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Mission, Margin, and Trust in the Nonprofit Health Care Enterprise

Thomas L. Greaney, J.D.* and Kathleen M. Boozang, J.D., LL.M.†

INTRODUCTION

Lost in the recent flurry of legal activity occasioned by corporate integration, disintegration, and scandalous episodes of managerial abuse, the law governing charitable corporations remains neglected and thoroughly muddled. Still unsettled are central issues regarding the accountability of directors and management, legal standards governing organic changes by nonprofit institutions, and mechanisms to ensure fidelity to the organization's charitable mission. For nonprofit corporations in the health care sector, which represent a large proportion of all health services supplied nationwide, particularly charity care, these shortcomings have had serious repercussions.

The adaptation of for-profit corporate law to charitable corporations*
has been clumsy and ineffective at best; in its worst moments, it has proved perverse. Legal doctrine has never adequately addressed the accountability void that results from charitable corporations' lack of shareholders and market for corporate control. Nor has it confronted squarely the *raison d'être* of nonprofits—that they exist not primarily to make money but to pursue charitable objectives. When dealing with transactions that implicate the nonprofit enterprise's purpose, such as conversions, closures, and abandonment of mission, courts and regulators are essentially left to their own devices. The law has failed to furnish guidance on the bedrock questions surrounding accountability and mission.

Confronted with ambiguous law governing oversight of the nonprofit enterprise, state attorneys general have resurrected charitable trust principles to facilitate more aggressive intervention in the managerial decisions of nonprofit boards. This activism by attorneys general, which predominantly focuses on hospitals and health insurers, addresses two broad categories of activities: alleged mismanagement by the nonprofit's board or its officers and organic changes that alter the status of the community hospital or nonprofit health plan. In both instances, the attorneys general quite properly serve as surrogate stakeholders for the societal and charitable interests inevitably implicated in such matters. Yet subset of nonprofit corporations that have as their purpose charitable activities as required by the Internal Revenue Code, I.R.C. § 501(c)(3) (2004).

2. Academic accounts diverge sharply over whether nonprofit corporations can be thought of as having owners, and if so, who those owners are. See, e.g., David M. Cutler & Jill R. Horwitz, *Converting Hospitals from Not-for-Profit to For-Profit Status: Why and What Effects?*, in THE CHANGING HOSPITAL INDUSTRY 45 (David M. Cutler ed., 2000) (asserting that the public does not own nonprofits); Jennifer Kuan, *The Phantom Profits of the Opera: Nonprofit Ownership in the Arts As a Make-Buy Decision*, 17 J.L. ECON. & ORG. 507, 517 (2001) (arguing that nonprofits have an owner—the board); Denise Lee Ping, *Note, The Business Judgment Rule: Should It Protect Nonprofit Directors?*, 103 COLUM. L. REV. 925, 931 (2003) (suggesting that nonprofits have no real owners); see also Lawrence Singer, *Realigning Catholic Healthcare: Bridging Legal and Church Control in a Consolidating Market*, 72 TUL. L. REV. 159, 162 (1997) (raising the question of whether a Catholic hospital is owned by the religious institute sponsor or the community being served).

3. Governmental enforcement actions against charities go back to fifteenth century England when the attorney general represented the Crown as *pares patriae*. NAT'L ASS'N OF ATTORNEYS GEN., STATE ATTORNEYS GENERAL: POWER AND RESPONSIBILITIES 184 (1990). In the United States, the authority of attorneys general to enforce charitable trusts was originally found in the common law; gradually, however, states enacted a variety of statutes that vested expanded powers in attorneys general to regulate charitable trusts and charitable corporations. *Id.* at 185; see also MARION R. FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS: FEDERAL LAW AND STATE REGULATION 54-55 (2004).
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their actions increasingly run squarely into two other important values: nonprofit managers’ need for the autonomy, discretion, and flexibility essential to fulfilling their charitable missions; and the need to foster coordinated public policies governing the provision of safety net health care resources.

Our focus in this Article is on the legal oversight of the dominant species of nonprofit health care organizations as measured by revenues and public policy concerns: the “commercial” nonprofit corporation, specifically nonprofit hospitals and health plans. These nonprofit hospitals constitute a large proportion of the nation’s hospital capacity, representing billions of dollars of charitable assets. As nonprofit health care enterprises also constitute a substantial percentage of the nation’s nursing homes and comprise many of the nation’s largest health insurers and managed care entities, these firms play a central role in providing much of the nation’s safety net services; as a result, they take on added significance (and earn regulatory scrutiny).

The modern nonprofit health care enterprise faces a rapidly evolving

4. As Henry Hansmann’s typology suggested some twenty years ago, the commercial nonprofit uniquely receives most of its funds from the sale of services with an expectation that it will return societal benefits in the form of charitable services or “community benefits” from its profits. See Henry B. Hansmann, Reforming Nonprofit Corporation Law, 129 U. PA. L. REV. 497 (1981) [hereinafter Hansmann, Reforming Nonprofit Corporation Law]. For more recent analysis, see HENRY HANSMANN ET AL., OWNERSHIP FORM AND TRAPPED CAPITAL IN THE HOSPITAL INDUSTRY (Yale Law & Econ. Research Paper No. 266, 2002), http://ssrn.com/abstract=313827 [hereinafter HANSMANN ET AL., OWNERSHIP].

5. See Jill R. Horwitz, Why We Need the Independent Sector: The Behavior, Law, and Ethics of Not-for-Profit Hospitals, 50 UCLA L. REV. 1345, 1352 (2003) (“Of the nearly 2800 urban acute care hospitals, slightly fewer than 20 percent are government hospitals run by state, local, and federal governments, slightly fewer than 20 percent are for-profit hospitals, and the remainder are not-for-profit corporations.”).

6. Approximately 28.6% of nursing homes are owned by not-for-profit corporations. See id.

7. See generally JACK NEEDLEMAN, NON-PROFIT TO FOR-PROFIT CONVERSIONS BY HOSPITALS AND HEALTH PLANS: A REVIEW (1996), http://www.pioneerinstitute.org/research/whitepapers/wp5.cfm. Dr. Needleman concludes that it is impossible to accurately estimate health plan conversions, which generally occur as changes in corporate form rather than acquisitions. Id. “Many of the converted HMOs have since merged with one another or with historically for-profit insurers. Six firms now dominate the national HMO market.” Id. Importantly, Blue Cross and Blue Shield plans (the Blues), which were established during the depression to provide expansive hospital and physician coverage and were historically nonprofit in their orientation, changed their requirements in 1994 by eliminating the requirement that their licensees be organized as nonprofit corporations. Id.
economic and technological environment—as well as well-capitalized for-profit rivals. Owing to its charitable and tax-exempt status, it must also undergo close scrutiny from community and regulatory overseers. Some of the most controversial legal questions arise from hospitals' efforts to adapt to ensure their continued relevance and financial stability. Prominent examples include shifting acute to out-patient services, relocating or closing a hospital facility, affiliating with multi-state systems, and joint venturing with for-profit entities or with religious groups that require changes in services. Nonprofit health plans fit uncomfortably in this legal landscape—some now claim that they are not charitable entities, and indeed, abandoned their original "mission" decades ago. Congress recognized this when it began taxing health insurers, and the IRS generally resists according charitable status to HMOs. Nonetheless, attorneys general and other regulators have intervened aggressively in many instances in which health plans sought to convert to for-profit status.

Although in most states it is unquestionably the responsibility of attorneys general to ensure the preservation and appropriate disposition of charitable assets, we question whether in its current unsettled and ambiguous state, the law can adequately guide their actions. It is also questionable whether attorneys general have the resources or expertise to engage in the detailed assessments of the business and health policy issues surrounding the appropriate deployment of charitable assets that such decisions implicate. Frequently presented in a politically charged

8. Several factors contribute to the changing landscape of health care and the increasing need to compete with for-profits. With governmental regulation of the health field receding and market forces becoming dominant, medicine has taken on a primarily business (rather than service) orientation, and the line between the standards governing for-profit and nonprofit enterprises has blurred. David B. Starkweather, Profit Making by Nonprofit Hospitals, in NONPROFIT ORGANIZATIONS IN A MARKET ECONOMY 105 (David C. Hammack & Dennis R. Young eds., 1993).

14. See infra note 277 and accompanying text.
atmosphere, these enforcement decisions may reflect policy judgments and preferences that go beyond the attorneys general's competence or mandate.

The central issue addressed in this Article is how fidelity to the mission of the charitable health care corporation should be monitored. Part I sets the stage, providing a brief overview of the economic underpinnings of the regulation of nonprofit health care players. It surveys the economic literature, concluding that ownership form is not the decisive factor in the cost, quality, or efficiency of hospital services. However, the record is a mixed one and many benefits associated with the nonprofit sector are not readily quantified; others may be enhanced by a more supportive regulatory environment. Part II introduces some of the most notorious interventions by attorneys general in nonprofit health care and explains the legal means by which regulators attempt to accomplish their goals. Part III begins the analysis of the legal framework in which nonprofit governance is analyzed, finding corporate fiduciary law muddled and too permissive in its oversight of nonprofit corporate governance. Part IV turns to charitable trust law, which it concludes is doctrinally inapposite and pragmatically unsuited to govern business conduct in the contemporary health care market. The consequence has been to enable attorneys general and charitable enforcers to inappropriately stretch legal doctrine, thereby exacerbating confusion for nonprofit boards over the boundaries of their discretion and the role of charitable mission in decision-making. Finally, Part V offers guidance for the future direction of law and policy governing nonprofit health care firms. It advances the normative perspective that the law should maximize opportunities for nonprofits to fulfill their charitable missions, but should insist on more than nebulous assurances that society will receive tangible benefits. For nonprofit corporate doctrine, this Article proposes that nonprofit corporate law incorporate a principle of "mission primacy"—a doctrinal recognition that the nonprofit corporation's articulated charitable mission is its central objective. Further, nonprofit directors should enjoy a presumption of deference to define and, within limits, alter that mission to serve the public's interest and preserve the relevance and financial stability of the charitable entity. Judges and regulators should read mission-centered values into interpretations of the traditional fiduciary duties of care and loyalty. This approach should preserve managerial discretion to balance the various constituents of the nonprofit firm, including donors, consumers, and the community.
I. THE NATURE OF THE COMMERCIAL NONPROFIT ENTERPRISE IN HEALTH CARE

Before considering state regulation of the nonprofit health care enterprise as a charitable entity, it is essential to first understand the role these "commercial nonprofits" play in health care delivery and coverage in the United States. Theoretically, charitable corporations are mission-driven institutions established to benefit the communities that they ostensibly serve. By all relevant indicia, nonprofits in the health industry are significant, profit-seeking enterprises that compete vigorously (and, for the most part, successfully) against for-profit rivals. Empirical studies reach varying conclusions on the question of whether nonprofits in the health care industry satisfactorily fulfill their purpose of supplying essential public goods and substituting for government in maintaining the health services safety net. However, these appraisals exhibit strong normative disagreements about what society expects from nonprofits. Also unclear is whether the vast array of laws affecting nonprofit entities enhances the sector's provision of benefits and accountability to the community or merely establishes minimal standards that encourage a "race to the bottom."

This Part examines the economic underpinnings for the public policies and legal doctrine that govern the nonprofit health care sector. It first provides, as background, a brief overview and critique of the theoretical justifications for the existence of the nonprofit firm. We find in this account no grounds for confidence that the nonprofit sector will automatically supply promised public benefits. Next we examine the economic literature, which paints a decidedly mixed picture. The nonprofit form currently plays a modest role in helping the hospital sector to achieve the ends of cost, quality, and access, but appears to have little if any similar salutary role with respect to health plans. We caution, however, that historical evidence may not provide an accurate assessment of the potential of the nonprofit sector if, as suggested by our analysis of legal doctrine, those firms are not given sufficient flexibility or incentives to achieve those goals.

A. Agency Cost, Trust, and Mission in Nonprofit Organizations

The explanation of why nonprofit firms exist provides the foundation

15. To qualify for exempt status as a charitable 501(c) (3) organization, they must be operated "exclusively" for charitable or other exempt purposes. See generally St. David's Health Care Sys. v. United States, 349 F.3d 232 (5th Cir. 2003).
for all discussions about their legal characteristics. In his seminal work, Henry Hansmann suggested that the prohibition on nonprofits disbursing their profits, denominated the "nondistribution constraint," provides a mechanism for overcoming the significant information asymmetries in the services those firms provide.\(^\text{16}\) Hansmann claimed that the institutional commitment not to distribute profits to private parties helps overcome agency costs by inducing patrons (customers and donors) to trust nonprofits. The theory suggests that for "commercial nonprofits" like hospitals and third party payors, the constraint ameliorates consumers' inability to accurately gauge the quality of services.\(^\text{17}\) The nondistribution constraint does double duty: It not only explains the existence of the nonprofit firm, but, in the words of Professor Evelyn Brody, it "keeps [them] honest, ensuring the dedication of assets and effort towards performing good deeds."\(^\text{18}\) Consumers do not have to undertake the costly and perhaps impossible task of monitoring nonprofits' delivery of services, thereby further reducing agency costs.

On closer examination, however, this rosy scenario collapses. First, multiple layers of informational and transaction cost problems are associated with the complex services provided by nonprofits. Even if the nondistribution constraint fosters trust, it does not solve the principal-agent problem between managers and directors of nonprofit firms. Board members of nonprofits are typically unpaid volunteers,\(^\text{19}\) many of whom are recruited for services other than providing supervision or assisting management.\(^\text{20}\) Most students of nonprofit boards question their capacity to effectively supervise management.\(^\text{21}\)

\(^{16}\) Hansmann, Reforming Nonprofit Corporation Law, supra note 4.

\(^{17}\) Id. at 505.


\(^{19}\) See Cutler & Horwitz, supra note 2, at 63.

\(^{20}\) See Peggy Sasso, Searching for Trust in the Not-for-Profit Boardroom: Looking Beyond the Duty of Obedience to Ensure Accountability, 50 UCL A L. REV. 1485, 1539-40 (2003) (arguing that boards should include more insiders to increase trust between directors and management and to enable education of lay trustees who are generally not selected for their expertise in the nonprofit’s enterprise).

\(^{21}\) See Brody, Agents Without Principals, supra note 18, at 499-500 (summarizing Richard Heimovics & Robert D. Herman, The Salient Management Skills: A Conceptual Framework for a Curriculum for Managers in Nonprofit Organizations, 19 AM. REV. PUB. ADMIN. 295, 307-08, 309 n.13 (1989)) ("We were unprepared for the fact that both actors and observers in our research found the [nonprofit chief executive] as responsible for all nonprofit
In addition, the nonprofit firm justifies its existence by reference to a "mission" that includes subsidization of worthy causes with the proceeds from commercial sales. The nondistribution constraint cannot meliorate contract failure given management’s objective (indeed “mission”) to accomplish charitable goals through revenue shifting and its unsupervised discretion to do so; in short, despite nondistribution, the patron of the nonprofit firm has no assurance that the nonprofit will fulfill her aspirations. Finally, the Hansmann analysis leaves unanswered the question of how, given information asymmetry, consumers can distinguish one nonprofit from another. In the end, market failure cannot by itself explain the continued existence of the nonprofit hospital. A more plausible account may be found in the complex agency arrangements that pervade health-purchasing decisions. First, health care decisions are the product of multi-tiered agency relationships. Consumers’ “choice” of hospitals is strongly influenced by intermediaries, namely their physicians and insurance plans. In turn, employers typically select health plans. At each stage of the decision-making process, agents are operating with highly imperfect information about the services they are selecting and about the preferences of their principals (the patient/consumer).

Physician intermediaries may have multiple reasons for preferring nonprofit hospitals, including their own autonomy and self-interests as well as quality of care considerations peculiarly within their expertise. To the

organizational outcomes, both successes and failures.”).

22. See Brody, Agents Without Principals, supra note 18, at 508-09 (“No matter how meritorious the cross-subsidization, how can a donor or patron be sure that her money is being used to provide the service that she wants? This pattern illustrates that the nondistribution constraint, while perhaps helpful, is not a sufficient bond to align the interests of management with the interests of patrons.”).

23. Hansmann conceded as much in later writings, contending that information asymmetry with a "lag effect" caused nonprofit hospitals’ predominance. See HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE 236 (1996). Nonprofit hospitals gained an initial foothold as donative institutions prior to the advent of widespread private insurance and public payment programs. Hansmann argues that “forces of inertia” have kept consumers from switching to for-profits despite their superior efficiency. Id.


26. See generally MARK V. PAULY, DOCTORS AND THEIR WORKSHOPS: ECONOMIC MODELS OF PHYSICIAN BEHAVIOR (1980): Jerry Cromwell, Barriers to Achieving a Cost-Effective Workforce Mix:
extent that doctors prefer hospitals for selfish reasons, agency failure is the root cause for the steady predominance of the nonprofit form. This explanation is obviously inconsistent with an efficient market and militates against public policies and legal doctrines that favor the form. If, on the other hand, physicians' election to affiliate with and steer patients to nonprofit institutions is an exercise of professional judgment that helps overcome their patients' information deficits as to quality and other salient non-price factors, the nonprofit form is efficiency-enhancing and should be encouraged. Unfortunately, empirical evidence is lacking as to which scenario most plausibly explains physicians' hospital preferences.

B. Economic Analyses of the Nonprofit Enterprise in the Health Care Industry

Few contemporary hospitals and virtually no nonprofit health plans reflect the popular image of a charity—an institution selflessly dedicated to all comers, irrespective of ability to pay. Quantitatively measured solely in terms of providing health services to the poor, hospitals offer at best marginal returns to society on its “investment,” while nonprofit payors offer negligible direct subsidies to the needy and only slight benefits


27. Scholars and public policy makers disagree about what comprises the community benefit that should be uniquely contributed by nonprofit hospitals. Uncompensated care is frequently cited because it is presumably measurable. In 2001, acute-care hospitals spent $21.5 billion on uncompensated care, or six percent of total expenses, which is the lowest percentage recorded since 1983. Patrick Reilly, Charitable Dropoff: Uncompensated Care Drops to Lowest Level in Years, MOD. HEALTHCARE, Feb. 17, 2003, at 4. However, an exclusive focus on uncompensated care discounts the important value of the maintenance of “loss leader” services, community education, and research. Further, controversies and data collection problems surround the issue of defining and calculating the amount of uncompensated care provided by nonprofits. Charity care rendered is not synonymous with accounting measures such as bad debt. In addition, calculations must include offset for payments received from government sources and other forms of support received. Comparisons across sectors require resolving the role to be afforded tax payments by for-profits. A public good framework would reflect uncompensated care, uncompensated community services, medical research, and taxes, and potentially includes federal health plan shortfalls, price discounts on private pay patients, and losses on medical education. Sean Nicholson et al., Measuring Community Benefits Provided by For-Profit and Nonprofit Hospitals, 19 Health Aff. 168, 169 (2000); see also Jill A. Marsteller et al., Nonprofit Conversion: Theory, Evidence, and State Policy Options, 33 Health Aff. 1495, 1523 (1998); Ramesh K. Shukla, et al., A Comparative Analysis of Revenue and Cost-Management Strategies of Not-for-Profit and For-Profit Hospitals, 42 Hosp. & Health Servs. Admin. 117, 131 (1997).
through their rating and underwriting practices. But appreciating the  
impact of the nonprofit health care sector under the current legal regime  
requires an examination of both nonquantifiable elements of the safety net  
and the societal framework within which nonprofits operate. As Jill Horwitz  
put it, besides “function[ing] as safety nets where government fails[,]  
[nonprofit hospitals] provide avenues of civic participation that generate  
social capital, and allow for the expression and promotion of diverse values  
or world views that sustain democracy.” 28 Additionally, economic studies  
reveal the chameleon-like character of nonprofit organizations: Their  
performance is strongly influenced by the degree to which they compete  
with for-profit counterparts and by the regulatory and payment  
environment in which they operate.

1. Hospitals

The economic literature concerning the nonprofit hospital sector is  
vast and in some respects indeterminate. One cannot confidently conclude  
that the nonprofit form does or does not “make a difference” in terms of  
its net “payback” for tax exemption and other benefits it enjoys. At the  
same time, a close examination of these studies reveals intriguing patterns  
that can guide legal and policy analysis. Moreover, uncertainty about  
performance of nonprofits is itself an important finding that should  
inform doctrinal analysis.

To start with the bottom line, measures of price, 29 cost, 30 profit

28. Horwitz, supra note 5, at 1350 (footnotes omitted).
29. Older studies pretty consistently showed that for-profits charged their patients  
more. See, e.g., Marsteller et al., supra note 27, at 1503. One recent study, focusing  
exclusively on Medicare data, found that in 1989, 1992, and 1995, “per capita Medicare  
spending in areas served by for-profit hospitals was higher than in areas served by not-for-  
profit hospitals.” Elaine M. Silverman et al., The Association Between For-Profit Hospital  
Ownership and Increased Medicare Spending, 341 NEW ENG. J. MED. 420, 424 (1999).  
Specifically, the study found that spending growth increased after conversion to for-profit  
status. Id. at 423. Many explanations are offered for why for-profits charge more, including  
price gouging, greater costs, and the economic disadvantage of for-profits’ obligation to pay  
taxes. Uwe E. Reinhardt, The Economics of For-Profit and Not-for-Profit Hospitals, 18 HEALTH AFF.  
178, 183 (2000); see Shukla et al., supra note 27, at 129 (suggesting that only about thirty  
percent of for-profits’ higher costs can be attributed to higher taxes). The most recent data  
on hospital pricing is mixed, suggesting that pricing is more sensitive to market factors. See,  
e.g., Cutler & Horwitz, supra note 2, at 71.
30. Older studies consistently showed for-profit expenses per day or admission to be  
greater than nonprofits. See Marsteller et al., supra note 27, at 1506. One study using 1993  
data from Virginia hospitals found that for-profits’ revenue margins were attributable to
Margin, efficiency, quality, and access give modest support to the claim that pricing strategies rather than cost savings: "[For-profit] hospitals charged 24.8 percent more for outpatient procedures and 28 percent more for inpatient procedures." Shukla et al., supra note 27, at 128. For-profit hospitals' administrative costs in 1994 averaged twenty-three percent more than those of nonprofit hospitals, and thirty-four percent more than those of public hospitals. Steffie Woolhandler & David U. Himmelstein, Costs of Care and Administration at For-Profit and Other Hospitals in the United States, 336 New Eng. J. Med. 769, 772 (1997). In 1994, both the per discharge and day in-patient costs were higher in for-profit than either not-for-profit or public hospitals, despite the lower wage and salary costs in for-profit facilities. See Woolhandler & Himmelstein, supra, at 772. Cutler and Horwitz have questioned the extent to which the accuracy of for-profit cost reports has been affected by behavior such as that engaged in by Columbia/HCA, which consistently overestimated costs to Medicare. Cutler & Horwitz, supra note 2, at 64.

31. For-profits unquestionably generate a healthier profit margin than other hospitals, hovering around nine percent, while not-for-profit margins come in at around four percent with public hospitals falling in slightly behind. Richard G. Frank & David S. Salkever, Market Forces, Diversification of Activity, and the Mission of Not-for-Profit Hospitals, in The Changing Hospital Industry, supra note 2, at 198. But see James B. Rebitzer, Comments on Chapters 1 and 2, in The Changing Hospital Industry, supra note 2, at 87 (citing data from Tennessee that conversion did not improve profitability). Cutler and Horwitz suggest that one of the primary reasons for-profits more successfully generate revenue is because they more effectively game the loopholes in Medicare reimbursement. Cutler & Horwitz, supra note 2, at 64. They further found, however, that nonprofits in the same market, after discovering the billing practices of the for-profit, soon followed suit. Id.


