Mergers and Conversions of Not-for-Profit Health Care Organizations

Contributed by Mark Hoenig and Cynthia Marian, Weil, Gotshal & Manges LLP

The evolution of health care from a community-based and strictly public-service oriented activity into a highly complex and competitive industry has, for some time, fostered an economic climate that requires constant strategic thinking with respect to both provision of services and organizational structure. To be sure, for many years companies in the healthcare industry, particularly hospitals, have attempted to navigate through an increasingly burdensome regulatory environment while simultaneously mired by an economic model that simply is not designed to address current competitive realities. More recently, and most acutely as a result of the current economic downturn layered on top of the latest cycle of heightened regulatory requirements and mounting public scrutiny, a sort of fascination with mergers and, perhaps even more so, conversions into for-profit organizations, has blossomed within the broader non-profit community. Understandably, this recent round of “merger mania” has pushed various players within the healthcare industry to consider mergers and conversions with even greater vigor and urgency.

As our non-profit community explores these options, it will be most important to identify and understand the underlying motivations, and to appreciate the associated big picture considerations and hurdles. The recent transitions of New York State health insurance providers WellChoice, Inc., which was created by the conversion of Empire Blue Cross Blue Shield, and EmblemHealth, Inc., which was created through the merger of GHI with HIP and which has been planning an initial public offering for sometime this year, serve as examples for discussion.

Sudden Interest in Mergers and Conversions

The emerging focus within the non-profit community on mergers and conversions is a consequence of a confluence of factors, something of a perfect storm. While there are a host of reasons why a given not-for-profit organization (NFP) would consider these options, there are just a few reasons why these options are currently being deliberated by boards across the entire spectrum of NFPs. In large measure the result of a variety of real and imagined scandals and abuses, non-profits have become subject to increasingly intense and aggressive government and regulatory scrutiny (just take a look at the revamped Form 990 tax return) with every intention to force-feed “best” governance and transparency on every single NFP. The significant strain imposed on NFPs by these government initiatives has now been severely aggravated by today’s difficult financial environment, in which most NFPs are struggling to make ends meet and uncertain about the future. Faced with these two “new” hurdles — the government and the economy — forward-thinking NFPs are including mergers and conversions among their options for long-term success and survival.

How is NFP Status Relevant to the Ability to Merge or Convert?

Despite many similarities in both organizational structure and day-to-day operations, business (for-profit) corporations and NFPs are very different creatures, subject to very different constraints. Unlike a for-profit entity, which operates for the benefit of its shareholders or partners, an NFP is, under state law, an entity that exists to provide some kind of *public* benefit and perform *charitable* work. Stated most simply, unlike its for-profit analog, the assets of an NFP are in essence held in trust for and dedicated to public use. Consequently, any transfer or disposition of those assets whatsoever, including in connection with a merger or conversion, is subject to more onerous state law constraints.

© 2009 Bloomberg Finance L.P. All rights reserved.
Originally published by Bloomberg Finance L.P. in the Vol. 2, No. 6 edition of the Bloomberg Law Reports – Health Law. Reprinted with permission. The views expressed herein are those of the authors and do not represent those of Bloomberg Finance L.P. Bloomberg Law Reports (R) is a registered trademark and service mark of Bloomberg Finance L.P.

For example, in order to dissolve or terminate an NFP in New York State, the organization's assets must be contributed to another tax-exempt organization with similar purposes, and permission must be obtained from the New York State Supreme Court, with notice to the New York Attorney General's office. Likewise, to ensure compliance with all statutory requirements and to protect the public interest, NFPs ordinarily must secure State Supreme Court and Attorney General approval in connection with a change in corporate purpose, a conversion to a for-profit entity, a sale of all or substantially all of the NFP's assets, or a merger.

Many (if not most) NFPs are also tax-exempt. Tax exemption typically covers federal and state income taxes, and other state and local taxes as well. Not surprisingly, receipt of tax-exempt status under the tax law comes with a variety of constraints on an NFP's ability to either merge or convert. As a general proposition, the relevant taxing authorities will scrutinize any activity or transaction undertaken by an NFP to ensure compliance and consistency with the basis on which exempt status was granted, as well as with the more generic tax law principles that the assets of an exempt organization — whether tangible or intangible, actual or contingent — are safeguarded, retained and applied toward achieving the organization's tax-exempt mission. In connection with any plan to merge with another NFP, and probably more so in connection with a plan to convert to for-profit status, these tax law constraints must be fully explored.

