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Key Nonprofit Corporate Law Developments in 2008

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The year 2008 witnessed an extraordinary series of developments in nonprofit corporate and charitable trust law as they affect the governance and operation of hospitals and health care systems. This is consistent with a decade-long trend that has made corporate law a key feasibility consideration for nonprofit organizations.

These developments reflect the following general trends: (a) increased oversight from state and federal charity regulators; (b) greater focus on corporate governance practices; (c) closer scrutiny of the exercise of business judgment by boards; (d) the evolution of system structures and business combinations; and notably, (e) the governance implications of general economic turmoil.

Based on these trends, our “top ten” list of major nonprofit developments for health care providers in 2008 is as follows:

1. **The IRS Jumps In.** 2008 saw the first full year of the Internal Revenue Service's unprecedented commitment to oversight of charity governance, as manifested in multiple different ways.

(a) **Public Policy.** Senior IRS officials have made it clear that, while committed to a robust charitable sector, the agency will insist that the sector remain “squeaky-clean,” and focused on “the high ideal of

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public benefit that underlies tax exemption.”¹ This commitment reflects an underlying concern with the substantial potential for abuse involving charity operations. Accordingly, [w]hat happens in the board room ends up mattering to [the IRS] “quite a bit.”^{2, 3}

Notably, 2008 saw a strong demonstration of the two-way exchange of information concerning exempt organizations (EO) between the IRS and state charity officials as authorized by the Pension Protection Act of 2006. Specifically, the IRS disclosed 196 separate EO enforcement activities (e.g. revocation and imposition of excise taxes) to state charity agencies. In response, these agencies made 83 separate referrals to the IRS on issues including (but not limited to) qualification for exemption, private benefit/inurement, and failure to operate in accordance with designated exemption status.⁴

(b) **Form 990.** Clearly, the most important 2008 reflection of this IRS focus was in the release of the Form 990 and its extraordinarily detailed final instructions. Part VI (Governance, Management and Disclosure) to

¹ Remarks of Douglas Shulman, commissioner of internal revenue, before Independent Sector, Nov. 10, 2008, at <http://www.irs.gov>.

² *Id.* See also, Stokeld, “IRS Continues Focus on EO Compliance, Governance, Officials Say,” Nov. 12, 2008.

³ The IRS's interest in charity governance is based on the concept of “implicit jurisdiction.” While the Internal Revenue Code does not expressly include a corporate governance standard, the IRS's view is that the quality of governance affects all aspects of its oversight of tax exempt organizations. Remarks of Steven T. Miller, commissioner, tax exempt and governmental entities, before Western Conference on Tax Exempt Organizations, Nov. 20, 2008, at <http://www.irs.gov> (henceforth, “Miller Remarks”).

⁴ “Internal Revenue Service Tax Exempt and Government Entities Report (December, 2008) (Henceforth, “IRS Annual Report”), p. 13 (http://www.irs.gov/pub/irs-tege/finalannualrptworkplan11_25_08.pdf).

the redesigned form incorporates an extensive set of governance-related questions relating to board size and structure, decision-making practices, audit committee, written governance policies, and the board's role in the preparation and review of the Form 990.⁵ (The number of governance questions in the Form 990 expanded from three to 20.) The final instructions elaborate on these themes, in part by including: (i) a revised definition of the critical concept of "key employee"; (ii) a new standard for determining the independence of board members; and (iii) standards for organizational "reasonable efforts" to obtain required information from "interested persons" or third parties on their relationships with one another.⁶

(c) *Governance Policies.* Further guidance was provided by the IRS in the February release of a comprehensive update of its position on corporate governance. In this "position paper," the IRS discussed its perspective on a series of important charity governance topics, including: (i) the duty of care; (ii) board size; (iii) board composition; (iv) governance policies, generally; (v) executive compensation; (vi) investments; (vii) fundraising; (viii) minute-taking; and (ix) compliance.⁷ This significant interest in charity governance may manifest itself in 2009 and beyond in the audit and examination process (e.g., the relationship between governance and tax compliance); education (focusing on board composition, financial controls and governance structure); and transparency (full and accurate completion of Form 990).⁸

Indeed, the IRS Exempt Organizations Workplan for FY 2009 provides for continued scrutiny of EO governance, with particular focus on three areas: (i) development of governance-related questions to be used by agents in examinations of EOs; (ii) expanded EO governance training of IRS agents; and (iii) consideration of new EO compliance initiatives, such as those involving executive compensation, transactions with interested persons and diversion or misuse of charitable assets.⁹

2. System Challenges. A series of judicial decisions and other controversies combined in 2008 to suggest further challenges to the traditional parent/affiliate form of nonprofit corporate structure. At a minimum, these developments suggest a re-evaluation of system governing documents and control relationships in order to preserve the cohesiveness of the system.

