

NATIONAL ASSOCIATION OF ATTORNEYS GENERAL



Adopted

**Summer Meeting
July 13-16, 1998
Durango, Colorado**

RESOLUTION

**ADOPTING MODEL LEGISLATION ON CONVERSION OF NONPROFIT
HEALTH CARE ENTITIES TO FOR-PROFIT STATUS**

WHEREAS, the rate of transfers of the assets of nonprofit, charitable health care entities to the for-profit sector, whether by sale, joint venture, or other sharing of assets, has increased significantly in the last several years; and

WHEREAS, this phenomenon represents the single most intensive and voluminous conversion of charitable assets in the history of the United States; and

WHEREAS, under general common law principles Attorneys General have traditionally served as protectors of charitable assets on behalf of the beneficiaries of charitable health care entities; and

WHEREAS, in March 1997, the National Association of Attorneys General adopted a resolution endorsing certain principles in connection with the conversions of charitable healthcare assets; and charged the NAAG Health Care Task Force with continuing to monitor developments in this area; and.

WHEREAS, a number of state legislatures are considering legislation to clarify the rights and obligations of health care entities that are converting from nonprofit to for-profit status; and

WHEREAS the NAAG Health Care Task Force established a staff committee to prepare model legislation enabling states to protect charitable assets during healthcare conversions; and

WHEREAS, that Committee drafted model legislation; and

WHEREAS, comments on the draft model legislation were solicited and received from interested persons, including industry groups and consumer groups; and

WHEREAS, all comments from interested persons have been carefully considered by the committee and appropriate revisions made to the model legislation;

NOW, THEREFORE, BE IT RESOLVED THAT THE NATIONAL ASSOCIATION OF ATTORNEYS GENERAL

1. Adopts the model legislation described above and attached hereto as a statement of the general views of the Attorneys General with respect to health care conversion legislation; and
2. Encourages each Attorney General to promote the use of the model legislation where appropriate, when health care conversion legislation is being developed or revised in his or her state; and
3. Authorizes the Executive Director and General Counsel to make the Model Health Care Conversion legislation available to appropriate state and federal officials and to interested individuals and associations.

Model Act for Nonprofit Healthcare Conversion Transactions

Section 1 - Definitions

1.01 "Nonprofit healthcare entity" means:

any nonprofit hospital (including corporations and hospitals created under a trust or a will), nonprofit health maintenance organization, or nonprofit healthcare insurer, including entities affiliated with any of these through ownership, governance or membership, such as a holding company or subsidiary. Nonprofit healthcare entity shall include, but not be limited to nonprofit entities which are licensed as hospitals, HMOs or healthcare insurers (including mutual corporations holding assets in charitable trust) under the laws of this State.

1.02 "Nonprofit healthcare conversion transaction" means:

(1) the sale, transfer, lease, exchange, optioning, conveyance, or other disposition of a material amount of the assets or operations of a licensed nonprofit hospital, nonprofit health maintenance organization or nonprofit healthcare insurer, including a mutual corporation holding assets in charitable trust, to an entity or person other than a charity; and

(2) the transfer of control or governance of a material amount of the assets or operations of a licensed hospital, nonprofit health maintenance organization or nonprofit healthcare insurer, including a mutual corporation holding assets in charitable trust, to an entity or person other than a charity.

1.03 "Nonprofit healthcare insurer" means;

any nonprofit provider of healthcare insurance, including hospital service associations, health service corporations, and physician service organizations.

1.04 "Person" means:

any individual, partnership, trust, estate, corporation, association, joint venture, joint stock company, insurance company, or other organization.

Section 2 - Notice to and Approval of Attorney General

2.01 Any nonprofit healthcare entity shall be required to provide written notice to, and obtain the approval of, the Attorney General [or the appropriate Court on advice of the Attorney General in mandatory *cy pres* proceeding states] prior to entering into any nonprofit healthcare conversion transaction. At the time of providing notice to the Attorney General [Court], the nonprofit healthcare entity shall provide the Attorney General [Court] with

written certification that a copy of this statute has been given in its entirety to each member of the board of trustees of the nonprofit healthcare entity.

- 2.02** The notice to the Attorney General provided for in this Section shall include and contain all the information the Attorney General determines is required. No notice shall be effective until the Attorney General has acknowledged receipt of a complete notice in accordance with regulations to be adopted pursuant to Section 6 of this article or in accordance with protocol established by the Attorney General.
- 2.03** This article shall not apply to a nonprofit healthcare entity if the nonprofit healthcare conversion transaction is in the usual and regular course of its activities and if the Attorney General has given the nonprofit healthcare corporation a written waiver of this article as to the nonprofit healthcare conversion transaction.

