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Key Nonprofit Corporate Law Developments in 2007

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The year 2007 witnessed a series of dramatic and significant 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 involve the following general issues: (a) state and federal oversight regulation; (b) corporate responsibility and Sarbanes-Oxley compliance; (c) fiduciary standards of conduct; (d) financial performance; and (e) business transactions, both external and intrasystem.

Furthermore, these developments suggest a series of corporate law trends that the authors believe counsel should consider as they advise their nonprofit clients on transactional, structural and governance matters. These trends include:

- The continued ''close scrutiny'' by state attorneys general of the business practices of nonprofit health care providers;

- An increasing recognition from a public policy perspective that governance structures of nonprofit organizations must be improved;

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- The continuing evolution of governance ''best practices'' and their relationship to fiduciary obligations;

- The ongoing pattern of stakeholders using charitable trust laws to seek remedies that would not be available under nonprofit corporation law;

- The ongoing focus of state and federal regulators on executive compensation arrangements of nonprofits; and

- The willingness of legislators, courts, and regulators to hold nonprofit directors accountable for the conduct and performance of the corporations they serve.

Based on these trends, our ''top ten'' list of major nonprofit developments for health care providers in 2007 follows.

1. ***Skeptical Environment.*** 2007 may well be remembered as the year in which the nonprofit sector as a whole began to suffer the consequences of the well-chronicled lapses and failures of individual nonprofit organizations over the past several years. Indeed, it may fairly be said that nonprofit organizations now are operating within an increasingly skeptical environment, that is less willing than before to extend the benefit of the doubt.[1] It is an environment which is prompting questions as to whether the public benefits provided by nonprofits are commensurate with the resources of the organizations and the value of their tax exemptions.[2] It is an environment which reflects concerns with increas-

[1] Remarks of Steven T. Miller, Commissioner, Tax Exempt and Government Entities, Internal Revenue Service, before Independent Sector, Los Angeles, California, Oct. 22, 2007 (Miller 10/22/07 Remarks).

[2] *Id.*

ing levels of misconduct in the general workforce.[3] It also is an environment which, through the emphasis on transparency, is raising challenges about certain nonprofit operating and governance practices and their ultimate cost to the public.[4]

Charity regulators (principally, the IRS and state attorneys general), together with legislatures and the media, have expressed growing concern with the presence and perception of abuse in the nonprofit sector.[5] This abuse is perceived as arising in some situations from a ''sense of entitlement'' by organizational insiders who are not accountable to their board of directors, the public, or to the regulatory agencies. [6] In many instances, nonprofit governance has been found to be wanting. Furthermore, there is a sense in the regulatory community that the nonprofit sector lacks a full appreciation of the extent to which abuse has emerged in recent years.[7]

Thus, nonprofits find themselves subject to an environment far less willing to tolerate instances of aberrant corporate behavior or inattentive governance, much less actual or perceived instances of abuse. It is also an environment which is increasingly unwilling to excuse potentially problematic behavior by a nonprofit organization merely in deference to a history and tradition of good works. This is notwithstanding the value broadly attributed to a vigorous nonprofit sector.

The ''cost'' of this new environment can be felt not only in increased skepticism and declining deference, but also in meaningful regulatory oversight and a greater willingness by legislatures to expand existing controls over business transactions and consider new controls over the internal governance matters of nonprofit corporations.

2. ***System Structures and Affiliations.*** The vitality and feasibility of traditional forms of nonprofit corporate structures and affiliations continued a substantial evolution in 2007. Indeed, a series of significant judicial decisions and other developments suggest some rather significant ''cracks'' may be forming in the foundation of the ubiquitous parent holding company structural model.

