Keeping the Trust:
Holding Nonprofit Hospitals to Their Charitable Missions

Introduction:

Over the past several years, attorneys general have been exercising increased regulatory scrutiny over nonprofit hospitals. This trend has occurred largely due to the move to privatize nonprofit hospitals. In the typical scenario, an attorney general will insist that the proceeds from the sale of a nonprofit hospital (that is, the money the for-profit buyer pays for the hospital) continue to be used to further the former nonprofit hospital's mission. This usually means that all of the proceeds go to a foundation to fund health projects in the community. Attorneys general get involved in these transactions as part of their authority to regulate nonprofit corporations, also known as "charitable trust" authority.

But recently, attorneys general have been venturing beyond just protecting the assets of nonprofit hospitals when they become for-profit. Attorney general scrutiny has moved into a new area – that of the regulation of transactions and other business decisions occurring entirely within the nonprofit realm. Attorneys general are increasingly using charitable trust law to enforce the charitable missions of nonprofit hospitals.

This report examines this trend of attorney general scrutiny of nonprofit hospitals and discusses the legal theories used to enforce the charitable missions of those hospitals.

The Law of Charitable Trust:

To understand regulatory oversight over nonprofit hospitals, it is first necessary to grasp the law of charitable trust. In a typical "conversion" of a nonprofit hospital to for-profit status, an attorney general will use charitable trust law to require that the assets of a former nonprofit hospital be transferred to a foundation which has a mission as similar as possible to that of the nonprofit hospital. The attorney general will therefore require that the money spent by the for-profit to acquire the hospital, which should represent the fair market value of the hospital, go to endow a foundation. As a result of this regulatory scrutiny, nonprofit assets totaling over $16 billion have been set aside in foundations for public health projects in communities that have experienced a "conversion" of their nonprofit hospital.

The law of charitable trust goes back centuries. Nonprofit and charitable organizations owe a fiduciary duty to the public to be true to their missions. The regulatory agent responsible for overseeing this fiduciary duty is a state attorney general. All of the assets of a nonprofit organization are held in "charitable trust," which means the assets must forever be used to further the mission of the nonprofit. For example, if you give money to Sam's Soup Kitchen, a homeless services organization, and Sam's decides to close its doors, or gets purchased by a for-profit restaurant chain, the attorney general will require that all of the assets of Sam's Soup Kitchen, including your donation, continue to serve the homeless.

The same legal theory applies to a nonprofit hospital that either closes or sells to a for-profit. Once the nonprofit establishes that its charitable mission has become impossible, impractical or unlawful, the attorney general will require that the assets be used for a purpose as close as possible to the original mission. Typically, this has meant that the assets are placed in a foundation to fund public health projects in keeping with the mission of the hospital

A nonprofit organization is not "owned" by anyone, but owes a fiduciary duty to the public. A for-profit, on the other hand, is owned by its shareholders and owes a fiduciary duty to them to maximize its earnings. Put another way, a for-profit corporation must serve the interests of shareholders; whereas a nonprofit serves the interests of the people its mission purports to serve. The attorney general "steps in the shoes" of the beneficiaries of that mission to ensure the nonprofit corporation remains loyal to its mission.

Recent Actions by Attorneys General to Hold Nonprofit Hospitals to their Charitable Missions:

Regulatory scrutiny not only happens when a nonprofit hospital becomes for-profit. Attorneys general are increasingly using their charitable trust authority to protect the charitable mission of hospitals that are remaining nonprofit. Following are some recent developments in this area of the law:

- The proceeds from the sale of a nonprofit hospital are protected by charitable trust, even when the hospital is acquired by another nonprofit. Those proceeds must remain with the community that built the hospital, and cannot be reinvested in a nonprofit hospital chain's other hospitals.

On May 21, 2003, the South Dakota Supreme Court issued a very important decision in the case of Banner Health System v. Long.[1] The court explicitly held that the assets of a nonprofit hospital, as well as the proceeds from the sale of those assets, are protected by charitable trust. It also held that a nonprofit hospital chain must leave those proceeds with the local community when it sells a hospital, even when the buyer is another nonprofit.

