Doing Due Diligence on Due Diligence

The following article appears in the April 2013 AHLA Healthcare Transactions Resource Guide.

Industry publications are replete with articles analyzing trends in hospital-physician alignment and health-system consolidation. In the past, the top economic driver for mergers and acquisitions was increasing delivery capacity, i.e., the ability of a single entity to provide more services. Given the transition from volume-based reimbursement to population-health management, today’s deals are driven by the need to demonstrate more efficient care delivery, improve quality and outcomes, and to expand the ability to manage the health of a defined population.

As advisors approach the task of due diligence for these contemporary transactions, they may be armed with their tried-and-true checklists, document requests, and interview schedules. If, however, today’s trend towards consolidation is driven by something different than yesterday’s deals, are the old, reliable due-diligence strategies still relevant?

Pershing Yoakley & Associates, P.C., (PYA) reached out to several healthcare executives and transaction attorneys to gain further insight from trusted colleagues. These executives provided insight into their recent transactions, and related how due-diligence processes should be altered, based on those experiences. We learned that like almost everything in healthcare these days, most organizations are building it as they fly it, and the due-diligence process is evolving to meet new demands.

These executives and attorneys have significant experience with transactions
involving physician practices, hospitals, ancillary business units, and other healthcare entities. Despite the diversity of the types of businesses being transacted, the responses provided by these executives primarily addressed one central theme: *increased physician alignment is dictating the need to alter the typical due-diligence approach*. Through our conversations, we identified three key developments: (1) the importance of the seller’s internal due diligence; (2) physician-practice interoperability; and, most importantly, (3) an increased focus on evaluating organizational culture.

**(1) Importance of the Seller’s Internal Due Diligence**

Describing a transaction that was significantly delayed, an attorney from a law firm in the Midwest addressed the need for the sell-side organization to perform the internal due diligence necessary to identify (and, to the fullest extent possible, remedy) noncompliant agreements with physicians. As healthcare attorneys and compliance officers know, convincing an organization to conduct an internal compliance review of existing physician agreements can be challenging. An organization contemplating any sort of affiliation should remember: An ounce of prevention is worth a pound of cure.

In the cases cited by the respondents, noncompliant agreements were identified during the buyer’s due diligence, but at such a late point in the process, that closing dates had to be extended. These issues often arise with agreements related to real estate, or other arrangements that fall outside typical compensation agreements. As an example, one respondent suggested the seller include within its due-diligence procedures a process to verify that agreements exist for all payments to physicians identified within the accounts-payable system.

A more comprehensive internal due diligence performed by the seller, prior to the buyer’s due diligence, allows the seller the opportunity to reconcile any issues discovered earlier in the transaction cycle. Finding the noncompliant agreements late in the due-diligence process can erode the momentum established when announcing the expected affiliation, and potentially delay or derail, the entire transaction.

**(2) Addressing Physician-Practice Interoperability**
A director of finance for a health system in the Southeast described a situation where a portion of a physician practice’s revenues was dependent on data connections with multiple referring physicians. As the practice was integrated into the buyer’s information systems, the practice learned these critical data connections were not supported by the new platform.

In hospital transactions, the transaction team performing due diligence usually includes an entire information technology (IT) group. The need to address hardware, software, networking, and telecommunications is critical to the early success of the affiliation. Similar to the accountants and legal counsel, IT professionals have honed their due-diligence processes for addressing the planning that is needed to keep data flowing smoothly following the transaction. However, the IT due-diligence process used during the acquisition and integration of individual physician groups can pose a dilemma. When the focus is on moving a hospital or multiple practices to a more robust IT platform, connectivity between individual physician practices may be overlooked. While these practice-to-practice interconnections may not be critical to a hospital’s mission, the inability, or more often, the delay, in restoring functionality to provide professional reads or access lab results can materially impact the financial performance of a physician clinic.

Additionally, these interruptions of service can erode confidence in the health system’s ability to adequately support its physician partners. More importantly, when these issues impact the compensation of physicians who are incentivized with productivity-based compensation contracts, lack of connectivity becomes more than a problem of perception.

Respondents cited the need for, and deployment of, an expanded approach where a dedicated IT team identifies the recipients and deliverers of data to and from each practice location. If new systems are implemented within the practice, testing is performed to ensure that connectivity between the practice and its external partners is maintained. This level of detailed planning engenders confidence between the physicians and their new parent organization.

(3) Increased Focus on Evaluating Organizational Culture

An October 15, 2012, Healthcare Finance News article– Most Hospital M&A
Transactions Are Financially Unsuccessful, Study Says – addresses the importance of partnering organizations having likeminded views about the future and their respective cultures. The study discussed several key factors contributing to the successful integration of organizations. Among those key factors identified were the importance of partnering organizations common views about the future, culture, and market positioning. Our respondents echoed these findings, and specifically cited the importance of this concept related to physicians.

Assessing the cultural fit between two healthcare organizations has always been a part of the transaction process. Discussions with board members, interactions between the management teams, and conversations with the organizations legal counsel and audit firms provided opportunities to assess cultural fit. With the proliferation of affiliated physicians, health systems are now affected by the subcultures represented by each of those affiliations. The need to work collaboratively with physicians to develop efficient processes for managing the care of a population dictates that organizations understand the willingness of physicians to participate in, and in most cases lead, the process of care delivery. Three areas were specifically addressed in our conversations with industry leaders:

1. **Determining the near- and long-term plans of physicians that will be joining the organization.** Beyond revenue considerations, knowing the plans of physicians who may be in the later stages of their careers is critical for understanding how patient access is affected, and to allocate resources needed for physician recruitment.

2. **Gaining an understanding of formal and informal physician leadership within a practice.** Established practices often have strong leadership either through a designated position or through a dynamic personality that informally leads the group. Identifying and working with existing leadership to gain an understanding of culture, and to share ideas regarding vision and future strategies can help smooth the transition into the new organization.

3. **Assessing the willingness of physicians to work within the new organization s processes.** The transition from an independent physician practice to a health system can be alarming for physicians who have not been accustomed to bureaucracy within their practice. Balancing the system s need for alignment with the culture of
leadership represented within its physician partners requires dedicated time and energy in the affiliation process.

Performing due diligence on physician culture is not easily captured on a due-diligence checklist. Internal counsel for a health system in the Southeast described a process that included the use of medical directors who have physician-to-physician conversations with incoming physicians. These peer-to-peer interactions, while time consuming, often led to candid discussions that allowed the organization to plan appropriately following the closing of the transaction.

**Conclusion**

Due-diligence activities have routinely addressed financial and regulatory concerns. While contemporary due diligence must still address these concerns, the factors driving consolidation in the healthcare industry necessitate enhanced due-diligence focus on physician- and hospital-alignment issues.

The transaction team performing due diligence must have a breadth of capabilities to address the strategic, human resources, accounting, finance, environmental, risk management, information technology, and compliance issues that have been routinely addressed during due diligence. In addition, the team must also include resources that understand physicians, physician-practice operations, and the cultures represented within those physician enterprises. By applying the appropriate resources early in the process, organizations can avoid pitfalls related to issues that risk compromising the opportunities presented by these consolidations.

For more information regarding due diligence, hospital-physician alignment, or mergers and acquisitions, contact the experts listed below at PYA, (800) 270-9629.