For example, an Oct. 19 decision of the California Superior Court for the County of San Francisco applied the hoary concept of *alter ego* to assign liability to a nonprofit parent corporation for damages attributable to the financial collapse of its nonprofit subsidiary corporation.[8] The decision offers important guidance on the types of intracorporate relationships that might expose a nonprofit corporation to *alter ego*/ascending liability treatment. It also provides a cautionary lesson to nonprofit organizations and systems seeking to ''streamline'' their corporate structures through ''systemness'' and similar efforts to consolidate control in the parent entity.[9]

Implementation of certain provisions of the Pension Protection Act of 2006 also began in 2007 to impact certain types of tax-exempt health care system corporations classified as non-private foundations pursuant to Internal Revenue Code Section 509(a)(3). These provisions, intended to correct perceived abuses associated with ''supporting organizations,'' have resulted in the imposition of new restrictions on some parent corporations and hospital foundations. The IRS has responded with an expedited process for such organizations to seek reclassification to ''publicly supported'' status under IRC Section 509(a)(1). The reclassification option is more feasible for hospital foundations, however, and affected parent corporations may be forced to deal with the PPA provisions.

In addition, certain traditional forms of nonprofit hospital affiliations also were subject to risk by 2007 judicial decisions. Most prominent among these was the April, 2007, decision of the Hamilton County, Ohio, Court of Common Pleas which allowed two hospitals to withdraw from the Health Alliance joint operating agreement.[10] The court determined that the terms of the joint operating agreement ''unambiguously'' allowed the two hospitals to withdraw from the arrangement. Of potentially broader significance, though, was the court's determination that the joint operating company, Health Alliance, breached the fiduciary duty it owed to the two hospitals.[11]

Also of interest was the dispute between the Habitat for Humanity parent organization and several of its local chapters.[12] The parent ''disaffiliated'' 12 of its local chapters which had refused to sign the basic document governing parent/affiliate relationships, and to participate in a shared fund-raising arrangement. The ''disaffiliation'' action could signal an increasing unwillingness of parent organizations to tolerate perceived wayward action by corporate affiliates.

3. ***M&A Scrutiny.*** Another significant 2007 trend related to increasing scrutiny of certain aspects of merger/acquisition activity involving at least one nonprofit organization party. As transactional activity in the nonprofit sector increases (particularly in health care), greater focus is being placed on the business judgment of governing boards, consistency with mission objectives, and on the reasonableness of the transaction process.

This trend appears to have been prompted by at least four developments: *first,* the proliferation of state ''change-in-control'' and other transaction oversight statutes and protocols; *second,* increasing concern with the process by which nonprofit assets are transferred to the for-profit sector; *third,* third-party intervention (*e.g.,* labor unions and social policy groups); and *fourth,* special issues associated with matters such as financial distress, removal of transaction proceeds across state

[3] ''Biennial Survey on Ethics in the Workplace Shows Misconduct Back at Pre-Enron Levels,'' *BNA Corporate Counsel Weekly* (12/12/07, p. 384).

[4] Remarks of Steven T. Miller, ''The IRS's Role in an Evolving Charitable Sector,'' before the Philanthropy Roundtable, Nov. 10, 2007 (Miller 11/10/2007 Remarks).

[5] *Id. See also* ''Senators Express Concern over Charitable Abuse, Cite Opportunity to Protect Charities'' (July 23, 2007) http://www.senate.gov/~finance/press/Gpress/2007/prg072307.pdf.

[6] *Id.*

[7] *Id.*

[8] *Network for Good v. United Way of the Bay Area,* No. CGC-04-436186, Filing Date Oct. 19, 2007, Tentative Findings of Fact and Conclusions of Law.

[9] *See* Peregrine, ''The Return of Alter Ego,'' *Health Lawyers Weekly*, The American Health Lawyers Association, Dec. 14, 2007.

[10] *Health Alliance of Greater Cincinnati v. Christ Hospital,* Ohio Ct. Com. Pl., No. A0601969, April 16, 2007.

[11] Peregrine and Schwartz, ''Breaking Up *Isn't* Hard to Do,'' *BNA's Health Law Reporter*, May 17, 2007.

[12] Stephanie Strom, ''Habitat for Humanity Expels Several Affiliates,'' *The New York Times*, Oct. 17, 2007.

