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## Independent Hospitals Innovating, Finding New Partnerships in Response to Market Pressures

Standard & Poor's (S&P) Rating Services recently warned the health care sector was at "a tipping point where negative forces have started to outweigh many providers' ability to implement sufficient countermeasures." S&P noted that for the past year, credit downgrades increasingly exceeded credit upgrades. Stand-alone providers are facing physician departures, rising bad debt, and higher employee benefit costs, all at a time when regulatory compliance requirements and technology upgrades also require significant attention.

"Hospitals have done a pretty good job cutting costs to deal with declining revenues," said Martin Arrick, managing director at S&P. "But in the last year with the additional pressure of volume declines, it's been the straw that is breaking the camel's back." To better weather the storm, numerous independent providers have turned to mergers with larger health systems as they "seek scale and efficiencies to offset increasing operating pressures," S&P reported.

With the Affordable Care Act (ACA) and market forces creating new challenges for stand-alone hospitals, many hospital leadership teams have addressed these forces with innovation, enhanced management, and consolidation or partnering with other players for efficiencies. With all hospitals now required to publish charges annually, greater transparency will empower counterparties with negotiating information. ACA exchanges and [greater] patient responsibility for [greater] deductibles are expected to promote market competition and comparative shopping by consumers, forcing nonprofits to compete on price against for-profit competitors.

Fee compression under federal and state health care programs, along with new integrated care delivery and payment models encouraged under the ACA will pressure nonprofits to innovate and find efficiencies as they compete against large health care systems and organizations in responding to the ACA's demands for better coordinated, high-quality care. Pay-for-performance programs will harshly impact facilities with high readmittance rates or clinical quality measures below national standards. Around the country, state-level subsidies and programs leveraging federal monies that have now been repurposed under the ACA have been curtailed as state legislatures face budget pressures of their own.

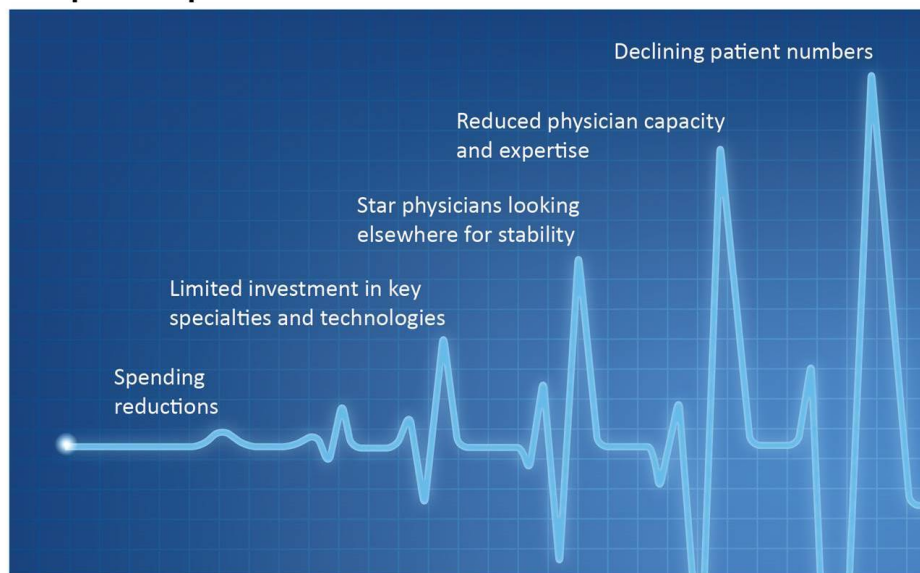
On top of these competitive forces, hospitals must comply with stringent new legislative and regulatory requirements and increased accountability to federal and state regulatory agencies, including additional requirements for nonprofit hospitals' operations and reporting, and compliance with more technical billing and collection practices for services provided to the uninsured. Finally, nonprofit hospitals face constant pressure to maintain their tax-exempt status, with potential decreases in the uninsured population making it harder for tax-exempts to meet required thresholds for treating uninsured patients.

If left unchecked, these competitive pressures can set off a vicious chain reaction at a hospital, with across-the-board spending reductions often necessary to compete. Strained budgets often result in

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limited investment in key specialties and technologies, accelerating the overall problem as patients look elsewhere for the expertise they need. Star physicians may seek stability, taking patients with them. The result: reduced physician capacity and expertise and declining patient numbers that further accelerate the hospital's challenges.

### Competitive pressures can set off a vicious chain reaction



Prescriptions for potential paths forward include development of innovative health care delivery models that promote delivery of integrated, quality health care within budgetary constraints. Specifically, hospital integrations with post-acute care providers are anticipated in response to the ACA, as providers strive for increased coordination to survive and thrive within bundled payments and value-based purchasing arrangements.

To the extent that a hospital pursues a consolidation or partnership transaction, nonprofit entities face rigorous regulatory scrutiny from health care and antitrust perspectives. Federal regulators specifically concerned that health care mergers could lead to anti-competitive practices are scrutinizing transactions, with state attorneys general requiring nonprofits to demonstrate proposed transactions will not result in misuse of charitable assets and will not harm nonprofit missions. More often than not, physician self-referral, False Claims Act, Anti-Kickback Statute, and other health care regulatory compliance issues come to light during the transaction process.

For most communities, the hospital provides the foundation for public health, as well as an economic development engine. With any innovation process, each hospital community stakeholder has a unique role in collaborating to reach a positive outcome: the board of directors, political leadership, patients, charitable foundations, vendors, staff, physicians, Medicare/Medicaid, private payors, and the local

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business community. Experienced third-party professionals can support the implementation of innovation and strategic responses within the hospital, or partnering with another industry player, and should honor the needs of the hospital community and its array of constituent parties throughout the process.

For some hospitals, the pressures described above may necessitate a financial restructuring, which could take many forms and involve several elements. The restructuring may be as simple as deferral of interest or principal payments on bank or bond debt secured by hospital assets. At the other end of the spectrum, circumstances may necessitate a joint venture, management agreement or outright sale. In the restructuring context, the hospital's bank lenders or bondholders become a critical additional constituency, and in some respects a predominant one. Exploration of options and negotiation of the most favorable outcomes require a proactive, aggressive approach. Because a financial restructuring may also require a set of experience and skills separate from those held by many nonprofit hospital boards, the hospital may be well served by specialized legal and financial advisors operating under the direction of hospital management and the board, as is typical in other industries.

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[Michael King](#). Health care transactional and finance matters, including structuring joint ventures and management arrangements, mergers and acquisitions, and financing transactions.

[Darryl Landahl](#). Health care regulatory and transactional matters, including structuring health care joint ventures and contractual arrangements, compliance program development and implementation, and medical staff and peer review issues.

[Mike Pankow](#). Business reorganizations both in and out of bankruptcy court. Represents debtors, creditors' committees, secured creditors and prospective purchasers in Chapter 11 cases.

[Julie Sullivan](#). Health care regulatory and transactional matters, including advising on fraud and abuse, reimbursement and privacy rules and regulations, as well as structuring health care entity joint ventures, mergers and acquisitions.

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**Michael W. King**

Shareholder

[mking@bhfs.com](mailto:mking@bhfs.com)

T 303.223.1130

**Darryl T. Landahl**

Shareholder

[dlandahl@bhfs.com](mailto:dlandahl@bhfs.com)

T 303.223.1117

**Michael J. Pankow**

Shareholder

[mpankow@bhfs.com](mailto:mpankow@bhfs.com)

T 303.223.1106

**Julie A. Sullivan**

Associate

[jsullivan@bhfs.com](mailto:jsullivan@bhfs.com)

T 303.223.1231