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How to Avoid Deal Risks in Hospital Mergers and Acquisitions

By Jim Owens and Felicia Perlman

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McDermott's Jim Owens and Felicia Perlman caution about the impact of economic conditions on hospital mergers and acquisitions, and offer restructuring options that distressed health systems might consider.

As health-care providers team up to enter new markets and expand their capabilities, hospital mergers and acquisitions are likely to continue at a steady, if less-blistering, pace in 2023.

Amid economic uncertainties, it's more important than ever for buyers, sellers, and investors to understand the key forces driving this activity, and some of the leading risks behind getting health-care deals done, particularly in the context of distressed systems.

Economic Pressures

Covid-19-related government spending and subsidies are winding down, energy and supply costs are rising, and interest rates are stabilizing after a 30-year peak.

Thus, once-profitable target companies find themselves on the distressed side of their balance sheets or face significant financial and operational challenges.

In the health-care sector, in particular, downward or flattening reimbursement pressures, physician recruiting challenges, and the transition to new payment models also create economic strains that erode revenues and negatively impact access to capital.

Labor issues are another growing concern. This month's strike of more than 7,000 nurses at two New York City hospitals highlights the challenges facing health-care employers.

In 2021, as noted in a study published in *Health Affairs*, 1.8% of the nursing workforce—more than 100,000 nurses, the majority of whom were under age 35, according to McKinsey & Company—left the profession, a trend that was expected to accelerate in 2022 and beyond.

For many providers, these and other workforce-related issues are prompting their own flight to safety, or scale.

What was once a relatively balanced environment dominated by dealmakers seeking fast profits is pivoting toward a market in which troubled assets—and options for turning around such companies and service lines—are at the center of many transactions.

Deals Involving Distressed Systems

While acquisitions of distressed assets can provide benefits to buyers and sellers, both parties should ensure that such transactions do not lead to stumbling blocks further down the road.

Buyers and investors should always conduct thorough due diligence. These analyses should involve more than clarifying the capital, financial, and operational structure of the target. They should also include a clear-eyed assessment of whether the acquirer can fix the challenges facing the seller.

Buyers and investors should also consider conducting transactions through the Chapter 11 process. Managed correctly, in-court processes can allow the buyer to emerge with the asset but without the debt.

In addition, deals handled through bankruptcy may allow buyers to discharge the conditions of collective bargaining agreements and acquire assets without assuming the litigation liability of the debtor.

A review of major contracts or leases that may shrink a target company's footprint but also strengthen the acquiring entity are also necessary. Chapter 11 can give buyers and investors an opening to terminate the seller's contracts, leases, and other cash-draining obligations.

Also tricky are situations where the buyer and seller are facing similar challenges. If, for example, both companies are facing steep labor costs, it may be better to step back from a deal rather than exacerbate an existing problem.

And lastly, deals should be avoided that result in a loss of value. Taking a hospital into bankruptcy can elicit negative responses from affected communities, physicians, patients, and other stakeholders. Buyers should communicate clearly that the bankruptcy filing is understood to be part of a rebuilding process that will lead to a positive result.

Positioning for Acquisition

While high-performing hospitals and health systems can exert leverage over the terms of the deal, struggling organizations will need to be creative and think broadly. Sellers should consider the following to better position their companies for a potential sale or to attract investors.

It is critical for sellers to clarify their missions and strategize accordingly. Depending on the hospital's goals, new ownership may enable them to move forward on their current path or provide the tools, assets and money required for a complete revisualization of their competitive strengths and service offerings.

They must also determine what, exactly, is for sale. These decisions must align with what potential investors and buyers see as valuable.

For example, as health systems look to increase revenues from ambulatory care divisions and shift losses from hospital settings, providers can explore options that allow them to monetize service-line assets.

Sellers should also begin to look outside the normal buyer box. Retail and technology companies are continuing to make forays into the health-care space, and private-equity investors may offer terms that allow for a certain level of independence. Not-for-profits may present interesting—sometimes challenging—deal terms.

They can also explore alternatives, such as outsourcing back-office and technology support functions, sale-leasebacks, joint ventures, and other collaborations**.** This can provide the selling or target company with the capital it needs to continue operating while reallocating resources to its core strengths and mission.

It is also necessary to address potential community opposition. Patients, local governments, and federal antitrust regulators alike are raising concerns that hospital and health system consolidations negatively impact the availability, quality, and affordability of health-care services.

Before positioning entities or divisions for sale, leaders should develop clear plans for identifying and addressing pushback that could gain momentum sufficient to scuttle a deal.

Ultimately, the guidance that applies to every business transaction—know your goals, do your due diligence, keep your options open—will increase the likelihood of a successful deal.

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