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lines, and application of the Ethical and Religious Directives for Catholic Health Care Facilities.

Specific manifestation of this trend can be seen in a series of controversies in 2007 involving proposed nonprofit hospital/health system transactions. For example, the proposed sale of Paradise Valley Hospital (National City, Calif.) met with substantial resistance of the California attorney general, who refused to approve the transaction until the parties agreed to 15 key conditions relating to hospital operations, provision of essential hospital services, commitment to capital expenditures and support of health care services in the hospital's service area.[13]

An additional example involved the California attorney general's July 11 refusal to approve the sale proposal involving the assets of Anaheim Memorial Hospital to a for-profit purchaser, based upon application to the proposed sale of the factors set forth in California law governing conversion of not-for-profit hospitals.[14] The attorney general's specific concerns included receipt of fair market value for hospital assets and, in particular, the validity of hospital's review process (*i.e.*, failure to properly and equally consider all potential bidders for the assets).

Similarly, a controversy ongoing at the end of 2007 involved the proposed transfer by Community First Foundation of its interest in Denver-area Exempla Healthcare system assets (Lutheran and Good Samaritan hospitals) to co-sponsor Sisters of Charity of Leavenworth Health System in exchange for a capital expenditure commitment and a separate payment to the foundation. The proposed transfer was opposed by the Exempla board and by various community groups and physician organizations, principally because of the application of the Ethical and Religious Directives for Catholic Health Care Facilities to Lutheran and Good Samaritan. Upon review, Colorado Attorney General John Suthers determined that the proposed transfer involved no material change in the charitable purposes of the subject assets, and thus there was no basis for his office to intervene.[15] The controversy continues in state court litigation.

4. ***Executive Compensation.*** Matters relating to executive compensation paid by nonprofit, tax-exempt organizations, and the board's role in approving such compensation, continued to be the source of regulatory attention in 2007. Indeed, there was no respite in 2007 from close regulatory attention to executive compensation matters at both the state and federal levels.

An important development in this regard was the March 1, 2007, release by the IRS of its long-awaited report on the executive compensation practices of tax-exempt organizations, including hospitals and health systems.[16] The specific purpose of the report was to summarize the findings and conclusions from the IRS' Executive Compensation Compliance Initiative during 2004-2006. The report contained many significant findings, both positive (*e.g.*, favorable impact of deliberative board compensation processes) and negative (*e.g.*, many organizations encountering difficulty in understanding and complying with the Form 990 disclosure rules). As such, the report offers important guidance for the board and executive leadership of tax-exempt hospitals and health systems.[17]

Another significant development was the Dec. 20, 2007, issuance by the IRS of the final Form 990, which contained a series of important provisions and changes relating to executive compensation. These include adding a new "Schedule J—Supplemental Compensation Information," to provide data for those individuals whose compensation from the hospital and related organizations exceeds certain thresholds. Other changes related to the reporting burden for nontaxable fringe benefits and expense arrangement reporting, elimination of double counting for deferred compensation, and similar changes.[18]

Also of interest in this regard was the Dec. 13, 2007, release by the IRS of its Exempt Organizations fiscal 2008 workplan.[19] In the workplan, the IRS summarized its 2007 activity with respect to executive compensation as well a series of related planned 2008 initiatives. These include (i) continuation of its Executive Compensation Compliance Project (*e.g.*, 200 compliance checks and 50 additional single-issue examinations); (ii) continuation of executive compensation examinations initiated in the Hospital Compliance Project; and (iii) conducting over 90 limited scope field examinations regarding the compensation practices of small tax-exempt organizations (as well as reviewing the executive compensation paid by colleges and universities).[20]

In the midst of these regulatory actions occurred the usual number of public controversies involving executive compensation practices of individual nonprofits. A related controversy involving New York's Museum of Metropolitan Art was typical of these. In that situation, the organization was subjected to criticism based upon allegations that the reasonableness of its senior executive's compensation may have been compromised by supplemental payments from a trust created by two organizational trustees.[21]

