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Financing Public Health Through Nonprofit Conversion Foundations

BY CHRISTOPHER W. FROST*

INTRODUCTION

Protection and promotion of the public's health are typically thought of as governmental responsibilities.¹ Certainly, the core functions of responding to contagious diseases through quarantine, vector control, mandatory reporting, mandatory immunizations, and other coercive measures require governmental power. Historically, public health has been defined by governmental response to immediate threats to the health of the population.²

As our view of the public's health expands to take into account broader measures, however, so too can we expand our view of the kinds of institutions that serve to promote the public's health. Most commentators agree that public health is a wide ranging discipline. Professor Lawrence Gostin writes, "The mission of public health is broad, encompassing systematic efforts to promote physical and mental health and to prevent disease, injury, and disability."³ While Gostin's focus is on the govern-

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¹ Professor Lawrence Gostin's definition of public health law includes as an essential characteristic his view that "[p]ublic health activities are a special responsibility of the government." LAWRENCE O. GOSTIN, PUBLIC HEALTH LAW: POWER, DUTY, RESTRAINT 4 (2000).

² See *id.* at 9-11 (discussing early public health efforts focused on "conditions of travel at sea; isolation and quarantine; inoculation with smallpox pus; sanitary controls on dead fish, animals, and garbage; and quality controls on bread, meat, and drinking water"); see also Elizabeth B. Cooper, *Social Risk and the Transformation of Public Health Law: Lessons from the Plague Years*, 86 IOWA L. REV. 869, 881-88 (2001) (providing a historical perspective on disease control).

³ GOSTIN, *supra* note 1, at 16.

ment's role in promoting public health,⁴ there is nothing about contemporary definitions of public health that exclude a role for the private, nonprofit sector.

One cannot doubt the importance of nonprofit institutions in assuring the conditions necessary for the health of the population. Nonprofit organizations operate most of our hospitals, train health care professionals, assure the supply of blood, and perform a myriad of other services that provide the infrastructure necessary to the public's health. In addition, the nonprofit form of organization enables health care organizations to provide public health services that profit seeking organizations are unable to maintain. Nonprofit hospitals provide education, indigent care, preventive health services, prenatal care, and mental health care services that may not be provided by for-profit organizations.⁵

Changes in health care financing and industry structure may substantially reduce the contributions to public health that have traditionally been made by nonprofit organizations. The rise of managed care and the ever increasing reliance on expensive medical technologies have increased the industry's need for capital,⁶ and changes in reimbursement formulas have reduced nonprofits' ability to maintain the level of uncompensated and poorly compensated services.⁷ At the same time, the changes have created

⁴ See Lawrence O. Gostin & James G. Hodge, Jr., *The Public Health Improvement Process in Alaska: Toward a Model Public Health Law*, 17 ALASKA L. REV. 77 (2000) (defining public health principally in terms of public health law).

⁵ Whether nonprofits meet this expectation is, however, subject to some doubt. A recent review of empirical literature shows that nonprofits do provide a greater amount of charity care and services that lose money. Div. of Health & Sci. Policy, N.Y. Acad. of Med., *The Empirical Literature Comparing For-Profit and Nonprofit Hospitals, Managed Care Organizations, and Nursing Homes: Updating the Institute of Medicine Study* (July 1999), available at <http://www.cnhc.org/Report3.pdf> (visited Jan. 27, 2002). Some commentators assert, however, that the differences between for-profits and nonprofits are small. See David A. Hyman, *Hospital Conversions: Fact, Fantasy, and Regulatory Follies*, 23 J. CORP. L. 741, 756-63 (1998).

⁶ See David M. Cutler & Jill R. Horwitz, *Converting Hospitals from Not-For-Profit to For-Profit Status: Why and What Effects?* (Nat'l Bureau of Econ. Research, Working Paper No. 6672, at 11-12, Aug. 1998), available at <http://www.nber.org/papers/w6672> (visited Dec. 12, 2001); Lawrence E. Singer, *The Conversion Conundrum: The State and Federal Response to Hospitals' Changes in Charitable Status*, 23 AM. J. L. & MED. 221, 225-28 (1997).

⁷ See BRADFORD H. GRAY, THE PROFIT MOTIVE AND PATIENT CARE: THE CHANGING ACCOUNTABILITY OF DOCTORS AND HOSPITALS 335 (1991) ("Trying to generate surplus patient revenues to finance money losing activities (so-called

the opportunity for providers to generate profits necessary to support their new capital requirements. The need for capital and the profits available to support it have led to an increase in for-profit ownership of health care facilities. For-profits have increased mainly through the acquisition of assets of nonprofit organizations.

The late 1980s and 1990s have witnessed an increasing number of nonprofit organizations converting to profit seeking ventures.⁸ This wave of nonprofit conversions has sent states' Attorneys General and public interest advocates scrambling to find ways to police these transactions. High profile transactions involving Blue Cross/Blue Shield conversions resulted in litigation involving billions of dollars that states claimed should be set aside in charitable foundations devoted to health care. At the same time, smaller transactions involving community hospitals, nursing homes, and ambulance services are also attracting attention. Unfortunately, many of these efforts have been hampered by inadequate conversion laws that force states to regulate conversions on a post-hoc basis with antiquated legal tools.

The conversion of health care assets from nonprofit to for-profit ownership raises questions of particular concern to public health officials. This shift in the health care industry requires that we examine whether the for-profit form of organization can provide health care services in the most economically efficient and efficacious manner, a debate which continues. Perhaps of more direct concern for public health, the conversion of health care assets also raises the question of the value of the nonprofit form to the community as measured by charity care, services to Medicaid patients, cross-subsidization of unprofitable units such as emergency rooms, health education, preventive care, and other, more elusive community benefits that may be lost in a conversion.

Assuming that nonprofit conversions will continue in the health care arena, the challenge to policymakers is to capture and invest the proceeds of such transactions in organizations that can replace the public health functions of the nonprofit. This Article will discuss ways in which proceeds from nonprofit conversions can be used by the nonprofit sector to continue

Robin Hood financing) has been made more difficult because of price competition and increasingly stringent rate-setting policies, particularly by Medicare.”)

⁸ Between 1970 and 1995, 330 hospitals converted from nonprofit to for-profit. See Cutler & Horwitz, *supra* note 6, at table 2. Conversion activity peaked in 1996 before falling off in the late 1990s. See GRANTMAKERS IN HEALTH, PHILANTHROPY'S NEWEST MEMBERS: FINDINGS FROM THE 1999 SURVEY OF NEW HEALTH FOUNDATIONS at 4 ex. 1 (1999).

the public health services provided by nonprofit health care organizations. An example can be found in the recent formation of The Foundation for a Healthy Kentucky. This Foundation was established from a \$45 million settlement obtained through litigation by Kentucky Attorney General Albert B. Chandler, III against Anthem Insurance Company over Anthem's 1993 merger with Blue Cross and Blue Shield of Kentucky. The Foundation is designed to meet the public health care needs of the Commonwealth through projects designed to influence health policy and improve access to health care generally.

Part I of this Article provides an overview of the law of nonprofit conversions. The law governing nonprofit conversions is founded on common law doctrines of charitable trust. In many states, the procedures surrounding conversions are further regulated by state statutes that provide states' Attorneys General the tools they need to assure that the change in ownership results in adequate proceeds that can replace the public benefits lost in a conversion. Parts II and III provide a case study based on the Kentucky Attorney General's litigation with Anthem Insurance Company. Part II will focus on the difficulties in the lack of a regulatory structure created in the Anthem case. Part III will discuss the process of forming the Foundation for a Healthy Kentucky from the \$45 million settlement of that case. The Foundation's focus on health care policy activities aimed at improving the health of all Kentuckians provides an example of one way to capture some of the public health benefits of the nonprofit form of organization.

I. THE LAW OF NONPROFIT CONVERSIONS

The activities of, and control over, nonprofit organizations are governed by an amalgam of federal tax law, state trust law, and nonprofit corporation statutes. As the number of conversions began to accelerate in the early 1990s, officials charged with regulating nonprofits found these legal tools inadequate to address the complexities in the organizations and transactions. In response, many states have enacted nonprofit conversion statutes that require buyers and sellers to provide advance notice to the state's Attorney General and obtain prior approval of the deal. These statutes permit the Attorney General to participate in the transaction while it is in the formative stages rather than forcing him or her to litigate after the fact. This section discusses the application of traditional common law trust principles to nonprofit conversions and the emergence of statutory approaches to the regulation of these transactions.

A. *The Theory of Nonprofit Conversions*

For many, the term “nonprofit” conjures up images of traditional charitable organizations like the Red Cross, or religious charities like the Salvation Army. These organizations rely on donations from individuals and corporations and carry on an explicitly charitable agenda. Commercial nonprofits, such as nonprofit hospitals, HMO’s, and Blue Cross/Blue Shield plans, do not fit the mold of these traditional charities. On the surface, large commercial nonprofit organizations seem more like for-profit corporations than charitable organizations. This similarity creates substantial confusion when considering the question of how to manage the conversion of assets from one organizational form to another. The confusion also results from the fact that little may visibly change immediately after a conversion. The new for-profit organization will continue to provide services and will continue to expect payment for those services. Thus, at first blush, it may be hard to determine what precisely is at stake in such transactions.

The confusion comes from a misunderstanding of the essential attributes of nonprofit organizations. Nonprofits are characterized by a lack of identifiable owners rather than by their good works or reliance on donations.⁹ The focus on ownership explains much about the law governing nonprofit organizations. A hospital or educational institution operated by a nonprofit organization may look like a for-profit competitor on the surface, but, unlike the for-profit,¹⁰ no individual or governmental entity possesses the right to control, or profit from the nonprofit organization’s assets. More simply, nonprofits charge for service and can earn profits, they just cannot pay out profits in the form of dividends.¹¹

⁹ See Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835 (1980). Hansmann is the architect of the prevailing theory of nonprofit organization, describing a nonprofit as “in essence, an organization that is barred from distributing its net earnings, if any, to individuals who exercise control over it, such as members, officers, directors, or trustees.” *Id.* at 838.

¹⁰ Evelyn Brody concludes that,

[i]n comparing the organization and operations of nonprofits in light of how proprietary businesses function, we learned that the two sectors are much more similar than conventionally believed. Firms, whether nonprofit or proprietary (or even public), are subject to many of the same economic forces, such as resource dependency, institutional isomorphism, and organizational slack.

Evelyn Brody, *Agents without Principals: The Economic Convergence of the Nonprofit and For-Profit Organizational Forms*, 40 N.Y.L. SCH. L. REV. 457, 535 (1996).

¹¹ See Hansmann, *supra* note 9, at 838 (“It should be noted that a nonprofit organization is not barred from earning a profit. Many nonprofits in fact

Understanding nonprofits as a form of organization rather than by their acts of charity provides insights into why nonprofits convert to for-profit organization and how the law should regulate that conversion. For example, consider a hypothetical hospital in a small to medium sized community. The nonprofit corporation that owns the hospital is likely to be controlled by a group of civic minded individuals who consider their role in the hospital's management as a contribution to the well-being of the community. They take pride in the fact that the hospital provides an emergency room, some charity care, and other community services such as prenatal care, stop-smoking clinics, reduced cost immunizations, and the like. The nonprofit continues to operate the hospital because the trustees believe the operation of a hospital is the best way to use the value of the organization's assets for the betterment of the community.

