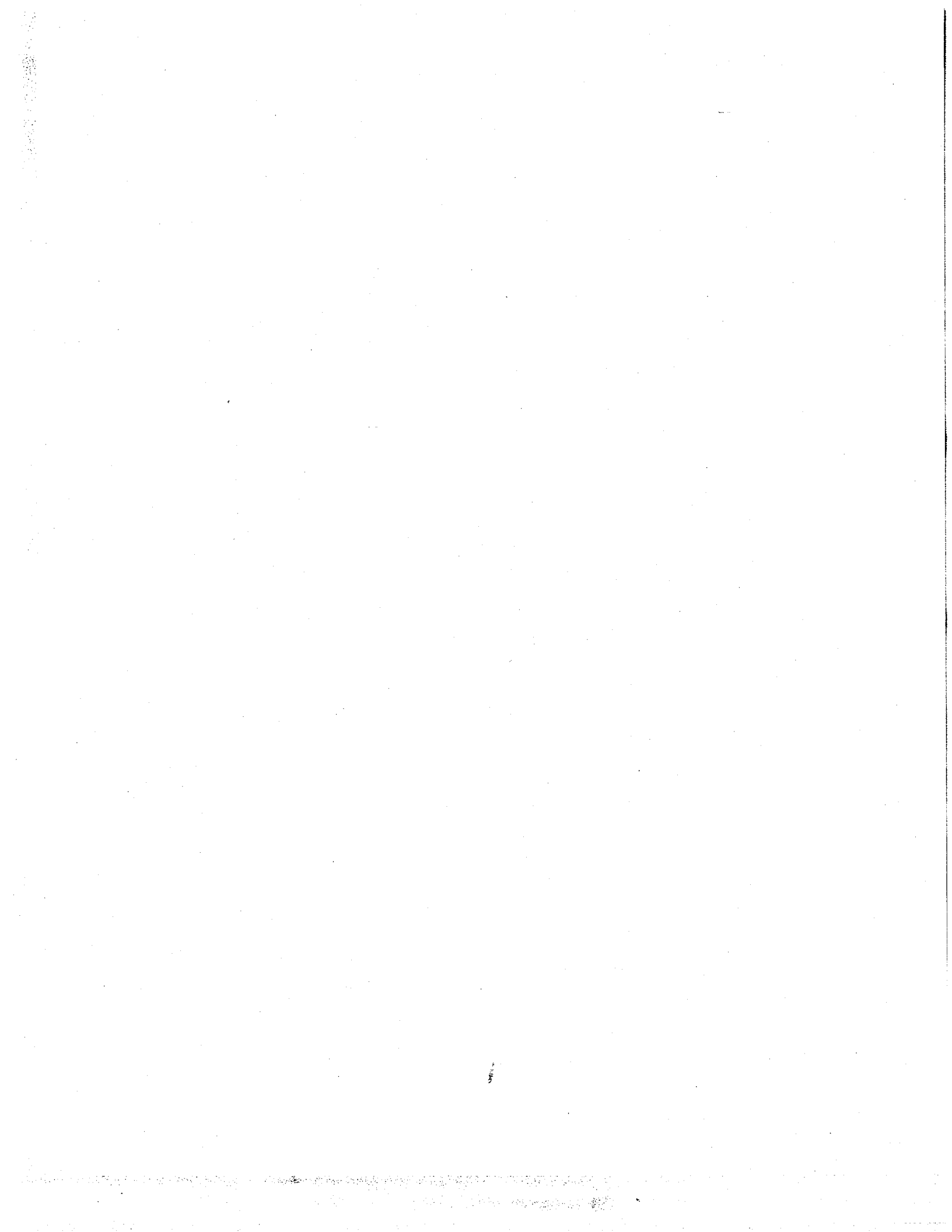


ATTORNEY GENERAL SUPERVISION

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1. Robert A. Boisture & Douglas N. Varley, State Attorneys General's Legal Authority to Police the Sale of Nonprofit Hospitals and HMOs, Sept. 1995.
2. Robert A. Boisture & Douglas N. Varley, Proposed Guidelines for State Regulators' Oversight of Sale and Joint Venture Transactions in Which the Assets of Nonprofit Hospitals or HMOs are Transferred to For-Profit Enterprises, 1995.
3. California Attorney General's Office, Sales of Charitable Assets to For-Profit Entities - Review Protocol.
4. A.B. 3101, Cal. Leg., 1995-96 Reg. Sess., (passed).
5. Massachusetts Attorney General's Office, For-Profit Conversions and Acquisitions of Nonprofits: Attorney General Issues and Procedures, Oct. 1995.
6. Summary of Massachusetts Attorney General's Agreement with MetroWest Health, Inc. and Columbia/HCA Healthcare Corporation, Apr. 1996.
7. Summary of Massachusetts Attorney General's Agreement with Fallon/OrNda, 1996.



**STATE ATTORNEYS GENERAL'S LEGAL AUTHORITY TO POLICE
THE SALE OF NONPROFIT HOSPITALS AND HMOs¹**

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I. **Introduction**

Nonprofit community hospitals have traditionally been the backbone of the American hospital system, accounting for substantially more than half of the nation's hospital capacity. However, over the past several years, powerful market forces reshaping the health care system have stimulated the rapid growth of large for-profit hospital chains.

While their initial growth was fueled largely by the consolidation of existing for-profit hospital companies, more recently the large for-profit chains have turned to acquiring significant numbers of nonprofit hospitals. Most of these transactions are structured as asset sales, however, a significant minority are structured as joint ventures in which the nonprofit transfers its hospital assets to a for-profit joint venture, receives cash equal to a portion of the value of these assets, and retains a passive investment interest in the for-profit joint venture.

Nonprofit acquisition is a publicly announced strategy of the largest for-profit chain, and industry experts agree that the rate of for-profit acquisition of nonprofit hospitals and HMOs will continue to accelerate. These transactions promise to result in by far the largest redeployment of charitable assets in history, potentially involving tens of billions of dollars.

Given the sheer magnitude of these transactions and the obvious risks they entail for misuse or mismanagement of charitable funds, the case for aggressive regulation is clear and

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compelling. While the IRS has some authority in this area – particularly in preventing private inurement and ensuring the adequacy of the purchase price – it does not have the authority to require advance approval. Further, the resources it can devote even to *ex post* review are quite limited relative to the magnitude of the task. Accordingly, the principal burden of protecting the public's interest when nonprofit hospitals go up for sale will necessarily fall to state charity regulators.

This memorandum examines the legal basis for, and scope of, state attorneys general's legal authority to oversee these transactions.²

II. Summary of Conclusions

Advance court approval required. The directors of a nonprofit charitable corporation – like the trustees of a charitable trust – must obtain prior court approval in a *cy pres*-type proceeding for any fundamental change in corporate purposes. This advance approval requirement clearly applies where a nonprofit corporation whose dominant purpose has been the operation of a hospital proposes to sell its hospital operation and devote the sales proceeds to a fundamentally different use.³

While the courts traditionally afford a nonprofit's directors broad discretion in managing day-to-day operations, directors receive no such deference when the issue is a fundamental

² Although the memorandum refers only to attorneys general, the legal arguments developed here should generally be equally applicable to other state officials assigned the duty of regulating charities.

³ While the following analysis refers only to nonprofit hospitals, as a general matter it is equally applicable to nonprofit HMOs.

change in corporate purpose. Rather, the court reviewing a proposed nonprofit hospital sale or joint venture will make its own independent judgment about the appropriateness of the proposed change in use of the charity's assets. As the representative of the public interest, the attorney general is automatically a party to any such court proceeding, and thus, has clear legal authority to undertake an independent review of the reasonableness and appropriateness of nonprofit hospital and HMO conversion transactions.

Where a nonprofit hospital corporation or holding company proceeds, without court approval, with a sale or joint venture transaction that will terminate the nonprofit's hospital operations and redeploy its assets, state courts have the authority both to enjoin the transaction and to hold the nonprofit's directors liable for breach of fiduciary duty.

Directors' duty of care. The directors of a nonprofit hospital corporation or holding company also have a duty to exercise reasonable care in reviewing and approving a sale or joint venture transaction. This duty of care requires the directors to employ a reasonable decision-making process directed toward ensuring that the transaction is in the best interest of the corporation. The nonprofit board's decision-making process will presumptively fail to meet this duty of care if the directors fail to obtain the assistance of competent experts and/or fail to consider competing offers. Nonprofit directors are entitled to the protection of the business judgment rule – under which a court will decline to second-guess the objective reasonableness of the directors' decisions – only if the directors can show that they have met the process requirements imposed by the duty of care.

The attorney general's authority to require advance review and approval. The requirement that a nonprofit hospital corporation obtain advance court approval for a sale or

transfer of its hospital operation, combined with director's personal exposure to suit for breach of their duty of care, give state charity regulators the practical leverage to require nonprofits to submit such transactions for advance review and approval. Proposed Guidelines for this review process are included under Tab 4. Faced with the prospect of a potentially protracted challenge by the attorney general to its petition for an authorization of new use, or a breach of duty action if it proceeds without court approval, nonprofit hospital corporations will almost certainly opt to comply with reasonable requirements for advance review and approval.

Leveraging state regulators' oversight capacity. It will be difficult within existing resource constraints for attorneys general and other state regulators to provide effective oversight for the increasing number of nonprofit hospital and HMO conversion transactions. Accordingly, regulators need to consider strategies to augment their existing regulatory capacity. In this regard, state regulators should consider requiring the parties to nonprofit hospital sale and joint venture transactions to fund the cost of an independent review of the fairness of the proposed transaction.

In addition, in appropriate circumstances, state attorneys general should consider authorizing private parties to bring relator actions challenging the terms of proposed transactions. Where state law permits such relator actions, the attorney general can exercise ultimate control over the action while requiring the private relator to bear the costs of the action.

III. Legal Analysis

A. The Requirement for Prior Court Approval of a Nonprofit Hospital Corporation's Sale of Its Hospital Operations

The directors of a charitable nonprofit corporation whose dominant purpose is the operation of a hospital must obtain prior court approval before selling the corporation's hospital operations and using the sale proceeds for other purposes. This obligation derives from the courts' application to charitable corporations of fundamental trust law principles concerning changes in use of charitable assets.

The trustees of a charitable trust seeking to use trust assets for a purpose other than the stated purpose of the trust must, of course, obtain prior court approval in a *cy pres* proceeding.⁴ In such a proceeding, to which the attorney general is automatically a party, the trustee must establish that (1) it has become impossible, or at least impracticable, to accomplish the stated purpose of the trust, and (2) the proposed alternative use of trust assets comes as close as present circumstances permit to fulfilling the original intent of the donor. Consistent with trust law's strong emphasis on fidelity to the settlor's intent, courts historically have taken a quite strict and literal approach in applying these *cy pres* criteria in cases involving charitable trusts. However, the recent trend has been toward somewhat greater flexibility – for example, courts have approved deviations from trust purposes without a showing of strict impossibility or impracticality where the trustee has made a credible argument that the settlor would have

⁴ Cy pres is an equitable doctrine under which courts may authorize trustees to use charitable assets in a way different from that intended by the donor, if the donor's intended use has become impracticable. Restatement Second of Trusts ' 399.

avored the proposed alternative use had he or she been able to take into account changed circumstances since the creation of the trust.⁵

While charitable corporations are not treated as trusts for all purposes,⁶ courts and commentators have taken the position that the assets of a charitable corporation are impressed with a charitable trust limiting the purposes for which they can be used to the purposes of the corporation as those purposes were defined at the time the assets were given.⁷ Thus, a charitable corporation's directors cannot authorize a fundamental deviation from those purposes without obtaining prior court approval in a *cy pres*-type proceeding.⁸

⁵ Scott on Trusts, ' 399.4.

