

MEMORANDUM

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803.30
802.40
801.40
801.1(b)

TO: FTC Bureau of Competition Premerger Notification Office Staff

FROM:

[REDACTED]

CONFIDENTIAL

SUBJECT: Request for Staff Interpretation

DATE: April 30, 1998

This material may be subject to the
confidentiality provisions of section
7A(4) of the Clayton Act which restricts
release under the Freedom of Information
Act.

Introduction/Conclusion

It is the belief of counsel (listed above) for each party that a premerger notification filing is not required for the proposed transaction as described below. But the transaction is sufficiently unique and complex that counsel for each party requests a confirming informal interpretation, pursuant to 16 C.F.R. §803.30, by the FTC Premerger Notification Staff.

DESCRIPTION OF TRANSACTION

Structure

"A" and "B" (both nonprofit corporations) each operate hospitals and other health care entities, in each case including a nonprofit health care corporation, A Corporation (in which A is the sole corporate member) and B Corporation (in which B is the sole corporate member). For purposes of this description, we assume both A and B (or their respective ultimate parents) each have annual net sales or total assets of \$100 million or more. A and B intend to enter into an agreement ("Agreement") to create a Joint Operating Organization known as Newco. Newco will be a non-profit, nonstock, Delaware corporation with A and B as its two members.¹ A (and A Corporation) and B (and B Corporation) will delegate to Newco the responsibilities, subject to certain exceptions, for the management of the operations of the health care activities of A (and A corporation) and the healthcare activities of B (and B corporation) and the entities each controls in a specified service area. ("JOO")

¹ An application for Recognition of Exempt Status will also be filed with the Internal Revenue Service.

To: ETC Bureau of Competition Premerger Notification Office Staff

From:



Date: April 30, 1998

Page: 2

Newco will have its own name. The signage of A Corporation's and B Corporation's health care facilities may mention that such facilities are a part of Newco and are affiliated with A and B.

As part of the creation/formation of the JOO, there will be no transfer to Newco of title to assets (or voting securities) valued in excess of \$10 million -- i.e., the combined total dollar value will not exceed \$10 million of (1) all assets (where title will *OK* transfer to Newco) which any person contributing to the formation of Newco has agreed to transfer or which agreements have been secured for Newco to obtain at any time, whether or not such person is subject to the requirements of the Hart-Scott-Rodino Act, and (2) any amount of credit or any obligations of Newco which any person contributing to the formation has agreed to extend or guarantee at any time.

Risk-Sharing

potentially reportable

One hundred percent (100%) of the cash flow (the excess of revenue over expenses, plus depreciation, less debt repayment) of Newco and the combined operations of A and B subject to Newco management will be shared in the following manner. Fifteen percent (15%) of such cash flow will be retained by Newco for establishment of a fund to finance Newco capital investments or operational expenditures. A and B each will be allowed to withdraw up to 7.5% of the cash flow, with the remaining seventy percent (70%) being distributed one-half to A's operating units that are subject to Newco's management and one-half to B's operating units that are subject to Newco's management.²

Newco Authority

Newco will have significant responsibility and authority to manage the health care activities of A and B within a designated geographic service area. Specifically, subject to certain rights and responsibilities reserved to A and B as the corporate members of Newco, Newco shall have the following powers and responsibilities:

² "Operating units" refer to programs, facilities, services and other assets wholly owned by A (or A corporation) or B (or B corporation) and all existing and future programs, facilities, services and other assets wholly owned, directly or indirectly, by Newco and Newco affiliates in the service area, whose operations are managed by Newco, whether separately incorporated or not.

