

Overview of State Law Challenges to Nonprofits

1.0 THE PREMISE OF THE PRESENTATION

1.1. Overview. There has been, in the last 24-36 months, a significant increase in actions by state attorneys general (and other third parties) challenging business operations and transactions of nonprofit health care corporations. The essence of these often high-profile challenges is that the health system's conduct violates state law governing charitable corporations-or at least the public expectation thereof. In a sense, a health system's nonprofit, charitable status is used against it. These challenges have financial, operational and reputational consequences.

1.2. Specific Application. These developments have specific application to such important issues as:

- “organic” corporate transactions
- facility closure/downsizing
- corporate structure and governance
- relationships with affiliates
- public disclosure
- fiduciary duties of the Board
- investment practices
- charitable solicitation of funds
- accessing restricted gifts

2.0 THE CORE ISSUES: WHAT IS AT STAKE?

2.1. Operational Consequences. The ability to successfully own and operate a nonprofit health care system, without undue risk of conflict with the regulatory vision of appropriate corporate conduct by a charitable organization.

2.2. Director Liability. The ability to recruit and retain competent individuals to serve as directors of nonprofit health care entities and to protect such directors from inappropriate legal exposure from the exercise of their business judgment.

2.3. Dialogue with Regulators. The importance of maintaining a meaningful dialogue with state attorneys general and other charity law officials, and discussing important issues with respect to the major areas of regulatory concern and the proper scope of regulatory jurisdiction.

3.0 THE GOALS OF THIS PRESENTATION

3.1. Review Nonprofit Status. Review the fundamental characteristics of the nonprofit corporation form of legal entity, and how it differs from other forms such as for-profit corporations, limited liability companies and charitable trusts.

3.2. Summary of Regulatory Intervention. Summarize the multiple instances in recent years of direct intervention on nonprofit and charitable trust law grounds by state attorneys general in the business and operations of nonprofit health care providers, which has dramatically increased in 2001.

3.3. Recommendations. Provide a detailed set of recommended action items which an individual nonprofit health care provider may immediately institute to better defend against any allegation that the corporation and its directors are acting in a manner inconsistent with nonprofit corporate law.

PART I: NONPROFIT PRIMER

4.0 THE BASIC CHARACTERISTICS OF THE NONPROFIT CORPORATION

4.1. Broad Acceptance. The nonprofit corporation is generally recognized as the traditional organizational form of choice for legal recognition of charitable activities in general, and the “promotion of health” (*e.g.*, charitable hospitals and healthcare providers) in particular.

4.2. Mission Limitation. The nonprofit corporate activities are limited to those as specifically set forth in its charter/articles of incorporation (*i.e.*, the “charitable purposes” clause), for the benefit of a charitable mission.

4.3. Nondistribution Constraint. The nonprofit corporation’s net income must be retained and applied for the purposes for which the corporation was created; it is prohibited from making distributions of profits and net earnings (other than reasonable compensation for services rendered) to individuals in a controlling position (*e.g.*, directors, officers, members, founders). This “restraint” is similar to the prohibition against private inurement of the earnings of tax exempt organizations as provided for in the Treasury Regulations.

4.4. Dedicated Statute. The nonprofit corporation is operated subject to the application (in most states) of a specific, dedicated nonprofit corporation code which sets forth the rights, powers and obligations of the entity, and the rights of the attorney general with respect thereto.

4.5. Advantages. The nonprofit corporate legal form offers several advantages to charitable organizations, including (a) access to federal tax exempt status; (b) limited liability; (c) organizational continuity; (d) administrative convenience; and (d) familiarity.

4.6. Distinctions with Business Corporation Model.

4.6.1. Organized and operated for corporate profit and shareholder gain; the corporation is a means to attain superior financial results, not an industry-specific end (the nonprofit being focused on pursuit of a specific charitable mission).

4.6.2. Owned on a collective basis by stockholders; net profits are distributable to shareholders (no individual possesses an ownership interest in a nonprofit; corporate earnings in excess of revenues are returned to the corporation for use in support of charitable goals).

5.0 KEY FIDUCIARY OBLIGATIONS OF THE NONPROFIT DIRECTOR

5.1. The Director's Basic Duty of Oversight. The director's fundamental duty to manage the corporate enterprise by delegation to full-time managers is referred to as the "Duty of Oversight." This duty is *central* to everything a director does. Courts recognize that directors cannot be expected to manage the day-to-day activities of a company, and thus will normally *give deference* to decisions of the board as to what matters in which it will (or will not) become involved.

5.2. The Related Duties of Care, Loyalty and Obedience. The duties of care, loyalty and obedience serve to describe the *manner* in which directors are required to carry out their fundamental duty of oversight of the enterprise.

5.2.1. The *Duty of Care* requires that directors apprise themselves of all reasonably available information before taking action; and then, having been so informed, to act with attentiveness and care appropriate under the circumstances in the discharge of their duties. In essence, it is similar to a "Duty of Attention."

5.2.2. The *Duty of Loyalty* requires directors to discharge their duties unselfishly, in a manner designed to benefit only the corporate enterprise and not the directors personally. It incorporates a "duty to disclose" situations which may present a potential for conflict with the corporation's mission, as well as a duty to avoid competition with, and appropriation of the assets of, the corporation.

5.2.3. The *Duty of Obedience* requires that directors be faithful to the underlying charitable purposes and goals of the nonprofit corporation they serve, as set forth in the corporation's governing documents. It presumes that the mission of the corporation, and the means to achieve it, are inseparable.