The mere fact that the community needs a hospital does not, however, say anything about who should own that hospital. A for-profit organization that owned the hospital might run it more efficiently.¹² Concomitantly, the fact that the nonprofit organization has substantial value does not mean that that value should be invested in the hospital. The value of the hospital might be put to better use if the assets were liquidated and the proceeds were used to continue the services that the for-profit will not provide or, perhaps, redirected to other activities that enhance the well-being of the community.

Conversion transactions, on this view, are simply the method by which a nonprofit can swap operating assets for financial assets when the change results in net social benefits.¹³ Presumably, a for-profit organization that can run a hospital more efficiently than it is being run in the nonprofit form, will be willing to pay the nonprofit more than the assets are worth to the

consistently show an accounting surplus. It is only the distribution of profits that is prohibited.”).

¹² See Robert Charles Clark, *Does the Nonprofit Form Fit the Hospital Industry?*, 93 HARV. L. REV. 1417, 1462 (1980) (“What the evidence on efficiency does confirm is [that] *ceteris paribus*, managerial discretion (or ‘slack’) is greater [in nonprofits] than in for-profits because of the absence of comparable capital-market controls—that is, controls exerted by capital suppliers as opposed to customers—and it results in organizational practices that increase the managers’ utility.”). Beyond operating inefficiencies, Clark argues that, overall, the nonprofit form imposes substantial costs on society. *Id.* at 1418.

¹³ See Singer, *supra* note 6, at 230 (“[T]he ability to secure a large pool of funds through sale or conversion, which can then be used to enhance the welfare of the community, presents an attractive alternative to continued ownership of an acute care hospital.”).

community in the nonprofit organization. The most straightforward paradigm and, in fact, the most common structure is that of a sale of the operating assets by the nonprofit and the creation of a new foundation to receive the proceeds. Through negotiation, the nonprofit board and the for-profit organization should be able to reach a price that splits the efficiency gains resulting from the transaction.¹⁴

Of course, this benign view of nonprofit conversions depends entirely on the assumption that the parties to the transaction are both fully informed about the consequences of the deal and have the correct set of incentives to negotiate a deal that is both value maximizing and fair from a distributional perspective. From a legal standpoint, the challenge is to develop regulatory structures that assure that all of the interests affected by the transaction have been represented by agents who share the incentives of their principals.

General theories underlying transactions in the for-profit arena can illuminate the issues arising in nonprofit conversions. For-profit corporation law focuses its regulatory efforts on the agency problems that inhere in the separation of ownership from control.¹⁵ Shareholders, as the owners of the firm (the principals), are represented by a board of directors (the agents) in the initial negotiation of a merger, sale or other acquisition.¹⁶ Corporate fiduciary duty principles regulate the relationship between the agents and their principals and allocate approval responsibility between them.¹⁷ Securities laws govern disclosure obligations so that the principals are provided adequate information to make a decision regarding the transaction.¹⁸ Governmental regulations, such as antitrust laws, protect the interests of the public that would otherwise be unrepresented in the transaction.

¹⁴ See RICHARD A. EPSTEIN, *SIMPLE RULES FOR A COMPLEX WORLD* 71-72 (1995).

¹⁵ A seminal work discussing the agency problems in firm governance is Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 *J.L. & ECON.* 301, 304 (1983).

¹⁶ Shareholders retain discretion over fundamental changes in the corporation such as mergers, DEL. CODE ANN. tit. 8, § 251 (2001); REV. MODEL BUS. CORP. ACT § 11.01 (1984), the sale of substantially all of the assets of the corporation, DEL. CODE ANN. tit. 8, § 271 (2001); REV. MODEL BUS. CORP. ACT §§ 12.01 - .02 (1984), and changes to the articles, DEL. CODE ANN. tit. 8, § 242 (2001); REV. MODEL BUS. CORP. ACT § 10.03 (1984).

¹⁷ See ROBERT CHARLES CLARK, *CORPORATE LAW* 93-141 (1986).

¹⁸ See 1 THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* 6-11 (3d ed. 1996) (discussing the scope and coverage of federal and state securities regulation).

The law regulating nonprofit conversions could follow the same general approach, but with one important difference. Because, the *sine qua non* of nonprofits is the lack of an identifiable group of owners, nonprofit conversions present the difficult question of how to resolve a principal-agent problem when the principal is undefined.¹⁹ Without a clearly defined principal, the normal process of bargaining cannot reliably value the assets sold and therefore cannot assure that conversion transactions increase net social wealth.

As discussed below, charitable trust law, and more recent nonprofit conversion statutes, provide a way to resolve this problem. Traditionally, transactions involving assets that have been dedicated to a public purpose (the hospital corporation conversion in our example) are regulated by the courts in actions brought by the states' Attorneys General, exercising their *parens patriae* power.²⁰ The managers of these assets, the board of trustees, serve as agents for the public, generally, and are answerable for failure of that trust to the courts, specifically. The Attorney General's role is necessary to assure that the public's interest, as principal, is adequately represented.²¹

Charitable trust law thus provides a mechanism to reduce the agency problems inherent in nonprofit conversions. Standing in for the "owners"

¹⁹ See Geoffrey A. Manne, *Agency Costs and the Oversight of Charitable Organizations*, 1999 WIS. L. REV. 227, 271 ("Currently, charities remain effectively uncontrolled due to the absence of traditional corporate controls from the nonprofit form, such as shareholders and the market for corporate control.").

²⁰ See 4A AUSTIN WAKEMAN SCOTT & WILLIAM FRANKLIN FRATCHER, SCOTT ON TRUSTS § 392 (4th ed. 1989); Singer, *supra* note 6, at 222.

²¹ Manne suggests that the market might provide an alternative approach to the resolution of the principal-agent problem by the creation of private for-profit monitoring agencies that nonprofit organizations could hire to ensure that the nonprofit fulfills its obligations to donors. The agency would act as a "private attorney general" that would have standing to sue to enforce compliance with the nonprofits obligations. Reassured by the presence of the monitor, donors would be more likely to give. Manne, *supra*, note 19, at 248-57. Whatever the appeal of Manne's proposal, it is unclear how it could work in a commercial nonprofit conversion since these organizations do not rely heavily on donations. Further, once the decision to convert the organization to the for-profit form is reached, the nonprofit would have nothing to gain by hiring such a watchdog.

Brody also invokes the principal-agent problem in her analysis of nonprofits, concluding that the ongoing need to satisfy constituencies alleviates some of the agency problems caused by the lack of owners. See Brody, *supra* note 10, at 512-35. Of course, Brody's analysis assumes that the nonprofit will continue in existence, an assumption that does not hold in analyzing the problems created by a nonprofit conversion.

of the assets—the general public—the state Attorney General and court can insist that the board negotiate a transaction that assures that the public receives full value for the charitable assets transferred in the conversion.²²

Before examining the contours of charitable trust law in detail, however, it is necessary to clear away some confusion that permeates many discussions of charitable organizations. Although charitable organizations exist for a “public purpose” and are closely regulated by the state, they are forms of private ownership of property. Thus, the state does not have a right to claim the proceeds of conversion transactions nor can state legislatures interfere with the rights the trust creates.²³ Professor Fratcher explains the rights and duties arising under a charitable trust as follows:

A trustee of a charitable trust is clearly under a duty properly to administer the trust, but it is difficult to see who has the correlative right. The duty can be enforced, as has been stated, in a proceeding brought by the Attorney General, but the duty is not owing to him. It can hardly be said that the duty is owing to the state. Certainly the state as such is not the beneficiary of a charitable trust, except in rare cases; and it has been held that the legislature has no power to destroy or to vary the terms of a valid charitable trust. The truth seems to be that the trustee of a charitable trust owes duties, but the duties are not owing to any person or persons in particular, although they are enforceable at the suit of a public officer for the benefit of the community.²⁴

The theme of community dominates most of the cases arising from nonprofit conversions. While the conversions involve assets held by the nonprofit entity, it is clear that the community is the beneficiary of the proceeds of the sale. Thus, much of the challenge in charitable conversions is to assure that the proceeds resulting from the transaction benefit the community whose interests in the operating assets were extinguished by the conversion.

²² Determining that value is a difficult proposition and beyond the scope of this Article. For our purposes, it is enough to understand generally that the value of any asset is the price which a willing buyer would pay and a willing seller would accept for the asset. In a nonprofit conversion, this determination requires that the for-profit buyer assess the present value of the revenue stream the assets will generate and that the nonprofit determine the present value of the services lost to the nonprofit's beneficiaries. These amounts fix a maximum and minimum range of efficient prices. The actual price should fall somewhere in between.

²³ See SCOTT & FRATCHER, *supra* note 20, § 348.

²⁴ *Id.*

B. Charitable Trust Law and Nonprofit Conversions

In addition to this concern for the community, much of the law of charitable trust is designed to protect the expectations of donors. A charitable trust is created through declaration of an intent to hold property for the charitable purpose of the donor. The trust is a legal entity with the power to hold, buy, and sell property, and is governed by a trustee or board of trustees with a fiduciary duty to uphold the wishes of the donor. The state protects the assets held by the trust and upholds the wishes of the donor through actions by the state Attorney General brought in courts of equity.²⁵

One can conceptualize charitable trust law as creating a compact among the donor, the trustee, and the state. The trustee, by accepting the assets, assumes a duty to use the assets in accordance with the wishes of the donor. The state agrees to protect this relationship through the courts as a way of encouraging philanthropic endeavors. Without the assurance of this protection, donors would be unlikely to give.²⁶

The law of charitable trust not only protects the assets from falling into private hands, but it also governs the post-conversion use of those assets. As noted above, a charitable trust is an entity with general powers to buy, sell, and use assets to advance the interests of the donors. Thus, a charitable trust created to operate a hospital, for example, must ordinarily continue to operate a hospital.

Changes in the charitable purpose are governed by the equitable doctrine of *cy pres*, a french term meaning "as near[ly] as [possible]."²⁷ Under this doctrine, where the original charitable purpose is no longer possible, a court of equity may approve an alternative use.²⁸ As the translation implies, the use chosen must generally be as close to the donor's intent as possible.²⁹

The regulation of nonprofit conversions under charitable trust law fits within the agency rubric set out above. When a donor commits assets to a

²⁵ See *id.*

²⁶ See Rob Atkinson, *Reforming Cy Pres Reform*, 44 HASTINGS L.J. 1111, 1114 (1993) (characterizing the law of charitable trust, including *cy pres*, as a bargain between the state and the donor).

²⁷ BLACK'S LAW DICTIONARY 392 (7th ed. 1999).

²⁸ See Atkinson, *supra* note 26, at 1115; Alex M. Johnson Jr. & Ross D. Taylor, *Revolutionizing Judicial Interpretation of Charitable Trusts: Applying Relational Contracts to Cy Pres and America's Cup Litigation*, 74 IOWA L. REV. 545, 561 (1989).

²⁹ Atkinson, *supra* note 26, at 1115 (citing RESTATEMENT (SECOND) OF TRUSTS § 399 (1957)).

public use, he or she relies on the state to represent both the community's interest in the funds and his or her own interest in the continuation of the charitable purpose to which the assets are committed. The compact among the donor, trustee, and state creates an agency relationship that will last long after the donor is deceased.