Clearly prominent among these developments was the Sept. 30, 2008, decision of the Ohio Court of Appeals in the high profile *Health Alliance* case.¹⁰ The court's crucial holding was that a fiduciary duty was owed by the parent entity to the affiliate under the circumstances of this particular joint operating agreement, and that the parent's breach of this duty was a basis for affiliate withdrawal from the arrangement. This decision breaks new, but not totally unexpected, ground. Furthermore, the decision was based on highly

unique facts and should be limited in its application to arrangements intended as "loose consolidations." Nevertheless, it has the potential for creating significant challenges for health systems that have not adequately structured their corporate governance documents to address the key charitable mission/fiduciary duty issues reflected in this case. Moreover, its application to systems already experiencing tension amongst corporate partners could lead to increased structural instability.

A similarly significant, but less prominent, dispute involves the terms of the disaffiliation between Lifespan Corp. (a Rhode Island nonprofit health system) and Tufts Medical Center (formerly known as New England Medical Center Hospitals Inc.) (NEMC), a Massachusetts nonprofit health system. While the corporate affiliation ended in 2002, LifeSpan subsequently filed an action in federal court in Rhode Island seeking payment of amounts (approximately \$3.7 million) NEMC allegedly owed LifeSpan. NEMC counterclaimed (for \$136 million) alleging breach by LifeSpan of various contractual and fiduciary duties owed to NEMC. The Massachusetts attorney general has filed a motion to intervene in the district court litigation in order to address, on behalf of the public interest, the fiduciary duties questions (among other issues). An additional controversy, now being litigated in a Massachusetts state court and in the Rhode Island federal court, relates to whether Lifespan has any right to a portion of a multi-million dollar recapture settlement received by NEMC. Any judicial resolution of the overarching controversy is likely to significantly contribute to the body of law on intra-system disputes.¹¹

Also noteworthy in this regard is the tension emerging in the traditional "headquarters/regional chapter" corporate structure applied by many large national charitable organizations. In recent months, each of the American Lung Association, Make-A-Wish Foundation, and the American Civil Liberties Union have been forced to take action to address (by dissolution or disaffiliation) allegedly "rogue" or other noncompliant action by a regional chapter.¹² Furthermore, the Girl Scouts of America affected a substantial corporate reorganization which reduced the number of regional councils from 312 to 109.

3. Transparency Matters. Transparency of the business, operations and governance of a tax exempt organization (including hospitals) has become a "cost of doing business." The release of the redesigned Form 990 (Return of Organizations Exempt from Income Tax) and accompanying instructions represents a watershed development in terms of the public disclosure obligations of tax exempt organizations, and one to which corporate leadership must respond.

Indeed, IRS specifically intended the redesigned form to provide both the IRS and the public a more comprehensive picture of a tax exempt organization, including its mission, programs and goals, its revenues and ex-

⁵ See, e.g., Peregrine and Mills, "Corporate Governance Emphasis in Final Form 990 Instructions," American Health Lawyers Association Business Law and Governance Practice Group, Aug. 2008.

⁶ *Id.*

⁷ http://www.irs.gov/pub/irs-tege/governance_practices.pdf.

⁸ Miller Remarks, *supra*.

⁹ IRS Annual Report, *supra*, p. 20.

¹⁰ *Health Alliance of Greater Cincinnati v. Christ Hospital*, 2008 – Ohio – 4981, Sept. 30, 2008 (In the Court of Appeals First Appellate District of Ohio, Hamilton County, Ohio).

¹¹ *LifeSpan Corp. v. New England Medical Center Inc. and New England Medical Center Hospitals Inc.*, U.S. District Court for the District of Rhode Island, C.A. No. 06-421-7-OLM.

¹² See, e.g., Gene Johnson, "Lung Association Disbanding Affiliate," Associated Press, Nov. 2, 2008. Edward Fitzpatrick, "Charity Seeks to Shed R.I. Chapter," *The Providence Journal*, Oct. 6, 2008; Stephanie Strom, "A.C.L.U. Votes to Take Over State Branch," *The New York Times*, April 28, 2008.

penses, and its internal policies and practices.¹³ Such transparency is, in turn, expected to promote accountability by these organizations.¹⁴

The IRS has made clear over the last year that it is committed to promoting transparency in the nonprofit sector.¹⁵ The Form 990 has historically been applied by the IRS as its primary tax compliance mechanism. Furthermore, most states rely on the Form 990 to assist in their performance of charitable and other regulatory oversight, and to satisfy relevant state tax filing requirements. Of course, the Form 990 is a public document to be made available by filing organizations, the IRS and others. As such, it is the primary transparency tool which a variety of groups (*e.g.*, the public, state regulators, the media, researchers and policymakers) use to obtain information about individual organizations, and the tax exempt sector generally. In this regard, it is relevant to note the significant increase in the incidence of state charity referrals to the IRS.¹⁶