The Impetus Behind NFP Mergers

Like their for-profit counterparts, NFPs often consider merging with one another for reasons such as operational efficiencies and expanded sources of capital. However, as noted earlier, the legal and other hurdles that confront the NFP considering a merger can be quite different from those faced by for-profit organizations.

As a preliminary matter, it helps to stay mindful that the word "merger" is used to describe at least three different types of combinations. Most often, a merger refers to the combination of two companies whereby one survives and absorbs the other, and the latter ceases to exist. A second form of merger, commonly referred to as a consolidation, involves the joining of two entities into a brand new corporation, where neither of the original organizations survives in its original form. Finally, some mergers are simply the sale by one company of all or substantially all of its assets to the other corporation, after which the selling corporation ends its corporate existence. Depending on the financial health of each company involved in the transaction, as well as a variety of other factors, including politics, corporate culture, optics, and contractual relationships with employees and vendors, one of these approaches (or even a different approach) may be more attractive than the others. For example, a company that has significant debt or contingent liabilities may be a better candidate for an asset sale than a merger or consolidation, because the acquiring company will want to protect its own assets from the reach of the selling corporation's creditors.

Any one of these avenues to effect a merger will be subject to oversight and approval as specified by the applicable state laws governing the NFPs involved in the transaction. In New York, for example, Supreme Court approval on notice to the Attorney General is required for a merger involving most NFPs. The role of the Attorney General is to assist the Court in conducting a comprehensive review of the financial and other documents submitted in connection with the merger proposal, with the goal of determining whether the proposed merger will be detrimental to the public interest or to either party to the transaction. For this reason, the New York statute provides not only that the consideration received by an NFP in the transaction must be "fair and reasonable," but also that the transaction must promote the purposes of the corporation or the interests of its members. This statute demonstrates that where an NFP corporation is involved,

© 2009 Bloomberg Finance L.P. All rights reserved.
Originally published by Bloomberg Finance L.P. in the Vol. 2, No. 6 edition of the Bloomberg Law Reports – Health Law. Reprinted with permission. The views expressed herein are those of the authors and do not represent those of Bloomberg Finance L.P. Bloomberg Law Reports (R) is a registered trademark and service mark of Bloomberg Finance L.P.

receipt of fair market value alone is not sufficient, which stands in stark contrast to the typical barometer for mergers of business corporations.

In the context of a merger of two NFPs in which the assets of each are combined (and neither is exchanging its assets for other consideration), New York's AG review and approval process is designed to ensure that the assets and activities of any New York NFP do not, as a result of the transaction, become subject to claims or liabilities, or otherwise "leak out" for the benefit of insiders or the private sector, or even for the benefit of the "wrong" public good. Any such result, which fails to preserve and employ the NFP's value for its intended public beneficiaries in a manner consistent with the State's determination of what is appropriate given the organization's mission and its duties to donors and the charitable classes it serves, is both prohibited under State law and contrary to public policy.

Any merger of an NFP that is tax-exempt also must adhere to constraints imposed under applicable tax law. This will include notifying and typically securing approval from the IRS and other taxing authorities. By and large this means that, in order not to jeopardize its tax-exempt status, even on a retroactive basis, or to incur penalties, the NFP will need to establish that the merger will result in a "new" organization and operation that continues to comport with the tax laws governing receipt and retention of its tax-exempt status.

Despite the heavier government involvement, which includes significant information requirements and makes for a longer transaction process, a merger of NFPs is often in the best interests of both the entities and the public. It is not unusual to find multiple NFPs with the same or similar missions, perhaps even operating in the same place or region. Although competition within a for-profit industry is typically seen as beneficial for consumers, given that most NFPs rely on government funding and/or charitable donations for their capital needs, duplication of efforts can be less of a boon and can instead weaken or inhibit the impact of each NFP's work. As a result, non-profits, often already thinly staffed, may realize significant economies of scale and make a substantially greater impact by joining forces and centralizing their efforts. Especially in the current global economic situation, NFPs are likely to have difficulty raising capital and meeting their budgets, and a merger may even help them to avoid bankruptcy or dissolution.

