A ‘Major Revolution’ In Texas

The future of charity care in Texas is uncertain, despite recent legislation regulating nonprofit hospitals.

by John W. Vinson

A major revolution is taking place at the intersection of the private for-profit sector and the public nonprofit sector: the conversion or sale of nonprofit health care organizations and hospitals to for-profit business entities. The fundamental differences in the cultures and business philosophies of these sectors suggest that the delivery of health care will be transformed. But will the provision of care suffer as a result? Many participants in this debate make dire predictions that for-profit medicine, at the institutional level, will be heartless and solely profit-driven. Others note that there is very little practical difference in the health care provided by the two types of entities or in their general administrative operations. This broad public policy question is largely outside the purview of attorneys general, whose primary duty in this area is to protect charitable assets and to ensure that such assets continue in one form or another to be dedicated to a health care mission.

Protecting Charitable Assets In Texas

The duty of attorneys general to protect nonprofits’ charitable assets does not differ much among the states. Charitable assets include the initial funds donated to or otherwise acquired by the nonprofit health care organization, as well as any increase in the value of the funds and any other sources of income of the organization. These funds often are raised or aggrandized by broad-based community efforts such as public appeals for funds, charity fund-raising events, and other methods of soliciting public support. State attorneys general are charged with representing the public’s expectation that such efforts will contribute to the institution’s charitable services.

Charity law in Texas, as in many states, is primarily based on the common law as derived from ancient English statutes. There is almost no specific Texas legislation pertaining to the protection of charity-related assets. However, the general common law in this area is effective in allowing the Texas attorney general to fulfill the public duty to monitor and protect charitable trust assets (in Texas law these include the assets of a nonprofit hospital or other health care entity). The mechanism used by the Texas attorney general to ensure that boards of directors of nonprofit organizations follow the law is the breach of fiduciary duty lawsuit. Such a suit would likely be filed against an organization if a health care conversion were determined to be violative of common-law charitable trust principles or if the conversion were determined not to be in the public interest because of a misapplication or undervaluation of charitable trust assets.

Many nonprofit hospitals in Texas historically have provided only a small amount of charity care to indigent patients. Although some have fulfilled an important public benefit as a quid pro quo for their tax-exempt status, others have operated in a manner indistinguishable from their for-profit counterparts. The Texas legislature therefore has enacted legislation requiring nonprofit hospitals to

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provide a specified minimum amount of charity care and community benefit.¹

How the current trend of conversions, sales, and joint ventures will specifically affect charity care is uncertain. Some predict shortfalls in the provision of care to the needy. Others contend that, although the ultimate mission of a for-profit entity is to maximize income to the enterprise, for-profit health care institutions provide indigent care to a degree similar to that of nonprofit institutions, so the medically needy will not suffer under the new corporate health care regime.

Hospital charity care legislation in Texas does not apply to for-profit hospitals, so the attorney general has less authority in this realm of charity care. The ultimate effect of conversions on charity care in Texas, therefore, remains to be seen.

Other Regulatory Issues

■ The problem of valuation. Whether the current frenzy of conversions is good or bad, we are going to have to live with this change in the health care community. One of the most significant concerns of attorneys general regarding conversions is the proper valuation of the converting or selling nonprofit entity.

In a straight conversion transaction (in which a nonprofit health care entity desires to convert to a for-profit entity by issuing stock or otherwise opening the ownership of the entity to private parties), the valuation issues can be quite tricky. There is usually no bidding process or other means of testing what the true market value of the converting entity should be. The entity usually will hire a valuator (which could be an accounting or investment banking firm) to issue a fairness opinion of the value of the converting entity. In most states the attorney general (or possibly some other authority) will insist on another independent valuation to ensure that the price originally proposed is fair to the public. This is often all that need be done to protect the public’s interest in the nonprofit charity assets of the converting entity. Major problems arise if there is a great difference between the two valuations. If the conversion is deemed fair and is allowed to be consummated, the charity assets generated by the conversion should be monitored to ensure their future use for a proper charitable health care purpose.

