

# Surviving a hospital merger



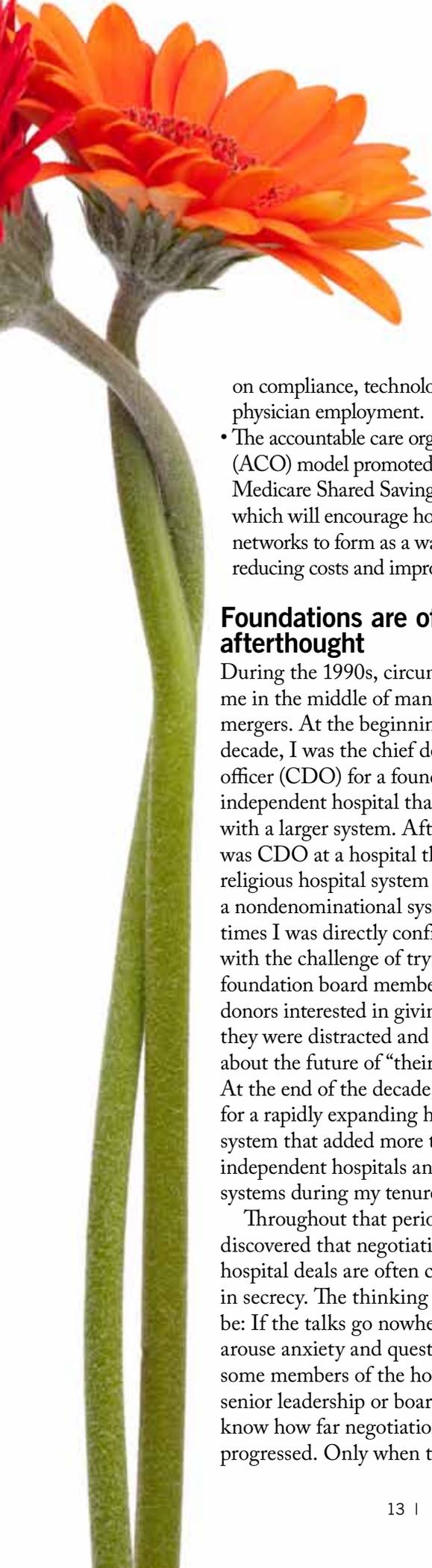
What does the upswing in mergers mean for foundations and development leaders?

Hospital mergers are on the rise again—climbing from 92 in 2011 to 109 in 2012, an increase of more than 18 percent.<sup>1</sup> During that same two-year period, 10 nonprofit hospital owners agreed to deals that changed the ownership of more than 160 hospitals, and the number of hospitals in merger and acquisition (M&A) deals rose from 212 to 352. This upturn represents a level of merger activity not seen since 2006, when access to low-cost debt drove a flurry of private-equity-fueled buyouts and mega mergers.<sup>2</sup>

Before that, a wave of merger activity occurred in the mid-1990s, driven by the threat of managed care and the power of larger health systems to negotiate favorable reimbursement rates with insurers. At the time, the growth of for-profit hospital companies was particularly dramatic and of great concern to nonprofit hospitals and their fundraising offices.

Now, according to an article in *Healthcare Financial Management*, three significant factors appear to be driving consolidation.<sup>3</sup>

- A decrease in payment rates, which will force hospitals to reduce costs in new ways and increase their negotiating clout with suppliers and payers.
- An increase in the cost of doing business, because hospitals will need to spend more



on compliance, technology and physician employment.

- The accountable care organization (ACO) model promoted by the Medicare Shared Savings Program, which will encourage hospital networks to form as a way of reducing costs and improving quality.

### **Foundations are often an afterthought**

During the 1990s, circumstances put me in the middle of many hospital mergers. At the beginning of the decade, I was the chief development officer (CDO) for a foundation at an independent hospital that affiliated with a larger system. After that, I was CDO at a hospital that left a religious hospital system and joined a nondenominational system. Both times I was directly confronted with the challenge of trying to keep foundation board members and donors interested in giving when they were distracted and concerned about the future of “their” hospital. At the end of the decade, I worked for a rapidly expanding hospital system that added more than 30 independent hospitals and small systems during my tenure.

Throughout that period, I discovered that negotiations for hospital deals are often conducted in secrecy. The thinking seems to be: If the talks go nowhere, why arouse anxiety and questions? Even some members of the hospital’s senior leadership or board may not know how far negotiations have progressed. Only when the deal is

developed to the point that leaders feel confident about an agreement do they let more people know what is being planned.

