The Role of the Nonprofit Hospital Board in Consolidation Transactions

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As the hospital consolidation market continues to grow, most consolidation transactions involve nonprofit health systems. Nonprofit boards of directors should prepare well in advance to evaluate consolidation opportunities in a timely and informed manner, consistent with their fiduciary duty.

The hospital consolidation market continues to gain steam. The year 2013 saw a total of 87 consolidation transactions, following 105 in 2012.

This volume represents a significant increase over 58, the median number of transactions completed each year between 2001 and 2011. Consolidation transactions offer the possibility of achieving economies of scale, better access to capital, geographic expansion, and improved quality and clinician expertise. The vast majority of consolidation transactions involve a nonprofit health system. In such cases, ultimately it is the nonprofit board's decision whether, and under what terms and conditions, a hospital pursues a consolidation transaction.

It is critical for a nonprofit board of directors to prepare in advance to evaluate a consolidation opportunity in a timely and informed manner, consistent with its fiduciary duty.

Doing so requires the board to, at a minimum, undertake the following preparation:

1. ***Be informed about the fiduciary obligations incumbent on the directors;***
2. ***Establish good governance processes well in advance;***
3. ***Make provisions to address certain regulatory and business issues common to consolidation transactions.***

The law expects the board to closely oversee the transaction process in order to preserve the value of the corporate assets and to protect the charitable mission. Failure to provide sufficient oversight will weaken the credibility of the board's ultimate decision and imperil any board-endorsed deal's chances for regulatory approval. Corporate conventions related to business combination decision-making policies offer good guidance for hospital boards. Several decades of case law and well-developed M&A market experience can provide meaningful direction for the new wave of hospital directors confronted with evaluating similar change-of-control opportunities.

The Board's Fiduciary Obligations

The board of directors of a nonprofit health system or hospital has three core fiduciary duties: the duty of loyalty, the duty of care and the duty of obedience to the charitable mission of the organization. These three core duties apply to the governing board as a whole and its various committees and subcommittees.

The fiduciary duties are not for the benefit of other board members, donors to the hospital, executives or physicians. Instead, these fiduciary duties are owed to the organization itself and its charitable purposes. Therefore, nonprofit directors are bound to serve the best interests of the organization itself, and not another constituency.

1 *The Duty of Loyalty*

The duty of loyalty requires corporate directors to exercise their powers in good faith in furtherance of the charitable mission and not in their own interests or the interests of another person or entity. In the context of evaluating a potential consolidation transaction, the duty of loyalty imposes an obligation on directors that they not consider other interests in making the decision. Furthermore, directors are obliged to keep confidential the presence and mechanics of a transaction process and the details thereof for the benefit of the organization. For example, the impact of a consolidation on certain physician groups or staff should not be put before the goal of furthering the organization's charitable mission.

2 *The Duty of Care*

The duty of care requires that corporate directors act in an informed, good faith manner when participating in board decisions and exercising their oversight of the organization. The duty of care applies not only to oversight of day-to-day operations and compliance issues, but also to the evaluation and oversight of consolidation transactions. Some states may hold a "seller's" board to an even higher standard of care. To fulfill the duty of care, corporate directors are encouraged to allow sufficient time for consideration, to gather and review all relevant data (including primary source data), and to ask questions in order to gather all necessary information. Furthermore, to meet this duty, boards often are advised to establish a basis of comparison across transaction options in order to be able to defend the fairness of the transaction's terms and conditions.

3 *The Duty of Obedience to the Charitable Mission*

Lastly, the duty of obedience to the charitable mission (which is acknowledged in a majority of states) requires that a director further the charitable purposes of the corporation and act in conformity with all laws generally affecting the corporation. To fulfill this duty, directors should have a strong understanding of the charitable purposes of the organization. It is incumbent upon boards to constantly examine their mission and purpose, and to understand how a consolidation might further (or detract from) that mission. In order to provide effective oversight, the board must understand the rationale prompting a specific proposal, and how that proposal supports the organization's objectives.

In examining any consolidation transaction, the general counsel or outside counsel should brief the board on the standards of conduct the law will expect it to apply in connection with its evaluation of a consolidation proposal. A consolidation transaction will require the board to apply a higher level of attentiveness and scrutiny to its review than it does to normal and customary board matters. If the board elects to delegate day-to-day oversight of the consideration and negotiation of a transaction to a standing or special committee, the extent of that delegation, and the communication between the committee and the full board, should be thoroughly understood.

Advance Establishment of Good Governance Structures

Establishing good governance structures and the authority of the board is critical to achieving a positive outcome in a consolidation transaction. Furthermore, hospital and health system boards should take this action well in advance of the actual consideration of a consolidation opportunity.