Indeed, according to a spokesperson for HIP and GHI, two New York state health insurers that completed a merger in 2007 and now operate together as EmblemHealth, Inc., the combination was viewed as crucial to survival by both entities. "In order for us to compete with the national plans, we thought it would be best to get together to be a strong, large, local company." ("State's Largest HMO Planned," by Alan Wechsler, *Albany Times Union, 9/30/05, page E1)* Although some commentators worried that the merger would reduce competition for municipal contracts and result in higher insurance premiums for more than 1.1 million municipal workers, New York's regulators approved the deal. Based on this and similar cases, one can surmise that New York favors the combination of entities with similar missions, so long as the assets intended for charitable or public purposes will not be diverted; in these situations, the standard imposed under New York law offers a presumption of approval.

Converting to "For-Profit" Presents Competing Government Considerations

Another way for an NFP to resolve budget problems and confront stiff competition is to convert to a for-profit entity, thereby opening the door to raising much-needed capital through the issuance of equity. Lack of sufficient access to capital is the most common motivation for NFP conversions to business corporations. The ability of for-profit corporations to sell stock has the potential to provide a fresh source of funding, which can simultaneously reduce leverage and ease operational restrictions arising from standard debt covenants. Moreover, for-profit entities are

© 2009 Bloomberg Finance L.P. All rights reserved.
Originally published by Bloomberg Finance L.P. in the Vol. 2, No. 6 edition of the Bloomberg Law Reports – Health Law. Reprinted with permission. The views expressed herein are those of the authors and do not represent those of Bloomberg Finance L.P. Bloomberg Law Reports (R) is a registered trademark and service mark of Bloomberg Finance L.P.

typically valued at higher amounts than their not-for-profit counterparts, which contributes to a somewhat circular funding dilemma for NFPs and makes conversion to for-profit status attractive for cash-short corporations. Other reasons to consider conversion to for-profit status include: (1) a desire to diversify beyond the mission of the NFP into other, potentially taxable, lines of business, which, absent a conversion, would result in unrelated business taxable income (UBTI) and could jeopardize the organization's tax-exempt status, (2) a desire to adopt an employee stock ownership plan (a so-called ESOP) or to offer other equity-based compensation, such as stock options or restricted stock units, as an incentive to employees and/or management, (3) regulatory changes and/or speculation surrounding government reimbursement changes, and (4) avoiding the Section 501(m) limitation on and taxation of commercial-type insurance.

Of course, there are costs to converting from NFP status too. As an NFP contemplates converting to for-profit status and relinquishing tax-exempt status, it must weigh the prospect of paying full tax on all its net income, as well as the inability to attract future charitable contributions and grants from government, foundations and the public at large. Aside from these quantifiable considerations, which point to whether a conversion might cost more than it brings in, the NFP also must give careful thought to the impact a conversion can have on its image. The manner in which others will perceive the NFP, including whether or not they will be willing to fund or do business with it, may change. Depending on the NFP's mission and particular financial and organizational challenges, these offsets may or may not make the better choice clear.

In New York State, as in the case of mergers, State Supreme Court and Attorney General approvals must be secured in advance of an NFP conversion to for-profit status. Unlike a merger of NFPs, however, conversion to for-profit status, at which point the entity will no longer be constrained by the state law and tax law limitations that apply to an NFP's use and application of assets, is a far more drastic step from the perspective of the State's interest in preserving the NFP's assets for the benefit of the public. Regardless of the approach used to achieve the conversion, pursuant to state charitable trust laws, all of the NFP's assets, or at least 100 percent of the value of those assets, must be transferred to another tax-exempt organization and typically must be devoted to the same or similar charitable ends. The challenge for the State remains to ensure that those assets, which have been held "in trust" for the benefit of the public, do not disappear or end up in the hands of private individuals, and that the public will not be adversely affected.

This State law requirement, which leaves considerable room for subjectivity with respect to the standards for "fair and reasonable consideration" and the analysis and weighing of potentially adverse effects, can present a significant challenge. The State must protect the original charitable mission of the NFP, but at the same time often confronts the possibility that a conversion might yield considerable value (for example, in the form of valuable public company stock) which, if realized, could be secured and channeled toward some underfunded public cause or benefit that may not be exactly on "all fours" with the NFP's original, often narrow, mission. In such a case, it often is difficult for the State to determine whether to permit the conversion and where and how the valuable public company stock should be deployed for the benefit of the public. Where this conflict presents itself, the State invariably finds itself in a very sticky thicket, and, understandably, often has struggled to come up with the right solution.