While nonprofit conversions can be shoe-horned into the common law of charitable trust, the doctrine was not intended to regulate contemporary transactions involving complex commercial nonprofits such as those that dominate the health care industry. The following discussion examines the contours of charitable trust law as it applies to modern health care transactions, highlighting the difficult issues the application of charitable trust law raises.

1. *The Basic Disconnect Between Charitable Trust Rubric and Commercial Institutions*

It is difficult to conceive of a modern hospital or insurance company as being a charitable institution.³⁰ Commercial nonprofits, such as those that comprise the majority of the healthcare industry, charge for their services.

³⁰ The apparent disconnect between a law created hundreds of years ago to govern specific bequests of property for the benefit of the poor and the modern healthcare institution causes many commentators to conflate the tax exemption with the claim that assets are held in charitable trust. See James J. Fishman, *Checkpoints on the Conversion Highway: Some Trouble Spots in the Conversion of Nonprofit Health Care Organizations to For-Profit Status*, 23 J. CORP. L. 701, 703 (1998) (discussing 501(c)(3) organizations as "traditional nonprofits"); Eric S. Tower, *Directors' Duty to Obtain a Fair Price in the Conversion of Nonprofit Hospitals*, 6 ANNALS HEALTH L. 157 n.1 (1997) (using the terms nonprofit and tax-exempt interchangeably).

This tax-exemption perspective on nonprofit conversions is not wrong, but it is incomplete. The Internal Revenue Code grants tax exemption under § 501(c)(3) to organizations that are organized and operated exclusively for religious, charitable, scientific, literary or educational purposes. See I.R.C. § 501(c)(3) (1995). These organizations are prohibited from engaging in activities that result in inurement of the income of the organization to insiders, and the I.R.S. enforces this prohibition in conversion transactions. See Fishman, *supra*, at 727-29. Not all organizations holding charitable assets are tax-exempt, however. For example, in 1986, Congress withdrew the tax-exempt status of Blue Cross/Blue Shield organizations. See Philip P. Bisesi, *Conversion of Nonprofit Health Care Entities to For-Profit Status*, 26 CAP. U. L. REV. 805, 818-20 (1997). In short, 501(c)(3) status is likely to result in a finding that an entity holds its assets in charitable trust, but 501(c)(3) status is not necessary to that determination.

While charity care and other charitable activities form a part of these institutions' missions, they by no means dominate their day-to-day activities. The near absence of any ongoing charitable mission may be a significant factor in litigation seeking to capture the proceeds of the transaction.

Nevertheless, the large nonprofit institutions that occupy the healthcare industry started their lives as charitable institutions. At their inception, hospitals were purely charitable institutions serving those too poor to afford health care in their homes.³¹ As surgical techniques made possible by advances in anesthesia and sterile procedures were developed, hospitals began serving the population generally. Charitable hospitals' sponsorship of Blue Cross organizations assisted the transition by providing the hospitals with a steady stream of income and making possible hospital care for the middle class.³²

The challenge in conversion litigation is linking the two points in history to show that all of the assets of the nonprofit are subject to the same charitable trust that was created when the institution was conceived. The key to establishing that link is the frame of reference of the founders of the organization.³³ When the initial founders created the organization, they chose to contribute time, energy and capital to a venture for a public, as opposed to their own personal, benefit. The fact that the venture grew and became self-supporting through commercial endeavors does nothing to change that original frame of reference.

Thus, the basic principles underlying charitable trust law govern the scope of the assets to which the trust extends. The founders' decision to organize the venture for the public's benefit deserves governmental protection that extends to all of the assets that that organization acquired. The organization's equity in the modern facilities and equipment and in the intangible assets of the organization are all subject to the charitable trust regardless of whether they were acquired through donation or through the accumulation of profit.³⁴ By defining the charitable trust as all of the entity's assets, the law requires a valuation of the entire entity to determine

³¹ GRAY, *supra* note 7, at 63-65.

³² See ROBERT CUNNINGHAM III & ROBERT M. CUNNINGHAM JR., *THE BLUES: A HISTORY OF THE BLUE CROSS & BLUE SHIELD SYSTEM* 3-32 (1997).

³³ See SCOTT & FRATCHER, *supra* note 20, § 348 ("A charitable trust . . . is created because a person having power to create it has manifested by his words or conduct an intention to create it.").

³⁴ See *Queen of Angels Hosp. v. Younger*, 136 Cal. Rptr. 36, 39 (Ct. App. 1977) (stating that nonprofit corporate assets are impressed with a charitable trust by articles of incorporation).

whether the proceeds paid by the new for-profit owners are sufficient to compensate the trust for the operating assets transferred.³⁵

The articles of incorporation and nonprofit corporation laws under which the nonprofit was organized provide a basis for the argument that the assets of commercial nonprofit organizations are held in a charitable trust.³⁶ Usually the articles of incorporation of the nonprofit make reference to the public benefit purpose of the founders who organized the entity.³⁷ In addition, older nonprofit corporations were organized under statutes that by their terms govern "religious, charitable and educational institutions."³⁸ Modern nonprofit corporation statutes require the corporation to distribute its assets upon dissolution to another nonprofit that will carry on the public benefit purpose found in the articles of the dissolved corporation.³⁹ These

³⁵ See Fishman, *supra* note 30, at 718-21 (discussing valuation issues and problems); see also *infra* notes 72-74, 78-81 and accompanying text (discussing nonprofit conversion statutes and valuation).

³⁶ See *Queen of Angels Hosp.*, 136 Cal. Rptr. at 39.

³⁷ REV. MOD. NONPROFIT CORP. ACT § 2.02(a)(2) (1987) requires that a nonprofit corporation include one of three statements in its Articles of Incorporation:

"(i) This corporation is a public benefit corporation.

(ii) This corporation is a mutual benefit corporation.

(iii) This corporation is a religious corporation."

The Act carefully distinguishes between the three types of organizations. For our purposes, the most important distinction is between a public benefit corporation and a mutual benefit corporation. Both types of organizations are "nonprofit," however, only the public benefit corporation holds its assets in charitable trust. Mutual benefit corporations are member-owned entities that may distribute assets to the members. See *id.* § 13.02(a) (permitting mutual benefit corporations to purchase its memberships), § 14.06(7) (permitting mutual benefit corporations to make distributions upon dissolution).

³⁸ See CARROLL'S KENTUCKY STATUTES §§ 879-83 (1936) (setting out provisions governing "Religious, Charitable and Educational Institutions").

³⁹ Where the articles or bylaws of a nonprofit public benefit corporation do not specify a successor for the corporation's assets on dissolution, the Revised Model Nonprofit Corporation Act requires that the assets be distributed to one or more 501(c)(3) organizations or, if the dissolved corporation itself is not a 501(c)(3) organization, to one or more public benefit or religious corporations. REV. MOD. NONPROFIT CORP. ACT § 14.06(a)(6) and Official Comments. The Comments make clear that the assets cannot be distributed to members of the organization unless they are public benefit organizations.

Here again, the Model Act draws a distinction between mutual benefit nonprofits and public benefit nonprofits. Mutual members are entitled to receive assets on liquidation. *Id.* § 14.06(a)(7) and Official Comments.

provisions are an indication of the intent of the founders that the corporation holds its assets in charitable trust.

In specific cases, however, nonprofit corporation statutes and articles of incorporation may fail to provide a clear picture of the intent of the founders to create a charitable trust. Nonprofit corporation law is often described as the step-child of corporate law⁴⁰—developing haphazardly over the years with little thought paid to transactions that might affect the corporation long into the future. Changes in the legal structure governing nonprofit corporations, articles of incorporation, and the actual operations of the nonprofit over the years may obscure the original intent of the founders to create a charitable trust. As a result, Attorney General representation of the public and donor interests in the organization is often subject to challenge regarding the charitable status of the nonprofit.⁴¹

2. *Enforcing the Compact:* *Cy Pres and the Charitable Purpose of the Donor*

The charitable trust doctrine of *cy pres* governs the use to which the proceeds must be put at the conclusion of the conversion transaction. The theory behind this application of the doctrine is that the conversion transaction represents a release of charitable assets from the entity where the specific use, operating a hospital, for example, is no longer the best way of accomplishing the donors' charitable purpose. The transaction provides liquidity for the entity, permitting direct funding of its charitable purpose. *Cy pres* regulates this redeployment of the charitable trust's assets so that the original purpose of the donor is maintained.

The courts' application of the *cy pres* doctrine in health care conversions is characterized by tension between the need to protect the interests of the beneficiary and the desire of health care policy advocates to redeploy the value of the charitable assets to address current needs. For example, in *Queen of Angels Hospital v. Younger*,⁴² the Franciscan Sisters of the Sacred

⁴⁰ James J. Fishman, *The Development of Nonprofit Corporation Law and an Agenda for Reform*, 34 EMORY L.J. 617, 657 (1985) (quoting Henn & Boyd, *Statutory Trends in the Law of Nonprofit Organizations: California, Here We Come!*, 66 CORNELL L. REV. 1103, 1104 (1981)).

⁴¹ See *infra* Part II.A for an example of the difficulties created by this lack of clarity.

⁴² *Queen of Angels Hosp. v. Younger*, 136 Cal. Rptr. 36 (Ct. App. 1977). For a further discussion of this case and other *cy pres* cases involving health care organizations, see Michael W. Peregrine, *Charitable Trust Laws and the Evolving Nature of the Nonprofit Hospital Corporation*, 30 J. HEALTH & HOSP. L. 11

Heart, the unincorporated religious order that ran Queen of Angels Hospital, filed a declaratory judgment action against the California Attorney General seeking a determination of the validity of a lease of the hospital assets to a for-profit hospital corporation. The lease was to run for twenty-five years with two ten-year renewal options and required the for-profit to make guaranteed rental payments to the lessor of \$800,000 for the first two years and \$1,000,000 thereafter.⁴³

Queen of Angels intended to use most of the lease proceeds to establish and operate medical clinics in Los Angeles that would provide free medical care to the poor.⁴⁴ The California Attorney General challenged the proposed lease and use of proceeds on the ground that the hospital's articles of incorporation imposed a charitable trust that required that the assets be used for the primary charitable purpose of operating a hospital.⁴⁵

The court agreed that all of the assets of the hospital were subject to a charitable trust "by virtue of the express declaration of the corporation's purposes."⁴⁶ Thus, the articles of incorporation determined the proper uses of the assets. Upon examination of the articles, the court concluded that Queen of Angels Hospital Corporation "was intended to and did operate a hospital and cannot, consistent with the trust imposed upon it, abandon the operation of the hospital business in favor of clinics."⁴⁷ The court then turned to the hospital's argument that the use of the proceeds of the lease to operate clinics serving the poor was as worthwhile as the operation of a hospital. The court was willing to assume that the operation of clinics would be a desirable purpose for a charitable corporation,⁴⁸ but because the articles of incorporation imposed a trust on the assets the court stated, "the issue is not whether the new and different purpose is equal to or better than the original purpose, but whether that purpose is authorized by the articles."⁴⁹

(1997).

⁴³ *Queen of Angels Hosp.*, 136 Cal. Rptr. at 39.