State law uniformly agrees that the board is in charge and that no consolidation transaction of any consequence can proceed without board approval. The expectation is that management and its advisors will do the basic "blocking and tackling," but that the transaction is the board's responsibility and the board must sign off on the final game plan. This is to ensure the presence of checks and balances deemed necessary to protect charitable assets, given the potential and unavoidable conflict of interest when management team members negotiate with their potential new employer. A prepared board will assess potential approaches to managing the process of a consolidation transaction well in advance. The board should consider establishing a "strategic review committee" or other committee that will be tasked with assessing combination opportunities (both inbound and outbound). While the committee should not take over the full activity of the board, the committee can vet opportunities, gather data and information, and present findings in a coherent fashion to the full board. Consolidation proposals and similar "big deals" require a transaction timetable that is sufficient to allow thorough evaluation. This is an area where the board and the designated committee can exercise particular common sense oversight (e.g., "This is dragging; we need to pick it up," versus, "This timetable is too aggressive; we need to slow it down.")

The board must have an understanding of the proposed transaction timeline, the implementation of a competitive process, the risk exchange involved in the major decision-making points (e.g., a letter of intent and definitive agreement) and any external factors (e.g., regulatory or principal vendor approvals) that may influence the timetable. Significant mistakes are made when boards do not realize the steps involved, the sequence of those steps or the intentional use of proven processes to maximize outcomes.

Lastly, the board should develop its evaluation criteria in advance of the consideration of a potential consolidation. Such evaluation criteria should include information relating to achievement of charitable goals, the reasonableness of financial terms, human resources issues, implications to the medical staff, and closing responsibilities and obligations. The criteria also should reflect recognition of specific transaction-related legal risks (e.g., antitrust challenges). An increasingly important consideration is the extent to which the board had the opportunity to consider the results of the due diligence investigation and the related risks (regulatory and operational) to the organization. This is especially the case if unusual or unexpected risks are identified. The presence of a written record reflecting application of such criteria will be very persuasive to regulators called upon to review the transaction and the board's related diligence.

Key Issues for Board Consideration

As the overseer and steward of the nonprofit hospital or health system's assets and charitable mission, the board should be aware of key issues that it will be asked to confront when considering a consolidation transaction.

At a minimum, issues include the following:

1. ***Know your state regulators and their power.***
   Consolidation transactions are frequently governed by various laws that are overseen by a State Attorney General office (charitable and antitrust sections). There also may be Certificate of Need filing requirements. A board should be aware in advance of the applicable regulators that would review and provide input on any consolidation transactions.

2. ***Be prepared to defend the decision.***
   The board should be prepared to answer central questions that external critics likely will pose, including "how did the board arrive at a particular decision?" and "what steps did it take to ensure that the transaction value and terms are fair?" The best defense against these questions is the rigor and thoroughness of a well-run board-led process.

3. ***Understand your corporate structure.***
   The differing corporate forms of hospitals and health systems and consolidation transactions are important to understand. For example, in change-of-membership-based arrangements, it is important to articulate with clarity such important governance-related terms as the formation, mission and board composition of the parent organization; the specific reserved powers to be retained by the parent over the affiliate hospital providers; the process by which board members and chief executive officers are selected and removed; and any special voting arrangements, such as supermajority provisions. In arrangements involving faith-based organizations, it is important to establish a process by which particular faith tenets and identities are preserved and protected.

. . . Key Issues, continued

4. Be prepared to handle federal antitrust matters.

Depending on the size and structure of the proposed consolidation transaction, the parties may be required to file a Hart-Scott-Rodino (HSR) application with the Federal Trade Commission (FTC) and the U.S. Department of Justice (DOJ). The HSR application requires that the parties disclose materials that discuss the proposed transaction and the service area. The general counsel and/or outside counsel should advise the board regarding the creation and content of written communications, which can create unintended issues and delays with the FTC and DOJ. Regardless of whether an HSR application is required, the FTC and DOJ continue to challenge transactions in the health industry that they view as anticompetitive. If the FTC believes the proposed consolidation transaction is potentially anticompetitive, it typically contacts payors for their input on the proposed transaction. Hospital leadership may positively influence payor reaction by identifying the community benefit and pro-competitive effects of the transaction and communicating those benefits to payors and the community. Demonstrating the transaction's value to the community is also part of the board's Duty of Obedience discussed before.

Conclusions

It is vitally important that management (including general counsel or outside counsel) make a special effort at the beginning of the transaction process to brief the board on the law's expectations and how the management team can support board compliance with those expectations. This should be neither a difficult nor cumbersome task. The failure to complete it, however, will jeopardize the likelihood of a successful transaction and the reputation of the board.

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