

Managing the Parent/Subsidiary Relationship: A Checklist for the General Counsel

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The growth of the nonprofit health system in terms of size, scope, and complexity calls for a consistent approach to monitoring and resolving legal issues arising from the parent/subsidiary relationship. How do these entities effectively relate to each other in terms of structure, purpose, governance, fiduciary relationship, authority, and liability? The successful management of this relationship is critical to system cohesiveness and sustainability.

Because the parent/subsidiary relationship is grounded in law, the general counsel is the logical corporate officer to assume responsibility for monitoring system governance and structural issues. The following legal checklist is offered to assist the general counsel in advising internal clients on these issues as they may periodically arise. Individual checklist items reflect some of the questions most often presented to the general counsel from directors and management in this regard.

ITEM #1 The Parent's Legal Status

From a checklist perspective, the general counsel is called upon to monitor two basic and ongoing formational considerations. First, is the parent company's status as a nonprofit corporation, and second is its status as tax exempt under the Internal Revenue Code.

Nonprofit Corporate and Charitable Trust Law. Most parent corporations are incorporated under the nonprofit corporate laws of the state of system domicile. The incorporation documents reflect adoption of one or more purposes recognized as charitable purposes. As systems grow and diversify, it becomes increasingly important to monitor the extent to which both the statement of corporate purposes and the flexibility of the state nonprofit corporation code are sufficiently broad to support the evolving parent entity agenda.

Exempt Organization Tax Law. As most general counsel are well aware, nonprofit status under state corporation law is not, in and of itself, sufficient to support federal tax-exempt status. The general counsel serves an important role in monitoring the extent to which the basis of the parent's tax-exempt status is established correctly and maintained.

Most health system parent corporations qualify for tax-exempt status under the "integral part theory" of exemption, not on the basis that they directly conduct charitable activities. Satisfaction of the integral part theory (also known as "derivative exemption") requires that the parent demonstrate: (1) that a sufficient structural or financial relationship (e.g., a legitimate

parent-subsidiary relationship) exists between the parent and another tax-exempt organization(s) (the "relationship requirement") and (2) that its activities (e.g., traditional headquarters and system governance services) are activities that could or would have been performed by such other tax-exempt organization(s) (the "activities requirement").

ITEM #2 Parent Purpose and Function

Thus for corporate, charitable trust, tax, and other legal reasons, it is important for the general counsel to monitor the actual purpose and function of the system parent corporation.

Core Purpose. The philosophical purpose of the parent is most often to serve as the corporate mechanism through which the mission of the organization (secular or religious) is achieved, and the agenda of the various second and third tier subsidiaries are directed. The functions and activities of the parent are designed to facilitate that fundamental purpose.

Headquarters Services. As noted above, this means either the performance of unique, stand-alone charitable activities or, as is much more common, the performance of traditional headquarters-like functions. These are most often achieved through both governance and operational orientation focused on providing certain services to the system subsidiaries that could or would have been performed by subsidiaries themselves. These typically include (among others) strategic planning, human resources, financial management, legal affairs, quality oversight, managed care contracting, information services, technology procurement, and corporate compliance.

The expectation is that by providing these services on a uniform basis throughout the system, efficiencies in terms of governance, operations, cost, timing, coordination, and consistency will be achieved.

ITEM #3 Parent Control Mechanisms

Parent corporations typically affect control over their subsidiary organizations through a combination of structural, governance, financial, and operational mechanisms. The general counsel is called upon to monitor the effectiveness and legal sustainability of these mechanisms.

From a structural perspective, the most historically common control mechanism is the designation of the system parent as the sole corporate member of the primary nonprofit subsidiaries. Under most state corporate laws, "corporate member" designation authorizes the parent to exercise approval

or “reserved” powers over the nonprofit corporations for which it serves as member. In some states, the nonprofit code also authorizes (directly or indirectly) the corporate member to “initiate” action with respect to its subsidiaries. Similarly, the parent corporation typically serves as sole shareholder of system for-profit companies (or perhaps more simply of a for-profit holding company).

Another common control mechanism is to implement 100% (or at least majority) overlap between the parent and its primary nonprofit subsidiaries; an option made more legally and operationally feasible by the Centers for Medicare & Medicaid Services (CMS) 2012 rule recognizing a “unified” governing body structure for health care systems.

ITEM #4 Subsidiary Purposes and Functions

In most health care systems, the creation and operation of the system parent company has no material effect on the operations of the subsidiary corporations; e.g., the licensed tax-exempt provider companies and diversified business organizations. The only exception is the extent to which a new organization is identified as the sole member of the subsidiary. Given the types of control mechanisms identified in Item #3, above, subsidiary management may more often than not be looking for substantive guidance, direction, and supervision from the senior leadership team of the parent corporation as opposed to senior management and governance of the subsidiary.

ITEM #5 Copperweld Considerations.