The dramatic 2008 “redesign” of the Form 990 reflects the IRS’s perception that the form itself was in need of a significant overhaul. Particular IRS concerns included the form’s: (a) failure to reflect changes in the law and the increasing size, diversity and complexity of the tax exempt sector; (b) failure to serve the IRS’s tax compliance interests; and (c) failure to address the transparency and accountability needs of organizational constituents (*e.g.*, the states, the public and the communities).¹⁷ Thus, the redesigned Form 990 reflects three main themes: (i) enhancing transparency; (ii) promoting tax compliance; and (iii) minimizing the administrative burden on the filing organization.¹⁸ Its main features include (but are not limited to) a new summary page; an entire new section devoted to corporate governance; enhanced reporting of both executive compensation and organizational relationships with “insiders” and certain third parties; and new reporting for non-cash contributions, tax exempt bonds and, of particular relevance, hospitals (the new Schedule H).

For the tax exempt hospital sector, Schedule H serves as an “exclamation point” for purposes of the IRS’s transparency focus. This brand-new schedule is designed to elicit information on community benefit activities and other information relevant to how the hospital serves the public consistent with the requirements of tax-exempt status. The schedule includes six parts: (1) Charity Care and Certain Other Community Benefits at Cost; (2) Community Building Activities; (3) Bad Debt; (4) Medicare Collection Practices; (5) Management Companies and Joint Ventures; (6) Facility Information and Supplemental Information.

The redesigned Form 990, its accompanying instructions, and related IRS initiatives represent a dramatic and comprehensive emphasis on the importance of transparency in nonprofit business, operations and governance. The extent to which the form is used by state charity officials for their own information and review

processes underscores the scope of the transparency emphasis.

Beyond the 990, the IRS recently announced that its FY 2009 workplan will continue this focus on transparency and accountability. Part of this focus will be on how nonprofits are reacting (in terms of charitable solicitation practices and business transactions) to the economic climate.¹⁹

4. Conflicts Concerns. A combination of public policy and regulatory developments, and high profile controversies, emerged in 2008 to highlight concerns with conflicts of interest and related issues. Collectively, they reflect increasing sensitivity to the harm associated with poor conflicts practices, as well as to the more fundamental need to preserve the integrity of the entire board decision-making process.

Foremost among these developments was the dramatic emphasis on conflicts-related matters in the Form 990 and accompanying instructions. Part VI thereof contains a series of specific conflicts-focused questions. Moreover, as the final instructions make clear, the IRS’s view is that there are at least five specific dimensions which must be considered to assure that all board/committee decisions are impartial and unbiased. The first of these, of course, is attentiveness to traditional corporate law concepts of conflict of interest. Second is the broader concern of positional independence of board members—with the instructions providing for the first time an IRS-sanctioned definition of “director independence.” Third is the application of the separate “disinterested directors” standard for purposes of satisfying the “Rebuttable Presumption of Reasonableness” safe harbor. Fourth is the potential for decision-making bias that can result from business and personal relationships *between* board members (*a/k/a* “horizontal conflicts”). Fifth and final are the new obligations to make disclosure of the organization’s business transactions with its current and former directors, officers, and lay employees.²⁰

The intersection of conflicts of interest and director independence also was underscored by the Panel on the Nonprofit Sector’s new “Principles for Good Governance and Ethical Practice.”²¹ These guidelines recommend not only the adoption of a conflicts of interest policy, but also that a “substantial majority” (*e.g.*, two-thirds) of the nonprofit board consist of independent members (with a different definition of “independence”). A going-forward challenge for nonprofit boards is thus not only to address the basic issue of director’s independence, but also to reconcile the potentially competing definitions of “independence” (*e.g.*, IRS, state law, Panel on Nonprofit Sector).

A series of high profile nonprofit sector controversies also served to keep conflict of interest issues in the forefront of corporate law in 2008. One of the most notable of these was the Massachusetts attorney general’s conflict of interest review of Holyoke (Mass.) Medical Cen-

¹³ IRS Annual Report, *supra*, p. 10.

¹⁴ *Id.*

¹⁵ Fred Stokeld, “IRS Continues Focus on EO Compliance, Governance, Officials Say,” Nov. 12, 2008, *Tax Notes Today* (Tax Analysts).

¹⁶ Internal Revenue Service, “Background Paper, Summary of Form 990 Redesign Process, Aug. 19, 2008, pp. 1-2.

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ Simon Brown, “IRS 2009 EO Workplan Focuses on Transparency, Accountability, EO Director Says,” *Tax Notes Today*, Nov. 26, 2008.

²⁰ IRS, 2008 instructions for Form 990 (core form), Part VI, “Governance, Management and Disclosure” (final Part VI instructions”), p. 8, available at http://www.irs.gov/pub/irs-tege/part_vi_instructions.pdf.

