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## **VIA ELECTRONIC MAIL AND FEDERAL EXPRESS**

Ronald Bossio
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401 Merritt 7
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Exposure Draft No. 194-B

Re:

Dear Mr. Bossio:

Thank you for the opportunity to speak with you directly regarding our comments to Exposure Draft No. 194-B, Consolidated Financial Statements: Purpose and Policy (the "Exposure Draft"). In our telephone conversation of June 30, 1999, we indicated that we would provide you with (1) a "real world" factual scenario wherein the financial consolidation of nonprofit healthcare entities may not be clear under existing or proposed financial accounting authority, (2) the rights of a member under Pennsylvania law, and (3) our comments with respect to Emerging Issues Task Force Issue No. 96-16, Investor's Accounting for an Investee When the Investor Owns a Majority of the Voting Stock but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights ("EITF Issue No. 96-16"). Those items, along with our recommendations for clarification of existing or proposed financial accounting authority as applied to the "real world" scenario, are set forth below.

## I. FACTS OF NONPROFIT HEALTHCARE SYSTEM EXAMPLE

System A, a tax-exempt charitable organization, is the parent corporation of a major academic medical center and integrated delivery system. Hospital B, a tax-exempt charitable organization, is a local community hospital. Pursuant to an Affiliation Agreement, Hospital B is to become a direct subsidiary of System A. Hospital B will maintain its historically respected identity within the community, but will operate financially and administratively within System A. The sole corporate member of Hospital B will be System A, and the board of directors of System A will have certain delegated approval rights or "reserved powers" with regard to Hospital B.

An integration period will apply to the affiliation of System A and Hospital B. The integration period is a five-year period commencing on the closing date of the affiliation. During the integration period, Hospital B shall be governed by a board of twenty-one directors, seven of whom shall be appointed by System A, and fourteen of whom shall be appointed on a self-perpetuating basis by Hospital B's current directors.

System A will have overall responsibility for the operation of all of its subsidiary corporations, including Hospital B, and the board of directors of System A will have the power to initiate and approve any action it so determines. Such initiation and approval power is limited only during the integration period by certain powers reserved to the board of directors of Hospital B.

During the integration period, the following actions will require (in addition to approval by the board of System A) an affirmative vote of three-fourths of the directors appointed to Hospital B's board:

- 1. any change in corporate structure of Hospital B
- 2. any sale, pledge or other transfer of any material assets or material portion of the business of Hospital B
- 3. any determination that Hospital B no longer be licensed or operated as an acute-care community hospital
- 4. the addition, cessation, relocation, or significant modification of any major service or program of Hospital B
- 5. the merger or combination of the medical staff of Hospital B with the medical staff of any System A affiliate
- 6. any amendment of the articles of incorporation or bylaws or medical staff bylaws or the medical staff development plan of Hospital B
- 7. any modification of the composition of the Hospital B board or rights accorded to such board members
- 8. any termination or material reduction in the activities performed by volunteer or auxiliary programs at Hospital B
- 9. the approval of any transaction relating to indebtedness of Hospital B
- 10. a decision to consummate a disposition or conversion of System A to an entity other than an entity which is exempt from federal income taxation

During the integration period, the fourteen Hospital B directors shall have the exclusive authority to hire or discharge the President and Chief Executive Officer of Hospital B, subject to the approval of the System A board of directors. Notwithstanding this exclusive authority during the integration period, the President and Chief Executive Officer of Hospital B shall work with and report to senior management of System A.