⁶ For example, as discussed below, charitable directors are not subject to the same fiduciary standards as charitable trustees. See, e.g., Stern v. Lucy Webb, 381 F. Supp. at 1013.

⁷ See, e.g., Queen of Angels Hosp. v. Younger, 66 Cal. App. 3rd 359 (1977); Holt v. College of Osteopathic Physicians and Surgeons, 61 Cal.2d at 750, 754 (1964); Att'y Gen. v. Hahnemann Hosp., 494 N.E.2d at 1018 (Mass. 1985); Greil Mem. Hosp. v. First Alabama Bank of Montgomery, 387 So.2d 778, 781 (Ala 1980); Riverton Area Fire Protection Dist. v. Riverton Volunteer Fire Dept., 566 N.E.2d 1015 (Ill App. 1991); Bossen v. Women's Christian National Library Assoc., 225 S.W.2d 336 (Ark. 1949), Stevens Brothers Foundation v. CIR, 324 F.2d 633 (Eighth Cir. 1963)(applying Delaware law); The National Foundation v. First National Bank of Catawba Co., 288 F.2d 831, 836 (Fourth Cir. 1961)(applying North Carolina law); 15 Am Jur 2d Charities ' 81 ("a gift or bequest to a corporation or unincorporated association engaged solely in charitable work will usually be construed as held in trust for that purpose"). Scott on Trusts ' 348.1 notes that, although there is diversity of opinion in the cases, "[i]t is probably more misleading to say that a charitable corporation is not a trustee than to say that it is . . .").

The Superior Court of New Jersey addressed the issue of whether the law of charitable corporations included strict trust law limitations on permissible changes in use in City of Paterson v. Paterson Gen. Hosp., 97 N.J. 514 (1967). The transaction under review in Paterson involved the relocation of a hospital a short distance outside the city it was incorporated to serve in violation of the literal language of the organization's corporate charter. Although the court held that a charitable corporation – like a business corporation and unlike a true trust – has the authority to make reasonable amendments to its charter, it noted that this authority is not unlimited. The court stated explicitly that the ability to amend corporate purposes did not extend to transactions that "constitute a substantial departure from the purposes of the charter." Id. at 491.

It is well settled that charitable corporations as well as charitable trusts are subject to the Attorney General's authority to bring suit charging the misapplication of charitable assets. Scott on Trusts ' 348.1.

⁸ See The National Foundation v. First National Bank of Catawba Co., 288 F.2d at 836 (Fourth Cir. 1961). See also Stevens Bothers Foundation v. CIR, 324 F.2d at 644 (Eighth Cir. 1963). In determining whether to approve a

The Supreme Judicial Court of Massachusetts, for example, has ruled that, although a charitable corporation has the power to amend purposes, it is not free to unilaterally apply pre-existing assets to the new purposes. In the court's view, such action would be a violation of the board's fiduciary duties to donors, and would potentially undermine the attorney general's "power and responsibility to 'enforce the due application of [charitable] funds.'"⁹ Thus, while the corporation in Hahnemann was authorized to sell its hospital facility, its use of the sale proceeds was limited to the purposes defined in its earlier governing instruments.

The clearest exposition of these principles can be found in Queen of Angels v. Younger, an important case in which a California Court of Appeals held that a nonprofit hospital corporation did not have the legal authority to lease its facilities to a for-profit concern and use the proceeds for other health-related activities. The court's analysis began with the proposition that:

the assets of a corporation organized solely for charitable purposes must be deemed to be impressed with a charitable trust by virtue of the express declaration of the corporation's purposes, and not withstanding the absence of any express declaration by those who contribute such assets as to the purposes for which the contributions are made.¹⁰

(..continued)

proposed change in use in the assets of a nonprofit hospital corporation, a court would presumably apply the basic trust law criteria outlined above, but probably with somewhat greater flexibility than in trust cases since rather than interpreting the clearly stated intent of a single settlor, the court would be interpreting the collective intent of all past donors to the hospital corporation.

⁹ Hahnemann Hospital, 494 N.E.2d at 1021. Although Hahnemann Hospital dealt with an organization that had incorporated the terms of a trust into its bylaws, the opinion is clear that the board's fiduciary duties ran not only to the original settlor but also to the public because of its contributions to the hospital prior to the amendment of purpose. The court stated explicitly its concern that, if a charitable corporation could freely redirect the use of its assets, then "[t]he public could not be assured that funds it donated would be used for similar purposes." Id.

¹⁰ Queen of Angels v. Younger, 66 Cal. App. 3d at 364.

To determine the terms of that trust – and hence the extent of the board's authority to authorize new activities – the court looked not only to the corporation's articles of incorporation but also to the way it had held itself out to donors and the community at large. While the court recognized that the corporation's articles explicitly empowered it to engage in a range of health-related activities, it found that all of those activities were predicated on the organization's running a hospital. The court went on to stress that the corporation had represented itself to donors, the public, and to state and federal tax authorities as a hospital. Thus, the opinion concludes that leasing the hospital to another organization constituted the abandonment of the organization's corporate purposes and violated the trust imposed on its assets.¹¹

In this regard, it is important to note that while the courts traditionally afford directors of a charitable corporation broad discretion in managing day-to-day operations, directors receive no such deference when the issue is a fundamental change in corporate purpose. The Supreme Court of Missouri has articulated this principle as follows in Taylor v. Baldwin:

"The point of demarcation at which the courts will interfere with the discretion

¹¹ See also Holt v. College of Osteopathic Physicians & Surgeons, 394 P.2d 932 (Cal. 1964), in which the California Supreme Court enjoined an action by the board of a charitable corporation to modify the nature of its activities because the modification was inconsistent with the way the organization had held itself out to the public and grant makers.

The issue of how to determine the limits imposed on the use of funds donated to a charitable corporation was also addressed by the Supreme Court of Alabama in Greil Mem. Hosp. v. First Alabama Bank of Montgomery, 387 So.2d 778 (Ala 1980). Greil posed the question of whether a bequest to a charitable corporation originally organized for the purposes of treating tuberculous lapsed when the corporation converted to a grant-making foundation funding a variety of projects. In answering this question, the court reasoned that "[a] bequest to a charitable corporation, formed for a single charitable purpose, is a gift in trust for that purpose . . ." Id. at 781. Thus, when the recipient organization abandoned "its sole corporate purpose" by ceasing to be a tuberculosis hospital and becoming a grant-making foundation, the bequest lapsed.

of those governing a public charity reasonably is the point of substantial departure by the governors (or Board) from the dominant purpose of the charity."¹²

In Taylor, the court considered a contractual affiliation between a nonprofit hospital and university medical center which involved selling the hospital's existing facility and buying a new one on the medical center campus. Although the court upheld the board's decision to affiliate with the medical center, it did so only in light of several express findings indicating that the affiliation was not a substantial departure from the corporation's dominant charitable purpose. Indeed, the court found that, under the affiliation agreement, the corporation would maintain its independence and control over its hospital operations and would "continue to perform its present functions and render its present services without change."¹³

On the other hand, where a nonprofit corporation whose dominant purpose has been the operation of a hospital proposes to sell the hospital and use the sale proceeds for a fundamentally different purpose – for example, to endow a grant-making foundation – it finds itself clearly on the other side of the "point of demarcation" defined by the court in Taylor. In this situation, the nonprofit hospital corporation is not seeking merely to modify the circumstances under which it supplies hospital services, but rather is getting out of the hospital

¹² Taylor v. Baldwin, 247 S.W.2d 741, 750 (Mo. 1952).

¹³ Id. at 752. The affiliation contract provided that the hospital's "Board of Directors retain all jurisdictional powers incident to separate ownership, including selection of the directing head or administrator of the hospital. . . ." Id. at 753. Moreover, the court found that the hospital board would retain "complete power and control over the professional policies of the hospital, and of all appointments to, and the government and supervision of the medical staff of the Hospital." Id. Thus, the court's refusal to treat the affiliation as a substantial departure from the corporation's dominant charitable purpose was well grounded in the facts of this particular case.

business all together.¹⁴ As the foregoing authorities make clear, the directors do not have the authority to make such a change without court approval.

There are as yet no reported cases applying the foregoing analysis to the relatively recent phenomenon of so-called whole hospital joint ventures with for-profit hospital corporations. The terms of these joint venture transactions, including the degree to which the nonprofit will remain involved in managing the hospital once it is owned by the joint venture, vary greatly. However, the nonprofit typically gives up control of its hospital, transferring the hospital to the joint venture in return for cash plus a passive investment interest in the joint venture. In such cases, the change in use of the charity's assets is usually substantially equivalent to that involved in a traditional asset sale. Hence, the authority discussed above requiring prior court approval for fundamental changes in corporate purpose should be applicable to these joint venture transactions as well.

In sum, the directors of a nonprofit hospital corporation or hospital holding company do not have the authority to consummate a sale or joint venture transaction through which the corporation disposes of its hospital operations without obtaining prior court approval in a *cy pres*-type proceeding. Where a nonprofit hospital corporation proceeds with such a transaction without prior court approval, state courts have the authority both to enjoin the transaction and to hold the nonprofit's directors liable for breach of fiduciary duty.

¹⁴ See Greil Mem. Hosp. v. First Alabama Bank of Montgomery, *supra*, note 7, in which the Supreme Court of Alabama found that conversion to a grant-making foundation constituted the total abandonment of the corporation's sole purpose.

B. Directors' Duty of Care in Approving Nonprofit Hospital Sales

Wholly apart from the duty of fidelity to the donors' intent imposed on them by the law of charitable trusts, directors of charitable corporations must fulfill their duty of care to the corporation. The standards applicable to directors of nonprofit corporations in fulfilling this duty are generally said to be the same as those applied to directors of for-profit corporations. In virtually all states, the duty of care for both nonprofit and for-profit directors requires that the director act with the care an ordinarily prudent person would exercise in similar circumstances.¹⁵

In the context of for-profit corporations, the courts have developed a strong policy – known as the "business judgment rule" – against second-guessing director's decisions. The business judgement rule raises a "presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company."¹⁶ This presumption does not mean, however, that directors' actions are not subject to judicial review. Indeed, in the leading case on the application of the business judgement rule to major transactions involving the sale of an entire corporation or its assets, Smith v. Van Gorkom, the Supreme Court of Delaware held that the rule does not protect decisions by board members who have breached their duty of care by failing to obtain sufficient information to make an informed business judgment.¹⁷ Thus, while

¹⁵ See, e.g., Conn. Gen. Stat. ' 33-447(d); NY Not-for-Profit Corp. Law ' 717; Mass. Gen. Laws, Ch 180 ' 6C; New Jersey Nonprofit Corp. Act ' 15A:6-14; Mont. Non-Profit Corp. Act ' 35-2-416; Revised Model Nonprofit Corporations Act ' 8.30. See also Paterson Gen. Hosp., 235 A.2d at 494 (refusing to enjoin relocation of non-profit hospital, since directors' "reasonable" decision had not breached duties of care and loyalty).

¹⁶ Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

¹⁷ 488 A.2d 859, 873 (Del. 1985).

the board's substantive decision is generally insulated from judicial scrutiny, the business judgement rule leaves room for the courts, and consequently attorneys general, to review the process by which those decisions are made.