²¹ http://www.nonprofitpanel.org/Report/principles/Principles_Reference.pdf (“Guidelines”).

ter in connection with certain transactions between the hospital and its insurance agent (principals of whom had served on the organization's board).²² Of particular concern to the attorney general was the failure to apply the organization's conflicts policies to the particular transactions, individual disclosures notwithstanding. The attorney general resolved its review with the organization's agreement to adopt a series of policy/oversight and transaction-specific remedial steps. Another relevant nonprofit conflict controversy in 2008 involved the perception of conflicts of interest in connection with executive compensation decisions of the Suffolk University Board of Trustees. Concerns with the very high level of compensation payable to the university president were exacerbated by the role several university vendors allegedly played in the compensation review process. Particular questions were raised concerning the effectiveness of the board's conflicts disclosure and review process.²³

5. Executive Compensation. 2008 was a particularly significant year with respect to executive compensation practices in the nonprofit sector. Leading 2008 developments emerged from the courts, the IRS, state charity officials, and media reports.

Particularly noteworthy was the pending release by the IRS of its final report on its 2006 compliance check questionnaire audit initiative of the tax exempt hospital sector.²⁴ A major portion of this report is to be dedicated to executive compensation practices. It is expected to conclude that many executive compensation arrangements are at high levels, but also that there is widespread reliance on the rebuttable presumption of reasonableness process to support the reasonableness of such arrangements. While these compensation arrangements may be defensible as the rebuttable presumption currently is applied, comments from senior IRS officials and other regulators make clear their concern that this particular safe harbor may be producing unintended consequences; e.g., contributing to higher levels of compensation, and hindering the IRS's ability to challenge individual instances of compensation.²⁵ This report will provide many issues for compensation committee consideration. Further developments on this topic can be expected in 2009, particularly given general commercial trends and the expected congressional response to reports of high compensation in the nonprofit health care sector.

Several additional executive compensation-related developments emerged from the IRS in 2008. The final Form 990 and accompanying instructions devote substantial new attention to executive compensation matters, both through a new Part VII in the "Core Form," to report basic information, and a new Schedule J ("Supplemental Information") to report detailed compensation information with respect to individuals whose compensation exceeds certain thresholds.²⁶ The

new intermediate sanctions regulations, released in March, provide a series of useful examples on the appropriate means of reviewing and approving executive and physician compensation, and applying the rebuttable presumption.²⁷ The IRS compliance questionnaire sent in October 2008 to approximately 400 colleges and universities reveals a surprising level of sophistication concerning nonprofit executive compensation arrangements. An entire section (Part 10)—almost 25 percent of the entire questionnaire—is devoted to compensation-related questions—including base salary, retirement and severance, personal use matters, and expense reimbursement.²⁸

A particularly significant development was the July order of the Maryland insurance commissioner reducing by half the severance pay awarded the former CEO of nonprofit CareFirst BlueCross BlueShield by its board. The commissioner ruled that the CareFirst board had violated state law requiring that nonprofit executive compensation be "fair and reasonable." While the CareFirst facts are unique in many respects, it is notable that a state regulator essentially overruled the board's exercise of business judgment as to appropriate compensation.²⁹ Also noteworthy was the end of the long-running *Spitzer v. Grasso* litigation, resolved in favor of the defendants. The case had attracted significant attention given its focus on the executive compensation practices of a nonprofit (noncharitable) corporation.

Given current economic conditions, and recent trends in the public sector, this close scrutiny of nonprofit executive compensation reasonably can be expected to continue, if not increase in 2009.

6. Corporate Compliance. The obligations of the nonprofit corporation and its board to implement and supervise an "effective" corporate compliance plan were emphasized in multiple ways in 2008.

IRS Commissioner Douglas Shulman effectively set the tone for compliance expectations with his public comments regarding the potential for abuse in the nonprofit sector, and the need for charities to be "squeaky clean."³⁰ Furthermore, senior IRS officials have expressed concern that the current economic turmoil may prompt some nonprofit corporations to violate the law in order to satisfy budgeting concerns.³¹ The IRS is expected to be particularly vigilant with respect to improper transactions, questionable fundraising and application of charitable donations, in light of the finan-

www.irs.gov/pub/irs-tege/summary_form_990_redesign_process.pdf.

²⁷ *Federal Register*, Vol. 73, No. 61, March 28, 2008 Department of Treasury, Internal Revenue Service, 26 CFR Parts 1 and 53.

²⁸ Internal Revenue Service, "IRS Sends Compliance Questionnaires to 400 Colleges and Universities," IR-2008-112, <http://www.irs.gov/irs/article/0,,id=187328,00.html>.

²⁹ Final order, *Insurance Commissioner for the State of Maryland v. CareFirst, Inc. and William L. Jews*, Maryland Insurance Administration, No. MIA-2007-10-027.

³⁰ Remarks of Douglas Shulman, commissioner of internal revenue, before Independent Sector, Nov. 10, 2008 ("Shulman Comments"), <http://www.irs.gov/newsroom/article/0,,id=188567,00.html>.

