Nonprofit Hospital Acquisitions: Structuring and Regulatory Considerations

A Lexis Practice Advisor® Practice Note by
William B. Eck, Seyfarth Shaw LLP


William B. Eck

This practice note discusses the transactional and legal distinctives of nonprofit hospital acquisitions. Most hospital acquisitions are of nonprofit hospitals and health systems (systems of nonprofit health care providers related by ownership or control). These transactions usually take one of four forms: membership substitution; acquisition or merger, if the acquirer is nonprofit; or asset acquisition, if the acquirer is for-profit. Membership substitution is somewhat analogous to a stock acquisition in a for-profit context. This practice note briefly summarizes the membership structure of nonprofit hospital systems and hospitals, proceeds to address the four kinds of transactions, and addresses some salient planning considerations bearing on the transactions for M&A attorneys.

Individual hospitals and smaller hospital systems pursue consolidation through acquisitions as a means to access capital, build market share, and control cost. However, it is not only smaller providers that view partnership strategies as the path forward. The signing of a definitive agreement between Catholic Health Initiatives and Dignity Health, creating the largest health system in the country with over $28 billion in revenues, as well as other large system combinations, indicate the quest to achieve scale to grow revenue and market share, and control cost, extends to the largest systems as well as to smaller systems and individual hospitals.

See also these practice notes on healthcare acquisitions:

- Physician Practice Acquisitions: Avoiding Legal Pitfalls
- Medicare and Medicaid Change of Ownership Considerations in Healthcare Industry M&A
- Telemedicine and Digital Health: Strategic Opportunities and Legal Considerations for Private Equity Investment

STRUCTURE OF NONPROFIT HEALTH SYSTEMS AND HOSPITALS

Nonprofit Health Systems

A tax-exempt nonprofit health system typically has as its parent organization a nonprofit health system corporation that is the sole member of the subsidiary hospital (and often of other health care providers and foundations). Sole members are analogous to sole shareholders of for-profit corporations. They have reserve powers that customarily are similar to the powers of shareholders. In some cases, there are intermediate subsidiaries, which themselves are membership nonprofit corporations which are the sole members of the operating nonprofit subsidiaries below them.

The ultimate parent of a nonprofit health system often has as its members the individuals on its board of directors. These individuals, in their capacity as members of the corporate parent, elect themselves to the board. As members of the board, they appoint themselves as members of the corporate parent. Typically, the initial members of the board are named in the articles of incorporation or organizational resolutions of the corporate parent. They proceed to appoint themselves as the members of the parent corporation. In turn, the members of the parent corporation elect the members of the parent corporation board.

A nonprofit system may and often does include for-profit subsidiaries. These for-profit corporations carry out activities that are not permitted for nonprofit or tax-exempt entities. They are owned, directly or indirectly, by the tax-exempt nonprofit parent organization.

Nonprofit Hospitals

Usually nonprofit hospitals are structured in health systems, with a parent organization, a subsidiary to operate the hospital, a subsidiary foundation, and other subsidiaries to operate other providers.

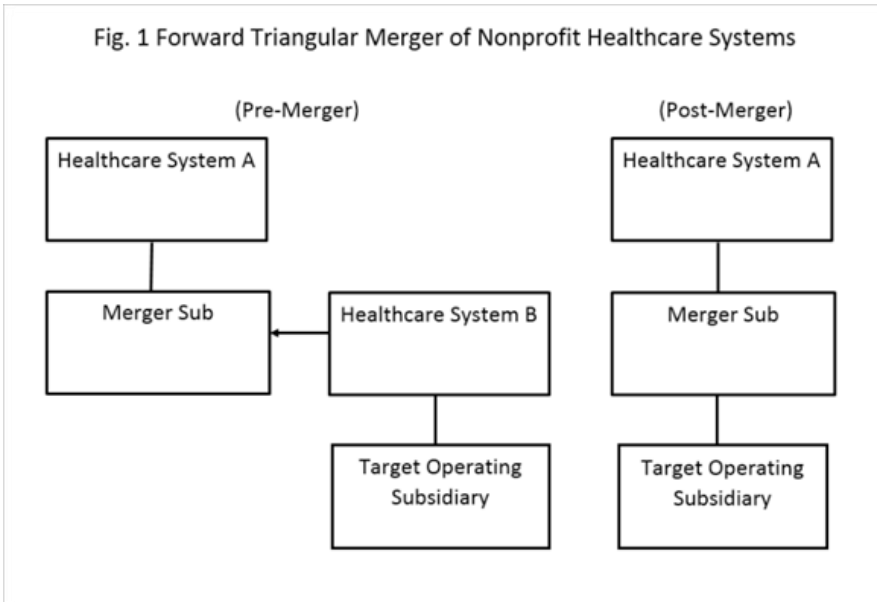
It is possible in some states for the parent of a health system or stand-alone hospital not to have members. These states permit nonprofit corporations without members. See, e.g., Del. Gen. Corp. Law § 102(a)(4); Cal. Corp. Code § 5310(a). In such states, the governing board of the parent organization exercises the powers customary to both the stockholders and the board of directors of a for-profit corporation. These states nevertheless do permit nonprofit corporations to have members. Consequently, the sort of membership substitution transaction discussed below is available, but instead of being a substitution, the transaction is the creation of new corporate memberships in the parent corporation.

