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FEATURE STORY

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pardon me: that's *our* money!

Healthcare organizations need to protect their not-for-profit corporate assets from charitable trust treatment.

AT A GLANCE

Not-for-profit healthcare providers have several options they can use to resist government attempts to apply the charitable trust doctrine to their business decisions. As a strategic defense, providers should perform internal due diligence that focuses on governing documents, financial arrangements, donations/solicitation, real estate, and charitable waste allegations.

Not-for-profit hospitals and health systems and other tax-exempt healthcare providers are under increasing financial stress—much of it the result of the government's mandates and its refusal to pay fair value for services it purchases or otherwise requires hospitals to provide. From low payment rates for Medicaid and Medicare to HIPAA costs to mandatory emergency services to the uninsured, government has been a major contributor to the financial distress affecting many community and faith-based providers as they carry out their charitable missions. Now, unfortunately, not-for-profit healthcare systems face another government impediment to fiscal responsibility: an attempt by certain state attorneys general to apply questionable legal theories under the charitable trust doctrine to the business decisions of boards of directors of not-for-profit healthcare corporations.

The successful imposition of such legal theories, which were never intended to apply to the business decisions of corporate entities, would threaten the ability of not-for-profit providers to effectively financially manage the delivery of healthcare services while both the number of uninsured and the need for such services are rising. As such, it is important for not-for-profit healthcare providers to ask: What really is at stake here? Is this just another exaggerated legal risk threatening to divert scarce corporate resources, or is it a legitimate threat to an institution's financial flexibility?

Experience suggests it is the latter, particularly since the typical targets of such aggressive charitable trust treatment are:

- Decisions as to the specific healthcare services to be provided at individual institutions
- Allocations of acute care services between specific campuses in a system
- Closure of certain campuses and reallocation of services at other campuses to improve financial viability of the system as a whole

> Cross-guarantees in master trust indenture financings
> Intra-system financing arrangements, such as loans, loan guarantees, and other internal credit arrangements
> Corporate treasury and cash management programs
> Intra-system distribution of specific sales proceeds
> Allocation of headquarters costs
> Assessment of system fees
> Mandatory transfers to fund strategic initiatives

All in all, the issues involved here are fundamental to the ability of a not-for-profit health system to apply its assets in the manner it believes is consistent with its charitable purposes and necessary to ensure its continued financial viability.

Fortunately, by implementing several reasonably simple and relatively effective measures, not-for-profit healthcare providers can help resist these challenges and protect the integrity of the corporation's decision-making process and the right of the board of directors/trustees to manage the private not-for-profit assets that have been entrusted to their care. To be effective, however, these measures need to be implemented *before* the problem arises. The challenge: committing scarce corporate resources in the immediate near term to address a nonimmediate problem.

The Legal Concept

The charitable trust controversy has its roots in the complex and often-misunderstood distinctions between the laws governing corporations and those governing charitable trusts. You don't have to be a lawyer to appreciate the basis for—and the implications of—the distinctions. Not-for-profit status generally refers to a corporation formed under a specific state law (e.g., a not-for-profit corporation statute) to pursue a charitable purpose, rather than profits. The general characteristics of not-for-profit corporations are twofold: (1) their corporate activities are limited to those set forth in their articles of incorporation and, in the healthcare area, are generally limited to charitable or social welfare purposes, and (2) their net income must be retained and applied for the purposes for which the corporation was formed (e.g., promotion of health, operation of acute care hospital). A not-for-profit corporation is created by filing organizational documents with the secretary of state or similar state official. The corporation may also seek federal and state tax-exempt status under the Internal Revenue Code and applicable state law.

A charitable trust is a trust relationship created by a donor (individual, corporate, or otherwise) for donative and/or tax planning purposes. The charitable trust may be created by a living trust agreement, declaration of trust, or will. Typically, the donor must expressly intend to treat property as subject to the trust and the trust document must set forth a specific charitable purpose. In many states, charitable trusts are subject to specific state charitable trust acts and charitable registration and solicitation laws. The attorney general is typically empowered to supervise both not-for-profit corporations and charitable trusts.

The Problem

The problem—and legal ambiguity that is at the heart of the current controversy—is historical in nature. Before the enactment of specific state not-for-profit corporation laws (which occurred mostly in the 1970s and 1980s), there was uncertainty as to whether corporate law or trust law should apply to not-for-profit charitable corporations. Federal courts throughout the country reached different conclusions on the issue in the mid-1980s. However, for at least 20 years, courts have repeatedly ruled, virtually without exception, that not-for-profit corporations, and the actions of their directors, are governed by not-for-profit corporate law standards, not by trust law standards. These decisions have profound significance, because trust law is generally more restrictive and provides less decision-making autonomy than does not-for-profit corporation law. Charitable trust law may also offer a wider range of enforcement remedies than is available under not-for-profit corporation law.

