

Tip Sheet: Analysis of Not-for-Profit Combinations under the HSR Act and Rules

Background

The PNO routinely provides informal guidance on reporting obligations that arise when combining not-for-profit entities, typically in the context of hospital combinations. In the past, much of this guidance focused on whether the combination resulted in a change of "control" of the board of directors of one or more of the combining entities. This was because those seeking guidance described hospital combinations primarily in terms of formal board governance.

Recently, however, when asked to analyze combinations of non-for-profit entities, the PNO began to appreciate the limitations of relying solely on the concept of control to determine reportability. In particular, as potential filers described combinations of not-for-profit hospitals, it became clear that a potentially reportable acquisition could occur even when there is no change in control of the board of directors of one of the combining entities. Typically, this is because one party obtains the indicia of beneficial ownership over the assets of another party – the fundamental basis for concluding that a potentially reportable acquisition occurs under any HSR analysis.

A hospital "affiliation" is one of the most common examples the PNO analyzes. This can take the form of one hospital becoming the corporate member of, and obtaining broad governance powers over, the other hospital. Alternatively, the affiliating hospitals may create a new not-for-profit entity (e.g., a "Newco") that will become the corporate member of, and have broad governance powers over, all the affiliating hospitals. Below, we outline how the PNO analyzes not-for-profit combinations, with a focus on these common types of affiliations.

As with any transaction, we start with the Part 801 coverage rules to see if the combination is potentially reportable, and then proceed to Part 802 to determine if one of the exemption rules applies. Such analysis requires answering the following questions:

Question 1: Is an acquisition of assets occurring? In answering this question, "control" is only one indication that "beneficial ownership" passes.

We start all HSR analyses at the beginning of the coverage rules: 801.1 and 801.2. When the HSR rules were promulgated in 1978, the Statement of Basis and Purpose (SBP) explained: "The first step in analyzing whether the act applies to a specific acquisition of assets or voting securities is to determine the identity of the 'acquiring person' and the 'acquired person,' and which assets or voting securities will be held 'as a result of' the acquisition." [43 FR 33450, 33453 \(July 31, 1978\)](#).

Essentially, this analysis seeks to answer the question of whether an acquisition is occurring by identifying who will "hold" the voting securities or assets as a result of the transaction. Rule 801.2(a) captures this concept, explaining "any person which, as a result of an acquisition, will hold voting securities or assets . . . is an acquiring person." Under Rule 801.1(c), a person holds assets or voting securities when the person has "beneficial ownership" of the assets or voting securities. And therefore, to identify the "acquiring person," one must "first determine which entity will have beneficial ownership of the assets or voting securities to be acquired." [43 FR 33450, 33453](#).

One means of obtaining beneficial ownership of the assets of a not-for-profit entity is by gaining control of the board of directors of the not-for-profit entity (that is, obtaining the contractual power presently to designate 50 percent or more of the directors of the not-for-profit corporation within the meaning of Rule 801.1(b)(2)). In discussing how to identify the acquiring person under Rule 801.2(a), the SBP clarifies that the Rule 801.1(b)(2) control test is not the sole means of obtaining beneficial ownership over the assets of a not-for-profit corporation:

"'Hold' is defined in § 801.1(c), and, in general, means beneficial ownership. The rule also mentions several ways in which a person may acquire beneficial ownership [e.g., through control of an entity], but these are supplied *principally for emphasis* since each is embodied in the definition of 'hold.'" See [43 FR 33450, 33467](#).

In other words, one obtains "beneficial ownership" of the assets of a not-for-profit corporation by gaining "control" of the entity holding the assets, but formal board control is not the exclusive method of obtaining beneficial ownership.

Although the rules state some specific scenarios under which beneficial ownership passes, e.g., gaining control of a corporation's board, the rules do not contain a definition of "beneficial ownership." "Instead, the existence of beneficial ownership is to be determined in the context of particular cases with reference to the person or persons that enjoy the indicia of beneficial ownership." See [43 FR 33450, 33458](#). While not an exclusive list, the PNO recently has considered the following factors relevant to the analysis of beneficial ownership in the context of hospitals affiliating under a Newco:

- Newco becomes the corporate member of the affiliating hospital entities
- Newco has the right to authorize and/or approve the articles, bylaws, and other governance documents of the affiliating hospital entities

- Newco has the right to authorize and/or approve the sale or lease of the affiliating hospital assets
- Newco has the right to appoint and/or approve the senior officers of the affiliating hospital entities
- Newco has the right to devise and/or approve the strategic plans, capital budgets and expenditures, and significant contracting of the affiliating hospitals

In short, where the Newco parent becomes the corporate member of the affiliating hospitals and obtains governance power over the existing hospitals to such an extent that the indicia of beneficial ownership of the hospitals passes, an acquisition has occurred. (Note that this transaction, in which a change in corporate structure occurs and beneficial ownership passes, is distinct from a scenario where two parties enter an "operating agreement" or "management agreement" without an accompanying change in corporate structure or other indicia of beneficial ownership).