To: ETC Bureau of Competition Premerger Notification Office Staff
From:



Date: April 30, 1998
Page: 3

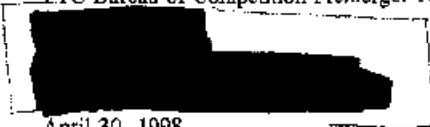
- (1) developing and overseeing the implementation of an annual business plan and strategic plan for Newco, its affiliates^{3/} and the Operating Units;
- (2) developing annual capital expenditures and operating budgets for Newco, its affiliates and the Operating Units;^{4/}
- (3) approving the incurrence by any Newco affiliate or Operating Unit of any debt or encumbrance, including guarantees, within parameters established by A and B;
- (4) approving any modifications by a Newco affiliate or Operating Unit of any existing affiliation and any new affiliations;

^{3/} "Newco affiliates" refer to entities for which Newco, directly or indirectly, either has the power to elect through membership or ownership greater than fifty percent (50%) of the governing body of an entity, or the unilateral power to direct or cause the direction of all significant policies and the overall management of an entity, whether through contracts, membership interests, ownership of voting securities, a lease, a management agreement or other arrangement; but the term excludes programs, facilities, services and other assets in the service area wholly owned by A, A Corporation or B, B Corporation or an entity for which any one of them has the power to elect through membership or ownership greater than fifty percent (50%) of the governing body of an entity, or the unilateral power to direct or cause the direction of all significant policies and the overall management of an entity, whether through contracts, membership interests, ownership of voting securities, a lease, a management agreement or other arrangement.

^{4/} The initial three year strategic and financial plan together with financial performance targets, each "new" third year of the rolling three-year performance plan, as well as any modification of the first or second year of such plans, must be approved by both A and B.

To: FTC Bureau of Competition Premerger Notification Office Staff

From:



Date: April 30, 1998

Page: 4

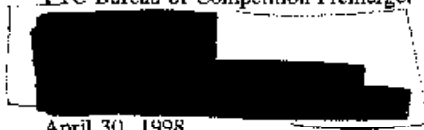
- (5) approving any sale, transfer, or other disposition of any material asset of a Newco affiliate or Operating Unit within parameters established by A and B;^{5f}
- (6) negotiating third-party payor relationships for its affiliates and Operating Units;
- (7) appointing, through use of the Nominating Committee of Newco, and removing the members of the boards of Newco affiliates; *potentially reportable*
- (8) transferring assets, including cash, among the various Newco affiliates and Operating Units and/or from a Newco affiliate or Operating Unit to Newco within parameters established by A and B;^{5f}
- (9) appointing, evaluating and removing the CEOs of the Newco affiliates;
- (10) approving and/or determining the creation of new health care services to be provided and any new location for the delivery of health care services, or the discontinuance of any existing health care service, by a Newco affiliate or Operating Unit;
- (11) developing uniform human resource policies for the Newco affiliates and Operating Units;
- (12) conducting marketing and promotional activities for the Newco affiliates and Operating Units;

^{5f} See, e.g., reserve powers (#10) which requires the approval of both A and B for certain transfers of assets, including transfers of cash in addition to those described in the "risk-sharing" Section on page 2.

^{5g} See, footnote 5 above.

To: FTC Bureau of Competition Premerger Notification Office Staff

From:



Date: April 30, 1998

Page: 5

- (13) conducting or coordinating fundraising activities for the Newco affiliates and Operating Units;
- (14) coordinating and planning the Newco management information systems for Newco affiliates and Operating Units; and
- (15) exercising other rights as shareholder or member of Newco affiliates as specified in the governing documents of such entities.

may result in control

In addition, each of A, A Corporation, B, and B Corporation will grant the Board of Directors of Newco to act as its proxy (irrevocable for the term of the Agreement) as a shareholder or member (in the non-profit setting) of any partially or any wholly owned entity providing health care services in the service area.

