Strategic Partnerships Between Investor-Owned Companies and Nonprofit Hospitals or Health Systems: Top Ten Key Considerations in Selecting a Transaction Structure

W. Kenneth Marlow  
Lanta Wang  
Donald B. Stuart  
Brandon M. Schirg  
Kim Harvey Looney  
Waller Lansden Dortch & Davis LLP  
Nashville, TN

Strategic partnerships between investor-owned companies and nonprofit hospitals or health systems are an unmistakable trend in the health care industry today. Such strategic partnerships can consist of a myriad of structures and variations thereof. The most common transaction structures include affiliations, management arrangements, joint operating arrangements, joint ventures, asset leases, and asset sales/acquisitions. Each transaction structure serves to fulfill the varying goals and objectives of the strategic partners involved in such relationships. As an investor-owned company evaluates the various transaction structures for the best fit in a strategic relationship with a nonprofit hospital or health system, there are a host of critical factors to consider. This article identifies and describes the top ten key considerations in a transaction structure evaluation and selection process.

1. Level of Integration Desired

Transaction structures offer varying levels of potential integration in all aspects of the strategic relationship, including operational integration, clinical integration, financial integration, and cultural integration. The strategic partners may mutually agree upon the level of integration that is desired among the parties and their hospital facilities. Complete integration is not always the goal for both parties, as one party may desire to retain separate systems of operation, identity, or culture. For example, a Catholic health system may desire to retain its Catholic values and characteristics, while its strategic partner may have little interest in injecting such values and characteristics into the culture and operation of its corporate office or its facilities; however, for practical purposes, any facility that is at least partly owned by the Catholic health system following the transaction will retain its Catholic values and characteristics.

2. Level of Control Desired

Transaction structures vary greatly with respect to the level of governance and operational control that is retained or held by each of the strategic partners. Within each transaction structure, the strategic partners may negotiate for their respective desired level of governance and operational control through various mechanisms, such as delineation of powers of the manager, reserved powers of the board of directors, super-majority powers of the board of directors, powers of the hospital board of trustees, powers of defined committees or other reporting bodies, and specifically-identified powers reserved for the nonprofit hospital or health system.

3. Responsiveness to Partnership Goals

A critical element to a successful strategic relationship in any transaction structure is the willingness of each strategic partner to respond to mutually agreed-upon partnership goals; however, in transaction structures where one strategic partner has more governance and operational control, the other strategic partner’s responsiveness may become less crucial.

4. Long-Term Stability and Flexibility

Some transaction structures offer more flexibility than others with respect to modifications to various aspects of the strategic relationship and the unwinding of the entire strategic relationship, both legally and operationally. For example, an asset sale/acquisition structure is much more difficult to modify or unwind than an affiliation structure. The strategic partners may utilize certain provisions of the definitive agreements, such as the term, termination rights, termination penalties, notice timeline and procedures, cure rights, and approval requirements of amendments, to achieve a level of stability and flexibility that is appropriate and desirable for the strategic relationship. It is worth noting that, typically, the more flexibility that is built into a structure, the lower the level of integration that is attainable by the strategic partners.
5. Ease of Execution

From a legal perspective, transaction structures that require more documentation, government approvals, and/or regulatory filings or applications often lead to lengthier transaction timelines and may be more costly than others. When the assets of the nonprofit strategic partner being transferred to a for-profit entity constitute all or substantially all of the assets of the nonprofit entity, the transaction timeline may be dictated by the state’s Attorney General and/or court approval process, which means in addition to the time it takes for the parties to agree on transaction terms, another layer of approval may be required, adding time to the completion of the transaction. The state must be satisfied that the charitable assets or the fair value of those assets continue to be used for a charitable purpose. From an operational perspective, the strategic partners’ decision to transfer certain authority and/or assets will affect the relative ease of the transition following the consummation of the transaction.