⁴⁴ *Id.*

⁴⁵ *Id.* The parties did not dispute that "a 'hospital' is not the functional equivalent of an 'outpatient clinic.'" *Id.*

⁴⁶ *Id.* (quoting *Pac. Home v. County of Los Angeles*, 264 P.2d 539, 543 (Cal. 1953)).

⁴⁷ *Id.* at 41.

⁴⁸ *Id.*

⁴⁹ *Id.* While this case, like many cases, revolved around provisions of the articles of incorporation which set forth the corporate purpose of the nonprofit, the court utilized *cy pres* concepts in its ruling. See also *Holt v. Coll. of Osteopathic Physicians & Surgeons*, 394 P.2d 932 (Cal. 1964).

The Queen of Angels court's application of the *cy pres* doctrine illustrates the tension inherent in charitable trust law. A restrictive interpretation of the trust's purposes may unduly limit the trustee's ability to apply the trust assets to the most pressing social needs.⁵⁰ The socially optimal use of charitable assets can be expected to change from generation to generation and a liberal approach to *cy pres* may be necessary to assure that the assets are deployed where 'most needed.'⁵¹ Health care advocates may find this liberal approach beneficial given the fast paced changes in modern health care.

Not all states apply the *cy pres* doctrine with equal force where the nonprofit is organized as a nonprofit corporation. Some jurisdictions hold charitable corporations to a lesser "quasi *cy pres*" standard and only apply pure *cy pres* to will bequests. See *Holden Hosp. Corp. v. S. Ill. Hosp. Corp.*, 174 N.E.2d 793 (Ill. 1961) (board of directors must show that the proposed distributees carry on "substantially similar" activities as the transferor). In *Multiple Sclerosis Service Organization of New York, Inc. v. New York City Chapter, Multiple Sclerosis Society*, 505 N.Y.S.2d 841, 845 (1986), the Court of Appeals of New York stated:

[T]he Legislature did not intend the stringent "as near as possible" standard of the common law to govern distribution of assets of a dissolving charitable corporation received other than through a will or other limiting instrument, but rather provided for distribution to corporations or organizations engaged in substantially similar activities and left it to the board of directors in the first instance to determine to whom distribution should be made.

⁵⁰ Perhaps the most notorious example of this restriction is the Buck Trust case. Mrs. Buck died in 1975 leaving a large estate in a foundation designed to benefit the needy of Marin County, California. Soon after Mrs. Buck died, the stock in the foundation increased dramatically in price due to a corporate acquisition. In fact, by 1985, the trust had grown from a value of \$9.1 million to a value of \$380 to \$400 million—all to be spent in Marin County, a county with the second highest per-capita income in the country.

Perhaps spurred on by the difficulty of finding poor in Marin County who needed the help of the trust and perhaps motivated by a desire to help fund social services in surrounding but less affluent counties, the San Francisco Foundation, trustee of the Buck Trust, filed an action seeking a *cy pres* determination loosening the terms of the trust. The court denied relief and the San Francisco Foundation resigned as trustee and the Marin County limitation remained intact. See Evelyn Brody, *Charitable Endowments and the Democratization of Dynasty*, 39 ARIZ. L. REV. 873, 880 (1997); John G. Simon, *American Philanthropy and the Buck Trust*, 21 U.S.F. L. REV. 641, 658-60 (1987); Roger G. Sisson, *Relaxing the Dead Hand's Grip: Charitable Efficiency and the Doctrine of Cy Pres*, 74 VA. L. REV. 635 (1988).

⁵¹ See Atkinson, *supra* note 26, at 1112; Johnson & Taylor, *supra* note 28, at 562.

On the other hand, an approach to *cy pres* that permits liberal departures from the intent of the donors or nonprofit corporation founders raises moral issues regarding the obligation of the state to abide by its agreements.⁵² Perhaps more compelling is the argument that a failure to adhere closely to the donor's intent may affect the willingness of the donors to give.⁵³ Thus, the traditional view of *cy pres* is that it forces a court to balance the need to respond to changes in the socially optimal use of charitable funds against the desire to maximize protection of the donor's intent.⁵⁴

The strictness with which a court views the *cy pres* doctrine may also be a function of other values. One of the traditional requirements for *cy pres* is that the original purpose of the donor have been frustrated.⁵⁵ This may be difficult to show in the case of a nonprofit conversion. In many cases the conversion of a nonprofit health care provider to a for-profit organization is not due to the fact that the continued operation of the hospital is impossible. In fact, in most cases the hospital will continue to be operated by the for-profit organization. Instead, the justification for conversions is that the hospital assets might *better* be operated by the for-profit organization, leaving the nonprofit organization to pursue other objectives.⁵⁶

⁵² See Atkinson, *supra* note 26, at 1121; Chris Abbinante, Comment, *Protecting "Donor Intent" in Charitable Foundations: Wayward Trusteeship and the Barnes Foundation*, 145 U. PA. L. REV. 665, 692 (1997).

⁵³ Abbinante, *supra* note 52, at 699 ("Without control over their charity, some philanthropists would decrease their level of giving.")

⁵⁴ Of course, as Judge Richard Posner has pointed out, donors are unlikely to intend to make useless gifts and would therefore welcome the intervention of courts if the purposes for which they made their gift were frustrated by an unforeseen contingency. See RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 556 (5th ed. 1998). Thus, on Posner's view, the dilemma presented by the *cy pres* doctrine is a false one.

Jonathan Macey, however, contests the notion that the settlor of the trust cannot draft a trust instrument that anticipates unforeseen contingencies and provides for alternative uses. See Jonathan R. Macey, *Private Trusts for the Provision of Private Goods*, 37 EMORY L.J. 295, 303-06 (1988).

⁵⁵ See Johnson & Taylor, *supra* note 28, at 561-62:

Most courts employ a three-part test to determine if *cy pres* modification is proper. To be successful, an applicant must show: first, there is a valid charitable trust; second, the settlor's specific charitable objective is frustrated, necessitating *cy pres* modification to carry out the settlor's wishes; and third, the settlor's "general charitable intent" is not restricted to the precise purpose identified in the trust instrument.

⁵⁶ Singer recognized this problem, writing, "In states whose courts follow a strict construction approach, conversion proceeds may be required to be dedicated

Thus, a court that views with suspicion the claim that for-profit ownership of health care organizations is at least equivalent to, if not better than, nonprofit organizations may insist on exacting proof that the conversion and consequent application of the *cy pres* doctrine is a last resort. At least one commentator has suggested that states that have taken the view that health care is best conducted in the nonprofit setting may be more likely to rely on charitable trust principals in reviewing conversions and other fundamental corporate transactions.⁵⁷ The *Queen of Angels* decision may be a case in point.⁵⁸ By strictly applying *cy pres* principals to the nonprofit corporation, the court prohibited a transaction that may have provided an overall benefit to the health of Los Angeles residents.

In agency terms, *cy pres* presents the Attorney General and the court with the challenge of defining the principals whose interests they must protect. To say that the assets are “owned” by the public and dedicated to a particular purpose by the donor is to recognize the potential for conflict between the public’s desire to use the assets in a particular way and the donor’s interest in controlling the assets after they are conveyed. Strict application of the *cy pres* doctrine recognizes the primacy of the donor’s purpose over the immediacy of current public interest on the assumption that the donor—perhaps long since deceased—has a continuing interest in a particular application of funds. Whether the doctrine is suitable to modern times and modern problems is subject to considerable doubt.

3. *Charitable Trust Law and Problems of Process*

Perhaps the most intractable problem with relying on charitable trust principles to resolve the agency problems inherent in nonprofit conversions is that the process of litigating these claims is not well suited to the type of transactions the doctrine is intended to regulate. On the surface, conversion transactions have all of the earmarks of large mergers and acquisitions in the for-profit arena. These are complex transactions with complex terms negotiated by individual board members who may not have the expertise to strike the best bargain for the public. Representation of the public occurs only at the back end of the transaction long after the parties have hammered out the details of the deal and often after the transaction has been consummated.

to the operation of a nonprofit hospital, the very entity whose sale, presumably because of a well thought out purpose or need, generated the proceeds.” Singer, *supra* note 6, at 239 n.114.

⁵⁷ See Peregrine, *supra* note 42, at 19.

⁵⁸ See *id.*

In addition, while litigation is a useful process under which to determine discrete facts and their application to legal principles, it is unlikely to be well suited to the kinds of multi-dimensional problems that a corporate transaction is likely to entail. The kind of fact finding and rulemaking that dominates the judicial process is fundamentally inconsistent with the give and take of the deal-making process.

Notwithstanding these limitations, charitable trust enforcement is inherently a judicial responsibility. Certainly, the donors and the public intend the court to force the state and the trustees to uphold their end of the charitable trust bargain. The challenge, then, is to develop a process under which the general principles underlying the law of charitable trust can be reconciled with the demands of the modern corporate transaction. The following discussion examines recent state statutory enactments designed to meet this challenge.

C. *Nonprofit Conversion Statutes*

As the pace of health care conversions increased during the late 1990s, states, led by Nebraska⁵⁹ and California,⁶⁰ began enacting legislation designed to regulate these transactions. As of February 1998, twenty-five states and the District of Columbia had enacted nonprofit conversion acts,⁶¹ basing their statutes on the Nebraska and California models and on models developed by the National Association of Attorneys General (“NAAG”)⁶² and Consumers Union and Community Catalyst.⁶³ These statutes apply to any agreement or transaction in which a nonprofit health care entity trans-

⁵⁹ NEB. REV. STAT. §§ 71-20,102 to 71-20,113 (1996). Nebraska was the first state to enact such legislation.

⁶⁰ CAL. CORP. CODE §§ 5913-5919 (West 1991 & Supp. 2001).

⁶¹ James D. Standish, *Hospital Conversion Revenue: A Critical Analysis of Present Law and Future Proposals to Reform the Manner in Which Revenue Generated from Hospital Conversions is Employed*, 15 J. CONTEMP. HEALTH L. & POL’Y 131, 143 (1998).

⁶² See MODEL ACT FOR NONPROFIT HEALTHCARE CONVERSION TRANSACTIONS [hereinafter NAAG PROPOSAL] and COMMENTARY TO THE PROPOSED MODEL ACT FOR NONPROFIT HEALTHCARE CONVERSION TRANSACTIONS [hereinafter NAAG COMMENTARY] (Nat’l Ass’n of Atty’s Gen. 1998), available at http://www.naag.org/naag/resolutions/res-sum98-healthcare_conv.pdf (visited Jan. 28, 2002).

⁶³ A MODEL ACT [hereinafter CONSUMERS UNION/COMMUNITY CATALYST PROPOSAL] (Consumers Union/Community Catalyst 1998), available at <http://www.communitycat.org/acrobat/ModelConLeg.pdf> (visited Jan. 28, 2002).

fers ownership or control over a "material amount" of assets⁶⁴ of the nonprofit to a for-profit entity,⁶⁵ and provide a process in which parties to nonprofit conversions must seek approval from the state Attorney General and other officials charged with supervision of health care entities.⁶⁶ In general, the statutes seek to systematize the application of the charitable trust principles by requiring a showing that the nonprofit will receive fair value for the assets, that no individual will receive a private benefit from the transaction, and that the proceeds will be applied to a charitable purpose that is generally consistent with the founder's or donor's intent. The following discussion provides an overview⁶⁷ of nonprofit conversion legislation and discusses how these statutes are consistent with the principles underlying charitable trust law.