5.3. The Protection Afforded by the Business Judgment Rule.

5.3.1. Courts may apply the "Business Judgment Rule" to determine whether a director's duty of care has been met with respect to corporate decisions. The Rule provides that a director will not be held liable for a decision *made in good faith*, where the *director is disinterested, reasonably informed* under the circumstances, and rationally believes the decision to be in the *best interest* of the corporation. The Rule includes a presumption *in favor of* its application.

5.3.2. Thus, unless a plaintiff is able to rebut the presumptions inherent in the rule (which it is the plaintiff's burden to do), directors will be shielded from liability arising from the implicated decision, even if the decision is later determined to have been wrong.

5.3.3. The concern is that some states, through their attorney general, will not recognize application of the business judgment rule to a nonprofit corporation if it is not specifically provided for by statute or if the attorney general intends to apply "charitable trust" jurisdiction (see below).

5.3.4. Special Rules – Financially Distressed Corporations. Directors of nonprofit corporations at, or approaching, financial distress should be aware of the "Insolvency Exception" to the rules with respect to the above-described fundamental duties. In essence, this "Exception" provides that once a corporation becomes insolvent (note: prior to entering into bankruptcy), the obligations of the directors "shift" from being owed to the corporation, to being (at least primarily) owed to the creditors of the corporation.

In other words, during this period of time the corporation is considered to be insolvent and before bankruptcy, the directors must exercise their obligations for the benefit of the creditors or risk breach of duty challenges. This obligation to consider the interest of creditors often places directors in a difficult conflict with the duty of obedience to corporate purpose.

6.0 THE CHARITABLE TRUST CONTROVERSY

6.1. The Core Issues. In many states, there exists a controversy as to whether the assets of a nonprofit corporation (irrevocably dedicated to nonprofit purposes) are nevertheless to be considered as held pursuant to a charitable trust, such that the investment and disbursement of each "trust" asset is subject to attorney general review. This is as opposed to situations where the attorney general's review is confined to a review of the overall activities of the corporation to confirm that they continue to be in furtherance of the corporate mission.

6.1.1. Prior to the enactment of dedicated state nonprofit corporation laws, courts were split on the issue. See, e.g., Stern v. Lucy Webb Hayes National Training School et al., 381 F. Supp. 1003 (1974) (corporate law based) and People v. Larkin, et al., 413 F. Supp. 978 (1976) (trust law based).

6.1.2. Since the adoption of dedicated nonprofit corporation laws, many courts have ruled that such corporations (and the actions of their directors) are governed by those specific statutes and not by trust law statutes. See, e.g., The Kansas East Conferences of United Methodist Church v. Bethany Medical Center, Inc. et al., 266 Kan. 366, 969 P.2d 859 (Kansas 1998) and Persan v. Life Concepts, Inc., 738 So.2d 1008 (Fla. 1999).

6.1.3. The comments to the Revised Model Nonprofit Corporation Act, upon which many state nonprofit corporations have been modeled, confirm the drafting intention that nonprofit corporations not also be treated as charitable trusts.

6.2. Why Nonprofits Should Care. The disposition of the “charitable trust” controversy impacts the legal standards that are applied to nonprofit corporations, *i.e.*, whether (broader, more lenient) corporate law standards or (more rigid, less flexible) trust law standards govern the activities of nonprofits and their directors:

6.2.1. Scope of Relief. Charitable trust law jurisdiction would allow the attorney general greater authority to seek trust-based relief against nonprofit corporations (*e.g.*, the “constructive trust” sought by the Florida Attorney General in the Intracoastal controversy, that is not clearly authorized by nonprofit corporation law), or to make trust-based allegations of misconduct against directors of nonprofit corporations (*e.g.*, the “waste of charitable assets” argument, which is a claim/cause of action with little or no direct previous application in the nonprofit corporate sense).

6.2.2. Director Conduct. Charitable trust law jurisdiction would also subject directors of a nonprofit corporations to a higher (*i.e.*, more demanding) standard of conduct. It would conflict with the protections afforded by the Business Judgment Rule.

7.0 THE PUBLIC/PRIVATE CONTROVERSY

7.1. The Concern. Some state attorneys general, such as the Florida Attorney General in Intracoastal, will describe nonprofit corporations as “public” charities due to the fact that such organizations provide services to the public and present themselves to the public as charities. The concern is that such a classification might provide the attorney general with a basis for arguing that the state or local government has substantially greater control and authority over corporate assets and operations than would normally be the case.

7.2. The Appropriate Distraction. This confuses the discrete but nevertheless important and traditional distinction between corporations as either “public” or “private.” Fortunately, courts continue to respect this public/private distinction:

Private hospital: A private hospital is one founded and maintained by private persons or a corporation, the state or municipality having no voice in the management or control of its property or the formation of rules for its government.

Public hospital: A hospital created and endowed by the government for general charity is a public corporation; and a public hospital may be defined in general as an institution owned by the public and devoted chiefly for public purposes.

Schwartz v. Geico General Insurance Co., et al., 712 So.2d 773 (1998).

PART II: SPECIFIC ATTORNEY GENERAL CHALLENGES

8.0 THE FIRST EXAMPLES – THE MID-TO-LATE ‘90s

8.1. The Florida Cases. The willingness of the state attorney general to challenge the business operations and decisions of a nonprofit healthcare corporation first developed in earnest in Florida in the mid 1990s:

8.1.1. Separate litigation instituted in 1996 by the Florida Attorney General and by interested donors and other individuals, respectively, with regard to the proposed sale of Boca Raton Community Hospital to a consortium of three nonprofit hospital systems.