System A shall rely upon Hospital B and the board of Hospital B, with the assistance of System A staff, to:

- 1. develop Hospital B's annual operating and capital budgets
- 2. justify all significant deviations from any budget
- 3. advise as to all affiliations, memberships in, or arrangements with other hospital or provider systems, groups of providers, or insurers
- 4. analyze the ability to transfer funds among Hospital B and other hospitals or entities in System A, provided that System A shall not have the right to transfer capital from Hospital B during the integration period without the approval of 3/4 of the votes of the board of Hospital B
- 5. review all transactions relating to long-term indebtedness
- 6. develop and oversee the filing of all licensure notifications or licensure applications by Hospital B
- 7. coordinate the identification and implementation of administrative services to be provided by System A to Hospital B

At the conclusion of the integration period, System A shall have the ability to restructure the composition of the Hospital B board, although System A will ensure that any successor Hospital B board will continue to reflect the character and composition of Hospital B's immediate service area and will include representatives of the communities served by Hospital B.

In summary, during the integration period, the Hospital B board shall have responsibility and authority with respect to local issues, subject only to the right of the System A board of directors to approve any action taken by the Hospital B board prior to such action becoming effective. At the conclusion of the integration period, the powers of the Hospital B board shall be exercised by and reserved to the System A board, subject to the right of the System A board to delegate any such powers to the Hospital B board.

### II. ASPECTS OF CONTROL DICTATED BY STATE LAW

Under the Pennsylvania Nonprofit Corporation Law, members of a nonprofit corporation have various rights and powers, including the following:

- the power to adopt, amend and repeal the bylaws of a nonprofit corporation (15 Pa.C.S.A. § 5504(a))
- the right to examine the books and records of the corporation (15 Pa.C.S.A. § 5508(b))
- the right to receive an annual report from the board of directors (15 Pa.C.S.A. § 5553(a))
- the right to adopt amendments to the articles of incorporation (15 Pa.C.S.A. § 5914(a))
- the right to adopt a plan of merger or consolidation (15 Pa.C.S.A. § 5924(a))
- the right to adopt a plan of sale, lease or exchange of all, or substantially all, of the property or assets of a nonprofit corporation (15 Pa.C.S.A. § 5930(a))

# III. ANALYSIS OF CONTROL FOR PURPOSES OF CONSOLIDATED FINANCIAL REPORTING

The issue in the scenario described above is whether System A controls Hospital B such that System A must include the financial information of Hospital B in consolidated financial statements.

### A. The Exposure Draft

<u>Paragraph 10</u>. Control, as defined by this Statement, involves the presence of two essential characteristics: (a) a parent's nonshared decision-making ability that enables it to guide the ongoing activities of its subsidiary and (b) a parent's ability to use that power to increase the benefits that it derives and limit the losses that it suffers from the activities of that subsidiary.

<u>Paragraph 45</u>. In the United States, noncontrolling shareholders, limited partners, creditors, and others typically have protective rights that enable them to block specific actions that might affect their interest in a parent's subsidiary. Those protective veto rights, however, generally do not enable them to initiate policies or share in a parent's decision making for the ongoing activities of its subsidiary. Examples include provisions in some state statutes that require a supermajority

vote (for example, two-thirds) of shareholders or votes of disinterested shareholders to approve fundamental corporate acts, such as amendments to articles of incorporation, mergers, or sale of substantially all corporate assets. Similarly, veto rights granted by a majority shareholder to a minority shareholder, creditor, or other party that enable that other party to block such corporate actions, by themselves, would not negate control by the majority shareholder.

<u>Paragraph 56</u>. If a nonprofit corporation is governed by an elected board of directors, whether it is a controlled entity usually depends on whether a single member or other entity has the right or ability to vote a majority or significant minority of the corporation's voting rights. That is, similar to control of a business corporation, voting rights may confer to the holder an ability to dominate the process of nominating and selecting the members of that corporation's board of directors.

#### B. EITF Issue No. 96-16

A working group formed by the EITF developed an approach to differentiate between those minority rights that are considered protective rights and those that allow the minority shareholder or shareholders to participate in determining certain financial and operating decisions of the investee. The working group agreed that:

- a. The assessment of whether rights of a minority shareholder should preclude a majority shareholder from consolidating a majority-owned investee is a matter of judgment that depends on facts and circumstances.
- b. The framework in which such facts and circumstances should be judged should be based on whether the minority rights provide for the minority shareholder or shareholders to participate in significant decisions that would be expected to be made in the "ordinary course of business."