Reserved Powers

The following actions of Newco will require the approval of both A and B:

- (1) changes to the mission and/or philosophy of Newco or any Operating Unit;
- (2) the sale, lease, transfer, encumbrance, or disposition of the tangible property or investments of Newco having a fair market value in excess of three million dollars (\$3,000,000);
- (3) the incurrence, assumption or guaranty by Newco its affiliates, A Corporation, B Corporation or an affiliate of A Corporation or B Corporation of any short-term or long-term indebtedness outside parameters established by A and B;
- (4) the merger, dissolution, consolidation, or sale of all or substantially all of the assets of Newco or any Operating Unit outside parameters agreed to by A and B;

To: FTC Bureau of Competition Premerger Notification Office Staff

From:



Date: April 30, 1998

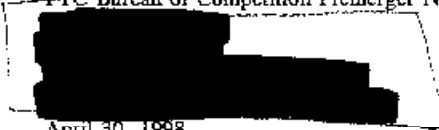
Page: 6

- (5) the amendment, repeal, or restatement of the Corporate Documents of Newco;
- (6) the appointment and removal of the jointly appointed *(not absolute control)* members of the board of directors of Newco;
- (7) the approval of capital and operating expenditures that are inconsistent with the three year financial targets, parameters and expectations approved by A and B;
- (8) the approval of major affiliations of Newco, Newco affiliates and the Operating Units;
- (9) the approval of the initial three year strategic and financial plan, as well as the annual update to such plan developed by the parties to create a rolling three-year financial performance plan, and the establishment of the parameters and expectations for the clinical quality, strategic, operating, mission, religious identity and financial performance of Newco;
- (10) the transfer of assets *potentially reportable*, including cash, among various Newco affiliates and Operating Units and from Newco or a Newco affiliate to an Operating Unit and from an Operating Unit to Newco or Newco affiliates, other than transfers between Operating Units that are owned by A Corporation or B Corporation, as the case may be, (and other than transfers of cash as provided in the Risk Sharing provisions);
- (11) the appointment, evaluation, including setting of compensation, and termination of the CEO of Newco. However, if A and B are not able to reach a mutual agreement on A's or B's proposal to remove the CEO, the CEO of Newco will be automatically terminated.

The following actions of Newco will require the approval of either A (and A Corporation) or B (and B Corporation), as the case may be, before the action may be implemented.

To: FTC Bureau of Competition Premerger Notification Office Staff

From:



Date: April 30, 1998

Page: 7

- (1) the sale, lease, transfer, encumbrance, or disposition of the tangible property or investment (of an Operating Unit whose assets are owned or controlled by either A or B Corporation) if the property or investment has a fair market value in excess of three million dollars (\$3,000,000);
- (2) the merger, dissolution, consolidation, or sale of all or substantially all of the assets of an Operating Unit whose assets are owned or controlled by either the A or B Corporation; and
- (3) the amendment, repeal or restatement of the Corporate documents of an entity controlled by either the A or B Corporation.

potentially reportable

potentially reportable

Neither A nor B has power to appoint initial Board.

Governance/Board Composition of Newco

The initial Board of Directors of Newco shall consist of eight (8) appointed members agreed to by A and B, plus the CEO of Newco (agreed to by A and B) serving *ex officio* with vote. A and B each will always be entitled to directly appoint, remove or replace two each (i.e., two by A; two by B) of the eight (8) members of the Board of Newco. After the terms of the initial Board of Directors expires, successors for the four members of the Newco board who are jointly appointed will be nominated by a nominating committee of the Newco Board, and appointed by the Newco Board upon joint approval of both A and B.

Neither A nor B has also power to appoint a majority of the Board

Proceeds of Asset Sales

Any proceeds from the sale of an asset owned by the respective A or B Corporations, or entities each separately controls, will be retained by A or B Corporation, as the case may be. In the event of a dissolution of Newco, A (or A Corporation) and B (or B Corporation) will each retain the assets to which it holds title. The remaining assets of Newco and Newco affiliates will be distributed one-half to A and one-half to B, after being adjusted for any disproportionate cash distribution received.

potentially reportable

To: FTC Bureau of Competition Premerger Notification Office Staff

From:



Date: April 30, 1998

Page: 8

HART-SCOTT-RODINO ANALYSIS

Formation of Newco

802.40 does not apply since there are no voting securities. However it is kicked over to 801.4 since there are no voting securities the formation is not reportable