In keeping with the notion that the assets of the nonprofit are held in charitable trust for the benefit of the public, nonprofit conversion statutes require an open process with full disclosure both to the Attorney General and to the public. The statutes generally require that the disclosure include all information that the Attorney General determines is required⁶⁸ and require the Attorney General to provide the public with access to the documents.⁶⁹ The Nebraska statute also requires that the application include

⁶⁴ See NAAG PROPOSAL, *supra* note 62, § 1.02; CONSUMERS UNION/COMMUNITY CATALYST PROPOSAL, *supra* note 63, § 1(a)(2); CAL. CORP. CODE § 5914(a)(1)(B). The Nebraska statute is more specific, applying to transactions resulting in a change of ownership or control of twenty percent or more of the assets of the nonprofit or to transactions resulting in the buyer holding fifty percent or more of the assets or control of a nonprofit. See NEB. REV. STAT. § 71-20, 103(3).

⁶⁵ California also regulates the transfer of assets between nonprofit corporations. See CAL. CORP. CODE § 5920.

⁶⁶ Nebraska, for example, requires that the transaction be approved by the Department of Health and Human Services Regulation and Licensure. NEB. REV. STAT. § 71-20,104.

⁶⁷ Comprehensive surveys of nonprofit conversion statutes are available. See Standish, *supra* note 61; Volunteer Trustees, *The Sale and Conversion of Not for Profit Hospitals: A State by State Analysis of New Legislation*, available at <http://www.volunteertrustees.org/hospitals/toc.html> (visited Jan. 27, 2002).

⁶⁸ NAAG PROPOSAL, *supra* note 62, § 2.02; CONSUMERS UNION/COMMUNITY CATALYST PROPOSAL, *supra* note 63, § 1(e); CAL. CORP. CODE § 5914(b).

⁶⁹ See, e.g., CONSUMERS UNION/COMMUNITY CATALYST PROPOSAL, *supra* note 63, § 2. Public scrutiny of proprietary information is a sensitive issue with business organizations, however. The NAAG Act and commentary makes explicit reference to the fact that some documents may be subject to confidential treatment under state open records laws. See NAAG PROPOSAL, *supra* note 62, § 8.01. The

a financial and economic analysis from an independent expert or consultant regarding the effect of the transaction.⁷⁰ Public input into the effects of the proposed transaction is facilitated by provisions requiring a public hearing prior to the approval of the transaction.⁷¹

Nonprofit conversion statutes also provide procedural and substantive standards that the transaction must meet prior to approval. Each of the statutes requires that the selling nonprofit receive a fair and reasonable value for the assets.⁷² Most of the statutes provide that the Attorney General may hire experts in the valuation of health care assets to assist in this determination.⁷³ The statutes also prohibit private inurement to any person as a result of the transaction.⁷⁴

In addition to requiring a buyer to pay a fair price for the assets, many nonprofit conversion statutes require the Attorney General or other state official to consider the impact of the transaction on health care in the affected community. The Consumers Union/Community Catalyst Proposal, for example, requires the Attorney General to “determine the effect the proposed transaction will have on the availability and accessibility of health care services to the affected community and the for-profit’s ability to maintain and improve health access, quality of services, and coverage.”⁷⁵ This proposal also requires that the for-profit demonstrate a commitment to provide health care to the uninsured and underinsured and to provide other benefits to the affected community which is at least comparable to the

commentary provides, however, that “the use of the confidentiality treatment should be closely scrutinized.” NAAG COMMENTARY, *supra* note 62, at 4.

⁷⁰ NEB. REV. STAT. § 71-20,104.

⁷¹ See NAAG PROPOSAL, *supra* note 62, § 4.01; CONSUMERS UNION/COMMUNITY CATALYST PROPOSAL, *supra* note 63, § 2(e); CAL. CORP. CODE § 5916; NEB. REV. STAT. § 71-20,106.

⁷² See NAAG PROPOSAL, *supra* note 62, § 5.01(1); CONSUMERS UNION/COMMUNITY CATALYST PROPOSAL, *supra* note 63, § 3(a); CAL. CORP. CODE § 5917(c); NEB. REV. STAT. § 71-20,108(5).

⁷³ See NAAG PROPOSAL, *supra* note 62, § 7.01 - 04; CONSUMERS UNION/COMMUNITY CATALYST PROPOSAL, *supra* note 63, § 5(d); CAL. CORP. CODE § 5919; NEB. REV. STAT. § 71-20,108(5). The Nebraska statute also requires that an evaluation by an independent expert be provided in the application itself. *Id.* § 71-20,104.

⁷⁴ See NAAG PROPOSAL, *supra* note 62, § 5.01(6); CONSUMERS UNION/COMMUNITY CATALYST PROPOSAL, *supra* note 63, § 3(d); CAL. CORP. CODE § 5917(b).

⁷⁵ CONSUMERS UNION/COMMUNITY CATALYST PROPOSAL, *supra* note 63, § 4(a).

commitment of the nonprofit.⁷⁶ Nebraska and the NAAG Proposal include a similar requirement but also provide that the continued activities of the selling nonprofit or successor foundation must be considered in determining whether the requirement is met.⁷⁷

Because of the uncertainty involved in the valuation process, nonprofit conversion statutes also require close scrutiny of the process under which the transaction was negotiated. While the requirements of the process are variously stated, the statutes generally require the Attorney General to examine whether the nonprofit has exercised due diligence in the negotiation of the transaction⁷⁸ and whether the transaction will result in a breach of trust⁷⁹ or undisclosed conflict of interest.⁸⁰ Whether the transaction was subjected to any market process is also an important consideration. The NAAG Commentary states, "Special attention should be paid where there has been no effort to market the charitable assets widely to insure maximum return."⁸¹ These provisions incorporate the agency principles underlying charitable trust law in an effort to ensure that the nonprofit board negotiating the transaction fulfilled their fiduciary duty to the public in the negotiation of the deal.

The statutes also incorporate the general principles underlying the *cy pres* doctrine by requiring that the proceeds of the transaction continue to be held in trust for a purpose consistent with that of the nonprofit.⁸² The

⁷⁶ *Id.* § 4(a)(1).

⁷⁷ NEB. REV. STAT. § 71-20,109(2); *see also* NAAG PROPOSAL, *supra* note 62, § 5.02(3) (providing a similar standard). The Nebraska statute is more consistent with the general theory of nonprofit conversions set forth in this Article than is the Consumers Union/Community Catalyst Proposal. As discussed above, nonprofit conversions permit a release of charitable assets with the proceeds dedicated to continuing the community benefits provided by the nonprofit. *See supra* notes 12-14 and accompanying text. The assumption is that the for-profit owner of the operating assets will behave as a for-profit behaves and that, therefore, the purchase price of the assets should reflect the value lost in continuing public benefits. The Consumers Union/Community Catalyst Proposal attempts to force the for-profit to behave in a manner that may be inconsistent with private ownership while at the same time forcing the for-profit to pay full value for the nonprofit's assets. Arguably, this approach may result in double payment for the assets.

⁷⁸ *See, e.g.*, NAAG PROPOSAL, *supra* note 62, § 5.01(5); NEB. REV. STAT. § 71-20,108(2).

⁷⁹ *See* CAL. CORP. CODE § 5917(f).

⁸⁰ *See* NEB. REV. STAT. § 71-20,108(4).

⁸¹ NAAG PROPOSAL, *supra* note 62, at 8.

⁸² *See* NEB. REV. STAT. § 71-20,108(8); CAL. CORP. CODE § 5917(e).

Consumers Union/Community Catalyst Proposal also provides detailed provisions governing the charitable organization receiving the proceeds. These provisions require the successor to remain independent of the for-profit buyer,⁸³ require procedures under which the successor's board and managers will avoid conflicts of interest,⁸⁴ require that the successor be "dedicated to serving the state's unmet health needs[,]""⁸⁵ and require that the successor be "broadly based in the affected community."⁸⁶ This approach requires the foundation or other successor holding the proceeds to recognize the general intent of the donors or founders while at the same time permitting flexibility in the use of the proceeds to meet contemporary needs.⁸⁷

Perhaps the principal advantage of nonprofit conversion statutes is that they provide specific authorization for the Attorney General to examine the details of a nonprofit conversion on the front end of the transaction. The pre-transaction notice requirements and provisions for public input assure that the transaction is not concluded in secrecy and that the Attorney General will discharge his or her duty to protect charitable assets. While the process necessarily involves some transaction costs,⁸⁸ there are substantial benefits. The for-profit buyer is provided assurance that the transaction will not be later challenged and the public, including those directly interested in the nonprofit organization, is provided assurance that the charitable assets are protected and applied to the health care needs of the community. As discussed below, the alternative—post-transaction litigation in which the Attorney General seeks to recover charitable assets—is costly and creates uncertainty for all of the parties.

II. LITIGATING A NONPROFIT CONVERSION:

COMMONWEALTH OF KENTUCKY V. ANTHEM INSURANCE COMPANIES

On October 22, 1997, Kentucky Attorney General Albert B. Chandler, III filed suit challenging a 1993 merger of Anthem and Kentucky's Blue

⁸³ See CONSUMERS UNION/COMMUNITY CATALYST PROPOSAL, *supra* note 63, § 3(i).

⁸⁴ See *id.* § 3(j).

⁸⁵ *Id.* § 3(k).

⁸⁶ *Id.* § 3(l); see also NAAG PROPOSAL, *supra* note 62, § 5.01(9).

⁸⁷ See *supra* Part I.B.2 and accompanying text for a discussion of the *cy pres* doctrine and the charitable intent of the donors.

⁸⁸ See Mark Krause, Comment, "First Do No Harm:" An Analysis of the Nonprofit Hospital Sale Acts, 45 UCLA L. REV. 503, 552-68 (1997) (criticizing the California and Nebraska statutes and providing other possible ways of regulating nonprofit conversions in the health care industry).

Cross and Blue Shield organizations (“Kentucky Blue”).⁸⁹ The gravamen of the action was that the merger enabled Anthem, an Indiana for-profit mutual insurance company, to convert charitable assets of Kentucky Blue to private use.⁹⁰ From the beginning, the action was vigorously challenged by Anthem, which claimed that judicial, legislative, and executive decisions precluded the Attorney General from bringing the suit.⁹¹ In addition Anthem claimed that Kentucky Blue was never a charity because it did not receive donations and did not directly provide benefits to the poor.⁹² After the trial court denied Anthem’s preclusion defenses,⁹³ the suit was settled for \$45 million.⁹⁴

Although the Anthem litigation did not result in a published judicial opinion, the claims and defenses raised in the case provide a good illustration of fundamental issues arising in conversion litigation. Anthem’s claim that Kentucky Blue was a business enterprise and not a charity presents the challenge of linking a large commercial entity with its charitable roots. Anthem’s preclusion claims raised the question of whether government agencies have the authority to permit the subversion of the charitable purpose of the founders of the organization through withdrawal of tax exemption, legislation, or executive action. The difficult issues encountered in the Anthem litigation were exacerbated by the fact that

⁸⁹ Complaint, Commonwealth *ex rel.* Attorney General Albert B. Chandler III v. Anthem Ins. Cos., No. 97-CI-01566, Commonwealth of Kentucky, Franklin Circuit Court, Div. I (filed Oct. 22, 1997) [hereinafter Complaint].