The long-running litigation involving the Richard Grasso/New York Stock Exchange executive compensation controversy also continued without resolution in 2007. In a May 8, 2007, decision, the New York Supreme Court, Appellate Division, dismissed four of the six causes of action that the attorney general had asserted against Mr. Grasso with respect to his compen-

[13] Attorney General Edmund G. Brown Jr., California Department of Justice, "Attorney General's Office Averts Closing of Paradise Valley Hospital and Gives Conditional Approval to Hospital Sale," Feb. 27, 2007, *http://op.bna.com/hl.nsf/r?Open=psts-7apmd2.*

[14] Letter from Chief Deputy Attorney General James M. Humes, California Department of Justice, *http://op.bna.com/hl.nsf/r?Open=psts-7apmdb.*

[15] *http://www.ago.state.co.us/press_releases/ExemplaFinal.pdf.*

[16] *http://www.irs.gov/pub/irs-tege/exec._comp._final.pdf.*

[17] *See also,* Peregrine and DeJong, "IRS Issues Detailed Report on Results of Executive Compensation Initiative," *Health Lawyers Weekly*, March 9, 2007, American Health Lawyers Association, *www.healthlawyers.org.*

[18] *http://www.irs.gov/pub/irs-tege/highlights_schedule_j.pdf.*

[19] *http://www.irs.gov/pub/irs-tege/fy08_implementing_guidelines.pdf.*

[20] Quay, "EO's 2008 Workplan Focuses on Universities, Non-501(c)(3) orgs," *Tax Notes* (Tax Analysts) Dec. 14, 2007.

[21] Stephanie Strom, "Donors Sweetened Director's Pay at Museum, Raising Questions," *The New York Times*, Feb. 16, 2007.

sation.[22] In so doing, the court concluded that the attorney general lacked authority under state not-for-profit corporate law to assert those causes of action.

The year ended with substantial congressional scrutiny of the independence of compensation consultants. The House Government Oversight Committee concluded that almost 50 percent of the largest public companies received executive compensation advice from consultants who also provided other services to the company, and that executive compensation was significantly higher at companies where such conflict existed.[23] A ''spillover effect'' on nonprofits from this scrutiny, and possible related legislation, can be expected.

5. ***Governance Best Practices.*** One of the most significant corporate governance-related developments of the year was the October 2007 release by the Panel on the Nonprofit Sector of its ''Principles for Good Governance and Ethical Practice.''[24] In the ''Principles'' document, the panel presented 33 concepts of ''sound practice'' recommended for consideration by every nonprofit, charitable organization as a guide for strengthening its effectiveness and accountability. The principles are particularly noteworthy for nonprofit leadership because they (a) address concepts beyond those that emerged in the wake of Sarbanes-Oxley (*i.e.*, they are ''second generation'' in nature); and (b) are emerging during a period of legislative, regulatory and media focus on the corporate governance of nonprofits. Given the prominence of the panel and the effort contributed to the development of the ''Principles'' document, there is some expectation that they may assume the status of *de facto* best practices for the nonprofit sector.

The IRS also contributed to the evolution of governance best practices by its Feb. 2, 2007, release of a series of proposed governance guidelines. The draft proposals are intended as guidelines and are not a prerequisite for exemption.[25] The IRS has no authority to require that exemption organizations adopt the proposed guidelines. Rather, it is the IRS's hope that the proposed guidelines will help charity directors ''understand their roles and responsibilities and actively promote good governance practices.''

6. ***IRS Governance Initiative.*** A related, significant development in 2007 was the substantially increased emphasis by the IRS on the corporate governance of nonprofit, tax-exempt organizations. This emphasis was manifested in a series of initiatives intended to stress the IRS's perspective that good governance and accountability practices provide safeguards that the organization's assets will be used in furtherance with its exempt purposes. It also reflects the IRS's ongoing concern with the presence and appearance of abuse in the nonprofit sector and the failure of nonprofit leadership to fully appreciate the extent to which abuse has emerged in recent years.