8.1.2. Litigation instituted in 1996 by individual members of the Board of Trustees of Holy Cross Hospital, Fort Lauderdale, Florida (“HCH”), against HCH’s corporate member and the regional healthcare system with which it was affiliated, with respect to the latter’s efforts to remove certain trustees and to implement a unified capital structure throughout the system. The HCH case also involved actions of the Florida legislature and a threat of intervention by the State Attorney General.

8.1.3. The central theme of these actions was that the best interests of the health system as a whole are subordinate to the wishes of the local community and of donors to and patients of the local hospital, and that system decisions contrary to wishes are violations of a charitable trust. Both were resolved by settlement.

8.2. Optima Healthcare. This refers to the dissolution (effective June, 2000) of a 1994 merger between a Catholic hospital (“CMC”) and a community hospital (“Eliot”) in Manchester, New Hampshire under substantial state attorney general pressure. The catalyst for the dissolution was the March, 1998 Report of the Attorney General challenging the merger on charitable trust and fiduciary duty grounds, based upon three specific findings:

8.2.1. *First*, that Optima should have notified the State Director of Charitable Trusts and/or sought *cy pres* approval for what the Attorney General perceived as three “fundamental changes to the charitable missions” of the two hospitals.

- Termination of CMC’s “historical role” as an acute care hospital
- Effective termination of CMC and Eliot as community hospitals through service consolidation and local board restructuring
- Governance restructuring transferring control

8.2.2. *Second*, the record did not support a finding that Optima would have been successful had it actually sought *cy pres* approval for its merger implementation and governance reorganization. The pre-and-post merger financial analysis supporting consolidation was unpersuasive to the Attorney General.

8.2.3. *Third*, that Optima failed to fulfill its “duty of candor” and “duty of inclusion” to the Director of Charitable Trusts and to the community (*i.e.*, the “social contract”) by:

- Failure to include the community in the decision making process
- Lack of data supporting the facility closure
- Repudiation of prior public comments regarding maintenance of local control
- Failure to adequately inform the community regarding the impact of its subsequent corporate transaction
- Failure to adequately disclose and address potential inconsistencies regarding application of Catholic health care principles
- Failure to establish a promised public accountability system to document the merger's success
- The Attorney General also questioned the legal effectiveness of the merger and subsequent corporation actions

8.2.4. The ultimate demise of the merger, and the related impact of the attorney general's challenge, has emboldened other state attorneys general to apply similar "social contract"/"duties of candor/inclusion" concepts to evaluating not-for-profit mergers in their own states.

8.3. The Rhode Island Challenges. This refers to separate challenges instituted in the late 1990s by the Rhode Island Attorney General with respect to two unrelated merger/affiliation transactions involving nonprofit health care systems.

8.3.1. Lifespan. This matter had its roots in the October, 1997 corporate affiliation by which Lifespan became the sole member of the NEMC system, through an affiliation agreement which, in part, provided NEMC with representative directors on the Lifespan Board. In June 1998, the Attorney General sought and received an injunction preventing Lifespan from implementing corporate bylaw changes effecting the affiliation. The Attorney General alleged, in part, that the proposed bylaw changes altered the power structure of Lifespan in a manner that jeopardized the charitable assets of the (Rhode Island-based) Lifespan affiliates. The controversy was resolved by settlement.

8.3.2. Care New England. In this 1998 matter, the Attorney General disapproved an affiliation between Rhode Island based Care New England Health System and Massachusetts-based Care Group, Inc. The crux of the Attorney General's challenge was that the proposed terms of the affiliation, by which CGI possessed the ability to amend CNE's bylaws, failed to adequately protect the public and charitable interests of Rhode Island institutions. This challenge was also resolved by settlement.

9.0 A SEISMIC EVENT – BISHOP ESTATE

The late 1999 settlements between the Kamehameha Schools Bishop Estate (a/k/a "Bishop Estate") and the Internal Revenue Service and the Hawaii Attorney General provide many valuable lessons with respect to the governance, management and regulation of sophisticated tax-exempt, not-for-profit charitable organizations, such as hospitals and health systems.

9.1. Background. In what appears to have been a highly coordinated enforcement effort, the Hawaii attorney general and the Internal Revenue Service aggressively challenged the operations of Kamehameha Schools Bishop Estate (KSBE), and the actions of its trustees – a challenge that resulted in the resignation and replacement of all of the trustees of KSBE and a substantial change in the manner in which KSBE will operate in the future.

Of **principal interest** in this case was the use of “leverage” by both regulatory agencies to impose conditions that are beyond the remedies expressly authorized by the relevant statutes. This practice of seeking extra-statutory remedies in order to address perceived problems by regulatory agencies is controversial—being strongly supported by some agencies and commentators and questioned by others. It is, however, increasingly prevalent and, as such, should be recognized by nonprofit institutions and their counsel.

9.2. The Settlement Agreements. The settlement agreement with the attorney general provides a settlement payment to the State of Hawaii for ultimate distribution to Bishop Estate for the unpaid balance of the \$25 million policy limit under Bishop Estate’s applicable insurance policy; dismissal with prejudice of the various related civil litigation, including the action to surcharge and remove the incumbent trustees; and various releases and covenants of the parties.