In Smith v. Van Gorkom, the court found that the directors of a business corporation had breached their duty of care when they approved a cash sale of their corporation which the corporation's chairman/chief executive officer had negotiated. In reviewing the board's action, the court stressed that: (1) the board had not adequately informed itself about the CEO's role in framing the deal and suggesting the purchase price to the buyer, (2) they had not adequately informed themselves about the value of the corporation, and (3) their decision had been made too quickly.¹⁸

In later cases, the Delaware court has continued to give special scrutiny to directors' decisions involving transactions in which control of the company will change hands.¹⁹ The reason for this heightened judicial concern is, of course, the fear that the management and directors of a selling corporation will evaluate competing offers more in terms of the treatment they expect to receive personally from new management than in terms of the corporation's best interest. The case law in this area is clear that in any transaction involving a change in control "the duty of the directors is to get the highest value reasonably attainable for the shareholders."²⁰

¹⁸ Id. at 874.

¹⁹ See Revlon v. MacAndrew & Forbes Holdings, 506 A.2d 173 (1986); Paramount v. QVC, 637 A.2d 34 (Del. 1993).

²⁰ See Paramount at 46. In transactions involving a change in control of a charitable corporation, the beneficiary of the value maximization rule would necessarily be the corporation's charitable purposes – since there are no shareholders. Given the very different nature of this "interest," it seems reasonable that the "value" maximized should be broadly defined to include considerations other than the purchase price. For example, it appears likely

At a minimum, this duty would require considering all available offers.²¹

From these general principles flow a series of more specific obligations that nonprofit hospital directors must meet if they are to discharge their duty of care with regard to a sale or joint venture transaction. First, directors must determine whether the officers on whom they rely for information about the transaction have any conflict of interest – for example, a promise of future employment from the prospective purchaser – that might color their judgment in recommending the transaction. Further, the directors must carefully ascertain the value of the assets they intend to sell or contribute to a joint venture. Given the complexity of this task, ordinary prudence clearly requires the directors to obtain an independent evaluation by a competent expert.²² Moreover, the requirement that the directors maximize the value the corporation receives requires directors carefully to consider all competing offers and to either accept the highest offer or be able to demonstrate a principled reason, rooted in the charitable purposes of the organization, for choosing another buyer. Finally, decisions as momentous for the organization as the decision to terminate its dominant activity require considerable deliberation, and directors need to be able to demonstrate that they have duly considered the ramifications of any such transaction.

Where directors fail to meet their duty of care, they may be held personally liable for breach of fiduciary duty. Attorneys general have both the authority and the duty to initiate

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that a board could, consistent with its duty of care, accept a lower bid, provided it could show that its choice was based on the belief that the chosen bidder would provide a higher level of service to the community.

²¹ See *id.* at 51.

²² See *Doyle v. Union Ins. Co.*, 277 N.W.2d 36, 41-44 (1979)(directors liable for breach of the duty of care for

such actions for breach of duty.

C. The Attorney General's Authority to Require Advance Review and Approval of Hospital Sale and Joint Venture Transactions.

Under the common law and by statute in many states, attorneys general are charged with the responsibility of overseeing the use of charitable assets. The authority vested in attorneys general to enforce charitable trusts and protect charitable assets is deeply rooted in the *parens patriae* power of the state to protect the public interest in assets pledged to public purposes. Thus, it is uniformly recognized that attorneys general have "an historic right and duty to supervise charitable trusts and to maintain such actions as may be appropriate to protect the public interest therein."²³ Indeed, in most states they are the only party authorized to fulfill this important role.²⁴

As discussed in detail above, a nonprofit hospital corporation must obtain advance court approval for hospital sale or joint venture transactions, and the attorney general is automatically a party to such proceedings. Likewise, the attorney general has the authority to bring breach of duty actions against nonprofit hospital directors who fail to meet their duty of care in approving

(..continued)

approving the sale of substantial corporate assets without obtaining an expert appraisal).

²³ Brown v. Memorial National Home Foundation, 329 P.2d 118, 132 (Cal. Ct. App. 1958).

²⁴ Kirby v. Kirby, 1989 WL 110541 at 1 (Del. Ch. 1989); Sarkeys v. Independent School District No. 40, Cleveland County, 592 P.2d 529, 533-34 (Okla. 1979); Nacol v. State, 792 S.W.2d 810 (Tex. Ct. App. 1990).

In a few cases, however, courts have granted standing to challenge actions by directors of nonprofit hospitals to parties who benefit or might benefit from the hospital's services on the grounds that they have a "special interest" in the operation of the hospital. City of Paterson v. Paterson General Hospital, 235 A.2d 487 (N.J. 1967); Town of Cinnaminson v. First Nat'l Bank and Trust Co., 238 A.2d 701 (N.J. Super. 1968); Stern v. Lucy Webb Hayes Nat'l Training School for Deaconesses and Missionaries, 367 F. Supp. 536 (D.D.C. 1974).

a sale or joint venture transaction.

The attorney general's legal authority to bring suit against nonprofit hospital directors who consummate a sale or joint venture transaction without court approval and/or without meeting their duty of care provides the attorney general with substantial leverage to require the parties to proposed hospital conversions to submit such transactions to the attorney general for advance review and approval. Faced with the prospect of a potentially protracted challenge by the attorney general to its petition for an authorization of new use, or a breach of duty action if it proceeds without court approval, nonprofit hospital corporations will almost certainly opt to comply with reasonable requirements for advance review and approval.

Consistent with the attorney general's broad *parens patriae* power to protect the public interest, the attorney general's advance review of proposed hospital sale and joint venture transactions need not be limited to a review of whether the directors have met their duty of care or whether the technical requirements for *cy pres* approval of a change in use are present. On the contrary, the attorney general has both the duty and the bargaining leverage to require the parties to submit to a comprehensive advance determination of whether the proposed transaction is in the public interest.

The central objectives of this advance review should be to: (1) safeguard the value of the charitable assets, (2) safeguard the community from loss of essential health care services, and (3) ensure that the proceeds of the transaction are used for appropriate charitable purposes. A set of proposed Guidelines for this advance review process is attached under Tab 4.

D. Leveraging the Attorney General's Oversight Capacity

In many states, charity regulators will have to deal simultaneously with multiple hospital sale and joint venture transactions. In most states it will be difficult, if not impossible, for regulators to effectively police these complex transactions within existing budget constraints. Accordingly, regulators need to consider strategies to augment their existing regulatory capacity.

First, as suggested in the proposed Guidelines, the attorney general should consider requiring the parties to a proposed hospital sale or joint venture transaction to fund an independent expert, to be selected by the attorney general, to review the overall fairness of the transaction from the nonprofit's perspective. The cost of such a review, while substantial, will not be unduly burdensome relative to the overall transaction costs borne by the parties.

Second, where state law permits, the attorney general should also consider the use of relator actions to augment the attorney general's limited enforcement capacity. A relator is a private party authorized to bring suit in the name of the state or the attorney general when the right to sue is vested exclusively in the attorney general.²⁵ Although the rule appears to be that the ability to authorize relator actions exists only by statute, at least one leading case indicates that the attorney general can consent to a suit in the name of the people by a private party even in the absence of statutory authority and that such consent may be informal.²⁶

From the perspective of an attorney general seeking a means of prosecuting charitable

²⁵ Brown v. Memorial National Home Foundation, 329 P.2d 118, 133 (Cal. Ct. App. 1958). See also James J. Fishman, The development of Nonprofit Corporation Law and an Agenda for Reform, 34 Emory Law Journal 617, 671 (1985).

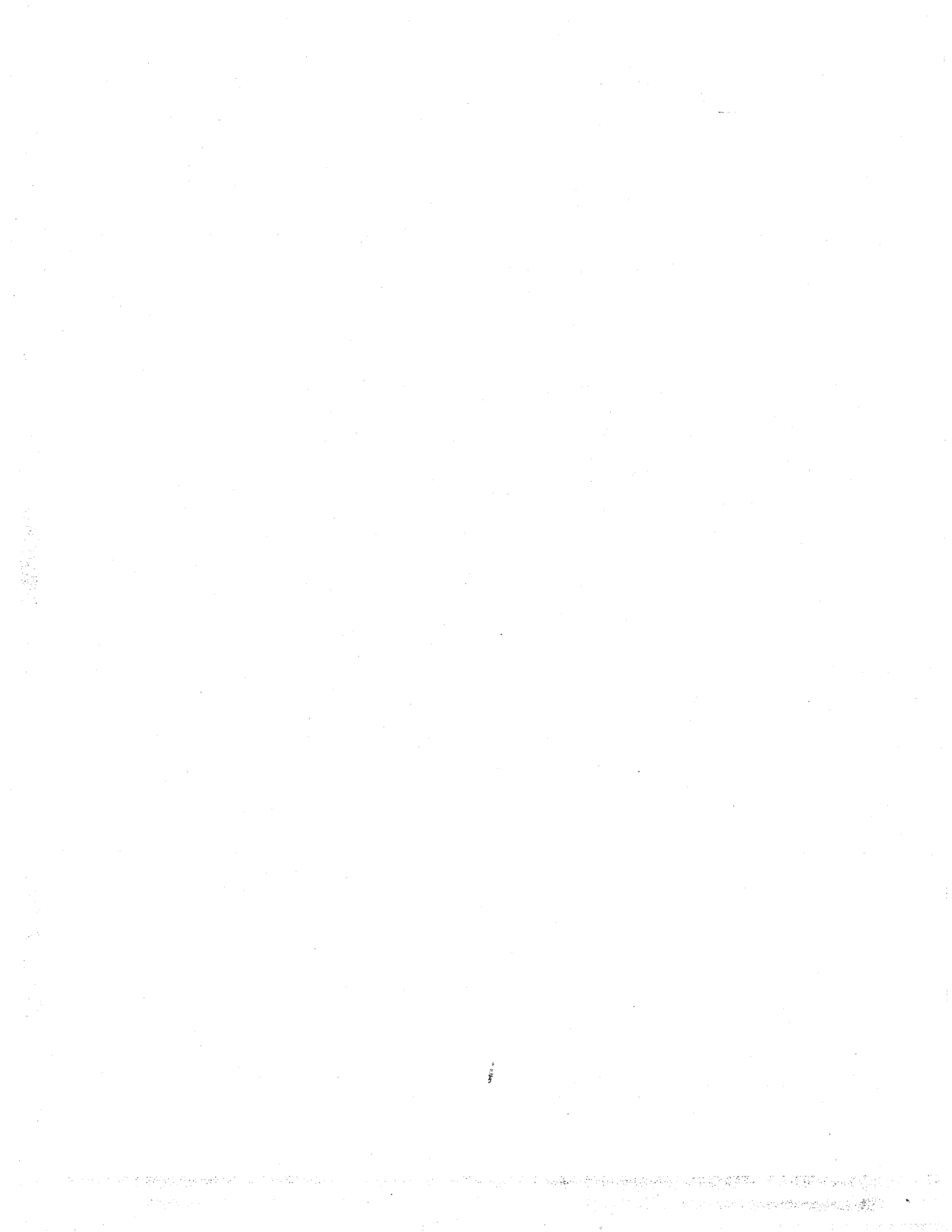
²⁶ Id.

enforcement cases without depleting his or her litigation budget, the advantage of relator actions is that the relator bears the cost of the suit while the attorney general retains ultimate control of the litigation.²⁷

IV. Conclusion

As a large and increasing number of nonprofit hospitals and HMOs enter into various types of sale, joint venture, and conversion transactions, state attorneys general face the challenge of policing the largest redeployment of charitable assets in history. The clear legal authority of state attorneys general to bring suit against nonprofit hospital directors who proceed with a sale or joint venture transaction without court approval – combined with the parties' presumptive desire to avoid a prolonged legal challenge – translates into substantial leverage for the attorney general to require that the parties submit proposed transactions for advance review and approval and to impose a variety of requirements as conditions for granting that approval. The goals of this review should be to safeguard the value of the charitable assets, protect the community from loss of essential health care services, and ensure that the proceeds of the transaction are used for appropriate charitable purposes. The attached Guidelines outline a process for achieving these important goals.