³¹ Fred Stokeld, "IRS in Monitoring Charities' Behavior During Economic Slump," Nov. 14, 2008, *Tax Notes Today*.

²² <http://op.bna.com/hl.nsf/r?Open=psts-7n9nzn>.

²³ Frank Phillips and Peter Schworm, "Trustees' Fiscal Ties Roil Suffolk," *Boston.com*, Nov. 26, 2008.

²⁴ Citation not available at time of publication.

²⁵ Fred Stokeld, "IRS Interest in EO Executive Compensation Strong, Officials Say," *Tax Notes Today*, Nov. 21, 2008.

²⁶ Internal Revenue Service 2008 Schedule J (Form 990) Instructions Compensation Information, <http://www.irs.gov/pub/irs-tege/schjinstructions.pdf>. Internal Revenue Service, Summary of Form 990 Redesign Process, Aug. 19, 2008, <http://>

cial crisis.³² According to Commissioner Shulman, the IRS will “pro-actively address misuse of tax exempt organizations and tax exempt status.”³³ This concern also extends to the potential for cutbacks in corporate compliance and administrative due diligence staff.³⁴

The tax compliance obligations of nonprofit corporations and their boards was also emphasized with the March 28, 2008, release of final intermediate sanctions regulations.³⁵ The principal purpose of the final regulations is to clarify the relationship between the substantive requirements for Section 501(c)(3) status and the imposition of excise taxes on excess benefit transactions under Section 4958 (intermediate sanctions). To that end, the final regulations provide guidance on factors to be considered by the IRS in determining whether a Section 501(c)(3) organization may jeopardize its tax-exempt status by engaging in one or more excess benefit transactions. Also, the final regulations seek to clarify the prohibition against excess private benefit under Section 501(c)(3) and how prohibited private benefit may jeopardize an organization’s tax exemption.

The final regulations provide that the IRS will favorably consider circumstances in which the organization discovers the excess benefit transaction and takes action *before* the IRS discovers the transaction. On the other hand, correction of the excess benefit transaction *after* the IRS discovers it will not, by itself, be a sufficient basis for preserving the organization’s exempt status. By this provision, the IRS indirectly places a premium on effective compliance activity (potentially increasing the scope of responsibilities of the corporate compliance office). This is an important compliance factor which should be noted by the board.

Important from a broader, corporate perspective is the Aug. 28, 2008, release of updated Department of Justice guidelines for the investigation and prosecution of corporate fraud.³⁶ These guidelines, applicable to nonprofit corporations, confirm the DOJ’s historical enforcement perspective on the importance of effective corporate compliance. The guidelines contain a highly significant discussion of how an “effective and pre-existing compliance plan” will be considered by DOJ in reaching a decision as to the proper treatment of a corporate target. The 2008 updated guidelines are particularly notable because they contain several important refinements from the prior version of the guidelines (the so-called “McNulty Memorandum”). These refinements emphasize the importance attributed to whether the organization’s compliance plan “is being applied earnestly and in good faith,” a subtle reference to the governing board’s compliance oversight obligations under

existing case law and the Federal Sentencing Guidelines.

Along the same lines, FBI Director Robert S. Mueller has publicly endorsed the important compliance role performed by independent board members, auditors and outside counsel.³⁷

Another noteworthy 2008 corporate compliance development was the April 15, 2008 announcement of changes to the Department of Health and Human Services/Office of Inspector General’s “Provider Self Disclosure Protocol.”³⁸ These several changes were instituted by OIG to facilitate provider self-disclosure involving conduct under the Medicare, Medicaid, and federal health care programs. As such, they provide health care providers—and their executive and board leadership—an attractive option for resolving particular corporate compliance issues on favorable monetary terms and without the burden of a corporate integrity agreement.

In a particularly jarring compliance development, an April decision of the U.S. Bankruptcy Court interpreted Delaware law as imposing *Caremark* obligations on corporate officers, specifically including the general counsel.³⁹ The *Miller* court also suggested that the general counsel may, in certain situations, have some responsibility for corporate waste committed by other officers even though he/she had not personally benefited from the (alleged) waste. (The matter of actual liability was not before the court.) Despite the egregious facts involved, the Bankruptcy Court’s close evaluation of fiduciary duty principles and the general deference given Delaware law suggest that the decision may receive broad attention, if not also application. As such, it is a development that should be the subject of careful consideration by the board, in conjunction with its nondirector officers, for its implication on: (a) corporate compliance oversight, and (b) the role, authority, and board support of the general counsel.

7. Economic/Financial Matters. The impact of the weakened national economy on the nonprofit sector generally, and on the governance and operations of nonprofit organizations in particular, was certainly a headliner item for 2008. Nonprofit boards and their executive leadership teams are struggling to control the challenges presented by the economic turmoil, including critical matters of solvency and compliance with debt covenants. In particular, boards have sought guidance on the extent of their financial oversight obligations and on the scope of their D&O liability. It is not, however, the only financial-related corporate law development to arise in 2008 for nonprofits.