Section 3 - Approval or disapproval; Written Notice; Time Period; Extension

- 3.01** Within 90 days of a complete written notice as required by Section 2 of this article, the Attorney General shall notify the nonprofit healthcare entity in writing of its decision to approve, [or advise the Court in mandatory *cy pres* proceeding states] or disapprove the proposed nonprofit healthcare conversion transaction. The Attorney General may extend this period for an additional 60 day period, provided the extension is necessary to obtain information pursuant to subdivision 6.02 or subdivision 7.01 of this article. [Longer time periods should be established for states which opt for attorney general review of health care impact under Section 5.02.]

Section 4 - Public Meetings: Notice of Time and Place

- 4.01** Prior to issuing any written decision pursuant to Section 3 of this article, the Attorney General shall conduct one or more public meetings, one of which shall be held in the county where the nonprofit healthcare entity's assets to be transferred are located. At the public meeting, the Attorney General shall hear comments from interested persons desiring to make statements regarding the proposed nonprofit healthcare conversion transaction. At least 14 days before the meeting, the Attorney General shall cause written notice to be provided of the time and place of the meeting through publication in one or more newspapers of general circulation in the affected community, to the county board of supervisors, and if applicable, to the city council of the city where the nonprofit healthcare entity's assets to be transferred are located.

Section 5 - Discretion of Attorney General; Review Elements

- 5.01** In making a decision whether to approve or disapprove a proposed nonprofit healthcare conversion transaction [or advise the Court in a mandatory *cy pres* proceeding state], the Attorney General shall consider:
- (1) Whether the nonprofit healthcare entity will receive full and fair market value for its charitable or social welfare assets;
 - (2) Whether the fair market value of the nonprofit healthcare entity's assets to be transferred has been manipulated by the actions of the parties in a manner that causes the fair market value of the assets to decrease;
 - (3) Whether the proceeds of the proposed nonprofit healthcare conversion transaction will be used consistent with the trust under which the assets are held by the nonprofit healthcare entity and whether the proceeds will be controlled as funds independently of the acquiring or related entities;
 - (4) Whether the proposed nonprofit healthcare conversion transaction will result in a breach of fiduciary duty, as determined by the Attorney General, including conflicts of interest related to payments or benefits to officers, directors, board members, executives, and experts employed or retained by the parties;
 - (5) Whether the governing body of the nonprofit healthcare entity exercised due diligence in deciding to dispose of nonprofit healthcare entity's assets, selecting the acquiring entity, and negotiating the terms and conditions of the disposition;
 - (6) Whether the nonprofit healthcare conversion transaction will result in private inurement to any person;
 - (7) Whether healthcare providers will be offered the opportunity to invest or own an interest in the acquiring entity or a related party, and whether procedures or safeguards are in place to avoid conflict of interest in patient referrals;
 - (8) Whether the terms of any management or services contract negotiated in conjunction with the proposed nonprofit healthcare conversion transaction are reasonable;
 - (9) Whether any foundation established to hold the proceeds of the sale will be broadly based in the community and be representative of the affected community, taking into consideration the structure and governance of such foundation; and,
 - (10) Whether the Attorney General has been provided with sufficient information and data by the nonprofit healthcare entity to evaluate adequately the proposed nonprofit healthcare

conversion transaction or the effects thereof on the public, provided the Attorney General has notified the nonprofit healthcare entity or the acquiring entity of any inadequacy of the information or data and has provided a reasonable opportunity to remedy such inadequacy;

(11) Any other criteria the Attorney General considers necessary to determine whether the nonprofit healthcare entity will receive full and fair market value for its assets to be transferred as required in rules adopted by the Attorney General under Section 6 of this article.

5.02 [THIS SUBDIVISION IS OPTIONAL FOR ATTORNEYS GENERAL WHO DEEM IT APPROPRIATE TO ALSO CONSIDER ISSUES OF HEALTH IMPACT IN THEIR REVIEW]

In making a decision whether to approve or disapprove an application, the attorney general shall also determine whether the proposed nonprofit healthcare conversion transaction may have a significant effect on the availability or accessibility of healthcare services to the affected community. In making this determination, the Attorney General shall consider:

(1) Whether sufficient safeguards are included to assure the affected community continued access to affordable care;

(2) Whether the proposed nonprofit healthcare conversion transaction creates or has the likelihood of creating an adverse effect on the access to or availability or cost of healthcare services to the community;

(3) Whether the acquiring entities have made a commitment, at least comparable to the nonprofit healthcare entity, to provide healthcare to the disadvantaged, the uninsured, and the underinsured and to provide benefits to the affected community to promote improved healthcare. Activities and funding provided by the nonprofit healthcare entity or its successor nonprofit healthcare entity or foundation to provide such healthcare or to provide support or medical education and teaching programs or medical research programs shall be considered in evaluating compliance with this commitment;

(4) Whether the nonprofit healthcare conversion transaction will result in the revocation of hospital privileges;

(5) Whether sufficient safeguards are included to maintain appropriate capacity for health science research and healthcare provider education; and,

(6) Whether the proposed nonprofit healthcare conversion transaction demonstrates that the public interest will be served considering the essential medical services needed to provide safe and adequate treatment, appropriate access and balanced healthcare delivery to the residents.