Unfortunately, hospital foundations are often an afterthought when negotiations are going on—and if they are small, with few assets, they are likely to be ignored completely. Perhaps it’s because the people involved in the negotiations are not particularly attuned to philanthropy, or because they think fundraising is a local enterprise and therefore will not be impacted by the new arrangement. No matter the reason, no one wants to risk ruining a deal involving several hundred million dollars in assets over a failure to agree on a small piece of the whole picture—the foundation assets.

If merging hospitals’ foundations have significant assets, their place in the future organizational structure is more likely to be a factor in negotiations. Sometimes a hospital foundation may be used as a safe haven to segregate assets from a merger. In that case, there is likely to be more emphasis on keeping the foundation “separate” from the assets merged into the system.

Some important points:

- CDOs must be aware that negotiations are happening before they can have any input about the future of their foundations.
- Even if no foundation exists, a potentially significant change in hospital identity, ownership or management causes internal

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**Ask questions,**  
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and external anxiety that affects development efforts.

- Maintaining strong trust relationships with your hospital chief executive officer (CEO) and influential board members is always extremely important, but becomes essential when some kind of new relationship is being considered. If those leaders understand the importance of philanthropy to the institution and the importance of maintaining strong donor relationships, they will be more aware of the need to prepare the CDO for what may be coming.

### Implications of for-profit conversion

Because it is engaged in promoting health, a nonprofit hospital is classified as a public charity (501(c)(3) organization). In exchange, the hospital is accorded tax-exempt status and allowed to grow without the burden of taxation, which is how the community invests in the hospital. A community board of trustees is appointed to oversee the community's ownership interest in the hospital.

To qualify as a 501(c)(3) organization, hospitals must do the following:

- Take care of everyone who comes in for treatment, regardless of ability to pay (provide charity care).
- Base decisions about their services on community need rather than profitability (the basis for the requirement for periodic community needs assessments).
- Reinvest any excess revenue (profit) in the business rather than benefiting owners or shareholders.

When a for-profit hospital system acquires a nonprofit hospital, community assets that have grown with the benefit of tax exemption will be sold and used to produce a profit for private investors. The public must be compensated for the

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privatization of their public asset and proceeds from the sale must be used in a manner consistent with the acquired nonprofit's charitable purpose. To protect the public's interest, the state attorney general usually must approve sales of nonprofit hospitals to for-profit operators.

What does the change mean for hospital foundations that have supported their nonprofit hospital?

- Your hospital will likely no longer have public charity status.
- Your foundation will no longer be raising money to support your hospital; it will either cease to exist or have to develop a new purpose. Your mission will have to be redefined.
- If your foundation is to receive the proceeds of the sale, you will become a much larger, more independent and different type of organization.
- Your operating and legal structures may need to be different. Will you be a grant maker only, or will you operate programs? Will you continue to raise money?
- Your board and staff members may not be the right people for the new organization.
- You will have to buy all the support services you now get from the hospital, such as payroll, benefits, human resources, finance,

information technology support, office space, insurance, etc.

If you're the head of a foundation supporting a nonprofit hospital that is being acquired by a for-profit company, start planning as early as possible for a very different future. Engage competent legal counsel knowledgeable in nonprofit taxation issues. Important and legally complicated decisions must be made about your ongoing tax-exempt status. Will you try to meet the requirements to remain qualified as a public charity? Will you become a private foundation? The questions and considerations involved in planning for the conversion of an existing foundation are detailed in the chapter by Patricia M. Ashmore, *Best Practices for a Conversion*, in a book I edited for AHP in 1997 as part of a "think tank" on hospital M&A issues.<sup>4</sup>

### Implications of a nonprofit merger/partnership

◀ If your nonprofit hospital will become part of an existing nonprofit system or will be creating a new system by joining with another nonprofit entity, your considerations and challenges are totally different—but they may be no less daunting. In this situation:

- Your beneficiary hospital's nonprofit status will not change.

- Management and governance will probably change.
- Your hospital's name, identity and culture may change.
- Eventually, changes may occur in the services offered at your hospital.
- Your foundation's purpose will probably continue to be linked to the needs of your hospital.