²⁷ Sarkeys v. Independent School District No. 40, Cleveland County, 592 P.2d 529, 533-34 (Okl., 1979)



**PROPOSED GUIDELINES FOR STATE REGULATORS' OVERSIGHT
OF SALE AND JOINT VENTURE TRANSACTIONS IN WHICH THE
ASSETS OF NONPROFIT HOSPITALS OR HMOs ARE TRANSFERRED
TO FOR-PROFIT ENTERPRISES¹**

State charity regulators have strong authority for taking the position that where a nonprofit hospital or HMO corporation or holding company proposes to sell its assets or enter into a whole hospital joint venture, the nonprofit must obtain advance court approval in a *cy pres*-type proceeding – a proceeding in which the attorney general is automatically a party.² State regulators should publicly state that they will (1) oppose favorable court action on a *cy pres* petition, and (2) bring a breach of fiduciary duty action against nonprofit directors who consummate a sale or joint venture transaction without court approval, unless the parties to the proposed transaction have submitted the proposed transaction for advance review and approval subject to the groundrules outlined below.

The central objectives of the state regulator's oversight should be (1) safeguarding the value of the charitable assets, (2) safeguarding the community from loss of essential health care services, and (3) ensuring that the proceeds of the transaction are used for appropriate charitable purposes. The following procedures are designed to accomplish these objectives.

I. Safeguarding the Value of Charitable Assets

Independent review of the fairness of the transaction. Determining the reasonableness of a proposed hospital sale or joint venture transaction requires: (1) a thorough understanding of the terms of the proposed transaction and of all collateral arrangements, (2) careful assessment of the short- and long-term risks that the nonprofit would assume as a result of the transaction, (3) an independent determination of the value of the operations and assets being transferred by the nonprofit to the for-profit, and (4) a determination of the overall fairness of the transaction from the perspective of the nonprofit.

These are complex questions on which state regulators will need expert advice in order to reach an informed judgment. Accordingly, regulators should require the parties: (1) to disclose to the regulator the complete terms of the proposed transaction and all collateral arrangements, and (2) to fund the cost of an independent review, by experts selected by the regulator, of the fairness of the proposed transaction to the charity.

Submission of a valuation report. As a basis for this independent review, and as evidence of the exercise by the directors of their duty of care, the nonprofit hospital, HMO, or holding company should be required to submit a detailed written valuation report.

Degree of risk to charitable assets. A major focus of review should be to determine whether the proposed transaction exposes the nonprofit's assets to inappropriate economic risks associated with the future operations of the for-profit purchaser. This issue will be of particular

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² The legal basis for this position is discussed in detailed in an accompanying legal memorandum entitled, "State Attorneys General's Legal Authority to Police the Sale of Nonprofit Hospitals and HMOs." See Tab 2.

importance in transactions in which the nonprofit becomes a passive investor in a joint venture transaction, and thus proposes to enter into a long-term economic relationship with the for-profit purchaser. It is also a major concern in asset sale transactions in which the charity does not receive the full purchase price at closing. Regulators should consider whether the nonprofit is adequately compensated, in the form of a higher rate of return, for its assumption of significant economic risk, and whether, even where this is the case, the absolute level of risk being assumed by the nonprofit is greater than is prudent for a charitable investor.

Disclosure of conflicts of interest. In assessing the fairness of the proposed transaction to the charity, it is important that the regulator be aware of any conflicts of interest. Accordingly, the regulator should require the nonprofit to submit a conflicts disclosure statement identifying any officers, directors, or affiliates who have direct or indirect economic interests in the transaction and, for each such person, describing the nature of the interest. This required disclosure should include the disclosure of any promises or discussions of future employment.

Consideration of other offers. Where the directors of a nonprofit hospital or HMO corporation or holding company have decided to sell the hospital or HMO operations, they have a duty to give careful consideration to all competing offers. To stimulate multiple offers, the regulator should generally require the nonprofit to make a public announcement, at the time it provides initial notice to the regulator of the proposed transaction, that it is considering a possible sale or joint venture transaction and inviting other potential purchasers or joint venture partners to submit competing proposals. Further, where the nonprofit receives such competing proposals, the regulator should require the nonprofit to submit a written report explaining the grounds for the board's decision for selecting between or among these proposals. Finally, the independent analysis of the proposed transaction commissioned by the regulator should consider all competing offers.

II. Safeguarding the Community from Loss of Essential Health Care Services

Determination of appropriate safeguards for the continuation of essential health care services. The community served by a nonprofit hospital that proposes to enter into a sale or joint venture transaction may depend on the nonprofit for essential health care services. For example, the nonprofit may operate the only emergency room in the community or provide substantial amounts of uncompensated care. In determining whether to recommend approval of the proposed transaction, the regulator should consider whether it is appropriate to require the for-profit purchaser/joint venture partner to agree, as a condition for court approval, to continue to provide specified services. Where the for-profit agrees to such conditions, the regulator should consider establishing an appropriate enforcement mechanism, including requiring the for-profit to bear the cost of a periodic independent audit of its compliance with these conditions.

Public hearing and/or solicitation of public comment. To provide the basis for a more informed judgment about the transaction's effect on community access to essential services, the regulator should hold a public hearing and/or invite the submission of written comments on the transaction. The public statement announcing the hearing should provide the public with a summary description of the proposed transaction and invite comment on whether the transaction is in the best interest of the community.

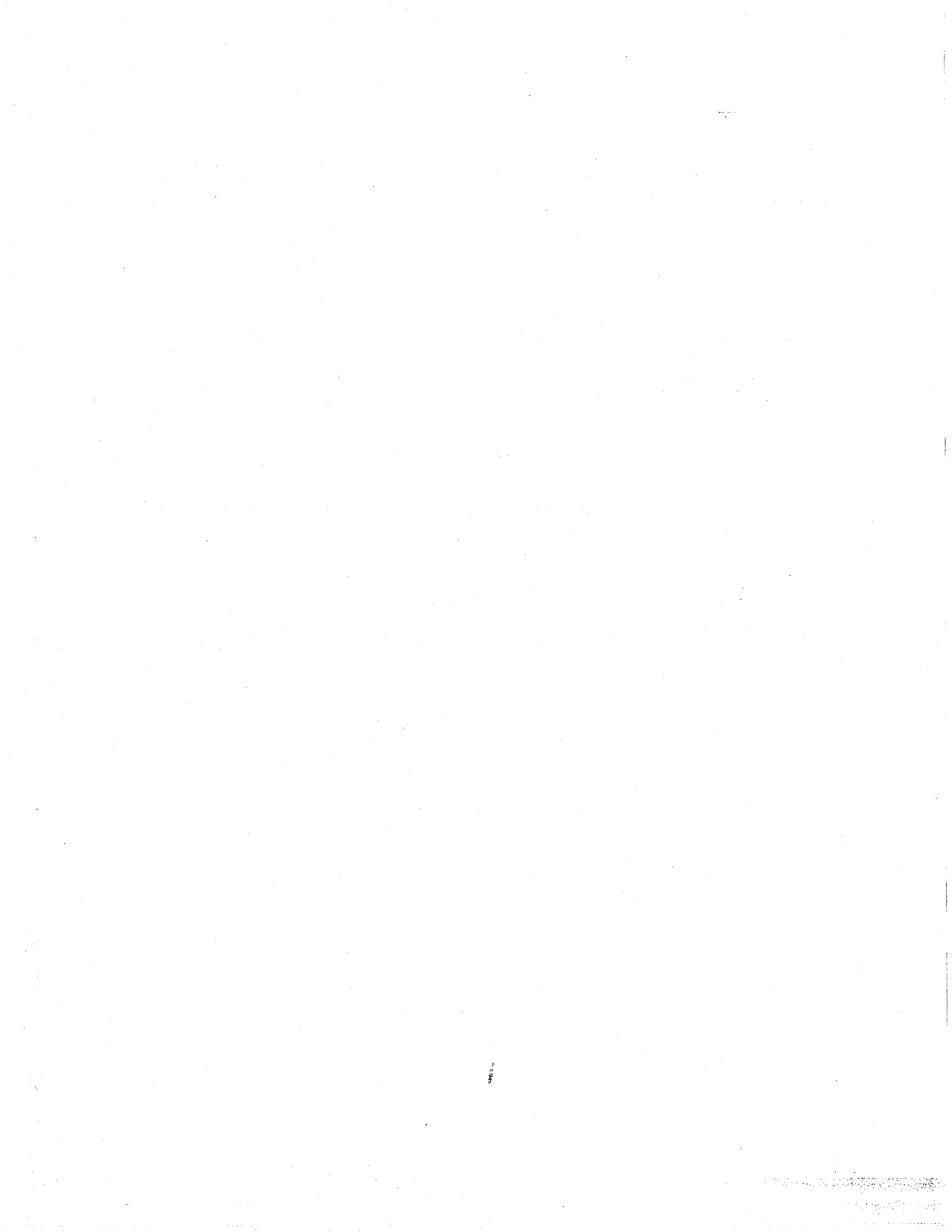
III. Ensuring That the Proceeds of the Sale Are Used for Appropriate Charitable Purposes

Ensuring that sale proceeds are not used for the private benefit of the for-profit purchaser. The regulator should ensure that the charitable entity that receives the proceeds of the transaction is not subject to direct or indirect influence or control by the for-profit purchaser. For example, the purchaser should not be represented on the nonprofit's board or have a legal right to require the nonprofit to fund the cost of uncompensated care or other services provided by the purchaser.

Charitable purposes for which the sale proceeds will be used. As a general matter, it is probably preferable to provide the nonprofit trustees considerable flexibility in using the sale proceeds to respond to changing community health care priorities. However, in some cases it may be appropriate for the regulator to recommend that some or all of the sale proceeds be dedicated to quite specific needs. In addition, as noted above, the regulator should ensure that the sale proceeds are not subject to inappropriate risk with respect to the future operations or capital requirements of the for-profit purchaser.

Governance and oversight of the nonprofit entity that receives the sale proceeds. In addition to ensuring that the nonprofit entity receiving the sale proceeds is neither influenced nor controlled by the for-profit purchaser, the regulator may also find it appropriate to limit, both by number and length of service, the participation on the board of the successor nonprofit of persons who were involved in negotiating the sale transaction. Regulators should also exercise close continuing oversight over the operations of the successor nonprofit, including requiring it to prepare and submit to the attorney general, and make available to the public, an annual report describing its charitable and investment activities.