Section 6 - Regulations; Authority to Adopt; Information Requests; Consequences of Refusal to Provide Information

- 6.01** The Attorney General may adopt such regulations as the Attorney General deems appropriate to implement this article and/or establish such protocols as are necessary to implement this article.
- 6.02** The Attorney General may demand that the nonprofit healthcare entity giving notice under Section 2 of this article provide such information as the Attorney General reasonably deems necessary to complete his/her review of any proposed nonprofit healthcare conversion transaction described in Section 5 of this article. A failure by the nonprofit healthcare entity giving notice under Section 2 of this article to provide timely information as required by the Attorney General shall be a sufficient ground for the Attorney General to disapprove the proposed nonprofit healthcare conversion transaction.

Section 7 - Contracts with Agencies and Consultants; Reimbursement for Costs and Expenses of Review; Failure to Pay

- 7.01** Within the time periods designated in Section 3 of this article, the Attorney General may do any of the following to assist in the review of the proposed nonprofit healthcare conversion transaction described in Section 2 of this article:
- (1) Contract with, consult, and receive advice from any agency of the state or the United States on such terms and conditions the Attorney General deems appropriate; or,
- (2) In the Attorney General's sole discretion, contract with such experts or consultants the Attorney General deems appropriate to assist the Attorney General in reviewing the proposed nonprofit healthcare conversion transaction.
- 7.02** Any contract costs incurred by the Attorney General pursuant to this Section shall not exceed an amount that is reasonable and necessary to conduct the review of the proposed nonprofit healthcare conversion transaction. The Attorney General shall be exempt from the provisions of [any applicable state laws regarding public bidding procedures] for purposes of entering into contracts pursuant to this Section. The nonprofit healthcare entity giving notice under Section 2 of this article, upon request, shall pay the Attorney General promptly for all costs of contracts entered into by the Attorney General pursuant to this Section.
- 7.03** The Attorney General shall be entitled to reimbursement from the nonprofit healthcare entity giving notice under Section 2 of this article for all reasonable and actual costs incurred by the Attorney General in reviewing any proposed nonprofit healthcare conversion transaction under this article, including attorney fees at the billing rate used by the Attorney General to

bill state agencies for legal services. The nonprofit healthcare entity giving notice under Section 2 of this article, upon request, shall pay the Attorney General promptly for all such costs.

- 7.04** The failure by the nonprofit healthcare entity giving notice under Section 2 of this article to promptly reimburse the Attorney General for all costs pursuant to subparagraphs 7.02 or 7.03 shall be sufficient ground for the Attorney General to disapprove the proposed nonprofit healthcare conversion transaction.

Section 8 - Public Records

- 8.01** All documents submitted to the Attorney General by any person, including nonprofit healthcare entities giving notice under Section 2 of this article, in connection with the Attorney General's review of the proposed nonprofit healthcare conversion transaction pursuant to this article shall be public records subject to all provisions of the applicable state public records act, [assuming the state public records act contains an exception for trade secrets or other commercially competitive information.]

Section 9 - Penalties; Remedies

- 9.01** Any nonprofit healthcare conversion transactions entered into in violation of the notice, review or approval requirements of this article shall be null and void and each member of the governing boards and the chief financial officers of the parties to the nonprofit healthcare conversion transaction may be subject to a civil penalty of up to \$1,000,000, the amount to be determined by the [court of competent jurisdiction] in the county in which the nonprofit healthcare entity's assets to be transferred are located. The Attorney General shall institute proceedings to impose such a penalty. In addition, no permit to operate a hospital may be issued or renewed under this Chapter or under any other applicable statute or regulation if there is a nonprofit healthcare conversion transaction entered into in violation of the notice, review and approval requirements of this article.
- 9.02** Nothing in this Section shall be construed to limit the common law authority of the Attorney General and the [director of charitable trusts] to protect charitable trusts and charitable assets in this state. These penalties and remedies are in addition to, and not a replacement for, any other civil or criminal actions which the Attorney General may take under either the common law or statutory law, including rescinding the nonprofit healthcare conversion transaction, granting injunctive relief or any combination of these and other remedies available under common law or statutory law.

