

The Non-Profit Board's Duties When Considering a Change of Control

The article is an executive summary of the complete publication, a detailed guide for the general counsel, which is available to members at www.governanceinstitute.com/changeofcontrol. The authors write from a legal perspective to correspond with our series of articles on the merger market by James Burgdorfer of Juniper Advisory (October and December 2007 issues of *BoardRoom Press*).

THE RECENT INCREASE IN change-of-control/"M&A" activity in the non-profit healthcare sector prompts the need to revisit the governing board's fiduciary duties when considering such transactions. This is particularly the case given state statutes that require board approval for a change of control, several new high-profile dissolutions of previously consummated transactions, and the willingness of state attorneys general to challenge individual transactions for perceived flaws in the review and approval process (for which the board is ultimately responsible). A change-of-control transaction is a corporate event of such import that heightened oversight by an informed, disinterested board is both expected and required. The following discussion reviews the applicable fiduciary duties and how they are satisfied in the context of a change-of-control transaction. Our discussion presumes that fiduciary duties exist in these transactions, regardless of whether the organization is "gaining" or "ceding" control over assets.

The process by which the non-profit board evaluates a change-of-control proposal should be designed to position the directors to satisfy their duties of loyalty, obedience to mission, and care, together with any additional obligations that may be required by state statute or regulation. Specific manifestation of the appropriate standard of care may vary depending upon whether the organization is either gaining control of another corporation, or ceding control of its own assets.

Duty of Loyalty

The components of the duty of loyalty that should be addressed at the incipency of proposal discussions include the following:

Conflicts of Interest: Throughout the change-of-control process, the board should apply its conflict-of-interest policy and be acutely sensitive to any relationships (or the appearance thereof) among its officers and directors that could bias or otherwise inappropriately influence their individual decision making. The board should also be sensitive to conflicts concerns presented when corporate executives receive (or are entitled to receive) stock options, retention or performance bonuses, loans, or similar executive benefits arising from the consummation of the transaction.

Confidentiality: The existence and particularities of a change-of-control proposal are normally highly confidential and sensitive. Inadvertent or unauthorized disclosure of proprietary transaction information may undermine the corporation's negotiating leverage and strategic position in the market, as well as create unnecessary and premature distress with corporate constituents (e.g., patients, medical staff members, employees, vendors). Inappropriate disclosure may also subject the corporation to significant financial penalties under a "confidentiality agreement," which may have been executed with a potential transaction partner. As such, it is very important that

board members protect confidential corporate information so as not to damage the corporation's interests.

Obedience to Mission

Directors must evaluate change-of-control proposals from the perspective of the potential implications to the charitable mission. The board's deliberations must reflect a clear and thorough evaluation of how specific strategic proposals will further the mission of the organization. The failure to adequately consider strategic mission issues create significant legal issues that can adversely impact the ability to close a transaction.

Duty of Care/Business Judgment Rule

The duty of care expectation is that the non-profit directors will exercise an informed business judgment when evaluating a change-of-control proposal. Whether a decision is indeed "informed" will depend on whether the directors have, before rendering a decision, informed themselves of all information material to the transaction that is reasonably available to them, taking into consideration the significance of the change-of-control proposal. In a change-of-control situation, elements of an informed decision might logically include the following:

- The strategic, operational, and mission issues prompting the proposal (i.e., overlap with duty of obedience to mission factors)
- The history of the proposal and how it came to be presented to the corporation and the board
- The fundamental terms and conditions of the transaction
- The legal requirements by which the transaction (and the board's review thereof) must be structured
- The financial feasibility and related implications
- The advantages and disadvantages of the proposal as well as the realistic alternatives to achieving the desired strategic, operational, and mission goals
- Whether the transaction is in the public interest (e.g., projected impact on access to and quality of care, employees, medical staff, donors, and other constituents)

In exercising their duty of care responsibilities, directors are entitled to rely on information, reports, and statements prepared by corporate officers, legal counsel, and advisors to the corporation. Directors are also authorized to rely on the recommendation of board committees on which the directors do not serve, as long as the subject is within the committee's designated authority and the directors believe that the committee merits confidence.

A related issue is the appropriate degree of familiarity by the full board with the specific provisions of the definitive change-of-control agreement. The traditional approach is for the full board to delegate to a special committee the responsibility for oversight of the process, subject to reporting to the full board. Under this approach, the committee members are expected to be familiar with the detailed terms of the agreement and to summarize its provisions to the full board for their ultimate approval.