1. As a threshold issue, the joint venture specific HSR rules (i.e., Rule 801.40 Formation and Rule 802.40 Exemption for Formation of Tax-Exempt Joint Venture) do not seem applicable since both rules contemplate acquisition of voting securities by the contributors. — *OK, as long as no merger or consolidation is taking place which does not seem to be the case here.*

2. The mere acquisitions of "membership interests" in a non-profit tax-exempt non-stock organization, such as Newco, should not constitute an acquisition of assets or voting securities. Arguably, the acquisitions of such membership interests in non-stock corporations should be treated in an analogous way to how the FTC PMN staff has previously treated formations of partnerships and/or acquisitions of partial partnership interests, i.e., as non-reportable events.²¹

OK, as long as no merger or consolidation is taking place.

Nevertheless, there is an issue that by each of A and B having "control", over Newco, each of A and B will have beneficial ownership of (1) those assets being contributed (e.g., with a change in title of assets) to Newco; (2) those assets held in subsidiaries²² of A (or A Corporation) and/or B (or B Corporation) where the Newco Board has received the proxy to exercise shareholder or member rights, (e.g. vote for the members of the Boards of Directors of such subsidiaries); and/or (3) those assets subject to the operational direction of Newco but where title remains with A Corporation and/or B Corporation or their individual wholly owned subsidiaries.

Neither A or B control through their appoint majority of the board. A and B do not beneficially own any assets contributed by the other person.

²¹ See, American Bar Association, Premerger Notification Practice Manual (2d Ed. 1991) interpretation no. 93, at p. 77, that an acquisition of a partial partnership interest is not a reportable event and interpretation no. 196, at p. 161, that formation of a partnership is not a reportable transaction.

OK

²² As used in this memorandum, the term "subsidiary" also refers to a non-stock membership organization for which A (or A Corporation) or B (or B Corporation), as the case may be, is a corporate member.

To: FTC Bureau of Competition Premerger Notification Office Staff

From: [Redacted]

Date: April 30, 1998

Page: 9

The "Control" Tests

Application of the Rule 801.1(b) "control" alternative definitions would seem to yield the following results:

A or B do not control by this method

1. A and B will each be deemed to control Newco if those initial Board members, subject to the mutual approval of A and B, are deemed to be a "present contractual power" held by both A and B with regard to such directors. Rule 801.1(b)(2)

2. Unless there are disparate "capital contributions" to Newco by A and B, both A and B control Newco under the assets dissolution definition of control. Rule 801.1(b)(1)(i) *yes*

3. Neither A nor B appear to control Newco by virtue of a right to fifty percent or more of its profits. Rule 801.1(b)(1)(ii)

4. By virtue of the agreement among between A (and A Corporation) and B (and B Corporation) to grant Newco their respective proxies to act as shareholders or members of other entities (including, in some instances, the power to elect/appoint/remove the majority of the members of the boards of directors of such entities) where, as Operating Units, the operations of such entities are subject to management by Newco, Newco could be deemed to "control" such corporations.

Thus, if A and B each "control" Newco² the question is whether, by virtue of such "control":

(1) A will acquire beneficial ownership of B's assets (and/or voting securities) contributed to Newco and of assets (and/or voting securities) held by subsidiaries of B or subsidiaries of B Corporation for which the Newco Board has the power, through proxies granted by B or B Corporation, to appoint/remove the majority of the members of the Boards of Directors of such subsidiaries; and

NO

(i)(ii)

² Using the "control" tests set forth in Rule 801.1(b), A and B each would appear to become an "ultimate parent entity" of Newco.

To: FTC Bureau of Competition Premerger Notification Office Staff

From:

Date: April 30, 1998

Page: 10

(2) B will acquire beneficial ownership of A's assets (and/or voting securities) contributed to Newco and of assets (and/or voting securities) held by subsidiaries of A or subsidiaries of A Corporation for which the Newco Board has the power, through proxies granted by A or A Corporation, to appoint/remove the majority of the members of the Boards of Directors of such subsidiaries.

If such "control" relationships, *ipso facto*, create "beneficial ownership", then a reportable acquisition(s), under the size of transaction test, would seem to exist.