COMMENTARY TO THE PROPOSED MODEL ACT
FOR
NONPROFIT HEALTHCARE CONVERSION TRANSACTIONS

Introduction

In March, 1997 the National Association of Attorneys General adopted a formal resolution addressing the issue of conversions of charitable healthcare assets (i.e., the acquisition of control of charitable healthcare assets by a for-profit entity). The resolution set forth certain principles to be adhered to in crafting legislation dealing with charitable healthcare conversions. In 1998, the National Association of Attorneys General circulated a draft model act dealing with conversions for comments from interested groups and associations. Based upon the comments received, the draft model act was revised and presented to the July, 1998 meeting of the National Association of Attorneys General for consideration. This model act addresses conversions of charitable assets and does not deal with the issue of nonprofit to nonprofit consolidations, since that issue is most effectively dealt with on a state-by-state basis. A number of states have adopted legislation dealing with this separate issue, including New Hampshire (NH RSA § 7:19-b), Rhode Island (R.I. Gen. Laws § 23-17.14-1 et seq.) and Georgia.

This Commentary has been prepared in connection with the model act and addresses directly the transfer of ownership or control of nonprofit healthcare organizations to for-profit, investor-owned entities. The model act imposes specific substantive and procedural requirements that nonprofit organizations have not previously encountered. Under the model act, it is the responsibility of the Attorney General's office to review these transactions, to obtain all material

financial and corporate information, and to consider all of the factors enumerated in the model act before approving or disapproving a specific transaction. Adoption of this statute will place significant demands upon the resources and staff of an Attorney General's office and consideration should be given to these additional demands.

One major purpose of the model act is to make certain that these health care transactions are open to public comment and public scrutiny. An open process maximizes the public's confidence in the review process and reduces any concerns that these charitable assets are not being adequately protected. The role of the Attorney General's Office is to enforce the provisions of the charitable trust laws so as to fully protect the charitable assets for the benefit of the public. The charitable trust laws are built upon the principle that charitable trusts are not private business entities, like fast food franchises and indoor plumbing supply companies. Rather, charitable trusts like hospitals are created for the benefit of the public. This Commentary is not intended to be a complete analysis of all aspects of the model act but, rather, is intended to provide general guidelines with respect to issues which are commonly found in these transactions.

I. PROCEDURAL REQUIREMENTS

A. Preliminary Meeting

In order to meet the strict deadlines established by the model act, an Attorney General should request that any nonprofit entity considering a transaction meet with the Attorney General early in the process to discuss the timetable and issues raised by a proposed transaction. This is especially critical in larger transactions where (1) the Attorney General must retain expert counsel and financial advisors, (2) where confidentiality of documents are an issue, (3) where extensive document

production may be necessary or (4) where multiple issues, such as valuation, conflicts of interest, due diligence, and related matters, present themselves in complex ways. A preliminary meeting, prior to the filing of the notice, will greatly facilitate compliance and enforcement.

B. Scope of the Statute

The statute is broadly defined and extends to all nonprofit hospitals, nonprofit health maintenance organizations, and nonprofit healthcare insurers, “including entities affiliated with any of these through ownership, governance or membership, such as a holding company or subsidiary.” As a result, many nonprofit “affiliates” will find themselves within the scope of the model act, including in certain cases, community health services, medical-surgical or other diagnostic or therapeutic facilities or services. The statute also extends to a variety of transactions, both direct or indirect, which are “material.” Under the model act, attorneys general have the ability to issue interpretative releases creating “safe harbors” with specific percentages indicating with greater specificity what is material and what is not material. The specific types of transactions include, but are not limited to, purchases and sales, mergers, leases, gifts, consolidations, exchanges, and joint ventures, among others. Given the rapid developments in the healthcare area and the movement towards integration and consolidation and the many diverse forms in which transactions may be structured, the list in the model act is not exclusive.

C. Documents and Public Access

1. Documents to be Filed

The model act requires the applicant to submit “all documents” relating to the transaction to the Attorney General’s Office, subject to the confidentiality treatment afforded by a state’s right to

know or public records statutes (section 8.01). Consequently, the majority to the documents filed will be publicly available unless the applicant requests confidentiality pursuant to the state statutes. Since the transactions are to be scrutinized by the public, with a public hearing being mandated, the use of the confidentiality treatment should be closely scrutinized.

The types of documents filed should include, but are not limited to, the following:

a. Parties to the Proposed Transaction.

The filed documents shall identify all parties to the transaction, whether directly or indirectly involved. In the case of a subsidiary nonprofit healthcare entity, this must include identification of the parent holding company and all subsidiary entities involved in the holding company structure. If, for example, the applicant were a nonprofit hospital or a nonprofit HMO which is part of an integrated delivery system, it is important to identify each component of the integrated delivery system.

b. Disclosure of All Material Terms.

The documents filed shall include all purchase and sale documents, together with collateral agreements, especially those agreements which involve directors, officers and employees (e.g., employment contracts for executive officers, severance payments and termination agreements). Where there are related entities in an integrated system, documents relating to those entities should also be filed. Where a joint venture with a Limited Liability Corporation (LLC) or a Limited Liability Partnership (LLP) is involved, the operating and management agreements of those entities must also be filed.