33. Studies from the 1990s suggest that nonprofits perform more favorably than for-profits on many of the benchmarks of quality. One study focusing on quality of care in Utah and Colorado hospitals, as measured by the occurrence of preventable adverse events, found a lower frequency of these events at nonprofit hospitals as compared with for-profit hospitals and minor teaching or non-teaching public hospitals. Eric J. Thomas et al., Hospital Ownership and Preventable Adverse Events, 15 J. Gen. Internal Med. 211, 215 (2000). A recent meta-analysis comparing mortality rates of for-profit and not-for-profit hospitals concluded that for-profits are "associated with a statistically significant increase in the risk of
that nonprofit hospitals historically have returned benefits to society. While some suggest that broader conceptions of “community benefit” (that include charity care, bad debt, losses from community programs, teaching, and research) yield convincing evidence that nonprofit hospitals contribute significantly more benefits than the cost of their tax exemption, others observe that for-profit hospitals’ “contribution” to society is at least as great when one counts their tax payments as a community benefit. Evidence further suggests that characteristics of the local market, such as the presence of other hospitals, managed care penetration, and socio-economic status of the community, are far more

death.” P.J. Devereaux et al., A Systematic Review and Meta-Analysis of Studies Comparing Mortality Rates of Private For-Profit and Private Not-For-Profit Hospitals, 166 CAN. MED. ASS'N J. 1399, 1402 (2002). The authors suggest that their results may underestimate the relative rate of mortality in for-profit facilities because of a possibility that nonprofits serve patients with greater disease severity, and that for-profits serve a greater proportion of private pay patients. Id. at 1404. Further, even if not-for-profits do set the bar in a market for quality, for-profits co-existing in the same market will be compelled to meet that bar, at least with respect to aspects of quality that are measurable and marketable. However, more sophisticated analysis suggests a more positive outcome for the for-profit entity:

On average, we find that for-profit hospitals have higher mortality among elderly patients with heart disease, and that this difference has grown over the last decade. However, much of the difference appears to be associated with the location of for-profit hospitals. When we compare hospital quality within specific markets, for-profit ownership appears, if anything, to be associated with better quality care. Moreover, the small average difference in mortality between for-profit and not-for-profit hospitals masks an enormous amount of variation in mortality within each of these ownership types. Overall, these results suggest that factors other than for-profit status per se may be the main determinants of quality of care in hospitals.

Mark McClellan & Douglas Staiger, Comparing Hospital Quality at For-Profit and Not-for-Profit Hospitals, in THE CHANGING HOSPITAL INDUSTRY, supra note 2, at 93, 94-95 (emphasis added). This outcome may be explained by the fact that higher quality hospitals tend to attract more difficult cases. Id. at 96. McClellan and Staiger confirmed others’ findings that higher volume hospitals tended to have lower mortality rates. Id. at 100. McClellan and Staiger further hypothesize that for-profit hospitals might be attracted to markets with lower quality care if low quality is a signal of poor management, making the hospital an attractive takeover target. Id. at 110.

34. Gary Claxton et al., Public Policy Issues in Nonprofit Conversions, 16 HEALTH AFF. 9, 18 (1997) (summarizing over twenty studies and concluding “the evidence indicates that there is a substantial difference between nonprofit and for-profit hospitals in terms of the [broadly defined] community benefits they provide.”).

35. See id. at 18; see also Jack Needleman, The Role of Nonprofits in Healthcare, 26 J. HEALTH POL. POL'Y & L. 1113, 1122-130 (2001) (summarizing the literature comparing for-profit and nonprofit hospitals).
powerful predictors of performance than the nonprofit form. Nevertheless, there can be little question that the nonprofit sector contributes to society free care and other measurable community benefits. Whether these benefits are less than or greater than the sum of societal expenditures (via foregone taxes, volunteer labor and other sources) remains a hotly disputed question. 36

This empirical record must be approached with caution, however. Most importantly, the economic literature does not enable one to draw conclusions about a "but for" world, i.e., one without nonprofit hospitals. A number of studies have attempted to compare performance between for-profits and nonprofits, finding generally that for-profits provide considerable charity care, perhaps approaching that of nonprofits, though certainly not at the level provided by government hospitals or academic medical centers. 37 Notably, for the most part these studies do not account for the dynamics that drive both sectors. Left unanswered are questions as to whether for-profits would be more or less willing to offer charity care in the absence of nonprofits in their markets, and whether nonprofits would generally adopt more aggressive pricing policies in response to competitive pressures of their counterparts. 38 The few studies that do tackle the issue depict a highly interactive relationship. 39

Furthermore, these studies cannot inform us about the potential of nonprofit firms to fulfill their goals if legal and regulatory constraints were removed. Indeed, across a number of characteristics and behavior, nonprofit status does appear to have significance in ways highly relevant to public policy analysis. Most importantly, ownership form correlates with market entry and exit with product line. Studies show that for-profits tend to locate in more affluent areas; 40 are quicker to enter new markets; 41 and

36. See Robert C. Clark, Does the Nonprofit Form Fit the Hospital Industry?, 93 HARV. L. REV. 1417, 1434 (1980) (questioning whether nonprofits provide societal benefits commensurate with the advantages offered to them).

37. Many nonprofit to for-profit conversion transactions involve contract provisions requiring maintenance of current levels of charity care for a fixed period of time. Only time will tell whether the expiration of these contract requirements will affect for-profits' provision of uncompensated care.

38. Horwitz, supra note 5, at 1361-62.

39. See Cutler & Horwitz, supra note 2, at 71-75 (citing studies that depict the highly interactive relationship); Horwitz, supra note 5, at 1361 (hypothesizing that "for-profit hospitals often move first in markets and that not-for-profit and governmental hospitals copy the behavior of for-profit hospitals.").

more readily exit if the community experiences economic deterioration.\textsuperscript{42} Growing evidence also suggests that for-profit and not-for-profit hospitals diverge along product market dimensions, with not-for-profit hospitals more likely to offer unprofitable services\textsuperscript{43} and less inclined to drop services.\textsuperscript{44}

2. Nonprofit Health Plans

There is also a large literature analyzing differences between nonprofit and for-profit health plans. Deriving generalized conclusions from these studies is difficult because much depends on how one defines “community benefits” and “health plans.” However, as a general matter, they illustrate some significant differences between nonprofit and for-profit HMOs in the extent to which they provide broadly-defined community benefits. As to health insurers, there is little evidence that the nonprofit form makes a positive difference for the communities in which they operate.

As with the hospital sector, the meaning of “community benefits” for health plans lies in the eye of the beholder. Health insurers are not providers of care and do not supply charity health services; in addition few plans provide significant amounts of free insurance, though some subsidize premiums for those who cannot afford to pay. Community rating, which spreads risk broadly across populations, has largely disappeared as competitive market pressures have caused nonprofit Blue Cross plans (which were once required by regulation to community rate) to emulate for-profit counterparts and adopt experience rating. More subtle community benefits may be found in the underwriting and risk selection practices of these organizations. That is, nonprofits may eschew practices associated with favorable risk selection such as seeking to attract healthier subscribers through underwriting or product design and marketing. Such practices diminish the benefits of broad pooling of risk and thus deprive the less healthy segments of society the implicit subsidy they receive from healthier citizens. Even here, however, the picture is not one-sided: More accurate risk underwriting increases the number of people who will be able to afford health insurance. Finally, there are a host of other, somewhat inchoate benefits that may be associated with nonprofit health plans. For example, they may be more responsive to community needs, more active in

\begin{footnotesize}
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  \item[41.] See HANSMANN ET AL., OWNERSHIP, supra note 4.
  \item[42.] See Brown, supra note 40, at 36.
  \item[43.] Horwitz, supra note 5, at 1364.
  \item[44.] Id. at 1373.
\end{itemize}
\end{footnotesize}
advocating public policies that serve the community, or more inclined to provide coverage for services that have public goods characteristics such as immunization and health education programs.

Studies of HMOs, which integrate insurance and delivery of health care, provide fairly persuasive evidence of differences between for-profit and nonprofit firms in the non-price dimensions of their services. One important recent study comparing HMOs using fifty-three measures representing eight distinctive dimensions of community impact reports that nonprofits provide more community benefits than their for-profit counterparts. It found statistically significant evidence that nonprofit HMOs were more likely to provide subsidies for medical services, support safety net health care agencies, target community benefit programs to low income neighborhoods, and provide general philanthropy. In addition, studies of consumer satisfaction and consumer evaluations of quality generally, but not uniformly, reflect favorably on nonprofit HMOs. Such findings may be the result of the public’s perception that the for-profit HMO owners’ financial stake and ability to make a profit results in the limiting of services to patients.

Turning from nonprofit HMOs to nonprofit companies primarily engaged in selling health insurance and network packages such as Blue Cross and Blue Shield plans (the Blues), there is far less evidence of community benefit, however defined. For example, a large number of studies examining health plans that converted from nonprofit to for-profit status show that the conversion had little or no impact on customer service.

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45. See generally Mark Schlesinger et al., Measuring Community Benefits Provided by Nonprofit and For-Profit HMOs, 40 INQUIRY 114 (2003).
46. Id. at 125.
47. Bruce E. Landon et al., Health Plan Characteristics and Consumers’ Assessments of Quality: For the First Time, the Characteristics of Health Plans Are Linked with Consumer Feedback in a Nationwide Survey, 20 HEALTH AFF. 274, 281 (2001); see also Mark A. Hall & Christopher J. Conover, The Impact of Blue Cross Conversions on Accessibility, Affordability, and the Public Interest, 81 MILBANK Q. 509, 520 (2003) (summarizing studies and concluding that “although the evidence is mixed, it suggests that members of nonprofit HMOs are more satisfied and receive better service and a somewhat higher quality of care”); Robert Kuttner, Must Good HMOs Good Bad?, 21 NEW ENG. J. MED. 1558, 1562 (1998) (“[N]onprofit [health] plans as a group tend to score better on many objective indicators and in surveys of consumers.”).
48. See Bradford H. Gray, Conversion of HMOs and Hospitals: What’s At Stake?, The Pros and Cons of Nonprofit Conversions Through the Lens of Public Policy, 16 HEALTH AFF. 29, 40 (1997). Another important qualification of statistical comparisons between for profit and nonprofit HMOs is that they may not adjust adequately to reflect significant differences in the populations they serve. See Hall & Conover, supra note 47, at 520.
or consumer satisfaction; evidence regarding recent Blue Cross Plans which have converted show that customer satisfaction scores have actually increased post-conversion.\(^4\)\(^9\) Conversion studies also examine relative profitability, pricing, and access: Here too there is no persuasive evidence that nonprofits offer significant benefits. While it is clear that moving from not-for-profit to for-profit status impels organizations to generate more profits,\(^5\)\(^0\) the change neither generates significant gains in efficiency nor improvements in terms of the firm’s overall financial condition.\(^5\)\(^1\) Although some claim that for-profit health plans in general engage in aggressive risk selection in underwriting practices,\(^2\) the evidence on this score is at best mixed.\(^5\)\(^3\)

Of course when one addresses the conversion issue from a policy standpoint, it is necessary to consider offsetting benefits that may accrue. Weighing in favor of conversions are factors such as enhanced efficiency and lower costs resulting from more aggressive negotiating with providers and tax payments that will flow to the public sector.\(^5\)\(^4\) Finally, and perhaps most important is putting resources to their best use. As Hall and Conover put it, “The largest potential benefit [of conversions of nonprofit plans] is to unlock considerable wealth that can be devoted to explicitly health related charitable purposes.”\(^5\)\(^5\)

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49. Hall & Conover, supra note 47, at 531 (noting that Blue Cross plans in California have improved customer satisfaction scores).
50. Hall & Conover, supra note 47, at 515.
51. See Robert Cunningham & Douglas Sherlock, Bounceback: Blues Thrive as Markets Cool Toward HMOs, 21 HEALTH AFF. 24, 30 (2002) (noting that while all Blue Cross plans have become more profitable in recent years, the for-profit Blue Cross plans may have been profitable even if they had remained nonprofit).
52. See Kuttner, supra note 47, at 1561 (“[E]ntrepreneurial commercial HMOs... tend to engage in more aggressive risk selection, use more stringent systems of approval and denial of care, and put a higher fraction of the physicians’ income at risk.”).
53. Hall & Conover, supra note 47, at 530 (studies indicate that “the time has passed when [Blue Cross] plans were much more lenient underwriters than other insurers, and underwriting practices and policies at nonprofit [Blue Cross] plans are now broadly consistent with those of for-profit insurers.”). Interviews conducted by Hall and Conover with a broad array of individuals familiar with the effects of Blue Cross conversions in their states indicate divergent outcomes. In some states, interviewees thought that the underwriting practices of the converted Blues were similar in comparison to other insurers, if not more lenient. However, respondents in California and Missouri thought that conversion had adversely impacted the risk selection in these states. Id. at 530-31.
54. See id. at 521-23, 532-33.
55. Id. at 538.
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This generalized description of the nonprofit health care sector provides background for evaluating legal doctrine in specific contexts. It suggests that theoretical accounts purporting to explain the persistence of the nonprofit sector do not provide a convincing argument that it will automatically supply desired public benefits. While the empirical literature confirms that the sector has not fulfilled society's goals, our interpretation of this evidence views the glass as half full. We find ample reason to believe that, properly incentivized, nonprofits could supply public goods efficiently and creatively. We turn next to explaining why the legal regime does not satisfy the conditions necessary to promote the sector achieving its goals.

II. ILLUSTRATIVE CASES

The 1990s witnessed a sharp increase in the number of cases involving breaches of fiduciary duties by directors and officers of nonprofit corporations that have prompted aggressive review by state attorneys general. 56 We identify in subsequent Sections of this Article two central flaws in the law regulating nonprofit governance: an insufficiently stringent standard of conduct for directors, which has countenanced neglect and abuse, and a failure to afford directors leeway to take into account the charitable mission in their business decisions. As a prelude to our doctrinal analysis and recommendations, this Part presents a handful of prototypical cases that illustrate these problems.


58. See, e.g., Sasso, supra note 20, at 1519 ("[E]xtrapolating from a few outrageous
hypothesis merits close attention and has received implicit endorsement from legislative actions targeting directorial oversight abuses though federal tax, Sarbanes-Oxley, House of Representative hearings on the tax exempt status of hospitals, Senate Finance Committee oversight hearings regarding nonprofit governance, state laws targeting governance in specific circumstances and regulatory actions taken by the Internal Revenue Service and national exchange regulators. The second

scandals to conclude that there is a pervasive problem plaguing the entire not-for-profit industry is a misguided leap in logic.

59. A significant recent change in federal tax policy targeting self-dealing abuses was the enactment of an excise tax penalizing so-called excess benefit transactions. 26 U.S.C. § 4958 (2000).

60. Pub. L. No. 107-204, 116 Stat. 745 (2002). While not directly altering fiduciary obligations, Sarbanes-Oxley contains a number of provisions that affect the conduct of fiduciaries and composition of important committees. For example, section 301 requires that audit committee members be independent; section 402 forbids personal loans to directors and executive officers; and section 407 mandates rules requiring public companies to disclose whether the audit committee is comprised of at least one member who is a financial expert. Id. See generally Lyman P.Q. Johnson & Mark A. Sides, The Sarbanes-Oxley Act and Fiduciary Duties, 30 WM. MITCHELL L. REV. 1149 (2004).


62. In June 2004, the Senate Finance Committee held hearings concerning a variety of abuses and failures of governance in charitable organizations. Charity Oversight and Reform: Keeping Bad Things from Happening to Charities: Hearing Before the Senate Comm. on Fin., 108th Cong. (2004). The committee also issued a white paper, STAFF OF SENATE COMM. ON FIN., 108TH CONG., STAFF DISCUSSION DRAFT, http://finance.senate.gov/hearings/testimony/2004test/062204stfdis.pdf, outlining possible reforms, many of which deal with the mechanisms of accountability in nonprofit organizations. Among the proposals contained in the white paper are limitations on the size of boards of directors, specific standards for fulfilling fiduciary duties, improved disclosures of financial matters, standards and enhanced penalties for self dealing, and a required five-year review of exempt status of all exempt organizations by the IRS. Id.


64. Responding to widespread concerns that charities were awarding excessive compensation and benefits to officers and insiders, the IRS recently announced a new enforcement effort that will examine levels of compensation, insider loans, and the exchange and sale of property to officers and others. Kurt Ritterpusch, IRS Launches Enforcement Effort Targeting Compensation in Tax-Exempt Organizations, 13 BNA HEALTH L. REP. 1183, 1183 (2004). The heightened attention to compensation issues appears to have been prompted in part by Congressional oversight hearings concerning nonprofit organizational
important challenge inadequately met by state law governing fiduciaries is the need to ensure nonprofit agents’ fidelity to their institutions’ charitable purposes. State law is curiously silent on how mission—the central precept guiding the nonprofit charity—should inform directors’ interpretations of their responsibilities under nonprofit corporate law. Wielding considerable leverage over nonprofit boards, some attorneys general have through their enforcement actions implicitly assumed de facto powers over a broad spectrum of business decisions and health policies.

A. Attorneys General’s Attempts To Police Conflicts of Interest and Laxity

The widespread conversions to for-profit status by nonprofit health plans and hospitals in the nineties served as a wake-up call to attorneys general, most of whom had not previously actively monitored that sector. These transactions, which in many cases the attorney general learned of after the fact, gave rise to numerous allegations of breaches of fiduciary duties by directors and officers. In some instances, overt conflicts of interest were present in which insiders took jobs or ownership interests in the for-profit acquirer with which they had negotiated sales on favorable terms. In *Butterworth v. Anclote Manor Hospital*, for example, Florida’s
governance. *Id.* ("The closer we look at charities in our Finance Committee, the stronger the case gets for meaningful legislative reforms that shut down exorbitant pay for charity executives and sweetheart deals for insiders . . . .") (quoting Senator Grassley).


67. *See* Andrea Gerlin, *Hospital in Florida Is Focus of Probes Tied to Scuttled Bid by Columbia/HCA*, WALL ST. J., May 8, 1995, at B10 (reporting allegations that the president of a Florida hospital who intentionally devalued the hospital in an attempt to sell it at an attractive price to a proprietary chain subsequently took a management position with that chain after being terminated by the hospital).

68. For example, when Health Net, a nonprofit HMO, converted to for-profit form, thirty-three executives were able to purchase twenty percent of the stock of the new entity for $1.5 million; four years later those shares were worth approximately $315 million.
Attorney General challenged the conversion of a nonprofit hospital whose assets were purchased by a for-profit, the sole shareholders of which were the directors and corporate members of the nonprofit. The assets were purchased for $6.3 million; two years later, the converted, for-profit hospital was sold for more than $29 million.°

While conversions and closures of health systems fueled concerns among attorneys general about managerial abuse, the rapid vertical integration occurring throughout the health care sector also gives rise to instances of self-dealing and lax directorial supervision. The collapse of the Allegheny Health, Education, and Research Foundation (AHERF) in the nation's largest nonprofit health care bankruptcy case provides the paradigm example of unsupervised management excess. Under the leadership of its Chief Executive Officer, Sherif Abdelhak, AHERF grew rapidly, borrowed heavily, and collapsed precipitously. As several careful studies of AHERF business operations reveal, the over-arching problem was the structure and performance of its corporate governance system.72 Over


69. 566 So. 2d 296 (Fla. Dist. Ct. App. 1990); see also Fair Care Found. v. D.C. Dep't of Ins. & Secs. Regulation, 716 A.2d 987 (D.C. 1998) (rejecting claims that the board's decision was infected by conflicts of interest and issues going to members integrity).

70. Butterworth, 566 So. 2d at 297.

71. In an interesting twist, in October 2003 the Santa Paula, California City Council voted to ask the California Attorney General to compel a local nonprofit hospital to complete a merger deal with the public health care system, which, the board claimed, offered a better chance than the nonprofit alternative to save the cash strapped rural facility. Laura B. Benko, California Attorney General Asked to Force Merger Meant to Save Hospital, MOD. HEALTHCARE, Oct. 27, 2003, at 14. The City Council alleged that the nonprofit board has been dilatory in taking the necessary actions to save the hospital, in violation of the state code governing nonprofit facilities. Amanda Covarrubias, Hospital Merger May Get a Nudge, L.A. TIMES, Oct. 22, 2003, at B1. Santa Paula ended up closing and declaring bankruptcy. Lynne Barnes, Clinics To Extend Medical Services, L.A. TIMES, Jan. 14, 2004, at B3.

72. The complex AHERF organization was governed by a parent board consisting of no fewer than thirty-five members. Ten other boards, having little overlapping membership, governed fifty-five corporations; each board was generally unaware of what other parts of the system were doing. Directors were chosen and dominated by Mr. Abdelhak and board meetings were, according to one analysis, "scripted affairs, intentionally staged to limit oversight and participation by board members . . . . [M]embers . . . receive as many as 1,000 pages of paper to be discussed at board meetings. . . . As one former member explained, 'Half of the people didn't even open the book. They didn't have the time.'" Lawton R. Burns et al., The Fall of the House of AHERF: The Allegheny Bankruptcy, 19 HEALTH AFF. 7, 21 (2000). Although the AHERF boards consisted of top-notch executives, all were extremely
sixty lawsuits were filed after AHERF’s collapse, most alleging breaches of the duty of care and duty of loyalty by directors. The Pennsylvania Attorney General’s prosecution and resulting recovery stressed the role of nonprofit directors in safeguarding assets and their legal responsibilities when oversight is lacking. The ultimate AHERF settlement resulted in a distribution of $93.7 million. Criminal prosecution also resulted in confinement for Mr. Abdelhak.

B. Attorneys General’s Attempts To Regulate Mission

As we discuss in Part III, the law is virtually silent on the question of when, why, and how a charitable corporation may alter its purpose or redeploy its assets to fulfill a re-envisioned sense of its mission. This Section samples a few instances in which attorneys general have challenged nonprofit boards’ strategic plans. Several have used mission-protective concepts from charitable trust law or invoked corporate fiduciary principles to enjoin the board’s execution of its plans or to replace board members. Other attorneys general have used similar legal arguments in attempts to bar movement of charitable assets out of state.

1. Whose Mission?

Frequently, challenges made by attorneys general to actions by

busy and unable to perform a broad oversight responsibility over the organization. In addition, the bylaws permitted many key decisions to be made by Mr. Abdelhak. Id.

73. See infra Subsection II.A.2.

74. The settlement “represent[ed] payments of $48 million from the insurers, $28.5 million from Mellon Bank, $1 million from Allegheny General Hospital and $7.75 million from funds held by bankruptcy trustees.” FREMONT-SMITH & KOSARAS, supra note 56, at 20 (citing the settlement agreement at http://www.attorneygeneral.gov/ppd/PDF/AHERF_Settlement_Agreement.pdf). “More than $49 million of the total was paid to creditors, $22 million was paid to the Attorney General for distribution to the surviving charitable foundation, $13 million was paid for legal fees, and $4.5 million was paid to settle a class action lawsuit doctors brought against the Foundation.” Id. at 20.


76. Evelyn Brody calls this the “front-end cy pres issue.” Brody, Whose Public?, supra note 13, at 962.
nonprofit boards implicate the organization's mission. These cases typically arise in the context of disputes over attempts by boards to change the corporate purpose or to undertake "organic" changes, e.g. mergers, joint ventures, conversions, and closures that ultimately impact the institution's mission. Underlying these legal disputes is an issue going to the heart of the nonprofit governance debate: Who ultimately controls a charitable corporation's mission?

Two New York cases illustrate the uncertainty attending judicial (or prosecutorial) attempts to monitor mission fidelity under the current state of the law. First, *Littauer v. Spitzer* involved a merger, driven by financial exigencies, between a secular and a Catholic hospital, each of which were controlled by parents; the merger was accomplished by transferring control of both hospitals to a common parent, which itself became a joint subsidiary of the original parents. A major point of contention was the hospitals' agreement that the Catholic Ethical and Religious Directives would apply to all corporate entities, thereby eliminating access to certain reproductive health services that had previously been provided by the secular hospital. Positing that the transaction essentially constituted a change in the purposes and ownership of the two facilities, the Attorney General contended that his approval was required under New York's nonprofit statute. An appellate court concluded that the state's nonprofit law was not implicated and that the attorney general had no role in approving the transaction. In reaching this result, it held that a change in corporate membership of the respective hospital corporations neither added, eliminated, or changed a corporate purpose or power nor constituted the "functional equivalent of a sale, lease, exchange or other disposition of corporate assets." Responding to the concerns expressed about the elimination of reproductive health services, the court in *Littauer* distinguished between a change to a corporate power and a change to services, holding that the latter falls squarely within the business discretion of the board of directors and should not be subject to judicial second-

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79. 287 A.D.2d at 204-06.