A sale of a nonprofit hospital or system to a for-profit entity can also present valuation problems. The “fair market value” of the nonprofit hospital may be low relative to the value the community places on the provision of health care by the nonprofit facility. The sale price may also be perceived as unfair if the “fair market value” is significantly lower than the value placed on the hospital by the state attorney general. Indeed, such a sale may not be permissible, even though the hospital may have legitimate business reasons to sell. Valuation of large business entities is not an exact science; there is great variation in results when various factors are given greater weight in one valuation as opposed to another, or when one valuation technique is used versus another. An additional problem occurs when a for-profit health care system closes the purchased facility, for competitive or other such reasons, thereby depriving the community of its hospital. This can be a major concern in smaller communities.

■ Conflicts of interest. Conflicts of interest can arise if the same board of directors or upper-management employees who are involved in the initial transaction are subsequently deeply involved with the resulting for-profit entity. Close scrutiny of such potential problems is warranted.

■ Joint ventures. In a joint venture transaction (in which a for-profit health care organi-
zation enters into a partnership arrangement with a nonprofit entity to operate as one, usually for-profit, entity), the two partners each rely on an income stream from the operations of the joint venture for the return on their investment. Usually a foundation or other nonprofit entity is created to continue the nonprofit’s health care mission. The foundation is funded largely or exclusively by the nonprofit entity’s share of the joint venture’s income stream. Alternatively, the nonprofit entity may change its mission and become the beneficiary of the nonprofit side of the income stream. This arrangement presents several potential problems for charity regulators.

Just as in the straight conversion, in the joint venture the value placed on the nonprofit’s assets must be accurately assessed by an independent source with studied review by the attorney general and/or other regulators. If the nonprofit side of the joint venture is undervalued, a great windfall to the for-profit venturer would occur to the detriment of the general public. The nonprofit share of the joint venture income stream must be sufficient in amount and regularity of distribution to support the health care mission of the beneficiary of the income (that is, the created foundation or remaining nonprofit shell organization).

Joint ventures also include the potential for conflicts of interest, because the board of directors and employees of the nonprofit entity, who have acted as negotiators of the deal, often become employees of the joint venture, which is usually managed by the for-profit entity. Thus, the former nonprofit managers and employees become, in effect, employees of the for-profit entity. State regulators must monitor continuously the operations and income stream of joint ventures to guard against lopsided deals and other potential problems.

The issue of whether a nonprofit/for-profit joint venture is ever an appropriate use of charity assets is an open question. It is true that the nonprofit assets are tied up in the venture and the assets will provide a return to the underlying or newly created health care charity only if the venture makes a distributable profit. It also seems that the for-profit joint venturer is reaping the benefit of the nonprofit entity’s assets without having to pay for them. Some have suggested that such joint ventures are simply masked sales that inure mainly to the benefit of the for-profit joint venturer. A nonprofit that sells its assets and invests those funds may reap a more stable and certain rate of return. On the other hand, it is possible that a long-term joint venture will ultimately provide a greater return for the health care charity. This issue will not be resolved for many years.

The Challenge To Regulators

Nonprofit conversions and sales transactions are limited in type only by the imagination of corporate counsel and other specialists in the health care industry. Each type of transaction will present unique issues or concerns for state regulators, and all transactions will have to be closely monitored. State regulators will have to become versed in health care accounting and valuation procedures and in the intricacies of the for-profit business world. Up until now, these matters were not necessary components of a charity regulator’s background.

Perhaps the greatest problem facing state regulators is the overwhelming number of conversions, sales, and other such transactions to be proposed in localities across the nation in the next few years. Texas has more than 140 nonprofit hospitals. Many of these facilities will be part of a conversion or sale in the near future. Eight conversions have already taken place; at least six more nonprofits are considering their options, including Baylor Health Care System, which has a potential worth of $1.3 billion.

Government resources, in Texas and in many other states, may have to be shifted so that charity regulators can fulfill their duties in this burgeoning, complex area of regulation.

NOTE

1. See Texas Health and Safety Code, sec. 311.041 et seq.