Changes in the capital structure and management of the nonprofit entity and all amounts to be paid in connection with the proposed transaction must be disclosed. In order to determine whether

the acquisition involves a wholly independent third-party in an arms' length transaction (and whether conflicts of interest analysis applies), information on the other parties to the transaction is required. Consequently, the corporate documents of all the parties (articles of agreement, as amended; by-laws, currently in force; statement of ownership; etc.) and the financial statements for all the parties to the proposed transaction must be filed. Also of critical importance are documents related to valuation. There must be a high level of confidence that the selling charity is receiving fair value for the assets it is conveying.

2. Public Access

The Attorney General's office should prepare to make available to the public all of information obtained in the review process which is not confidential (e.g., trade secrets) under state law. Care should be taken by the Attorney General's staff to segregate out the confidential documents and to prepare in advance for the many requests for public copies which will be received after the notice of public hearing is published.

D. Retention of Experts by Attorney General

The model act permits the Attorney General's Office to retain outside experts for the purpose of evaluating a proposed transaction. The experts may include independent legal counsel and independent financial advisors. Under Section 7.01(2) of the model act, the costs of retaining such experts are to be paid by the nonprofit entity. As indicated earlier, a period of time will be required to retain outside experts and, consequently, the parties should meet with the Attorney General prior to the required filing to discuss time frames.

E. Public Hearing

Section 4.01 of the model act requires the Attorney General's Office to call one or more public hearings prior to issuing his decision approving or disapproving the proposed transaction. Since the Attorney General is required to "hear" comments from "any" interested person "desiring to make a statement," the public proceedings may be productive, lengthy and spirited. Since the topic involves issues of healthcare needs, healthcare costs, accessibility and affordability, careful planning is required to make certain the hearing is fair and affords a full opportunity for the public to offer comment. Based upon past transactions, communities are very involved with their local hospitals and questions raised will range from valuation issues to the purposes to which the charitable assets will be directed. (See below for a discussion on the creation of new nonprofit foundations). The Attorneys General from a number of states have had experience with these public hearings and their advice should be solicited.

II. SUBSTANTIVE REVIEW

The substantive review which the Attorney General is mandated to undertake has a number of specific components which are set forth under Section 5 of the model act. These components include (1) a determination of whether due diligence has been exercised by the governing board in the proposed transaction; (2) whether there are breaches of fiduciary duties; (3) whether fair market value is being paid for the assets of the nonprofit entity; and (4) whether the proceeds will be used for a proper charitable purpose, among others. Each of the 9 items contained in Section 5.01 of the model act has a substantial history behind it, with either growing case law or past history in other

jurisdictions to provide guidance to states adopting the model act. These issues can only be set forth in a general manner below.

A. Fiduciary Standards

The review by the Attorney General must be conducted to determine if the transaction involves self-dealing or other conflicts of interest violations. In all cases, the directors of the nonprofit entity should reach their decision based upon independent valuation information and should exercise due diligence to ensure that the proposed transaction is for fair value. The review by the Attorney General focuses on the duty of reasonable inquiry and the key elements include whether appropriate consultants were retained to evaluate the benefit to the charity, valuation, tax consequences, etc. Special attention should be paid where there has been no effort to market the charitable asset widely to insure maximum return. In some jurisdictions, a sworn statement from the members of the governing board of the nonprofit entity stating that there are no conflicts of interest is required as a method of calling attention to this element. This avoids the need for extensive background investigation into the financial holding of each board member.

B. Transactional Details

All terms and conditions of the sale should be scrutinized by the governing board and any committees of the governing board, with particular emphasis placed on a variety of items. These items could include the following:

- (1) are there contingencies which affect the purchase price, such as pay-outs over a period of months and years;

(2) are there indemnification provisions or hold-backs which could substantially reduce the purchase price;

(3) are stock certificates or promissory notes being included in lieu of cash as part of the purchase price and, if so, are there restrictions on the resale of the stock, possible adverse tax consequences, possible future dilution of interest, and issues of imprudent concentration of assets in a single holding, among others; and

(4) if a joint venture is involved, have certain key issues be examined, including management contracts, operating agreements, guarantees, valuation of the contributed assets of all parties, and the possibility of dilution of control or financial interest through capital calls.

This list sets forth only a few of the complex issues which the Attorney General's office may need to examine within a very limited timeframe.

