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# Affiliations and Strategic Alliances in Long Term Care



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Reinhart Boerner Van Deuren's Post-Acute Care and Long Term Services Practice Group has provided legal counsel in connection with many successful strategic alliances and affiliation transactions between health care providers. Post-acute and long term care providers are increasingly seeking legal counsel regarding strategic alliances and affiliations, both horizontal and vertical, to improve quality of care and maximize operating efficiencies and negotiating leverage. This white paper, prepared specifically for post-acute and long term care providers, analyzes the merits of pursuing an affiliation strategy.

## Reasons for Pursuing an Affiliation

Traditionally, affiliations involved a weaker provider affiliating with or being acquired by a stronger provider. Now, more than ever, we are seeing an increasing number of value-driven affiliations between/among financially viable providers in efforts to add new services, achieve economies of scale and increase access to services.

In the recent past, affiliations involving acute care providers dominated. Developing partnership networks became a clear priority following passage of the Patient Protection and Affordable Care Act of 2010, which incentivizes lower-cost delivery, improved quality and more effective treatment of chronic conditions by specialized providers.

The marketplace is evolving. Marketplace incentives have driven higher acuity patients downstream from hospitals to long term care facilities. Many nursing homes, assisted living facilities and other providers are now interested in entering into strategic alliances to share resources, maximize operating efficiencies and improve patient care. To be clear, most affiliations are not structured as mergers or acquisitions, but often include less formal arrangements that require a lower degree of integration.

## Common Misconceptions

Some providers equate pursuing an affiliation with failure, and avoid even discussing an affiliation. The reality is that all providers would be well-advised to analyze affiliation alternatives as an essential component of their long term strategic planning. Should a provider reach the point where an affiliation is the only way to survive, having *not* included affiliation alternatives in comprehensive strategic planning would result in the provider entering affiliation discussions from a position of weakness, forcing the provider to agree to whatever affiliation is offered it. By analyzing affiliation alternatives before affiliation becomes necessary, the provider can choose to decline alternatives it deems inopportune. A financially strong provider will ask, is this particular affiliation the best way to increase our quality of care? But a financially struggling provider will ask, what other providers

are willing to affiliate with us now? Or even, what other providers are willing to undertake a rescue mission? A provider that analyzes affiliation alternatives from a position of strength has access to a wider pool of potential partners and is more likely to succeed in structuring a mutually beneficial transaction. A struggling provider has access to a limited pool of potential partners—those with an appetite for resurrecting a struggling organization.

## Roadmap

The focus of this article is strategic alliances and affiliations in the post-acute and long term care space. Although each strategic alliance and affiliation involves unique issues and progresses on a different schedule, they roughly follow the same steps in the following order. First, after deciding to explore strategic alliances and affiliations, the provider defines the criteria essential to accomplishing its mission. This involves a strategic, financial, operational and political analysis. Second, the provider evaluates the market to identify and evaluate possible partners. Third, the provider reviews the various affiliation structures with advice from legal counsel. Fourth, the provider forms a steering committee to guide the transaction through closing and beyond. Fifth, after closing, the provider gauges the success of the strategic alliance or affiliation according to both quantitative and qualitative criteria.

For example, take two not-for-profit corporations—NFP-1 and NFP-2. NFP-1 is aligned with the Catholic Church; NFP-2 is aligned with the Lutheran Church. Both entities explore affiliation options and eventually form a partnership to construct and operate a faith-based campus offering a variety of senior living options as well as skilled nursing. NFP-1 and NFP-2 view the affiliation as an opportunity to extend their community outreach and accomplish more by collaborating and sharing resources. Although NFP-1 and NFP-2 follow different religious traditions, they agree to a set of principles to guide future decision-making.

The following outlines the process by which a provider can successfully enter into a strategic alliance or affiliation, and includes a set of questions that a provider should consider as it evaluates affiliations and strategic alliances.

## Step 1: Identify Your Mission and Objectives

Before a provider can identify potential partners or decide how to structure the affiliation, it must thoughtfully consider its mission. To be successful in the long term, an affiliation strategy should align with each entity's mission and goals. Is the provider a faith-based not-for-profit? Is the provider a secular for-profit? These questions must be answered and all subsequent decisions must be grounded in the provider's mission. Responses to the questions posed in the subsequent steps must be grounded in each entity's mission and long-term objectives.

It is important to note that the distinction between not-for-profit and for-profit is becoming less important in the context of strategic alliances and affiliations. For-profits have become more experienced in accommodating the needs of not-for-profits. A provider considering a strategic alliance or affiliation may consider the tax status of potential partners in assessing suitability, but tax status need not stop a mutually beneficial transaction.