September 19, 1995





**SALES OF CHARITABLE ASSETS TO
FOR-PROFIT ENTITIES - REVIEW PROTOCOL**

Pursuant to the provisions of the Non-Profit Public Benefit Corporation Law (Corporations Code section 5000 et seq.), the approval of the Attorney General is not required as a condition of the sale of charitable assets. Rather, this decision is left to the discretion of the charitable corporations's Board of Directors (Corporations Code section 5911). The sole procedural requirement under the law in this respect is that the Attorney General be provided with 20-days' notice of the transaction if it involves all or substantially all of the charity's assets. (Corporations Code section 5913).

Notwithstanding these limitations, the Attorney General has authority to fully review the transaction, to obtain all relevant information and data, and to take appropriate action to remedy a breach of trust, should such occur. (Corporations Code sections 5142; 5250). In this regard, the role of the Attorney General is not to make public policy, but rather to enforce the provisions of the Non-Profit Public Benefit Corporation Law and California trust law so as to fully protect the charitable assets for the benefit of the public, who are the beneficiaries of all charitable trusts.

This protocol is for use by the attorneys and auditors within the Charitable Trust Section. It is not intended to be a complete or exclusive list of items to be reviewed and/or investigated, as these will vary on a case-by-case basis. Instead, it is intended to provide broad, general guidelines with respect to issues which are commonly found in such transactions.

I. INFORMATION GATHERING

Prior to the substantive review, care should be taken to obtain all necessary information and data relevant to the transaction. These generally include:

- A. All sale documents, including all collateral or ancillary agreements that may involve officers, directors, or employees, e.g., employment contracts, stock option agreements in the acquiring for-profit entity, etc. Where there are related business entities (partially or wholly-owned subsidiaries, related corporations, partnerships, etc), whether non-profit or for-profit, all necessary documents to determine the effect on these entities must also be obtained.

- B. Financial documents, including audited financial statements, ownership records, business projection data, current capital asset valuation data (marked to market), and any other records upon which future earnings, existing asset values and fair market value analysis can be based. Again, where there are related entities (non-profit or for-profit), similar data should be obtained for them.

- C. Relevant major contracts (assets and liabilities) which may affect value. These should include not only business contracts, but also employee contracts including buy-out provisions, profit-sharing agreements, etc.

- D. With respect to the acquiring entity, all ownership information necessary to determine whether there is a wholly independent third party involved in an arms-length acquisition or whether statutory self-dealing provisions apply. (Corporations Code section 5233). Particular attention should be paid where the acquiring entity is also acquiring additional interests in related companies or partnerships in which officers, directors or employees may have an ownership interest.
- E. In sales which are not "all cash to seller", all documents relating to the non-cash elements (stock, notes, etc.) should be obtained, including all necessary valuations of security for loans, stock restrictions, etc.
- F. All information, including Articles of Incorporation, bylaws, endowment fund documentation, trust restrictions, expenditure history, and other information necessary to define the trust upon which the selling charity's assets are held. In addition, all documentation regarding the process by which Board approval of the transaction was obtained should be reviewed.
- G. Tax-sensitive information, including the existence of tax-free debt which must be redeemed, disqualified person transactions yielding tax liability, etc.

H. With respect to the remaining or successor charity, similar information to that contained in Paragraph F. In addition, all information with respect to officers, directors, and employees (both current and post-sale) in order to determine independence, Board make-up, charitable purposes, and to review any financial arrangements with officers, directors, or employees which may be affected by the transaction. Particular attention should be paid to financial arrangements which might affect an individual's objectivity in supporting or approving the transaction.

I. Information from the beneficiary class and/or representatives thereof to insure that the sale proceeds are utilized for purposes consistent with the charitable trust for which they are held and that the beneficiary class remains constant. While the Non-Profit Public Benefit Corporations Law provides no statutory or regulatory authority to hold hearings in this regard, informal public input is usually readily available and should be obtained.

II. SUBSTANTIVE REVIEWS

A. Fiduciary Standards

1. Self-Dealing Transactions -

Initially a review should be conducted to determine if the transaction involves self-dealing. If so, strict compliance with the provisions of Corporations Code section 5233 is required.

Normally, the insider-purchasers and the charity should have separate counsel, separate valuation consultants, etc. Special concern should exist in those cases where no attempt has been made to expose the transaction to potential outside purchasers through employment of investment bankers, etc.

In all cases, independent directors (and this office) should be provided with independent valuation information and should exercise diligence to insure that the proposed transaction is the most advantageous available. (Corporations Code section 5233(d)(2)(D)).

2. Arms-Length Transactions -

Where the sale is to an independent third party in an arms-length transaction, the directors' decision is guided by the fiduciary standards set forth in Corporations Code section 5231. (See also Corporation Code section 5911).

- a. Initial review should concentrate on the duty of reasonable inquiry. Key elements should include whether appropriate and adequate consultants were retained to evaluate the benefit to the charity, valuation, tax consequences, etc.
- b. Special attention should be paid where there has been no legitimate effort to market the charitable asset widely to insure maximum return.

B. Specific Transactional Issues

1. Terms and Conditions of Sale

All terms and conditions of the sale should be carefully scrutinized.

Particular emphasis should be placed on the following:

- a. Contingencies which affect the purchase price.
- b. Indemnification provisions.
- c. Where stock (in lieu of cash) represents a significant portion of the sales price, issues of control, restrictions on sale, possible adverse tax consequences (redemption of tax-free bonds, minimum pay-out requirements, transactions involving disqualified persons, etc.), possible future dilution of interest (through stock options, retention of treasury stock, etc.), lack of liquidity, imprudent concentration of assets in a single holding, discount for minority interest, voting versus non-voting stock and related tax issues, etc., need to be considered.
- d. Where notes (in lieu of cash) are involved in the sale proceeds, security, discount to present value, marketability of note, tax consequences, etc., need be considered.
- e. Where related entities exist (e.g. co-owned partnerships, or corporations, wholly or partially-owned subsidiaries, etc.), special attention should be paid to the terms and conditions of sale so as to insure that arbitrary and/or unfavorable allocations

of assets, liabilities, costs, or proceeds are not used to reduce the charity's share of the total purchase price.

- f. Where the final purchase price is related to future earnings, special protections are often necessary to prevent unfavorable allocations of costs or corporate expenditures to depress earnings over the short-term.

2. Fair Market Value -

This is the key issue in most cases. A useful definition is found at Code of Civil Procedure section 1263.320. Simply put, the charitable beneficiaries are entitled to receive maximum value for their assets. Since we are normally dealing with valuation of a "going business concern", key items include:

- a. Make sure all assets are "marked to market" and not carried at book value (this is particularly important regarding land and securities).

- b. Future earnings are a key element of value -- as such, projected earnings, business plans, anticipated contracts, and sale timing are crucial.
- c. Whether the asset has been aggressively marketed by investment bankers, etc., in an attempt to generate multiple bidders and maximum value.
- d. Whether there are competing offers.
- e. Whether business valuation appraisals have been obtained and whether they include stock offerings, IPO values, and comparable sales, including control premiums, etc.
- f. Normally inadequate professional assistance, e.g., investment bankers, accountants, valuation analysts is indicative of lack of reasonable inquiry and due diligence.
- g. Values are normally estimated within ranges. If at the lower end of the range, look for overly lucrative officer, director, employee contracts, overly lucrative buy-outs of related, non-

wholly-owned subsidiaries or entities, etc., at the expense of the charitable interest.

- h. Non-cash transactions need to be scrutinized with special care to obtain an equivalent cash value. (See B. 1. c. and d. herein.)
- i. Be alert to specific items peculiar to non-profits that can depress earnings and which may cease immediately upon sale (e.g., indigent care in hospital sales). These items should be factored out if not mandated to continue by the purchase agreement so as to avoid understating value.

3. Inurement -

All transactions should be investigated to insure that no officer, director, employee, spouse or family member, or private party receives inurement from the transaction. Key areas of inquiry normally include:

- a. Stock options;
- b. Pension plans and perquisites;

- c. Performance bonuses;
- d. Corporate loans;
- e. Golden parachute provisions;
- f. Excessive salaries;
- g. Side deals for officer, director, employee private ventures;
- h. Over-market compensation for employee-owned related entities.
(See B.1.a.; B.2.a.).
- i. A related issue is whether post-sale employment terms at the remaining (or successor) charity affected objectivity in approving the transaction.

III. CHARITABLE TRUST ISSUES

A. Charitable Purposes

1. Attendant to the sale of charitable trust assets, it is important to insure that the sale proceeds are used for their proper purposes. In this regard, all restricted funds must remain segregated and used for their restricted purposes. With respect to general corporate funds, the remaining (or successor) charity must utilize the assets for a like charitable purpose benefitting the same class of beneficiaries, e.g., health care, education, low-cost housing, etc. Obviously any newly created charity must have the same purposes and same dedication clause as its predecessor.

2. In those instances where a sale of assets results in the reallocation of funds from an operational use to a grant-making use, it is particularly important to insure that a constancy of purpose is maintained. Where specific charitable purposes are likely to be lost or significantly diminished by the sale of assets, restrictions should be placed on the sale proceeds to mitigate those losses and to insure that those charitable purposes continue.

B. Prevention of Conflicts

1. Charity-Acquiring Entity Contracts

Where sale proceeds are tied to the provision of services by the acquiring for-profit entity (e.g., health services to the poor in lieu of cash or guaranteed payments by the charity to the acquiring entity for indigent services), they should be carefully scrutinized for necessity, valuation, and verifiability. These provisions are always suspect.

2. Non-Independent Charities

Acquiring for-profits should not be permitted to maintain control of the payment proceeds through the creation of a new controlled foundation or through appointments to the existing charity's Board. It is hardly an arms-length sale if the buyer controls the proceeds after sale.

3. Individual Conflicts

Inquiry should be made to attempt to insure that conflicts of interest do not exist between officers, directors, or employees of the charity and the acquiring entity.

C. Continuing Oversight

Since such sales often create new and extremely large charitable foundations, often with significant restricted funds, continuing oversight under normal charitable trust standards should be maintained to insure compliance with applicable laws.

IV. CONCLUSION

While Corporations Code section 5911 expressly authorizes the sale of charitable assets at the discretion of the corporation's Board of Directors, such authorization is subject to review by this office for compliance with the substantive provisions of the Non-Profit Public Benefit Corporations law. The fiduciary standards required of Directors should be firmly enforced. In doing so, we are most able to protect the public beneficiaries of charitable trusts.

AMENDED IN SENATE JULY 10, 1996
AMENDED IN SENATE JUNE 25, 1996
AMENDED IN ASSEMBLY MAY 8, 1996
AMENDED IN ASSEMBLY APRIL 18, 1996
AMENDED IN ASSEMBLY APRIL 10, 1996

CALIFORNIA LEGISLATURE—1995-96 REGULAR SESSION

ASSEMBLY BILL

No. 3101

**Introduced by Assembly Member Isenberg
(Principal coauthor: Assembly Member Knowles)
(Principal coauthors: Senators Killea and Kopp)
(Coauthors: Assembly Members Davis, Ducheny,
Goldsmith, and Morrow)**

February 23, 1996

An act to amend Section 5913 of, to add a heading of Article 1 (commencing with Section 5910) to, and to add Article 2 (commencing with Section 5914) to, Chapter 9 of Part 2 of Division 2 of Title 1 of, the Corporations Code, relating to public benefit corporations.

LEGISLATIVE COUNSEL'S DIGEST

AB 3101, as amended, Isenberg. Public benefit corporations: health facilities: sale of assets.