Nonprofit Banner Health System announced in the fall of 2001 that it was selling 27 hospitals and nursing homes in seven states and reinvesting the proceeds from the sales in its other nonprofit hospitals in Arizona and Colorado. Attorneys general in three states – New Mexico, North Dakota and South Dakota – challenged Banner's ability to remove the proceeds from their states, asserting that the funds were held in charitable trust, and could only be used to further the missions of the community hospitals. Banner then sued each attorney general in federal court,

[1] Banner Health System v. Lawrence E. Long, 663 N.W.2d 242 (2003).

claiming it had a right under state law and the federal constitution to move the money to another state.

The federal judge assigned to the South Dakota case first sent the case to the state Supreme Court to resolve whether or not state law allowed the attorney general to protect the proceeds. Consumers Union filed an *amicus* brief before the court, arguing that the law of charitable trust required the attorney general to ensure the sale proceeds remain in their original communities and continue to promote the mission of the community hospitals. The South Dakota attorney general argued that Banner "never paid a nickel" for the seven hospitals and nursing homes it acquired through a merger in 1999. Nevertheless, Banner claimed it had a right to millions of dollars in charitable assets from the sale of those facilities, and intended to remove those funds from the state.

The South Dakota Supreme Court affirmed the attorney general's authority on several accounts. First, the court made it clear that charitable trust law applies just as much to a sale between nonprofits as it does to a sale of a nonprofit to a for-profit corporation. In both cases, the mission of the charitable funds must continue. Second, the court held that a nonprofit organization cannot unjustly profit from the sale of a community hospital, and that the net profits from the sale of the hospital belong to and must remain in the community. Third, the court stated that a nonprofit hospital chain must act in the interests of each community in which it operates, and that the parent corporation cannot further its interests at the expense of the interests of the community. Finally, the court held that a corporation that acquires a nonprofit hospital is bound by the articles of incorporation that governed that hospital throughout its history. The new parent corporation cannot escape these pre-existing obligations simply by amending the articles of incorporation.

- A hospital board cannot close or sell a nonprofit hospital without investigating all available options to keep the hospital open.

In 1999, New York Attorney General Eliot Spitzer "stepped in the shoes" of the beneficiaries of a nonprofit hospital in a landmark case known as MEETH.[2] When the board of the nonprofit Manhattan Eye, Ear, and Throat Hospital (MEETH) decided to sell the hospital's underlying real property and use the proceeds to fund diagnostic and treatment centers, the attorney general challenged the sale.[3] Spitzer argued that MEETH "had failed to explore all available options to maintain the principal charitable purpose of the corporation, which was to operate a hospital in the city of New York."[4]

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[2] In re Manhattan Eye, Ear & Throat Hospital, 715 N.Y.S.2d 575 (N.Y. Sup. Ct. 1999).
[3] Michael W. Peregrine and James R. Schwartz, The Application of Nonprofit Corporation Law to Healthcare Organizations, at 61 (2002).
[4] Id. See also Michael W. Peregrine and James R. Schwartz, Nonprofit Corporations: The M&A Process and the Meaning of MEETH, 28 Health Law Digest n.5, 3-12 (May 2000).

A New York Supreme Court judge agreed with the attorney general, reasoning that the fact that the sale made good business sense was insufficient to allow the hospital to abandon its mission.[5] MEETH echoes and expands the 1977 decision of Queen of Angels v. Younger, in which the California Court of Appeals held that a hospital corporation is bound by its articles of incorporation, the historic use of its assets, and how it holds itself out to the public.[6] These three factors determine the charitable mission of the hospital and, therefore, determine the restrictions on the charitable trust. In Queen of Angels, this meant that the nonprofit could not lease its hospital to a for-profit and use the proceeds to provide outpatient clinics when its charitable mission was to operate a hospital.[7] Doing so, the court held, would constitute an abandonment of that mission.

- A nonprofit hospital chain that abandons the mission of a community hospital may be investigated for violations of charitable trust law.

California Attorney General Bill Lockyer threatened an injunction and launched an investigation of Catholic Healthcare West, a large nonprofit hospital chain, in 2000 when the hospital chain announced it would close Long Beach Community Medical Center. CHW, which already owned the nearby St. Mary Hospital, had purchased Long Beach Community Medical Center 18 months earlier, and had assured the community it did not intend to close the Long Beach facility. Prior to the closure, CHW had been gradually moving equipment and services from Long Beach to St. Mary, in violation of its charitable trust obligations to Long Beach. Activists argued that a nonprofit chain could not come in and purchase a community hospital and replace its charitable mission with the mission of the larger hospital system. Attorney General Lockyer agreed and launched an investigation of CHW for potential charitable trust violations.