### (a) Goals.

Before a provider can decide on an affiliation structure, it must enunciate the criteria by which structures are to be evaluated. A provider must consider: (i) long-term goals; (ii) financial targets; (iii) value-based criteria; and (iv) political criteria. A provider must approach affiliation with a strategic eye. Clearly, the provider must also ask whether a strategic alliance or affiliation will enhance its quality of care. A provider must be thorough in analyzing and evaluating the available options. Options range from the least involved (*e.g.*, a clinical/shared services agreement), which involves a low degree of integration, to highly involved (*e.g.*, member substitution, etc.), which involves a high degree of integration.

The end goal is to clearly articulate why an affiliation will allow the provider to better serve its current and prospective residents as well as why an affiliation will improve the provider's financial position.

- (i) Long-Term Goals. Affiliation transactions should be evaluated using long-term criteria. No affiliation goes precisely according to plan in the near term. Frustrations and setbacks are nearly inevitable. The end goal, however, should be a highly effective integration to enhance care and improve financial performance in the long term.

A provider must always consider whether an affiliation would be in accord with both entities' stated missions. A provider must also consider how an affiliation would impact its ability to serve clients in different geographical areas, and whether an affiliation would improve the provider's competitive position.

- (ii) Financial Targets. A provider must approach an affiliation with an eye towards long-term financial stability without ignoring short-term financial targets. Would the affiliation reduce costs or increase revenues, whether in the form of an improved payer mix, improved cash flow, or the ability to make necessary capital outlays?

Often, a provider will search for an affiliation partner only after identifying financial warning signs, such as increasing expenses, erosion in payer mix, cash flow deterioration, or an inability to fund budgeted expenditures. In such a case, a provider approaches negotiations from a position of weakness, and will lack negotiating leverage. A provider can approach negotiations from a position of strength by considering affiliation options as a strategic move before experiencing the aforementioned financial warning signs. It is never too early for a provider to evaluate strategic alliance and affiliation options.

[a] Tax-Exempt Considerations. Relevant tax status considerations include, among others: [i] the structure of the transaction; [ii] if the affiliation will result in a high degree of integration (*e.g.*, asset acquisition), whether the not-for-profit or the for-profit will survive; and [iii] if the not-for-profit survives, whether its services would be changed such that it could jeopardize its not-for-profit designation. Tax consequences of strategic alliances and affiliations are beyond the scope of this white paper; however, the provider should consult expert advisors early in the evaluation process.

- (iii) Value-Based Criteria. Operational issues affect both the financial viability and value proposition of an affiliation. Entities must consider their ability to enhance the quality of care at each provider, their ability to enhance care coordination between the providers, and their ability to recruit and retain staff and service providers. As with the financial targets, a provider should take a long-term view when assessing value-based criteria. A provider should consider whether the affiliation would allow it to provide new services and how the new services would benefit current and prospective residents. Often, a significant benefit of strategic alliances and affiliations is the provider's ability to offer residents a continuum of care. Take, for example, an assisted living facility that affiliates with an independent living facility. Clearly, current and prospective residents of both facilities would benefit, as they could move from the assisted living facility to the independent living facility when their health permits, and vice versa. Such a benefit would not be present if both entities only operated assisted living facilities.

With highly-involved affiliations, such as an acquisition, employee retention can be one of the most difficult issues. Research shows that organizations lose a disproportionate number of key employees following an affiliation's closing. To minimize turnover, the parties must make clear which entity will be the cultural acquirer. The best solution to the employee retention issue is prompt, clear communication with employees at all levels. A steering committee, composed of the top decision makers, should provide consistent communication that directly and honestly addresses all relevant issues, including job security and any changes to salaries or benefits.

- (iv) Political. Much more intangible than financial criteria, yet just as important, are political criteria. Political criteria can affect the financial considerations because community opposition to an affiliation may result in fewer prospective residents. A provider considering an affiliation must consider how the community would perceive the affiliation and whether that perception may vary based on the structure of the affiliation. A provider must also consider whether the potential partner has a troublesome reputation and whether it can or wants to improve its brand in your target market. For example, political considerations can derail a transaction if two parties intend to enter into a joint venture to construct a new facility that requires city council approval. Public opposition could prevent such parties from securing the required votes to proceed with the project.

## Step 2: Identify Possible Partners

Once a strategic, financial, operational and political analysis has been completed, the provider evaluates the market to identify and evaluate possible partners. The best affiliation partners are those that complement or supplement a provider's existing services. A provider should analyze its weaknesses and identify other providers that can help improve on any weaknesses. For example, a skilled nursing facility that is struggling financially due to a large Medicaid population may seek an affiliation partner with a larger private pay or Medicare population. Alternatively, a skilled nursing facility may desire to branch into assisted living, hospice or adult daycare. A provider should only focus on potential partners with a reputation for providing quality care.

A provider considering affiliation should compare its own mission and goals with that of each potential partner to identify any conflicts. A provider should also consider how it would benefit the potential partner, and vice versa. If a provider seeking affiliation cannot clearly and persuasively enunciate the benefits of an affiliation, a potential partner is unlikely to agree to it. Also, a provider

must consider the timing of an affiliation with each potential partner, as timing can affect the provider's negotiating leverage as well as the urgency of the transaction.