Changes may happen rapidly or slowly, depending on characteristics of the joining organizations, but change is inevitable. In my experience:

- Independent hospitals joining mature existing systems are more likely to see changes sooner. If the system has incorporated new

hospitals before, it is more likely to have a plan for handling staff department functions such as finance, human resources, planning and perhaps fundraising—especially if a system executive is leading the development effort.

- Independent hospitals in financial distress will also see changes sooner. More aggressive changes in staffing levels, pay scales, debt refinancing and other measures will be likely when hospitals and systems experience declines in profitability.
- The geography in which the system's member hospitals exist also impacts the pace of change.

Hospital partners in the same service area will find it easier to share staff and management and to consider centralizing service lines at one or another of the hospitals. Large systems with widely dispersed and rural hospitals will not have the same options.

- When there is no mature system or immediate financial distress, change is likely to start slowly and accelerate as the system matures.
- As the hospital system develops, strategic planning and administrative decisions are more likely to be made at the system level, which, of course, affects planning for fundraising and can

## Foundation **separateness**

Whether your foundation is a subsidiary corporation of your hospital or a totally separate and self-sustaining entity, you are not really separate. Foundations exist to harvest goodwill created by their hospitals. Foundation executives and board members who believe that their separate corporate status insulates them from changing or agreeing to collaborative development programs have totally missed the symbiotic nature of their relationship.

Even if your foundation is a legally separate entity, it's unlikely to be functionally separate. You may get direct or indirect economic support, such as free or reduced-rate office space, inclusion in hospital benefits programs and use of hospital facilities and services, for example. But even if your foundation is economically self-supporting, it requires other forms of support to be effective, such as:

- Access to the hospital's strategic plans.

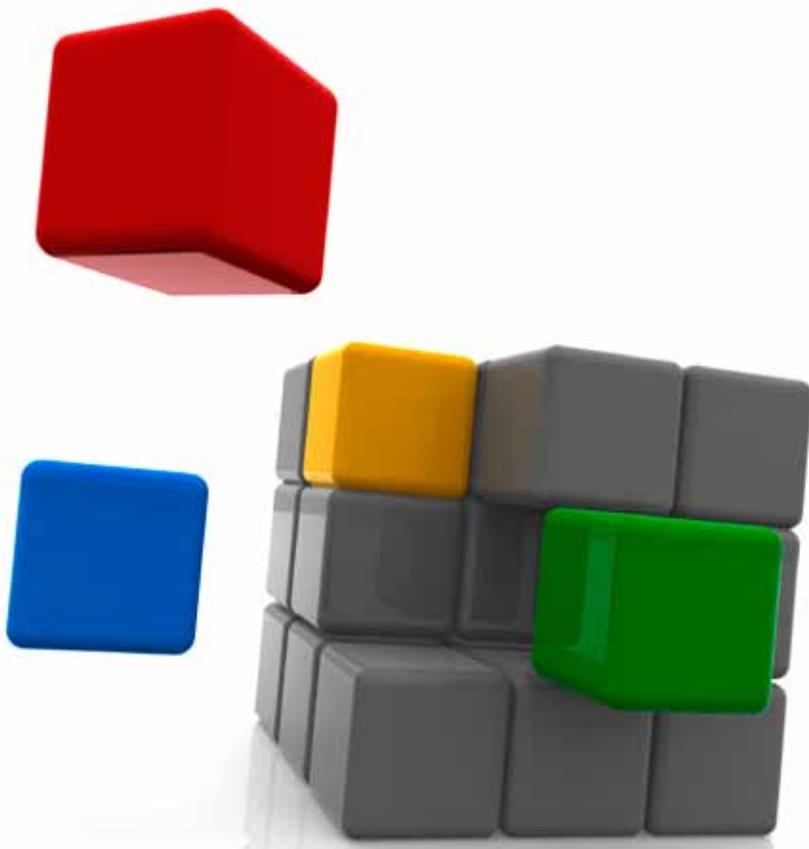
- Use of the hospital's name.
- Advance knowledge of publicity initiatives.
- Access to physician, patient and employee groups.

You function as the exclusive fundraising agent for your hospital because it benefits *the hospital*—and people donate to express support for the work of *the hospital*, not the foundation. Hospitals do not require separately incorporated foundations to receive or manage charitable support.