⁹⁰ *Id.* ¶ 103 (“The merger of Southeastern Mutual Insurance Company with and into Anthem unjustly converted non-profit assets to for-profit use”).

⁹¹ Answer, Commonwealth *ex rel.* Attorney General Albert B. Chandler III v. Anthem Ins. Cos., No. 97-CI-01566, Commonwealth of Kentucky, Franklin Circuit Court, Div. I (filed Dec. 11, 1997) [hereinafter Answer] at ¶¶ III, IV, VI and V.

⁹² See Memorandum in Support of Motion for Summary Judgment on Counts I, II, and III, Commonwealth *ex rel.* Attorney General Albert B. Chandler III v. Anthem Ins. Cos., No. 97-CI-01566, Commonwealth of Kentucky, Franklin Circuit Court, Div. I (filed June 17, 1998) [hereinafter Anthem Memoranda] at 3 (“Other substantive deficiencies in the Commonwealth’s charitable trust claims—such as the fact that [Kentucky Blue] never received donations or provided free benefits—will not require the Court’s attention if this motion is granted.”).

⁹³ Order, Commonwealth *ex rel.* Attorney General Albert B. Chandler III v. Anthem Ins. Cos., No. 97-CI-01566, Commonwealth of Kentucky, Franklin Circuit Court, Div. I (entered May 5, 1999) [hereinafter Anthem Order].

⁹⁴ Order, Commonwealth *ex rel.* Attorney General Albert B. Chandler III v. Anthem Ins. Cos., No. 97-CI-01566, Commonwealth of Kentucky, Franklin Circuit Court, Div. I (entered Dec. 16, 1999) [hereinafter Settlement Order].

Kentucky does not have a statutory scheme governing nonprofit conversions.⁹⁵

A. *Blue Cross/Blue Shield as a Charitable Entity*

Perhaps the most basic hurdle Attorney General Chandler faced was Anthem's challenge to the assertion that Kentucky Blue held its assets in charitable trust for the benefit of the public. At first blush, the charitable nature of the organization appeared counterintuitive. Kentucky Blue was a large commercial enterprise that could attribute its substantial reserves to the success of its core health insurance business. The vast majority of its assets were not donated but instead were accumulated earnings—the excess of policy proceeds over reimbursements.

Even before General Chandler filed suit, Anthem began a public relations blitz challenging the charitable trust claims and accusing Chandler and consumer groups supporting the claims of trying to confiscate assets of a private business and its policyholders.⁹⁶ Advertisements and letters appeared soon after the suit claiming that the suit would result in higher premiums.⁹⁷ The advertisements prompted state insurance regulators to demand that Anthem prove its claim under regulations prohibiting “deceptive and misleading” advertising.⁹⁸ Kentucky Insurance Commissioner George Nichols, concluded that the advertisements were misleading and reprimanded Anthem but failed to require that Anthem retract the ads.⁹⁹

⁹⁵ See *supra* Part I.C for a discussion of nonprofit conversion statutes.

⁹⁶ See Jim LeMaster, *Anthem: No 'Ransom' Due for Legal Merger*, LEXINGTON HERALD-LEADER (Lexington, Ky.), June 29, 1997, at E3; *Anthem: A Mutual Insurance Company*, COURIER JOURNAL (Louisville, Ky.), May 5, 1997, at A8 (op-ed columns written by the President of Anthem Blue Cross and Blue Shield Kentucky Operations); Angela Muhs, *Anthem is Asked to Prove Claims in Ads, Letters*, LEXINGTON HERALD-LEADER (Lexington, Ky.), Oct. 30, 1997, at A1, A4 (discussing advertisements and letters to policyholders contending that the suit would lead to higher insurance premiums and reduced policyholder security if successful).

⁹⁷ Muhs, *supra* note 96, at A1, A4 (discussing advertisements and letters to policyholders contending that the suit would lead to higher insurance premiums and reduced policyholder security if successful).

⁹⁸ *Id.*; see also Patrick Howington, *More Evidence Demanded to Back Anthem Ads*, COURIER JOURNAL (Louisville, Ky.), Nov. 29, 1997, at E1 (discussing Kentucky Department of Insurance view that Anthem had not provided sufficient information).

⁹⁹ Susan Fernandez, *Anthem Ad Series is Found Misleading*, LEXINGTON HERALD-LEADER (Lexington, Ky.), May 8, 1998, at B4. Commissioner Nichols'

In both its advertising and in the litigation, Anthem focused on the lack of substantial donations and specific acts of charity in the recent history of Kentucky Blue.¹⁰⁰ Anthem claimed that it was a commercial enterprise locked in "cutthroat competition" with other insurance companies.¹⁰¹ Anthem further asserted that these facts showed that Kentucky Blue, like Anthem itself, was a mutual company,¹⁰² owned by policyholders, and that the merger did not convert charitable assets to private use.¹⁰³

General Chandler responded that the history of the Blue Cross/Blue Shield movement nationally as well as the specific history of the formation of Kentucky Blue indicated the founder's intent to organize Kentucky Blue as a nonprofit entity with its assets held in charitable trust. Blue Cross and Blue Shield plans were created by nonprofit charitable hospitals in the 1930s as a method of funding their operations.¹⁰⁴ The inability of people to pay for health care services threatened the existence of charitable hos-

decision not to require a retraction was met with sharp criticism from General Chandler and Consumers Union. *Id.*; see also Michael Quinlan, *State Says Anthem's Ads Misled Consumers*, COURIER JOURNAL (Louisville, Ky.), May 8, 1998, at C1.

¹⁰⁰ Robert T. Garrett, *State, Anthem Argue Over Blue Cross Assets*, COURIER JOURNAL (Louisville, Ky.), Mar. 4, 1999, at B3 (quoting Anthem attorney Gregory Haynes as saying, "There were no charitable donations, [Blue Cross] never provided free insurance.").

¹⁰¹ Patrick Howington, *Once Tax-Exempt Blue Cross is Now Told It's Payback Time*, COURIER JOURNAL (Louisville, Ky.), Apr. 20, 1997, at A1 (quoting James T. Parker, Anthem's vice president for external relations and corporate marketing, as saying, "This is not the United Way. This isn't people dedicating their volunteer time. We're in cutthroat competition with the Aetnas and Uniteds.").

¹⁰² As noted above, modern statutes distinguish between member-owned mutual companies and public benefit corporations. See *supra* note 37. Throughout most of its life, however, the statutory structure governing Kentucky Blue obscured that distinction. See KY. REV. STAT. ANN. [hereinafter K.R.S.] § 273.010-050 (Pre-1970).

¹⁰³ See *Suit Moves Forward Following Anthem-Kentucky Blues Merger*, BESTWIRE (May 17, 1999).

¹⁰⁴ See Attorney General's Response to Defendants' Motion for Summary Judgment, Commonwealth *ex rel.* Attorney General Albert B. Chandler III v. Anthem Ins. Cos., No. 97-CI-01566, Commonwealth of Kentucky, Franklin Circuit Court, Div. I (filed Sept. 18, 1998) [hereinafter Attorney General's Response] at 4 ("Feeling the effects of the Great Depression, the incorporators of Kentucky Blue followed a national trend of establishing a Blue plan as the financing arm of charitable hospitals.").

pitals.¹⁰⁵ By developing a pre-paid medical plan, hospitals were assured a steady stream of income and the public was able to pay for medical care on an affordable basis.¹⁰⁶ Community rating and reimbursement for charity care provided by participating hospitals further distinguished the Blues from commercial insurers.¹⁰⁷

Thus, General Chandler argued, Kentucky Blue was founded by civic-minded individuals and organizations who dedicated the results of their efforts to the public good. The basic idea and capital might have resulted in substantial profits to the founders, but by choosing to organize as a nonprofit, the organizers eschewed any claim to the profits of the organization.¹⁰⁸ The action was brought to vindicate the intent of those founders that the residual value of the organization continued to be devoted to a public purpose.¹⁰⁹

The issue was never definitively resolved before the November 1999 settlement of the litigation, but following the court's denial of Anthem's

¹⁰⁵ See CUNNINGHAM & CUNNINGHAM, *supra* note 32, at 10.

[I]n the early 1930's—although tax-supported hospitals caring for veterans and the indigent were full—occupancy rates at voluntary hospitals nationwide had fallen to [fifty] percent, and before the end of the decade, four hundred voluntary and for-profit hospitals went out of business. Those wanting to survive had to act.

Id.

¹⁰⁶ See Attorney General's Response, *supra* note 104, at 8.

¹⁰⁷ See CUNNINGHAM & CUNNINGHAM, *supra* note 32, at 31.

Most of the Plans offered the same rates to all subscriber groups regardless of age, sex, occupation, or other characteristics that might affect the frequency with which members of the group would require hospitalization. Although this approach—to become known as “community rating”—was equitable and administratively simple, it violated a long-established insurance principle of tailoring rates to the risk potential of a subscriber group.

Id.

¹⁰⁸ See Attorney General's Response, *supra* note 104, at 8 (“There is overwhelming evidence that the incorporators intended that Kentucky Blue hold its assets for the benefit of the people of Kentucky, *not* private shareholders or corporate officers.”).

¹⁰⁹ Despite Anthem's claims to the contrary, the Attorney General recognized that the interests of Kentucky Blue's policyholders in maintaining adequate reserves to cover medical claims enjoyed a higher priority than the Attorney General's charitable trust claims. Thus the Attorney General sought return of the residual value—the amount by which the value of Kentucky Blue's assets exceeded assets required to pay present and future claims.

preclusion defenses, discussed below, it was clear that the question would dominate the trial of the case. The lack of clear statutory provisions declaring that the assets of Kentucky Blue were held in charitable trust created a risk that the Attorney General would be unsuccessful in his claim. Of course, this risk, coupled with the risk of a substantial award to the Attorney General, prompted the parties to settle the case.

B. Anthem's Preclusion Defenses

Another aspect of the Anthem case tested the charitable trust doctrines underlying General Chandler's suit. In a motion for summary judgement filed near the end of the first year of the case, Anthem asserted that the Attorney General was precluded from bringing a charitable trust claim by three events in the corporate history of Kentucky Blue. First, Anthem pointed to a 1953 tax decision of the Jefferson Circuit Court that Kentucky Blue was not a "public charity" within the meaning of the Kentucky Constitution. Second, Anthem asserted that a 1986 enactment by the Kentucky General Assembly permitted the mutualization of Kentucky Blue and that as a result of that change in corporate form, Kentucky Blue became an entity owned by its policyholders and not the public. Finally, Anthem claimed that a finding by the Kentucky Department of Insurance that the 1993 merger of Anthem and Kentucky Blue complied with the laws of the Commonwealth estopped the Attorney General from bringing suit to recover charitable assets.¹¹⁰

Anthem relied on an appeal to consistency in governmental pronouncements. The Commonwealth, it argued, had denied Kentucky Blue a tax exemption¹¹¹ based on the fact that it was never a charity, permitted its conversion to a mutual insurance company which was owned by its members,¹¹² and approved the merger with Anthem Insurance as complying with all applicable laws in a proceeding with all of the "essential features of a trial."¹¹³ These governmental determinations, Anthem claimed, violated

¹¹⁰ See Garrett, *supra* note 100.

