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## Corporate Governance

### Breaking Up Isn't Hard to Do: *Health Alliance* and Health System Structuring

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Despite its unique facts, the April 16 decision in the closely watched *Health Alliance* case<sup>1</sup> has potentially significant implications for nonprofit health systems formed through joint operating agreement, change of membership/affiliation, or similar means. This judicially sanctioned withdrawal of two parties to a joint operating agreement (JOA) could create increased instability in those systems where tension among corporate parties already has arisen. This is particularly the case where the underlying system agreements are loosely drawn, or provide some basis for a party's withdrawal or disaffiliation.

Of particular interest—and potentially greater importance than the court's findings with respect to the rights of the parties under the specific JOA in question—is the court's conclusion that “parent”-type organizations

owe fiduciary duties to their independent nonprofit affiliates. This conclusion eventually could have far-reaching implications for the organization, operation and control of nonprofit health systems. Attentive health systems and their counsel may wish to consider the obligations such a judicially recognized relationship creates on the part of “parent” organizations—and the risks it engenders with respect to both monetary liability and with respect to equitable remedies related to operational and governance controls in the traditional parent/affiliate organizational structure. Moreover, the obvious question is, assuming the existence of such a fiduciary relationship and the obligations it entails, whether the benefits of a JOA (or similar) structure outweigh the potential benefits provided by alternative models—including a single corporation model.

#### I. Brief Case Overview

The basis for the litigation was an action filed by the Health Alliance, a \$1.4 billion joint operating company (JOC), to prevent corporate affiliates Christ Hospital and St. Luke's Hospital from withdrawing from the nonprofit system which had been the largest health care network in the Greater Cincinnati/Northern Kentucky region.<sup>2</sup> Christ Hospital and St. Luke's subsequently filed counterclaims to seek court confirmation of their right to withdraw, and the Ohio attorney gen-

<sup>1</sup> *Health Alliance of Greater Cincinnati v. Christ Hospital*, Ohio Ct. Com. Pl., No. A0601969, April 16, 2007.

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<sup>2</sup> Cliff Peale and Peggy O'Farrell, “Judge Lets Christ, St. Luke Quit Health Alliance,” *The Cincinnati Enquirer*, April 17, 2007.

eral intervened in the case to protect the public interest with respect to the charitable assets involved. After a lengthy trial, Judge Fred Nelson of the Hamilton County (Ohio) Court of Common Pleas ruled that the two hospitals were entitled to end their participation in Health Alliance pursuant to the provisions of the underlying joint operating agreement. The court also found a separate basis for withdrawal in Health Alliance's breach of the fiduciary duty it owed to the hospitals.

### A. Right to Withdraw

Much attention has been focused on the provision in the underlying joint operating agreement that authorized a "Participating Entity" to withdraw upon an uncured event of default. However, the significance of this withdrawal right must be viewed in the context of two other key terms: (a) the right of the "Participating Entities," through their respective boards, to "continue to exercise ultimate responsibility for fulfilling their respective charitable missions and obligations"<sup>3</sup> and (b) the obligation of Health Alliance (the JOC) to "at all times operate the Alliance consistent with the charitable missions of the participating entities."<sup>4</sup>

The controversy was prompted by independent decisions, first by Christ Hospital and subsequently by St. Luke's Hospital, to declare an event of default and withdraw from the JOA. Health Alliance actually initiated the litigation by its request for a declaration that "there were no pending circumstances" that would allow Christ Hospital and St. Luke's Hospitals to withdraw.

The court concluded that both Christ and St. Luke's Hospital had "manifestly" established their respective rights to terminate their Health Alliance relationships through their good faith determination that the Health Alliance relationship had impeded pursuit of the hospitals' charitable missions. Applying a "business judgment rule" analysis, the Court concluded that the independent withdrawal decisions were effected with "due care," and not a pretext (as Health Alliance had argued). For example, Christ Hospital's decision to withdraw was based upon multiple mission-based reasons, including concerns that: (a) Christ Hospital had been "under funded within the Alliance structure"; (b) programming and funding arrangements were subordinated to the University of Cincinnati (another participating entity); (c) Christ Hospital had failed to realize benefits originally envisioned from Alliance participation; and (d) Alliance had adopted an adversarial position with respect to Christ Hospital.<sup>5</sup>