- The sale of a community hospital to a nonprofit hospital chain can constitute a violation of the community hospital's charitable mission.

In 1996, Florida Attorney General Robert Butterworth sued to stop the sale of Boca Raton Community Hospital to a nonprofit hospital chain.[8] The attorney general claimed that the charitable purpose of the hospital was to operate a community facility and that it would be inconsistent with that purpose to sell the hospital to an out-of-town hospital chain. The decision to sell was eventually rescinded by the trustees, and the case was voluntarily dismissed by the attorney general.

- A reduction in services by a nonprofit hospital can also constitute a violation of the hospital's charitable mission.

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[5] In re Manhattan Eye, Ear & Throat Hospital, 715 N.Y.S.2d at 596.
[6] Queen of Angels v. Younger, 136 Cal. Rptr. 36, 40-41 (1977); Schwartz and Peregrine, Nonprofit Corporations: The M&A Process and the Meaning of MEETH, supra, at 7.
[7] 136 Cal Rptr. at 41.
[8] Butterworth v. Boca Raton Community Hospital, No. CL 96-10191AF (Fla. Cir. Ct. Dec. 2, 1996).

In 1998, New Hampshire Attorney General Philip McLaughlin investigated two nonprofit hospitals that had merged and thereafter moved to consolidate acute care services at one of their campuses. As part of his review, the attorney general released a report concluding that the hospitals violated the state's charity laws by attempting to consolidate acute care services.[9] The report found that a reduction in services by a nonprofit hospital falls under the doctrine of charitable trust.[10] As a result of that report, the 1994 merger that created Optima Health was abandoned.[11]

In a similar case, Florida Attorney General Robert Butterworth sued Intracoastal Health Systems to block the proposed reduction in services of a hospital in Palm Beach County – St. Mary's hospital. St. Mary's had a history of serving a low-income community and was the largest provider of charity care in the county.[12] The hospital system owned two hospitals in the area, and planned to consolidate inpatient services at the other hospital, using St. Mary's only for non-acute care services.[13] The attorney general investigated[14] and concluded that closure of acute care services at St. Mary's would reduce health care services for the poor.[15] The attorney general then went to court to prevent the closure, arguing that court review of the change in mission was appropriate because both hospitals were charitable trusts.[16] The defendant hospital sought a court declaration that the attorney general lacked authority to bring the claim.[17] The court, however, ruled in favor of the attorney general, and the lawsuit was settled prior to trial.[18]

Conclusion:

As nonprofit hospital transactions become more and more complex, actions by attorneys general to protect the charitable mission of these hospitals are likely to become more commonplace. These actions can yield tremendous benefits for communities and health care consumers. Community groups can use the cases cited in this report to encourage their attorneys general to assert charitable trust authority over nonprofit hospitals and hold them to their charitable missions.

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[9] New Hampshire Attorney General's Report on Optima Health, March 10, 1998.
[10] Michael W. Peregrine and James R. Schwartz, The Application of Nonprofit Corporation Law to Healthcare Organizations, supra at 63.
[11] Deanna Bellandi, The Watchdogs are Biting: State Attorneys General Asserting Authority Over Not-For-Profit Hospitals, Modern Healthcare, January 29, 2001, at 22-23.
[12] Elena N. Cohen and Jill C. Morrison, National Women's Law Center, Hospital Mergers and the Threat to Women's Reproductive Health Services: Using Charitable Assets Laws to Fight Back, at 31 (2001).
[13] Id.
[14] See Office of the Florida Attorney General, Report: Intracoastal Health Systems, Inc. (2000).
[15] Peregrine and Schwartz, The Application of Nonprofit Corporation Law to Healthcare Organizations, supra, at 60.
[16] Cohen and Morrison, supra, at 31; State ex rel. Butterworth v. Intracoastal Health Sys., Inc., No. CL 01-0068 AB (Fla. Cir. Ct. Feb. 27, 2001).
[17] Cohen and Morrison, supra, at 32.
[18] Id.

Sources and Recommended Reading:

Deanna Bellandi, The Watchdogs are Biting: State Attorneys General Asserting Authority Over Not-For-Profit Hospitals, Modern Healthcare, January 29, 2001, at 22-23.

Elena N. Cohen and Jill C. Morrison, National Women's Law Center, Hospital Mergers and the Threat to Women's Reproductive Health Services: Using Charitable Assets Laws to Fight Back, (2001).

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