¹¹¹ See *supra* note 30 for a discussion of tax exempt status and conversions.

¹¹² In 1986, the Kentucky legislature enacted K.R.S. § 304.32-045 which provided a procedure under which Kentucky Blue could convert from a nonprofit corporation to a mutual insurance corporation. After its 1986 conversion, Kentucky Blue was clearly a member-owned mutual, that was operated for the benefit of its members. K.R.S. § 304.32-180.

¹¹³ Anthem Memoranda, *supra* note 92, at 1-2.

doctrines of judicial estoppel,¹¹⁴ res judicata,¹¹⁵ collateral estoppel,¹¹⁶ equitable estoppel,¹¹⁷ and due process.¹¹⁸ Anthem characterized the action as an unconstitutional attempt by the Commonwealth to “gain millions for the public coffers.”¹¹⁹

General Chandler based his response on the basic compact that the charitable trust doctrine represents. Since Kentucky Blue held assets in charitable trust, only a court of competent jurisdiction could alter the trust.¹²⁰ The 1953 tax case in which Kentucky Blue was found not to be a “purely public charity,” addressed only the tax status of the organization and did not purport to involve the charitable trust questions presented in the litigation against Anthem.¹²¹ Thus, no court had ever determined whether Kentucky Blue held its assets in charitable trust.

The Attorney General argued further that neither the General Assembly, in 1986, nor the Insurance Commissioner in 1993 had the authority to permit the conversion of the charitable assets to a private use.¹²² General Chandler relied on the principle that the state, as such, has no interest in the property subject to the charitable trust. Thus, neither the legislative branch nor the executive branch had a right to dispose of the property or permit the conversion of the charitable trust.¹²³ In explaining this lack of authority, the Attorney General argued that granting power to permit the conversion of charitable assets to the General Assembly,¹²⁴ the Insurance Commissioner or the taxing authority “would so erode the public’s confidence in the integrity of charitable trusts as to make future charitable endeavors difficult, if not impossible.”¹²⁵

¹¹⁴ *Id.* at 19-20.

¹¹⁵ *Id.* at 30-34.

¹¹⁶ *Id.* at 21-24.

¹¹⁷ *Id.* at 35-38.

¹¹⁸ *Id.* at 38-42.

¹¹⁹ *Id.* at 43.

¹²⁰ See Attorney General’s Response, *supra* note 104, at 19.

¹²¹ *Id.* at 22-26.

¹²² *Id.* at 19.

¹²³ See SCOTT & FRATCHER, *supra* note 20, § 348 (“it has been held that the legislature has no power to destroy or vary the terms of a valid charitable trust”).

¹²⁴ General Chandler characterized the 1986 mutualization of Kentucky Blue as a mere change in the form of the organization. This change in form did not, however, change the fact that Kentucky Blue held its residual value as of 1986 in charitable trust nor did the operation of the mutual after 1986 convert charitable assets to private use.

¹²⁵ Attorney General’s Response, *supra* note 104, at 19.

General Chandler was supported by *amicus curiae* memoranda filed by nineteen Kentucky charities,¹²⁶ Consumers Union of U.S., Inc.,¹²⁷ and the National Association of Insurance Commissioners (“NAIC”).¹²⁸ In addition to providing both a national and local context for the litigation, the Consumers Union Memorandum and Kentucky Amicus Brief made clear that the purpose of the litigation was not to “confiscate” private assets for government coffers, but rather that the litigation would ultimately result in the creation of a foundation that would carry on the charitable purpose to which the assets were devoted.¹²⁹ The NAIC Brief focused on the Kentucky Insurance Commissioner’s 1993 approval of the merger between Kentucky Blue and Anthem, providing additional background on the role of state insurance regulators in approving such transactions.¹³⁰

On May 5, 1999, Judge Roger Crittenden of the Franklin Circuit Court, entered an order denying Anthem’s motion for summary judgement and permitting the case to proceed to trial on the question of whether Kentucky

¹²⁶ *Amicus Curiae*, Commonwealth *ex rel.* Attorney General Albert B. Chandler III v. Anthem Ins. Cos., No. 97-CI-01566, Commonwealth of Kentucky, Franklin Circuit Court, Div. I (filed Sept. 18, 1998) [hereinafter Kentucky *Amicus* Brief] (filed by The American Association of Retired Persons (Kentucky State Legislative Committee), Catholic Conference of Kentucky, Center for Accessible Living, Community Farm Alliance, Hazard-Perry County Community Ministries, Homeless and Housing Coalition of Kentucky, Justice and Peace Office (Diocese of Covington), Kentucky Association of Regional Programs, Kentucky Council of Churches, Kentucky Domestic Violence Association, Kentucky Psychological Association, Kentucky Retired Teachers Association, Kentucky Task Force on Hunger, Kentucky Youth Advocates, League of Women Voters of Kentucky, Mental Health Association of Kentucky, Metro Human Needs Alliance, Sisters of Charity of Nazareth Leadership Team, and Women’s Crisis Center).

¹²⁷ *Amicus Curiae* Consumers Union of U.S., Inc’s Memorandum in Response to Defendants’ Summary Judgement Motion, Commonwealth *ex rel.* Attorney General Albert B. Chandler III v. Anthem Ins. Cos., No. 97-CI-01566, Commonwealth of Kentucky, Franklin Circuit Court, Div. I (filed Sept. 18, 1998) [hereinafter Consumers Union Memorandum].

¹²⁸ Brief of National Association of Insurance Commissioners as *Amicus Curiae* in Support of the Kentucky Attorney General and the Kentucky Department of Insurance, Commonwealth *ex rel.* Attorney General Albert B. Chandler III v. Anthem Ins. Cos., No. 97-CI-01566, Commonwealth of Kentucky, Franklin Circuit Court, Div. I (filed Sept. 18, 1998) [hereinafter NAIC Brief].

¹²⁹ See Consumers Union Memorandum, *supra* note 127, at 9-10; Kentucky *Amicus* Brief, *supra* note 126, at 15-17.

¹³⁰ NAIC Brief, *supra* note 128, at 13-21.

Blue held charitable assets.¹³¹ During a regular status meeting in November of 1999, the court ordered the parties to attempt to mediate a settlement of the matter, appointing former Kentucky Senator and Supreme Court Justice Walter Baker as mediator. After two days of negotiations, the parties entered into an Agreement of Understanding, agreeing to settle the case for \$45 million and setting in motion the process under which the Foundation for a Healthy Kentucky would be formed.

C. Protecting Charitable Assets Without a Statutory Framework

The Anthem litigation illustrates the importance of a carefully conceived statutory framework to regulate nonprofit conversions. The absence of such legislation made the scope of the assets subject to the charitable trust unclear.¹³² It also created difficult issues regarding the interplay between the common law of charitable trust and the insurance regulations governing Kentucky Blue following its 1986 mutualization.¹³³

Perhaps more importantly, the absence of a conversion statute put the Attorney General into the posture of litigating the charitable trust issues only after the 1993 merger had been consummated. The Kentucky Insurance Commissioner was the only state official with explicit statutory authority to examine the merger at the time it was approved. Predictably, the only issues raised during the merger approval process concerned the effect on Kentucky Blue as an insurer. Thus, the focus of the merger approval hearings was on the effect of the merger on Kentucky policyholders.

Of course, it is much more difficult to recover assets lost in a consummated transaction than to protect those assets in the merger process. Conversion legislation providing the Attorney General with approval authority would have better assured that all of the charitable assets were accounted for and that the merger agreement would have provided compen-

¹³¹ Anthem Order, *supra* note 93, at 2 (“It is the Attorney General’s burden to demonstrate both the existence of the trust and the amount of assets.”).

¹³² See *supra* notes 108-09 and accompanying text.

¹³³ K.R.S. § 304.24-180(1) provided that a mutual insurance company is “owned by and shall be operated in the interests of its members.” This provision granted the members an equity interest in the company that must be satisfied if the company converted to a stock insurer, K.R.S. § 304.24-380, or a liquidation, K.R.S. § 304.24-440(1). These provisions raised questions regarding the proper way to calculate the value of the charitable trust and the relative priority of the charitable obligation and the members ownership interest.

sation for those assets. Such a framework would have vitiated the claims of unfairness and inconsistency that permeated Anthem's case.

Rather than heed the lessons of the Anthem litigation, the Kentucky General Assembly further clouded the difficult issues surrounding ownership and control of charitable assets when it enacted House Bill 629. As originally introduced, House Bill 629 would have required the \$45 million proceeds of the Anthem case to be paid over to the state for appropriation by the legislature.¹³⁴ The section seeking control over these proceeds was removed from the bill but the Foundation formed by the settlement was declared a "public trust" and subjected to provisions requiring compliance with the state's open meetings and open records laws,¹³⁵ annual audits by the State Auditor of Public Accounts,¹³⁶ and reports to a committee of the General Assembly prior to the foundation's disbursement of funds.¹³⁷

House Bill 629 also requires future recoveries of charitable assets to be handed over to a newly formed Charitable Assets Administration Board.¹³⁸ This quasi-governmental body¹³⁹ is charged with the obligation of holding and administering the charitable assets¹⁴⁰ and preserving the "identity character and nature" of the charitable funds consistent with the documents, laws, and court orders that govern the funds.¹⁴¹

¹³⁴ See Michael Quinlan, *House Leaders Won't Seek Control of \$45 Million Anthem Settlement*, COURIER JOURNAL (Louisville, Ky.), Mar. 14, 2000, at A7; Monica Richardson, *Anthem Settlement Disputed: Attorney General, Legislators Fight over Control of Money*, LEXINGTON HERALD-LEADER (Lexington, Ky.), Feb. 10, 2000, at A1.

¹³⁵ K.R.S. § 48.005(3)(a) (Michie Supp. 2001).

¹³⁶ *Id.* § (3)(c).

¹³⁷ *Id.* § (3)(f). The statute provides only that the Interim Joint Committee on Appropriations and revenue may hold a hearing and make findings concerning whether the disbursement is "consistent with the nature, character and purpose for which the funds were recovered" and "in the best interest of the Commonwealth." *Id.* The committee has no power to approve or deny approval of the disbursement. *See id.*

¹³⁸ *Id.* § (4). The author currently serves as a member of the Charitable Assets Administration Board.

¹³⁹ The Charitable Assets Administration Board members are appointed by the Governor, the Attorney General, and the Auditor of Public Accounts and are subject to confirmation by the Senate. *Id.* § (4)(a).

¹⁴⁰ *See id.* § (4).

¹⁴¹ *Id.* § (4)(f).

House Bill 629 was roundly criticized by General Chandler¹⁴² and over forty consumer and philanthropic organizations.¹⁴³ The principal criticism is that the bill attempts to wrest control over charitable assets from the courts, which had previously exercised exclusive jurisdiction over charitable assets. The transfer of control from the courts to the Charitable Assets Administration Board, coupled with references in the bill to the “public” nature of the funds, violates the basic compact that charitable trust law represents.