The working group believes that minority rights (whether granted by contract or by law) that allow the minority shareholder or shareholders to block the following corporate actions would be considered protective rights and would not preclude consolidation by the majority owner of its majority-owned investee:

Amendments to articles of incorporation

- Pricing on transactions between the majority owner and the investee and related self-dealing types of transactions
- Liquidation of the investee or a decision to cause the investee to file a bankruptcy petition
- Major acquisitions (for instance, mergers and acquisitions) and dispositions of assets outside the ordinary course of business

The working group believes that minority rights (whether granted by contract or by law) that allow the minority shareholder or shareholders to block the following corporate actions would be considered participating rights and would create a presumption that the majority owner should not consolidate its majority-owned investee:

- Hiring, firing, and setting compensation of management
- Operating and capital budgets (if such budgets are effective in determining management's actions)
- Acquisitions and dispositions in the ordinary course of business

# C. Determination as to Whether Financial Consolidation is Proper Under Above Factual Scenario

Pursuant to the Exposure Draft, it must be decided whether System A has control over Hospital B, whether control over Hospital B is shared, and whether System A can use its power to increase the benefits it derives and limit the losses it suffers from Hospital B.

First, as to whether one entity controls another, the Exposure Draft indicates that whether a nonprofit corporation is a controlled entity usually depends on whether a single member or other entity has the right or ability to vote a majority or significant minority of the corporation's voting rights. The Exposure Draft implies that the ability to appoint a majority of a nonprofit corporation's board of directors would be indicative of control.

With respect to nonprofit corporations, however, perhaps the existence of a sole corporate member of a nonprofit corporation should raise a presumption of control by such member over the corporation. Once the presumption of control is raised, it may still be possible to find that the sole corporate member does not

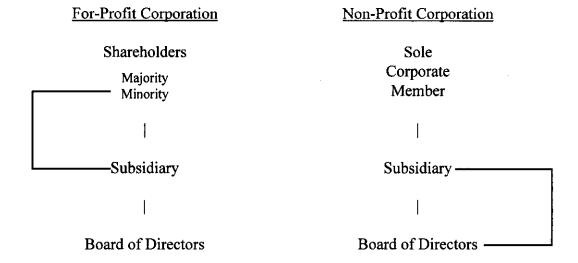
<sup>&</sup>lt;sup>1</sup> A member of a nonprofit corporation is analogous to a shareholder in a for-profit corporation; however, unlike a for-profit corporation, a nonprofit corporation may not use its income or profits to pay dividends to members.

control its subsidiary. In creating the relationship, the sole corporate member could negotiate so many rights away that the subsidiary may not be deemed to be controlled. For example, if power to initiate and approve any action of the subsidiary rests with the subsidiary itself, arguably the subsidiary is not controlled by the sole corporate member (as control is contemplated in the Exposure Draft).

In the above factual scenario, System A is the sole corporate member of Hospital B. Considering the contractual rights afforded to System A in the affiliation agreement, as well as the statutory rights of System A over Hospital B by virtue of the status of System A as a sole corporate member, it does not appear that the presumption of control by System A over Hospital B should be overcome.

Second, as to whether control is shared, the Exposure Draft indicates that a party may have "protective" rights in the subsidiary of a parent while not necessarily sharing control of the subsidiary with the parent. The Exposure Draft references the principles of EITF Issue No. 96-16 in the explanation of shared control; however, such principles are clearly inapplicable to nonprofit corporations.

