THE BOND BUYER
Wednesday, February 15, 2017 | as of 10:42 AM ET

Commentary

Membership Substitution Transactions – Why Are They So Misunderstood?

By Ken Marlow and Rex Burgdorfer and Alex Voss
February 14, 2017

Membership substitution transactions are the most common form of business combination transaction in the nonprofit hospital industry. They are also widely misunderstood and the source of many mistakes. Many large 501(c)(3)s have become more acquisitive as a result of economic pressures of the ACA. Nonprofit health systems have been getting much better at participating in and winning competitive sale processes, resulting in an increased use of this business combination form.

In April 2013, St. Luke's Episcopal Health System announced its sale, via membership substitution, to Catholic Health Initiatives. In responding to a suit from physician owners (a minority faction) of a St. Luke's subsidiary, St. Luke's Sugar Land Hospital, St. Luke's attorney asserted: "the ownership of St. Luke's Sugar Land Hospital is totally unchanged by the Transaction." We have no opinion on this legal debate, but it points out something that repeatedly arises in these transactions – most participants don't really understand them to any depth.

Given the forecasted level of nonprofit hospital M&A activity in the coming years, as well as the increased use of the membership substitution specifically, it is important that these new and often inexperienced participants consider the implications of the structure. This article will explore the membership substitution structure – its history, use, pros, cons, and potential future applications. Issues such the impact on one's credit stature, bond covenants, and the legal handling of consolidating Master Trust Indentures are reviewed.

Description

Fundamentally, there are two means to acquire ownership and control of a company. One can either buy the assets of the business or its stock. Membership substitutions are analogous to a stock sale in corporate finance. A majority of public company mergers are completed via the acquisition of equity. Classic examples include Proctor and Gamble's acquisition of Gillette and Berkshire Hathaway's purchase of Heinz. In these arrangements, the legal entity of the target (Gillette and Heinz) remains intact with a new parent "stepping into Seller's shoes" as sole owner. This transaction structure has several advantages:

- It creates *successorship* for contractual agreements – employment, collective bargaining, management teams and similar operational matters are preserved.
- Business operations are uninterrupted – licensures, working capital, and leases are unchanged.

- The acquisition process is streamlined – timing and due diligence are simplified, regulatory scrutiny can be eased, and often there is no need for wind down corporation.
- Pensions, swaps, and other liabilities continue as a going concern – no need to terminate with the PBGC or unwind costly derivative instruments.
- Debt issues – avoid pre-payment penalties and defeasance costs associated with today's low interest rate environment.
- No need for tail insurance – beneficial if confronted with Stark or compliance issues that cause such coverage to be unattainable or unduly expensive.

It is easy to see that selling the stock of a business has certain advantages to sellers related to simplifying the transaction and costs. Conversely, buyers commonly prefer to acquire assets as it limits real and theoretical future legal obli¬gations.

Asset purchase transactions certainly have merit as well. In industries with significant intellectual property, e.g., technology, this more focused structure can isolate certain attractive assets and exclude other components of the business. For the same reason, divestitures of a subsidiary division within a conglomerate are generally acquired via a purchase of assets.

Governance

In a membership substitution model, typically the buyer will become the sole equity holder (or "membership interest" in nonprofit language) of the seller. As a result, the buyer will achieve full ownership and control of the seller. Think of this relationship much like that of a parent company and subsidiary, where the parent ultimately retains senior controls of the subsidiary. In connection with a member substitution transaction, the bylaws of each of the buyer and seller will be amended and restated in order to reflect the new governance structure and to provide for reserve powers that rest with the buyer. Oftentimes, the seller may negotiate with the Buyer to have a limited minority number of board seats on the buyer's board.

Forms of Consideration

In either a membership substitution or asset sale, there are generally three forms of economic consideration that the buyer provides to the seller of a hospital: (1) a purchase price, (2) assumption of liabilities, and (3) a commitment to spend capital in the future. Together, the sum of these must equate to "fair market value." The mixture of these forms varies based on the capital structure of the target and objectives of the parties. In a nonprofit to nonprofit membership substitution, a purchase price is rarely paid, instead the Seller is relieved of its financial liabilities and secures a commitment to invest capital in the future. In many cases, nonprofit Buyers are now the highest bidders in sale processes due to: (1) the high use of financial leverage, and (2) the strategic importance of growth. So while for-profit conversations were popular a decade ago to extract a purchase price and create a community foundation with the proceeds, today the total economic consideration of a membership substitution transaction is often equal or greater. Evidence of the achievement of "fair market value" is critical to defend the transaction to any critics, notably the state attorney general.

Financial Features

- All assets are *conveyed* to the buyer.
- All liabilities should be *assumed* or *guaranteed* by the buyer.
- Capital expenditures are *committed* by the buyer for routine and strategic needs in the future.
- Rarely are charitable foundations created, if so it is most always restricted to supporting the hospital.

