

REPORT OF THE ANTITRUST, TRADE REGULATION
AND CONSUMER AFFAIRS SECTION
OF THE DISTRICT OF COLUMBIA BAR
ON ENFORCEMENT OF THE
HEALTHCARE ENTITY CONVERSION AMENDMENT ACT OF 1997

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Executive Summary

The D.C. Bar's Antitrust, Trade Regulation, and Consumer Affairs Section encourages vigorous enforcement of the recently enacted "Healthcare Entity Conversion Amendment Act of 1997." The purpose of the Act is to increase public scrutiny of transactions in which entities are converted from nonprofit to for profit status, and avoid dissipation of public moneys for inappropriate private use. The recent acquisition of local nonprofit George Washington University Hospital by Universal Health Systems, Inc., ("Universal") a for profit company, is a conversion of a nonprofit that spurred consideration of reform legislation.

The new Act requires approval of conversions by the D.C. Corporation Counsel. The Act establishes a public interest standard for Corporation Counsel review that includes a determination of the fair value of the nonprofit's charitable assets, and dedication of those charitable assets to charitable purposes. In addition, the Act provides for payment to D.C. to recoup past foregone taxes.

The new Act improves D.C. government regulation in this area. The Section's view is that the D.C. Government could effectively regulate nonprofit conversions under the new Act and, indeed, could have done so under prior law.

The Section emphasizes the rudimentary point that careful accounting of public assets of a nonprofit entity is a step preliminary to, and distinct from, a governmental decision whether or not to object to conversion. It may have been prudent for the D.C. Government to permit conversion of nonprofit GWU Hospital upon acquisition by for profit Universal, and it may also have been prudent to allow Universal the benefit of charitable assets of GWU in return for services rendered to the public. However, the decision hinges in part on first determining the amount of GWU's charitable assets. In order to ensure that the owners of for profit entities, such as Universal, are not unjustifiably enriched at public expense, it is essential that the D.C. Government determine that the value of the public services provided exceeds the value of the public assets acquired.

The Section also emphasizes that the major health care issues that face the D.C. Government do not preclude careful attention to nonprofit conversion issues. To the contrary, knowing the amount of charitable assets held by a nonprofit entity facilitates a reasoned decision on their use.

I. Overview

The D.C. Bar's Antitrust, Trade Regulation, and Consumer Affairs Section supports vigorous enforcement of the recently enacted "Healthcare Entity Conversion Amendment Act of 1997." The Act apparently was proposed in response to the recent acquisition of George Washington University ("GWU") Hospital (a local nonprofit hospital) by Universal Health Systems Inc. ("Universal") (a for profit organization). The legislative purpose of the Act is to increase public scrutiny of conversion of nonprofits to for profit status, and to avoid dissipation of public moneys for inappropriate private use.

The Act's basic plan is to require approval of conversions by the D.C. Corporation Counsel. The new law includes some "sunshine" provisions for a public record and a possible hearing concerning the conversion transaction. The Act establishes a public interest standard for Corporation Counsel review that includes requiring payment of fair value for charitable assets, dedication of charitable assets to charitable purposes, and avoidance of conflicts of interest affecting the conversion process. In addition, the Act provides a formula for payments to D.C. to recoup past foregone taxes.

Important applicable principles for D.C. government action are well stated in the new Act: D.C. government should require an accounting of charitable assets whenever a nonprofit hospital or other nonprofit organization proposes to sell its assets or enter into a joint venture or other arrangement affecting its nonprofit status. A determination should be made that a fair value is being paid for those assets, and that the assets are retained for appropriate charitable purposes. It is crucial that the actual amount of the charitable assets be carefully determined, so that there can be an orderly decision on their disposition.

The reasons for these principles are clear. The nonprofit's assets include contributions from the public made because of promised charitable purposes. A nonprofit hospital's assets also reflect the benefit of real estate tax and other tax breaks. The government should ensure that private investors are not unjustly enriched at the expense of the public.

While D.C. government and its Corporation Counsel had power to regulate conversion of nonprofits under prior law, the new Act clarifies the regulatory obligations of D.C. government. The Act does not significantly improve the amount and quality of information to be provided to the Corporation Counsel by the parties, and because of that omission the Act is weaker than the legislation initially introduced by Councilmember Allen. Vigorous regulatory enforcement may nevertheless be pursued under the Act, much as it could have been under prior law.