For example, the New Uniform Prudent Management of Institutional Funds Act (UPMIFA) was approved by the National Conference of Commissioners on Uniform State Laws and now has been enacted in at least 24 states and the District of Columbia. It was designed as a successor to the widely accepted Uniform Management of Institutional Funds Act (UMIFA). As such, UP-

³² Simon Brown, “IRS 2009 EO Workplan Focuses on Transparency, Accountability, EO Director Says,” Nov. 26, 2008, *Tax Notes Today* (Tax Analysts).

³³ Shulman Comments, f.n. 31, *supra*.

³⁴ Fred Stokeld, “IRS Interest in EO Executive Compensation Strong, Official Says,” *Tax Notes Today*, Nov. 21, 2008.

³⁵ Standards for Recognition of Tax-Exempt Status if Private Benefit Exists, 73 *Fed. Reg.* 16519-16525 (March 28, 2008).

³⁶ The Department of Justice, “Principles of Federal Prosecution of Business Organizations.” This guidance is available at <http://www.usdoj.gov/opa/documents/corp-charging-guidelines.pdf>; see also, the Justice Department’s press release: <http://www.usdoj.gov/opa/pr/2008/August/08-odag-757.html>.

³⁷ Comments of Robert S. Mueller III, director, Federal Bureau of Investigation, American Bar Association Litigation Section Annual Conference, Washington, April 17, 2008 (www.fbi.gov).

³⁸ <http://www.oig.hhs.gov/fraud/docs/openletters/OpenLetter4-15-08.pdf>.

³⁹ *Miller v. McDonald*, 2008 WL 1002035 (Bkrtcy.D.Del. April 9, 2008).

MIFA contains many significant “upgrades” on UMIFA as they relate to prudent investment by charitable organizations. Thus, UPMIFA should be a significant reference point to nonprofit organizations and their investment committees during the current market turmoil.⁴⁰

On a related matter, the spiraling Madoff investment scandal has caused many nonprofits to re-examine their portfolios and the oversight of their investment managers. This is particularly the case as state attorneys general signal their willingness to scrutinize investment decisions of nonprofit boards.⁴¹

Financial concerns of an entirely different kind were the subject of a ground-breaking 2008 academic study, which examined financial fraud committed *against* (as opposed to *by or on behalf of*) charitable organizations.⁴² The basic theme of this study was that the incidence of such fraud has dramatically increased—a theme which seems to be confirmed by near weekly media disclosures of financial fraud and asset misappropriation.⁴³ The study concentrates on four key points: (i) the victims and perpetrators of the fraud; (ii) the type of fraud committed; (iii) how the fraud is committed; and (iv) preventative measures. This development is causing charity regulators (*e.g.*, the IRS and state attorneys general) to be more attentive not only to individual occurrences of fraud, but also to measures taken by the nonprofit organization to identify the fraud, and to prevent its occurrence. (*See, e.g.*, Part VI, Section A-5 of the new IRS Form 990, asking whether the organization became aware during the year of a material diversion of assets.)

In many respects, the current focus on investment committee performance is consistent with a prescient “Special Comment” released in late 2007 by one of the major public finance rating agencies. That commentary expressed concern with the sufficiency of investment policies and investment oversight practices in the nonprofit hospital sector.⁴⁴

8. Tax Exempt Status. Tax exemption on both the state and federal level came under increased scrutiny in 2008, due in part to a combination of new decisions, regulatory reports and legislative pressures.

On the federal level, 2008 was a year of substantial focus on application of the “Community Benefit Standard” of hospital tax exempt status. Sen. Charles E. Grassley (R-Iowa), ranking member of the Senate Finance Committee, has indicated his intention (once again) to revise this standard by introducing legislation that would establish specific charity care and community benefit standards. Sen. Grassley clearly seeks a “rollback” of the current standards for hospital tax exempt status as provided for in Rev. Rule 69-545.⁴⁵ The immediate impetus for his initiative was his original (April 2007) request that the Government Accountability Office (“GAO”) study the manner in which nonprofit

hospitals meet their requirement to provide community benefits in exchange for tax exempt status under I.R.C. Section 501(c)(3). Sen. Grassley’s long-held concern is that the Community Benefit Standard is loosely defined and capable of multiple differing interpretations. (To that end, the new Form 990 contains an entire Schedule H dedicated to the reporting by hospitals of their community benefit practices).