C. Fair Market Value

In all transactions, fair market value is a critical element, since charitable beneficiaries are entitled to receive maximum value for their assets. Key items in any fair value analysis include the following: (1) whether the nonprofit entity has been aggressively marketed by investment bankers in a public auction to generate multiple bidders and maximum value; (2) whether there are competing offers and the proper evaluation of those competing offers; (3) whether appropriate business valuation appraisals have been obtained; (4) whether adequate professional assistance has been retained by the governing board to fulfill its duty of reasonable inquiry and due diligence; and (5) whether there is evidence of lucrative contracts with officers or employees, or lucrative buy-outs of related, subsidiaries or entities, at the expense of the charitable interest, among others.

D. Inurement

All transactions should be scrutinized to insure that no officer, director, employee, spouse or family member, or private party receives inurement from the transaction. Special scrutiny should be used where specific items are found in a transaction, including stock options, pension plans, performance bonuses, corporate loans, golden parachute provisions, excessive salaries, and side letters and arrangements for officers, directors, and employees.

E. New Foundation/Charitable Uses

Under Section 5.01(3) of the model act, the Attorney General must ensure 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 charity or a newly-created foundation must utilize the assets for a charitable purpose benefiting the same class of beneficiaries, (see Queen of Angels Hospital v. Younger, 66 Cal, App. 3d 359; Holt v. College of Osteopathic Physicians & Surgeons, 61 Cal. 2d 750).

Section 5.01(9) establishes criteria for any newly-created nonprofit foundation resulting from the proposed transaction. In light of the many new foundations which have been created since 1990 as a result of these healthcare conversions, this section is very significant. Over 50 new foundations, with assets in excess of \$3 billion dollars, have been established; and the charitable purposes of these new entities is, generally, to meet the healthcare needs of the disadvantaged or uninsured/underinsured populations in particular states. The model act does speak specifically of whether the new foundations are “broadly based in the community” and the need for the governing boards to be “representative of the affected community, taking into consideration the structure and

governance of such foundation.” Consequently, the Attorney General has a major responsibility in connection with the crafting of the articles of agreement, the bylaws and the mission statements, as well as the selection of the initial governing board of the new foundation; and public comment on these issues should be invited at the public hearing and in written comments. The establishment of a new healthcare foundation can be a major event in the history of charitable foundations in a state, and issues of affordability, accessibility, charitable mission, and duplication of existing healthcare services are legitimate topics for public comment.

F. Continuing Oversight

Since the conversions occurring during the past 7 years have involved billions of charitable dollars in assets, continuing oversight by the Attorney General must be maintained to ensure compliance with applicable laws. This may be done in a number of ways, including monitoring of all cases under provisions inserted in consent decrees for approval. Specific audit reviews on an annual basis for an appropriate time period might be useful. So too is an annual accounting to the communities involved.

IV. CONCLUSION

As indicated earlier, this is an area of rapidly changing law with major healthcare entities at risk. The responsibility of the Attorney General’s Office in this process is to conduct a thorough and complete review under the model act, to do so in a manner that is open to public comment and scrutiny, and to protect the charitable assets involved consistent with the Attorney General’s traditional trust duties.

Notes to the Proposed Model Act

Section 1.01 Definitions

The scope of the model act is broad, bringing hospitals, HMOs, and health care insurers, as well as nonprofit organizations affiliated with these entities, within the scope of the Attorney General's review authority. Including the affiliated organizations within which a hospital, HMO or insurer operates into the definition is important not only because of the rapid development of integrated healthcare systems, but also because conversion transactions often involve the transfer of assets from multiple corporate entities within a system, rather than the primary entity alone. It is a policy decision for each state whether the sale of subsidiary assets alone, which could constitute a material amount of a healthcare system's wealth, will trigger the statute.

The definition of the term "hospital" varies from state to state, with many states defining hospital as meaning an acute-care hospital. In other states, "hospital" may be defined more broadly to include psychiatric and rehabilitative hospitals. Each state adopting this model act should check its own existing statutes to determine precisely how broadly the term will be defined.

Section 1.02(2). Definitions.

The model act uses the term "material amount" as a trigger for the statute. This is a flexible and imprecise concept but has advantages for the Attorney General. Two factors weigh in favor of a materiality standard. First, in states where there are limited resources at the Attorney General's Office, the Attorney General retains more discretion in deciding when to investigate a proposed transaction. Second, using a specific percentage in the statute may invite gaming or manipulation of the percentage cut-off, either by pre-transaction mechanisms or by fragmenting or staggering the transaction over a number of years and coming in under the statutory percentage trigger. The model act allows attorneys general to issue interpretative releases, creating "safe harbors" with specific percentages indicating with greater specificity what is material and what is not material. Local corporate attorneys might benefit from the predictability of such interpretative releases.

Section 2.01. Court Approval/Cy Pres.