Closely connected with issues of parent corporation control (*see* Item #3) is the need to understand whether a parent and subsidiary are able to coordinate their competitive activities without running afoul of the antitrust laws. As most general counsel are aware, a parent must exercise sufficient control over and have a unity of economic interest with its subsidiaries and/or joint venture investments in order for those entities to collectively engage in competitive activities.

This is the essence of the well-known “Copperweld” doctrine. As system relationships with subsidiaries evolve, the general counsel seeks to preserve in the ultimate relationship those indicia of control/unity of interest that are necessary to avoid having certain intra-system arrangements characterized as unlawful agreements under the antitrust laws. The strategic business decisions of senior executive leaders are more informed by the advice of their general counsel on how best to assure, through corporate controls and financial relationships, this unity of interest.

ITEM #6 Parent Governance

The parent corporation accomplishes its goals through a combination of, among other key tasks: (a) the informed exercise of its reserved powers; (b) exercising certain centralized system supervision and direction through parent company management; (c) establishing system-wide policies and procedures; (d) directing the creation and implementation of the system

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strategic plan; and (e) oversight of system-wide governance and operations through the actions of committees of the parent board that have system-wide duties in scope. The general counsel serves a critical role in supporting the board and senior management of the parent in the informed exercise of these duties; i.e., in providing legal advice and education with respect to matters of board and committee operation, oversight, and decision making. The general counsel can also act in support of management’s efforts to direct policy and operations across the system.

The general counsel also performs an important role with respect to the composition of the board, and of the identification, composition, and operation of its committees. In this regard, board composition is a particularly key role, as the general counsel is called upon to address issues relating to (1) the proper size of the board (i.e., large enough to allow it to comfortably respond to the full board agenda); (2) assuring board control in a majority of “independent” directors per state corporate law and best practice; (3) supporting the director nomination, onboarding, evaluation, and renomination process; and (4) providing advice on the most appropriate board composition, including but not limited to, matters of subject matter competency, industry experience, and diversity considerations across a broad spectrum. The general counsel also will be called upon to advise on duty of loyalty challenges associated with constituent directors.

ITEM #7 Subsidiary Governance

One of the most misunderstood and controversial aspects of the parent/subsidiary relationship relates to the composition, functions, and responsibilities of the subsidiary board, especially for the inpatient provider subsidiaries. The general counsel can provide substantial guidance with respect to the proper legal, and practical, interpretation of that relationship.

Perhaps the most challenging aspect of subsidiary governance is a proper understanding of the basic duties of the subsidiary board. For a fiduciary board, the extent of its oversight responsibilities may differ from the extent of its decision-making responsibilities under most state laws. From an oversight perspective, a fiduciary board will likely be expected

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to exercise oversight over the entirety of corporate operations and financial matters assets. The decision-making responsibilities of that board may be less, and will depend upon the scope of the subsidiary bylaws.

Typically, the subsidiary board is directly responsible for those actions assigned to it under the bylaws and by state law and licensure/accreditation rules. In many circumstances, this may involve primary responsibility for quality of care matters and medical staff appointment (*see* Item #11); amendment of articles and bylaws; budget approval; incurrence of certain levels of indebtedness; election/appointment of the board and Chief Executive Officer; and preservation of corporate formalities and licenses. It may also involve taking the initial action on matters that are subject to parent company reserved powers or other authority. It is important to note that some state corporate laws may limit the subsidiary board's ability to delegate certain actions to the parent for final authority.

ITEM #8 Allocation of Authority

Related to the elements of parent corporation vs. subsidiary corporation responsibilities is the need for a clear articulation of the division of responsibility between the board and management at all levels of the health system. This involves clarity on both horizontal and vertical levels as to the issues that merit executive management and/or board or committee action. The goal is to preserve corporate formalities at all levels and to avoid gaps in the oversight or decision-making process.

Written governance and management matrices can be very helpful in articulating levels of authority and responsibility for particular oversight and decision-making responsibilities between parent and subsidiary boards, and between governance and management at both the parent and subsidiary levels. These types of matrices typically identify specific elements of oversight responsibility and action items, and differentiate between those matters for which specific board (at whatever level) authority is required, and those matters for which notification, review, and discussion is sufficient. The general counsel is well equipped to guide senior management and governing boards through this type of process, so that all levels of leadership have a clear understanding of their respective authorities, and of the

standards for what must be brought to various levels of system hierarchy for approval.

ITEM #9 Fiduciary Roles

The general counsel is well-positioned to advise internal clients and members of system governance on the key question, “what are my fiduciary duties, and to whom or what do I owe them?”

The answer to the first part of the question is relatively straightforward. All voting members of boards and committees carry with them traditional duties of care and loyalty as articulated under state law; advisory and similar volunteers usually do not have such powers (with possible exceptions for loyalty-based obligations). Whether executive officers owe a fiduciary duty is a matter of state law and the scope of their employment contract.