On Oct. 14, 2008, the GAO issued its long-awaited report, concluding that the standard provides hospitals “broad latitude” to determine and measure the value of their community benefit services and activities, while state community benefit requirements are particularly variable.⁴⁶ The GAO further concluded that, given the large number of uninsured individuals, and the important role of nonprofit hospitals in provide them care, “it is important that federal and state policymakers and industry groups continue their discussion addressing the variability in defining and measuring community benefit activities.”⁴⁷

This community benefit standard debate is expected to be intensified by the pending release of the IRS’s final report on its hospital industry compliance check audits.⁴⁸ In that final report, the IRS is expected to continue the focus on variations in the types and amounts of reporting of community benefit and in hospital treatment of bad debt and uncompensated care.⁴⁹ Notably, the IRS indicated its intention to test reported community benefit expenditure amounts by conducting data analysis, compliance checks and examinations of individual hospitals.⁵⁰

Related developments include the petition of Vision Service Plan (VSP), a provider of prepaid vision service plans, for a writ of certiorari with the U.S. Supreme Court in an effort to regain its federal income tax status.⁵¹ The IRS had revoked VSP’s I.R.C. Section 501(c)(4) status in 2003. Although the Supreme Court Jan. 12 refused to grant the petition, related litigation continues in a federal court in Ohio. Also noteworthy was Sen. Grassley’s (September) inquiries of several leading nonprofit academic medical centers⁵² following newspaper stories that raised questions about the billing practices of the hospitals and the manner in which it treated uninsured patients.⁵³ Another exemption-related development was the May 2008 announcement of IRS Exempt Organizations Commissioner Steven Miller that the IRS intends to reactivate the “commen-

⁴⁶ “Nonprofit Hospitals: Variation in Standards and Guidance Limits Comparison of How Hospitals Meet Community Benefit Requirements” (GAO-08-880; *see also*, 17 HLR 1357, 10/16/08).

⁴⁷ *Id.*

⁴⁸ Citation not available at publication date.

⁴⁹ *Id.*; *see also* 17 HLR 1536, 11/20/08.

⁵⁰ *Id.* at 1538.

⁵¹ *See, e.g.*, <http://www.reuters.com/article/pressRelease/idUS159038+08-Aug-2008+PRN20080808>.

⁵² Including University of Chicago Medical Center, the University of Texas M.D. Anderson Cancer Center, and Silver Cross Hospitals and Medical Centers (Joliet, Ill.).

⁵³ Fred Stokeld, “Grassley Starts Inquiry of Two Exempt Hospitals,” *Tax Notes Today* (Tax Analysts), Sept. 3, 2008.

⁴⁰ *See, e.g.*, <http://www.upmifa.org>.

⁴¹ Carrie Coolidge, “Blumenthal May Investigate Charities Ripped Off By Madoff,” *Forbes.com*, Dec. 22, 2008.

⁴² Janet Greenlee, Mary Fischer, Teresa Gordon, Elizabeth Keating, “An Investigation of Fraud in Nonprofit Organizations: Occurrences and Deterrents.” *Nonprofit and Voluntary Sector Quarterly*, Vol. 36, No. 4, December 2007.

⁴³ *See, e.g.*, Stephanie Strom, “Funds Misappropriated at 2 Nonprofit Groups,” *The New York Times*, July 9, 2008.

⁴⁴ Moody’s Investors Service, “Not-For-Profit Hospitals Vulnerable to Investment Market Volatility” (November 2007).

⁴⁵ 17 HLR 1676, 12/25/08.

surate test”⁵⁴ of tax exempt status, in order to effect “efficiency and effectiveness.”⁵⁵

Furthermore, it appears that there may soon be a final resolution of the long-running, highly visible property tax exemption dispute involving Provena Covenant Medical Center in Urbana, Illinois (PCMC), and the Illinois Department of Revenue. On Nov. 26, 2008, the Illinois Supreme Court announced that it will review the Aug. 26, 2008, state appeals court ruling that PCMC was not a charitable or religious organization entitled to state property tax exemption for the 2002 year.⁵⁶ The appellate court had, in turn, overturned a previous administrative law judge decision favoring PCMC. The Supreme Court’s pending decision not only will provide definitiveness on property tax exemption standards for Illinois nonprofit hospitals, but also may influence courts and property tax regulators in other states as well.

9. M&A Scrutiny. A downturn in transactional activity did not serve to prevent several important nonprofit sector merger/acquisition developments in 2008.

One such development was the continued interest of state charity regulators in monitoring changes of control transactions, particularly those in which nonprofit assets are transferred to for-profit control or ownership. A prominent 2008 example of this is the long-running saga of Anaheim Memorial Hospital (AMH) and its efforts to effect a change of control. On Aug. 14, 2008, the California attorney general denied consent to the sale of AMH to a for-profit consortium. This denial followed a July 11, 2007 decision by the attorney general to deny approval of a separate sale of AMH to another for-profit purchaser.⁵⁷

Also noteworthy was the controversy surrounding the proposed transaction by which the controlling interest in Exempla Health System’s Lutheran Medical Center (Wheat Ridge, Colo.) and Good Samaritan Medical Center (Lafayette, Colo.) would transfer to the Sisters of Charity of Leavenworth Health System. Local groups have challenged the proposed transfer due to concerns with the loss of reproductive services options to the local community. The Colorado attorney general declined to evaluate the proposed transfer of assets, citing the absence of any change to the charitable purposes of the Exempla hospitals arising from the proposed transfer.⁵⁸ Related litigation initiated to block the transaction was stayed and the parties entered into alternate dispute resolution intended to resolve the controversy, the result of which is pending as of the date of this publica-

⁵⁴ Rev. Rul. 64-102; A corporation will be deemed to meet its primary purpose for IRC Section 501(c)(3) purposes if it demonstrates, through contributions and grants, a charitable program “commensurate in scope” with its financial resources.