This section of the model act requires approval of the Attorney General for such transactions. However, a number of states have existing cy pres statutes which require court approval for such conversions. If your state has such a cy pres statute, you must consider the options available: substituting the Attorney General for the court procedure and approval; requiring both court and Attorney General approval; or retaining only court approval. In one state, the merger statute preserves court approval where a for-profit entity is acquiring a nonprofit entity (cy pres) but requires the Attorney General's approval where two nonprofit healthcare entities are involved. The cy pres statutes set a very high standard in these matters (the entity must prove illegality, impracticability, etc.). The model act has a more flexible standard; and how to proceed is a policy question for each

state to decide. Because of concerns that members of governing boards be fully informed of their fiduciary duties in these complex transactions, Section 2.01 requires that a copy of the statute be given to each member of the governing board, with a certification to the Attorney General that this has been done.

Section 2.02. Notice and Filing.

The model act requires the filing of "all the information the Attorney General determines is required." There is a need for regulations or interpretative releases to define this provision in more specific language and to alert attorneys representing the parties in advance as to what documents are required. Creating such a list will avoid having the Attorney General continually go back to the applicant to request additional documents, will save time and will allow for greater efficiency. Required documents would include purchase and sale agreements, joint venture agreements, side agreements, employment contracts, financial data and expert analysis, including valuation studies, financial statements, certified board resolutions, minutes related to the approval and deliberations on the transaction, and a description of the corporate and management structures, to name a few items. (See the attached Commentary for a more specific list). The Attorney General must make clear that the 90 day time period does not begin to run until the filing is deemed "complete" by the Attorney General. The 90 day time period is a very brief period for the type of review which the Attorney General's office must undertake.

Section 2.03. Waivers.

This section speaks of waivers for transactions "in the usual and regular course of its activities." This allows for routine sales of equipment to avoid exhaustive reviews. Regulations or guidelines must be clear on how broad the scope of this exemption is. Is it limited, for example, to the sale of used MRI equipment? This waiver provides an opening for attorneys representing healthcare entities to craft exemptions which were not originally contemplated; consequently, the use of the word "and" (requiring the Attorney General's written approval of any waiver) is important.

Section 4.01. Public Meetings.

The public has a right to be heard on any proposed healthcare transaction. This is so because public charities are responsible to their public beneficiaries. This section makes such public hearings mandatory in all transactions. (In some states because of limited staff and resources, the public hearing is in the discretion of the Attorney General.) Public hearings should be tape-recorded and written statements should be invited. Because parties to the transaction - or opponents of the transaction - may "pack" the meeting, consideration should be given to an orderly process for selecting speakers and the time periods for speakers to present their materials. Community cable programs may ask to videotape the proceedings. If so, thought should be given to ensuring an

orderly process where public comment is fully received in a way which ensures fairness to all. Section 4.01 does not limit the scope of the public comments. For those states reluctant to adopt a mandatory public hearing requirement, some provision must be made for receiving formal, written public comment, especially since the proposed transaction will be scrutinized both by the local communities affected and by national health care advocates.

Section 5.01. Discretion of Attorney General; Review Elements

Section 5.01(1). Full and Fair Market Value

If a bidding process has been used to determine fair market value and an investment advisor has been retained, the process is generally fair but the challenge is comparing bids which contain many different provisions (cash, stock, promissory notes, differing pay-out periods, etc.). When no bidding process has been used, determining full and fair value can be fraught with difficulty. In these instances, experts need to be retained to represent the Attorney General in making a determination; and the fact that the parties themselves have already retained their own experts is not always decisive.

Section 5.01(4). Fiduciary Duties

Among the items to be considered in determining whether to approve or disapprove a transaction is whether there are breaches of fiduciary duties by the governing board or officers of the entity. Because fiduciary duties are not always clearly understood, even by the most sophisticated board members (see the Adelphi University controversy), the Attorney General may wish to provide general commentary on fiduciary duties in the regulations or in releases or the Commentary to the model act. More specifically, the duty of care and the duty of loyalty need to be explained in these complex transactions, if only to prepare board members to ask questions and scrutinize the recommendations of management. There are a number of excellent articles on the duty of directors of healthcare entities in complex, integrated transactions.

Section 5.01(9). The New Foundation

The establishment of the new charitable foundation is a critical outcome of the transaction. However, because of the pressure of time and the attention paid to issues of valuation, this aspect often does not get the attention it deserves during the review process. Over 50 new healthcare foundations have been established as a result of healthcare conversions in the 1990s with assets of over four billion dollars; and the Attorneys General should consider taking an active role in the drafting of the articles and bylaws, the identification of the disadvantaged groups to be served, the defining of the charitable mission, and the critical selection of the members of the first governing board.

Of considerable importance is the obtaining of public comment on the new foundation and the healthcare needs that foundation should address. The public comment may be obtained during the public hearings required under Section 4.01 of the model act and that hearing may be supplemented with an opportunity for the public to submit additional written comments on this aspect.