N/A

(1) For A as the acquiring person and B as the acquired person -- if A values, in excess of \$15,000,000, the combination of B's assets (and voting securities, if any) contributed to Newco and assets held by subsidiaries of B or B Corporation where the board members of such subsidiaries are subject to appointment/removal by Newco exercising its proxy vote; and

(2) For B as the acquiring person and A as the acquired person -- if B values, in excess of \$15,000,000, the combination of A's assets (and voting securities, if any) contributed to Newco and assets held by subsidiaries of A or A Corporation where the board members of such subsidiaries are subject to appointment/removal by Newco exercising its proxy vote.

However, FTC staff has on prior occasions opined that "control" is not necessarily the decisive factor in determining whether a person holds beneficial ownership. See, e.g., American Bar Association, Premerger Notification Practice Manual (2d Ed. 1991), interpretation no. 54, at pages 49-50, wherein FTC staff apparently advised that shareholders who enter into voting agreements or voting trusts or grant or obtain proxies are not regarded as reportable transactions, "even if control of an issuer may be conferred or transferred as a result." Similarly, interpretation no. 74, at pgs. 64-65, reflects advice on whether "a person who controls an issuer by reason of a contractual power to designate fifty percent or more of its directors holds the issuer's voting securities." The FTC staff apparently opined that "A person does not hold voting securities under §801.1(c)(1) unless that person has beneficial ownership of the securities. A contractual power to designate 50 percent or more of the directors of an issuer does not, by itself, confer beneficial ownership." These interpretations would seem to mean that the proxies conferred by A, A Corporation, B, and B Corporation which could result in Newco having the ability to appoint/remove/approve the majority of an

To: FTC Bureau of Competition Premerger Notification Office Staff

From:



Date: April 30, 1998

Page: 11

being done in formation of Newco (itself a non-report event).

entity's board of directors does not necessarily mean that Newco holds beneficial ownership of those entities or their assets. *Correct*

Beneficial Ownership Achieved Other Than Through Application of the "Control" Tests

If the acquisition of "control" as defined in the HSR Rules, does not, *ipso facto*, create beneficial ownership, the question is whether A acquires beneficial ownership of B's assets and B acquires beneficial ownership of A's assets by virtue of such "control" relationships (as described above) together with the management authority given to Newco and cash flow retained by Newco related to A's and B's assets where title remains in the separate A and B Corporations or their individual subsidiaries. (See description in "Newco Authority" section above).

A & B will each derive benefit from increase in Va. of their respective assets (as well as suffer decrease in value)

However, there are limits imposed upon Newco by virtue of those reserve powers for actions that require the mutual approval of both A and B, and those reserve powers for actions which require approval of either A or B (See Reserve Powers Section above). On balance, the existence of these reserve powers, as well as A Corporation and B Corporation continuing to hold title to their respective assets and the right of A and B to the proceeds of any sale of assets to which each separately holds title, directly or through a wholly owned subsidiary, suggests that (1) beneficial ownership of A's assets, subject to Newco management, has not transferred to either Newco or B and (2) beneficial ownership of B's assets, subject to Newco management, has not transferred to Newco or A -- simply as a result of the management authority granted to Newco by A and B and related cash flow retained by Newco.

agrees

QUESTION PRESENTED

The question presented is whether, under the facts and circumstances described, -- i.e., the control held by each of A and B over Newco, Newco's "control" over the subsidiaries of A Corporation and B Corporation, and the parameters of Newco's management of A (or A Corporation's) and B's (or B Corporation's) operations -- separately or in combination, constitute an acquisition of beneficial ownership by A of B's assets and/or by B of A's assets.

no

If there is no acquisition by A of beneficial ownership of B's assets and no acquisition by B of beneficial ownership of A's assets, no Hart-Scott-Rodino filing should be required in connection with the formation of Newco.

agrees

called [redacted] 5/8/98 & 5/11/98 basically concurs with comments noted. (PS) - (PS) reviewed and concurs exception