The IRS closing agreement provides in relevant part for (a) permanent removal of the incumbent trustees; (b) a \$9 million payment in lieu of taxes for the years subject to examination; (c) the institution of sweeping organizational changes designed to effect a CEO-based management structure with numerous internal checks and balances; (d) safeguards on inappropriate political involvement; and (e) a “reaffirmation” of the charitable educational mission of Bishop Estate.

9.3. Relevance to Nonprofit Healthcare. The Bishop Estate settlements are relevant to nonprofit healthcare for two principal reasons:

9.3.1. *First*, it is important to recognize that the Bishop Estate tax controversy involves the same sections of the Internal Revenue Code -- Sections 501(c)(3), 509(a)(1) and 4958 -- that are regularly applied to tax-exempt health care entities. Along the same lines, the fiduciary duties the Bishop Estate trustees were alleged to have breached are the same that are regularly applied to trustees/directors of nonprofit health care entities (particularly in those states where attorneys general seek to apply charitable trust principles to nonprofit corporations). In other words, the issues raised by both the IRS and by the Hawaii attorney general are just as applicable to nonprofit, tax-exempt health care organizations as they are to the educational trust of a Hawaiian princess.

9.3.2. *Second*, the settlements reflect what appears to be a highly coordinated enforcement effort by the IRS and the attorney general to remake a charitable trust and to alter its mechanisms of self government. It would be reasonable to conclude that these agencies could act in a similarly coordinated manner with a nonprofit health care entity when they deemed it necessary to preserve the charitable assets and exempt status of such an entity.

10.0 MEETH AND THE DUTY OF OBEDIENCE

10.1. Overview. In a strong defense of the duty of obedience to purpose as it pertains to nonprofit directors and trustees, the New York attorney general's office in late 1999 successfully challenged the planned closure of the Manhattan Eye, Ear & Throat Hospital (MEETH) and the proposed sale of its real estate assets to Sloan Kettering Memorial Cancer Center (SKMCC) and a real estate development firm. The MEETH trustees had proposed to cease hospital operations, to "monetize" the real estate assets, and to thereafter use the corporation's assets to fund free-standing diagnostic and treatment centers.

10.2. The Basis of the Challenge. The MEETH trustees had justified their decision on the advice of independent investment bankers that the long-term financial prospects for the hospital were negative, given decreasing reimbursement rates for services. The New York attorney general's office challenged the proposed sale on the ground that the board of directors of MEETH had failed to adequately explore all available options to maintain the corporation's charitable purposes -- which were "to establish, provide, conduct, operate and maintain a hospital in the city . . . of New York"

10.3. Application of the Duty. In a ruling directly analogous to the 1977 decision of the California court of appeals in the case of Queen of Angels Hospital v. Younger, 66 Cal.App.3d 359, Judge Bernard Fried of the New York Supreme Court held that the MEETH board was required to explore all alternatives that would permit the corporation to continue to carry out its nonprofit hospital purposes -- and that it could not close the hospital, sell the real estate, and utilize the sale proceeds for outpatient services without considering whether the "hospital purposes" of the corporation could otherwise be preserved.

11.0 THE HOSPITAL CLOSURE CASES

11.1. Long Beach Community Medical Center. A large regional, religious-sponsored non-profit health care system's 1999 decision to close a failing hospital facility prompted substantial third party challenge, a threatened action for injunctive relief by the state attorney general and, ultimately, a general investigation of the system's compliance with state charitable trust law.

11.1.1. The health care system had justified its decision in large part upon (a) the continued insolvency of the facility despite substantial ongoing financial support; and (b) the presence of another system-controlled acute care hospital in the same general area.

11.1.2. Third party opponents to the planned closure alleged charitable trust violations by the system from the (a) failure to search for a "buyer" for the subject hospital; and (b) transferring valuable assets from the subject hospital to the other area system hospital (*i.e.*, "sealing its fate").

- SEIU Report, "Uncharitable: How Nonprofit Hospitals Chains Threaten Community Hospitals"
- California Attorney General Task Force re: connection between tax status and charity care

11.2. Intracoastal. This was a highly publicized controversy between Intracoastal Health Care Systems, Inc., the Florida Attorney General and various community groups, in which the Attorney General had sought to remove control of the affected hospital from a private, nonprofit corporation on the grounds that the hospital was a charitable trust.

11.2.1. On January 2, 2001, the Florida Attorney General filed a lawsuit that asked the Court to declare St. Mary's Hospital Inc. to be a charitable trust. St. Mary's was a private, Catholic-affiliated, nonprofit hospital corporation in West Palm Beach. The Attorney General asked that control of the hospital be transferred to a receiver, under the control of a new community board.

11.2.2. The Attorney General's action was prompted by the plan of Intracoastal Health System Inc., a nonprofit corporation controlling two West Palm Beach hospital corporations, St. Mary's Hospital and Good Samaritan Hospital, to consolidate all acute-care inpatient services to the Good Samaritan campus and to use the St. Mary's campus primarily for a range of outpatient services. Intracoastal had operated the 80+ year old Good Samaritan Hospital and the 60+ year old St. Mary's Hospital since a 1994 joint operating agreement. Intracoastal adopted the reconfiguration plan as the solution to mounting financial difficulties it was encountering.

11.2.3. The Attorney General alleged that, although St. Mary's was organized as a nonprofit corporation, it was a charitable trust because it has received donations from the public over decades. He alleged that, although St. Mary's articles of incorporation did not require the operation of an acute-care hospital, the public nonetheless view that as St. Mary's primary purpose. The reconfiguration plan, the Attorney General alleged, would change St. Mary's purpose and thus required court approval under the doctrine of *cy pres*.