Question 2: What type of acquisition is occurring? Accurately identifying the type of acquisition is key to determining which coverage and exemption rules apply.

The PNO generally sees three types of not-for-profit combinations: a simple acquisition, a consolidation, and a joint venture formation.

1. In a simple acquisition, an existing acquiring person (e.g., a not-for-profit hospital) is deemed to hold the assets of the acquired entity (e.g., another not-for-profit hospital) as a result of the acquisition. This can occur through obtaining the contractual right to appoint 50 percent or more of the directors of the acquired entity, or alternatively through obtaining beneficial ownership of the assets of the acquired entity, as explained above. See Rule 801.2(a)-(b)&(f)(3). Sometimes, the acquiring person may obtain direct control over the acquired entity, and sometimes the acquiring person will form a Newco, which the acquiring person will control, and which in turn will control the acquired entity or obtain beneficial ownership of the acquired entity's assets.
2. Existing not-for-profit entities also can consolidate under a Newco not-for-profit entity. Specifically, Rule 801.2(d)(2)(iii) provides: "All persons party to a transaction as a result of which all parties will lose their separate pre-acquisition identities or will become wholly owned subsidiaries of a newly formed entity shall be both acquiring and acquired persons. This includes **any** combination of corporations and unincorporated entities **consolidating into any** newly formed entity."
3. By contrast, existing entities can form a new entity, which can facilitate the ownership of a joint venture. See Rules 801.40 and 801.50. In such circumstances, the pre-existing not-for-profit entities remain separate persons for HSR purposes. For example, Hospital

A and Hospital B can form a joint venture entity through which they will own and operate an ambulatory surgery center.

While the difference has confused some practitioners in the past, the rules clearly distinguish consolidations from formations when explaining that two persons consolidating under a Newco is a "consolidation" under Rule 801.2(d)(iii) and not a "formation" under Rules 801.40 or 801.50. Specifically, Rule 801.40, addressing the formation of corporations, does not apply "in connection with a merger or consolidation." Similarly, Rule 801.50, addressing the formation of unincorporated entities, does not apply "in connection with a consolidation." The 1978 SBP conveys the rationale for the distinction: "The formation of new corporations in connection with mergers or consolidations is excluded from the [formation] rule, since the character and likely competitive consequences of such transactions are dissimilar to those treated under this rule." [43 FR 33450, 33486](#).

This distinction between consolidations and formations was reemphasized in 2005 when the FTC revised Rule 802.40, which exempts the formation of certain not-for-profit entities:

"The proposed amendments to Section 801.2(d) [defining consolidations] would codify a longstanding informal staff position that the combination of any two entities into a new holding company is the functional equivalent of a consolidation and should be treated in the same manner, regardless of whether the entities are corporations or non-corporate entities. It also clarifies that even if the two entities are retaining their separate legal identities by becoming subsidiaries of the new holding company, the transaction would be treated in the same manner, i.e., as a consolidation." [70 FR 11502, 11505 \(March 8, 2005\)](#).

Thus, when affiliating not-for-profit hospitals combine under a Newco such that the Newco controls the boards of the affiliating hospitals or obtains beneficial ownership of the assets of the affiliating hospitals, the transaction is a consolidation under Rule 801.2. This type of consolidation is easily distinguished under the rules from a transaction in which two hospitals will form a new entity to own and operate, for example, an ambulatory surgery center, which typically would be evaluated under Rule 801.40 or 801.50 as a joint venture formation.

Question 3: Does an exemption apply under Part 802 of the Rules? Rule 802.40 applies only to "formations" under the plain language of the rule.

If the above analysis identifies a potentially reportable transaction, potential filers should apply Part 802 of the HSR rules to determine if an exemption applies. Potential filers in hospital affiliations often assess whether the acquiring person is making an exempt acquisition under

Rule 802.40, which exempts the formation of entities that will be not-for-profit within the meaning of certain sections of the Internal Revenue Code (e.g., a "501(c)(3) entity"). Rule 802.40, however, exempts "formations," not "consolidations," under the plain language of the rule. As explained above, the HSR rules clearly distinguish between formations and consolidations. Therefore, while Rule 802.40 may exempt certain joint venture formations between not-for-profit hospitals, it will not exempt a consolidation, such as two not-for-profit health care systems affiliating under a Newco.

The Bottom Line

In the context of not-for-profit combinations, focus on board control alone has led to some informal determinations of non-reportability when the PNO was not fully informed about the extent to which the indicia of beneficial ownership would pass. But the rules are clear: board control is not the sole determinant of whether an acquisition has occurred; affiliations (whether simple acquisitions or consolidations) are potentially reportable transactions; and 802.40 exempts certain formations, not simple acquisitions and consolidations.