

The Board's Role in the M&A Process: Meeting Fiduciary Obligations

CHANCES ARE THAT MOST NON-PROFIT HOSPITAL BOARDS will be called upon to evaluate a merger/acquisition proposal at some point in the very near future. Healthcare reform is prompting hospitals across the country to reevaluate their market strength and competitive posture given the new regulatory dynamic. Local healthcare markets are increasingly fluid, as providers and physician groups are anxiously wondering whether there will be a chair remaining when the reform-styled music stops playing. Alignment with a complementary provider—whether as partner, seller, or buyer—may be the favored strategic option. Whether, and under what terms and conditions, the provider pursues such alignment ultimately should be the board's decision.

For that reason, it is increasingly critical that executive management properly prepare the board to evaluate an M&A opportunity in a timely and informed manner, consistent with its fiduciary duty. Questions to ask include: What is our role? What should we be looking at? How involved are we to be? State law expects the board to closely oversee the transaction process in order to preserve the value of the corporate assets and protect the charitable mission. Absent management-directed preparation, however, will increase the odds of a fiduciary misstep. This, in turn, will weaken the credibility of the board's ultimate decision and imperil any board-endorsed deal's chances for regulatory approval.

Experience suggests the following topics as forming the core of the board's M&A preparation:

It's really your call. State law is uniform on this point—no M&A deal 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 board must sign off on the final game plan. This is to assure the presence of checks and balances deemed necessary to protect charitable assets. *Problems will arise when the board is uncertain or unaware of its fundamental transaction authority.*

The “why” of the deal. In order to provide effective oversight, the board must understand the rationale prompting a specific proposal. Is it *offensive* (e.g., the opportunity to expand services into a new market)? *Defensive* (e.g., blocking a competitor from increasing its strategic position)? *Practical* (e.g., the need for a stronger capital base and economies of scale from which to respond to reform initiatives)? *Problems will arise when the board is not familiar with the mission and business realities that recommend the transaction, or if it has unrealistic expectations (or predisposed notions) about transaction rationale.*

Any simpler options? In its consideration of any major transaction, the board will be expected to ask whether the intended goals can be achieved in a less intrusive, or expensive manner. That's an essential element of oversight—calling the question, “Is there a simpler way to

do this?” Regulatory approval may well depend on evidence of such analysis (e.g., “We looked at ‘A,’ we tried ‘B,’ we ran the numbers on ‘C,’ and none serve the mission as well as the deal on the table right now.”). The board will need to exercise particular scrutiny if the hospital seeks to pursue the first change-of-control offer it has ever received (i.e., if the hospital seeks to “marry” the only organization it has ever “dated”). *Problems may arise if the record does not reflect board consideration of alternative approaches to achieving the acknowledged goals.*

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The source of the matter. The board should be familiar with the source of the specific M&A proposal; what is its history and how did it come to be presented to the organization? For example, is it prompted by unusual circumstances? Is it an unsolicited offer or the product of specific negotiations or bid process? Does it reflect the vision

of the executive leadership team, a prominent board member, the entire governance team, or an influential third party? Is the proposal specific in its terms and benefits, or is it vague or uncertain? *Problems may arise if the proposal reflects uninformed pressure from community groups, or “social blackmail” (e.g., leading constituents threaten to abandon the hospital absent “this deal”).*

Establish the standard of review. The general counsel should brief the board on the standards of conduct the law will expect it to apply in connection with its evaluation of the proposal. This will likely 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 carefully understood. *Problems will arise if, when called upon to approve fundamental transaction decisions, the board does not find itself sufficiently involved or informed.*

No conflicts. The board must be vigorous in the application of its conflict-of-interest policy to the consideration of the transaction proposal. Reliance on the results of the annual disclosure process simply won't do; there must be a transaction-specific conflicts disclosure and review process. The law is extraordinarily concerned that biases of individual officers and directors not unduly affect the board's decision-making process. Effective disclosure will target not only relationships between board members and the prospective partner organization (and its fiduciaries), but also relationships between board members and the

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organization's advisors, as well as relationships those advisors may have with the target organization. *Problems will arise if arguably conflicted directors (or advisors) participated in the board's discussion of, and vote on, the transaction.*

What's the timetable? M&A proposals and similar "big deals" require a transaction timetable that is sufficient to allow thorough evaluation. This is an area where the board can exercise particular common-sense oversight (e.g., "This is dragging; we need to pick it up," versus, "This timetable is way too aggressive; we need to slow it down."). The board must have an understanding of the proposed deal timetable, the length of time allocated for negotiation, the projected closing date, and any external factors (e.g., regulatory or principal vendor approvals) that may influence the timetable. Specific items requiring full board vote should be flagged and scheduled. The board (and in particular, the negotiating committee) must work closely with management to balance legitimate time exigencies with the need for appropriate board involvement and awareness. *Problems will arise if the board cannot digest key transaction information fast enough to keep pace with transaction events or if director attendance at key board meetings is sporadic.*

Information review and reliance.

Management should clarify for board members the specific documents and other information they will be required to review in connection with their oversight responsibilities. This relates not only to definitive transaction documents, but also to reports and summaries provided by management and outside experts. Different standards may apply to the negotiation committee and to the full board, especially if the expectation is that the board will be relying on the oversight activities of that committee. However, there should be some fundamental expectation that the full board will have reviewed a detailed definitive agreement summary prepared by counsel, even if it has deferred to the negotiation committee the review of the draft and final versions of that agreement. The board should also have an understanding of the extent to which it may rely on the judgment and recommendations of management, board committees, and outside advisors. *Problems may arise if neither the board nor the negotiating committee has at least reviewed a thorough summary of the definitive agreement.*

Evaluation criteria. One of management's most important transaction responsibilities is to provide the board with the specific criteria by which it can evaluate the benefits of the transaction and render an informed decision. Such evaluation criteria should include information relating to achievement of mission goals, the reasonableness of financial terms, human resources issues, implications to the medical staff, and closing responsibilities and obligations. It should also 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. *Problems may arise if the record does not reflect a coherent and relevant board evaluation process.*

It's their call. Each board member should understand that the basic standard they should apply in determining how to vote is whether he/she reasonably believes that the transaction as they understand it is in the best interest of the organization. There is no obligation to vote in a manner consistent with management's recommendation, but a decision to vote in a contrarian manner should be one that is informed, rather than emotional. They should ask themselves whether the transaction they are voting on is essentially the same transaction that was first brought to the

board or whether it has evolved through negotiation to something different—and whether the reasons for that shift are understood by the board. In addition, the board must be capable of resisting the pressure to vote one way or another based upon the prevailing transaction momentum, whether it be positive or negative. *Problems will arise if the board is perceived as simply "rubber stamping" management's plan.*

We are currently in a period of unprecedented merger and acquisition activity in the non-profit hospital sector, as providers attempt to respond to the extraordinary financial and

other challenges presented by the Patient Protection and Affordable Care Act. Rare is the hospital or health system that will not be considering a merger/acquisition opportunity in the near term, either for offensive or defensive reasons. State and federal regulators will closely review these transactions, especially those in which non-profit assets are to pass from non-profit to for-profit ownership. Central to that review will be the extent of informed, disinterested oversight exercised by the governing boards of parties.

For that reason, among others, it is vitally important that management (including the general 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. Certainly, failure to do so will jeopardize not only the likelihood for a successful transaction, but also the personal reputations of board members.

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