11.2.4. The defendants argued that the Attorney General's case was premised solely on a disagreement with a Board of Directors' business judgment on how best to serve the purposes stated in the St. Mary's articles. The defendants argued that under Florida case law, donations to a nonprofit corporation are not held in trust, but are "gifts absolute" for use by the corporation consistent with its corporate purposes. Also, the defendants argued that the Court could not impose a constructive trust on St. Mary's general assets because only some, not all, of those assets came from donations.

11.2.5. The parties were directed to mediation. On March 8, 2001, the parties announced they had reached a settlement and the Judge dismissed the case. The Attorney General agreed not to seek to have St. Mary's turned over to a receiver and a community board, and Intracoastal agreed not to proceed with its reconfiguration plan. Rather, Intracoastal proceeded to sell both hospitals to Tenet Health System on various conditions, including keeping both facilities open as acute-care centers and continuing to fulfill both hospitals' charitable missions.

12.0 AHERF

12.1. Overview. There are over 60 (and probably more) cases that have been brought in civil, criminal or bankruptcy related matters arising from the financial collapse of Allegheny Health, Education and Research Foundation (“AHERF”). Although there have been procedural developments in many of these cases, very few have been tried to conclusion or have otherwise been resolved.

12.2. Major Cases. Of all the AHERF-related cases filed to this date against the AHERF officers and directors, several have the potential of being particularly relevant to nonprofit health care corporations:

12.2.1. A bondholders’ class action

12.2.2. An action by the Official committee of Unsecured Creditors

12.2.3. An action by the Pennsylvania Attorney General and Tenet

12.2.4. an action by the Trustee in Bankruptcy

12.2.5. A RICO action brought by physicians and medical researchers (resolved in favor of the defendants)

12.2.6. An SEC action

12.3. Principal Allegations. The AHERF cases as filed focus on a series of allegations of interest to nonprofit health care providers, including the following:

12.3.1. Breach of the Duty of Care;

12.3.2. Breach of the Duty of Loyalty;

12.3.3. Improper Use of Research Funds;

12.3.4. Improper Access of Restricted Gifts;

12.3.5. Financial Mismanagement;

12.3.6. Accounting/Reporting Concerns;

12.3.7. “Zone of Insolvency” Issues; and

12.3.8. Third Party Standing Consideration.

13.0 ALLINA HEALTH SYSTEM

This recently concluded matter involved the lengthy nonprofit law compliance review of a nonprofit integrated delivery system by the Minnesota Attorney General. The review terminated with Allina’s decision to “spin off its HMO affiliate, Medica Health Plans, and to

enter into a “Memorandum of Understanding” dated September 24, 2001. The MOU reflected the results of the Attorney General’s Compliance Review, based on which the Attorney General “believes that Allina has engaged in misconduct and may have engaged in violations of the law.”

13.1. The Initial Allegations. Litigation between Allina and the Attorney General over the production of documents in connection with the Compliance Review provided the first glimpse of the conduct with which the Attorney General was (at least initially) concerned. These publicly available litigation documents suggest that the focus of concern was on corporate expenditures “inconsistent with the principles and mission of a charitable organization:”

“that the management of Allina and its subsidiaries has wasted substantial assets as it relates to personal perquisites such as travel and entertainment; has not properly administered almost \$50 million in consulting contracts over the past three years; has acted contrary to the mission and purpose of Medica; has failed to negotiate and administer executed compensation contracts in the best interest of the non-profit organizations; and has utilized a significant amount of non-profit assets for the personal benefit of executives.”

Source: State’s Memorandum in Support of Motion for *In Camera* Review.

13.2. The MOU. The Memorandum of Understanding reflects the agreements of Allina and the AG concerning practices by which (the AG alleges) Allina “has engaged in misconduct and may have engaged in violations of law.”

13.2.1. The MOU requires Allina to adopt new policies on (a) expenses and expense reimbursement; (b) conflicts of interest; (c) ethics and related issues; (d) sexual harassment; (e) anti-discrimination; (f) third party contracting; and (g) actions involving corporate affiliates. Furthermore, it establishes new ground rules for interaction between the system Board and management, places a limitation on certain corporate expenses, requires board officer oversight of any executive, consultant or employee termination agreement involving payments, as well as other company expenses.

13.2.2. It provides for a closer examination of executive compensation arrangements (with particular focus on deferred compensation and retirement programs, which may in certain cases be required to be terminated or modified), and incentive arrangements. All officer compensation arrangements are to be established in compliance with the “rebuttable presumption of reasonableness” under IRC Sec. 4958.

13.2.3. Further, the Board Chair is required to certify that the various agreed to policies and procedures have been adopted by 11/1/01.

13.2.4. Of particular importance to integrated delivery systems and systems with multiple corporate affiliates is the Chapter discussing intra-system corporate conflicts of interest.

14.0 DRISCOLL CHILDREN'S FOUNDATION

On June 12, 2001, the Texas Attorney General reached a settlement with a hospital-affiliated foundation by which the foundation was required to increase its support of Driscoll Children's Hospital by **800 percent**:

“The foundation's agreement to increase its funding of the hospital, and the hospital's agreement to [dedicate more than \$3 million to building and staffing a pediatric clinic in a Texas/Mexico border community] send a strong signal that nonprofit, charitable medical foundations must devote a sizable portion of their income to charitable work and public health, as originally intended by the creators of such charities.”

14.1. The Attorney General's investigation ad included that the Foundation had been setting aside only 10% of its annual income for children's health care at the hospital.