80. *Id.* at 207.
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guessing. 81

The \textit{Littauer} decision stands in marked contrast to the decision two years earlier of another New York court in the \textit{Manhattan Eye, Ear and Throat Hospital} (\textit{MEETH}) case that had suggested much broader attorney general authority over nonprofit board decision-making. 82 \textit{MEETH}, a fixture on the upper-east side of Manhattan for almost a century, is a world-renowned, acute care specialty hospital in ophthalmology, otolaryngology, and plastic surgery. 83 In the face of continuing declines in operating revenues resulting from reductions in third party reimbursements and a general shift from in-patient to out-patient admissions, the board decided that its mission would be best actualized by “monetizing” \textit{MEETH’s} principal asset—real estate—and investing the proceeds in free-standing diagnostic and treatment centers in underserved areas of the city. 84 The court characterized \textit{MEETH’s} strategy as abandoning the “acute care, teaching and research hospital component of its mission,” and analogized it to a conversion. 85 Because the hospital sale constituted a fundamental change to its business purposes, the court concluded, that the attorney general did indeed have standing to review the transaction. “While it is certainly correct that the definition of ‘hospital’ . . . includes a diagnostic and treatment center, as \textit{MEETH} now argues, it is sophistry to contend that this means that \textit{MEETH} is not seeking a new and fundamentally different purpose.” 86 Thus, in contrast to \textit{Littauer}, the court performed its own “de novo” analysis of the nonprofit’s mission and reached a conclusion that virtually ignored the board’s assessment of how to respond to a significantly changed financial environment while remaining true to its original mission.

The elusive legal status of mission is also illustrated in cases involving integrated delivery systems which bring multiple actors in the health care system under one corporate parent, sometimes including both providers and payors. 87 The unique invocation of mission principles by the

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81. \textit{Id.} at 206-07.
83. \textit{Id.} at 577.
84. \textit{Id.} at 577-79.
85. \textit{Id.} at 594-95. “[I]n both there is a charitable organization which alleges that it is incapable of continuing its primary mission of operating a hospital, seeks approval of the sale of all its assets, and plans to apply the sale proceeds towards a newly revised mission.” \textit{Id.}
86. \textit{Id.} at 595.
87. These integrated delivery systems are generally formed precisely for the purpose of
Minnesota Attorney General in his investigation of the Allina Health System suggests the protean nature of the doctrine as currently applied. Allina’s multi-corporate structure included entities that provided health services and health insurance. Although this organizational structure is quite common, the Minnesota Attorney General took the position that the structure is impermissible because it is impossible for related organizations to pursue the missions of both its nonprofit HMO and its hospitals. He claimed that the HMO’s mission—to manage health costs and control premiums—conflicted with the hospitals’ “different,” “broader,” and “sometimes conflicting” mission “to act as caregivers to patients.” Following extensive and sometimes bitter negotiations, Allina agreed to capitalizing on the benefits that can be achieved from horizontal and vertical integration. Thomas L. Greaney, *Managed Competition, Integrated Delivery Systems and Antitrust*, 79 *Cornell L. Rev.* 1507, 1516 (1994).


89. Health Systems and Medica Health Plans had interlocking directorates—seven Allina board members served as Medica directors. Id. at 3.

90. Allina Health System entered into a Memorandum of Understanding (MOU) that required Allina to spin-off its HMO affiliate, Medica Health Plans, and adopt a variety of new policies dealing with problems arising out of conflicts of interest, expense reimbursement, executive compensation, third party contracting, and other matters. See Memorandum of Understanding Between Allina Health System and Attorney General of Minnesota, http://www.ag.state.mn.us/consumer/PDF/allina/MemUnder.pdf (last visited Mar. 18, 2003).

91. The report accompanying the memorandum of understanding between the state and Allina, Min. Atty Gen. Office, Allina Health System Reports, collected at http://www.ag.state.mn.us/consumer/PR/pr_allina_mou_92401.htm (last visited Nov. 12, 2004), enumerated several instances of Medica board decisions that benefited the Allina Health System—by favoring other Allina entities—to the potential detriment of Medica. For example, Medica resolved to undertake a number of changes designed to reduce the unfavorable sector of its Medicare risk pool. Medica reported its plan to Allina Health System, which then studied the profitability of seniors to its hospitals. After Allina concluded that the Medicare population was an important revenue base for its hospitals, Medica reversed course, rejected its conclusions of a year prior, and re-entered the senior Medicare managed care market. This led the Attorney General to conclude:

While it would serve Medica’s interest to charge a fee that included a profit for such services, it generally operates the PPO function as a ‘channeling’ vehicle for Allina. Medica basically charges health plans and TPAs a fee less than competitors for PPO work in order to build up patient volume for Allina. Id.
spin the HMO off from its integrated delivery system. The outcome was more than a bit startling. Neither before nor after this case have commentators or policy experts seriously entertained the thought that common ownership of providers and insurance subsidiaries gave rise to a disabling conflict of interest. Perhaps equally notable was the Attorney General’s ability to assert direct control over the nonprofit plan. The settlement agreement empowered Attorney General Hatch to appoint eight “special administrators,”

92 itself creating something of a conflict of interest since the new fiduciaries appointed by the Attorney General were also subject to his supervision.

2. Whose Money?

Recent interventions by attorneys general and state insurance regulators in multi-state transactions reveal what Evelyn Brody has aptly characterized a growing “parochialism” that often seems more related to political ends than public policy goals.93 As noted above, conversions of not-for-profit to for-profit hospitals and health plans resulted in the disappearance of millions of dollars in charitable assets due to undervaluation, laxity, and in some cases, management self dealing.94 Attorneys general and state legislatures finally reacted to ensure that boards were making conversion decisions in the interests of the corporation rather than themselves,95 that the assets of the corporation

92. See Stephanie Strom, Strong-Arm Shaking of Charities Raises Ethics Qualms, N.Y. TIMES, May 11, 2003; see also Brody, Whose Public?, supra note 13, at 1007. Perhaps not coincidentally, Minnesota Blue Cross and Blue Shield decided in 2003 to get out of the hospital business, selling its Fargo hospital to a Catholic health care system. Patrick Reilly, Back to Basics; Minn. Blues To Abandon Hospital Ownership, MOD. HEALTHCARE, Sept. 15, 2003, at 12.


were being appropriately valued,\(^{96}\) and that the proceeds resulting from the conversions were being dedicated to suitable ends.\(^{97}\) In what may at first blush appear to be a natural extension of these concerns, attorneys general have sought vigorously to capture the proceeds of transactions involving nonprofit health care enterprises. As we shall see, however, there are serious reasons to question the doctrinal and policy foundations for these enforcement actions.

\(\text{i. Banner}\)

A common reason that nonprofit health care systems have been disposing of some of their health care facilities only to turn around and pick up new ones is regionalization. Systems whose holdings were scattered across disparate states have been attempting to consolidate in fewer contiguous states where resources can be more effectively (and more profitably) deployed.\(^{98}\) In 2001, Banner Health System, a nonprofit corporation based in Arizona, began doing precisely this—funding expansions in Arizona and Colorado with the proceeds from sales of ten of its twenty-seven hospitals and seventeen long-term-care facilities in seven other states.\(^{99}\) Concerned about the exodus of charitable assets from their states resulting from these sales, the attorneys general of North Dakota, South Dakota, and New Mexico\(^{100}\) attempted to prevent Banner from removing the proceeds from the facilities within the borders of their respective states.\(^{101}\) The attorneys general posited that because the facilities


\(^{97}\) See Standish, \textit{supra} note 94, at 144-64 (categorizing the different approaches states have taken in legislating post-conversion foundations).

\(^{98}\) Since 1998, the large mergers emblematic of the preceding decade have fallen off. Most mergers and acquisitions in 2002 involved community hospitals acquiring nearby facilities, so that they could expand their local market. Patrick Reilly, \textit{Mergers Minus the Mania}, \textit{Mod. Healthcare}, Jan. 20, 2003, at 36.


\(^{100}\) Banner's sale of its forty-seven bed New Mexico facility to Province Healthcare Co., a Tennessee-based for-profit company, prompted that state's attorney general to threaten a lawsuit for breach of trust; Banner paid a $4 million settlement to New Mexico. \textit{Id.}

\(^{101}\) Barbara Gorham, Opinions/Commentary, \textit{Banner's End Run Must End: Company Plays Chess with Assets It Inherited While Communities Pay the Price}, \textit{Mod. Healthcare}, Mar. 3,
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had benefited from the support of their local communities, which enhanced the value of each entity's assets, Banner would be unjustly enriched if allowed to transfer those assets out of state. 102

On notice of the South Dakota Attorney General's plans, Banner Health System filed a declaratory judgment action 103 to preclude the Attorney General from imposing a constructive charitable trust on Banner's South Dakota facilities. 104 Although nonprofit corporate law would plainly permit sales and transfers within a multicorporate structure, the South Dakota State Supreme Court was unpersuaded by Banner's argument that the state's nonprofit corporate statute exclusively controlled the transaction. Rather, it held that in enacting the state's nonprofit corporate law, "there is nothing in the code to indicate that the Legislature intended to abrogate common law and statutory trust provisions with regard to nonprofit corporations." 105 And even though Banner was not

2003, at 21.

102. Patrick Coffey et al., The "Charitable Trust" Controversy Confronting Banner Health and Other Nonprofit Healthcare Systems, 16 HEALTH L. 1, 3 (2003). Banner's consolidation resulted in several settlements and court decisions. A trial court in North Dakota dismissed the Attorney General's complaint against Banner, concluding that community donations to local hospitals do not satisfy the elements of a constructive trust; the court also rejected the unjust enrichment argument. Id. Banner and the North Dakota Attorney General eventually settled their differences when Banner agreed to a $1 million payment to the state. State Roundup, GRAND FORKS HERALD, Dec. 16, 2003. Banner settled with New Mexico for $8.5 million, which would be paid to charities dedicated to health care selected by the Attorney General. Briefly: Hospital Deals, MOD. HEALTHCARE, Dec. 23, 2003, at 10; New Mexico: Banner Health Systems, State AG Settle on Sale of Medical Center to For-Profit Firm, 11 BNA HEALTH L. REP. 831 (2002).


104. The history of the several facilities, each of which changed hands several times, is detailed in the state Supreme Court decision. Although certain donations to at least a couple of the facilities clearly created trusts (e.g., The Dorsett Home), the facilities were established or supported by a combination of unrestricted donations, fundraisers, and government support. Banner Health Sys. v. Long, 663 N.W.2d 242, 245-46 (S.D. 2003).

105. Id. at 247. The court specifically sought to preserve the relevance of the following statutory language preserving a court's ability to employ the implied trust device when equity so requires:

The enumeration in §§ 55-1-7 to 55-1-10, inclusive, of cases wherein an implied trust arises does not exclude or prevent the arising of an implied trust in other cases nor prevent a court of equity from establishing and declaring an implied,
obligated under any express trust, the court remanded the case on the theory that an "implied trust" might be applied as a remedial construct to preserve the status quo when "a person owning title to property is under an equitable duty to convey it to another because he would be unjustly enriched if he were permitted to retain it." 106 If other states adopt this rather freewheeling approach, nonprofit corporations could find their business plans completely thwarted by the imposition of trust-based responsibilities that have little grounding in trust doctrine.

ii. Health Midwest

Another prominent case involving claims of trust-based duties arose from the $1.125 billion acquisition of nonprofit Health Midwest hospital system by the for-profit corporation HCA, Inc. This transaction provoked a renewed Missouri-Kansas "border war," pitting the Attorney General of Missouri against the Attorney General of Kansas in a dispute over the legality of the transaction and, more importantly, where the charitable proceeds would land. Although similar to Banner, in that it involved an attorney general asserting charitable trust law to extract concessions from the nonprofit entity, the contention met with less success.

Health Midwest was a Kansas City-based integrated delivery system whose various constituent corporations straddled the borders of Kansas and Missouri. After initially threatening to dissolve Health Midwest and remove its board, the Missouri Attorney General settled its side of the case for an agreement that would create a conversion foundation (whose directors would be chosen by the Missouri Attorney General) and which would devote a minimum of ten percent of the conversion proceeds for

resulting, or constructive trust in other cases and instances pursuant to the custom and practice of such courts.


106. Long, 663 N.W.2d at 247 (quoting Knock v. Knock, 120 N.W.2d 572 (S.D. 1963)). The court left open the possibility that an implied trust might be appropriately imposed if the Attorney General could establish that Banner had engaged in behavior which created unjust enrichment, constituted a breach of fiduciary duties, or improperly amended Banner's articles of incorporation. Id. at 248-49. Further, if Banner was in a fiduciary relationship with the communities in which its facilities were located, pursuant either to trust law or the general common law governing fiduciary relationships, Banner may have breached its duties as a fiduciary if, as alleged by the Attorney General, its actions were premised on the best interests of Banner, rather than the local communities, who are the beneficiaries of the relationship. Id. at 249.
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the benefit of Kansas.\textsuperscript{107} Kansas, finding itself on the short end of the distribution of sales proceeds (Health Midwest's internal estimate placed Kansas' share of assets at twenty percent), unleashed arguments grounded in charitable trust and corporate law to oust the board members who had approved the transaction with HCA and settled with the Missouri Attorney General. Fanning the flames, the Kansas legislature attempted to intercede as well.\textsuperscript{108}

Relying on charitable trust theory, the Kansas Attorney General asked for a judicial \textit{cy pres} proceeding, removal of Health Midwest's directors and the appointment of a fifteen person board (appointed by her) to run the resulting charitable foundation.\textsuperscript{109} The court rejected almost all of the Kansas claims, squarely holding that the corporate standard, not the charitable trust standard, governed decision-making in nonprofit corporations.\textsuperscript{110} Further, contrary to the Attorney General's assertions, the


\textsuperscript{108} Literally days before the Health Midwest trial began, the Kansas legislature enacted a bill, designed to apply to Health Midwest's Kansas' assets, which requires a Kansas nonprofit corporation to forfeit its assets to a foundation rather than to any third party. In the course of declaring the statute unconstitutional, \textit{id.} at *24, the court criticized the state's charitable trust theories as unsupported by Kansas law. Finally, the court observed that the state's compulsion that all charitable assets remain within Kansas' borders could result in the withdrawal from charitable activity any enterprise, foreign or domestic, seeking to protect its assets from seizure by the state. \textit{id.}

\textsuperscript{109} The Attorney General claimed that the board was influenced by overly generous compensation packages, failed to exercise due diligence, and failed to exercise reasonable business judgment as to price, process, and use of proceeds in approving their mergers into Health Midwest. \textit{See} Brody, \textit{Whose Public?}, supra note 13, at 1008-17 (summarizing the pleadings in the Health Midwest litigation).

\textsuperscript{110} The Kansas District Court held that application of the charitable trust doctrine in \textit{cy pres} proceedings applied only to changes in restricted gifts and refused to apply it to changes to a corporation's purposes. The Kansas court explained:

The Kansas \textit{cy pres} statute governs changes to the purposes of charitable trusts, devises and bequests. The \textit{cy pres} statute does not apply to changes to the purposes of nonprofit corporations. The \textit{cy pres} statute applies only to any restricted gifts and not the entity as a whole. No restricted gifts have been identified herein and therefore the \textit{cy pres} statute does not apply.

\textit{Health Midwest}, 2003 WL 328845, at *19 (citation omitted). The court further rejected the Attorney General's attempt to assert the business judgment rule where there was simply a "disagreement over contract terms, \textit{id.} at *18, and reasoned that "a court can not second guess the wisdom of facially valid decisions" of the board of a charitable corporation, \textit{id.} at *17.
court held that *cy pres* does not apply to changes to purposes of charitable corporations.  In sum, the court believed that it was required to uphold the Health Midwest board’s decision unless the directors are guilty of ‘willful abuse of their discretionary power or of bad faith, neglect of duty, perversion of corporate purpose, or when fraud or breach of trust are involved.’ At the same time the Kansas Court found that under nonprofit corporate law, mission obligations should have compelled the Health Midwest directors to strike a better balance for Kansas: It found that the proposed post-merger Missouri foundation would have insufficient “Kansas participation in its governance” and that the plan offered “nebulous spending commitments to benefit the citizens of Kansas in Health Midwest’s Kansas service area.”

*iii. CareFirst*

Finally, some organic changes by nonprofit third party payors have encountered objections from insurance commissioners invoking a mix of corporate, trust and insurance law. Although fourteen Blues plans have converted to for-profit status since 1994, such conversions increasingly face stiff opposition, and several have been abandoned, apparently out of concern about the approval process. The legal standard applied by state insurance agencies is, if anything, less clear than that invoked by the judiciary.

In 2003, the Maryland Insurance Administration (MIA) rejected the

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111. *Id.* at *19. The court specifically observed that the assets represent “proceeds of the sale of corporate assets and not assets of a trust, therefore the *cy pres* statute does not apply.” *Id.*

112. *Id.* at *18. The court held that the Attorney General’s authority over a nonprofit was limited to determining whether the board’s business decisions satisfied the business judgment rule. *Id.* at *17. Calling upon Delaware law, the court recognized its authority to “enjoin the ‘transaction of unauthorized business’” if the Attorney General establishes that the board’s decision was “ultra vires or a perversion of corporate purpose.” *Id.* at *18.

113. *Id.* at *26.

114. *Id.*

115. Laura B. Benko, *Curtain Falls: CareFirst Settlement Dims Hope for Blues Conversions*, MOD. HEALTHCARE, June 16, 2003, at 14. The next conversion battleground is Washington state, where the Washington Hospital Association is attempting to block the proposed conversion of Premera Blue Cross. *Id.*

116. For example, North Carolina Blues withdrew its plan to convert in the face of “a process with no end in sight.” *Plan To Convert North Carolina Blues Withdrawn, in Face of Regulatory Risks*, BNA HEALTH CARE DAILY REP., July 9, 2003.
application of CareFirst BlueCross BlueShield to convert and be acquired by for-profit WellPoint Health Networks, Inc.  

In a report exceeding 350 pages, the Maryland Insurance Commissioner concluded that the proposed transaction did not satisfy the public interest standard set forth in the state's conversion statute. The report recounted a number of procedural derelictions, concluding that the bidding process was "flawed and did not produce fair market value."  

The Commissioner's report relies on a mix of corporate law and regulatory criteria from the state conversion statute. The result is something of a hodge-podge, with selective application of corporate law principles, leavened by invocation of various open-ended statutory criteria that the Commissioner concluded justified departure from straightforward corporate analysis. Much of the report is written in the language of corporate fiduciary duties, evaluating the board's diligence and weighing conflicts of interest. Further, the report imposes an obligation "to obey the articulated mission of the corporation," and sweepingy concludes that CareFirst's nonprofit status conferred special

117. CAREFIRST CONVERSION INFORMATION, MARYLAND INSURANCE COMMISSIONER, http://www.mdinsurance.state.md.us/jsp/CareFirst.jsp?divisionName=CareFirst+Conversion+Information&pageName=/jsp/CareFirst.jsp (last visited Mar. 22, 2004) (on file with author) [hereinafter CAREFIRST CONVERSION INFORMATION]. In June 2003, a federal judge approved a settlement between CareFirst and the Insurance Administration that precludes CareFirst from considering a conversion to for-profit status for five years. Benko, supra note 115.

118. The auction "appeared designed to, and did, end in a tie on price," while assets were undervalued, the transaction did not protect against private inurement of Blue Cross directors. Overall, the report found that the CareFirst board did not exercise due diligence in deciding to sell, selecting the purchaser, and negotiating the deal; further, it did not sufficiently protect against conflicts of interest. CAREFIRST CONVERSION INFORMATION, supra note 117.


120. The CareFirst opinion specifically refers to MD. CODE ANN., CORPS. & ASS'NS § 2-405.1 (1999), dealing with the corporate directors generally and codifying the business judgment rule, and to MD. CODE ANN., INS. § 14-115(c) (2002) for the directors of nonprofit health service plans. CAREFIRST CONVERSION INFORMATION, supra note 117, at 66.

121. While finding that the state insurance statute "codifies the traditional fiduciary duties of care and loyalty that historically govern the conduct of directors of both for-profit and nonprofit corporations," the report further states that certain entities vested with a public trust have "a higher degree of care than the directors of a general corporation." Id. at 68, 69.

122. Id. at 75.
obligations on its board. At the same time, the opinion expressly declines to apply some bedrock corporate law standards like the business judgment rule or standards applicable to corporate takeovers.

III. STATE FIDUCIARY LAW

As is the case with for-profit businesses (and probably more so), agency problems make the issue of accountability the central problem that must be addressed by nonprofit organizational law. Until recently, however, courts and charitable regulators have paid remarkably little attention to the key mechanisms affecting accountability. As Part II describes, state attorneys general have brought dozens of cases in recent years that implicate these issues in contexts ranging from unvarnished corruption to business reorganizations necessitated by changing economic conditions. But the glare of the spotlight has only highlighted the manifold inadequacies of legal doctrine regulating governance of nonprofit organizations.

This Part summarizes and criticizes nonprofit corporation law regarding fiduciary duties, which has been a principal tool used by attorneys general in their cases involving the accountability of nonprofit boards. The Part first concludes that corporate fiduciary law is too permissive and uncertain to protect against opportunistic or lax business

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123. The Court stated:

CareFirst is a nonprofit corporation. Its [sic] was formed for a public purpose. Its economic "value" constitutes a public asset. The CareFirst Board is, therefore, entrusted with an enterprise whose assets belong to the public. The CareFirst Board was, therefore, required to act with the highest degree a [sic] care....

Id. at 75.

124. The report observes:

The business judgment rule was designed to limit judicial interference in corporate affairs.... The "rule," as such, has no place in this regulatory proceeding.... Oversight of the Insurance Administration over insurance regulatory matters without exception involve evaluation of the substantive outcomes rather than the process through which those outcomes were derived.... Application of the business judgment rule in that type of setting would simply emasculate the role of the MIA in evaluating whether or not the company had complied with the statutory standards that govern financial transactions and financial condition.

Id. at 71-72 (emphasis added).

125. Id. at 70; see also infra note 200 (discussing corporate directors' obligation in takeover contests under the "Revlon Rule" to accept the highest bid in certain circumstances).

126. See discussion supra Part I.
practices. As is true in the for-profit sector, where market discipline and the possibility of a takeover exerts some pressures, nonprofit corporate law cannot be relied upon to police the activities of nonprofit managers and directors. Second, there is reason to doubt that fiduciary law can ensure that managers and directors remain faithful to the nonprofit’s corporate mission or will be effective in vetting decisions to alter the mission.

A. Fiduciary Theory and the Nonprofit Commercial Enterprise: An Uneasy Fit

Fiduciary law, embodied in common law duties, statutory standards, and equitable principles, is the primary legal mechanism for assuring accountability in American corporations. The chief significance of these duties lies in their capacity to address principal-agent problems inherent in the corporate form. In the for-profit context, agency costs, principally those arising from information asymmetries, limit the ability of residual claimants to monitor the activities of corporate managers in all forms of business association. For nonprofit corporations, the principal-agent problem is magnified in at least two ways: first, that the principal may be an indefinite class (e.g., donors, public beneficiaries of charity, governmental entities, etc.), whose interests may diverge, and second, that the relationship between the (uncertain) principal and agent is not specified

127. Fiduciaries are those undertaking a duty to act for the benefit of others as to matters within the scope of their fiduciary relationship. In the context of business associations, fiduciaries (i.e. corporate directors, who are also sometimes confusingly referred to as “trustees”) are held to a good faith standard. James Fishman, Improving Charitable Accountability, 62 Md. L. Rev. 218, 252 (2003); see infra notes 155-169 and accompanying text. In the charitable trust context, fiduciaries (“trustees”) hold property subject “to equitable duties to deal with the property for a charitable purpose,” RESTATEMENT (SECOND) OF TRUSTS § 348 (1959), and are governed by strict responsibilities to avoid all conflicts of interest, to preserve assets, and to act with prudence and due care. Fishman, supra at 228-31. This standard is more exacting than the standard applied in the context of business associations. Id. at 231.