Mergers and Acquisitions of Nonprofit Health Systems and Hospitals

Forward Triangular Merger

One common form of a nonprofit acquisition transaction, where both the target and the acquirer are nonprofit, is a forward merger. In this transaction structure, the acquirer typically forms a new subsidiary. The parent of the target is merged into the new subsidiary, with the new subsidiary being the surviving corporation. See Figure 1.

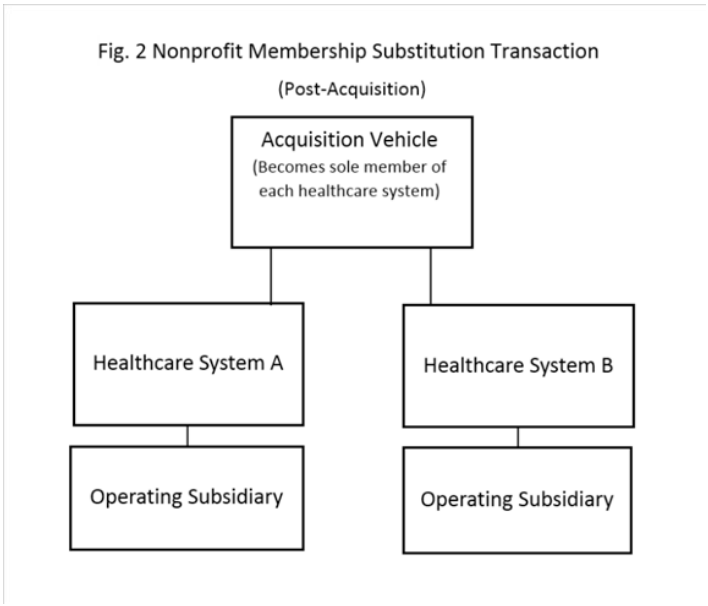
Fig. 1 Forward Triangular Merger of Nonprofit Healthcare Systems



Membership Substitution Transaction

In a combination of relative equals, it may be desirable to use a membership substitution structure. A new corporation is formed. The articles of incorporation of the parents of the two constituent health systems are each amended to provide that its respective sole member is the new corporation. Thus, the new corporation becomes the parent of a new, combined health system. See Figure 2.

