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HEALTHCARE MANAGEMENT ADVISORS

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Anatomy of a Deal: Navigating the Due Diligence Process

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Performing due diligence can seem like a "check the boxes" exercise—but it's much more than that. It's an opportunity to explore the strategic implications of a proposed merger or acquisition, such as the impact of consolidation on physician alignment, governance or financial performance. It's also a chance to dig deep into dynamics that could influence post-transaction operations, such as clinical referral patterns or employees' response to the changes that are about to take place, and how these factors could influence performance.

When the acquirer is too quick to gloss over issues discovered during due diligence—a process that typically takes about 90 days—this can leave the system dealing with issues, the ripple effects of which impact revenue and operations long after the deal has closed.

In the case of Independent Hospital (IHX) and Regional Health System (RHS), RHS was anxious to close the deal, knowing that if it didn't, a competitor would be ready to step in. But the consultant hired by RHS to conduct due diligence uncovered a surprise: an outstanding malpractice suit that had the potential for a multimillion-dollar settlement if it were not decided in IHX's favor. RHS needed to consider: "How would this settlement be paid? Has the hospital set aside funds for possible payment of the claim? Has the potential for claim payment been factored into an assessment of the hospital's overall capital and financial picture?"

Suddenly, these considerations became the focus of further negotiation, as it materially changed the impression that RHS leaders had of the hospital's financial picture. Because RHS had made a capital commitment to IHX prior to signing a letter of intent, leaders for both organizations agreed that the capital commitment would be adjusted if IHX were forced to pay a settlement (e.g., 70% of the settlement would come from the health system's capital commitment to the hospital).

Other types of issues that can become topics for deeper discussion when during due diligence include:

- Issues related to fair market value, such as contractual agreements with physician groups for directorships. It's not uncommon for a community hospital to have 100 to 200 types of agreements such as these.
- The impact of a competitor's response to the transaction on the organization's existing relationships. For example, if all of IHX's orthopedic physicians are employed by a RHS competitor, the parties may wish to align with independent orthopedic practices in the area.
- Implications for executive leadership. For example, if an executive leader has a change-of-control clause that stipulates the leader may leave voluntarily after a transaction is complete, complete with a severance package, this could present financial risk for the newly merged organization.

Once due diligence is complete, the findings inform final negotiations before an agreement is signed.

Our final blog in this series will focus on what this merger looks like a year later.

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