Arguably, EITF Issue No. 96-16 should not apply to situations in which there is control of one nonprofit entity over another nonprofit entity by virtue of sole corporate membership status. EITF Issue No. 96-16 analyzes rights granted to minority shareholders. In the situation of the sole corporate member in the above factual scenario, the rights of the board of directors of the subsidiary are at issue. As the chart below depicts, extending EITF Issue No. 96-16 principles to the nonprofit membership model simply does not make sense:



Extension of EITF Issue No. 96-16 to the nonprofit membership model is inappropriate for several reasons. Minority shareholders of a for-profit corporation, which stand in some financial relationship to the corporation, are not analogous to the board of directors of a nonprofit corporation, which stands in a governance role over the corporation. Also, while it may be out-of-the-ordinary for minority shareholders to have the right to hire management, establish operating and capital budgets, and make acquisitions and dispositions in the ordinary course of business, such rights are typical for the board of directors of a nonprofit corporation.

As stated above, with respect to nonprofit corporations, the existence of a sole corporate member relationship should raise a presumption of control by such member over the corporation.<sup>2</sup>

Third, as to whether System A can use its power to increase the benefits it derives and limit the losses it suffers, the Exposure Draft suggests, among other things, that a parent may be able to direct a subsidiary to contribute assets to a parent. Such contributions, however, when made by nonprofit corporations, may violate charitable trust principles. Under the above factual scenario, System A arguably can use its power to increase the benefits or limit the losses of Hospital B, but it must do so within the parameters of applicable charitable trust law.

In summary, financial consolidation of System A and Hospital B appears to be proper under the above factual scenario.

<sup>&</sup>lt;sup>2</sup> Even if EITF Issue No. 96-16 was applied to the above factual scenario, consolidation would arguably still be appropriate. EITF Issue No. 96-16 distinguishes between "protective" rights and "participating" rights (protective rights not precluding consolidation of a subsidiary, but participating rights creating a presumption that financial consolidation should not occur).

The rights of the Hospital B board in the governance of Hospital B appear to be both protective (e.g., amendment of articles of incorporation) and participating (e.g., develop operating and capital budgets), at least during the integration period, but arguably should not preclude System A from consolidating Hospital B. In the above scenario, the local Hospital B board is given certain rights over Hospital B primarily so that Hospital B can maintain its historically respected identity within the community. Hospital B must, however, operate financially and administratively within System A. Thus, an interpretation of the above scenario which allows the existence of "minority rights designed to assure continuity of the business" (the "steady state" exception discussed in EITF Issue No. 96-16) without creating the presumption that System A should not consolidate Hospital B, would properly reflect System A's control over Hospital B.

#### IV. RECOMMENDATIONS FOR CLARIFICATION OF FINANCIAL ACCOUNTING AUTHORITY ON CONSOLIDATION OF NONPROFIT **HEALTHCARE ENTITIES**

In light of the above discussion, the following recommendations and/or suggestions are offered for your consideration for inclusion in any final accounting pronouncement regarding financial consolidation of nonprofit healthcare entities:

- The existence of a sole corporate member of a nonprofit entity creates the presumption that the sole corporate member "controls" the nonprofit entity.
- EITF Issue No. 96-16 is inapplicable to the nonprofit membership model.
- If, however, EITF Issue No. 96-16 principles are adopted in a final pronouncement, the existence of "minority rights designed to assure continuity of the business" are not necessarily participating rights as contemplated by EITF Issue No. 96-16, and should not create a presumption that a parent should not consolidate a subsidiary.
- The concept of increasing benefits/limiting losses, as applicable to nonprofit corporations, should be qualified by a statement that recognizes the limiting effect of charitable trust law.

Again, we thank you for the opportunity to provide additional input to our comment on the Exposure Draft. As always, additional comments or questions are welcomed by Thomas E. Boyle, Esq. (412-562-8823) or Janice M. Smith, CPA, Esq. (412-562-8940) of Buchanan Ingersoll Professional Corporation, or George A Huber, Esq., General Counsel of UPMC Health System (412-647-8470).

Very truly yours,

Thomas E. Boyle (your)

cc: George A. Huber, Esq. Janice M. Smith, CPA, Esq.