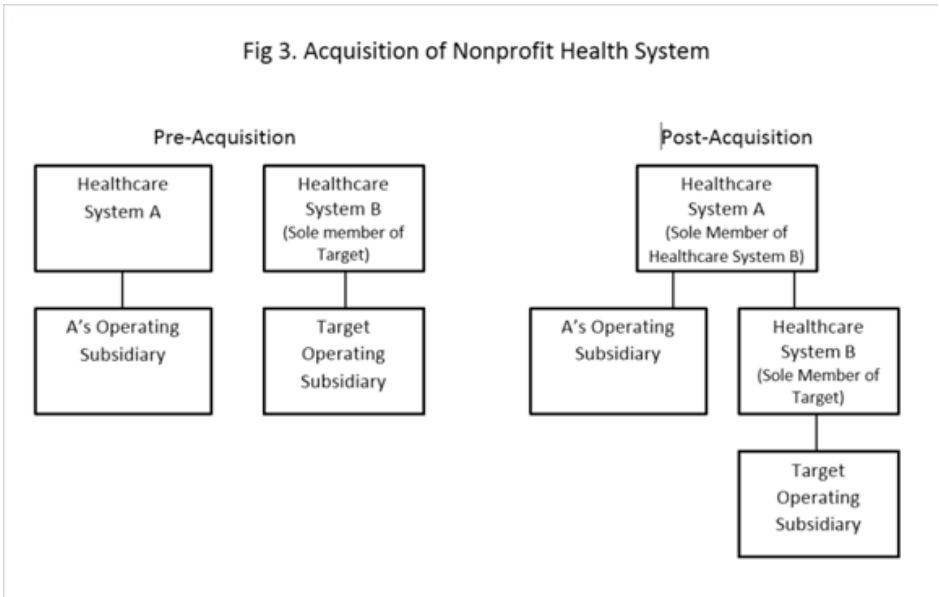
Fig. 2 Nonprofit Membership Substitution Transaction



Acquisition

In an acquisition of a health system or hospital, the articles of incorporation of the parent of the target are amended to provide that the sole member of the parent of the target is the parent of the acquirer. In this way, the parent of the target becomes a subsidiary of the acquirer. See Figure 3.

Fig 3. Acquisition of Nonprofit Health System



PLANNING FOR PARENT MERGERS AND NONPROFIT MEMBERSHIP SUBSTITUTIONS

Authorizations and Consents

Similar to a stock acquisition of a for-profit corporation, a nonprofit parent merger or membership substitution transaction is simpler than an asset purchase with respect to governmental and private third-party consents. However, in most states a merger or a change in membership of a nonprofit hospital will constitute a change in control necessitating re-licensure of subsidiary hospitals. Nevertheless, in others, the changes of membership of a health system parent corporation do not require re-licensure of the subsidiary hospitals. The practitioner must review the requirements of the particular states involved.

A parent-level merger or change in the membership of a health system parent will have no effect for Medicare purposes. A stand-alone nonprofit hospital that undergoes a change in membership must file a change of information to update its control structure, but otherwise its Medicare participation will not be affected. Medicaid filing requirements vary by state. In some states, changes of information are all that is required. In others, a new Medicaid provider agreement is required. Usually, a notice filing may be required with changes of information, but there will be no other effect on Medicaid participation.

Parent level mergers and changes in nonprofit membership also are unlikely to require consents or assignments of payor agreements, physician agreements, or other agreements (subject to financing agreements discussed below). In a small number of cases, agreements may have provisions that require consent or assignment in case of changes in nonprofit membership, but these are exceptional.

Financing

The significant issues in nonprofit acquisitions of nonprofit health systems and hospitals relate to bond financing, mission, and control. As to bond financing, it is sometimes possible to keep both the acquirer's and the target's bonds in place. This is cumbersome in the long run, because it results in multiple obligated groups, but it avoids the costs of call or defeasance of one of the bond issues. In a call, a bond issue is redeemed prior to maturity pursuant to the terms of the bond documents. In a defeasance, in brief, treasury notes that, with interest, will be sufficient to repay the bonds, are substituted for the hospital and/or its revenue as collateral for the bonds, and the hospital is released from its obligations under the bonds.

Sometimes, the target's or acquirer's bond documents will not permit the transaction, and it will be necessary to call or defease one or both of the target's or acquirer's bonds. In some cases, because of conflicting provisions, such as debt covenants, maintenance of both bond issues is not a practical option.

In these cases, it is necessary to call or, if the bonds are in a no call period under the bond documents, to defease either the target's or the acquirer bonds. The choice of which bonds to call or defease will depend on interest rates, the covenants of the bond trust indentures and loan agreements, and transaction costs. Infrequently, based on the foregoing, both the target's and the acquirer's bonds will need to be called or defeased.

In other cases, particularly in acquisitions of stand-alone hospitals, it is necessary to defease only the target's bonds. This is often accomplished by the issuance of bonds under the acquirer's trust indenture, the proceeds of which fund the call or defeasance of the target's bonds. Less frequently, both the target's and the acquirer's bonds are called or defeased by a new issue by the acquirer.

Finally, where the bond documents otherwise preclude a transaction, if the bonds are not widely held, it may be a viable alternative to obtain bondholder consent to the transaction.