128. The issue of agency costs has been the centerpiece of the debate for those attempting to develop a viable theory of the modern corporation. As Berle and Means observed seventy years ago, “The separation of ownership from control produces a condition where the interests of the owner and of the ultimate manager may, and often do, diverge, and where many of the checks which formerly operated to limit the use of power disappear.” ADOLF A. BERLE, JR. & GARDEINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 6 (1933); see Evelyn Brody, Agents Without Principal, supra note 18, at 473-78 (1996); Geoffrey A. Manne, Agency Costs and the Oversight of Charitable Organizations, 1999 Wis. L. Rev. 227, 252.
with exactness in either the entity’s charter or the law. The fundamental objective of fiduciary duties in the corporate context, then, is to bind managers to serve their principals’ interests and thereby overcome the high agency costs inherent in the corporate form.

Close examination of the structure and economics of the nonprofit firm exposes paradoxes in extending corporate principles to charitable corporations. First and most fundamentally, the nonprofit faces greater obstacles in overcoming agency costs than its for-profit counterparts because it lacks residual claimants. The ability of the capital market to monitor and police the actions of managers in the for-profit sector is generally acknowledged. Interested shareholders can also serve those functions through the mechanisms of corporate democracy, including election of directors, proxy contests and other means of shareholder “activism.” However, because the principal of the nonprofit corporation is not readily identifiable, there is no claimant with sufficient incentives to monitor agents’ abuses. Further, even if some altruists were willing to act as monitors, existing legal regimes provide few direct remedies for abuses.

See Brody, Agents Without Principals, supra note 18, at 486; Manne, supra note 128, at 234.


While serious questions exist about the sufficiency of capital markets to accomplish these objectives, see infra notes 171-172, the extensive literature on corporate governance is in substantial agreement that the market for corporate control has some chastening effect on managers and directors.

See Summers v. Cherokee Children & Family Servs., 112 S.W.3d 486, 506-07 (Tenn. Ct. App. 2002) (noting that nonprofit statute allows members to bring a “derivative-like” action, but where no members exist, it is left to the attorney general to respond to breaches of fiduciary duties and where necessary, to seek dissolution).
MISSION, MARGIN, AND TRUST IN THE NONPROFIT HEALTH CARE ENTERPRISE

Lacking effective monitors to demand accountability, one might expect legal doctrine to provide substitute mechanisms to trigger regulatory review in well-defined circumstances. As we shall see, such is not the case.

A caveat is necessary at this point. Public and sponsored hospitals provide an interesting wrinkle in this “absence of residual claimant” problem. In this context, local governments and sponsors frequently

133. We use the term “sponsored” to refer to entities controlled by a religious organization, such as an order of Catholic sisters. Professor Singer predicts that Catholic-sponsored hospitals and attorneys general in particular are on a collision course, as:

[A]ttorneys general and local communities [are] beginning to rigorously question the use of charitable assets. At the same time, Church law clearly vests control of the health care institution and, to a large extent, disposition of its assets in the sponsoring religious congregation. Challenges to sponsor strategies are beginning. There is little doubt that the continued need of sponsors to respond to ministry pressures will, more frequently, result in litigation to contest sponsor authority and direction. See Singer, supra note 2, at 164-65.

134. Of course, some nonprofits (including charitable entities) have structures that mimic “ownership” to some extent. Both public benefit and mutual benefit corporations may have members with rights to elect directors. Under the Revised Model Nonprofit Corporation Act (RMNCA), members of corporations are entitled to vote for directors, while public benefit corporations may have members. REVISED MODEL NONPROFIT CORP. ACT §§ 6.02, 6.03 (1987). Despite having control and governance powers inherent in possessing voting rights, members are not analogous to shareholders in all other respects. Most obviously, they lack any claim to profits: Distributions to members are forbidden except that mutuals may distribute to members on dissolution. Reserved powers are rights of control vested in members that normally are held by the corporation’s Board of Directors. These reserved powers may include power over major operational decisions, sales or conversions, and approval of budgets. See generally Dana Brakman Reiser, Decision-makers Without Duties: Defining the Duties of Parent Corporations Acting As Sole Corporate Members in Nonprofit Healthcare Systems, 53 RUTGERS L. REV. 979 (2001). In addition, members may also may have “reserved powers” to make operational decisions thus bypassing the traditional powers of boards and management. Reserved powers are rights of control vested in members that normally are held by the corporation’s Board of Directors. These reserved powers may include power over major operational decisions, sales or conversions, and approval of budgets. See Brakman Reiser, supra, at 991. Some nonprofit statutes have recognized these distinctions and applied slightly stricter fiduciary standards to boards of public benefit corporations because of the general absence of members to monitor governance of those organizations. REVISED NONPROFIT MODEL CORP. ACT § 8.30 (1987); Lizabeth A. Moody, The Who, What, and How of the Revised Model Nonprofit Corporation Act, 16 N. KY. L. REV. 251, 274 (1988) (noting that RMNCA drafters believed it “essential to find devices to hold directors [of nonprofits without members] accountable”). As a general matter, however, members are best understood as relating to the nonprofit organization by virtue of their participation and
behave as "owners" that provide a consistency of vision and accountability, thereby possibly being even more efficient than shareholders in their oversight of the corporation’s managers. While their existence may ameliorate the "residual claimant" problem in one sense, sponsored hospitals present another analytical challenge. While they may indeed represent well patients’ interests, particularly when they are an on-going enterprise, they also have significant interests of their own, which are easily and powerfully exercised. In short, corporate theories do not account for the "member" corporation, whose members have their independent missions, loyalties, and financial pressures that might be resolved by redeployment of the assets of "subsidiary" corporations.

A second factor undermining the efficacy of fiduciary law in nonprofit corporations is that their goals are multi-faceted and often not well-defined. While managers of business corporations must strictly observe the over-arching objective of profit maximization, their nonprofit counterparts face a more complex array of goals. Although generating net income is surely an important objective (especially in commercial not-for-profit organizations), it is also necessary to simultaneously accommodate the other, competing objectives of the organization articulated in the mission. Thus, nonprofit managers and directors must reconcile business objectives and mission. Complicating the task further is the fact that the mission objectives are often stated in general terms that lack the precise, quantifiable frame posed by the profit maximization standard.135 While vague standards may appear to ensure flexibility and maximize director discretion,136 the other side of the coin is that they may invite freewheeling

limited governance role in the corporation as distinguished from having a financial investment in the entity. Id. at 270 ("[M]embers generally relate to the organization by participation rather than by the financial interest generated by an investment."); id. at 273 (noting that the membership relationship in nonprofits is much more personal than shareholders’ relationship to for-profit corporations).

135. See Goldschmid, supra note 57, at 641 ("The obligation of the nonprofit directors and officers with respect to the corporation’s mission creates a more difficult and complex decision-making process for them than for their for-profit peers."); see also Manne, supra note 128, at 235-36 ("[T]he analytical power of the theory of the firm does not readily transfer to the realm of nonprofits. . . . [S]trong conclusions in the for-profit context regarding incentives and capacities to minimize agency problems are weaker in the nonprofit context.").

136. See, e.g., Goldschmid, supra note 57, at 641 (noting it would be in accordance with the duty of care in business to the responsibilities for directors of the nonprofit hospitals to accept the lower bid from one of several suitors because the winning bidder would provide a higher level of public benefit to the community).
regulatory interventions that can bring carefully planned business strategies to a halt.

The efficacy of fiduciary principles is further hampered by the scarcity of precedents. Only a handful of cases address the duties of care and loyalty, mention of the duty of obedience is even rarer. This is in part due to state law limiting standing to challenge breaches of the fiduciary duties to attorneys general, members, and directors. However, state charity enforcers, particularly attorneys general, are notoriously circumscribed by a lack of investigative resources and the dearth of information about managerial abuses or contemplated business decisions owing to the minimal disclosure requirements applicable to nonprofits. Also limiting precedent is the attraction of settlement to both states and boards: State regulators and attorneys general focus on “fixing the

137. A search on Westlaw, http://www.westlaw.com, using the following terms: “duty of care, w/5 director! trustee & nonprofit charitable not-for-profit,” found only ten reported decisions involving the duty of care in nonprofit corporations, three of which were cases decided on other grounds, and therefore did not explicate the duty. Search on Westlaw, All State Cases Database (Mar. 11, 2004).

138. A search on Westlaw, http://www.westlaw.com, using the terms: “duty of loyalty, w/5 director! trustee & nonprofit charitable not-for-profit,” produced five nonprofit cases which discussed the duty of loyalty. Search on Westlaw, All State Cases Database (Mar. 11, 2004); see also 2 FURROW ET AL., HEALTH LAW §§ 5-15 to 5-16 (2000).

139. A search on Westlaw, http://www.westlaw.com, using the search terms: “duty of obedience w/ 5 director! trustee & nonprofit charitable not-for-profit,” produced one nonprofit case which discussed the duty of obedience. Only one case has cited the duty of obedience since 1984. Search on Westlaw, All State Cases Database (Nov. 20, 2004); see also 2 FURROW ET AL., supra note 138, § 5-17 (listing cases and describing the duty of obedience).

140. See DANIEL L. KURTZ, BOARD LIABILITY: GUIDE FOR NONPROFIT DIRECTORS 92 (1988) (most states deny standing to persons other than members, directors and attorneys general); see also 2 FURROW ET AL., supra note 138, § 5-18 (standing occasionally but rarely recognized for donors and others with "special interest"); Developments in the Law-Nonprofit Corporations, 105 HARV. L. REV. 1581, 1594-98 (1992); Manne, supra note 128, at 241 ("Standing limitations for nonprofit entities are grounded largely in the outdated notion of the state as parens patriae, and thus . . . have relegated enforcement to the exclusive province of the state."). While some statutes and court decisions have granted standing to members and directors of not-for-profits, this adds little protection because it tends to make the goat the keeper of the cabbage patch. Rarely is standing recognized even for donors and others with a "special interest," much less for members of the community the nonprofit serves. See, e.g., Jackson v. Stuhlfire, 547 N.E.2d 1146 (Mass. App. 1990) (allowing members of nonprofit to bring suit); John v. John, 450 N.W.2d 795 (Wis. App. 1989), cert. denied 498 U.S. 814 (1990) (allowing directors to sue co-director).

141. Fishman, supra note 127, at 259-65.
problem," not necessarily getting to root causes.\textsuperscript{142} Boards, comprised of volunteers, are notoriously risk-averse and eager to avoid sullying their own or their institution’s standing in the community.\textsuperscript{143} A consensus view is that applying for-profit corporate fiduciary standards to charitable corporations has proved inadequate to deter wrongdoing or to encourage responsible stewardship.\textsuperscript{144} As Harvey Goldschmid stated, “[T]he central paradox of nonprofit corporate governance . . . is the fact that the nation’s nonprofit institutions are the recipients of so much public and private largesse—in terms of gifts, grants, tax benefits, volunteer efforts, and other subsidies—and yet are subjected to so few accountability constraints.”\textsuperscript{145} Questioning the efficacy of fiduciary law generally,\textsuperscript{146} many academic commentators have proposed stricter standards for nonprofits.\textsuperscript{147}

By the same token, wholesale importation of for-profit corporate law gives short shrift to the nuanced role of directors of commercial

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\item 142. See id. at 268-69.
\item 143. See Manne, supra note 128, at 245; see also Goldschmid, supra note 57, at 643 (citing forbearance by state regulators and understaffing as limiting enforcement of fiduciary duties).
\item 144. James J. Fishman & Stephen Schwarz, Nonprofit Organizations: Cases and Materials 86 (1995); see also Demott, supra note 130, at 146-47 (“[I]t is foolish to import for-profit norms respecting self-dealing generally into the nonprofit context. Governance mechanisms are so much weaker in the nonprofit sector that loose controls on self-dealing create unacceptably high risks of misconduct.”); Goldschmid, supra note 57, at 643 (describing fiduciary standards as “aspirational” and proposing stronger enforcement); Manne, supra note 128, at 239 (“Much has been written about the application of fiduciary duties to directors of nonprofits, and all of it call for some reform in this area . . . . [T]he current regime is commonly viewed as inadequate.”); see also Hansmann, Reforming Nonprofit Corporation Law, supra note 4, at 568 (describing standard of conduct regarding conflicts of interest for nonprofit directors as “too weak”).
\item 145. Goldschmid, supra note 57, at 652; see also Brody, Agents Without Principals, supra note 18, at 457-71; Manne, supra note 128, at 227-30.
\item 146. Singer, supra note 68, at 237 (citing “subtle nuances and reasonable characterizations that can be attached to signing bonuses and other forms of executive compensation” that make it difficult to prove breaches of duty of loyalty).
\item 147. DeMott, supra note 130, at 135-36 (noting the charitable trust model as a potential alternative to the corporate model adopted in the RMNCA); Thomas H. Boyd, Note, A Call to Reform the Duties of Directors Under State Not-For-Profit Corporation Statutes, 72 Iowa L. Rev. 725, 744 (1987) (proposing that trustee standards should apply to public benefit nonprofits, while corporate standards should apply to mutual benefit nonprofits); see Hansmann, Reforming Nonprofit Corporation Law, supra note 4, at 570 (arguing that a strict prohibition on director self-dealing in nonprofit corporations would have “an enormously salutary effect”).
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nonprofits—one that demands a balance of mission and margin. Critical to the success of any legal regime is preserving the managerial discretion necessary for the efficient operation of the nonprofit as a business enterprise.\textsuperscript{148} External review imposes costs, such as increased risk aversion, transaction costs, and uncertainty in business decisions. The most obvious risk is that overly intrusive oversight may reduce efficiency, as impaired managerial discretion may constrain risk-taking and innovation.

Less widely appreciated is the danger that such reviews may pose to the corporation's charitable mission. As the Delaware Supreme Court recently acknowledged, strict application of corporate standards may be anomalous in the nonprofit setting: "Although principles of corporate law generally govern the activities of . . . a [charitable] corporation, its fiduciaries have a special duty to advance its charitable goals and protect its assets."\textsuperscript{149} The threat of extensive second-guessing by regulators may tend to cause directors of charitable enterprises to substitute for their own judgments those of the regulators. When governmental actors exercise a heavy hand, they risk blurring public and private decision-making.

Finally, extensive regulatory oversight may undermine the norms that guide managers' behavior. As recent scholarship examining the role of trust and other extra-legal forces suggests, norms and other forms of social ordering that arise outside of the legal system strongly impact behavior of business managers.\textsuperscript{150} There is reason to believe norms play a vital function in nonprofits: Board members and managers take their cues from their institution's mission and history and are driven by social forces such as prestige and embarrassment rather than threat of legal sanction.\textsuperscript{151} Yet the

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148. Stephen Bainbridge summarizes the problem as follows:

Neither discretion nor accountability can be ignored, because both promote values essential to the survival of business organizations. Unfortunately, they are ultimately antithetical: one cannot have more of one without also having less of the other. Managers cannot be made more accountable without undermining their discretionary authority. Establishing the proper mix of discretion and accountability thus emerges as the central corporate governance question . . . .


150. Margaret M. Blair & Lynn A. Stout, \textit{Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law}, 149 U. PA. L. REV. 1735, 1739 (2001) (trustworthy behavior helps explain the "puzzling persistence of cooperative patterns of behavior in firms in circumstances in which legal and market sanctions are ineffective or unavailable").

151. Describing the paradox of the fact that nonprofit managers tend to "adhere to good practices, and demonstrate fidelity to the organization's mission and the eleemosynary ideal" despite facing only abstract legal standards and scant enforcement, Professor

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impact of legal commands is uncertain. Law may work to support social norms by its expressive effects or weaken them by perversely undermining their social significance.

B. Applying the Fiduciary Duties to Commercial Nonprofits in the Health Care Sector

Despite the inadequacies associated with applying corporate law to the nonprofit context, it has become the template for all state nonprofit statutes. Almost every state applies the for-profit standard, rather than the more exacting trust standard, to nonprofit corporations. Somewhat startling is the fact that the special considerations raised by the non-distribution constraint and the mission of the nonprofit corporation are given only nodding recognition in statutes and case law dealing with fiduciary duties. As discussed below, a third duty, sometimes called a duty of obedience, pays some heed to directors' responsibilities to protect and promote their corporation's charitable mission. However, to date the case law governing nonprofits has failed to satisfactorily integrate the dictates of charitable responsibilities with the duties of care and loyalty imported from the for-profit corporate model. We discuss briefly the standards of the three fiduciary duties and then analyze some of the conundrums they pose for directors of nonprofit health care charities.

1. The Duty of Care

The duty of care is traditionally characterized by a three-part test

Fishman writes, "Why is the level of fidelity so high? Why do most fiduciaries do what is right? The answer may be that most charitable fiduciaries have internalized the norms of appropriate behavior. Accountability is a normative issue that reflects the role of the nonprofit sector in law and society." Fishman, supra note 127, at 242.


154. See REVISED MODEL NONPROFIT CORP. ACT § 8.30(a) (1987) (nonprofit duty of care and good faith); id. § 8.31 (nonprofit duty of loyalty). In drafting the Model Nonprofit Corporation Act, the ABA essentially used the for-profit model act as a template, electing not to employ a different approach, as recommended by some, that recognized the dramatic differences between the two corporate forms. As a result, the scarce common law that has evolved in the interim has, until recently, not developed a distinct "nonprofit" body of law.
inquiring into whether directors acted "in good faith," with that level of care that an ordinarily prudent person would exercise in like circumstances and in a manner they reasonably believe to be in the best interest of the corporation. The seeming negligence-focused formulation, however, is mitigated by the application of the business judgment rule, which establishes a rebuttable presumption that directors who employ appropriate processes in the course of their decision-making have satisfied the duty of care. The business judgment rule essentially changes the negligence standard suggested by the technical articulation of the duty of care to one of gross negligence or recklessness by focusing on the decision-making process. Directors who make decisions that are informed, in good faith, and clear of conflicts of interest will avoid judicial scrutiny altogether.155 The important caveat that the decision be the product of an informed judgment limits somewhat the rule’s potentially all-encompassing sweep and bars its application in situations of nonfeasance.156 In addition, recent decisions by some courts suggest that boards that consciously disregard risks fail to satisfy the “good faith” requirement and will not enjoy the rule’s protection.157

State courts have applied the business judgment rule to nonprofit directors, utilizing standards derived from the corporate context.158


156. See Cede & Co. v. Technicolor, Inc., 634 A.2d 345 (Del. 1993); Smith v. Van Gorkum, 488 A.2d 858 (Del. 1985); BAINBRIDGE, supra note 148, at 242-86 (contrasting precedent treating the business judgment rule as a substitute standard of review versus a rule of abstention).

157. See In re Abbot Labs. Derivative S’holders Litig., 325 F.3d 795 (7th Cir. 2003); In re Walt Disney Co. Derivative Litig., 825 A.2d 275 (Del. Ch. 2003). The Chief Justice of the Delaware Supreme Court states that the evolving standard requires “honesty of purpose and eschews a disingenuous mindset of appearing or claiming to act for the corporate good, but not caring for the well-being of the constituents of the fiduciary.” E. Norman Veasey, Corporate Governance and Ethics in the Post-Enron WorldCom Environment, 38 WAKE FOREST L. REV. 839, 851 (2003).

158. The Minnesota Supreme Court recently expressed concern that “[d]irectors of nonprofits may take fewer risks than would be optimal if they were overly concerned about liability for well meaning decisions.” Janssen v. Best & Flanagan, 662 N.W.2d 876, 883 (Minn. 2003); see also Beard v. Achenbach Mem’l Hosp. Ass’n, 170 F.2d 859 (10th Cir. 1948); Scheuer Family Found., Inc. v. 61 Assocs., 582 N.Y.S.2d 662 (N.Y. App. Div. 1992); 2 FURROW ET AL., supra note 138, §§5-15; FISHMAN & SCHWARZ, supra note 144, at 185 (describing the rule as “more appropriately known in the nonprofit context as the best judgment rule” and as providing “if a director has made a decision by informing herself in
Although common law rarely addresses explicitly the propriety of applying the business judgment rule to nonprofit corporations, those courts that have faced the question have accepted the rule. In reality, however, despite the lofty standard of diligence provided by statutory and common law formulations, the duty of care very rarely results in courts imposing sanctions upon directors. The business judgment rule protects almost all judgments by directors as long as they are plausibly "informed." Some scholars have sought to explain this "schizophrenic" state of affairs by stressing the central role of trust in shaping behavior and suggesting that the law may reinforce trustworthy behavior by influencing the internal preferences of actors in contrast to affecting the external incentives they encounter.

2. The Duty of Loyalty

In the business corporation context, the duty of loyalty flows from the directors' duty to maximize shareholder wealth. This philosophical underpinning poses obvious difficulty for application to the nonprofit corporation, which does not have shareholders, whose legal form rests on a commitment to a charitable enterprise, and whose mission therefore is not good faith without a disabling conflict of interest, there will be neither judicial inquiry nor liability even if the action was unfortunate for the organization or its membership.


159. Janssen v. Best & Flanagan, 662 N.W.2d 876, 883 & n.2 (Minn. 2003) (noting it found no case rejecting the business judgment rule in the nonprofit context, and that the Supreme Courts of Alabama, Hawaii, and South Dakota, as well as intermediate appellate courts of Colorado, New York, Ohio, South Carolina, Tennessee, and Wisconsin have applied the business judgment rule to nonprofit boards); see also Beard, 170 F.2d 859; Woo Chul Lee v. Interinsurance Exch., 50 Cal. App. 4th 694 (Cal. Dist. Ct. App. 1996); Oberly v. Kirby, 592 A.2d 445, 462 (Del. 1991) ("A court cannot second-guess the wisdom of facially valid decisions made by charitable fiduciaries, any more than it can question the business judgment of the directors of a for-profit corporation."); Scheuer Family Found., 582 N.Y.S.2d at 662.

160. In cases involving for-profit corporations, under the business judgment rule the standard of care is almost uniformly applied only to review the process by which decisions are made, not the result. In only a handful of cases have courts found directors liable under this standard, and few, if any, find liability for even egregious mistakes in judgment. See Charles Hansen, The ALI Corporate Governance Project: Of the Duty of Care and the Business Judgment Rule, A Commentary, 41 Bus. Law. 1237 (1986). See generally Melvin Aron Eisenberg, The Director's Duty of Care in Negotiated Dispositions, 51 U. Miami L. Rev. 579 (1997).

primarily wealth maximization. The question then becomes whether the corporate notion of the duty of loyalty can be usefully reformulated to ensure appropriate director behavior and preservation of the charitable mission in the nonprofit context. 162

The duty of loyalty also governs the individual board member’s relations with the corporation of which she is a director. Interestingly, neither courts nor legislatures have interpreted the duty of loyalty in the for-profit context as prohibiting outright self-dealing and other conflicted interest transactions. 163 In general, the law prohibits only those self-dealing transactions that are not approved or ratified by the board of directors or shareholders under specified standards. In the business corporation context, approval may be gained by the vote of a disinterested majority of the board of directors or by a majority of disinterested shareholders provided the terms of the transaction are fully disclosed prior to the vote. 164 In the nonprofit context, most states appear to have applied the business corporation standard in addressing the duty of loyalty, 165 although some states have imposed somewhat more stringent standards for self-dealing transactions. 166

3. The Duty of Obedience

A third duty, applicable only to the directors of nonprofit corporations, is the duty of obedience. Although articulated as a distinct


163. Neither wants to deny the nonprofit entity the potential of a board member facilitating beneficial contracts or business relationships for the nonprofit. KURTZ, supra note 140, at 60-61, 63.