6. Assumption of Risk and Liability

Some transaction structures expose the investor-owned company to more risks than others; however, conducting a more extensive due diligence review of the assets or business of the nonprofit strategic partner may mitigate the higher level of risk. Transaction structures, such as the asset sale/acquisition structure, allow the for-profit company to be selective in terms of the assets and liabilities it acquires. As such, it assumes certain liabilities and excludes certain liabilities of the nonprofit hospital or health system as part of the negotiation between the strategic partners. Other transaction structures, such as a merger or consolidation structure, do not allow for such flexibility, and make it harder to unwind the arrangement if it is later determined that the merger or consolidation has not resulted in the benefits the parties expected.

7. Debt Considerations

The requirements for the treatment of tax-exempt debt or other debt held by the nonprofit partner vary across the transaction structures. For example, in the asset sale/acquisition structure, tax-exempt debt held by the nonprofit partner generally must be paid off or defeased. In certain transaction structures, the nonprofit partner with tax-exempt or other debt may need to seek the approval of bondholders and other creditors prior to the consummation of the transaction. Transaction structures in which an investor-owned company manages the property of a nonprofit hospital or health system that is financed with tax-exempt debt are subject to certain limitations on terms and fees.

8. Regulatory considerations

**Antitrust.** The most important factor in predicting the level of antitrust scrutiny that the transaction will garner from the Federal Trade Commission (FTC) is the resulting market share in the hospital facility’s local health care market. The FTC is generally more critical of complete mergers, consolidations, or sales/acquisitions. Thus, the FTC may look into the intent behind a merger, consolidation, or sale/acquisition in assessing whether the transaction will produce anticompetitive effects. Structures that fall short of a complete merger, consolidation, or sale/acquisition, such as management and joint venture structures, and provide for bona fide financial or clinical integration reasonably necessary to achieve consumer cost savings or improved care, may face less antitrust scrutiny.

**Governmental approval: Attorney General.** In transaction structures whereby the ultimate control or all or substantially all of the charitable assets of the nonprofit hospital are being transferred to an investor-owned entity, some state Attorneys General may require that a determination be made by the Attorney General that there is no objection to the consummation of the transaction. The Attorney General may also require that a determination be made by the Attorney General that there is no objection to the consummation of the transaction. The Attorney General may require that a determination be made by the Attorney General that there is no objection to the consummation of the transaction. The Attorney General may also require the monitoring and reporting of certain of the parties’ obligations post-closing for a certain period of time to the Attorney General or an independent third party appointed by the Attorney General. Furthermore, the Attorney General may require that the transaction documents be made part of the public record or be made available through state sunshine laws. The penalty for failing to follow the proper process may allow the regulating entity to revoke a hospital’s license or impose other penalties.

**Governmental approval: Court.** In transaction structures where the assets of a nonprofit hospital or health system are being transferred to an investor-owned company, some states, such as the Commonwealth of Pennsylvania, may require the prior approval of the local court of equity to consummate the transaction. The court approval process may require a formal petition and one or more hearings. Additionally, the court may require that the transaction documents be made part of the public record or be made available through state sunshine laws.
**Governmental approval: Licensure.** Transaction structures that result in a change of ownership of a hospital facility will generally require new complete applications to be filed for all of the hospital’s Medicare and Medicaid provider numbers and state licenses. Transaction structures that do not result in a change of ownership of a hospital facility will generally not require complete applications to be submitted for the hospital’s Medicare and Medicaid provider numbers and state licenses, but may only require the parties to submit a change of information form in order to update the information that the hospital has on file with the applicable regulatory agencies.

**Governmental approval: Certificate of Need.** For hospitals and health systems located in some certificate of need states, such as West Virginia, transaction structures that result in a change of ownership of a hospital may require approval. In addition, transactions that involve the acquisition of certain types of major medical equipment (i.e., PET, CT), require capital expenditures in excess of certain threshold amounts, or relate to the initiation of certain service lines (i.e., cardiac catheterization or open heart surgery), or involve certificates of need that have been approved, but not yet implemented and/or licensed, could require certificate of need approval by a state agency. In some cases, the approval requirement could significantly impact the timing of the transaction and/or limit the strategic partners’ ability to modify the facilities or operations of a nonprofit hospital or health system post-closing.