Liabilities of the new subsidiary either remain in place by being *assumed* or *guaranteed* by the new parent company (as part of the obligated group), or are *retired* via refinancing. Issues associated with assuming the debt can include intercompany loans (potentially with interest), a support or guarantee arrangement, or inclusion or exclusion within the system's obligated group.

Similarly, the handling of balance sheet assets is also customized for each setting. Can the cash be swept to corporate treasury? Who controls the foundation, where is it housed, who gets to select grant donations? Will the capital commitment be infused into the local subsidiary or simply be funded through retained free cash flow?

As a result of the change in the organizational structure, it is important for each party to review its Master Trust Indenture, as well as any and all material documents ancillary to or apart from the Master Trust Indenture between a bondholder and any member of the obligated group. With the assistance of investment bankers and legal counsel, the parties will want to determine whether each Master Trust Indenture may remain in place, and if so, whether this is the desired approach. Alternatively, the parties may determine that it is in the best interests of the combined organization and permitted pursuant to the terms of the Master Trust Indentures to consolidate the debt under one Master Trust Indenture. If consolidation is permitted and desired, then the parties will want to determine under which Master Trust Indenture they wish to proceed post-closing. For example, it may be advantageous to the parties to consolidate the debt under one of the Master Trust Indentures in order to take advantage of less restrictive and less burdensome covenants. In addition, there may be significant savings by capitalizing upon a more favorable cost-of-capital under one Master Trust Indenture over another.

The parties should also have an understanding of how the consolidation may affect the rating of the bonds as a result of the combination, which will require a review of the rating agencies on analysis of pro-forma ratios. As part of the review of the documents, the parties also will want to identify any consents that may be required of the bondholders and develop a timeline for reaching out to and obtaining such consents of the bondholders. Regardless of whether consent is required, there may be other covenants required by the Master Trust Indenture or ancillary documents, such as the delivery of legal opinions, officer's certificates and posting of additional collateral of which the parties should be aware. Finally, the parties will want to understand the terms of any other debt outside the Master Trust Indentures (including any swaps) that may be outstanding to determine if the combination will be in violation of any covenants, and consider whether it is best to obtain consent or alternatively, redeem or pay off such debt.

As a result of the modified structure via a membership substitution, the parties will need to review the contracts to determine whether the change of control will trigger any consent requirements of third parties, any terminations or defaults under any agreements or rights of first refusals. The parties will want to ensure that they abide by the terms of their agreements with third parties. In addition, in the event that the parties are members or partners in a joint venture, there may be transfer and consent requirements that are triggered as a result of the change of controls. Further, the parties will want to carefully review their contracts for non-competition restrictions, non-solicit restrictions and confidentiality provisions to fully understand the implications of the change of control.

Misnomers

Most of the confusion surrounding this structure in the nonprofit world centers on whether the parties acknowledge that a sale is occurring. Often there are incentives to obfuscate reality, namely easing the public relations messaging locally.

Part of the uniqueness of the membership substitution is the nonprofit nature of the partners entering the transaction. While for profit enterprises can access and variety of equity, debt, and synthetic markets to raise capital to finance strategic growth, nonprofit hospital companies are

typically limited to the tax-exempt municipal bond market. Buyers of institutional debt are heavily reliant on credit rating (rather than growth prospects in the equity markets) in determination of the cost of capital or required yield. As a result, hospitals, and nonprofits generally tend to be more conservative with capital and have an affinity toward creative relationships to increase market share, revenue, and ultimately profits while not diluting one's rating and thus ability to raise capital.

Sellers are becoming more sophisticated, however, and are questioning what they're getting in return for selling their hospital. The give-away transactions of yesteryear are not likely to be repeated in the era of more commercially oriented partners.

Conclusion

From our standpoint, it seems as though M&A techniques in the nonprofit hospital industry are given too much credit for their uniqueness. Much of this stems from a heartfelt belief that M&A transactions in the nonprofit world are completed on more friendly terms. As the stakes get higher in the increasingly capital intensive, regulated, and complicated hospital industry, however, this is changing. Transactions now seem more adherent to corporate norms – following SEC conventions and Delaware Law. Negotiations surrounding the accounting treatment of financial statements and technical topics such as representations and warranties, escrows, and breakup fees are becoming more common. Overall, it seems like the cottage hospital M&A business is maturing and taking on characteristics of public company transactions.

Ken Marlow is a partner and chair of the healthcare department at Waller Lansden Dortch & Davis in Nashville, Tenn. Rex Burgdorfer and Alex Voss are with Juniper Advisory in Chicago, a specialized investment banking firm focused exclusively on hospital M&A. Sources for this research include Waller Lansden and Juniper Advisory's M&A experience, as well as information compiled by The Harvard Business Review, The American Bar Associate, and Latham & Watkins studies.

© 2017 SourceMedia. All rights reserved.
Mobile Version