Existing law provides that a public benefit corporation may sell, lease, convey, exchange, transfer, or otherwise dispose of all or substantially all of its assets when the principal terms are approved by the board of directors and the members of the

corporation and by any other person whose approval is required by the articles, except as specified. Existing law requires a public benefit corporation to give written notice to the Attorney General 20 days before it sells, leases, conveys, exchanges, transfers, or otherwise disposes of all or substantially all of its assets, except as specified.

This bill would subject a *nonprofit corporation that is subject to the public benefit corporation law* and is a health facility or provides similar health care to additional requirements prior to the corporation entering into any agreement or transaction to sell, transfer, lease, exchange, option, convey, or otherwise dispose of a material amount of its assets to a for-profit corporation or entity or to a mutual benefit corporation or entity, unless the agreement or transaction is in the usual and regular course of the activities of the corporation or unless the Attorney General has given the corporation a written waiver of these requirements as to the proposed agreement or transaction.

The bill would require the corporation to notify the Attorney General. The bill would require the Attorney General to conduct a public meeting and to notify the corporation in writing of his or her decision to consent, conditionally consent, or not consent to the agreement or transaction. The bill would authorize the Attorney General to adopt regulations, to contract with, consult, and receive advice from any state agency, and to contract with experts or consultants.

The bill would require the public benefit corporation to reimburse the Attorney General for costs in complying with its provisions, upon request of the Attorney General.

Vote: majority. Appropriation: no. Fiscal committee: yes. State-mandated local program: no.

The people of the State of California do enact as follows:

- 1 SECTION 1. The Legislature finds and declares all of
- 2 the following:
- 3 (a) Charitable, nonprofit health facilities, including
- 4 nonprofit hospitals, hold all of their assets in trust, and
- 5 those assets are irrevocably dedicated, as a condition of

1 their tax-exempt status, to the specific charitable
2 purposes set forth in the articles of incorporation of
3 nonprofit entities.

4 (b) The public is the beneficiary of the trust on which
5 charitable, nonprofit health facilities hold their assets.

6 (c) Charitable, nonprofit health facilities have a
7 substantial and beneficial effect on the provision of health
8 care to the people of California, providing as part of their
9 charitable mission uncompensated care to uninsured
10 low-income families and under-compensated care to the
11 poor, elderly, and disabled.

12 (d) Transfers of the assets of nonprofit, charitable
13 health facilities to the for-profit sector, such as by sale,
14 joint venture, or other sharing of assets, directly affect the
15 charitable use of those assets and may affect the
16 availability of community health care services.

17 (e) The state Attorney General is entrusted by law to
18 bring actions on behalf of the public in the event of a
19 breach of the charitable trust of a nonprofit entity and to
20 represent the public in the sale or other transfer of the
21 assets of a nonprofit entity.

22 (f) It is in the best interests of the public to ensure that
23 the public interest is fully protected whenever the assets
24 of a charitable nonprofit health facility are transferred
25 out of the charitable trust and to a for-profit or mutual
26 benefit entity.

27 (g) The consent of the state Attorney General shall be
28 required for any transaction involving a nonprofit,
29 charitable health facility when a material amount of the
30 charitable assets are transferred to a for-profit or mutual
31 benefit entity.

32 SEC. 2. A heading of Article 1 (commencing with
33 Section 5910) is added to Chapter 9 of Part 2 of Division
34 2 of Title 1 of the Corporations Code, to read:

35
36 Article 1. General Provisions
37

38 SEC. 3. Section 5913 of the Corporations Code is
39 amended to read:

1 5913. Except for an agreement or transaction subject
2 to Section 5914, a corporation must give written notice to
3 the Attorney General 20 days before it sells, leases,
4 conveys, exchanges, transfers or otherwise disposes of all
5 or substantially all of its assets unless the transaction is in
6 the usual and regular course of its activities or unless the
7 Attorney General has given the corporation a written
8 waiver of this section as to the proposed transaction.

9 SEC. 4. Article 2 (commencing with Section 5914) is
10 added to Chapter 9 of Part 2 of Division 2 of the
11 Corporations Code, to read:

12
13 Article 2. Health Facilities
14

15 5914. (a) Any ~~public benefit corporation that~~
16 *nonprofit corporation that is subject to the public benefit*
17 *corporation law and is a health facility, as defined in*
18 *Section 1250 of the Health and Safety Code, or is a facility*
19 *that provides similar health care ; care, shall be required*
20 *to provide written notice to, and to obtain the written*
21 *consent of, the Attorney General prior to entering into*
22 *any agreement or transaction to do either of the*
23 *following:*

24 (1) Sell, transfer, lease, exchange, option, convey, or
25 otherwise dispose of, its assets to a for-profit corporation
26 or entity or to a mutual benefit corporation or entity
27 when a material amount of the assets of the public benefit
28 corporation are involved in the agreement or transaction.

29 (2) Transfer control, responsibility, or governance of
30 a material amount of the assets or operations of the
31 nonprofit public benefit corporation to any for-profit
32 corporation or entity or to any mutual benefit corporation
33 or entity.

34 (b) The notice to the Attorney General provided for
35 in this section shall include and contain the information
36 the Attorney General determines is required.

37 (c) This article shall not apply to a public benefit
38 corporation if the agreement or transaction is in the usual
39 and regular course of its activities or if the Attorney

1 General has given the corporation a written waiver of this
2 article as to the proposed agreement or transaction.

3 5915. Within 60 days of the receipt of the written
4 notice required by Section 5914, the Attorney General
5 shall notify the public benefit corporation in writing of
6 the decision to consent to, give conditional consent to, or
7 not consent to the agreement or transaction. The
8 Attorney General may extend this period for one
9 additional 45-day period, provided the extension is
10 necessary to obtain information pursuant to subdivision
11 (a) of Section 5919.

12 5916. Prior to issuing any written decision referred to
13 in Section 5915, the Attorney General shall conduct one
14 or more public meetings, one of which shall be in the
15 county in which the facility is located, to hear comments
16 from interested parties. At least 14 days before
17 conducting the public meeting, the Attorney General
18 shall provide written notice of the time and place of the
19 meeting through publication in one or more newspapers
20 of general circulation in the affected community and to
21 the board of supervisors of the county in which the facility
22 is located.

23 5917. The Attorney General shall have discretion to
24 consent to, give conditional consent to, or not consent to
25 any such agreement or transaction described in
26 subdivision (a) of Section 5914. In making the
27 determination, the Attorney General shall consider any
28 factors that the Attorney General deems relevant,
29 including, but not limited to, whether any of the following
30 apply:

31 (a) The terms and conditions of the agreement or
32 transaction are fair and reasonable to the nonprofit public
33 benefit corporation.

34 (b) The agreement or transaction will result in
35 inurement to any private person or entity.

36 (c) Any agreement or transaction that is subject to this
37 article is at fair market value. In this regard, "fair market
38 value" means the most likely price that the assets being
39 sold would bring in a competitive and open market under
40 all conditions requisite to a fair sale, the buyer and seller,

1 each acting prudently, knowledgeably and in their own
2 best interest, and a reasonable time being allowed for
3 exposure in the open market.

4 (d) The market value has been manipulated by the
5 actions of the parties in a manner that causes the value of
6 the assets to decrease.

7 (e) The proposed use of the proceeds from the
8 agreement or transaction is consistent with the charitable
9 trust on which the assets are held by the health facility or
10 by the affiliated nonprofit health system.

11 (f) The agreement or transaction involves or
12 constitutes any breach of trust.

13 (g) The Attorney General has been provided,
14 pursuant to Section 5250, with sufficient information and
15 data by the nonprofit public benefit corporation to
16 evaluate adequately the agreement or transaction or the
17 effects thereof on the public.

18 (h) The agreement or transaction may create a
19 significant effect on the availability or accessibility of
20 health care services to the affected community.

21 (i) The proposed agreement or transaction is in the
22 public interest.

23 5918. The Attorney General may adopt regulations
24 implementing this article.

25 5919. (a) Within the time periods designated in
26 Section 5915 and relating to those factors specified in
27 Section 5917, the Attorney General may do the following:

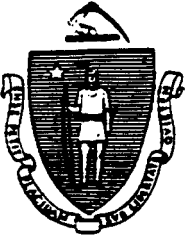
28 (1) Contract with, consult, and receive advice from
29 any state agency on those terms and conditions that the
30 Attorney General deems appropriate.

31 (2) In his or her sole discretion, contract with experts
32 or consultants to assist in reviewing the proposed
33 agreement or transaction.

34 (b) Contract costs shall not exceed an amount that is
35 reasonable and necessary to conduct the review and
36 evaluation. Any contract entered into under this section
37 shall be on a noncompetitive bid basis and shall be exempt
38 from Chapter 2 (commencing with Section 10290) of Part
39 2 of Division 2 of the Public Contract Code. The nonprofit

1 public benefit corporation, upon request, shall pay the
2 Attorney General promptly for all contract costs.
3 (c) The Attorney General shall be entitled to
4 reimbursement from the nonprofit public benefit
5 corporation for all actual, reasonable, direct costs
6 incurred in reviewing, evaluating, and making the
7 determination referred to in this article, including
8 administrative costs. The nonprofit public benefit
9 corporation shall promptly pay the Attorney General,
10 upon request, for all such costs.





SCOTT HARSHBARGER
ATTORNEY GENERAL

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Office of the Attorney General
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October 30, 1995

FOR-PROFIT CONVERSIONS AND ACQUISITIONS OF NONPROFITS:
ATTORNEY GENERAL ISSUES AND PROCEDURES

A) OVERVIEW OF ATTORNEY GENERAL'S ROLE

- 1) The Attorney General has the common law and statutory responsibility to enforce the due application of funds held by public charities within the commonwealth and prevent breaches of trust in the administration thereof. G.L. c. 12, §8 et seq.
- 2) All charities operating or raising funds in Massachusetts must register and file annual financial reports with the Division of Public Charities. G.L. c. 12, §§8E & 8F.
- 3) Attorney General shall be a party to all judicial proceedings in which he may be interested in the performance of his duties under the provisions of [G.L. c. 12, §§8 - 8M]. G.L. c. 12, §8G.
- 4) A public charity must give the Attorney General at least 30 days written notice before disposing of all or substantially all of its assets, if a material change in the nature of the activities conducted by the charity will result. G.L. c. 180, §8A. The purpose of this notice requirement is to give the Office of the Attorney General the opportunity to review these matters in an orderly fashion to determine prior to a transaction whether, in the office's view, court approval for such a change is required and, if so, whether court approval ought to be supported or opposed by the Attorney General.
- 5) A charity which desires to close its affairs must follow the dissolution procedure set forth in G.L. c. 180, §11A. This is the sole method for dissolution for all charitable corporations organized under any general or special law, not just corporations organized under c. 180. The Attorney General is a necessary party.