In addition, existing resources are available without charge to advise the Attorney General and the parties to the transaction in defining the charitable mission. Existing needs assessments are available from hospitals, healthcare groups and governmental agencies (state health and human services departments in particular), among others. Depending on the quality and currency of available data, it may be advisable to commission a particularized needs study. There is also a growing number of resources available to the parties and to the Attorney General: consumer groups, other state attorneys general, as well as literature and newspaper analysis on the existing 50 foundations. There are also sample articles, bylaws and mission statements now available from other attorneys general, as well as information on how to assure diversity on the governing board. The establishment of a broad-based charitable foundation, independent of the parties involved in the merger, deserves to be high on the checklist of things to be done and not left until the last moment. Once the transaction is completed, the role which the Attorney General has in the development of the new foundation diminishes significantly. However, it is worth considering a system for monitoring the grant-making activity of the resultant foundation. For example, the Attorney General may wish by rule to establish a policy to review the initial round of grant-making to ensure that grants fall within the appropriate range of charitable purposes. Further, the Attorney General may wish to establish a policy to appoint an ex officio board representative to serve for one term and report the board's activity to the Attorney General.

Section 5.02 Impact upon Health Care

This section of the model act is optional. However, the issues which the section addresses are critical and are of enormous public concern: the adverse impact which the transaction may have upon free care for the indigent or upon the affordability of care after the transaction is consummated. Some Attorneys General may view these issues as falling outside the scope of their abilities and resources; however, these issues will be high on the list of concerns of the communities affected by the transaction. If adoption of this optional section is deemed to be inappropriate, it is strongly recommended that oversight for these issues be placed within an existing public health authority for review by that agency.

Section 6.01. Regulations

Once the model act is adopted, the Attorney General should move quickly either (1) to adopt regulations or (2) to issue Interpretative Guidelines or Interpretative Releases to alert the legal community and educate the healthcare industry on the impact and significance of the new statute.

Adopting the model act is just a first step in obtaining compliance. Educating the legal and healthcare communities on the scope and significance of the model act and on the Attorney General's interpretation and procedures is also important, since it will help ensure efficiency and compliance. The Attorney General should consider offering or participating in seminars or CLEs and contacting the healthcare section of the state bar association. Direct mailings of the statute and a commentary to the regulated hospitals and other regulated entities might also be considered. (See the attached sample Commentary on the Model Act, which could serve this purpose.) If the new regulatory structure is to work effectively, the Attorney General should alert board members on compliance and enforcement issues. In addition, regulations or a commentary will protect against charges of unfair treatment in what is becoming a highly charged, rapidly changing area of the law.

The Attorney General should seek to reassure directors, not intimidate them or cause good individuals to avoid serving on governing boards.

Section 7.02. Retention of Experts

When experts must be retained in a complex transaction, the Attorney General will find his/her office in a difficult position. The model act contains restricted time limitations on the Attorney General's review, with 90 days from a completed filing and an additional 60 additional days if experts need to be retained. Identifying outside legal counsel and financial experts and bringing them up to speed are always time-consuming. The model act contemplates retention of experts outside the scope of a state's purchase regulations, thereby avoiding lengthy RFP procedures. In states where this is not possible, an alternative is to pre-qualify a pool of experts in advance, thereby enabling all parties to proceed expeditiously with the selection. Contract negotiations and conflict-of-interest analysis will still have to be undertaken for each specific engagement, but the time period for this can be greatly compressed.

Two related problems present themselves in connection with the retention of experts. First, financial experts and outside legal counsel are very costly. To control costs, specific issues and tasks should be identified at the start of the engagement and expanded only as needed. If possible, there should be agreement on specific team members for the experts and regular, monthly billings should be required. Second, ensuring that all information has been filed under section 2.02 of the model act will be difficult, since first document production requests often lead to supplemental document requests. No decision as to whether the filing is complete should be made without consulting with the retained experts.

Section 8.01 Public Records

Although the model act emphasizes public access to the filed documents, full investigation by the Attorney General requires disclosure of trade secret or other commercially competitive material. This material may be subject to third-party confidentiality agreements under which the

nonprofit entity is subject to liability if disclosed without a promise of confidentiality. In addition, some filed material necessary to the Attorney General's expert to determine valuation (such as rate levels or on-going medical service agreements) will have value to the buyer only if the information remains confidential. In order to ensure full disclosure of all information, the Attorney General should have the ability to promise confidentiality for this very narrow category of information, either under an existing public access/public records statute or by explicit provisions in the new legislation.

Section 9.01. Penalties.

The penalties contained in this section may, at first glance, appear stringent. However, the assets involved in these transactions are charitable assets involving public charities for which the public has granted tax-exemptions to build the value of the entity over time. Because these transactions involve healthcare entities and raise critical issues of healthcare availability and accessibility, the standards contained in the model act are appropriate and warranted.