One such initiative was the issuance of the draft governance guidelines released on Feb. 2, 2007 (discussed above). A second initiative was the series of public remarks by Steven T. Miller (commissioner, tax exempt and government entities) articulating in a straightforward, ''easy to understand'' manner the goals of the IRS in focusing on charity governance.[26] By these remarks, Mr. Miller explained the reasons prompting the IRS' decision to make promotion of good governance a new ''pillar'' of its education and compliance program for exempt organizations.

A third, and most recent initiative was the emphasis on governance-related questions in the new Form 990, released on Dec. 20, 2007. The governance-related questions incorporated in the new form (principally, Part VI, ''Governance, Management and Disclosure'') address board size and structures, conflicts of interest management, director independence, intra-board relationships, audit committee practice, written governance practices, and the role of governance in the preparation and review of the form. The scope and nature of the various questions underscore the important relationship between governance and tax-exempt status.[27]

The IRS again did not release final regulation under the intermediate sanctions rules of IRC Section 4958 but identifies that task as part of its ''Business Plan'' for 2008.

7. ***Legal Controls.*** 2007 was particularly notable for a series of events which emphasize the importance of legal controls, and of a strong internal legal/general counsel function, within the nonprofit corporation. The first of these developments was the year-end 2006 release by the influential New York City Bar Association (NYCBA) of its Task Force Report on the role of lawyers in corporate governance. [28]

By its report, NYCBA confirmed and expanded upon several of the points regarding the lawyer's role in assuring corporate responsibility, first made in the seminal ''Cheek Report'' on corporate responsibility adopted by the American Bar Association in 2003. Among the many important recommendations contained in the NYCBA report were several which stressed the reporting relationship between the general counsel and the board and argued for practices which assure full access by the general counsel to the board.

Two other key 2007 developments related to the public loss of board support of prominent CEOs who sought to marginalize the role of general counsel, among other problems. For example, a controversy arose at the venerable Smithsonian Institute (an IRC Section 501(c)(3) entity) from the allegedly autocratic management style of its then-CEO. According to reports from the Smithsonian's internal review, this style limited the CEO's access to a small number of senior executives, discouraged those who disagreed with the CEO, and restricted the flow of information to the board so as to prevent it

[22] 2007 N.Y. App. Div. Lexis 5719. *See also* Peregrine and DeJong, ''*Spitzer v. Grasso II* and the Limits of Challenging Executive Compensation,'' Executive Summary, Corporate Governance Task Force, American Health Lawyers Association (June, 2007), *www.healthlawyers.org*.

[23] Joann S. Lubin, ''Conflict Concerns Benefit Independent Pay Advisors,'' *The Wall Street Journal*, Dec. 10, 2007.

[24] *http://www.nonprofitpanel.org/*.

[25] *http://www.irs.gov/pub/irs-tege/good_governance_practices.pdf*.

[26] *See, e.g.*, n. 1, 4 above.

[27] Peregrine, ''Final Form 990 and Corporate Governance,'' Executive Summary, Corporate Governance Task Force, American Health Lawyers Association, Dec. 21, 2007, *www.healthlawyers.org*.

[28] ''The Lawyer's Role in Corporate Governance,'' *www.nycbar.org/CityBarReport.htm*.

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from exercising proper insight.[29] In particular, the CEO allegedly obstructed the general counsel's ''gatekeeper'' role by isolating him from the governing board, and by reducing the budget and staff of the office of general counsel while the size and complexity of the workload increased.[30] The CEO ultimately resigned under pressure, and in a governance reorganization the Smithsonian adopted policies giving the general counsel direct access to the board, including participation of all board and key committee meetings.[31]

A similar example occurred at the World Bank, with respect to the short-lived and highly controversial tenure of Paul Wolfowitz as CEO. A specific reason which prompted the board of the World Bank to seek Mr. Wolfowitz' resignation related to the CEO's decision not to consult with the bank's general counsel regarding legal issues implicated with the employment matters that were at the core of the underlying controversy. Also of concern was the CEO's action in prohibiting the bank's vice president-human resources (or anyone else) from contacting the general counsel on the matters.[32]

Based on these and other, similar examples, boards will increasingly be expected to become more involved in confirming the effectiveness of the organization's system of legal controls.