164. See, e.g., DEL. CODE ANN. tit. 8, § 144 (2001); REVISED MODEL BUS. CORP. ACT § 8.31 (1983); Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 365 (Del. 1993) (characterizing Delaware statute as “a legislative mandate that... an approving vote of a majority of informed and disinterested directors shall remove any taint of director or directors’ self-interest in a transaction”).


166. See, e.g., CAL. CORP. CODE § 5233 (West 2004) (requiring that transactions be fair and reasonable at the time entered into and approved by a majority of the board, which must consist entirely of disinterested members; it must also be shown that the board determined, after reasonable inquiry, that a more advantageous deal could not be obtained).
fiduciary duty in only a handful of cases, the concept appears to have been broadly popularized by the work of Daniel Kurtz, presumably to overcome the perceived deficiencies of applying the duty of loyalty to the nonprofit corporate board. Broadly construed, the duty of obedience expresses the obligation of nonprofit directors to observe and advance the mission of the charitable corporation by adhering to its purposes, usually as set forth in the entity’s articles of incorporation or bylaws. However, in the few instances in which it is specifically mentioned by courts, it has been invoked to indicate directors’ responsibility to assure that their corporations obey the law and not stray from the dictates of the purposes expressed in their articles and bylaws. In various cases in which courts have dealt with nonprofit hospitals seeking to change their business to provide health care services other than acute care, the concept limits such changes unless permitted by the corporation’s articles.

C. Practical Problems with Applying Fiduciary Duties to Nonprofit Boards and Managers

Even in the for-profit context, the efficacy of common law and statutory duties in ensuring that directors meet their fiduciary duties is the subject of considerable debate. A raft of studies examining the failures of oversight in the wake of Enron, WorldCom, and other corporate scandals

168. See Kurtz, supra note 140, at 84-85.
169. See Fishman & Schwarz, supra note 144, at 230 (“The duty of obedience resembles the trustees’ duty to administer a trust in a manner faithful to wishes of creator . . . . Thus, the director has a duty to follow the purposes and powers as expressed in the [corporation’s] governing legal documents.” (citation omitted)). The duty of obedience is regarded by some commentators as a particularized obligation under the duty of loyalty or care. See e.g., Goldschmid, supra note 57, at 650.
170. For example, in Queen of Angels Hosp. v. Younger, 136 Cal. Rptr. 36 (Ct. App. 1977), a religious order sought to close a hospital in order to provide health services to the indigent through outpatient neighborhood clinics. Even though the articles of incorporation indicated several purposes, the court interpreted them to require continuing operation of a hospital. Id. at 40-41. In Attorney Gen. v. Hahnemann Hosp., 494 N.E.2d 1011, 1021 (Mass. 1986), trustees of a hospital sought to sell its assets in order to become a grant-making institution for health care institutions. The Court allowed the trustees to amend the articles to do so but noted without such provision they would have violated fiduciary duties. Id. at 1018-19.
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points to the insufficiency of director oversight in the for-profit sector.\textsuperscript{171} The emerging consensus that fiduciary duties are no substitute for other means of assuring honesty and diligence by corporate managers would seem to apply a fortiori to nonprofit entities.\textsuperscript{172} Adding to the problems

\begin{itemize}
  \item \textsuperscript{171} See, e.g., First Interim Report of Dick Thornburgh, Bankruptcy Court Examiner, In re Worldcom Inc., No. 02-15533(AJG) (Bankr. S.D.N.Y. Nov. 4 2002), http://news.findlaw.com/hdocs/docs/worldcom/thornburgh1strpt.pdf (citing “numerous failures, inadequacies and breakdowns” among the “Board of Directors, the Audit Committee, the Company’s system of internal controls and the independent auditors.”); AM. BAR ASS’N TASK FORCE ON CORPORATE RESPONSIBILITY, REPORT OF THE AMERICAN BAR ASSOCIATION TASK FORCE ON CORPORATE RESPONSIBILITY 25, 29 (2003) (finding outside directors “overly dependent upon and overly passive with respect to senior executive officers” and recommending that “outside directors abandon the passive role many have been content to play and replace it with a new culture stressing constructive skepticism and an active, independent oversight role”); WILLIAM C. POWERS, JR. ET AL., SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP., REPORT OF INVESTIGATION 148 (2002), http://i.cnn.net/cnn/2002/LAW/02/02/enron.report/powers.report.pdf (describing oversight by Enron’s Board and Management as “cursory”; stating that Board “did not fully appreciate the significance of some of the significant information that came before it”; and characterizing controls put in place governing self dealing as inadequate); see also William H. Donaldson, Chairman, U.S. Securities and Exchange Commission, Remarks at the 2003 Washington Economic Policy Conference before the National Association for Business Economics (Mar. 24, 2003), http://www.sec.gov/news/speech/spch032403whd.htm (“[I]nattention to good corporate governance practices over the past decade or more is at the heart of what has gone so terribly wrong in corporate America in the past few years . . . . [A]t too many companies, the chief executive position has steadily increased in power and influence. In some cases, the CEO had become more of a monarch than a manager. Many boards have become gradually more deferential to the opinions, judgments and decisions of the CEO and senior management team. This deference has been an obstacle to directors’ ability to satisfy the responsibility that the owners—the shareholders—have delegated and entrusted to them.”).

  \item \textsuperscript{172} Besides suggesting that the potential for abuse was larger than previously suspected, the well-documented shortcoming in the for-profit sector is all the more startling because of the enormous phalanx of analysts and experts that monitor the securities markets and institutional investors ostensibly monitoring directors’ behavior. The lack of comparable watchdogs in the nonprofit sector suggests that directorial abuse might be even harder to detect. Further, extensive corporate scholarship identifies a number of factors, all applicable to nonprofit boards, which impair effective director oversight. For example Professors Bebchuk, Fried and Walker persuasively explain excesses in executive compensation by demonstrating the subtle conflicts that arise out of managers’ influence over the appointment of directors, the effects of board decision-making dynamics, and the impact of directors’ lack of independently supplied information. See Lucian Arye Bebchuk et al., Managerial Power and Rent Extraction in the Design of Executive Compensation, 69 U. CHI.
associated with relying on fiduciary principles are multiple administrative limitations facing state charitable enforcers.178 Attorneys general lack resources, access to information, and expertise to effectively monitor conduct of the extensive and economically significant commercial nonprofit sector.174

The numerous examples of abject breaches of oversight responsibilities by directors of major commercial health care charities raise serious doubt as to how effectively the fiduciary duties serve their prophylactic function of averting abuse and encouraging director vigilance. For example, as described in Subsection II.A, in a number of high profile conversions of nonprofit health plans in the early 1990s, insiders personally profited from lucrative arrangements and sales that took place for vastly undervalued amounts, resulting in losses of billions of dollars of charitable assets.175 The fact that few, if any, of the directors involved in these cases were held to account under fiduciary theories confirms the view that the duties are "relatively weak weapon[s] in the

173. Although the Delaware courts have recently signaled an intention to apply the requirement of good faith more aggressively, that standard nevertheless requires a showing that directors "consciously and intentionally disregarded their responsibilities, adopting a 'we don't care about the risks' attitude . . . " In re Walt Disney Co. Derivative Litig., 825 A.2d 275, 289 (Del. Ch. 2003); see also In re Abbot Labs. Derivative Litig., 325 F.3d 795, 807-11 (7th Cir. 2003) (finding absence of good faith where directors were aware of extensive safety problems leading to large civil fine and took no efforts to remedy them).

174. James Fishman has catalogued a number of deficiencies including the fact that few states even have charities sections within the attorneys general office, staffing is minimal, and responsibilities are often divided with other agencies in a way that impairs effective oversight. Fishman, supra note 127, at 262-63. In addition, attorneys general lack staff to efficiently review information provided in mandatory reporting such as Form 990 and are unable to effectively share information with IRS or other state enforcers. Id. at 263-65.

175. Examples are legions of vastly underpriced sales of assets of nonprofits, often engineered by insiders who ultimately profited by stock ownership in or lucrative employment agreements with the purchaser. See, e.g., Colombo, supra note 96, at 785 (estimating actual value of assets of California’s Health Net HMO to be approximately 500% higher than originally estimated and describing funding of charitable foundations on conversion of PacifiCare Health Systems at less than 1% of actual value of the enterprise). For a detailed account of the numerous instances of under-valuation in such conversions and the successful efforts of the Consumers Union to have hundreds of millions of dollars turned over to independent foundations, see Eleanor Hamburger et al., The Pot of Gold: Monitoring Health Care Conversions Can Yield Billions of Dollars for Health Care, 29 Clearinghouse Rev. 473 (1995).
arsenals of attorneys general" for dealing with such problems. Although subsequent intervention by consumer groups caused attorneys general to review and ultimately challenge some (but far from all) of these transactions, few if any directors were personally prosecuted. Responding to the problem posed by conversions, by 1998 over twenty-five states and the District of Columbia had adopted legislation. However, most of the nonprofit conversion statutes do not change the substantive standard for review of fiduciary breaches.

As an example of the problems associated with relying on fiduciary law to police nonprofit governance, consider the complete breakdown in governance that was central to the demise of AHERF, discussed in Subsection II.A. Several careful studies of AHERF place prime responsibility on its boards for effectively ceding governance to the CEO and accepting a model of corporate control designed to prevent effective oversight. Multiple and overly large boards thwarted effective discussion or analysis of corporate policy and the CEO's domination of the board (through selection process and personal ties) discouraged any meaningful board input. When one holds this framework up against the lenient standard widely applied under the duty of care, however, it is entirely possible that the board members might have avoided personal liability.

176. Singer, supra note 68, at 237.
179. Burns, et al., supra note 72, at 21-22; see also Michael W. Peregrine & James R. Schwartz, Revisiting the Duty of Care of the Nonprofit Director, 36 J. Health L. 183, 201 (2003).
180. A recent account by one of AHERF’s insiders that is highly critical of top management explains that the Boards were supplied with extensive information, perhaps so much so that they were unable to digest it and properly supervise management.

It might be reasonable to suppose that the [AHERF] trustees were unable to see and perhaps prevent the oncoming train wreck because they were underinformed. In fact, nothing could be further from the truth. The trustees of the constituent corporations of HERF and of AHERF itself were regularly given reams of information, including detailed financial statements. Although it would have taken a reader of financials with extraordinary insight to discern from one of the constituent corporation's statements how all of AHERF was doing, there was enough crossover on the various boards that there was a core of trustees who had most if not all of the relevant information available to them. The more likely scenario, in fact is that the trustees had too much information; they were given so much to absorb that they could not winnow out what was important.
Even with such a remarkable record of inattentiveness, the business judgment rule may have afforded protection, as it requires only that directors be reasonably informed. Moreover, to pass the process-oriented information hurdle, directors can rely on ostensibly trustworthy surrogates to supply expertise and evaluation. Assuming the AHERF boards were reasonably attentive to information placed before them and relied on the advice of executives and responsible intermediaries, there is every likelihood that their conduct would enjoy the protection of the business judgment rule.¹⁸¹

The ineffectiveness of the fiduciary duties in policing board behavior has spurred charitable regulators to invoke charitable trust law to supply a more stringent standard of conduct. For example, the Attorney General of Minnesota’s business compliance reviews of the Allina Health System¹⁸² and HealthPartners¹⁸³ examined in extraordinary detail the day-to-day business decisions of those companies.¹⁸⁴ Attorney General Hatch claimed that the
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boards had failed in their oversight of senior management and had neglected their responsibilities to exercise independent judgment. Citing a variety of “governance failures” by the HealthPartners’s Board, the Attorney General petitioned for the appointment of two “special administrators” to act as trustees of the HealthPartners charitable trust.”

The Attorney General’s legal theory rested on an amalgam of charitable trust and corporate law. Its legal brief asserted that Minnesota law subjects nonprofit board members to charitable trust standards by virtue of the fact that the corporation holds charitable assets. It charged that poorly documented or excessive expenditures “waste[d]” corporate assets and ineffective oversight breaches directors’ fiduciary duties. **Rather confusingly,** the Attorney General cited the duties of care and obedience from nonprofit *corporate* law for these propositions along with conclusory statements that the stricter charitable trust standard should apply. **It is highly doubtful** that a court would find a breach of fiduciary duty under the nonprofit corporate standard in these circumstances (the court never reached the question of whether charitable trust law could be imported to supply a stricter standard). **The corporate waste doctrine is exceedingly difficult to satisfy** and, as we have seen, duty of care claims

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See also Brody, Whose Public?, supra note 13, at 1005.

185. Brody, supra note 13, at 1005.


187. PEREGRINE & SCHWARTZ, supra note 158 (citing Manhattan Eye, Ear & Throat Hosp. v. Spitzer, 715 N.Y.S.2d 575, 593 (Sup. Ct. 1999) for the duty to ensure “that the mission of the charitable corporation is carried out”). It also cites commentary summarizing directors’ general fiduciary duties under nonprofit corporate law, *e.g.*, KURTZ, supra note 140 (“[D]irectors should be diligent and attentive.”), but makes no reference to the business judgment rule. Id.

188. Commentators have sharply questioned whether theories of corporate waste or breach of fiduciary duty can be brought in instances of director nonfeasance such as HealthPartners petition. See PEREGRINE & SCHWARTZ, supra note 158, at 26-27.

189. Under Delaware law, “waste entails an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade.” Lewis v. Vogelstein, 699 A.2d 327, 336 (Del. Ch. 1997) (citing Grobow v. Perot, 539 A.2d 180, 189 (Del. 1988)); *see also* Saxe v. Brady, 184 A.2d 602, 610 (Del. Ch. 1962). This extraordinarily high standard of proof has led some courts to doubt it can ever be met absent proof of self dealing. Steiner v. Meyerson, No. Civ. A. No. 13139, 1995 WL 441999, at *5 (Del. Ch. July 19, 1995) (“But rarest of all—and indeed, like Nessie, possibly nonexistent—would be the case of disinterested business people making non- fraudulent deals (non-negligently) that meet the legal standard of
are easy defended by invoking the business judgment rule.

The doctrinal and policy flaws of borrowing the charitable trust standard are discussed in Part IV. However, two important collateral aspects of attorney general activism in the face of doctrinal uncertainty in this area should be noted. As discussed in Part II, one highly controversial aspect of Allina was the relief obtained by the Minnesota Attorney General—a spin off of the HMO subsidiary. As troubling, however, was the Attorney General’s petition for authority to select eight of the special administrators who were to serve as the new entity’s board. He sought this same power to appoint directors, first informally and later with court approval, in the HealthPartners case (ultimately the probate division of the district court ordered that one be appointed special administrator with responsibilities to report instances of board failure to act in good faith).\(^{190}\)

The state’s attempt to substitute its own decision-makers for the directors of the nonprofit corporation does considerable violence to the independence of the nonprofit sector. The problems associated with this intervention go beyond the merits of the claimed failures of the current board. The threat of direct intervention by politically-selected regulators blurs the line between public and private.\(^{191}\) If not reserved for instances of outright corruption, the power to replace decision-makers may be too potent a weapon to entrust to courts, especially when attorneys general may accomplish the result by the mere threat of seeking judicial relief.

**D. The Misuse or Neglect of Mission in Analyzing Directors’ Fiduciary Duties**

Finally, we consider the curiously neglected role of institutional mission in informing directors’ duties. Conversions, closures, asset sales, and other organic changes involving nonprofit corporations require directors’ most assiduous adherence to their fiduciary duties. Fiduciary questions arise in many contexts, including whether the conversion or change of purpose is consistent with the purpose of the nonprofit organization; whether the purchaser is appropriate in view of the entity’s charitable purposes; whether directors approving the decision resolved waste!”)


\(^{191.}\) Brody, Whose Public?, supra note 13, at 942. Further, some have inferred political impropriety in elected officials’ appointment of some special administrators or board members. See Strom, supra note 92 (raising concerns about politicians’ appointment of friends, colleagues and political contributors, and quoting experts who suggest that such appointments are more appropriately made by courts).
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conflicts of interest; and how the directors decided to use the assets acquired by the nonprofit corporation. Though these questions would seem to force regulatory agencies and courts to confront directly the role of mission in nonprofit corporate decision-making, the standard to be applied remains muddled. Arising in different statutory contexts, and often applying different substantive standards, the case law presents a less than uniform picture. Three approaches can be discerned in the case law: the pure corporate law standard; the mixed corporate/nonprofit mission standard; and the corporate/regulatory policy standard. None, however, offers a coherent formula for accommodating mission values into the fiduciary duties of directors.

1. Pure Corporate Standard

In a number of cases, courts confronting organic changes have purported to apply the corporate fiduciary standard in reviewing directors' decisions. For example, in Health Midwest, the court declared unequivocally "corporate law applies to all aspects of this transaction." In so doing, it declined to apply the Kansas cy pres statute to the transaction, finding that the statute did not apply to changes in corporate purposes. Applying the corporate standard in a straightforward fashion, it went on to hold that the business judgment rule required deference to the board's decision to convert, its choice of a buyer, and its evaluation of an appropriate sales price. Likewise, it summarily rejected a challenge to executive compensation arrangements for executives involved in the transaction.

However, despite its invocation of a pure corporate standard, the Health Midwest court could not resist invoking mission-related obligations in reviewing one financially important (and parochial) aspect of the board's decision. The Kansas court struck down the board's decision to pay the sale


193. Health Midwest, 2003 WL 328845, at *19 ("The Kansas cy pres statute governs changes to the purposes of charitable trusts, devises and bequests. The cy pres statute does not apply to changes to the purposes of nonprofit corporations. The cy pres statute applies only to any restricted gifts and not the entity as a whole. No restricted gifts have been identified herein and therefore the cy pres statute does not apply." (citations omitted)).

194. The court observed that "[t]he appropriateness of the packages (even though they appear on their face to be excessive) has no bearing in regard to whether the Agreement should be approved. Health Midwest's decision to approve the compensation is an internal matter of the Missouri company and is subject to review by a Missouri court." Id. at *19.
proceeds into a Missouri foundation, noting that the board had elsewhere concluded that twenty percent of Health Midwest’s assets had previously served Kansas residents. The court made no effort to explain why corporate law analysis including the business judgment rule did not mandate judicial abstention here, except to suggest rather obliquely that mission factors compelled the result.\(^{195}\)

2. Mixed Corporate/Nonprofit Mission Standard

Some courts have more explicitly weighed mission responsibilities in interpreting nonprofit directors’ fiduciary duties. For example, in MEETH the court invoked the duty of obedience to buttress its conclusions that the hospital directors had neglected their obligation to fully consider all options for avoiding closure of the hospital and had not received adequate value in the sale of its assets.\(^\text{196}\) Yet, the court gave little deference to the judgment of the directors and in fact never mentioned the business judgment rule in reviewing the merits of the decision to “monetize the assets” of MEETH for use in what the directors regarded as a more needed and financially viable charitable use. Nor did it explain how the Board was to go about weighing mission and business responsibilities. Similarly, in Queen of Angels, the court was willing to override the business judgment of the hospital board where it interpreted the nonprofit corporation’s mission as commanding unavering allegiance to the continued operation

195. The court stated:

The attorney general . . . has persuaded the Court that the decision to merge into a Missouri Foundation is a “perversion of corporate purpose” and that the Kansas boards have neglected their duties to the communities in their service areas and have breached the trust placed in them. The announced foundation plan does not confirm that Health Midwest’s Kansas subsidiaries’ historic charitable purposes will remain intact following the transaction.

\textit{Id.} at *26.

196. The court noted:

It is axiomatic that the Board of Directors is charged with the duty to ensure that the mission of charitable corporation is carried out. This . . . “duty of obedience” . . . requires the director of a not-for-profit corporation to be “be faithful to the purposes and goals of the organization,” since “[u]nlike business corporations, whose ultimate objective is to make money, nonprofit corporations are defined by their specific objectives: perpetuation of particular activities are central to the raison d’etre of the organization.”

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of a hospital. 197

3. Corporate/Regulatory Policy Standard

Perhaps the most confusing analysis of mission is found in the regulatory context. In its evaluation of the conversion and sale of CareFirst to WellPoint Health Networks, the Maryland Insurance Commissioner applied a multi-pronged regulatory standard to determine whether the transaction satisfied the statute’s broad public interest criteria. 198 The statute gives the Commissioner broad discretion to determine what constitutes due diligence, setting forth eight criteria that may be brought to bear. As discussed above, 199 the Commissioner’s decision at times invoked for-profit fiduciary standards and at others rejected them. Indeed, in one passage, the opinion considered a particularly rigid application of the for-profit standard, inquiring whether the directors of CareFirst had an obligation to accept the highest bid and thus were bound to ignore mission-based considerations in selecting a buyer. Under for-profit corporate law in many states, the Revlon doctrine obligates fiduciaries to act as a broker and accept the highest bid, once the decision to sell is definitive. 200 While application of this rule to nonprofits would be controversial, strict application of corporate fiduciary standards might suggest that in a change of control transaction, a nonprofit board is bound to opt for the best financial offer even though another bidder may offer nonfinancial terms more in keeping with the mission of the nonprofit corporation. 201 Although special counsel vigorously supported applying the

198. The CareFirst decision is discussed supra notes 117-126 and accompanying text; see CAREFIRST CONVERSION INFORMATION, supra note 117, at 5-7.
199. See supra notes 117-26 and accompanying text.
200. Revlon Inc. v. MacAndrews & Forbes Holdings Inc., 506 A.2d 173, 182 (Del. 1985) (holding that once the board of a target company of a takeover bid “no longer faced threats to corporate policy and effectiveness, or to the stockholders’ interests,” their role “changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company.”).
201. In change-of-control transactions, the nonprofit board may seek to achieve nonfinancial objectives. For example it may wish to obtain “capital improvement commitments, access to acute care commitments, preservation of workforce, and preservation of employee benefits.” Peregrine & Schwartz, supra note 179, at 199. For an argument in favor of applying Revlon to nonprofits, see Colin T. Moran, Why Revlon Applies to Nonprofit Corporations, 53 BUS. LAW. 373 (1998).
Revlon Rule, the Maryland Insurance Commissioner concluded it did not need to decide the issue as it found the director’s conduct wanting for failure to exercise “due diligence.”

In other passages, the opinion departed sharply from for-profit fiduciary principles. For example, acknowledging that courts employ the business judgment rule in cases involving directors’ breach of the duty of care, the Commissioner announced that the presumption did not apply in a regulatory context. The opinion deemed the business judgment rule inapposite in an administrative proceeding governed by a broad regulatory mandate. Thus, the Commissioner concluded he had broad latitude to conduct his own de novo review of whether a transaction is in the public’s interest.

IV. THE ELUSIVE SLIDE FROM A FIDUCIARY TO CHARITABLE TRUST STANDARD

Part III establishes that the strict importation of for-profit corporate law principles and applying mixed for-profit and nonprofit mission or regulatory policy standards is inefficacious in the nonprofit health care enterprise context. This Part argues that the invocation of charitable trust principles, either directly or implicitly, is fundamentally unsound. It contends, first, that doctrinal developments militate strongly against applying charitable trust standards except where an express trust exists. Although some states have chosen to buck the trend and retain a broad charitable trust standard for their nonprofits, courts and attorneys general should take care to recognize that those are sui generis cases owing to their statutory law. Further, there is no reason to believe that these states’ approaches advance sound public health care policy.

Next we argue that conceptually, charitable trust law, which assumes an identifiable settlor, beneficiaries, and trust purpose, is ill-suited to the nonprofit corporation. We also find that in stretching the law governing charitable trusts beyond recognition, attorneys general have undertaken a wholly impractical and ad hoc course. There are reasons to believe that rigid application of charitable trust principles will undermine sound health policy aimed at maintaining a health care delivery system sufficient to meet the nation’s needs. By the same token, these efforts make it impossible for nonprofit boards to have any clear sense of what power they have to direct the corporate mission in a way that is market-responsive, or to deploy assets consistent with a long-term strategic plan.

