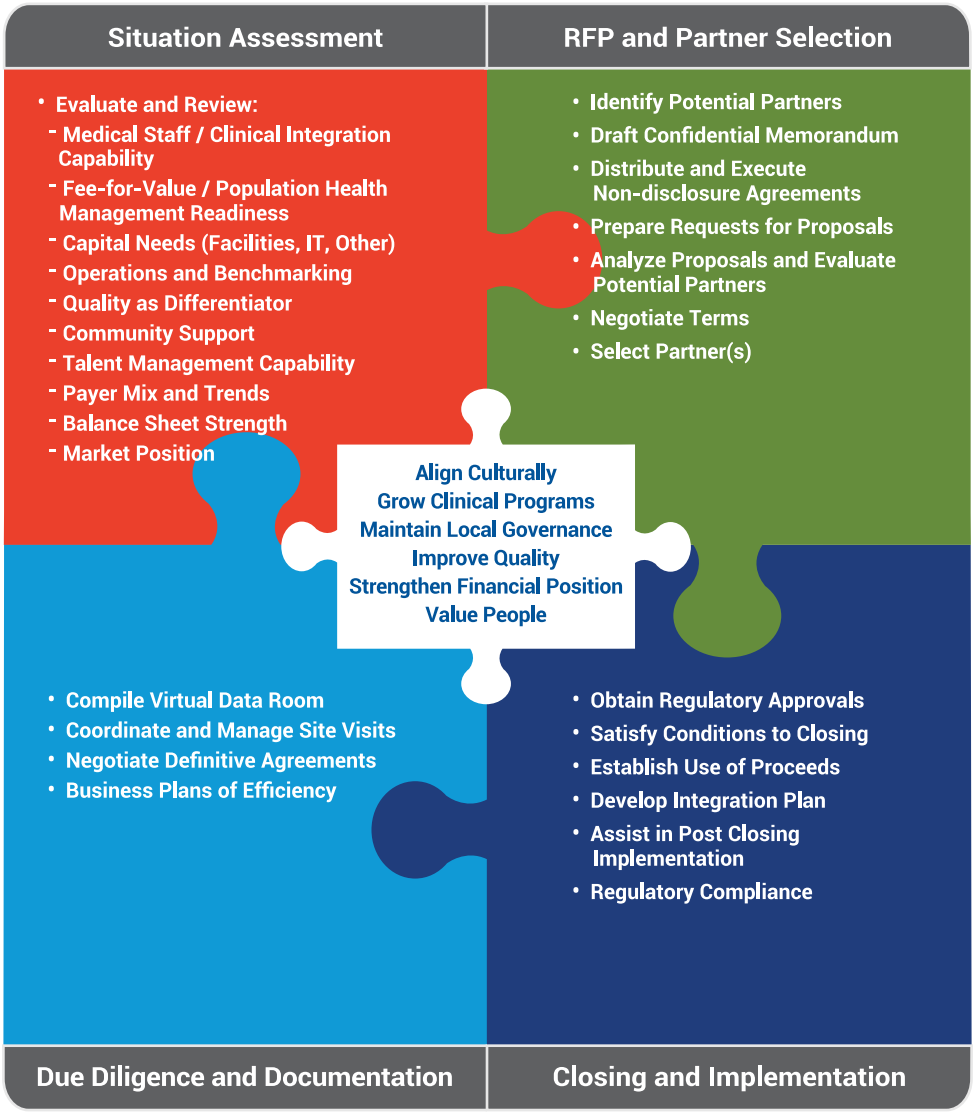

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