8. ***Conflicts/Independence.*** Issues associated with director conflicts of interest and independence continued to emerge with emphasis in 2007, placing boards under increasing pressure to address regulatory/legislative concerns with the integrity of the board's decision-making process.

Conflicts of interest have historically been a ''hot button'' issue with legislatures, regulators, and with the media, given the obvious threat to basic duty of loyalty considerations. Thus, it was not a positive development for the nonprofit sector as a whole when the Urban Institute released a June 25, 2007, report on nonprofit boards concluding, among other things, that it found an ''extensive'' amount of financial transactions between nonprofit organizations (especially larger entities) and board members.[33]

Other high-profile nonprofit sector conflicts of interest controversies involved the Robin Hood Foundation (foundation money invested in hedge funds run by donors and board members);[34] Carnegie Hall (board authorization of vendor relationship to son-in-law of board member and principal donor);[35] the James Beard Institute (resignation of board chair to facilitate qualification for award process);[36] broader conflicts issues associated with the college financial aid/lending controversy;[37] and the congressional scrutiny of the independence of compensation consultants (see above). In addition, a significant Delaware Chancery Court decision with nonprofit ''spillover'' implications chronicled a multitude of board level conflicts involving a major corporation and how it may have negatively affected board decision-making.[38] Furthermore, the new Form 990 presents multiple questions regarding conflicts of interest and raises potentially significant issues regarding the potential for ''horizontal bias''; *i.e.*, business and family relationships among board members (*see, e.g.*, Part VI-A, question 2).

Separate but important issues relating to the independence of nonprofit board members arise from two key sources. First, the Panel for the Nonprofit Sector's important ''Principles for Good Governance and Ethical Practice'' dramatically raised the stakes on director independence standards by calling for nonprofits to achieve a level of least two-thirds of its membership constituting ''independent'' directors. Satisfaction of this ''best practice'' may result in significant turnover on many nonprofit boards, and it exceeds the standard required for hospital tax-exempt status. Second, the new Form 990 directly asks (at Part VI, Section A-1(b)) for the number of independent directors on the board, as well as other questions relating to the executive compensation determination process and the audit committee, which implicate independence issues.

9. ***Charity Care/Community Benefit.*** 2007 witnessed several important developments relating to the ability of nonprofit hospitals and health systems to qualify for local and federal tax exemption. These developments occurred within an environment in which questions continue to be raised whether the public benefits that tax-exempt organizations are providing are commensurate with the organization's resources and the tax subsidies they receive.[39] More pointed concerns arose from federal regulators who continue to express concern with the ability to differentiate nonprofit from for-profit health care providers in terms of provision of community benefit and charity care.[40]

At the federal level, one key development was the July 19, 2007, release by the IRS of its interim report on its 2006 survey of tax-exempt hospitals and community benefit.[41] The interim report summarized responses from almost 500 hospitals to the survey about how they

[29] Smithsonian Institution, the Board of Regents, ''Report of the Governance Committee to the Board of Regents,'' June 14, 2007, p. 3. *http://newsdesk.si.edu/releases/Governance_Committee_Report.pdf.*

[30] *Id.*

[31] *Id.*

[32] *http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/0,,contentMDK:21335418~pagePK:64257043~piPK:43.*

[33] Francie Ostrower, ''Nonprofit Governance in the United States: Findings on Performance and Accountability from the First National Representative Study,'' *www.urban.org/url.cfm?ID=411479.*

[34] *See, e.g.*, Ryan J. Donmoyer and Alison Fitzgerald, ''Robin Hood Nest Egg Draws Scrutiny from Congress''; Bloomberg.com, July 16, 2007.