The Section emphasizes the rudimentary point that careful accounting for public assets of a nonprofit entity is an important step distinct from, and preliminary to, a government decision whether to object to or endorse a conversion. It may have been prudent for D.C. Government to permit conversion of nonprofit GWU Hospital upon acquisition by for profit Universal. It may have also have been prudent to allow Universal the benefit of charitable assets of GWU in return for services to the community. The wisdom of the decisions hinges in part on knowing the amount of charitable assets involved. If the value of the charitable assets exceeds the value of the services to be rendered by the for profit, then D.C. government has struck a poor bargain. It is not clear that a sufficient accounting of charitable assets and a balancing against value received was made by D.C. government in the case of GWU and Universal.

The Section recognizes that accounting for charitable assets is a small part of the difficult array of health care problems that beset D.C. government. The problems include dealing with the financial difficulties and likely restructuring and shrinkage of the area's hospitals, and providing needed health care services, such as emergency trauma care, and maintaining health services for the uninsured poor. The Section's view is that the need to solve these additional problems would not justify a failure to account for charitable assets of a converting nonprofit. To the contrary, knowing the amount of charitable assets facilitates a reasoned decision on their use.

In the following sections we elaborate on some aspects of the discussion above. First, we review some experience from several states concerning government review of conversions. Next we discuss some aspects of the new Act in greater detail. We then discuss the need of D.C. government to apply the new Act with a clear focus on accounting for charitable assets. We briefly discuss recent health care developments in D.C. as they bear on some of the major health care problems that face D.C. government. We make the point that the need to solve big health care problems is not a sufficient reason for D.C. government to skip over accounting for charitable assets.

II. The experience in the States -- the need to account for the value of the charitable assets and require that charitable assets be maintained for charitable purposes

Careful government review of conversions is critically important. James Schwartz, deputy attorney general in California, describes the role of the California Attorney General with regard to nonprofit conversions as follows:

[I]t is our job to ensure that nonprofit directors meet their fiduciary obligations of loyalty and due care to the public -- who are the beneficiaries of the

trust upon which all charitable corporations hold their assets'-- and to ensure that those directors do not permit the charitable assets to be used in a manner inconsistent with that trust or allow the charitable purpose to be abandoned.

John Vinson, assistant attorney general in Texas, explains that a government regulatory role typically is derived from routine charity law based on common law:

The duty of attorneys general to protect non-profits' charitable assets does not differ much among the states. . . . Charity law in Texas, as in many states, is primarily based on the common law as derived from ancient English statutes. . . . [T]he general common law in this area is effective in allowing the Texas attorney general to fulfill the public duty to protect charitable trust assets. . . . [A] suit would likely be filed against an organization if a health care conversion [from nonprofit to for profit] were determined not to be in the public interest because of a misapplication or undervaluation of charitable trust assets.

Valuation and charitable application issues apply to conversions of a variety of nonprofit organizations. Several states have taken action in response to proposed conversions of nonprofit Blue Cross-Blue Shield health care insurers to for profit status. For example, California allowed a Blue Cross conversion transaction to go forward only after requiring Blue Cross to create foundations with \$3 billion in assets, an amount much greater than Blue Cross initially offered. Missouri recently won a conversion case against Blue Cross, which permits benefits for the public similar to those achieved in California. For further detail see "State Policy Issues in Nonprofit Conversions," by Patricia Butler, in *Health Affairs*, March/April 1997, Volume 16, No. 2, at p. 71.

The citizens of the District of Columbia are no less deserving of protection from possible misuse of charitable assets than the citizens of the states mentioned above.

III. Discussion of particular provisions of the new Act

A. Preventing secrecy in conversion transactions -- the original Allen bill contrasted with the new Act

While the D.C. Corporation Counsel under prior law had power to determine whether acquisition of a nonprofit is permitted under the Non-profit Corporation Act and other laws of the District of Columbia governing nonprofit entities, the Corporation Counsel had limited ability to force disclosure of the financial details of the transaction. New legislation as

initially proposed by Council member Allen would have solved that problem by requiring the parties to the conversion transaction to supply substantial information to the Corporation Counsel. The written application would have provided an explanation of the details of the transaction, including the price paid. The application also would have included a valuation report and an expert financial and economic analysis.