For example, trustees of charitable trusts are subject to higher fiduciary standards than are not-for-profit corporate directors (e.g., charitable trustees may be liable for mere mistakes in judgment). Furthermore, trustees are prohibited from dealing with trust property for their own financial benefit without express court approval, whereas not-for-profit corporate

directors may do so within specific statutory guidelines. Along the same lines, it is much more difficult to modify the governing documents of a charitable trust, which requires unanimous agreement of all trust beneficiaries or court approval, than it is to amend the governing documents of a not-for-profit corporation, which can be accomplished by affirmative action by the board members typically without court approval. Corporate directors also may delegate duties more freely than charitable trustees. In other words, trust and not-for-profit principles in this area are mutually exclusive. Only one set of rules can logically and equitably apply to govern the conduct of the director of a not-for-profit, charitable corporation, right? Unfortunately, not.

In recent years, the attorneys general of several states have turned to charitable trust law as an enforcement tool with respect to not-for-profit corporations and their boards of directors. This may be because the more severe provisions of charitable trust law offer regulators greater flexibility and leverage in dealing with concerns related to the not-for-profit sector.

For example, the Minnesota attorney general is using "waste of charitable assets" arguments to challenge certain corporate expenditures (e.g., executive compensation, consulting fees, and board expenditures) of leading integrated delivery systems in the state. The attorneys general of New Mexico, North Dakota, and South Dakota have challenged Banner Health's ability to allocate within its system proceeds from the sale of several of its community healthcare facilities. The Florida attorney general attempted to use a "constructive trust" to remove the Intracoastal Health System board's control of its assets. Indeed, the Florida attorney general has issued a position paper asserting that not-for-profit hospitals should be regarded as charitable trusts. Also, the Texas attorney general attempted to restrict the National Benevolence Association's use of consultants in its reorganization efforts, notwithstanding the fact that not-for-profit corporation law authorizes boards of directors to retain and rely on outside consultants in meeting the duty of care. In these and other, similar matters, attorneys general have applied charitable trust rules and remedies—largely unavailable under corporate law—to challenge practices and expenditures by not-for-profit corporations that are construed as threats to the charitable assets.

Getting It Straight

It is important to recognize that this "charitable trust initiative" has two discrete components. One component is based on the "waste of charitable assets" theory, and is typically used by attorneys general to challenge corporate expenditures (e.g., executive compensation, board expenditures, management prerequisites, use of consultants, incurring penalties, and otherwise failing to make "trust" property productive). "Waste" allegations typically arise from state charitable trust statutes or common law obligations of trustees to maintain the productive use of assets. These issues often involve issues of personal benefit and, as such, resonate with the public.

The other component—and one of even more fundamental concern—is based on a "community asset" theory, and is typically used by attorneys general to restrict the ability of the not-for-profit organization to freely transfer assets among affiliated corporations (e.g., in a parent/subsidiary system). In these situations, the attorneys general are concerned with retaining for use in the local community assets that can be attributed to donations restricted (directly or indirectly) as to use, and to the benefits conferred by local tax-exempt status. Community asset allegations are most often raised in transactions involving the sale, conversion, or closure of a not-for-profit hospital.

Dealing with It

One benefit of knowing the kinds of arguments to be applied against you is that you have an opportunity to develop your own strategic defense initiatives. Most charitable trust controversies follow a predictable path, allowing organizations to act proactively and address key issues before they become the subject of litigation.

A unique aspect of charitable trust allegations against not-for-profit organizations is that they often rely on a "suspect" legal basis (i.e., the challenge of asserting that charitable trust law does indeed apply to not-for-profit corporations). This means that in many instances, initial allegations may be vulnerable to a prompt, detailed, fact-and-document-based response from the not-for-profit, detailing the

TAX-EXEMPT?

Final Report of the HFMA Chairman's Task Force on Tax-Exempt Status of Institutional Healthcare Providers **discusses the challenges and identifies the requirements healthcare providers must meet to be considered tax-exempt (www.hfma.org/resource/focus_areas/business_of_hc/articles/02_21_02.htm).**

reasonableness of its expenditures, its compliance with specific provisions of the state's not-for-profit corporation law, and the absence of asset restrictions, as the case may be. The goal in such a response is twofold: first, to educate the regulatory agency with respect to the facts of the case so as to dissuade it from an expensive fight that will expend both scarce charitable dollars and state tax dollars in a matter that has questionable, if any, merit; and, second, to make the case as to why, on a public policy basis, the proposed use of charitable funds best carries out the underlying charitable purpose of the organization.

Hence, the question becomes how best to build up such a persuasive body of corporate documents and record keeping. Clearly, there is a certain "roll-up-the-sleeves" element here committing internal resources to a dull internal diligence review. The good news is that the not-for-profit shouldn't need to "reinvent the wheel" in this regard: the organizational "hot spots" and other areas of focus are pretty clear-cut.