[35] Daniel J. Wakin, ''Chairman's Kin Hired as Architect for Carnegie,'' *The New York Times*, Oct. 11, 2007.

[36] Julia Moskin, ''An Early Departure for Beard Board Head,'' *The New York Times*, Oct. 16, 2007.

[37] *See, e.g.*, Jonathan D. Glater, ''College Officers Profited by Sale of Lender Stock,'' *The New York Times*, April 5, 2007; Libby George, ''Alleged Conflicts of Interest, Probe of College Lending Get Hill's Attention, *Congressional Quarterly Today*, April 6, 2007; Jonathan D. Glater, ''New Ties Found to Link Lenders and Colleges,'' *The New York Times*, Sept. 5, 2007.

[38] *In re InfoUSA Inc. Shareholders Litigation,* Del. Ch. 1956-CC, opinion revised 8/20/07, *http://courts.delaware.gov/courts/Court%20of%20Chancery/* under the ''Opinions/chancery tab; *see also BNA's Corporate Accountability Report*, Vol. 5, No. 36, Sept. 14, 2007, p. 920.

[39] Miller 10/22/07 Remarks, *supra;* Miller 11/10/2007 Remarks, *supra.*

[40] *http://www.senate.gov/~finance/press/Gpress/2007/prg071907a.pdf.*

[41] *http://www.irs.gov/pub/irs-tege/eo_interim_hospital_report_072007.pdf.*

provide and report community benefits to the community. According to the interim report, uncompensated care made up the largest reported expenditure but no uniform definition of ''uncompensated care'' arose from the responses. The IRS continues to analyze the reported data and expects to issue a follow-up report.

Simultaneously with the release of the IRS interim report, the minority staff of the Senate Finance Committee released a discussion draft staff document reflecting a series of proposals for reform in the area of nonprofit hospitals, including a proposed revision to the ''community benefit'' standard of tax exemption. The staff document emphasizes that it is not proposed legislation.[42]

Of course, particularly significant was the treatment afforded the charity care/community benefit issue in the new Form 990, released on Dec. 20, 2007. In particular, the instructions to ''Schedule H–Hospitals'' were refined to state that bad-debt expense and Medicare shortfalls are not to be reported in Part I of the Schedule. However, Part III has been revised to include additional reporting of bad-debt information and to collect Medicare shortfall information.

Also noteworthy were two developments in the hospital property tax exemption battleground that has become the state of Illinois. In a stunning victory for nonprofit hospitals, a state trial court judge in July reinstated the property tax exemption of Provena Covenant Medical Center, which had been revoked in somewhat dramatic fashion by the Illinois Department of Revenue in September 2006.[43] That decision currently is on appeal by the IDOR to the Illinois Court of Appeals. Provena Covenant subsequently filed suit against county tax collectors seeking repayment of approximately $6 million in property taxes it claimed it never should have been required to pay.[44]

In a case with a somewhat similar fact scenario, Carle Foundation of Champaign/Urbana, Ill., filed an appeal in December 2007 of a prior decision by IDOR to deny it a property tax exemption for a group of properties used to operate a hospital and provide other health care delivery services.[45] Both the Provena and Carle controversies had their origin in action by the Champaign (Ill.) County Board of Review to deny the organizations' property tax exemption for their alleged failure to comply with applicable Illinois law.

10. ***Financial Impropriety.*** One important 2007 development that ''flew under the radar,'' yet constitutes a significant threat to nonprofits, is the dramatic increase in reported cases/allegations of financial impropriety involving corporate management. Instances of embezzlement, ''revenue management,'' improper accounting entries, expense report abuse, improper management/allocation of restricted gifts and other financial improprieties in the nonprofit sector are being reported at an alarming rate, which requires closer attention to corporate governance.