### B. Breach of Fiduciary Duty

The court also concluded that Health Alliance breached its fiduciary duties to the two hospitals, thus providing further grounds for their withdrawal from the JOA relationship. Specifically, the court found that the nature of the joint operating arrangement created the very kind of special relationship of "trust and confidence" that establishes a fiduciary relationship.<sup>6</sup> Particular *indicia* of this "special relationship" included Al-

liance's responsibility to: (a) manage the affairs of the participating entities; (b) hold the assets of the participating entities; (c) collect and allocate all revenues of the participating entities; (d) maintain the business records of the participating entities; (e) employ the operational staff of the participating entities; and (f) "at all times operate . . . consistent with the charitable missions of . . . the Participating Entities,' among other responsibilities."<sup>7</sup> Other JOA features deemed to establish a fiduciary relationship included the fact that the "Participating entities . . . surrendered to the Alliance all control over their revenue streams, are precluded from incurring debt, do not control their assets, and do not hire or manage their own staff . . ."<sup>8</sup> From the court's perspective, it was the combination of these *indicia* and features, coupled with the "resulting imbalance of resources," that created the fiduciary relationship.<sup>9</sup>

The breach of these duties was found to arise from both operational actions taken by Alliance, as well as specific steps it took associated with the litigation. According to the court, specific breaches included Alliance's (a) initiation of the subject litigation without notice and in contravention to the contractually required resolution period; (b) use of JOA funds to pursue the litigation while denying Christ Hospital and St. Luke's Hospital access to their own revenues to fund their defense; (c) action during the course of the litigation to bind Christ Hospital and St. Luke's Hospital, without their consent, to over \$200 million in additional Master Trust Indenture bond obligations; and (d) use of its "superior position" to constrain, by a variety of means, Christ Hospital's ability to compete in the future.

## II. Analysis

In evaluating the significance of *Health Alliance*, it should be recognized that while many aspects of the court's decision are fact-specific to this particular joint operating agreement, certain other aspects of the decision have broader application to nonprofit health systems. Taken collectively, however, they create new corporate law challenges that some traditional nonprofit health systems may find difficult to meet.

### A. Fact-Specific Considerations

1. The court's perspective was clearly that the terms and conditions of this particular joint operating agreement preserved autonomy for the participating entities. Most relevant in this regard were specific protections for the participating entities to protect their charitable mission; valid withdrawal rights; and testimony/documentary evidence that the JOA was recognized as a "limited confederation model" that anticipated the potential for withdrawal.

2. The Health Alliance JOA ultimately appears to have suffered from the absence of specific provisions in the articles and bylaws of the participating entities providing for a common charitable mission and system-wide obligations. Indeed, the court observed that "the language of the JOA suggests separate mission determinations by the separate participating entities and no-

<sup>3</sup> Decision, p. 3.

<sup>4</sup> *Id.*

<sup>5</sup> *Id.*, p. 9-10.

<sup>6</sup> "The term 'fiduciary relationship' has been defined as a relationship in which special confidence and trust is reposed in the integrity and fidelity of another and there is a resulting position of superiority or influence, acquired by virtue of this spe-

cial trust." *Health Alliance*, *supra*, p. 20, citing *Groeb v. Keybank* (2006), 108 Ohio St. 3d 348, 351.

<sup>7</sup> Decision, p. 20-22.

<sup>8</sup> *Id.*

<sup>9</sup> *Id.*

where requires that each subscribe to one uniform charitable mission.”<sup>10</sup> It was this factor that the court relied on to support the right of each participating entity to separately determine what was required to fulfill its own charitable mission and to justify withdrawal based on its independent determination that Alliance was not operating in a manner consistent with such mission(s).