How Does an NFP Convert to "For-Profit" Status?

There are a number of structuring avenues that can be employed to achieve conversion to for-profit status. A "drop-down" conversion is one in which the NFP transfers some or all of its assets to a wholly or partially owned corporate subsidiary in exchange for stock and, perhaps, other securities. The new corporation then might publicly or privately issue new equity for cash, or the

© 2009 Bloomberg Finance L.P. All rights reserved.
Originally published by Bloomberg Finance L.P. in the Vol. 2, No. 6 edition of the Bloomberg Law Reports – Health Law. Reprinted with permission. The views expressed herein are those of the authors and do not represent those of Bloomberg Finance L.P. Bloomberg Law Reports (R) is a registered trademark and service mark of Bloomberg Finance L.P.

NFP itself might sell some or all of the stock or other securities publicly or to a third party. A "conversion in place" is permitted only in a few states and is by far the easiest mode of effecting a conversion, essentially requiring only an amendment to the incorporation documents to expressly change from an organization whose purposes and activities are constrained to a stated charitable or non-profit objective, into one that seeks to make a profit. Depending on various factors, a conversion also can be implemented through the vehicle of a state law merger.

Navigating Through to a Successful Conversion

While the conversion transaction and the precise form chosen to effect the conversion invariably will raise tax-related issues regarding the taxability of the transaction itself and the tax profile of the new for-profit entity on a going forward basis, these issues ordinarily are not the "show stoppers." Rather, the key hurdle usually relates to the State law approval, the focus of which is on ensuring that not a single dollar worth of the NFP's asset value escapes and instead continues to be dedicated to the public good.

The Wellpoint conversion provides a good illustration. Following California Blue Cross Blue Shield's "drop-down" conversion, wherein it transferred its assets to for-profit Wellpoint Health Networks, Inc., the State created two health-related foundations to hold and apply the value of the Wellpoint stock. Since that time, the two foundations have spent the total $3.2 billion received for the NFP's assets on public health research, education, and advocacy projects ("Non-Profit to Profit: Free Money No More," by Chana R. Schoenberger, *Forbes*, 1/9/07).

Unfortunately, not all states have been able to steer non-profit conversions to outcomes quite so clearly consistent with the goal of preserving value for the public good in a manner that does not materially alter the pre-conversion goals of each NFP. For example, in 1996 Virginia's Trigon Blue Cross Blue Shield converted to a for-profit entity and the State allocated $175 million of the proceeds for general expenses in the state budget. And in 2002, when New York's Empire Blue Cross Blue Shield converted into for-profit WellChoice, Inc., the State chose to allocate $5 billion (95 percent of the value received for the NFP's assets) to salary raises for hospital workers. According to Forbes magazine (1/9/07), only 5 percent of Empire's pre-conversion fair market value ($250 million) was retained and applied toward public health projects. Obviously, these conversions often pose serious challenges that require a very difficult balancing of conflicting considerations and the analysis of a multitude of imperfect options. Different states, confronted with varying situations, have attacked the problem in different ways and have had varying degrees of success. It does seem clear though (at least as measured by popular opinion), that California's choices serve as the model to which all states should aspire.

In today's financial environment, NFPs across all industries need to consider the possibility of either merging or converting. A non-profit's ability to both survive and thrive often will hinge on its willingness to explore and pursue potential changes to its organizational form and objectives. At the same time, NFPs must proceed with eyes wide open, understanding the full panoply of options and the challenges they will confront as they move forward along one path or another.

Mark Hoenig is a Tax Partner at Weil, Gotshal & Manges, LLP, specializing in mergers, acquisitions, reorganizations and work-outs. Mr. Hoenig also is Co-Chair of his firm's Not-for-Profit Practice Group, and has counseled many non-profits and tax-exempts through all phases of their existence (including New York's Blue Cross Blue Shield in connection with its conversion to WellChoice, Inc.). Cynthia Marian is an associate in the Tax practice of Weil, Gotshal & Manges, LLP, working in the firm's New York office.

© 2009 Bloomberg Finance L.P. All rights reserved.
Originally published by Bloomberg Finance L.P. in the Vol. 2, No. 6 edition of the Bloomberg Law Reports – Health Law. Reprinted with permission. The views expressed herein are those of the authors and do not represent those of Bloomberg Finance L.P. Bloomberg Law Reports (R) is a registered trademark and service mark of Bloomberg Finance L.P.