Throughout 2007, both the mainstream media as well as charity sector press have reported on numerous allegations of potential financial abuse involving officers, board members and other senior officials of nonprofit organizations. Many of these have involved prominent, nationally recognized charitable organizations and senior officials within those organizations.

The sheer volume of these allegations, together with the risks to charitable assets that they create, have increased the already-high sensitivity of state charity officials to such abuse and the need for appropriate board-level response.

Indeed, concern with respect to financial impropriety/abuse of charitable assets was sufficient to prompt the IRS to include a question on ''material diversion of the organization's assets'' (Part VI, Section A-5) in the new Form 990.

11. ***Other Highlights.*** Other 2007 nonprofit developments worthy of mention include the following:

(a) A series of cases and other developments which reject application of special, more severe standards of fiduciary conduct while an organization is within the ''Zone of Insolvency'' and defer to application of the business judgment rule.[46]

(b) The release of a new fiduciary duty educational resource concerning a health care entity director's duty of oversight with respect to quality of care (jointly prepared by HHS OIG, and American Health Lawyers Association).[47]

(c) Guidance from a prominent health industry rating agency concerning the need for governance oversight of the investment practices of nonprofit hospitals.[48]

(d) The dramatic (163 percent) increase in referrals of exempt organization tax law issues received by the IRS from state charity officials over the past year;[49] and

(e) The continued movement toward trial of the *Robertson v. Princeton University* dispute, in which the donors/plaintiffs seek to assert claims relating to alleged misspending of gifts directly against a nonprofit charity rather than through the attorney general or other state charity official.[50]

Conclusion

2007 was a year in which developments in nonprofit corporate law, as applied to hospitals and health sys-

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[42] *http://www.senate.gov/~finance/press/Gpress/2007/prg071907a.pdf.*

[43] *See, e.g., BNA's Health Care Daily Report*, Vol. 12, No. 140, July 23, 2007.

[44] *See, e.g., BNA's Health Law Reporter*, Vol. 16, No. 47, Dec. 6, 2007.

[45] *See, e.g.,* ''Nonprofit Hospital in Illinois Files Appeal of Decision Denying Property Tax Exemption,'' *BNA's Health Care Daily Report*, Vol. 12, No. 241, Dec. 17, 2007.

[46] *See, e.g., North American Catholic Programming Foundation v. Gheewalla,* 930 A. 2d 92 (Del. May 18, 2007); *Trenwick American Litigation Trust v. Billett,* 2007 Del. Lexis 357 (Del. Aug. 14, 2007); *In re International Philanthropic Hospital Foundation,* Bankr. C.D. Cal., No. 02-20579, Aug. 8, 2007.

[47] U.S. Department of Health and Human Services Office of Inspector General and American Health Lawyers Association, ''Corporate Responsibility and Health Care Quality: A Resource for Health Care Boards of Directors,'' *http://www.oig.hhs.gov/fraud/docs/complianceguidance/CorporateResponsibilityFinal%209-4-07.pdf.*

[48] Moody's Investors Service, ''Special Comment: Not-for-Profit Hospitals Vulnerable to Investment Market Volatility.'' (Lisa Martin, analyst).

[49] Comments of Lois G. Lerner, director, IRS Exempt Organizations Division, ''Exempt Organizations/state Official Year-End Report FYE 2007, October 1, 2007,'' presented to National Association of State Charity Officials, Denver, Colo., Oct. 15, 2007.

[50] *Robertson v. Princeton University,* N.J. Super. Ct. Ch. Div., No. C-99-02, Oct. 25, 2007; John Hechinger, ''Ruling May Cost Princeton Millions if Heirs Win Case,'' *The Wall Street Journal*, Oct. 26, 2007.

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tems, continued apace. Of particular significance were the increased level of regulatory interest in governance practices of nonprofit organizations (and a willingness to closely review and question such practices) as well as the release of important publications, such as the Panel on the Nonprofit Sector's ''Principles of Good Governance,'' and the new Form 990.

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.