202. See supra note 124 and accompanying text.
Finally, we conclude that by blending charitable trust and corporate fiduciary law in their oversight of nonprofit board decision-making, attorneys general and other charity regulators have opportunistically capitalized on doctrinal confusion in this area. While acknowledging that corporate law requires some development to regulate the nonprofit sector well, we conclude that it is unquestionably the better doctrinal starting point. Specifically, nonprofit corporate doctrine should explicitly recognize the centrality of mission to the charitable enterprise, and presume that directors are best situated, at least in the first instance, to advance the corporation’s mission. Recognition of directors’ superior expertise and dedication to mission preservation would hopefully ameliorate the trends described in this Article that counter policies uniquely important in the health care sector and that may have a particular deleterious impact on long-term access to appropriate health care in many communities. That is, by inappropriately interfering with directors’ responsibility to balance mission and margin, the vibrant and creative impact of the health care sector may be seriously impeded. Further, it may hamper the efficient reorientation of segments of the sector, such as redeployment of charitable assets and conversion to for-profit form. Finally, by broadly invoking various policy concerns that implicate federal tax law, state licensure and access statutes, and health care fraud law in their state law analyses, attorneys general usurp power, distort policy, and subject entities to inconsistent application of these laws.

A. The Impact of the Adoption of Modern Nonprofit Statutes

Approximately twenty-nine states have adopted all or part of the Revised Model Nonprofit Corporation Act (RMNCA) or its predecessor. In retrospect, it seems surprising that the RMNCA does not more helpfully address the issues associated with the most distinctive aspect of the charitable corporation, its nonprofit mission. Like most nonprofit statutes, it requires that a nonprofit corporation have a public benefit, religious, or mutual benefit purpose. At the same time, most states adopting modern nonprofit statutes are relatively clear that corporate law standards generally apply in these matters. Problems arise, however, because the RMNCA and most state nonprofit acts do not address the extent to which public benefit,

203. The original model act was adopted in 1942, but did not address directors’ duties; the revised model act was adopted in 1987. See James Edward Harris, The Nonprofit Corporation Act of 1993: Considering the Election To Apply the New Law to Old Corporations, 16 U. ARK. LITTLE ROCK L. REV. 1, 3 n.11 (1994).

204. REVISED MODEL NONPROFIT CORP. ACT § 2.02(a)(2) (1987).
mutual benefit, and religious purposes may alter the frame of analysis applied by directors in exercising their fiduciary duties or by courts in assessing their conduct. As we have seen, this gap has been only episodically addressed by courts and has invited attorney general activism in the form of transporting charitable trust law to fill the void. It should be noted that a few states, such as Illinois, New Hampshire, and Virginia, have gone in an entirely different direction, enacting statutes that explicitly impose a charitable trust upon the property of nonprofit corporations. While this approach unquestionably gives courts and attorneys general clear and significant authority over mission decisions by nonprofit boards, the law of other states should not be read to vest such discretion. We survey and analyze below the state statutory approaches to the issue.

1. Model Nonprofit Corporation Act States

Most states apply corporate law principles to charitable corporations, either by judge-made law or the adoption of all or part of the Model Nonprofit Corporation Act. This "modern trend" of significantly

205. Mission is little addressed by either the Model Act or the common law. It has long been assumed that a board may alter its mission by amending its articles of incorporation. The process is rather uncomplicated; the Revised Model Act provides that a "corporation may amend its articles of incorporation at any time to add or change a provision that is required or permitted in the articles or to delete a provision not required in the articles." Id. § 10.01. Nowhere is it suggested that such amendments may not affect the corporate purposes.

206. The following states' nonprofit corporate statutes are based upon the Model Act adopted in 1964: ALA. CODE §§ 10-3A-1 to -225 (1999); ALASKA STAT. § 10.20.005 (Michie 2002); ARIZ. REV. STAT. ANN. §§ 10-3301 to -3304 (West 2004); CAL. CORP. CODE §§ 5510-27 (West 1990); COLO. REV. STAT. §§ 7-123-101 to -137-204 (1999); D.C. CODE ANN. §§ 29-301.01 to -321.01 (2001); GA. CODE ANN. §§ 13-8-101 to -1703 (Harrison 2003); IOWA CODE ANN. §§ 504A.1 to .101 (West 1999); KY. REV. STAT. ANN. §§ 273.070-.991 (Michie 2003); ME. REV. STAT. ANN. tit. 13B, §§ 101-110 (West 1981); MINN. STAT. §§ 317A.001-.909 (2004); MO. REV. STAT. §§ 355.001-.881 (2001); MONT. CODE ANN. §§ 35-2-115 to -1402 (2003); NEB. REV. STAT. §§ 21-1901 to -19,177 (1997); NEV. REV. STAT. 82.006-.546 (1999); N.M. STAT. ANN. §§ 53-8-1 to -99 (Michie 2001); N.C. GEN. STAT. §§ 55A-1-01 to -17-05 (2003); N.D. CENT. CODE §§ 10-33-01 to -147 (2003); OR. REV. STAT. §§ 65.001-.990 (2003); 15 PA. CONS. STAT. ANN. §§ 5101-6145 (WEST 1995); S.D. CODIFIED LAWS §§ 47-22-1 to -78 (Michie 2000); TEX. REV. CIV. STAT. ANN. art. X § 1396-1.01 to 1396-11.01 (Vernon 2003); UTAH CODE ANN. §§ 16-6a-101 to 16-6a-304 (2001); VT. STAT. ANN. tit. 11B, §§ 1.01-17.05 (1997); WASH. REV. CODE §§ 24.03.005-.925 (1994); W. VA. CODE ANN. §§ 31E-1-101 to -15-1520 (Michie 2003); WIS. STAT. §§ 181.0103-1703 (2002). The following states' statutes are based upon the 1987 Revised Model Nonprofit Corporation
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displacing trust law with corporate law was famously articulated in Stern v. Lucy Webb Hayes National Training School.207

The charitable corporation is a relatively new legal entity which does not fit neatly into the established common law categories of corporation and trust. . . . [T]he modern trend is to apply corporate rather than trust principles in determining the liability of the directors of charitable corporations, because their functions are virtually indistinguishable from those of their “pure” corporate counterparts.208

As we have seen, a number of more recent opinions like Health Midwest have followed Stern and applied the corporate standard rejecting categorical attempts to import charitable trust law to guide evaluations of directors’ decisions:

The Kansas cy pres statute governs changes to the purposes of charitable trusts, devises and bequests. The cy pres statute does not apply to changes to the purposes of nonprofit corporations. The cy pres statute applies only to any restricted gifts and not the entity as a whole (citation omitted). No restricted gifts have been identified herein and therefore the cy pres statute does not apply.209

Consistent with the common law trend, the Revised Model Nonprofit Corporation Act of 1987 adopted virtually the same fiduciary duty standard applicable to business corporations210 and specifically rejected the stricter

208. Id. at 1013. As far back as 1967, a New Jersey court observed that the hospital was a charitable corporation, governed by the law applicable to charitable corporations which is rooted partially “in the law of trusts, to some extent in the law of corporations; to some extent it may partake of both or indeed be sui generis.” Paterson v. Paterson Gen. Hosp., 235 A.2d 487, 489 (N.J. Super. Ct. Ch. Div. 1967). Thus, although the court did not say that the board had unlimited discretion to deviate from its charter, it clearly and ultimately viewed the case as subject to the law governing nonprofit corporations, as opposed to trusts. Id. at 489. Delaware followed suit, repeatedly affirming that charitable corporations are subject to corporate rather than trust law. Oberly v. Kirby, 592 A.2d 445, 467 (Del. 1991). The court further noted that philanthropists understand the difference between a trust and nonprofit corporation when they make their gifts, and when they use the corporate form, they “invoke the far more flexible and adaptable principles of corporate law.” Id.
210. Section 8.30 of the Revised Model Nonprofit Corporation Act adopts the standard

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trust standard. Thus, for purposes of assessing liability of corporate directors, the Revised Act and most state nonprofit corporation laws apply the corporate standard discussed earlier.

It must be acknowledged that the RMNCA is not without ambiguity. While it is clear that the Revised Act was designed to shift the standard applicable to the nonprofit director from the trust to business standard, the Act suggests the possibility that the corporation, as distinct from the director, may continue to be subject to state common law that applies trust rules to the property held by the nonprofit corporation. Several state attorneys general have exploited this uncertainty to apply a different standard to the regulation of the assets of nonprofit corporation, as opposed to imposition of director liability.

That corporate law governs directors' fiduciary duties, but trust law would govern their power to manage charitable assets, makes little sense of conduct almost identical to that of the Revised Model Business Act:

> [D]irector shall discharge his or her duties as a director, including his or her duties as a member of a committee: (1) in good faith; (2) with the care of an ordinarily prudent person in a like position would exercise in similar circumstances; and (3) in a manner the director reasonably believes to be in the best interest of the corporation.

REvised Model Nonprofit Corp. ACT § 8.30 (1987); see Moody, supra note 134, at 275 (noting that section 8.30 “clearly settles the dispute as to whether directors of nonprofit corporations should be held to the standard of the director of a business corporation or the standard of a trustee”). See generally Peregrine & Schwartz, supra note 158 (general standard for directors of for-profit and nonprofit corporations same in almost all states).

211. Section 8.30 of the Revised Act sets for the general standards of conduct for nonprofit board directors: A director shall not be deemed to be a trustee with respect to the corporation or with respect to any property held or administered by the corporation, including without limit, property that may be subject to restrictions imposed by the donor or transferee of such property. REvised Model Nonprofit Corp. ACT § 8.30(e) (1987).

212. See generally Peregrine & Schwartz, supra note 179, at 185 (explaining that the Revised Model Act tracks directors' duties articulated in the Model Business Corporation Act).


214. REvised Model Nonprofit Corp. ACT, § 8.30 cmt. 1 (1987). Several states that have substantially adopted the Revised Act have not adopted 8.30(e), thereby leaving open the question of how the relationship between statutory and common law applies to the nonprofit director. Some commentators advance this interpretation as well. See Frost, supra note 177, at 946; Singer, supra note 68, at 237; cf. 1 Phelan, supra note 213, § 4:02 ("The charitable corporation is a relatively new legal entity that does not fit neatly into the established common-law categories of corporation or trust.")
doctrinally or analytically. The drafters of the Model Act clearly intended to recognize nonprofits as corporations, and to regulate them as such. While the corporate law model has its deficiencies, it is unquestionably superior, both analytically and practically, to a charitable trust approach to governing nonprofits. States can more easily tailor corporate law to the unique aspects of the nonprofit sector either statutorily or, for example, by differently articulating the business judgment rule. Because only a handful of states had common law one way or the other addressing the relationship of trust law to the assets of nonprofit corporations before the enactment of nonprofit corporate statutes, clarifying the law should not be difficult. Most state courts facing this issue today are doing so for the first time. The corporate standard of governance facilitates the articulation of clear parameters within which nonprofit boards may alter the corporate mission, which power is essential to the functioning of commercial not-for-profits. This result is consistent with the comments to the Revised Model Act, which merely leave open the possibility that trust law would still apply to charitable assets.

2. Nonprofit Corporate Law and Quasi-Cy Pres

New York has sought a middle ground between the corporate standard and charitable trust law. Yet, New York law makes clear that even states that have attempted to address the unique characteristics of the nonprofit form have not avoided activism by the attorney general or confusing guidance from the courts on the scope of board autonomy to direct mission.

New York clearly subscribes to corporate law principles in the governance of the charitable corporation. Unlike most states, however, it also addressed the ownership and mission questions unique to the charitable corporation by rejecting the concept that the assets of a nonprofit corporation operate under legal regimes designed for traditional for-profit corporations. However, fundamental structural differences between not-for-profit corporations and for-profit corporations render this approach incapable of providing effective internal mechanisms to guard against directors' improvident use of charitable assets. For example, in the for-profit context, shareholder power ensures that Boards make provident decisions, while in the not-for-profit context, this internal check does not exist. To put it another way, a nonprofit corporation has no "owners" or private parties with a pecuniary stake to monitor and scrutinize actions by the directors.

Manhattan Eye, Ear & Throat Hosp. v. Spitzer, 715 N.Y.S.2d 575, 592 (Sup. Ct. 1999). Both the attorney general and a court must be involved in the disposition of substantially all of the nonprofit's assets, "to ensure that the interests of the ultimate beneficiaries of the
nonprofit that accrue from a gift are subject to a trust;216 requiring notice to the attorney general, and court approval, whenever an amendment to the articles of incorporation affects the corporate purposes or powers;217 recognizing the duty of obedience; and treating the disposition of assets upon dissolution under a process that the courts refer to as quasi-cy pres.218 As conceptualized by the MEETH court, “A charitable Board is essentially a caretaker of the not-for-profit corporation and its assets. As caretaker, the Board ‘ha[s] the fiduciary obligation to act on behalf of the corporation . . . and advance its interests.’”219

Despite its attempts to affirmatively deal with the unique characteristics of the nonprofit form, New York law fails to articulate a clear definition of mission or the extent to which the board may alter the nature of the nonprofit’s business while still remaining faithful to that mission. Consequently, courts’ conflicting signals about the scope of the attorney general’s power over charities has created uncertainty for nonprofit boards. For example, the MEETH board asserted that its strategic plan was not a new or different mission, and consequently sought to implement its planned transition to out-patient services without amending its articles of incorporation; this approach dispensed with any requirement of obtaining court approval of a change in purpose. The court disagreed with MEETH’s view on the scope of its mission, of course,

corporation, the public, are adequately represented and protected from improvident transactions.” Id. Further, the MEETH court observed that the legislature imposed a higher standard of care upon the director of the nonprofit. Id. at 593.

216. N.Y. NOT-FOR-PROFIT CORP. LAW § 513(a) (McKinney 1997). Subsection b adds: “Except as may be otherwise permitted under article eight of the estates, powers and trusts law or section 522 (Release of restrictions on use or investment), the governing board shall apply all assets thus received to the purposes specified in the gift instrument.” Id. § 513(b). The legislative history elucidates: “[t]he board is under a duty to apply such funds in accordance with the directions of the donor, but within the framework of the corporation law rather than the trust law.” Alco Gravure v. Knapp Found., 490 N.Y.S.2d 116, 121 n.7 (1985) (quoting Memorandum of the Joint Legislative Committee to Study Revision of Corporation Laws (Jan. 13, 1969)).

217. N.Y. NOT-FOR-PROFIT CORP. LAW § 804 (a) (ii) (McKinney 1997).


but more troubling is that the court’s analysis fails to guide other charitable corporations making significant changes that arguably fall within the original mission.

The MEETH court also invoked the duty of obedience, declaring that “the duty of obedience, perforce, must inform the question of whether a proposed transaction to sell all or substantially all of a charity’s assets promotes the purposes of the charitable corporation when analyzed under section 511.” The court treated the proposed MEETH transaction as analogous to a conversion, “inasmuch as in both there is a charitable organization which alleges that it is incapable of continuing its primary mission of operating a hospital, seeks approval of the sale of all its assets, and plans to apply the sale proceeds towards a newly revised mission.” In applying the duty of obedience, the court characterized its role as ensuring that nonprofit boards are “faithful to the purposes and goals of the organization”—nonprofits are not ultimately about making money, but about the “perpetuation of [the] particular activities [that] are central to the raison d’être of the organization.” The court also held that the duty of obedience mandates that the board depart from its core mission only as a “last resort.” While this court’s interpretation of the duty of obedience seems more liberal than that embodied by charitable trust law, it certainly was not so in application to the facts of the MEETH case, and resulted in a much different outcome than Littauer, which did not invoke the duty of obedience.

Quasi-cy pres is also intended to ensure fidelity to mission, by requiring boards to dispose of charitable assets upon dissolution to entities that will subscribe to the dissolving corporation’s original purpose. As interpreted by New York’s highest court, quasi-cy pres is less restrictive than the charitable trust cy pres concept. It:

accords greater authority to the corporation’s board of directors and the courts than governs the distribution of the assets held by a trustee under a will or other instrument making a disposition for charitable purposes... or than was the cy pres standard at

220. According to the MEETH court, the duty of obedience had only been previously raised in breach of duty situations, and never in the context of the sale of assets. 715 N.Y.S.2d at 593.
221. Id.
222. Id. at 594 (emphasis added).
223. Id. at 593.
224. Id. at 595.
common law ("as nearly as possible").

Interestingly, however, MEETH was not dissolving. Rather, the board sought to monetize the hospital facility to enable it to establish clinics. Thus, the court appears to have taken some liberties in its invocation of the cy pres doctrine. This is, of course, consistent with the trend of other states employing charitable trust principles to strengthen their ability to second-guess nonprofit boards.

By contrast, and further confusing the matter of what constitutes a mission change, the Littauer court held that a change in corporate membership, which the attorney general characterized as a disposition of assets, was not a change in the underlying purpose, nor the overall business purpose, of the hospitals. The court observed: "Plainly, the statute is designed to require prior court approval only in instances where the proposed amendment truly seeks to change the nature, object or powers of a particular corporation." The court also rejected amici arguments that a requirement of compliance with the Catholic Ethical and Religious Directives in addition to the articles of incorporation constituted a curtailment of corporate powers requiring judicial approval. The court distinguished between corporate powers and purposes, and the services the

226. In re Multiple Sclerosis Serv. Org., 68 N.Y.2d 32, 35 (1986). The Court of Appeals further stated:

Under the quasi cy pres standard of the Not-For-Profit Corporation Law, a Supreme Court Justice in determining whether to approve the plan of distribution proposed by the corporation's board, and if not to what other charitable organizations distribution should be made, should consider (1) the source of the funds to be distributed, whether received through public subscription or under the trust provision of a will or other instrument; (2) the purposes and powers of the corporation as enumerated in its certificate of incorporation; (3) the activities in fact carried out and services actually provided by the corporation; (4) the relationship of the activities and purposes of the proposed distributee(s) to those of the dissolving corporation, and (5) the bases for the distribution recommended by the board.

Id.


228. 287 A.D.2d at 204; see also supra notes 77-81 and accompanying text.

229. Id. at 205.
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entity actually provides, stating: "the decision to delineate in a restated certificate of incorporation a specific or potential restriction upon the services to be provided by the corporation is not the functional equivalent of altering the corporation's underlying purpose or curtailing its power to achieve its overall objectives." In sum, then, the New York statute's attempt to regulate boards' oversight of the nonprofit mission has, in the courts' hands, generated confusion without promoting attention to the role of mission. Since charitable corporations pursuing a dynamic strategic plan are likely to avoid court intervention, of greater relevance to the daily operation of the charitable corporation is the wide gulf between the attorney general's and nonprofit sector's concept of the scope of an entity's mission, and what actions comprise a change to mission requiring judicial approval.

3. **Statutory Charitable Trust States**

As noted above, Illinois and New Hampshire have long been clear in their treatment of the nonprofit corporation—nonprofit assets are subject to charitable trust by virtue of statute. Virginia has just recently joined this statutory charitable trust group. This Subsection will focus its discussion on New Hampshire, where the attorney general has asserted his statutory charitable trust power over the health care industry quite aggressively.

New Hampshire law specifically delineates "health care charitable trusts," to include health care providers and payors. As a result, the New

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230. *Id.* at 207.

231. **RESTATEMENT (THIRD) OF TRUSTS** § 10 cmt. b, at 198 (Tentative Draft No. 1, 1996). The examples and illustrations included in the draft, however, are dissimilar to the scenarios presented here. An Illinois appellate court, applying the state's Charitable Trust Act in *Riverton Area Fire Prot. District v. Riverton Volunteer Fire Dep't*, 566 N.E.2d 1015 (Ill. App. Ct. 1991), held that a not-for-profit corporation held its assets as trustee of a charitable trust; no trust documents were required to evidence the creation of the trust, rather, the court observed, "charitable trusts are remedial and created by statute." *Id.* at 1019.

232. 2002 Va. Acts. ch. 792, § 2.2-507.1 (codified as amended at VA. CODE ANN. § 2.2-507.1 (Michie 2004)). The next section of the act gives the courts the same subject matter jurisdiction over the assets of the charitable corporation as they have over the assets of a charitable trust. *Id.* § 17.1-513.01 (codified as amended at VA. CODE ANN. §17.1-513.01 (Michie 2004)).

Hampshire Attorney General’s opinion letter in Optima Health, in which he demanded the “unmerger” of two hospitals was, in the abstract, legally sound. From a public policy perspective, however, we argue against states statutorily imposing a trust on nonprofit assets. As discussed throughout this Article, characterizing nonprofit holdings as trust assets devalues those assets, making it significantly more difficult for nonprofits to partner and obtain access to affordable capital. The New Hampshire Attorney General’s devolution of the Optima deal would certainly make any potential affiliate think twice before partnering with an entity incorporated in a charitable trust state. Further, it is wholly unclear whether and how the Attorney General’s opinion accounted for the health policy questions implicated by the hospitals’ merger.

The New Hampshire Attorney General’s response to the Optima merger was dramatic and has become a significant example of the potential of an attorney general to require cy pres proceedings to ensure, as conceived by the attorney general, that the charitable corporation abides by the articulated purposes of the corporation. The Optima opinion has also become “seminal” for other states because it not only relies upon the New Hampshire Charitable Trust Act, but also comprehensively brings together charitable trust common law from across the country. For precisely this reason, the opinion has contributed significantly to the current doctrinal confusion regarding the application of trust law to nonprofit assets. Optima relies upon California common law, Illinois statutory charitable trust cases, and express charitable trust cases, without explaining the doctrinal distinctions between the law of states that are “statutory charitable trust states” and those that are not, or the inapplicability of express trust cases to most nonprofit health care

234. N.H. DEP’T OF JUSTICE, supra note 10. The multi-hospital merger, in its inception, was the product of a 1994 deal between Elliot Hospital and the Catholic Medical Center (CMC). Id.

235. Specifically, the Attorney General observed that “[a]lthough a charitable corporation may not be governed as a trust in every respect, courts have held that the assets of a charitable corporation are impressed with a charitable trust that restricts the use of the assets to the defined purposes of the corporation.” N.H. DEP’T OF JUSTICE, supra note 10.

236. Footnote 10 of the Attorney General’s opinion, id., is a string cite of a collection of charitable trust cases virtually identical to footnote 7 in ROBERT A. BOISTURE & DOUGLAS N. VARLEY, STATE ATTORNEYS GENERAL’S LEGAL AUTHORITY TO POLICE THE SALES OF NONPROFIT HOSPITALS AND HMOs (1995), http://www.volunteertrustees.org/legal.html (describing attorneys general’s authority to use charitable trust doctrine against hospitals). These cases are much more nuanced than either report concedes.
Finally, *Optima* is a very hard case from a public policy perspective. There is no question that the Attorney General was responding to the community's unhappiness with the merger, which resulted from application of the Catholic Ethical and Religious Directives to the new entity, the elimination of acute care services at one of the campuses, and finally, Optima's 1997 decision to affiliate with out-of-state Covenant Health Systems, itself a Catholic multi-state hospital system. The community also felt misled by the hospital leaders about what the implications of the transaction would be. This is not at all atypical, and captures why, as a doctrinal matter, questions of nonprofit ownership, mission accountability, and satisfaction of the beneficiaries remain unresolved. Every community wants to retain its hospital, ideally, with the most up-to-date technology and a full panoply of services. These aspirations are frequently inconsistent with what the providers in the community can financially sustain, and what, from a public policy perspective, represents a responsible allocation of resources. So, the question becomes who dictates how the assets of the nonprofit provider are best used—the board, the community, or some arm of the state (the attorney general, the department of health, or a court). The *Optima* opinion does not engage the full scope of these issues, and is therefore poor precedent for their resolution.

Ultimately, Optima Health was dissolved at a cost of ten million dollars, and the two hospitals returned to their original independence. Whether the outcome was worth the price is probably impossible to ever determine.


238. That few people seemed to understand the implications of the Ethical and Religious Directives bolstered the Attorney General's argument that the new entity's mission was unclear and inconsistent with both of the predecessor organizations. Notably, the Attorney General expressed significant concern that, in his view, Optima was disregarding CMC's traditionally commitment to religious health care and was potentially violating the Ethical and Religious Directives in its delivery of health services at the newly established acute care facility. N.H. DEP’T OF JUSTICE, *supra* note 10.