As noted earlier, charitable trust law can be thought of as creating a compact between the state and individuals and organizations who donate time, ideas, and money to philanthropic endeavors. In exchange for donations to worthy efforts, the state agrees to preserve the essential character of the charitable assets—preventing those assets from inuring to the benefit of private individuals. The deal would be incomplete, however, if the fruits of the donors’ efforts were subjected to the vagaries of the political process. No less a political theorist than Chief Justice John Marshall recognized this fundamental truth when he wrote:

It is probable, that no man ever was, and that no man ever will be, the founder of a college, believing at the time, that an act of incorporation constitutes no security for the institution; believing, that it is immediately to be deemed a public institution, whose funds are to be governed and applied, not by the will of the donor, but by the will of the legislature.¹⁴⁴

House Bill 629, by placing control of charitable funds with a quasi-governmental organization, presents at least the potential for erosion of the compact the state has traditionally made with donors.¹⁴⁵

¹⁴² See Charles Wolfe, *Chandler to Seek Veto of Charitable Asset Bill*, COURIER JOURNAL (Louisville, Ky.), Mar. 31, 2000, at B6. I have also criticized the provisions of HB 629, see Christopher W. Frost, *Court Rightful Overseer of Anthem Trust Funds*, LEXINGTON HERALD-LEADER (Lexington, Ky.), Feb. 21, 2000), at A13, and appeared with General Chandler at a March 22, 2000 Senate Judiciary Committee hearing considering the bill.

¹⁴³ Consumers Union, *Blue Cross, Blue Shield Conversion Update*, available at <http://www.consumersunion.org/health/bcbs-update901/htm> (visited Jan. 16, 2002).

¹⁴⁴ *Trs. of Dartmouth Coll. v. Woodward*, 17 U.S. (4 Wheat.) 518, 647 (1819).

¹⁴⁵ This abrogation of the courts’ jurisdiction over charitable funds raises serious questions about the constitutionality of the statute under the state separation of powers doctrine, KY. CONST. §§ 27-28, and unjust takings provisions, *id.* §§ 3, 13. Perhaps recognizing these difficulties, the General Assembly included

III. COMMUNITY BASED *CY PRES*:

THE CREATION OF THE FOUNDATION FOR A HEALTHY KENTUCKY

The Definitive Settlement Agreement in the Anthem litigation called for the creation of a new foundation to hold the \$45 million proceeds of the settlement in trust to address the unmet health care needs of Kentucky citizens. At the press conference announcing the settlement, General Chandler made clear that the formation of the new foundation would be accomplished with the help of a broad based advisory committee of Kentucky citizens appointed by Judge Crittenden, with the advice of Senator Walter Baker, the court-appointed mediator who facilitated the settlement. Thus began the difficult, but much less contentious, process of redefining the charitable trust fund into a related use.

In a letter to Judge Crittenden, Scott White, Robert Gray, and David Kaplan of the Office of the Attorney General outlined the procedure to establish what would ultimately become the Foundation for a Healthy

an unprecedented provision in the statute which provision precludes any statewide constitutional officer or any other state official or agency from participating in any suit challenging the constitutionality of the statute. K.R.S. § 48.005(8) provides:

Notwithstanding any statute or common law to the contrary, and except as provided in this subsection, an elected statewide constitutional officer or any other state official or agency shall not file or participate as a plaintiff, petitioner, party, intervening party, attorney, or amicus curiae in any litigation challenging the constitutionality of this section. State funds and employee time shall not be expended by any person or agency in support of such a challenge. If the constitutionality of this section is challenged, the Finance and Administration Cabinet shall be the sole named respondent in that litigation, and shall consult with the Legislative Research Commission regarding defense of that litigation.

House Bill 629 also included provisions that erode the authority of the Attorney General to apply proceeds of other types of cases to rectify the harms that gave rise to the litigation. For example, the Kentucky Consumer Protection Act, K.R.S. §§ 367.110 - .300 grants the Attorney General standing to bring actions to recover damages for violations of the Act. K.R.S. § 48.005(5) provides that any funds recovered by judgment or settlement of a suit brought on behalf of the Commonwealth must be held in a state account and may be disbursed only on specific legislative appropriation. *Id.* § (5)(b). This provision applies to public and private funds unless the recovery was sought and received for specific individuals identified as parties to the action. *Id.* § (7).

Kentucky.¹⁴⁶ The letter discussed the background research and planning that the Office of the Attorney General had undertaken and provided a five phase plan for the creation of the new independent Foundation.¹⁴⁷

General Chandler's plan provided that the Kentucky Charitable Health Care Trust Advisory Committee (the "Advisory Committee") would be composed of twenty-five to thirty persons with a broad range of expertise and including a significant proportion of consumer advocates. The Advisory Committee would also include three members appointed (one each) by the Governor, the Speaker of the Kentucky House of Representatives, and the President of the Kentucky Senate.¹⁴⁸ The Office of the Attorney General provided staffing for the Advisory Committee, paid for out of agency funds,¹⁴⁹ but otherwise permitted the Advisory Committee free reign to create the Foundation. The broad citizen involvement was an important feature of the process under which the Foundation was created, insuring freedom from political influence. In addition, Judge Crittenden retained jurisdiction over the funds, thereby assuring continued judicial supervision over the work of the Advisory Committee.

In an effort to ensure that the Foundation would incorporate the best practices of similar foundations around the country, the Attorney General's office solicited the assistance of national experts on charitable conversion foundations from Consumers Union, Community Catalyst, Grantmakers in Health, and the Ford Foundation. Representatives of these organizations attended the meetings of the Advisory Committee and provided substantial technical assistance in both the definition of the Foundation's mission and its governance.

From the first meeting of the Advisory Committee, a clear consensus developed around the idea that the Foundation should direct its efforts toward health policy analysis and advocacy. As everyone recognized, \$45 million, while a substantial sum, would not last long if the money were used on the provision of medical services. By creating a foundation with a health policy mission, the Committee believed that the funds would have

¹⁴⁶ Letter from Scott White, Assistant Deputy Attorney General, Robert Gray, Executive Director, Office of Rate Intervention, and David A. Kaplan, Assistant Attorney General, to Judge Roger L. Crittenden, Franklin Circuit Court (Aug. 7, 2000) (copy on file with author).

¹⁴⁷ The plan included: 1) Formation of the Advisory Committee; 2) Operation of the Advisory Committee; 3) Court Approval; 4) Appointment of the Initial Board; and 5) Initial Meeting of the Advisory Committee. *Id.* at 3-7.

¹⁴⁸ *Id.* at 3.

¹⁴⁹ *Id.* at 6.

a more lasting impact on the citizens of the Commonwealth.¹⁵⁰ The Advisory Committee recommended that that mission be implemented through grants of \$1,000,000 each to the University of Kentucky and the University of Louisville to endow chairs in health policy.¹⁵¹ These grants, which were matched by a state financed fund, would provide the resources with which the universities could hire health policy scholars to further assist in the policy agenda of the Foundation.

The focus on health policy also provided a better fit with the original charitable purpose of the founders of Kentucky Blue. Kentucky Blue was created with a broad goal of providing a mechanism for pre-paid medical care and a financing device for charitable hospitals.¹⁵² As such, the founders appear to have been interested in promoting the health of the citizens of the Commonwealth—not through charitable provision of services, but rather through private financing, education of the public, and support of the health care infrastructure. By preserving the funds and devoting the investment income to health care policy, the Committee assured that the charitable assets would continue to be devoted to promoting the health of the citizens of Kentucky generally, rather than that of a single group of individuals.

In addition to its work on the Foundation's mission, the Advisory Committee also developed the basic structure that would govern the Foundation in the future. The Committee drafted articles of incorporation and bylaws for the Foundation that would continue the state-wide focus and community-based orientation that characterized the Advisory Committee itself. The articles provided that the Foundation would be governed by a fifteen member board comprised of members from across the state.¹⁵³ The

¹⁵⁰ The Articles of Incorporation of the Foundation set forth its general purposes as follows: "To make grants, contributions and program-related investments, and sponsor or participate in activities, designed to address the unmet health care needs of Kentuckians by developing and influencing health policy, improving access to care, reducing health risks and disparities, and promoting health equity. . . ." Articles of Incorporation, Foundation for a Healthy Kentucky (filed with the Kentucky Secretary of State on May 8, 2001), at Art. II(a)(i) (copy on file with author).

¹⁵¹ See *id.* at Art. II (a)(iii).

¹⁵² See *supra* notes 104-07 and accompanying text for a discussion on the goals of Kentucky Blue.

¹⁵³ The Bylaws of the Foundation provide that the fifteen member board of directors include two members appointed by the Governor and one member appointed by Anthem. The gubernatorial appointments were the result of H.B. 629, see *supra* notes 134-45 and accompanying text, and the Anthem appointment was

Community Advisory Committee continued in existence to assure continued community involvement in the affairs of the Foundation and board accountability to the citizens of the state. The board also developed and approved investment and financial policies to assure good stewardship of the funds.

Although the Foundation is just beginning its work, its formation provides a good example of how a carefully crafted and transparent process can accomplish the difficult task of applying *cy pres* to charitable assets. Once the contentious task of recovering the charitable assets was accomplished, the Community Advisory Committee provided a deliberative body that had substantial experience in health care and charitable assets administration to advise the court regarding the mission and structure of the new Foundation. The court's retention of jurisdiction over the fund provided further assurance to philanthropically minded individuals that the state will adhere to its end of the bargain. In the end, the Foundation for a Healthy Kentucky is likely to carry out the general intentions of the founders of Kentucky Blue while serving as a positive force for health care policy in the Commonwealth of Kentucky.

CONCLUSION

Continued change in the health care industry is assured as technology progresses, costs skyrocket and the population ages. Not only will these specific changes provide continuing challenges to public health officials, but they will also continue to put pressure on health care institutions' ability to make their traditional contributions to the health of the population.

While most people can agree on the basic notion that public health is, and should continue to be, an essential function of government, it cannot be doubted that nonprofit organizations provide both funding and infra-

provided by the agreement settling the case.

The remaining twelve directors are elected by the Board from nominees provided by the Community Advisory Committee and must be residents of Kentucky with knowledge, expertise and skills in health care policy, the delivery of health care services, and health care finance. These individuals, who must include consumer representatives, are drawn from each of the seven Supreme Court districts in the Commonwealth (one each) with five members serving at large. The mechanism for filling board vacancies was carefully chosen to insure continued community involvement in the affairs of the foundation. *See* Bylaws, Foundation for a Healthy Kentucky (copy on file with author).

structure necessary to the health of the population. The unregulated conversion of those organizations from nonprofit to for-profit organizations poses a substantial threat to the provision of those services while, at the same time, creating an environment in which charitable donation and work is less attractive to people. Conversion transactions, therefore, have serious implications for public health advocates.

States have taken an interest in addressing the issues that nonprofit conversions raise. Through application of charitable trust doctrines, state Attorneys General have recovered billions of dollars in charitable assets released through nonprofit conversions. As illustrated in the case study of the Anthem litigation in Kentucky, however, the application of these ancient legal principles is fraught with difficulty.

Much of the difficulty is attributable to the confusion surrounding the application of charitable trust law to modern commercial nonprofits. These organizations bear little resemblance to the types of charitable entities the law was developed to protect. Properly understood, however, conversion transactions can be regulated in ways that permit the capture of the transaction proceeds and the rededication of those proceeds to their intended purpose. Nonprofit conversion statutes provide a framework under which courts and Attorneys General can participate in the conversion process to assure the continued protection of charitable assets while applying those assets to the challenges of maintaining and promoting health.