3. For whatever reason (terms of the JOA, client demands, etc.), several of Health Alliance’s actions and subsequent litigation arguments appear to have been counterproductive. For example, both the court—and the attorney general—vigorously rejected the argument that the governance authority of the boards of directors of the participating entities were, by the terminology in the JOA, “passive” rather than “active.” Indeed, because most state nonprofit laws expressly require that the governing board exercise ultimate authority over the corporation, to argue that a board’s fiduciary duties are “passive” (i.e., less than full) seems almost certain to be rejected as a matter of law.

4. A linchpin of the court’s analysis was the application of the business judgment rule to evaluate the boards’ determination of the charitable mission of their respective organizations. While the business judgment rule normally is applicable to decisions of boards of directors of nonprofit organizations, the determination of the specific charitable purpose of an entity (in the context of litigation over the nature and extent of that purpose) most often has been treated by the courts as a legal issue to be determined by the court, after considering the articles of incorporation, bylaws, donative instruments and historical operations of the organization—and not one subject to the same deference as for normal business decisions.

5. The language and tone of the written decision strongly reflects substantial irritation by the court with Health Alliance’s technical approach to the controversy, including the manner in which it initiated the litigation (“the race to the courthouse does not always benefit the swift”).

## B. Broader Considerations

1. The important part of the decision—from a broader health system perspective—is its discussion of fiduciary duties. The court’s definition of the type of “special relationship” creating a “fiduciary relationship” is well-stated, and transcends not only the unique facts of this case but also the particular structural characteristics of a JOA. Where a joint operating company—or a parent company in a “holding company” model—acts in a manner that is adverse to one or more of its affiliates (and the corporate documents do not expressly provided for an agreed upon primacy of system purposes) the *Health Alliance* decision provides a basis for breach of fiduciary duty exposure. This potential for breach could be increased where there are “overlapping” boards between the parent and its affiliates. An open question remains, though, as to how much “primacy” for the system-wide purposes an affiliate board may

“cede” without violating its own fiduciary duties set forth under its own articles of incorporation. Moreover, the authors note that significant legal issues may arise if a JOA were to contain provisions that might be interpreted to abandon the historical dominant purpose of a formerly independent hospital—particularly if there were geographic, beneficiary class, or other restrictions in the hospital’s governance documents or in relevant donative instruments.

2. In the negotiation and documentation of any major corporate transaction, there is tension between the benefits of detail and the natural attraction of “getting the deal done.” Where these two concepts are not properly balanced, there exists significant risk of a failure to have a meeting of the minds on critical issues. In *Health Alliance*, there appears to have been a fundamental disagreement on the fiber and character of the relationship—whether it was to be a “virtual merger” (Health Alliance) or a loose confederation permitting more individualized determination (Christ Hospital, St. Luke’s Hospital and the attorney general). It is, thus, a significant reminder that structural/control accommodations in the negotiation of system structuring can have a haunting effect.

3. The active intervention of the Ohio attorney general on behalf of Christ Hospital and St. Luke’s Hospital was to be expected and is entirely consistent with the traditional perspective of state charity officials on fiduciary duties. Nonprofit health systems and related organizations encountering similar controversies in other states should thus anticipate the close scrutiny, and potentially the involvement, of state charity officials.

## III. Conclusions, Recommendations

It should be emphasized that *Health Alliance* is a trial court decision and is subject to appeal. It also should be emphasized that the case is based on a unique set of facts (i.e., the specific terms of the JOA). Nevertheless, the decision has potentially broad implications for the formation and administration of nonprofit health systems. System-type organizational structures that involve parent organizations seeking to control independent nonprofit affiliates (which have their own “legal” governing boards and separate definitions of charitable mission) are increasingly subject to institutional conflicts of interest.

The potential for disputes of this kind merits a review of the continued effectiveness for the established organizational model of a parent “supporting” organization that maintains control over independently incorporated affiliates, whether through contractual arrangements (e.g., a JOA), reserved powers and/or overlapping board memberships. There can be little argument that this model was developed for sound reasons and has long served as an effective and responsive governance structure. However, as health systems are increasingly being subject to intra-system and external control challenges, they may wish to revisit the continued effectiveness of this model. Indeed, “single corporate” models (while not without their own legal “hurdles”) may offer more efficiencies, greater control, and less vulnerability to these types of challenges.

<sup>10</sup> Decision, p. 4.