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The Use of Board Seats as Currency in M&A Transactions

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As the merger and acquisition (M&A) activity in non-profit healthcare remains unabated, continued focus is on considerations for such transactions. For transactions between non-profit organizations, the "change of membership" and M&A models remain highly popular structural options. And, with these models, "cash" is rarely the preferred or required method of consideration or benefit. More often than not, it is an amalgam of financial incentives (e.g., capital commitments), service line support, and governance opportunities that provide the bulk of the material terms and conditions.

Of these, the extent to which the combining parties agree to share or consolidate governance can be the most immediate manifestation of the transaction. The use of board seats as "currency" in these transactions is thus a very popular negotiation term. However, it should not be relied upon without careful consideration of its advantages and disadvantages, the highlights of which include the following.

Potential Advantages

1. **Recognized option:** The use of board seats/"legacy representation" as consideration in non-profit M&A transactions—especially change of membership arrangements—is a commonly accepted practice. It is typically used in conjunction with other benefits/inducements to the party transferring control or membership. With powers effectively balanced, it can prove to create a meaningful governance partnership between the legacy representatives.
2. **Flexibility in structuring:** There is no set number of board (or committee) seats that must be applied in extending governance input to the other party. The general concept is a number that is sufficient to guarantee a "voice" in board and committee processes. To that extent, 49 percent or similarly high (but less than 50 percent) levels are not usually necessary to provide the necessary vehicle for input. Smaller percentages are often buttressed by the addition of special powers (e.g., supermajority voting rights, with respect to certain agenda items).
3. **Transitional assurance:** Oftentimes, the use of board currency is structured in a manner to assure proper transition to a "unified" (i.e., community-based or non-constituency) arrangement. This is most often made through the use of gradually reduced term limits and other service limitations that provide a sensitive evolution away from reliance on legacy representation. This is often done for the terms of officers, directors, and committee members.
4. **Preservation of culture:** Apart from governance authority, one of the more recognized advantages of legacy board seats is to assure the extension of an organization's particular culture for a significant period of time past the closing date. The expectation is that through its representatives on the governing board of the combined entity, and their participation in the work of the board/committees, the elements of culture and values of the system that transferred control can be continued and perhaps embedded in the new organization.
5. **Use of shared leadership options:** Legacy considerations can also be reflected in the sharing, for at least limited periods of time, of board and committee officer positions. This is often accomplished through two different means. One is the concept of "co-officers" (e.g., co-board or committee chairs). The other is the concept of staggered officer positions (e.g., the position of board or committee chairs alternates per term between representatives of the controlling organization and the legacy organization).

Potential Disadvantages

1. **Constituency concerns:** The primary disadvantage of board seats as currency is the potential it establishes for duty of loyalty concerns (i.e., that it memorializes constituent representation at the board level). Individuals appointed to board or committee service as "representatives of" a particular constituency (e.g., the legacy health system) can often act as

if their fiduciary duties are owed to the legacy organization and its (now-past) mission, as opposed to being owed to the mission of the successor organization. This becomes especially complex when the legacy directors are charged with the enforcement of post-closing rights.

2. **Culture clashes:** Another disadvantage is the extent to which legacy representation on boards and committees actually serves to heighten differences in corporate and organizational cultures. This is often the case when there are substantial differences in the size and scope of the merging parties (e.g., one is a large system and the other is more of a conglomeration of smaller hospitals). It is also often the case when the organizations reflect different approaches to governance style, or to the board–management dynamic. Unless these differences are carefully discussed and resolved in advance, they can have a jarring and perhaps adversarial effect once the combined board begins to meet.
3. **Integration delays:** Along the same lines, legacy representation on boards can provide a significant hurdle to integration of the combining systems' operating and governance styles. In many instances, the continuing preservation of legacy governance roles (especially beyond initial terms) can greatly reduce the incentive to pursue the necessary integration of operations. Legacy board leaders sometimes seek to preserve, for various reasons, elements of the prior organization's presence and operations (as well as leaders) instead of working towards system commonality. This can also lead to delays in achieving the intended goals of operating as a combined system.
4. **Size of board:** Significant legacy representation can also limit board effectiveness. Merger terms that require substantial numbers of legacy directors be added to the combined post-merger board can often create boards of potentially unmanageable size. These very large post-merger boards can lead to difficulties in achieving quorum, unproductive meetings, attenuated decision-making processes, unproductive committee processes, and an unfortunate reliance on the executive committee to maintain the process of governance. Of course, boards of even size and constituency are highly prone to dispute, dysfunction, and disability.
5. **Competency/diversity concerns:** The application of legacy representation has the potential for limiting the ability of the combined board to achieve necessary elements of competencies and diversity across all recognized elements. While the legacy representatives to the new board are usually selected through a thoughtful, deliberative process, it is by nature an internal process; the pool of candidates is limited to existing board members. This reduces the ability of the combined board to identify and appoint directors with particularly needed competencies and particularly attractive diversity. It can serve to delay, for years, the introduction of "new blood" into the board of the combined system.

The use of board and committee seats, as well as officer positions, can be valued—and valuable—bargaining "chips" in hospital merger and acquisition transactions. They can, in many circumstances, provide a clear and demonstrable means of confirming a partnership between hospitals and health systems. But this practice has both its advantages and disadvantages, which should be carefully considered by both negotiating parties before committing to an approach based on board seats as deal currency.

The Governance Institute thanks Michael W. Peregrine, a partner at McDermott Will & Emery LLP, for contributing this article. He advises corporations, officers, and directors on matters relating to corporate governance, fiduciary duties, and officer-director liability. His views do not necessarily represent the views of McDermott Will & Emery or its clients. He can be reached at mperegrine@mwe.com.

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