### Step 3: Affiliation Options

Strategic alliance and affiliation structures range from the least involved (*e.g.*, a clinical/shared services agreement), which involves a low degree of integration, to highly involved (*e.g.*, a member substitution, etc.), which involves a high degree of integration. The following strategic alliance and affiliation options are arranged from least involved to highly involved. While other structures are used from time to time, those listed below are the most common. For example, other structures may include a joint operating agreement or a long-term asset lease.

Providers should carefully consider advice from legal counsel regarding the optimal transaction structure.

#### **(a) Clinical/Shared Services Affiliation.**

A shared services affiliation requires little, if any, capital contribution by the affiliating entities. Services are provided by and for each entity at fair market value. Each entity maintains its own governance and finances. For example, a shared services affiliation could take the form of a group purchasing arrangement designed to allow each entity to gain economies of scale. The entities could also share employees or marketing functions.

#### **(b) Management Agreement.**

A management agreement similarly does not require a high degree of integration between entities. An example would be a provider contracting with a third party to manage an independent living facility, wherein the management fee is usually a predetermined percentage of net revenues. For outsourced administrative functions, the fee is often a fixed price per service. Governance remains separate because neither ownership nor control of the assets changes.

#### **(c) Joint Venture.**

A joint venture involves a relatively high degree of integration. Where a not-for-profit seeks to enter into a joint venture with a for-profit, the for-profit contributes cash for ownership interests, while the not-for-profit contributes other assets (*e.g.*, real property, equipment, etc.). The entities share the net income based on a previously agreed upon formula. For example, a for-profit desiring to enter the post-acute and long-term care space may enter into a joint venture with a not-for-profit skilled nursing facility. The for-profit would likely contribute cash to the joint venture and the not-for-profit would contribute beds and other equipment.

**(d) Member Substitution.**

The most common affiliation structure involving not-for-profits, a member substitution is a transaction between not-for-profit organizations where one becomes the corporate member of the other. This is usually a cashless transaction. To accomplish the member substitution, the partner-seeking organization amends its Articles of Incorporation and By-Laws such that the other organization becomes the new corporate member.

**(e) Asset Purchase/Acquisition.**

Outside the realm of strategic alliances and affiliations is the asset purchase/acquisition structure. An asset purchase requires the most involvement between the parties because the seller is absorbed into the purchaser's organizational structure. In such a transaction, a cash payment is used to repay any existing liabilities not assumed by the purchaser. The purchaser provides all operational support from the date of closing.

**Step 4: Planning for Integration**

After discussing the difficult questions posed above, organizations must contemplate how to integrate the organizations post-closing. Too often, executives overlook the integration planning issues. This can significantly impact the success of an affiliation transaction. Usually, several months pass between the execution of the nonbinding letter of intent and the execution of the definitive, binding documents. This is the perfect time to contemplate how to best integrate the entities.

Integration planning can proceed in a variety of ways. It requires, at a minimum, a steering committee, composed of the provider's top decision makers, the CEO, CFO, COO, legal counsel, and other advisers, and may benefit from a central project coordinator and a variety of teams to accomplish tasks across the organization. The steering committee makes the final decision on recommendations it receives from teams across the organization. The steering committee is responsible for communicating with interested parties, including employees. Consistent communication is imperative to the integration, effectively decreasing employee dissatisfaction and turnover, and increasing employee confidence in the decisions made by senior executives and the steering committee. Consistent communication can be achieved by centralizing the communication function to the steering committee. The central project coordinator acts as a liaison, conveying recommendations from the various teams across the organization—those involved in the day-to-day decision making—to the steering committee, thereby increasing the likelihood of employee buy-in.

## Step 5: Achieving and Measuring Success

The goals of an affiliation must be clear from the start. Still, gauging the success of an affiliation transaction is difficult to define quantitatively, except with respect to the post-closing financial results.

The provider must have strong and continuing leadership to fully realize the benefits of an affiliation, and ongoing, clear communication from individuals at all levels to interested parties is paramount. For example, as an entity evaluates ongoing staffing needs and makes post-closing adjustments, the steering committee must inform employees of changes as soon as possible.

## Conclusion

There is no one-size-fits-all strategy for exploring and pursuing strategic alliances and affiliations between post-acute and long term care providers. Strategies are entirely dependent on a provider's goals, its current financial and operational situation, and opportunities available to it. As a result, a provider considering a strategic alliance or affiliation should consult expert advisers early in the process.

As you evaluate these difficult issues, Reinhart Boerner Van Deuren's [Post-Acute Care and Long Term Services](#) Practice Group is prepared to assist you throughout the process. If you have questions about this white paper, or if you would like help evaluating your organization's affiliation options, please contact [Rob Heath](#), [John Kramp](#) or another member of Reinhart Boerner Van Deuren's Post-Acute Care and Long Term Services Practice Group.



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