The answer to the second part of the question can be more tricky, and particularly benefits from the guidance of the general counsel. Generally speaking, fiduciary duties in the nonprofit sector are owed to the organization, and to its charitable mission articulated in the articles of incorporation and bylaws. That's pretty much straight-up. The complexity arises in two situations. First, “constituent” and “legacy”-styled directors must be quickly weaned off any suggestion that they have dual loyalties to the constituency (e.g., community or interest group) or legacy entity (a hospital recently affiliated with the system) that appointed or nominated them.

Second, it is not uncommon in many health systems to have widely disparate corporate mission statements across the subsidiary tiers. This typically arises from the acquisition of previously unaffiliated systems. In that situation, the potential for governance conflict at the subsidiary level may arise—even in situations with completely overlapping boards. This problem often can be eliminated by the adoption of a common, system-wide “unity of mission” clause that makes it clear that all entities exist in primary part to serve the charitable mission of the system.

The general counsel will also wish to monitor the evolution of the legal theory, as adopted by some academics and a small number of state courts, that the parent corporation may actually owe a fiduciary duty to the subsidiaries for which it serves as sole member. This theory, if applied in the health system context, can lead to significant structural destabilization.

ITEM #10 Intra-System Liability

An additional structural concern is the potential for intra-system liability; i.e., whether (apart from written debt guarantees and similar obligations) system legal entities can be exposed to liability for the wrongdoing of another system entity. The most obvious exposure to intra-system liability arises under the well-known theories of “alter ego,” “attribution,” “ascending liability,” and “direct participation.” Most general counsel are aware that claims based on these theories arise from the failure to maintain corporate formalities and the presence of fraud or similar misconduct.

From the perspective of a health system, concern for intra-system liability can arise from efforts to implement much

tighter corporate control at the parent corporation without dissolving existing subsidiary corporations. Such “systemness” activity often focuses on asserting greater influence and (in some cases) outright control at the “top”/parent level over system assets, governance, management, and quality. This model reflects the goal of acting more like a single integrated organization rather than as a collection of independent entities under common control. Such efforts can, if unsupervised, reduce or marginalize previously existing corporate form, structure and control provisions. It is in the aggressive use of these control and efficiency mechanisms that the risk of alter ego (or other similar) treatment may arise.

ITEM #11 The Joint Commission/ Accreditation Matters

As noted in Item #7, where a subsidiary board is the governing body of a hospital (i.e., in the absence of a “unified” governing body structure), that subsidiary board must meet all of the CMS Conditions of Participation (CoPs) and accrediting organization standards applicable to a governing body. Where there is a unified governing body, that single governing body must act on behalf of each separate hospital for which it serves as the governing body. Neither CMS nor accrediting organizations will accept blanket actions for “all hospitals” taken by a unified governing body; there must be a careful delineation of which actions are taken by and on behalf of, and apply to, each separate facility in a unified governing body structure.

Each hospital’s governing body, regardless of structure, must ensure independent compliance with the CoPs and accreditation standards, mindful that each separately enrolled hospital remains responsible for its own key activities, including professional staff privileging, quality assessment, and performance improvement and infection control. The general counsel can assist these efforts by ensuring that each facility governing body within the system (or the unified governing body, if that structure is implemented) develops a process for documenting its actions appropriately, and ensures that the governing body remains mindful of the independent compliance requirements placed on each facility.

ITEM #12 “Morristown” Concerns

From a global, “optics” perspective, the general counsel is called upon to monitor prominent developments challenging the presumption that large, diversified health delivery systems can be operated under the control of a nonprofit, charitable corporation. Several of these developments serve to identify potential areas of vulnerability for that model under state nonprofit corporation and federal tax-exemption laws. These areas of vulnerability challenge the foundational pillars of the modern diversified nonprofit health system; ruling in some instances that such an “entangled” organization is incompatible with property tax exemption and results in taxpayer subsidization of proprietary interests. Indeed, one leading decision appeared to reject the very nature of the parent/subsidiary corporate model

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(“a legal fiction”) and the legal/regulatory/operational rationale for its existence. Of particular concern is judicial criticism of the commingling of for-profit and nonprofit activities as part of health system operations.

ITEM #13 Who Is the GC’s Client?

A necessary derivative to these governance and structural considerations is the ability of the health system general counsel (and the larger legal affairs office) to formally establish the attorney-client relationship between the legal affairs office (housed at the parent corporation) and the various wholly controlled or owned subsidiaries. Not only is it important from a professional responsibility perspective to confirm the existence of those relationships, but it is also important from an operational perspective to avoid any uncertainty in that regard. The rules of professional responsibility in most states support the “enterprise” concept of representation; i.e., that the law department of a parent entity can represent that corporation, as well as its subsidiary or affiliated corporations. Along those lines, corporate legal departments are considered as the equivalent of law firms for purposes of the current conflict rules.

The system general counsel may wish to consider the advisability of a clear written protocol identifying which members of the corporate family are to be the legal department’s clients (e.g., all controlled system entities) and which are not (e.g., joint ventures, less-than-wholly owned entities; individual constituents). 



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