**Fraud and abuse.** In transaction structures in which the investor-owned company and/or the nonprofit hospital or health system will be sources of referrals to each other (or the other) post-closing, the strategic partners must ensure that the transaction is consistent with fair market value, is commercially reasonable, and otherwise complies with the requirements of the Anti-Kickback Statute. In transaction structures that involve physicians, the strategic partners must ensure that the transaction complies with the Stark Law, the Anti-Kickback Statute, and any applicable state physician self-referral laws.

**Reimbursement.** Transaction structures that result in a change of ownership of a hospital facility have the potential for causing reimbursement delays while the Medicare and Medicaid change of ownership applications are pending. In transaction structures where the assets of a nonprofit hospital or health system are being transferred to an investor-owned company or joint venture, the nonprofit hospital facility may lose its eligibility to participate in certain grants or governmental programs, such as the 340B drug pricing program.

**9. Tax Considerations**

**Generally.** Some transaction structures allow the investor-owned company funding an asset sale/acquisition or joint venture transaction with a nonprofit hospital or health system to receive tax benefits of asset step-up in basis for depreciation purposes. Transaction structures that involve partial or full transfer of ownership of the nonprofit hospital or health system’s real property, which is generally exempt from property taxes, will likely change the property tax status to taxable. Certain transaction structures may give rise to unrelated business taxable income (UBTI) for the nonprofit hospital or health system. With respect to tax consolidation, certain transaction structures permit the consolidation of income/losses of the subsidiary for tax purposes with the investor-owned parent company.

**501(c)(3) & 501(r) requirements.** For a nonprofit hospital or health system to maintain its 501(c)(3) tax-exempt status in certain transaction structures, such as the joint venture structures, the nonprofit hospital or health system will generally be required to maintain certain “control” over the hospital facility. “Control” does not have to mean majority ownership or governance by the nonprofit, just that the nonprofit hospital or health system maintains “effective” control over the charitable aspects of the hospital facility and major actions. Additionally, the nonprofit hospital or health system’s charitable purposes must continue to be met through the operation of the hospital facility and the strategic relationship. Given such, if the preservation of the nonprofit partner’s 501(c)(3) tax-exempt status is crucial, some transaction structures may not be plausible options. With respect to 501(r) requirements, in certain transaction structures, the hospital facility may be subject to rules requiring periodic community health needs assessments, adopting implementation strategies, financial assistance policies, charge limitations, and billing and collection policies and limitations.

**10. Accounting Considerations**

Some transaction structures allow for the consolidation of the earnings of the target hospital facility with the investor-owned parent company. For an investor-owned company to consolidate the earnings of the target hospital facility, the investor-owned company must control the decisions that occur as part of the ordinary course of the hospital facility as well as the directing and carrying out of the activities of the entity owning the hospital facility. In a joint venture structure, the nonprofit hospital or health system can be permitted to protect its investment by holding certain “protective” rights without overcoming the presumption of the investor-owned company’s control; however, the nonprofit hospital or health system cannot be permitted to participate in the ordinary course of the joint venture’s business by holding certain substantive “participatory” rights.

**Conclusion**

As investor-owned companies and nonprofit hospitals or health systems contemplate potential transaction structures, it will be important to keep the aforementioned considerations in mind. The importance of each of these factors will generally be specific to each individual party. Accordingly, while one party may determine that full integration is its most important consideration, another party may determine that long-term stability and flexibility is its most important consideration. Together, the parties will need to examine the goals of their potential partnership and then find a structure that maximizes the most important considerations of each party. An open dialogue regarding these considerations will allow the parties to find the structure that is most likely to result in success.

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