14.2. The MOU between the Attorney General and the Foundation requires the foundation to boost its spending to 90% of its annual income.

14.3. Similarity to Bishop Estate issues.

15.0 OTHER RELEVANT NONPROFIT DECISIONS

15.1. Terra Museum. The recently settled litigation involving the corporate future of the Terra Foundation for the Arts is a strong reminder that even the most prudent of business decisions must nevertheless be vetted for consistency with the organization's charitable purposes. The case also is an example of the willingness of state attorneys general to challenge nonprofit board decisions deemed inconsistent with charitable purposes.

15.2. Eychaner v. Roosevelt University. In an action that could have significant corporate law implications for nonprofit hospitals and health systems, the Illinois Supreme Court has agreed to hear the appeal of the March 30, 2001 decision of the Illinois Appellate Court in *Eychaner and Weiss v. Gross and Roosevelt University*. This case is important because it is expected to address such important corporate and charitable trust law issues as (i) disaffiliation by a subsidiary from a parent corporation; (ii) how charitable trust law may affect the ability of such controlling entity to allocate funds raised by an affiliated organization; and (iii) the fiduciary duty owed by a subsidiary corporation and its directors to a parent corporation. *Eychaner* also involves some of the legal issues inherent in the operation of multiple businesses, as separate but unincorporated divisions of any charitable corporation.

PART III: OTHER NOTEWORTHY MATTERS

16.0 FIDUCIARY DUTY DEVELOPMENTS

16.1. It is important to recognize that each of the “Community Asset Controversy” and “Duty of Obedience” cases have at their core an allegation of trustee mismanagement and breach of a core fiduciary duty (*e.g.*, care, loyalty and/or obedience).

16.2. Illustration of particular “hot areas” are the allegations of the Attorney General in the West Palm Beach litigation. There, the Attorney General bases its complaint of breach of the duty of care on the following allegations:

- The trustees failed to adequately educate themselves about the financial operations of the facilities
- They lost “millions” of governmental receivables through their failure to correct ineffective billing and collection procedures
- They failed to implement policies and procedures intended to ensure the preservation of “market share”
- They failed to renegotiate managed care contracts with service providers
- They embarked on a corporate merger plan without court approval and absent demonstration of how charitable missions could be met
- “Imprudent investment” practices can also be the subject of attorney general scrutiny; many challenges are settled for amount of “D&O” liability coverage
- Bishop Estate suggests that risk areas include (i) lack of portfolio planning; (ii) investment in high risk and illiquid ventures; (iii) failure to document investment decisions;
- (iv) poor investment due diligence practices; failure to establish reporting requirements; and (vi) absence of defined investment exit strategies.
- See also, Brehm v. Eisner, Ovitz, et al.

17.0 RELEVANT NEW LAWS - NOT-FOR-PROFIT “M&A” AND OTHER SIMILAR TRANSACTIONS

Many state nonprofit corporation laws governing “conversion” and similar types of transactions are being expanded to require state approval of a wide range of nonprofit arrangements. *See, e.g.*, California A.B. 254: provides for Attorney General approval of all transactions in which control of over 20% or more of the assets of a nonprofit hospital is transferred. The required preparation of a “community health impact” statement is a significant review feature. Other similar examples:

- Pennsylvania Review Protocol for Non-profit Transactions
- Ariz. Rev. Stat. Ann. § 910-2601 to 2604 (1997)
- Colo. Rev. Stat. § 56-19-101 to 407 (1998)
- GA. Code Ann. § 31-7-400 to 412
- LA Rev. Stat. Ann §§ 40-2115.11 to 2115.22
- NH Rev. Stat. Ann § 7:19-b (1997)
- Ohio Rev. Code Ann. § 1702.39(B)
- OR Rev. Stat. §§ 65.600-815 (1997)
- RI Gen. Laws §§ 23-17.14-1 to 14-35 (1997)
- SD Codified Laws Ann. § 47-24 (1997)
- VA §§ 55-531 to 533 (1997)
- NJ “Community Health Care Assets Protection Act” (2000)

Common features of these types of statutes include: (i) notice to, or approval of state of a subject transaction; (ii) confirmation of continuing accessibility to health care; (iii) absence of

any breach of duty and absence of any conflict of interest; (iv) compliance/ monitoring of the transaction process; (v) fair market value; (vi) use of sale proceeds; (vii) public hearing.

- See Also NAAG Model Act
- Note application of similar type statutes to challenge transactions between systems in different states (e.g., Lifespan/NEMC in 1999; Care New England/Care Group, Inc. in 1998)

18.0 RELEVANT NEW LAWS - “COMMUNITY BENEFIT” REPORTING OBLIGATIONS

A growing number of states are enacting legislation designed to increase the public accountability of nonprofit healthcare organizations with respect to the provision of community benefit. New Hampshire’s “Community Benefit Statute” is a primary example. It requires an annual “Community Benefits Plan” which focuses on:

- Periodic preparation of a “community needs assessment”
- Those activities the hospital will pursue to address identified community need
- Community benefits provided in the proceeding year and results therefrom
- How the hospital involved community groups in Plan preparation

19.0 THIRD PARTY STANDING ISSUES

At issue is the ability of third parties to successfully assert standing to challenge the business decisions of the charitable organization. Types of Third Party Challenges:

- Labor Unions
- Consumer Groups, Taxpayer Advocacy Groups
- Community Groups
- Medical Staffs
- Competing Institutions
- Donors

Relief Typically Sought:

- Injunctive relief to prevent the transaction consummation
- Specific relief (i.e., trustee removal or accounting)
- Damages
- Other relief (e.g., improper charitable solicitation)
- Donors and beneficiaries in AHERF
- Medical staff, union and competitors in MEETH
- Labor union in Long Beach
- Community groups, donors in West Palm Beach

To date, third parties have been unsuccessful in overcoming the general rule that absent a “special interest” (e.g., *right of reverter*), third parties do not have standing to challenge the actions of a charitable trust.