The new Act does not require a detailed filing that would provide important information to the Corporation Counsel. The burden of obtaining information needed to assess a proposed transaction is placed on the Corporation Counsel's Office, yet no efficient means is provided for the Corporation Counsel to require that the parties submit transaction and financial information. In addition, the Corporation Counsel is obligated to pass on the transaction within 60 days. The difficulty of locating information in such a short time could create pressure on the Corporation Counsel to forego rigorous accounting of charitable assets. The Section encourages the Corporation Counsel to resist these pressures and require a rigorous accounting.

B. Public notice provisions

The new Act requires the Corporation Counsel to provide public notice of the application for conversion, and invite comments from the public. A public hearing may occur. The Section thinks the provisions may be used to encourage public attention to conversions, and supports their vigorous use.

C. Definition of the Corporation Counsel's duty of public interest review

Prior law permitted the Corporation Counsel great discretion concerning review of conversions. The new Act obligates the Corporation Counsel to undertake a review of conversions using specified criteria.

The criteria to be applied by the Corporation Counsel include the evaluation of steps taken to safeguard the value of the nonprofit's charitable assets and to ensure that proceeds of the acquisition are placed into a charitable trust for appropriate charitable use. Also required is analysis of conflicts of interest which might lead to improper profit taking by management insiders, among other criteria.

The Section thinks that the articulation of criteria is desirable, and supports the provisions. The Section hopes these criteria will be vigorously applied.

D. Formula for tax payback

The new Act contains provisions for payments that permit the District to recoup foregone past taxes. The formula for tax

recoupment is distinct from provisions for accounting for charitable assets. The payments are desirable; it is important, however, that they not be treated as a substitute for an accounting of charitable assets and a reasoned disposition of those assets in the public interest.

III. Government pursuit of broad health care goals should not preclude vigorous application of the Act

Advocates concerned with nonprofit conversions may give priority to achieving their goals concerning the kind and nature of services to be provided to the community, and give short shrift to accounting for charitable assets. Some supporters of for profit Universal's acquisition of nonprofit GWU Hospital put priority on the argument that Universal would continue GWU's important community services, and gave short shrift to Corporation Counsel review and accounting for GWU's charitable assets.

A brief survey of recent restructuring of D.C. health care services reinforces the point that preservation of charitable assets is fully consistent with broad concerns about preservation of health care services for the community.

Recent developments threaten the traditional role of D.C. General as a "safety net" hospital, providing low cost primary care to uninsured and impoverished populations. D.C. Mayor Barry has proposed decreased funding. District officials are reportedly considering the creation of a managed-care health system for the working poor that has the potential to funnel Medicaid funds away from D.C. General.

With regard to non-public hospitals, there has been great financial pressure for hospital consolidations and other changes. With regard to GWU Hospital, it had been struggling financially for several years. The hospital had sought a buyer since 1995. Universal reportedly agreed to purchase GWU Hospital this April with a purchase price of \$125 million, with another \$40 million promised in immediate improvements. GWU officials argued that the acquisition would preserve important community health services.

There has been other merger-related activity at other D.C. hospitals. Columbia Hospital has been beset in the past few years with a debt of \$23.5 million and a diminishing number of patients, and has sought court assistance in choosing a merger partner. A Washington Post article (March 6, 1997) said that "Columbia's plight reflects population shifts in the Washington area as well as competitive forces that have weakened the financial pictures of District hospitals." Georgetown University Hospital reportedly also faces financial difficulties and cut backs and possible new business arrangements.

There is no serious argument that government response to these great issues of hospital consolidation and preservation of services is inconsistent with the simple goal of vigorous protection of charitable assets. Careful accounting of the amount of public assets of a nonprofit entity should facilitate a well reasoned decision on whether to permit conversion of a nonprofit and how to allocate the assets. The Corporation Counsel should not allow pursuit of other health care goals to deter vigorous enforcement of the new Act.

IV. Conclusion

The Section finds the general scheme of the new Act to be desirable. The Section's view is that omission of requirements for detailed reporting to the Corporation Counsel is unfortunate, and deprives the Corporation Counsel of important information. The Section supports vigorous review of conversions by nonprofits to for profit status. The issue of accounting for the value of charitable assets should be treated as distinct from, and preliminary to, the government decision to object to or approve conversion.