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Problem Areas

Examples of problematic director conduct in change-of-control transactions include (but are not limited to) the following:

- Failure to consider mission factors in any aspect of the board's decision-making process
- Failure to consider alternatives to the proposed transaction
- Failure to provide board/committee members with adequate information in a timely manner to allow for an informed decision
- Failure to involve the full board in the decision-making process
- Failure of the board to commit time and energy to render an informed decision (e.g., failure to familiarize itself with the relevant terms and conditions of proposals and definitive agreement terms)
- Reliance on assumptions which the board knew (or had reason to know) were inaccurate or unreliable
- Unwarranted/inappropriate reliance on, or deference to, executive management and/or outside advisor failure to exercise "constructive skepticism"
- Use of a selection criteria for bidders that benefited management or was non-responsive to mission interests
- Structuring an otherwise "flawed" auction process for the assets
- Absence of a written record (e.g., board/committee minutes) that reflects the board's deliberative process

Unique Factors: For-Profit Purchaser

A change-of-control transaction involving a for-profit purchaser potentially requires additional director diligence and inquiry because of unique legal issues they pose. *In addition to* the general duty of care factors identified above, the directors should consider the following factors, among others, when presented with a conversion proposal:

- **Conversion Plan:** Development of an approach to the transaction that satisfies the hospital's charitable purpose. This would include (a) confirmation of the provisions of any state conversion statute and of the organization's charter, particularly as they relate to both the fundamental authority to convert assets to for-profit ownership and director standards of conduct for such transactions; and (b) preparation of an appropriate charitable uses spending plan, to address the application of the proceeds from sale.
- **Evaluation:** Ability to appropriately distinguish between offers from non-profit and from for-profit partners, and their relative advantages and disadvantages. This might include a preliminary due diligence-related examination of their respective operational and financial performing history.
- **Market Process:** The board must be committed to a change-of-control process that allows market forces to work freely, not to impermissibly favor one bidder over another in the establishment of any auction or "market clear" process, and to render an informed, disinterested decision with respect to selection of a change-of-control partner. Retention of a qualified advisor to help structure this process may be of significant importance.
- **Fair Market Value:** The board's duty of care will obligate it to assure that fair market value is received for corporate assets. This may

involve retention of an experienced valuation advisor (particularly a firm concentrating its practice in the healthcare industry).

- **Non-Cash Factors:** An additional important consideration is the extent to which the non-profit board may consider non-cash factors in negotiating and consummating a change-of-control transaction. Of course, many non-profit, change-of-control transaction processes are structured only to involve other non-profit organizations in which no assets go out of charitable trust. Other processes may involve multiple offers from non-profit and for-profit purchasers alike, with some offers received at or in excess of the independently determined fair market value of the assets. Furthermore, in many non-profit change-of-control transactions, the non-profit board is motivated to achieve certain mission-related objectives. As such, the board may wish to consider/accept certain forms of non-cash consideration, such as capital improvement commitments, quality and access to acute care commitments, preservation of workforce, and preservation of employee benefits, which are consistent with the charitable mission yet may reduce the ultimate purchase price.

As noted above, it is without question that non-profit boards must satisfy "fair value," and "fair market value" requirements for transactions involving a sale of assets to a for-profit entity (most likely through a market clear or auction process). This does not mean, however, that non-profit corporations must choose the highest cash offer in every instance. When the non-profit board is presented with several offers reasonably close in value that satisfy "fair value" requirements, the non-profit board should *not* be required to accept the highest cash offer to the exclusion of other offers that include non-cash elements that provide material benefits which relate to mission. Non-cash factors that reflect a concern for the best interests of the corporation and its charitable mission should be an appropriate consideration by the board. In addition to the mission-related factors identified above, other non-cash factors might include the structure of the proposed or actual financing for the offer, and the consequences of that financing; the financial strength and corporate integrity of the putative purchaser; the experience of the putative purchaser in serving the healthcare consumer needs, and its particular post-closing plans for the market. In other words, non-profit directors should be entitled to exercise their business judgment by conducting a fair and unbiased process, carefully considering all of the relevant factors (including, among others, the dollar amount of competing offers, the terms and conditions of those offers, and the non-price considerations). Assuming that is done, and absent self-interest or bad-faith, it appears to the authors that the business judgment rule should apply.

Regulators will view the non-profit healthcare board's evaluation of change-of-control options as requiring a high degree of diligence, loyalty, and care.

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