B. Attorneys General’s Attempts To Integrate Charitable Trust Doctrine with Nonprofit Corporate Law

I. Attorneys General’s Activism

As cases discussed in this Article reveal, attorneys general who find current law inadequate to accomplishing their goals of increased oversight of nonprofit boards are attempting to strengthen their power with a reinvigorated charitable trust law blended with corporate analyses whenever possible. In most cases, the attorneys general assert that the legislatures’ enactment of statutes clearly applying corporate principles to nonprofits did not wholly displace pre-existing common law applying trust principles to not-for-profits. In some instances, attorneys general have had to import the charitable trust law upon which they are relying from other states. We explore in this Section the attorneys general’s use, or misuse, of common law to accomplish these ends. California common law is an extremely important source for the proposition that the assets of a charitable corporation comprise a charitable trust, subject to the oversight of the state attorney general, and limited to the purposes articulated in the articles of incorporation. In 1964, the California Supreme Court, in *Holt v. Coll. of Osteopathic Physicians & Surgeons* directed that “charitable contributions must be used only for the purposes for which they were received in trust.” A decade later, a California appellate court precluded Queen of Angels Hospital from closing its hospital and converting its assets to the operation of health clinics. The primary purpose for which Queen of Angels was organized, argued the attorney general, was the operation of a hospital, and that is what it must do, as long as it remains in existence. It is highly uncertain whether these cases remain good law in California. In 1980, California adopted a nonprofit corporate act, which became the model for the ABA’s Revised Model Nonprofit Corporation Act. In so doing, the California legislature applied corporate fiduciary duties to nonprofit directors, and, like New York, incorporated some charitable trust concepts with respect to nonprofit corporate assets. Whether the California statute occupies the entire field of nonprofit governance, or whether some vestiges of the pre-1980 common law remain

viable, is an unanswered question in California.\textsuperscript{244} This question is not unique to California, of course. The relevance of trust-based common law after a state’s enactment of a nonprofit corporate statute must be considered in every state.

Taking advantage of the doctrinal ambiguity, attorneys general have argued four different cases for subjecting the assets of a nonprofit hospital corporation to a charitable trust: that assets acquired from general donations are subject to a trust; that assets intermingled with acquisitions resulting from general donations cannot be separated, thereby necessitating that all of the charities’ assets be subject to a trust; that a consequence of tax exemption is the imposition of a trust on the nonprofit’s assets; and that restricted gifts are subject to a trust. Only the last of which, restricted gifts, finds support in the doctrine of traditional trust law. Restricted gifts comprise what is generally understood to be charitable trust property, irrespective of whether the donor uses the designation “charitable trust”:\textsuperscript{245} The donor gives money or property for a very specific articulated use by the corporate recipient. The property is subject to a trust,\textsuperscript{246} with the corporation as trustee.\textsuperscript{247} Thus, it is uncontroversial that if a nonprofit hospital corporation is sold, converts, or dissolves, it must treat separately any trust property it received during its existence, ensuring that in its capacity as trustee, it is faithful to the settlor’s intent.

The disputes between states and hospitals arise from attorneys general’s use of charitable trust law more expansively, by asserting that all of the assets of the nonprofit corporation are subject to a trust. This

\textsuperscript{244} Our thanks to James Schwartz for helping us sort through the morass that California law appears to be to a New Yorker.

\textsuperscript{245} Property held by a charitable corporation is subject to a charitable trust most typically when the donor attaches conditions to a gift. “A disposition to [a hospital or university] for a specific purpose, such as to support medical research, perhaps on a particular disease, or to establish a scholarship fund in a certain field of study, creates a charitable trust of which the institution is the trustee for purposes of the terminology and rules of this Restatement.” \textit{Restatement (Third) of Trusts} § 28 cmt. a (2003).

\textsuperscript{246} In New York, pursuant to the not-for-profit corporate statute, the corporation would not become a trustee or be subject to charitable trust law, but corporate law. Nonetheless, if the corporation receives a gift with conditions, or that uses trust language, it is bound by the intentions of the donor, unless it undergoes a \textit{quasi-cy pres} proceeding. \textit{See} Alco Gravure, Inc. v. Knapp Found., 479 N.E.2d 752, 757 n.7 (N.Y. 1985).

\textsuperscript{247} The members of the board of directors are not trustees, in the strict sense, however, because they do not hold title to the property of the corporation. \textit{Restatement (Third) of Trusts} § 5 cmt. g (2003).
assertion takes three different forms, none of which charitable trust law supports. The first form of the argument posits that whatever is acquired by general donations to the hospital becomes property subject to a trust because donors expected and understood that their gifts would be used for and by the recipient hospital. This argument is wrong; outright donations to a charity, particularly those solicited in connection with a campaign or fund-raising event, simply do not satisfy the prerequisites for the establishment of a trust. A slight variant of this first argument is that the assets owned by a charitable corporation with restrictions on use articulated in its articles of incorporation are subject to a constructive charitable trust, protecting them from a non-compliant use. Though not

248. See, e.g., Banner Health Sys. v. Long, 663 N.W.2d 242, 247 (S.D. 2003). In Banner Health, although the court rejected the Attorney General's argument that an implied charitable trust resulted from donations made to support the corporation's general purposes, it did recognize the possibility of a constructive trust if "Banner was unjustly enriched by the sale of the assets and removal of the proceeds from the local communities at the expense of those communities..." Id. at 248. The court then suggested that if indeed the facts support the finding of a constructive charitable trust, the directors could be in breach of their fiduciary duties for having used the trust property in a manner adverse to the interests of the beneficiaries. Id. at 249; see also supra notes 99-107 and accompanying text.

249. See, e.g., Nat'l Found. v. First Nat'l Bank, 288 F.2d 831, 834, 836 (4th Cir. 1961) (finding that donations made to a local chapter of National Foundation in response to a general appeal did not constitute a charitable trust to the local chapter, but rather were an unrestricted gift to National Foundation); Persan v. Life Concepts, Inc., 738 So. 2d 1008 (Fla. Dist. Ct. App. 1999) (making a gift to a charity for a specific purpose does not create a charitable trust; creation of trust must be express, with intent established beyond a reasonable doubt); United Methodist Church v. Bethany Med. Ctr., 969 P.2d 859 (Kan. 1998) (not a case where originating donor created a trust but rather a situation where five Methodists incorporated for the purpose of collecting donations for a hospital but no single donor, including the church, acted as a trust settlor); see also 76 AM.JUR. 2D § 141 (2004). This outcome is consistent with the Restatement of Trusts: "An outright devisee or donation to a nonproprietary hospital or university or other charitable institution, expressly or impliedly to be used for its general purposes, is charitable but does not create a trust as that term is used in this Restatement." RESTATEMENT (THIRD) OF TRUSTS § 28 (2003).

The distinction between a trust and an unrestricted gift is controlled by the intention of the donor to impose enforceable duties upon the recipient. See 15 AM. JUR. 2D § 120 (2004); see also Eychaner v. Gross, 747 N.E.2d 969 (Ill. App. Ct. 2001) (resolving dispute as to whether university evidenced intent to place in trust with theater council either theater building or intangible interests in maintaining the theatre), rev'd, 779 N.E.2d 1115 (Ill. 2002).

250. See, e.g., Banner, 663 N.W.2d at 250. This result occurs from a convoluted combination of trust and statutory analysis, and depends upon a finding that non-members'
doctrinally grounded, the rationale advanced for this position is not unappealing: that "[a]ny other rule of law would allow a charitable nonprofit corporation to eviscerate the charitable purpose for which it was formed without recourse for those who donated funds for that purpose." A response to this argument is that a donor committed to the perpetual mission of her designated charity might have protected her intent by creating a trust; that she did not subjects her to the risk of a charitable board taking the entity in a new direction.

The second argument in favor of imposing a charitable trust on the entire assets of a nonprofit corporation assumes that, because it is impossible to separate out assets acquired from general fund-raising (which are wrongly designated trust assets by this analysis) from non-donated assets, all assets must be treated as subject to a trust. The adage that "two wrongs don’t make a right" comes to mind. Third, attorneys general posit that nonprofit hospital assets that are under-written by the government through tax exemptions and payments by government health plans should be subject to a trust. This sweeping approach is free-floating social policy masquerading as trust law.

The attorneys general in North Dakota, South Dakota, and New Mexico all attempted to use charitable trust principles to block Banner's removal of the proceeds from Banner's liquidation of its assets in their respective states. Recall that Banner is a multi-state health care system that sold its holdings in North Dakota, South Dakota and New Mexico so that it

rights are affected by the elimination of the restrictions. Id. at 248-49. Such would unlikely succeed in a state whose nonprofit corporate statute does not resemble North Dakota's.

251. Id. at 250.

252. This "implied trust" argument is also explained as a "base capital" concept—that the originally donated assets facilitated the generation of other assets or value, such that the entire body must be subject to trust. See Coffey et al., supra note 102, at 4. A Massachusetts case represents a situation where the hospital was originally founded as a result of a trust and whose assets were later indistinguishable from subsequent gifts. Att'y Gen. v. Hahnemann Hosp., 494 N.E.2d 1011, 1021 (Mass. 1986) (finding that where assets of a charitable trust dedicated to the operation of homeopathic hospitals are so intertwined with other hospital funds, the board would violate fiduciary duties if it dedicated funds from the trust, or funds donated prior to the change in corporate purpose by donees who understood the purpose to be governed by the trust, to a new purpose).

253. See Horwitz, supra note 5, at 1347; see also Coffey et al., supra note 102, at 5 (observing that the South Dakota Supreme Court did not address the contention that the taxes not paid by the hospitals enable them to enhance their value). The North Dakota trial court rejected the argument that by accepting tax benefits, a nonprofit corporation converted to a charitable trust. Id.
could concentrate its operations in and around Colorado and Arizona. The attorneys general sought to limit Banner's ability to liquidate its holdings and move the proceeds by establishing the existence of a constructive or implied trust. They relied on two now familiar arguments: first, that the donations, and possibly the entirety of the hospital's assets, particularly from local citizens, were intended for the community hospital, and not the larger corporation, and therefore created a trust for the benefit of the community; second, that the tax benefits obtained through the hospitals' exemption created a trust of which taxpayers are the beneficiaries—otherwise, unjust enrichment would result from the hospitals' retention of the value of the benefits accruing from tax forgiveness.254

In the only case that actually produced a court opinion, the attorney general of South Dakota convinced the South Dakota Supreme Court to integrate charitable trust law with the state’s nonprofit corporation act, producing a legal precedent which is doctrinally flawed and impossible to apply. While the South Dakota Supreme Court agreed that nonprofits are subject to the state’s nonprofit corporate statute, it also held that the corporate statute did not supersede the law of charitable trusts.255 Thus, the court concluded that it may be necessary to impose a constructive charitable trust on the hospital assets to protect donors.256 Finally, the court suggested that if the attorney general could establish that Banner was in a fiduciary relationship with the various communities it served, pursuant either to trust law or the general common law governing fiduciary relationships, Banner's decision to sell its facilities may have breached its duties as a fiduciary.257

The South Dakota Supreme Court correctly rejected any possibility that charitable corporate assets are subject to an express trust258—the

254. See id.
255. Banner Health, 663 N.W.2d at 247. The court specifically sought to preserve the relevance of the following statutory language preserving a court's ability to employ the implied trust device when equity so requires:

The enumeration in §§ 55-1-7 to 55-1-10, inclusive, of cases wherein an implied trust arises does not exclude or prevent the arising of an implied trust in other cases nor prevent a court of equity from establishing and declaring an implied, resulting, or constructive trust in other cases and instances pursuant to the custom and practice of such courts.

Id. at 246-47 (quoting S.D. CODIFIED LAWS § 55-1-11 (Michie 2004)).
256. Id. at 249.
257. Id.
258. RESTATEMENT (THIRD) OF TRUSTS § 27 (2003) provides that a trust may be created for
specific elements of an express trust are absent.\textsuperscript{259} Without further explication, the Supreme Court recognized the possibility of an implied trust "based on theories of unjust enrichment, breach of fiduciary duties, and improper amendment of the charitable corporation's articles of incorporation."\textsuperscript{260} This outcome is unsupported by precedent. The imposition of a charitable trust as a result of tax-exemption\textsuperscript{261} and fund-raising finds no support in charitable trust doctrine. The literature states that charitable trusts result only from express and not implied trusts.\textsuperscript{262} Further, the law has been clear that unrestricted charitable donations do not create a trust,\textsuperscript{263} donations to hospitals, particularly those solicited in connection with a campaign or fund-raising event, do not satisfy the private or charitable purposes, or a combination thereof. \textsc{Restatement (Second) of Trusts} § 372 (1959) provides that "[a] trust for the promotion of health is charitable." \textit{See also \textsc{Restatement (Third) of Trusts} § 28(d) (2003).} For an historic overview of the development of the legal recognition and treatment of charitable trusts in the United States, see Nina J. Crimm, \textit{A Case Study of a Private Foundation's Governance and Self-Interested Fiduciaries Calls for Further Regulation}, 50 Emory L.J. 1093, 1098-1133 (2001).

259. Property held by a charitable corporation is subject to a charitable trust most typically when the donor attaches conditions to a gift, whether or not she explicitly designates that it be held as a charitable trust. \textsc{Restatement (Third) of Trusts} § 13 (2003) ("The manifestation of intention requires an external expression of intention as distinguished from undisclosed intention. There may, however, be a sufficient manifestation of intention to create a trust without communication of that intention to the beneficiary or to the trustee or any third person."). By virtue of the restrictions, the donee corporation becomes the trustee obliged to ensure that the property is devoted to the specified purposes. The members of the board of directors are not trustees, in the strict sense, however, because they do not hold title to the property of the corporation. \textit{Id.} § 5 cmt. g. "A disposition to [a hospital or university] for a specific purpose, however, such as to support medical research, perhaps on a particular disease, or to establish a scholarship fund in a certain field of study, creates a charitable trust of which the institution is the trustee for purposes of the terminology and rules of this Restatement." \textit{Id.} § 28.

260. \textsc{Banner Health}, 663 N.W.2d at 248. South Dakota's nonprofit corporate statute is unremarkable; it allows amendments to the articles "in any and as many respects as may be desired," S.D. \textsc{Codified Laws} § 47-22-14 (Michie 2004), so long as "[n]o amendment to the articles of incorporation shall affect any existing cause of action in favor of or against such corporation, or any pending action to which such corporation shall be a party, or the existing rights of persons other than members," \textit{id.} § 47-22-22 (emphasis added in \textsc{Banner Health}, 663 N.W.2d at 249).

261. \textit{See, e.g.}, Hughes v. Good Samaritan Hosp., 158 S.W.2d 159 (Ky. 1942); Levin v. Sinai Hosp., 46 A.2d 298 (Md. 1946).

262. \textit{See, e.g.}, Coffey et al., \textit{supra} note 102, at 4.

263. \textit{See supra} note 249 and accompanying text.
prerequisites for a trust.\textsuperscript{264} This analysis is consistent with the Restatement of Trusts: "[a]n outright devisee or donation to a nonproprietary hospital or university or other charitable institution, expressly or impliedly to be used for its general purposes, is charitable but does not create a trust as that term is used in this Restatement."\textsuperscript{265}

The South Dakota Supreme Court accepted an extremely complicated analysis that provides literally no guidance to the nonprofit sector as to the circumstances that may give rise to a charitable trust. For multi-state nonprofit systems, even the specter that an attorney general might seize its assets can cripple the organization by devaluing those assets and suggesting protracted litigation to potential suitors. The reality of attorneys general's attempts to capture charitable assets at the very least extends the time it takes to close any deal, and dramatically increases transaction costs, including attorneys' fees, which, of course, are paid from the charitable proceeds the attorney general is seeking to preserve. These problems increase exponentially when several attorneys general enter the fray, as happened with Banner.

Finally, attorney general involvement with multi-state charitable corporations raises the question of who is looking out for the national public interest in the allocation of charitable resources.\textsuperscript{266} Large health care systems have the financial ability to sustain the rural or urban hospital that struggles to break even each year, has limited access to affordable financing, and lacks the resources to invest in the capital necessary to stay current with the technology required to survive in the current health care market.

\begin{itemize}
\item \textsuperscript{264} See, e.g., Nat'l Found. v. First Nat'l Bank, 288 F.2d 831, 834, 836 (4th Cir. 1961) (finding donations made to the local chapter of the National Foundation in response to a general appeal is not a charitable trust to local chapter but an unrestricted gift to National Foundation); United Methodist Church v. Bethany Med. Ctr. Inc., 969 P.2d 859 (Kan. 1998) (not a case where originating donor created a trust but rather a situation where five Methodists incorporated for the purpose of collecting donations for a hospital but no single donor, including the Kansas East Conference, acted as a trust settlor). See generally 15 AM. JUR. 2D § 141 (2004).
\item \textsuperscript{265} RESTATEMENT (THIRD) OF TRUSTS § 28 (2003).
\item \textsuperscript{266} See Brody, Whose Public?, supra note 13, at 968. Evelyn Brody gives substantial thoughtful attention to Banner in her article. She notes that "In terms of the national public interest, however, relocation could be a positive-sum game: The governing board of a charity might determine that the overall social benefit can be increased by moving its activities from a state with a low utility to a state with a higher one." Id.
\end{itemize}
2. Charitable Trust Law Is Conceptually Ill-Suited to the Nonprofit Corporation

Subjecting a commercial enterprise and its board to charitable trust principles is strained in application and constrained in outcome. Traditional trust standards prioritize preservation of trust assets and strict adherence to the settlor’s intent. The duty of loyalty requires strict obedience to the specifications of the trust instrument, and administration of the trust solely in the interests of the beneficiaries. While several doctrines somewhat blunt the edge of charitable trust requirements, the trust standards are nonetheless exacting and unforgiving in their insistence that trustees devote their energies selflessly and diligently toward accomplishing the settlor’s objectives.

Further, trust law as the organizational mechanism for nonprofit corporations has little to commend it. First, it is analytically ill-suited to


268. Although attorneys general so far have not sought to apply the trustee fiduciary standards to the directors of charitable corporations, two of the most prominent hospital counsel in this area, Michael Peregrine and James Schwartz, suggest that hospitals should protect against attorneys general imposing constructive trusts upon charitable assets for fear that the imposition of the trust fiduciary standards cannot be far behind. Peregrine & Schwartz, supra note 179, at 193. If their prediction proves accurate, corporate rules that subject directors to what essentially amounts to a gross negligence standard would be replaced with a charitable trust regime of simple negligence. Id. at 192. Further, a trustee may not engage in transactions with the trust for their personal benefit. Evelyn Brody, The Limits of Charity Fiduciary Law, 57 Md. L. Rev. 1400, 1419-20 (1998); see also Boyd, supra note 147, at 734-35; Restatement (Third) of Trusts § 227 cmt. c (1991). Trustees must fully disclose any conflicted transaction, which nonetheless must be fair and reasonable, and in the interests of the beneficiaries. See 1 Phelan, supra note 213, § 4:03. Corporate rules are not nearly so strict.

269. Courts employ the doctrines of cy pres to relieve the distress to a trust whose purpose no longer exists, or for which the means dictated by the settlor to accomplish the purposes have become impossible. In so doing, the courts typically evaluate the degree of departure from the original intent before approving a substitute purpose. See Grein Mem’l Hosp. v. First Ala. Bank, 387 So. 2d 778, 781 (Ala. 1980) (finding a testamentary gift to charitable corporation made for sole purpose of “curing and preventing tuberculosis” was a charitable trust which assets could only be used for that purpose, despite change in treatment of TB; abandonment of purpose caused legacy to lapse); see also Taylor v. Baldwin 247 S.W.2d 741, 750 (Mo. 1952) (holding that courts will intercede where there is a substantial departure from the charity’s dominant purpose). Courts sometimes distinguish the trust’s purpose, to which the trustees must adhere, from the means about which the trustees may use their discretion, as long as it is not otherwise addressed in the charter. Id. at 756.

270. See Fishman, supra note 127, at 226-87 (explaining the distinctions between
the organizational form of the charitable corporation. A charitable trust is created by the grant of a settlor (the principal) to accomplish a specific and defined benefit for the public; the trustees (agents) are charged with fulfilling the settlor's wishes. The typical charitable corporation, however, has no settlor. To remedy this analytical deficiency, attorneys general are treating taxpayers and donors as the settlors; as a result, the donors/taxpayers become both the settlors and the beneficiaries of the trust. Interestingly, no attorney general has suggested treating the corporation itself as the settlor; this alternative is obviously unappealing to a regulator, because it would leave the corporate board accountable to itself.

Focusing on the identity of the settlor and the beneficiary understates the analytic difficulties, however. The notion that trustees must adhere to the settlor's original intent is justified by the "theory that the right to testation is a fundamental aspect of private property." This rationale simply does not apply to the means by which nonprofit corporations have accumulated their assets. Obviously, where a donation to a hospital carries a testator's express restrictions as to its use, a trust is created and the testator's desires are respected. Typically, however, the assets of a health care corporation have been acquired or built from myriad sources, including the entity's profits, bond issues, tax subsidies, governmental aid charitable trusts and nonprofit corporations and detailing the benefits of the nonprofit corporate form, for example with respect to governance and ability to respond to changed circumstances).

271. Further, it is unclear precisely who the intended beneficiaries were in the cases of some hospitals' founding. Many Jewish hospitals, for example, were founded as much to ensure residency placements for young Jewish doctors who were precluded from such opportunities in most of America's prestigious academic medical centers. PAUL STARR, THE SOCIAL TRANSFORMATION OF AMERICAN MEDICINE 174 (1982). So, in many instances, the physicians who comprise the medical staff were as much the intended beneficiaries as the community that would constitute the hospital's patient base.


Allowing the trust terms to run in perpetuity produces several public costs. First, economic costs of dead-hand control include limitations on alienability of property, limited marketability, and a decrease in productivity of trust assets and property. ... Second, time and changing conditions create a risk of obsolescence and thereby detract from the charitable efficiency of the organization.

Id. at 1763-64 (footnotes omitted).
and unrestricted donations. Even with private property, public policy strives to limit dead-hand control. It is simply bad policy and law to attach gratuitous restrictions on the significant holdings of a commercial nonprofit enterprise, particularly one that operates in a dynamic industry such as health care. This is not to say, of course, that there are not public policy detriments of allowing too permissive use of charitable assets. Donors and taxpayers may be discouraged from supporting entities that do not promise some reasonable commitment to the community good for which the contribution was originally intended. As potentially debilitating, donors might confer only restricted gifts, to guarantee the use to which their support is put.

An over-arching theme is a desire to avoid the burden of adhering to legal constructs that preclude responding to changed circumstances and force the misuse and wasting of charitable assets. How health care is delivered has evolved from predominantly acute care in the 1960s to predominantly outpatient care today and will likely be comprised of pharmaceuticals and “continuum care” tomorrow. What health care is delivered depends upon the ever-changing demographics of the community, including the age, education, and socio-economic status of the population. Where health care is delivered must respond to population shifts. Those responsible for directing the uses of the privately-held assets that substantially comprise the U.S. health care system must have the flexibility and autonomy to make the timely decisions necessary to respond to these changes. On the other hand, their power should not go unchecked.

Thus, it is no surprise that charitable trust law presents a potentially appealing source from which to fill the legal void attorneys general face when concerned about a nonprofit board’s deviation from its mission. Nonetheless, trust law is ill-suited to address the myriad questions that arise in a corporate context: Does fealty to mission require merely that the nonprofit subscribe to a valid charitable purpose or must it assiduously and forever adhere (absent state consent) to the mission originally articulated in the corporation’s formation documents? If the answer is somewhere in between, so that nonprofit boards may variously deploy assets in response to significant market changes, the question becomes at what point in this middle ground state approval is required.