B) APPLICABLE CHARITIES LAW PRINCIPLES

- 1) All nonprofit hospitals and HMOs (including HMOs with Sec. 501(c)(4) rather than Sec. 501(c)(3) tax exemptions), and most other nonprofit health care providers, are public charities under Massachusetts law and are subject to the requirements discussed herein.
- 2) An otherwise charitable organization is not rendered noncharitable by the fact that it has never solicited or received any charitable contributions.
- 3) A charitable organization holds its assets in trust to be used in furtherance of the organization's nonprofit charitable purposes. The assets cannot inure to the organizations's members or other private parties.
- 4) If a charitable organization is going to dispose of a charitable asset, it must use proper care to obtain full fair value in return, or else obtain court permission.
- 5) A Massachusetts charitable organization may not, on its own, "convert" to for-profit status.
- 6) A charity does not have total freedom to change the use to which charitable assets are to be applied without court approval. A material change in the purposes to which charitable assets will be devoted may only be accomplished through a judicial cy pres proceeding.
- 7) A charity does not have total freedom to transfer the control of its assets to another organization (even to another charity) without authorization of either the legislature (e.g., merger pursuant to G.L. c. 180, §§10 - 10B) or else a court.
- 8) If charitable assets are to be transferred to a for-profit, it must be for fair value, with the board of the charity making a careful decision, without influence by board members or executives who have a financial interest in the outcome, that the transaction is necessary and in the best interest of the charity.
- 9) The resulting charitable assets must be applied by the charity to the same charitable purpose, or else the

charity must dissolve or obtain court approval for the changed use. The resulting charitable assets must not be used, directly or indirectly, for the benefit of the for-profit.

- 10) The charity fiduciaries (i.e., the board of directors and top executives) must adhere to the fiduciary duties of care and loyalty.

C) ATTORNEY GENERAL'S ISSUES

- 1) A significant asset transaction of this nature with a for-profit will receive close scrutiny by the Division. This includes joint venture arrangements as well as direct purchases.
- 2) In most cases, court approval is required. If the Office of the Attorney General is satisfied that the public interest will be served by the transaction, the Attorney General will assent to the request for court approval. If court approval is not sought by the charity, the Attorney General may ask the court to enjoin the transaction.
- 3) The standing to assert the public interest in this proceed rests exclusively with the Attorney General.
- 4) The issues on which the Attorney General's review focuses include the following:
 - a) is the for-profit acquisition a transaction that is permitted under general nonprofit and charities law? is the proposed disposition of the hospital's or HMO's assets sufficiently necessary to pass muster under state nonprofit and charities law? is the proposed disposition the best alternative available to the nonprofit?
 - b) was due care followed by the nonprofit in deciding to sell, in selecting the buyer, and in negotiating the transaction? did the nonprofit use appropriate expert assistance?
 - c) was conflict of interest avoided (including conflict by board members, key executives, counsel, retained experts)? E.g., financial interest in the buyer by board member or relative? doing business with or planning to do business with the buyer?

- d) did the charity obtain the best deal? will the nonprofit receive fair value for the nonprofit assets?
 - e) will the sale proceeds be used for appropriate charitable purposes consistent with the nonprofit's original purposes, and will the funds be controlled as charitable funds independently of the resulting for-profit?
 - f) will the transaction adversely affect access to affordable health care by residents of affected communities?
- 5) Subsidiary questions and considerations include:
- a) are the charity's PC filings up-to-date with the Division?
 - b) is the disposition prohibited under a trust provision? under an implied trust from fundraising?
 - c) were proper voting procedures under G.L. c. 180, §8A followed?
 - d) has the board considered less drastic alternatives than selling to a for-profit entity? Why sell? why not merge, etc. with another non-profit? would merger raise anti-trust concerns?
 - e) did the charity obtain the best deal? once the buyer was selected, did the charity take care to negotiate the best possible terms? should there be more of a bid process?
 - f) if top executives of the selling charity may be interested in employment with the resulting entity, what steps has the board taken to protect the integrity of the board's decision-making and of the information provided by the staff to the board? For example, has the board made sure that it, not the executive, is handling the negotiation? And, has the board taken steps to avoid the potential criticism that the charity was operated by the executives during the period leading up to the transaction in a way that devalued the nonprofit's business or assets in order to make the transaction better for the future employer?

- g) what financial arrangements are there between the charity and its experts? is compensation based on incentives that may be contrary to the charity's interests? has the expert had prior business dealings with the buyer? if the expert was suggested to the charity by the buyer, what is the history of prior engagements in which the same for-profit was a party?
- h) what is the buyer's history of prior acquisitions, joint ventures, and management arrangements with nonprofits?
- i) what assets are included in the transaction and which are excluded? what will be done with the remaining assets?
- j) is there sufficient protection in the terms against a subsequent "flip" sale by the for-profit buyer?
- k) in a joint venture, or in an outright sale that is financed in part by the charity, are charitable funds placed at risk to the financial success of the for-profit buyer or of the resulting entity?
- l) in a joint venture, if subsequent participation in the control of the venture is an important factor in the charity's decision to enter into the transaction, does the agreement clearly spell out the charity's share of the control? is the control subject to unilateral dilution by the for-profit? Does the control apply meaningfully to the issues that are important to the charity?
- m) in a joint venture, has the nonprofit retained a realistic option to sell its remaining interest to the for-profit for a fair price?
- n) in a joint venture, is the management contract with the for-profit for fair value?
- o) after debts and expenses are paid, what is the net amount that will remain in the resulting charitable fund?
- p) nonprofit money may not be used directly or indirectly for the benefit of the for-profit buyer. The nonprofit must operate independently

of the for-profit buyer, and the for-profit may not restrict or control the future use of the proceeds.

- q) what will be the structure and governance of the resulting charitable entity? what community role?
- r) is there sufficient protection against the buyer later closing down the hospital.
- s) how will health care quality and access to affordable care be maintained? what will be the hospital/HMO's policies regarding maintenance of services? regarding access to care? what will be the free care and community benefits policies? Does the resulting hospital/HMO support the Attorney General's community benefits guidelines for hospitals and HMOs?
- t) if physicians are going to be offered the opportunity to invest in the resulting entity, what will be the procedures to avoid conflict of interest in patient referral?

D) ATTORNEY GENERAL REVIEW PROCESS

- 1) The Public Charities Division urges charities and their attorneys to bring such transactions to our attention as early as possible, to avoid later delays in the transaction as the Division conducts its review. Formal notice under G.L. c. 180, §8A can be given at this time. Agreements between the buyer and the seller as to timelines or closing dealines cannot serve to prevent the Attorney General from conducting an appropriate review in the furtherance of the public interest.
- 2) The Division will want to know the complete terms of the transaction and all collateral arrangements, the complete process followed by the charity in the transaction, and the terms of competing offers that were not accepted.
- 3) The Division will want to see convincing evidence that the charity has followed a careful, conflict-of-interest-free process, and that each of the issues outlined in Part C(4), above, has been addressed.
- 4) The terms of the transaction must be disclosed in the pleadings in court. The best practice is for the

charity to share draft pleadings with the Division for discussion and negotiation.

- 5) In one of the two currently pending transactions, the Attorney General will be holding a public hearing (see attached hearing notice). In the other, the Attorney General invited public comment (see attached Massachusetts Register notice). In the case of either a public hearing or a public comment notice, sufficient information about the transaction must be made available to the public to enable the public to make informed judgments and articulate informed views.
- 6) In each of the two transactions pending at this writing, the Office of the Attorney General asked the parties in each transaction to make a payment into a fund from which the Office has hired health care acquisition experts to review the process followed by the seller and to advise the Attorney General as to whether fair value was obtained. Sufficient information must be provided by the parties to enable the experts to review the transaction adequately.
- 7) In the pending matters, the Division has engaged in formal discovery focusing on the issues outlined in Part C(4)(a)-(f), above, and has utilized requests for production of documents and interrogatories, as well as informal methods of information gathering. In appropriate situations, depositions may also be used.

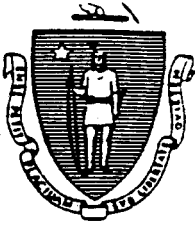
Discovery requests may be directed to the charity, its board members and senior executives, the charity's valuation experts, and the for-profit buying entity. When seeking discovery from for-profit buying entities, the Division will focus on issues of conflict of interest/inducement, history under prior transactions, community impact, and future community benefit.
- 8) The Division may require that the charity board members, executives and experts and the for-profit buying entity provide sworn certifications at specified times after the transaction as to financial or business relationships that may have occurred between the charity-related respondents and the for-profit buyer subsequent to the transaction.
- 9) The most appropriate entity to hold and control the charitable fund resulting from the purchase price may not necessarily be the former hospital or HMO directors. There is likely to be an intense local

feeling that the community has a stake in the future control and usage of the proceeds. Likewise, there is likely to be intense local community interest in the question of who will control the funds and the purposes to which they will be dedicated. Delicate community negotiations may be required. The Division is prepared to work closely with the charity on these issues.

A detailed discussion of the Attorney General's overall role with respect to public charities is contained in Allen, "Regulation of Public Charities & Fund-Raising", ch. 9, Massachusetts Nonprofit Organizations (1992) MCLE, Inc. (Frederic J. Marx, ed.) (hereinafter, "Regulation of Public Charities"). Similar chapters appeared in MCLE's "Dilemmas For Nonprofit Boards" (1993); "Lawyers for the Arts" (1994, 1992, 1990); "How to Incorporate and Counsel a Nonprofit Corporation" (1990); "Changes in Massachusetts' Venerable Non-Profit Corporation Statute" (1990).

For further background on the charities law issues affecting health care transactions, see Allen, "Charities Law Issues For Health Care Provider Transactions" in MCLE 's Health Law Update '94.

RA2.169



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April 1, 1996

The following is a summary of the agreement reached between Attorney General Scott Harshbarger, MetroWest Health, Inc., which operates the MetroWest Medical Center, comprised of the Leonard Morse Campus in Natick and the Framingham Union Campus in Framingham, and Columbia/HCA Healthcare Corporation on the terms of the proposed for-profit partnership between MetroWest and Columbia, a national for-profit hospital chain.

A. PURCHASE PRICE CALCULATION AND SETTLEMENT PROCEDURES

The following changes were made to ensure fair value to MetroWest and, ultimately, the Foundation:

1. The parties presented a final, fixed price - allowing precision for review purposes and reducing the threat of costly price adjustments and other disputes about price.
2. MetroWest will retain a CPA to audit the working capital adjustment portion of the final purchase price (approximately \$10.5 mil.) and to monitor post-transaction settlement. The CPA findings will be reported to the Attorney General and Court (which will retain jurisdiction to monitor settlement after closing and foundation issues). This will ensure that net proceeds ultimately transferred to the Foundation are maximized.
3. An enhanced dispute resolution procedure in the event of post-closing dispute over the working capital adjustment will reduce the chances of costly post-transaction litigation.

B. METROWEST AS A LIMITED PARTNER

The following changes were made to ensure that the joint venture is in the best interest of the charity, that the MetroWest partnership investment is protected and any associated risk of loss is minimized, and that the anticipated return to MetroWest, and ultimately the Foundation, is commercially reasonable.

1. MetroWest Health Partner, Inc. agreed to make an annual payment to the Foundation out of cash flow representing a minimum, annual return on the capital invested by MetroWest in the Partnership. If MetroWest is unable to meet this obligation, protections

(more)

will limit MetroWest's discretion to re-invest profit in the Partnership, rather than return proceeds to the Foundation, and require consultation with the Foundation as to continued participation in the venture.

