

**PROPOSED GUIDELINES FOR STATE REGULATORS' OVERSIGHT
OF SALE AND JOINT VENTURE TRANSACTIONS IN WHICH THE
ASSETS OF NONPROFIT HOSPITALS OR HMOS ARE TRANSFERRED
TO FOR-PROFIT ENTERPRISES¹**

State charity regulators have strong authority for taking the position that where a nonprofit hospital or HMO corporation or holding company proposes to sell its assets or enter into a whole hospital joint venture, the nonprofit must obtain advance court approval in a *cy pres*-type proceeding -- a proceeding in which the attorney general is automatically a party.² State regulators should publicly state that they will (1) oppose favorable court action on a *cy pres* petition, and (2) bring a breach of fiduciary duty action against nonprofit directors who consummate a sale or joint venture transaction without court approval, unless the parties to the proposed transaction have submitted the proposed transaction for advance review and approval subject to the groundrules outlined below.

The central objectives of the state regulator's oversight should be (1) safeguarding the value of the charitable assets, (2) safeguarding the community from loss of essential health care services, and (3) ensuring that the proceeds of the transaction are used for appropriate charitable purposes. The following procedures are designed to accomplish these objectives.

I. Safeguarding the Value of Charitable Assets

Independent review of the fairness of the transaction. Determining the reasonableness of a proposed hospital sale or joint venture transaction requires: (1) a thorough understanding of the terms of the proposed transaction and of all collateral arrangements, (2) careful assessment of the short- and long-term risks that the nonprofit would assume as a result of the transaction, (3) an independent determination of the value of the operations and assets being transferred by the nonprofit to the for-profit, and (4) a determination of the overall fairness of the transaction from the perspective of the nonprofit.

These are complex questions on which state regulators will need expert advice in order to reach an informed judgment. Accordingly, regulators should require the parties: (1) to disclose to the regulator the complete terms of the proposed transaction and all collateral arrangements, and (2) to fund the cost of an independent review, by experts selected by the regulator, of the fairness of the proposed transaction to the charity.

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² The legal basis for this position is discussed in detailed in an accompanying legal memorandum entitled, "State Attorneys General's Legal Authority to Police the Sale of Nonprofit Hospitals and HMOs." See Tab 2.

Submission of a valuation report. As a basis for this independent review, and as evidence of the exercise by the directors of their duty of care, the nonprofit hospital, HMO, or holding company should be required to submit a detailed written valuation report.

Degree of risk to charitable assets. A major focus of review should be to determine whether the proposed transaction exposes the nonprofit's assets to inappropriate economic risks associated with the future operations of the for-profit purchaser. This issue will be of particular importance in transactions in which the nonprofit becomes a passive investor in a joint venture transaction, and thus proposes to enter into a long-term economic relationship with the for-profit purchaser. It is also a major concern in asset sale transactions in which the charity does not receive the full purchase price at closing. Regulators should consider whether the nonprofit is adequately compensated, in the form of a higher rate of return, for its assumption of significant economic risk, and whether, even where this is the case, the absolute level of risk being assumed by the nonprofit is greater than is prudent for a charitable investor.

Disclosure of conflicts of interest. In assessing the fairness of the proposed transaction to the charity, it is important that the regulator be aware of any conflicts of interest. Accordingly, the regulator should require the nonprofit to submit a conflicts disclosure statement identifying any officers, directors, or affiliates who have direct or indirect economic interests in the transaction and, for each such person, describing the nature of the interest. This required disclosure should include the disclosure of any promises or discussions of future employment.

Consideration of other offers. Where the directors of a nonprofit hospital or HMO corporation or holding company have decided to sell the hospital or HMO operations, they have a duty to give careful consideration to all competing offers. To stimulate multiple offers, the regulator should generally require the nonprofit to make a public announcement, at the time it provides initial notice to the regulator of the proposed transaction, that it is considering a possible sale or joint venture transaction and inviting other potential purchasers or joint venture partners to submit competing proposals. Further, where the nonprofit receives such competing proposals, the regulator should require the nonprofit to submit a written report explaining the grounds for the board's decision for selecting between or among these proposals. Finally, the independent analysis of the proposed transaction commissioned by the regulator should consider all competing offers.

II. Safeguarding the Community from Loss of Essential Health Care Services

Determination of appropriate safeguards for the continuation of essential health care services. The community served by a nonprofit hospital that proposes to enter into a sale or joint venture transaction may depend on the nonprofit for essential health care services. For example, the nonprofit may operate the only emergency room in the community or provide substantial amounts of uncompensated care. In determining whether to recommend approval of the proposed transaction, the regulator should consider whether it is appropriate to require the

for-profit purchaser/joint venture partner to agree, as a condition for court approval, to continue to provide specified services. Where the for-profit agrees to such conditions, the regulator should consider establishing an appropriate enforcement mechanism, including requiring the for-profit to bear the cost of a periodic independent audit of its compliance with these conditions.

Public hearing and/or solicitation of public comment. To provide the basis for a more informed judgment about the transaction's effect on community access to essential services, the regulator should hold a public hearing and/or invite the submission of written comments on the transaction. The public statement announcing the hearing should provide the public with a summary description of the proposed transaction and invite comment on whether the transaction is in the best interest of the community.

III. Ensuring That the Proceeds of the Sale Are Used for Appropriate Charitable Purposes

Ensuring that sale proceeds are not used for the private benefit of the for-profit purchaser. The regulator should ensure that the charitable entity that receives the proceeds of the transaction is not subject to direct or indirect influence or control by the for-profit purchaser. For example, the purchaser should not be represented on the nonprofit's board or have a legal right to require the nonprofit to fund the cost of uncompensated care or other services provided by the purchaser.

Charitable purposes for which the sale proceeds will be used. As a general matter, it is probably preferable to provide the nonprofit trustees considerable flexibility in using the sale proceeds to respond to changing community health care priorities. However, in some cases it may be appropriate for the regulator to recommend that some or all of the sale proceeds be dedicated to quite specific needs. In addition, as noted above, the regulator should ensure that the sale proceeds are not subject to inappropriate risk with respect to the future operations or capital requirements of the for-profit purchaser.

Governance and oversight of the nonprofit entity that receives the sale proceeds. In addition to ensuring that the nonprofit entity receiving the sale proceeds is neither influenced nor controlled by the for-profit purchaser, the regulator may also find it appropriate to limit, both by number and length of service, the participation on the board of the successor nonprofit of persons who were involved in negotiating the sale transaction. Regulators should also exercise close continuing oversight over the operations of the successor nonprofit, including requiring it to prepare and submit to the attorney general, and make available to the public, an annual report describing its charitable and investment activities.

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