3. It Is Impracticable To Apply Charitable Trust Law to Nonprofit Corporations

Finally, we explore the potential impact of wholesale importation of charitable trust standards to govern oversight of the modern commercial
enterprise. Strictly applied, charitable trust law would invite detailed judicial review of all board decisions that implicate the nonprofit’s mission and perhaps application of the *cy pres* doctrine to determine whether the prior business activity under review has become impossible, inexpedient, or impracticable, 274 and whether the new business plan is as “near as possible” to the settlor’s original intent. 275 This approach would obviously pose enormous practical difficulties for the court. For example, ascertaining whether the settlor’s original intent has become impossible, inexpedient, or impracticable to fulfill in the context of a multi-million dollar commercial enterprise attempting to respond to a rapidly changing health care market would be an enormously complicated, perhaps intractable, inquiry. Also troublesome is the artificiality of determining the “settlor’s intent” (are the settlors current taxpayers and donors or those who supported the entity at the time of its establishment, or an aggregation of all taxpayers?) from articles of incorporation that can be decades if not a century old. It makes little sense to require the corporation to remain as “near as possible” to its original mission when to do so might result in economic demise, represent a misallocation of significant health care resources, or is simply not in the best interest of the community that is the current beneficiary of the nonprofit’s activities.

First, as is illustrated by this discussion, the notion that a trust comprises a third party beneficiary contract between settlor and trustee 276 is a legal construction ill-conceived for the charitable corporate context. Because the beneficiaries of the charitable corporation/trust cannot be identified, they must be represented in *parens patriae* by the attorney general. Unlike the private trust context, where the beneficiaries have a clear incentive to monitor the trustees, and to litigate if the trustees fail in their obligations, 277 attorneys general have neither access to the information necessary to monitor the charitable corporation/trust, nor the resources necessary to determine or pursue the beneficiaries’ interests.

Second, using trust law to oversee governance of nonprofit corporations is inefficient. While trust law in the *private* trust context is

274. See generally FISHMAN & SCHWARZ, supra note 144, at 100.
277. This argument obviously does not apply if the beneficiaries are as yet unborn, or are incompetent. *Id.* at 663, 668.
arguably the most efficient means of achieving the best interests of the trusts beneficiaries “within the settlor’s legally permissible objectives,” critics increasingly question whether trust law is efficient for charitable trusts. Irrespective of how that debate is resolved, trust law unquestionably should not extend to the nonprofit corporation.

Finally, much of trust law, specifically, the duty of care, attends to beneficiaries’ presumed lower “risk tolerance”; trustees are charged with the preservation of the trust assets. By comparison, corporate law’s business judgment gloss on the duty of care seeks to preserve boards’ risk-taking instincts, all the better to pursue opportunities that will maximize profits. Neither model is ideal for the nonprofit corporation, whose primary goal is community service, irrespective of its profit potential, and without necessary reference to asset valuation. On the other hand, nonprofit health care providers are acutely aware that they cannot accomplish their mission without financial wherewithal.

In sum, application of trust doctrine to nonprofit corporations is analytically strained—no identifiable “settlor,” beneficiaries, or “trust instrument” exists, so attorneys general and courts engage in a fictitious analysis that is confusing at best. At worst, applying the inflexible standards of trust law can be devastating to the economic survival of a significant health care enterprise and might cause dissipation of the corporation’s assets, which conflicts precisely with the ostensible goal of charitable trust.

4. Directors’ Duties in Transitions of Nonprofit Corporations

The case law evaluating directorial decisions regarding organic changes gives mixed and conflicting guidance with respect to the proper role of mission in that process. Most states appear to accept in principle that corporate fiduciary standards should apply to nonprofit directors. Yet developing a framework for allowing consideration of charitable purposes in appropriate cases remains elusive. As the discussion of applying the Revlon principle to nonprofit conversions illustrates, in some

278. Skitoff explains that the trustees’ duty of impartiality as among different classes of beneficiaries whose interests may conflict is the “salient distinguishing characteristic of trust law as organizational law.” Id. at 652. This concept is likely inapplicable to the charitable corporation unless, in the hospital context, patients and doctors are conceived of as competing classes of beneficiaries.

279. See, e.g., Eisenstein, supra note 273. Eisenstein suggests that in some circumstances, the public is best served by allowing the trust to fail. Id. at 1781-83.

280. See Skitoff, supra note 276, at 656-57.

281. See supra note 200.
circumstances strict application of the corporate standard may fail to take into account mission-related issues that should be appropriately considered by directors in evaluating changes. At the same time, where statutes or common law invite consideration of mission-related factors, there is a real risk that regulators, courts and attorneys general will substitute their judgments for the discretion of directors.

5. Impact

For managers of nonprofit health care enterprises, legal uncertainty breeds inefficiency and impairs pursuit of charitable goals. Most obviously, threats of second-guessing by charity regulators impede managers' ability to deploy assets and plan strategically in a dynamic health services market. The interventions by the Minnesota and New York Attorneys General with Allina, MEETH, and Littauer created uncertainty that pervades the business decisions of the entire nonprofit health care sector in those states. One can scarcely doubt that management, acutely aware that attorneys general may question routine business expenditures, now asks itself how everyday decisions might appear if they were widely publicized. Moreover, interventions that question long-established business structures raise significant policy questions. For example, the demand that Allina spin off its HMO implicates the permissible relationships among the component parts of an integrated delivery system and ultimately whether an integrated delivery system is even possible. Further, the Attorney General's position in *Allina* questions whether the corporate purposes of a system member may be subsumed by the system's over-arching mission.

We have also seen that the role of mission in informing directors' decision-making is quite ambiguous. When assessing whether boards have satisfied their fiduciary responsibilities, courts and charity regulators sometimes invoke mission responsibilities, and sometimes ignore them. For example, the *MEETH* and *Littauer* decisions send mixed messages about boards' autonomy to interpret and direct their mission in New York.

282. As described in a recent New York Times article: "Charities and foundations have been bracing for stronger regulatory intervention in their affairs, and many are already taking steps to beef up their governance....." Stephanie Strom, Questions About Some Charities' Activities Lead to a Push for Tighter Regulation, N.Y. TIMES, Mar. 21, 2004, at 23; see also Brody, Whose Public?, supra note 13, at 943 (describing numerous examples of activism by attorneys general and concluding, that "should charities too quickly accede to state demands over matters of discretionary governance, the sector as a whole can see a degradation in charities' willingness to take risks, and in volunteer board members' willingness to serve").
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Likewise, the legal posture assumed by the three attorneys general who challenged Banner's re-deployment of its assets across state lines threatens the very existence of multi-state systems—these systems risk losing their assets if they attempt to move them out of the local communities in which they are currently invested. Further, a public policy requiring that the assets of a charitable corporation constitute a trust belonging to the public makes the entity less attractive as a potential strategic partner, which may negatively affect the value of those assets.

At a more quotidian level, attorneys general's overzealous prosecutions may deter service on boards by just the kind of experienced professionals that both state and federal regulators hope to see actively engaged in corporate oversight. Further, nonprofit boards may be made excessively risk-averse by the specter of overreaching regulatory oversight. Studies suggest that they are prone to overestimate risk and be less inclined to pursue innovative business strategies. Lacking financial incentives, volunteer nonprofit directors appear to be driven by a combination of social norms and their personal loyalty to the mission of the institution they serve.

In this environment, it is important to remember the norm-shaping impact of law. As scholarship has stressed, an important objective of the law is to shift social norms and social meaning. As we have argued, this role is particularly significant in nonprofit fiduciary law because of the absence of financially interested monitors and the ambiguity surrounding the objectives guiding corporate agents. With respect to health care nonprofits, we conclude that the legal milieu in which they operate seems inimical to fostering good stewardship. A legal regime that is slow to insist on director vigilance but intrudes on decisions of central importance regarding mission likely reinforces directorial abdication.

Finally, we consider the law of nonprofits from an institutional perspective. Attorneys general play a complicated role in the current environment. They fill a variety of roles with respect to the nonprofit sector: prosecutor, consumer advocate, public representative as parens patriae, supervisor of charitable trusts, regulator, and politically accountable officer of the state. Abhorring a vacuum, many have assumed a multi-faceted role in the oversight of the governance of


284. See Fishman & Schwarz, supra note 144, at 254-56 (enumerating common law and statutory powers of the attorney general regarding charitable corporations and trusts); Brody, Whose Public?, supra note 13, at 938-39.
nonprofit organizations that extends far beyond enforcing fiduciary and trust principles. As described in Part II, this has led some down a path to micromanaging business affairs, seeking direct appointive power over board positions, and parochial control over the redeployment of charitable assets. From a health care policy perspective, it has also resulted in de facto centralization of several important regulatory functions. Attorneys general have used their leverage over nonprofits in asset sales, conversions, and mergers to direct the geographic and service dimensions of the charitable sector. As they candidly admit, attorneys general offices see themselves as assuring an appropriate allocation of society’s scarce charitable resources, and they freely use legal tools (and capitalize on the doctrinal ambiguities in the law) to do so. One must seriously question, however, whether a mandate exists for reposing so much discretion in that office and, even if it did, whether attorneys general command the resources to responsibly assume it.

We also speculate that attorney general activism may have untoward spillover effects on other governmental actors. Given the centralization of authority in the attorneys general, it is perhaps not surprising that states have not felt impelled to forthrightly consider the difficult issues posed by the changing landscape of charitable health care. Most states have weakened or abandoned certificate of need review; hospital closings are not closely supervised; and the preservation of the health care safety net is largely unattended. Thus, few departments of health actively supervise the geographical locations of charitable health facilities or the range of services they offer. These are public policy tasks essential to maintaining a viable health care system that are properly vested in state departments of health, which should not abdicate their responsibilities to attorneys general offices that are wholly unequipped to fill this function.

V. CONCLUSION: A PROPOSAL FOR MISSION PRIMACY

Our review of the application of fiduciary and charitable trust law to nonprofit health care corporations has identified a number of significant problems. First, there is widespread confusion about the boundaries between those bodies of law. Difficulties are compounded by the impact of those laws on the health sector—notably the uneasy fit of importing wholesale for-profit corporate principles to govern entities having decidedly different attributes and goals, and the inappropriateness of using rigid trust concepts to guide management of dynamic commercial enterprises. This confusion has led to opportunism among certain attorneys general who have sought judicial relief, which inappropriately transfers power over business and mission decisions to them. It has also
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spawned uncertainty in business planning that may weaken the nonprofit sector’s ability to serve its societal purposes. Finally, ambiguity about the role of boards and attorneys general may have diverted health policymakers and regulators from dealing squarely with the central task of fairly and efficiently allocating charitable assets.

As discussed throughout this Article, commercial nonprofits in health delivery and payment must anticipate and respond to demographic shifts, reimbursement reform, and technical innovation. Attorneys general should not usurp departments of health and insurance, which are the agencies properly responsible for ensuring that the business climate in which providers and payors operate can supply high quality and affordable health care. To give a concrete example, attorneys general’s insistence that nonprofit hospitals forever adhere to their original purpose of serving the local community as a free-standing acute care facility can have detrimental long-term consequences for that community’s access to appropriate health care. It may force them to forgo the efficiencies, stability, and capital accruing from affiliation with a financially strong national system; or it may deny the community a sensible re-deployment of its charitable assets, e.g. from acute care hospital services to disease prevention or outpatient clinics. A final concern, focusing on institutional competence, is that the attorney general’s office lacks the expertise, resources, and legal mandate to micro-manage business affairs of commercial enterprises or to macro-manage the allocation of health services within the community.

This Part offers several core principles that should guide future judicial, legislative, and regulatory adjustments affecting nonprofit health care organizations. Admittedly, few of the problems we have identified are subject to easy correction by isolated changes, e.g., judicial interpretation of doctrine, attorney general forbearance, or modest legislative adjustments. What we offer below, however, can provide a useful first step: guidance as to the central issues that should be addressed in redefining nonprofit accountability so as to ensure that governmental oversight is both coordinated and appropriate.

A. Principles for Reorienting Nonprofit Organization Law and Policy

The complex tangle identified in this article of confused doctrine, lack of managerial accountability, and overreaching by attorneys general poses challenges for all branches of government dealing with nonprofit governance. Because there is so much variation in state law in this area, a precise road map for implementing change is impossible. However, we identify below three core principles to guide legislatures, courts, and regulators as they move toward developing governance standards for
nonprofit enterprises in health care.

Our analysis takes as a starting point that the evidence of modest benefits flowing from the nonprofit sector supports continued reliance on legal mechanisms that enable and require those institutions to achieve their charitable missions. At the same time, the record of community benefits is not so compelling as to support use of legal tools to preserve nonprofit entities at any cost.

1. Ownership and Accountability

The fundamental question of who, broadly speaking, “owns” the nonprofit corporation merits close attention. Many questions, such as defining and evaluating community benefit, ascertaining directors’ obligations under changing conditions, and enumerating the rights and obligations of controlling members, cannot be addressed without a clearer understanding of to whom (or what) nonprofit fiduciaries should be accountable. As discussed above, corporate scholars continue to debate whether for-profit governance should adopt a model of shareholder primacy, director primacy, or some other objective function reflecting societal goals that underlie the corporate form. In the nonprofit sector, the debate has scarcely moved in the last twenty years. The absence of discussion is remarkable because the issue is, if anything, more pointed for nonprofits than for commercial profit corporations. That is, lacking shareholders, the candidates for primacy are a more diffuse and amorphous group: the class of beneficiaries to be served by the charity; the directors who manage those objectives; members, where present; donors and taxpayers; or the representative of the public beneficiary class such as the Attorney General. Moreover, the absence of the disciplining effect of a capital market or vigilant, interested shareholders to vindicate abuses in court exacerbates the agency costs inherent in the nonprofit form. At the same time, the similarities between the commercial nonprofit sector and the for-profit sector are also striking. Commercial nonprofits do not rely

285. See supra Part I.


287. Evelyn Brody’s impressive body of scholarship has addressed these issues. As she summarizes the dilemma, “[N]onprofit ‘accountability’ is a difficult question. Accountable to whom? For what? While nonprofits as suppliers of goods and services must respond to their customers, and as employers must respond to their professional staffs and employees, the same types of resource dependency affect for-profit firms.” Brody, Agents Without Principals, supra note 18, at 534-35 (footnote omitted).
heavily on donations and, from a financial standpoint, are driven by a need
to satisfy customers in the marketplace. 288

The failure of courts and commentators to resolve questions of
ownership and mission accountability is in part explained by the plurality
of competing interests. Starting with the perspective that tax expenditures
and legal support create a strong public entitlement, some regard the
public at large (or its representative) as the appropriate locus of
accountability. Others identify as the appropriate party in interest the
beneficiaries of the nonprofit's charitable mission. Still others advocate
including the "patrons"—donors and customers who provide the financial
wherewithal to fulfilling the nonprofit's charitable mission. Finally, there is
the perspective of the "sponsor" or "member" of the nonprofit
corporation, whose control and support keep the enterprise running.
Choosing among these competing parties in interest is ultimately a
normative and political question that underlies any workable definition of
"accountability." As Evelyn Brody framed the issue: "Who are the
principals' to whom society wants the charity to answer...?" 289 Like many
before us, we will dodge that question. Instead we offer a framework for
allowing courts and legislatures to address the issue by allocating
presumptive decisionmaking authority to those entrusted with serving the
nonprofit's purposes, but insisting that they follow clearly articulated
mission statements.

As a general guiding principle, we suggest that "mission primacy"
should be recognized as a central objective of the nonprofit enterprise with
the corollary that directors enjoy presumptive deference in defining and,
within limits, amending that mission. This focus would incorporate
mission-centered values into interpretations of the traditional fiduciary
duties of care and loyalty. At the same time, like the model of "director
primacy" advanced for proprietary corporations, 290 it would preserve
managerial discretion to balance the various constituents of the nonprofit
firm including donors, consumers, and the community. Consequently, this
standard would accommodate the relational imperatives of the modern
business environment in health care by deferring to managerial expertise,
avoiding interference with discretionary judgments, and encouraging

288. Id. at 535 ("Effectively, then, nonprofits are generally as untethered to their donors
as large for-profit firms are to their shareholders."); id at 536 ("In many ways, the formal
legal and economic differences between nonprofit organizations and proprietary firms are
more of degree than of kind.").

289. Id. at 512.

290. See BAINBRIDGE, supra note 148, at 192-240.
appropriate risk-taking. Finally, mission primacy accounts for the particular circumstances of nonprofit governance because it preserves the central values of trust and volunteerism that are needed to reinforce legal duties.

Mission primacy, then, would extend the concept of the duty of obedience to underscore directors’ core responsibilities as stewards of a nonprofit enterprise to advance its public purpose. It has been seen that by embracing the for-profit corporate model, nonprofit governance law has often blindly applied fiduciary norms that neglect mission values entirely. Our approach would hold directors to a fiduciary standard that requires them to weigh mission considerations in all decisions. At the same time, however, by requiring courts to grant deference to directors’ judgments, the rule would reduce risks of unwarranted judicial interference and preserve the norm-shaping role of fiduciary law. Thus, mission primacy would allow legitimate mission-centered factors to override corporate fiduciary standards in some cases while imposing a more exacting standard of care or loyalty where mission issues predominate. Several examples will serve to illustrate the way in which mission primacy would affect application of fiduciary duties.

In cases involving organic change, such as the hospital closure at issue in MEETH, mission primacy would mandate consideration of and deference to the board’s evaluation of mission, and its determination of the most appropriate means to accomplish that mission. Where a board’s actions are questioned under duty of care or loyalty standards, mission factors may help give content to the inchoate considerations that contribute to the board’s deliberation. Likewise, mission primacy may compel deference in the economically important cases involving multi-state charitable corporations consolidating their holdings, or whose mission calls for the reallocation of revenues from profit-producing facilities to facilities in financially distressed communities, irrespective of whether such aid crosses state lines.

Mission primacy would not affect the attorney general’s extant authority to ensure compliance with the duty of care by appropriate due diligence, particularly when a board decides to dispose of the charity’s assets. However, it would prevent courts from blindly applying corporate

291. In this regard mission primacy would likely have required a less categorical evaluation of purpose in MEETH. See Manhattan Eye, Ear & Throat Hosp. v. Spitzer, 715 N.Y.S.2d 575, 595 (Sup. Ct. 1999) (“[I]t is sophistry to contend that this means that MEETH is not seeking a new and fundamentally different purpose . . . .”). This approach is more in keeping with the court’s approach in Littauer, discussed supra notes 12, 77, 79 and accompanying text.
principles in a manner that overlooks mission entirely. For example, charitable corporations selling their assets frequently find themselves courted by prospective buyers with diverse missions, whose offers vary dramatically. As discussed above, some would apply the Revlon doctrine to nonprofits, thus imposing an obligation on directors to sell for the highest price and ignore mission-based considerations, once a decision to sell the corporation has been made. Mission primacy would avoid this trap, allowing a nonprofit board to weigh mission preservation against price, and to select a buyer whose offer best accommodates both of these concerns.

2. Clarify the Charitable Trust/Corporate Law Boundary

This Article counsels strongly against states’ reliance on charitable trust law to regulate nonprofit assets, except, of course, where an express trust exists. We have argued that applying charitable trust law to corporate assets is doctrinally unsound and produces outcomes that potentially waste, rather than preserve, scarce charitable assets. The alternative approach, adopted by most of the courts to have directly addressed the issue, is to look to corporate law as the foundation for the law governing all aspects of charitable corporations. While this reflects our preferred doctrinal path, recognition of the mission primacy principle proposed above is necessary to assure that both boards and charity regulators observe core nonprofit purposes.

Clarifying that corporate law governs disputes involving nonprofit business decisions would remove an important obstacle to efficient business planning by multi-state entities in most cases. Thus, corporate analysis with a focus on mission would likely have resulted in Banner being able to re-deploy its assets to Colorado and Arizona with relative ease. Except for the circumstances where express trusts existed, Banner’s holdings should not otherwise have been impressed with a trust—traditional trust doctrine does not support the imposition of a trust on the basis of generalized donations or tax subsidies. In some circumstances, legislative action would be required to assure corporate principles prevail; for example, in the Banner litigation, the South Dakota Supreme Court recently decided that the enactment of the nonprofit corporate statute did not preempt the pre-existing charitable trust statutory or common law. Clarification of the rather murky doctrine of implied charitable trust in

292. See supra note 200 and accompanying text.
those states that recognize the concept would also serve to remove uncertainty in this area.

Recognizing that the corporate standard has not been a model of successful prophylactic law in the for-profit sector, it might be appropriate to adjust fiduciary standards applicable to nonprofits in some circumstances. For example, most state nonprofit corporate statutes bar loans to directors, a development that long preceded parallel developments in the for-profit sector under Sarbanes-Oxley law. Moreover, an evolving recognition that the business judgment rule’s impact should be tempered by requiring good faith and informed decision-making should be encouraged. Further, administrative improvements may well be needed to assure that fiduciary derelictions are detected and remedied. At the same time, enhanced enforcement mechanisms must be carefully designed so as not to undermine the social norms that play a critical role in assuring fiduciary performance.

While regulatory interventions in the health care sector would have to be sensitive to the multiple regulatory entities sharing oversight of the sector, it is unquestionably the case that states need to invest the resources in some charity agency that will provide better regulatory guidance to the nonprofit sector, and will review the increasingly available information about nonprofit entities to detect potential problems.

3. Clarify and Delineate State Agencies’ Supervisory Responsibilities

Viewed from the perspective of health care policy, the most important—and most vexing—public policy question emanating from our analysis of charitable nonprofit law is how the law can best achieve the appropriate distribution of health care resources. These concerns undoubtedly drive attorneys general to undertake many of the actions for which we take them to task in this Article. Simply stated, the problem we identify in this regard is one of institutional competence and transparency. To the extent that there are market failures, there are alternative and more focused means of regulation and allocation including licensure, certificate of need regulation, and subsidies from state departments of

294. See cases listed supra note 159 and accompanying text.
295. James Fishman has usefully advanced the idea of employing a charity commission that would operate under the aegis of the attorney general to review complaints about charitable corporations. Fishman, supra note 127, at 266-72 (reviewing the scope of proposals and changes made by nonprofit experts). The attorney general’s office would only be required to become involved where a viable complaint could not be resolved at the commission level. Id. at 272-75.
health; exercise of the state’s tax-exemption powers; and contracting by state entities funding health services. Without expressing a preference for any particular regulatory regime, we believe that policy-making through these agencies is preferable because it is more likely to identify and evaluate deficits in safety net services. By contrast, allocating broad and unrestricted discretion to attorneys general to make allocative decisions behind a veil of corporate or charitable trust litigation appears to be a recipe for ad hoc and inefficient decision-making. Whatever oversight agenda of the charitable sector a state attorney general decides to pursue, we view it as essential that the office clearly articulate its public policy concerns, expectations, and standards of review. The need for such guidance is particularly acute if attorneys general intend to assert standing on mission issues, for which there is virtually no precedent to guide nonprofit boards.

Our final point concerns problems that flow from attorneys general seeking to replace directors, or to appoint a “super-board” with veto or special administrative powers. Such appointments provoke charges of political cronyism, which threatens the private and necessarily non-political nature of nonprofit tax-exempt charities. More important, political appointments to charitable boards create inherent conflicts for the appointees—whether they are bound to act as they independently believe appropriate to fulfill their fiduciary duties, or whether they are required to pursue the preferences of the regulator who appointed them. The inevitable blurring of the line between public and private accountability occasioned by these interventions threatens to undermine director discretion; quite startlingly, rather than improving accountability to mission, it shifts director fealty to the interests of political officials.

296. We acknowledge the myriad problems surrounding efficient deployment of charitable resources. Certificate of Need processes, which were originally intended to reduce health care expenditures and eliminate inequitable distribution of resources by regulating significant capital investments on new facilities or equipment, currently exists in fewer than half the states. See M. Gregg Bloche, The Invention of Health Law, 91 CAL. L. REV. 247, 298 (2003); Lauretta Higgins Wolfson, State Regulation of Health Facility Planning: The Economic Theory and Political Realities of Certificate of Need, 4 DEPAUL J. HEALTH CARE L. 261, 261-62 (2001).