2. Columbia agreed to annual disclosure of working capital levels to the Partnership Board. This will ensure advance notice to MetroWest if its investment is threatened by under capitalization of the Partnership and will assist MetroWest in exercising its option to sell back to Columbia in a timely fashion, if necessary.
3. If MetroWest does sell its interest back to Columbia, the purchase price will be increased to reflect any capital, including its share of cash flow, that MetroWest has invested in a major hospital transaction or in any new ventures outside the 10 mile radius of the Partnership.
4. A definition of Distributable Cash was added to the Limited Partnership Agreement to provide clearer standards for determining MetroWest's, and ultimately the Foundation's, share of the profits.
5. An explicit requirement was obtained that the General Partner must consult with the Partnership Board and use its best efforts to cause the Partnership to make such capital expenditures relating to the MetroWest Facilities that the General Partner deems necessary and appropriate.
6. In order to assist MetroWest in determining whether management fees paid by MetroWest to Columbia, as General Partner, are fair and reasonable, the General Partner must now provide a status report of the services being provided to the Partnership every three years and annually notify the Partnership Board of any transactions between the Partnership and Columbia/HCA, or its affiliates.
7. MetroWest and the Foundation had the right to meet any offer to buy Columbia's interest in the Partnership, but the time lines for exercising this buyback right were unrealistically short. We obtained new timelines.
8. Explicit language was obtained to ensure that the Foundation's ability to make grants, or offer services (other than operating an acute care hospital), will not be restricted by the parties' non-competition agreement.

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C. LOCAL PARTICIPATION

Changes were necessary to strengthen local participation while Metro West holds an interest in the partnership in order to protect its investment and ensure that the Metro West trustees are able to carry out their fiduciary duties of due care and loyalty under Massachusetts law. To accomplish this:

1. The General Partner must now obtain Board approval before it does any of the following:
 - * Borrow money from all sources above 10 percent of the total asset value of the Partnership;
 - * Make capital expenditures within the Partnership area out of cash flow in an amount greater than 10% of the total asset value of the Partnership;
 - * Change indigent care policy;
 - * Nomination of CEO or CFO candidates for Board selection.
2. The General Partner must now consult with the Board in advance before doing any of the following:
 - * approving a strategic plan and capital and operating budgets for the Partnership;
 - * making a non-discretionary capital expenditure which does not require prior approval of the Board;
 - * discontinuing at the Leonard Morse campus any of the following categories of service: medical-surgical service; obstetrical service; 24 hour physician covered emergency service; or radiology and laboratory services as necessary to support emergency services;
 - * closing either the Leonard Morse or Framingham campus of the hospital or converting either campus to a use other than acute care;
3. The General Partner must also:
 - * notify the Partnership Board of all significant reorganization transactions affecting Columbia;

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- * deliver monthly balance sheets to the Partnership Board showing working capital levels;
- * provide annual disclosure to the Partnership Board of transactions between the Partnership and Columbia;
- * provide a status report to the Partnership Board on service provided under the Management Agreement every three years;
- * report to the Partnership Board certain declines in hospital admissions or licensed beds at Leonard Morse;
- * provide regular reports to the Partnership Board on the amount of indigent care provided by the Hospital.

D. COVENANT AND MARY ANN MORSE WILL

Several changes were necessary to ensure that MetroWest's right to enforce the covenant can be effectively exercised.

1. The notice requirements of the 1991 Leonard Morse decree were added to the Contribution and Sale Agreement;
2. Prior notice to the Partnership Board is now required before the General Partner can discontinue at the Leonard Morse campus any of the following categories of service: medical-surgical service; obstetrical service; 24 hour physician covered emergency service; or radiology and laboratory services as necessary to support emergency services: close either the Leonard Morse or Framingham campus of the hospital or convert either campus to a use other than acute care;
3. Certain declines in hospital admissions or licensed beds at Leonard Morse specified in the 1991 decree must also be reported to the Partnership Board.
4. Prior notice must be given to the public prior to closure of either hospital, exercise of MetroWest's option to sell, or dissolution of the Partnership;
5. Language changes were obtained strengthening MetroWest's ability to enforce the covenant which obligates the Partnership to conform to the requirements of the Mary Ann Morse Will. The parties have also agreed to incorporate the covenant into the court decree;

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6. Language was added making it clear that the Attorney General also has the right to enforce the covenant.

E. COMMUNITY ACCESS AND FREE CARE

Maintenance of Both Campuses and Emergency Rooms

Changes obtained to ensure continued community access by the public include:

1. An explicit commitment that the General Partner will use its best efforts to cause the Partnership to make such capital expenditures relating to the MetroWest Facilities as the General Partner, after consulting with the Partnership Governing Board, deems necessary and appropriate was obtained.
2. Confirmation was obtained from MetroWest that capital improvements specified in MetroWest's 1994 10-Point Plan have been accomplished. MetroWest will also file with the Court a schedule of capital expenditures the trustees have identified as critical going forward.
3. Columbia has agreed to provide to the Attorney General an annual community benefits report on the same voluntary basis as other Massachusetts hospitals;
4. An explicit commitment to operate 24 hour emergency rooms at both campuses for at least three years was obtained.

Free Care

1. The Partnership Board must now approve all changes to the free care policy of the hospital not related to a change in law, and regular reports on free care levels must be provided by the General Partner;
2. A schedule will be filed with the court as an exhibit to MetroWest's complaint showing the amount of free care provided by MetroWest in the last three years.
3. MetroWest will fund an Independent Healthcare Access Analyst, to monitor and report as a matter of public record community healthcare access afforded by the Partnership, including levels of free care, for three years post-closing.

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E. FOUNDATION STRUCTURE AND POST-CLOSING MATTERS

While development of a plan for creation of a community-based foundation to receive the proceeds of this transaction will be largely deferred to the second stage of the proceeding, certain fundamental agreements have been reached with MetroWest in this area:

1. The Foundation created by proceeds of this sale will be a 501(c)3, community-based entity which is independent of Columbia and MetroWest;
2. To avoid conflict of interest, the Foundation will not invest directly in the Partnership, or in Columbia/HCA;
3. Current MetroWest trustees will file sworn interrogatories post-transaction disclosing any future business relationships with the Partnership, or Columbia/HCA.
4. MetroWest will refrain from approving investment in the Partnership by current management for a period of one year.
5. An agreement was reached to expand the MetroWest Health Partner, Inc. Board of Trustees to include two, rather than one, representatives nominated by Natick and Framingham, respectively. Two other seats will be selected by MetroWest Health, Inc. from nominations by regional health planning organizations.

(end)



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August 21, 1996

SUMMARY OF THE FALLON/ORNDA INVESTIGATION

The following is a summary of the results of the Attorney General's investigation of the transaction between Fallon Healthcare System of Worcester and OrNda HealthCorp, a Tennessee-based, for-profit national health care chain.

A. Transaction Overview

OrNda is buying the assets of the charitable corporations which comprise Saint Vincent Healthcare System -- the hospital, a nursing home, and other subsidiaries. Fallon Community Health Plan, a non-profit charitable HMO, is not being sold and will remain a subsidiary corporation of Fallon Foundation, the non-profit parent company for the non-profit system. OrNda is paying approximately \$135 million for the St. Vincent system by assuming the liabilities and certain costs of the system.

In addition, OrNda is purchasing a 45% interest in the Fallon Clinic, a for-profit medical practice comprised of more than 200 physicians. OrNda will pay \$45.5 million to the Clinic, and the Clinic will also receive a 10% ownership (presently valued at \$13 million) in Medical City to become effective after Medical City is completed. The \$45.5 million in cash will be available to be distributed to the shareholders of the Clinic as a result of this transaction. The shareholders are the physicians who comprise the Clinic. Senior managers are entitled to a distribution as well.

OrNda has assumed responsibility from Saint Vincent Healthcare System to build Medical City. The estimated amount to complete this project is \$215 million.

All of the money paid by OrNda will be used to pay St. Vincent debts, however it is expected that a fund will remain in the Fallon Healthcare System after expenses relating to the transaction, ranging from between two and four million dollars. In order to bring certainty to the purpose and amount of this fund, OrNda and Fallon have committed, subject to court authorization, to making four million dollars available for health-related charitable purposes in central Massachusetts.

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B. Proper Valuation of the Non-profit Assets

Saint Vincent Healthcare System and Fallon Clinic together comprise an "integrated delivery system." made up of a hospital, a nursing home, the HMO insurance component (Fallon Community Health Plan) and a for-profit medical practice (Fallon Clinic). In order to assure that the hospital and its related assets were being properly valued, in the face of the amount going to the Clinic, and the high amount of debt assumed by OrNda for the hospital, the Attorney General asked Fallon and its advisor, the investment banking firm, Morgan Stanley, to produce financial data which would support the relative values of the non-profit and for-profit entities.

Upon receipt of that data, the Attorney General's expert, Arthur Andersen LLP, analyzed the information and concluded that, especially because the hospital facility was in need of extensive and expensive renovations, the value reached for the hospital and related non-profit entities was proper, and the value placed upon the Clinic was also proper.

C. The Selection of OrNda

The Attorney General issued to Fallon extensive document requests which covered all aspects of the transaction, including the process by which Fallon made its decision to seek a buyer and devised a process for that selection and ultimately decided on OrNda. Fallon had engaged the services of Morgan Stanley to advise it on all aspects of its decision-making. The Attorney General analyzed the decision-making process to make sure that due care was followed and that decisions were made that were in the best interest of the non-profit system. The Attorney General concluded, based upon minutes, sworn statements, and other documentation, that the selection of OrNda was prudent under the circumstances.

D. Conflict of Interest

The Attorney General had a heightened concern about the impartiality of the negotiations because OrNda was also proposing to purchase a 45% share in the for-profit Clinic and the resulting fund will be distributed among the Clinic shareholders which include Clinic board members involved in the decision-making about the potential buyers of both the Clinic and the non-profit system.

In order to assure that the transaction was not tainted by personal interest in financial gain, the Attorney General examined the board minutes of St. Vincent Health System, and required board members and senior managers to provide sworn answers to questions on the issue of personal gain. In addition, the Attorney General obtained sworn affidavits from key senior managers to verify that the terms of the transaction were untainted by any desire for personal gain to the detriment of the hospital system.

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At six and 12 month intervals following the closing of the transaction, key negotiators for Fallon are required to answer questions under oath on the issue of personal gain post-transaction

E. The HMO

The Attorney General became concerned that the new structure of the resulting integrated delivery system could threaten the independence of the HMO, the remaining charitable corporation in an otherwise for-profit system. The HMO board is made up of a majority of Fallon Clinic physicians with a minority of consumer board members. This situation could have been detrimental to the independence of the HMO because interactions constantly occur between the HMO and the Clinic which require board members to be totally faithful to the best interests of the HMO.

Fallon agreed to several governance changes which will protect the continued independence of the HMO.

1. The number of independent consumer board members will be increased to a reflect a larger percentage of the full board.
2. On all matters relating to the interactions between the HMO and the Clinic, non-independent board members will recuse themselves from voting.
3. The Health Plan budget will include \$100,000 each year for use by the Consumer Class to retain any outside legal and/or consulting advice which the Class director deem necessary to assist them in the exercise of their fiduciary duties.
4. The consumer board members will be nominated and selected by the HMO board itself, not the Fallon parent.
5. Terms limits will be instituted.

F. Public Access to Affordable Healthcare

OrNda has agreed to the following:

1. \$4 million will be committed by OrNda and Fallon to community health care.
2. Compliance with the Attorney General's Community Benefits Guidelines for Acute Care Hospitals in Massachusetts.
3. Continue the St. Vincent policy of providing free care.

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4. Fund an Independent Healthcare Access Analyst for three years post-closing to monitor issues pertaining to free care and community health care access at Fallon.
5. Create a Community Benefits Task Force comprised of members of the Central Massachusetts Community Healthcare Coalition and other concerned groups to facilitate community involvement in community benefits planning and implementation.
6. Use the Task Force to coordinate issues relating to interpreter services, cultural competency, facility accessibility for the disabled and other related issues.

(end)