

## Understanding the Role of the Subsidiary Board

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Health system parent–subsidiary relationships may be enhanced when the affiliate board has a working understanding of the legal nature of that relationship, and of their specific duties and responsibilities. Such an understanding may be achieved, in part, by reviewing the 10 concepts presented in this article.

**1. The history:** This relates to the origination of the relationship between the parent and the subsidiary. For example, the subsidiary could have been created as part of the original hospital restructuring that created the health system. Or, the relationship may have been established through some form of organic transaction (e.g., sale, merger, or change of membership). Whatever the case, an understanding of how the parent/subsidiary relationship was created, and also why it was created, is fundamental to the subsidiary board’s effectiveness.

**2. Regulatory framework:** This does not suggest a close awareness of the regulatory framework in which the subsidiary must operate. Rather, it suggests a basic familiarity with how the state and federal laws that impact corporate governance (e.g., the state non-profit corporation law, the Internal Revenue Code, and HHS/OIG guidance) relate to the subsidiary’s governance structure.

**3. Structural relationship:** The subsidiary board need not be lawyers to have a basic understanding of the legal ties that

### Key Board Takeaways

Subsidiary boards will improve their understanding of their role, and that of the subsidiary, within the larger health system construct through a greater awareness of:

- How, and why, the parent/subsidiary relationship was created
- The subsidiary’s corporate purposes
- The controls retained by the parent over the subsidiary
- The affirmative duties assigned to the subsidiary board
- The employment and reporting relationships
- How subsidiary directors are selected for their position, and why

bind the parent to the subsidiary. Oftentimes this will be a corporate membership relationship under state non-profit corporate law, but other options exist (depending on state law) by which the relationship is asserted. The subsidiary board should be generally familiar with the form of structural relationship and its legal foundation.

**4. Fiduciary relationship:** Rare would be the circumstance in which the parent corporation actually owes a fiduciary relationship to the subsidiary corporation. This is a legal theory that has been accepted in only a very few states, and is unlikely to be a significant factor in the relationship unless the parties have contractually agreed that such a fiduciary relationship is to be established. Along the same lines, the subsidiary board should not view its role as fundamentally adversarial to the parent organization and its board, or that its primary role is to exercise a system of checks and balances over parent actions. The only significant exception to that is where the subsidiary has negotiated legacy-type protections over certain

aspects of operation or governance.

**5. Corporate purposes:** It is particularly important for the subsidiary board to be aware of the scope of the corporate/charitable purposes of the subsidiary. These powers not only articulate the subsidiary’s “raison d’être,” but they also represent the mission to which the subsidiary directors owe their fiduciary duties. As such, it is the foundational basis for their oversight and decision making. Increasingly, the charitable purposes extend beyond community or geographic purposes to service in support of the broader charitable purposes of the parent corporation (and in some instances that of its sponsor).

**6. Reserved powers:** The control feature in many parent/subsidiary relationships is a set of powers reserved to the parent organization over certain articulated business and operational decisions of the subsidiary. Oftentimes the parent exercises these rights after certain initial action has been taken by the subsidiary board, while in other instances the parent has the

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right (under state law) to actually initiate action that is binding on the subsidiary, without separate action by the subsidiary board. It is crucial that the subsidiary board understand the scope of these powers and their relationship to them.

### 7. Subsidiary board appointment:

Board members should understand the process by which they, and members of board committees, are selected. Most likely the selection process will involve some input (if not direct approval) by the parent. Many relationships make sure that the nomination process reflects a governance selection matrix prepared by the parent for all boards in the system. The board should also be aware of any specific “legacy” or other constituent-based board/committee appointment rights and their source (e.g., prior commitment, sponsor rights, or specific terms in an affiliation agreement).

### 8. Subsidiary board duties:

Another critical touchpoint for the subsidiary board is the scope of its responsibilities. Typically, these are substantially reduced in a parent/subsidiary relationship given the need of the parent (for efficiency,

cost-effectiveness, and mission sustainability reasons) to assert material control of the operation of the subsidiary. Yet, even in such situations, the subsidiary board often retains important direct and indirect duties and authorities. A typical example of a material subsidiary board duty is to exercise the quality-related powers of the designated governing board under CMS conditions of participation and accreditation requirements.

### 9. Executive reporting:

The establishment of parent/subsidiary relationships often leads to either direct or more subtle shifts in the reporting relationships of the senior management team. Rather than reporting directly to the subsidiary board, the nature of the parent/subsidiary control relationship more often includes a reporting relationship to the parent’s senior executive leadership. This is typically necessary to ensure alignment of executive direction and supervision of all senior officers in the system. Also, in many systems, the subsidiary’s executive leadership team is transitioned to direct employment with the parent, from

the subsidiary.

**10. System policies:** In most parent/subsidiary relationships, the members of the subsidiary board become subject to various policies and procedures established by the parent organization to apply uniformly to all boards throughout the system. These might include a system governance policy, conflict-of-interest policies and disclosure obligations, codes of conduct, limitations on other board service, “fitness to serve” policies and “refreshment” standards, and policies that address matters of appropriation of corporate opportunity and of confidentiality.

## Summary

An effective health system parent/subsidiary relationship is the byproduct of a number of tangible and intangible factors, including trust, transparency, and commitment. However, a critical factor is also a working knowledge by subsidiary board members of the legal and fiduciary nature of their role and responsibilities. Being part of a system very often requires a shift in focus by subsidiary boards, but one which still positions them to play an important and vital role in the achievement of the overall mission of the organization. It is incumbent on subsidiary board members to understand the full scope and importance of that role.

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