20.0 POTENTIAL FUTURE DEVELOPMENTS

- Where Goes West Palm?
- Musings on the Meaning of MEETH
- The Spread of the Optima Virus
- “Donor Diatribe”
- Third Party Standing
- Imprudent Investment
- Charitable Activity Probes
- Failure to Exercise Business Judgment
- Charitable Solicitations

PART IV: NONPROFIT LAW COMPLIANCE PRACTICAL RECOMMENDATIONS AND ACTION ITEMS

The following represents a non-exclusive list of practical steps a nonprofit health care system and its general counsel may wish to implement in order to better position the system to respond to (a) queries from the state attorney general and other interested third parties as to the scope of the system’s compliance with nonprofit corporation (and, where applicable) charitable trust law; and (b) efforts by such parties to intervene in the business and affairs of the nonprofit health care system.

I. Adopt a General Compliance Philosophy.

The nonprofit health care system should recognize nonprofit corporation law as a **major legal feasibility issue** affecting the system’s organization, day-to-day operations and participation in major corporate transactions. Compliance with nonprofit corporation law should be added as a “Standard of Conduct” to the system’s Corporate Compliance Plan, and system governance and senior management should receive compliance education concerning the implications and requirements of nonprofit status.

II. Understand the Applicable Law.

The scope of nonprofit corporate law in the states in which the system conducts business should be understood by governance and senior management. Accordingly, system general counsel should be requested to advise the system Board and the senior leadership team as to the following with respect to each nonprofit corporation in the system:

- (a) The presence of a dedicated state nonprofit corporation code and recent decisions interpreting that code;
- (b) Whether the corporation would be subject to “charitable trust” jurisdiction;
- (c) The presence of other significant state laws relating to nonprofit, charitable status;
- (d) The current standard of conduct under state case law for directors’ fiduciary duties of care, loyalty and obedience (*e.g.*, does the law acknowledge the business

judgment rule? Are there specific provisions governing the resolution of conflicts of interest?); and

- (e) The presence of any legal authority for member or director-based “derivative” or similar individual action against board or corporate action.

The Office of General Counsel should also be encouraged to regularly check the Attorney General’s website for new developments.

III. Focus on Corporate Purposes.

The Board should evaluate the sufficiency of the statement of charitable corporate purposes for each nonprofit in the system. Particular consideration should be given to whether the statement of purposes adequately reflects a charitable purpose, accurately reflects the business and operations of the system and provides sufficient flexibility for evolution of corporate activities. The goal of this exercise would be to implement necessary changes to the charitable purposes (with whatever approvals including membership and judicial—as may be required) now, rather than in the midst of a subsequent corporate transaction or other strategic initiative in which the purposes of the corporation become a material legal issue.

IV. Refine Governance Policies and Procedures.

The adoption *and* maintenance of governance policies and procedures designed to reflect the unique requirements of nonprofit law can be a powerful demonstration of a system’s commitment to charitable purposes and operations. The Board should compare its current list of corporate governance-level policies against the following list, prepared in specific recognition of nonprofit law compliance considerations:

- (a) *The Governance Policy*, intended as an overarching summary of the individual director’s core duties and the corporation’s commitment to charitable purposes.
- (b) A detailed *Conflicts of Interest Policy*, designed to accommodate (at a minimum) state and IRS requirements and a detailed process for disclosure and resolution of conflicts.
- (c) A policy on *Corporate Opportunity* that establishes the basic prohibition against “appropriation of corporate opportunity.”
- (d) A policy that sets forth the Board’s position on *Outside Board Service* by directors and senior executives.
- (e) A strongly worded *Policy on Confidentiality*.
- (f) A Policy on *Executive Compensation* that establishes the methods, limitations and determinations documentation of such compensation arrangements.
- (g) A Policy on *Board Compensation* which sets forth rationale, method, ceiling, and approval of compensation decisions.

- (h) An *Investment Management Policy* which delineates the basic protocols and guidelines by which the organization's funds are invested.
- (i) The *Corporate Audit Policy* by which the independence of the corporate auditor and of the audit process is reviewed and preserved.
- (j) A Policy on *Use of Consultants* which governs the use of expert advice by the Board and the manner to which consultant advice is reviewed by the Board.

V. Confirm the Board Decision-Making Process.

A frequent topic of regulatory criticism is that a board has failed to render an informed decision with respect to a particular matter it is being called to address. To confirm the prudence of its decision-making process, the Board should assure itself that the following steps are in place:

- (a) Relevant information is provided on a *timely basis*.
- (b) Meeting *attendance* requirements are *enforced*.
- (c) Directors are provided with *direct access to outside advisors*.
- (d) *Meeting schedules* are set to enhance informed decision-making.
- (e) Where relevant, the *reasonableness of financial terms* is confirmed.
- (f) The *arms-length* nature of negotiations is confirmed for the record.
- (g) Directors are supported in their efforts to make a "*reasonable inquiry*."
- (h) Results of "due diligence" and transaction options, risks are *shared with the Board*.
- (i) The *relationship* between the goal of the particular transaction and the corporation's charitable mission *is confirmed by the Board*.
- (j) *Board minutes* and resolutions are used judiciously to record the material deliberations of the Board.