Because foundations have functionally dependent relationships with their hospitals and enjoy exclusive franchises, it's obvious that hospitals should seek, and foundations grant, reasonable involvement, communication and direction of the foundation's activities. If a system retains independent foundations, it gives them exclusive rights to raise funds for a specific hospital. The foundation also may continue



to administer significant assets that are in trust and intended to further the hospital's mission. In granting this exclusive franchise, the system can and should set requirements for the cost, quality, term and performance of the foundation's services.



## Common terms for hospital deals

The chart below defines six terms frequently used to describe hospital deals. Other terms sometimes used are “amalgamation,” “partnership” and “alignment,” but these describe what are actually mergers, acquisitions or long-term leasing arrangements. Other terms such as “buy outs” or “takeovers” are routinely avoided because of their negative connotations and the public anxiety they might arouse.

DEAL TYPE	DESCRIPTION
<b>MERGER</b>	Two or more health care organizations combine to form a new entity
<b>ACQUISITION</b>	An existing organization is purchased
<b>JOINT VENTURE</b>	Two or more organizations combine resources on a specific project
<b>AFFILIATION</b>	An organization joins another for a specific purpose (such as contracting)
<b>LEASING</b>	Lease of facility with retained ownership
<b>MANAGEMENT CONTRACT</b>	Contract to manage with retained ownership

impact donor confidence and trust in your hospital’s leadership.

As soon as your foundation board, donors, employees and physicians learn of potential partnership discussions, they are likely to have concerns. You may call it a partnership rather than a merger, but they will understand instinctively that change is coming and the way things have always operated is not going to stay the same. If not managed carefully, their anxiety can have a paralyzing effect on their willingness to make donations. Some things to keep in mind:

- Your hospital’s leaders decided to seek a partner because the future did not seem viable as an independent entity. Is your community better served by a hospital that is part of a system, or by a closed hospital? That is the central issue. People will disagree about how dire the future really is as an independent entity, but the financial pressure on hospitals is real and increasing.
- As a foundation director and hospital executive, you are not being paid to preserve the past or serve your personal interest. Your job is to help your organization adapt to the future and stay true to donor intent. You may not look forward to the new world order or want to work in it. But even if your future diverges from that of the organization, the patients, the donors and the need for a solid philanthropy program will still be there after you are gone.
- Once the partnership decision is made, CDOs must be strong, positive advocates for the partnership if they are to have any hope of raising money through the transition. Expressing personal concerns about your future or role will worry board members and donors and give them a reason to

who negotiate agreements need to understand the powerful role foundation executives can play in influencing community opinion-makers about the merger's desirability. Many of those opinion-makers probably sit on the foundation board. Because foundation executives are rarely brought into the loop, they are tempted to share fears with members of the board.

How can a foundation executive serve the organization in those uncertain circumstances? Here are some attitudes and prescriptions that I think can work:

- **Be proactive.** Ask questions, seek information and talk to as many people as possible—both in your own organization and in the system you are about to join. Sometimes it's easier to do this unofficially rather than through official channels, since the general rule for negotiations seems to be not to say or explain anything until all is signed, sealed, and delivered and widely known in the community.
- **Work out requirements and freedoms in advance.** If the system already has an entity responsible for fundraising, go see them and ask how they're organized. Find out what plans, if any, they have for you and your board. If the system already has an organizational structure, will you be expected to conform to it? Find out what's flexible and what isn't.
- **Make an early decision.** Do you like the person in charge of development for the system? Could you accept working for him or her? If no one holds this position now, will someone be named? Will you have a chance at the position? Will your CEO or another CEO be heading the merged organization? The answer to the CEO question could make a big difference in your chances for the top development job. Think about your future and

decide what you want to do as early as possible. Could there be a growth opportunity for you as a part of the new organization? Would you want it, if it were there? If it looks like something is possible and attractive, get all the way on board, help smooth the transition and be positive about the new arrangement. If you feel you will not be happy or welcome as part of the new organization, start looking elsewhere.

- **Serve the institution, not yourself or the current board.** When the whole world changes, it's natural to think about how you're affected, and it's hard to imagine how anything can work out better if the board goes away or the hospital's name changes. You may feel the need to mourn the passing of the freestanding hospital you knew. It's a mistake, however, for development leaders to get too wrapped up in lamenting or resisting changes. No one can raise much money in an atmosphere of worry, doubt and pessimism—so don't foster that atmosphere.

A hospital decides to join or form a system as a strategic action to preserve or strengthen its future. The organizations we work for are struggling to survive in a turbulent time. As their agents and employees, our charge is to serve our organizations' best interests for the long term. 



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