RESOURCES ON THE UNINSURED

For a list of HFMA conferences, reports, technical documents, articles, and audio-teleconferences on the uninsured, see *Uninsured Patients: Comprehensive List of HFMA Products and Services* (www.hfma.org/resource/uninsured.htm).

Community Asset Allegations

The focus here will primarily be on documents or records relating to the existence, or nonexistence, of facts that would support a claim that assets are restricted as to purpose or geographic use. A related area of focus is on the benefits received by the facility or system from conducting business in (and receiving favorable tax treatment from) a particular location. Preparing for this type of allegation requires an internal due diligence process focused primarily on organizational, legal, and financial documents.

Governing documents. To the extent possible, the organization's articles of incorporation and bylaws should speak broadly in terms of charitable purposes, emphasizing system or other big-picture goals and objectives rather than those of an individual facility. Along those lines, enabling language that authorizes intra-system financial arrangements (see below) can be useful. It may be important to avoid using language that could be interpreted as adding a geographic or similar limitation on the use of corporate assets. The organization should keep an inventory of amendments to corporate governing documents. State charity officials often take a tiered approach to a charitable trust analysis, i.e., restricting assets to use in accordance with the governing documents in place when the asset was received/created.

Financial arrangements. It will be very important to document the existence of all intra-system financial arrangements (e.g., loans, advances, debt guarantees, and transfers to pooled investment/cash management funds). A system facing charitable trust treatment with respect to one of its affiliates will want to be able to support its basis for being repaid or otherwise reimbursed for instruments in, and credit arrangements with, its affiliated entities. The presence of written agreements and related documentation supporting the bona fide nature of the investments/arrangements will be important.

Along the same lines, it is useful to maintain documentation of all system predecessors and of the entities that previously owned the facility(ies) in question to identify restrictions in the corporate purpose of such entities.

A review of financial statements should also be made to determine whether the facility(ies) in question have been profitable, and whether any equipment or earnings were transferred to other system facilities out of the community or state.

Donations/solicitation. Obviously, a central area of charitable trust inquiry is the "log" of gifts to an organization that are restricted as to use or location. State charity officials will review both of these types of gifts, as well as gifts given for specific purposes or in response to specific charitable fund-raising requests. Organizational record-keeping on such matters can often prove to be a daunting task. Often, the donors keep better records than the organization, which can be problematic. Of particular concern are documented representations made by charitable solicitors on behalf of the hospital in seeking funds for particular projects. On a going-forward basis, steps can be taken to mitigate the risk of creating dedicated funds (as distinguished from general use funds) without excessive effort.

Real estate. Focus should also be on donations of real property, from whatever source (e.g., residents, municipalities, and other not-for-profit or for-profit corporations) and land received from governmental entities or purchased from for-profit entities at less than fair-market value. The concern is that such donations may contain direct or indirect restrictions on use that might be argued as supportive of a charitable trust.

Charitable waste allegations. The focus will be on the reasonableness—and documentation—of the process as it may relate to a compensation arrangement or consultant relationship. Preparing for this type of allegation requires internal due diligence focused primarily on financial/deal confirmation and term sheet records.

For example, when considering allegations involving use of outside vendors, the organization should identify documents that reflect the need for such vendors/consultants; their particular, unique expertise; a request for proposal or similar bid process where warranted; written invoices submitted regularly; the presence of an engagement letter; and corporate policies governing the use of outside vendors and oversight of their services.

Matters of executive compensation are clearly a hot-button item for many state charity officials. To reduce related waste of corporate assets exposure, the organization should be able to document the terms of arrangements and their reasonableness (including any professional opinions on reasonableness), evidence of appropriate comparability data, board review and approval, and absence of conflicts of interest. Also supportive will be evidence of satisfaction with the "rebuttable presumption of reasonableness standard" under the Intermediate Sanctions rules.

Final Word

The above list is not intended to be exhaustive, but rather illustrative of the issues typically considered by state charity officials when evaluating charitable trust-based claims against a not-for-profit corporation.

In many instances, it would be unusual for a corporation to maintain meticulous records/documentation with respect to each of these issues. However, the core of any charitable trust defense (apart from lack of jurisdiction) is the ability to clearly and effectively demonstrate the absence of restrictions on corporate assets and the reasonable, arm's-length nature of corporate expenditures and intra-system financial arrangements. To this end, not-for-profit organizations may find it well worth the effort to increase the internal focus on documentation and recordkeeping. The emerging application of charitable trust principles to not-for-profit corporations can create significant impediments to corporate financial planning. Particularly where the legal issue is so ambiguous, it makes sense to start planning a response now. As potentially time-consuming and distracting as it may be, such an effort may ultimately be well worth the cost. ●

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INTERNET RESOURCES YOU CAN USE

HFMA's Internet Guide to Billing and Collections for the Uninsured **is a collection of policies and procedures, reports, and government resources on the uninsured (www.hfma.org/resource/focus_areas/medicare/authoritative_sources/400287.htm).**

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