VI. Monitor Application of Restricted Gifts and Endowments.

A significant source of nonprofit law exposure to the corporation will arise from the potentially improper application of donor-restricted gifts and endowments. To reduce such exposure, system general counsel should be requested to take the following steps:

- (a) Confirm applicable state law (*e.g.*, "UMIFA").
- (b) Prepare and maintain an inventory of the system's major restricted gifts.

- (c) Maintain pertinent access information for donors and their relatives.
- (d) Make the planned giving/foundation department subject to the authority and supervision of the general counsel.
- (e) Provide input to planned giving staff in the gift structuring process to enhance flexibility of restrictions.
- (f) Assure appropriate restrictions placed on “upstreaming” funds from system affiliates to parent corporation.
- (g) Provide oversight of public fundraising campaigns and apply restrictions to contributed funds per solicitation terms.
- (h) Institute ongoing review of underutilized restricted funds and consider seeking modification of relevant terms.
- (i) Recognize that in many cases judicial approval may be the most prudent means of a releasing a particular restriction.

VII. Apply Nonprofit Review to Major Transactions.

To reduce the potential for an undesirable regulatory or third party concerns as to the nonprofit law issues associated with a particular transaction, the Board and general counsel should address the following core questions at the incipency of transaction planning:

- (a) How does the proposed transaction further the corporation’s charitable mission and goals?
- (b) Conversely, is the transaction inconsistent with any provision in the corporation’s articles of incorporation and bylaws?
- (c) Has the Board been advised as to other options for achieving the goals proposed to be achieved by the transaction?
- (d) Is the Board aware of the potential risks (as well as the anticipated rewards) of the transaction?
- (e) Does the transaction contemplate a transfer of control of charitable assets to out-of-state interests?
- (f) Does the proposed transaction impact any restricted gift to, or fund-raising campaign of, the corporation?
- (g) Have all potential conflicts of interest been thoroughly vetted?
- (h) Is a Board process in place that will allow for an informed decision as to the transaction?

VIII. Preserve the Independence of the Corporate Audit.

The Board and senior management may wish to more closely consider all types of consultant engagements to better assure that the engagements will not undermine the independence of the corporate audit. Particular attention should be paid to the purchase of those non-audit services presumed by the SEC rules to impair the independence of the audit if purchased from the organization's independent audit firm or an affiliate thereof. To assist in this process, the Board and senior management should consider requesting system general counsel to pursue the following "action items":

- (a) Inventory all existing non-audit service arrangements with the corporation's audit firm and/or an affiliate; identify potential areas for non-compliance with the SEC rules and recommend corrective action (*e.g.*, termination of problematic arrangement); anticipate extent to which issue may present itself (*e.g.*, major transaction).
- (b) Prepare protocol for application by Board/senior management when considering potential non-audit service engagements with the corporation's independent auditor and/or its affiliates.
- (c) Carefully record in the Board meeting minutes the justification for hiring the independent auditor or its affiliate for non-audit services (*i.e.*, identify how the engagement has been structured to preserve the independence of the audit firm).
- (d) Require (i) formal, written agreements for each discrete non-audit service provided by the independent audit firm and/or its affiliates, specifying in detail the scope of the engagement, and (ii) detailed billing statements which substantiate the services provided and expenses charged.
- (e) Advise the Board and senior management on the oversight of the performance by the audit firm and/or its affiliate in the provision of non-audit services to the corporation.

IX. Document and Expand Incidents of Community Benefit.

Boards should be pro-active in their efforts to document the extent of community benefit (beyond the normal provision of health care services) that they regularly provide. Examples of such community benefit activities could include:

- (a) Adoption of a specific charity care policy; maintenance of specific account or other records of the extent of free or reduced cost care provided to the poor or indigent;
- (b) Financial or in-kind support of public health programs;
- (c) Allocation of funds, property, services or other resources that contribute to community health care needs identified in a community benefits plan;

- (d) Donation of funds, property, services or other resources which promote or support a healthier community;
- (e) Support of medical research and education and training of health care practitioners;
- (f) The extent to which the nonprofit system consults with the community concerning health care needs as provided for by the nonprofit;
- (g) Periodic preparation of a “community needs assessment” and identification of the steps the nonprofit corporation will take to address the identified needs; and
- (h) The extent to which the nonprofit health system accounts to the public for the community benefit that it provides.

X. Executive Compensation Audit.

The combination of three recent events-issuance of (i) the Allina Report; (ii) the IRS “CPE Textbook”; and (iii) the IRS Business Plan for FY 2002; underscore the fact that executive compensation payable by nonprofit, tax-exempt organizations is definitely a “front burner” legal issue. Boards and senior management should consider authorizing system general counsel (with the assistance of qualified compensation consultants) to conduct an internal audit of the compensation arrangements payable from the vice presidential level to more senior positions, including Board-based compensation. The goals of the internal audit would be to confirm that the arrangements are:

- (a) reasonable in nature;
- (b) have been approved in accordance with corporate policy;
- (c) are received in exchange for services rendered; and
- (d) given the required tax treatment.

In this manner the nonprofit system would be better positioned to respond to any outside inquiry as to the reasonableness of its compensation arrangements.

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Through these and other, similar questions, the corporate Board and the senior management team can better assume transaction compliance with relevant nonprofit law.