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System Focus

Emerging Health System Structural Issues

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Key Board Takeaways

1. Recognize how the changing environment is creating corporate structure challenges.
2. Monitor how the corporate strategy is consistent with express charitable purposes.
3. Identify specifics for how operations are distinguishable from those of for-profits.
4. Clarify the duty of loyalty obligations of constituent directors.
5. Confirm whether state law projects parent fiduciary duties to subsidiaries.

The transformation of the healthcare environment is creating particular structural concerns for non-profit health systems. The continuing consolidation trend, together with the necessary shift towards outpatient-focused operations, are contributing to pressures with respect to the charitable mission, tax-exempt status, board-level conflicts, board duties, and relationships with subsidiaries.

The good news is that each of these concerns can usually be addressed through proactive planning by the board and senior leadership, working in close concert with its general counsel.

Mission Drift

One of the most subtle means by which transformation affects the structure and legal status of non-profit health systems is through what is referred to as "mission drift."

The term "mission drift" describes the circumstances when the business affairs of a non-profit corporation begin to shift from its stated purpose to some alteration or derivative thereof, without proper state/judicial approval. The focus is on the statement of corporate purposes in the organization's articles of incorporation. For health systems, the statement of purpose can sometimes be restrictive (e.g., "operate an inpatient hospital in community X") in ways that could not reasonably have been foreseen when the health system was formed.

The relevance to healthcare organizations arises from increasing recognition that the inpatient healthcare facility business model is becoming obsolete. As a result, healthcare companies are shifting their focus to ambulatory and other care delivery platforms. Operational diversification is becoming a major goal. To the extent such shift in platform focus carries the organization away from its original (e.g., inpatient) mission, the need for appropriate state and judicial approvals should be considered.

The implications of a business model that evolves from its primary charitable purposes are demonstrated in a recent, highly publicized 2018 state attorney general enforcement action involving a prominent local charity.[1] According to the attorney general, while the non-profit organization drifted away from its mission, served a dwindling amount of needy clients, and employee morale plummeted, inattentive directors and the CEO continued receiving bonuses and other excessive pay. The investigation didn't result in any criminal charges but led to the removal of the CEO and several board members, and the charity had to agree to other new business practices as part of a court decree.

Tax-Exempt Status

The transformative forces that are prompting "mission drift" risks are also placing greater pressure on non-profit hospitals to support their claim to federal tax-exempt status. As the delivery model evolves away

1 For more information, see Henry J. Cordes, "AG's Goodwill Probe Faults Excessive Pay That Harmed Mission but Says Nonprofit Is Back on Track," *Omaha World-Herald*, June 27, 2018.

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The IRS's core standards for hospital tax-exempt status dates back to 1969 and envisions a community-based facility that has decreasingly little in common with the large, sophisticated business enterprise that the health system has become, no matter its non-profit, charitable status. Fifty years is a very long life cycle for a tax-exemption standard that has such significant financial implications.

The main IRS and legislative concern is to what extent tax-exempt hospitals should be taxed like the commercial/for-profit sector since they are drifting towards the commercial sector in terms of their delivery model. There is growing recognition that non-profit hospitals conduct business alongside for-profit, investor-owned hospitals in many parts of the country, yet they are indistinguishable from the latter facilities in many of the most obvious indicators. The concern will be exacerbated by expected renewed scrutiny from the Senate Finance Committee, again under the leadership of Senator Charles Grassley. Additional, more discrete pressure will come as increasing numbers of for-profit companies, across industry sectors, adopt the call of BlackRock Chair Laurence Fink to address more forcefully the social needs and political issues of the day.

This concern has most recently manifested in the 2017 Tax Cuts and Jobs Act, which contained several provisions (e.g., the excise tax on non-profit CEOs) that are punitive to tax-exempt organizations. The Act is one of several developments that are questioning whether very large, sophisticated businesses can operate within the framework of non-profit corporate and Section 501(c)(3) tax-exempt status.

The challenge to such systems is to identify and externally articulate their truly charitable factors—how their focus and operations are different than those of for-profit healthcare companies. The board must recognize the risk and manage it in order to preserve favorable tax and corporate status.

Constituent Governance

Similar transformative forces are reshaping the governance processes of health systems in a manner that can create fiduciary uncertainty and dissonance.

The continued rapid pace of industry consolidation is reflected in an increase in business combinations (e.g., membership substitution) between non-profit health systems. Unlike transactions with for-profits, these collaborations rarely involve direct financial consideration, and are affected in part through governance commitments (e.g., granting one of the parties a set of director positions on the board of the other party). In other words, the right to appoint a certain number of directors can be an important bargaining "chip" to a health system that is transferring control to another organization.

The expectation is that such "constituent" directors will help address post-merger cultural integration and ensure that terms and conditions in the combination agreement will be enforced (i.e., their constituency is in part the purposes of the system they once served). Other "constituent" directors include medical staff appointees, and those appointed by community or other interested groups with a strong tie to the system's mission.

The governance concern is a divided loyalty—the perception (if not the fact) that such constituent directors may owe loyalty both to the new health system they were appointed to serve, as well as the "legacy" organization that appointed them. The law of most states won't see it that way—the traditional rule is that a director's primary fiduciary obligation is to the board he/she is serving at the moment (i.e., the boardroom you are sitting in). However, constituent directors frequently struggle with the nuances of that distinction, which can lead to substantial disagreement and even stalemate at the board level.

Thus, in this evolving environment, the board should give much greater focus to the wisdom and fiduciary mechanics of applying constituent directorships.

Parent Fiduciary Duties

Health systems should also take note of case law, existing now in only a few states, that would attribute fiduciary obligations to health system parent organizations in their dealings with controlled subsidiaries. This controversial position can have significant implications for system controls, decision making, and financial integration. It is in the news more recently with a case that is making its way through the New York State courts, in which state charity officials are challenging the manner by which the parent organization of a non-profit long-term care system is interacting with its subsidiary companies.

Conclusion

One of the most significant challenges facing non-profit health systems in 2019 and beyond is the need to address the implications of transformation and consolidation as they affect strategic mission, charitable status, and system governance. These are challenges that informed governing boards are often able to manage, given proper timing, resources, and internal support.

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