⁵⁵ *Daily Tax Report* (Bureau of National Affairs) June 4, 2008, p. J-1.

⁵⁶ *Provena Covenant Medical Center v. Illinois Department of Revenue*, Ill., No. 107328, petition allowed (Nov. 26, 2008). See also, 17 HLR 1579, 12/4/08.

⁵⁷ Kim Christensen, “Sale of Anaheim Hospital Halted,” *Los Angeles Times*, Aug. 15, 2008.

⁵⁸ Colorado Attorney General John W. Smithers, “In the Matter of the Exempla Healthcare System Membership Transfer,” Dec. 27, 2007, <http://www.ago.state.co.us>.

tion.⁵⁹ The Anaheim Memorial and Exempla matters are representative of the intense interest of regulators and other third parties in the manner by which the change of control of nonprofit hospital assets is effected.

10. Challenge to Business Judgment. The recent economic turmoil—and the fall-out from significant losses in charitable endowment funds—may have significant effects on the way in which business judgment is exercised and scrutinized in the nonprofit sector. With increasing frequency, hard questions are being asked concerning the manner in which investment portfolio management is delegated and overseen by boards of directors. As governmental intervention and related efforts hopefully cause the current economic situation to slowly pull back from the brink, anxiety is being joined by anger as the emotions of the day. From this climate, a trend toward increased accountability, if not outright finger-pointing, is likely to emerge.

Historically, statutory protections related to the delegation of investment decision-making by nonprofit boards and the reticence of regulators to punish volunteer directors for investment losses gone awry, except in the most egregious of circumstances, have tended to limit enforcement activities in this regard. However, in the case of investment losses that are not due simply to overall market trends, but rather to a failure to exercise adequate oversight over investment managers or to identify discoverable fraud, these regulators increasingly may be likely to seek to hold boards more directly accountable than before for harm to charitable assets.

More generally, there also may be a greater inclination to look at the board room when the health care corporation suffers what is perceived to be self-inflicted financial harm—viewed in the light of the fundamental duty of stewardship of charitable assets. It is not hard to imagine the “trigger of attention” in such cases being extraordinary investment losses, a compliance controversy, poor transaction diligence, failed/flawed business strategies, excessive compensation, or embezzlement.

Initial indications of this climate of accountability can be found in both the late fall congressional hearings on the failure of Lehman Brothers and in the reaction to the Madoff-related losses suffered by numerous charities. In what may prove to be a popular line of regulatory inquiry, legislative questions to Lehman focused on the composition of the board, the qualifications of its individual members, and the frequency of board meetings.⁶⁰ More recently, and as referenced above, at least one state attorney general has announced an intention to review the conduct of boards of nonprofits that have suffered significant financial losses in prominent investment scandals.⁶¹

Finally, we have seen heightened concerns on the part of major donors to charitable organizations, who are expressing greater interest and concern over the

⁵⁹ Court order, *Exempla Inc. v. Sisters of Charity Health Systems Inc.*, No. 2008 CV188, District Court, City and County of Denver, Colo., June 23, 2008.

⁶⁰ “Lehman Board Faulted for Excessive Pay, Poor Governance Practices in Face of Crisis,” *BNA’s Corporate Accountability Reporter*, Vol. 6, No. 40, Oct. 10, 2008.

⁶¹ Carrie Coolidge, “Blumenthal May Investigate Charities Ripped Off by Madoff,” *Forbes.com*, Dec. 22, 2008.

level of care and oversight that is maintained over their donations to endowment and other charitable funds.

Conclusion

2008 was a year in which developments in nonprofit corporate law, as applied to hospitals and health systems, continued apace. Of particular significance were the increased level of regulatory interest in governance practices of nonprofit organizations, evolving pressures on the business judgment of nonprofit board members, and the impact on nonprofit governance of general economic conditions.

Collectively, these developments reflect greater interest in the application of nonprofit and charitable trust law concepts on a variety of public and private levels. It is the authors' perspective, however, that these developments should not be a basis to question the continued propriety and reasonableness of nonprofit status. Rather, counsel to such organizations should be mindful of identifying nonprofit corporate law as a principal legal issue when conducting any material legal analysis for a health care client.