Mission and Control

Mission issues should be confronted early in the discussion of the transaction. Particularly where either the target or the acquirer is of one religious affiliation, and the other is of either a different religious affiliation or none, difficult issues can be presented regarding services to be provided post-acquisition and other matters. The proposed merger between Catholic Health and Dignity Health will require the approval of no less than six religious orders, two archbishops (who consult with a combined 40 bishops where the two systems' hospitals are located), and potentially even the Vatican. See Wall Street Journal's article, Is This Hospital Takeover Permitted? Ask the Catholic Church.

Control issues post-closing are also common points of negotiation, especially where the target is a health system (versus a stand-alone hospital), or the transaction is closer to a merger of equals than an acquisition. This is usually played out through negotiation of board seats and negotiation of the reserve powers of the new parent or acquirer. Reserve powers are powers or rights to consent that are reserved to the parent board after the acquisition transaction. When the target has less bargaining power, an advisory board is sometimes established and comprised of target representatives, which provides nonbinding input with respect to the target hospitals. It is common, however, for the target to maintain control of its fundraising foundation.

FOR-PROFIT ACQUIRER TRANSACTION PLANNING

Asset Purchase

If the acquirer is for profit, it will desire to operate the health system or hospital on a for-profit basis subsequent to the acquisition. This condition rules out the membership substitution transaction, in which the nonprofit target remains nonprofit. Also, in order to maintain its status as a tax-exempt organization, the nonprofit may not simply be merged or converted into a for-profit corporation, even if such a transaction can be accomplished under state law. Instead, the acquirer purchases substantially all of the assets of the nonprofit target for fair market value. This is the typical structure of a nonprofit health system or hospital acquisition where the acquirer is for profit (in unusual cases nonprofit transactions are structured as asset purchases, typically to avoid significant contingencies, but again, these cases are unusual).

Payoff of Debt and Establishment of Foundation

For-profit buyers may not carry tax exempt debt, so they will either call or defease the nonprofit's debt as part of the purchase. As in the case of nonprofit transactions, this payoff may take the form of a call, if the bonds are in a period in which they may be called, or a defeasance, if the bonds are in a no call period. Importantly, beyond retiring the debt, the total consideration paid by the for-profit acquirer must at least equal the fair market value of the assets acquired from the nonprofit health system or hospital. Typically, the parties will use any excess amount of the fair market value of the assets over the cost of retiring debt to fund a foundation.

The purpose of the foundation may be a matter of some negotiation between the acquirer and the target. This process is analogous to the negotiation of mission in nonprofit transactions. For example, the acquirer may tend to favor a purpose more narrowly related to the target hospital(s), such as funding indigent care. The target may favor a purpose more broadly related to health care in the community. Often this is resolved such that the foundation has a multi-faceted purpose of supporting health care in the community, including indigent care at the target hospital(s). Mission concerns of the target, such as religious affiliations, may also affect the purpose of the foundation.

Assignment of Agreements

In an asset purchase transaction, the seller must assign certain agreements to the acquirer, or the acquirer will need to enter new agreements. The seller will need to assign any Medicare provider agreement(s) of the target hospital(s) to the acquirer. Although it is possible in an asset purchase not to assign the Medicare provider agreement (thus allowing the acquirer to avoid any potential overpayment liability of the seller), this is not generally practical because doing so creates a gap in Medicare participation of the involved hospital(s). Therefore, parties to an asset purchase will customarily assign Medicare provider agreements and address the overpayment risk through indemnification. See Medicare and Medicaid Change of Ownership Considerations in Healthcare Industry M&A.

Unless the acquirer has system-wide agreements that will replace the target's agreements, or where the acquirer will negotiate new health insurance company payor agreements, the seller will need to assign its payor agreements. Similarly, health care provider network substitutions will need to be negotiated. The seller will also need to assign physician and other agreements of the target hospital(s) to the acquirer.

ISSUES AFFECTING BOTH NONPROFITS AND FOR PROFITS

Governance

Whether the acquirer is nonprofit or for profit, the parties will need to address certain issues, the primary examples being governance and board structure. Particularly where the transaction is between approximate equals, or where the target is a relatively large health system, the target will desire limitations on the acquirer's reserve powers and will seek a significant voice on the governing board of the target after the acquisition.

The target will also desire to continue its mission, perhaps in some modified fashion. As noted, where the target is religious, it will want its ethical and religious directives to survive the closing.

Antitrust

Both nonprofit and for-profit acquisition transactions are subject to various regulatory requirements, including federal antitrust regulation. Here, an initial antitrust feasibility analysis is important. The healthcare industry is currently experiencing an atmosphere of heightened enforcement and sensitivity to market concentration. In March 2017, Advocate Health Care and NorthShore University HealthSystem were unable to overcome antitrust concerns raised by the Federal Trade Commission and the attorney general of Illinois and dropped their merger effort (Advocate subsequently has made a bid to combine with Wisconsin's largest health system, Aurora Health Care). Of course, the parties will need to address the Hart-Scott-Rodino premerger notification process. The parties should also avoid "gun jumping" behavior, which is sharing of competitively sensitive information, prematurely coordinating or combining parties' activities, or premature transfer of beneficial interest in a target. See Reportability of a Merger or Acquisition under the Hart-Scott-Rodino (HSR) Act and Integration Planning: Antitrust Considerations.

State Approvals

Acquisitions are also subject to state approvals. Many states require attorney general or court approval of the acquisition of nonprofits by for-profit entities. Some states require attorney general approval of the acquisition of nonprofits by nonprofits. Typically, these approvals require findings that the transactions are in the public interest or benefit the public.

In addition to attorney general or court approval, in many states, acquisitions of hospitals require certificate of need exemption determinations. Certificate of need laws are intended to prevent health care price inflation

by stemming the overbuilding of health care facilities. Currently, 35 states have certificate of need programs. Acquisitions of hospitals may not be subject to a full certificate of need review process, but it is necessary to obtain an exemption determination.

Due Diligence

Complex hospital regulation sets hospital transactions apart from other corporate deals. Due diligence should identify key issues relevant to negotiating the transaction. A large part of the focus should be on successor liability, particularly in governmental health care programs. A government investigation can also complicate the process. The acquirer should examine the target's or seller's compliance with federal and state health care fraud and abuse laws, such as the federal health care program anti-kickback statute and the Stark Law.

Together with health regulation, customary areas of due diligence review apply to hospital transactions. Thus, for example, the acquirer should review employment matters such as pensions, benefits, retention bonuses and severance agreements, and paid time off accruals. Collective bargaining agreements should be addressed. The parties will need to address real estate and environmental matters. As with any due diligence review, doing so timely will assist in addressing issues pre-closing and avoiding surprises. See Common Topics of Review in M&A Due Diligence.

The target similarly should consider performing reverse diligence. The scope of reverse diligence is narrower than the acquirer's diligence, but a target that places significant importance on reputational and mission issues may benefit from diligence on the acquirer.

SUMMARY

In summary, there has been a high volume of nonprofit health system and hospital acquisitions over the past couple of years, and this trend is expected to continue. Nonprofit health systems and hospitals are being acquired by both other nonprofit health systems and by for-profit systems. These transactions differ from typical M&A transactions because of the particular structuring and regulatory issues for nonprofit targets (and often nonprofit acquirers), and because of the significant regulation of the health care industry. Nevertheless, these differences are manageable, and nonprofit hospital acquisitions will remain an important part of the health care landscape.

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William B. Eck
Partner, Seyfarth Shaw LLP

William Eck is a partner in the Corporate Department of Seyfarth Shaw LLP's Washington D.C. office and chair of the firm's national Health Care Mergers and Acquisitions practice. Mr. Eck's experience in the health care arena ranges from matters involving mergers and acquisitions to sales and affiliations.

More specifically, Mr. Eck has represented parties in syndications of ambulatory surgical centers, imaging centers, and other kinds of providers, as well as several hospitals and practice management companies in acquisitions of physician practices, including those specializing in primary care, emergency medicine, neonatal intensive care, radiology, and pathology. In addition, Mr. Eck has also represented hospital and health system clients in the formation of various kinds of provider-sponsored health care networks. Some of his most recent work involves representing hospitals in the formation of a generic drug company.

Mr. Eck earned his J.D. from Harvard Law School and his B.A. from Loyola University Chicago, *summa cum laude*.