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STATE REQUIREMENTS IN THE CONVERSION OF NONPROFIT HEALTH CARE CORPORATIONS,

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In 1995, the National Association of Insurance Commissioners formed a task force to provide resources to state insurance departments regarding conversions and reorganizations of hospital service corporations and to promote decision-making frameworks to review conversion and reorganization proposals. At this same time, states began to enact legislation on this same subject in order to prescribe a framework for regulators to review reorganization proposals by hospital and medical service corporations.

This article outlines the approaches in Georgia, North Dakota, Colorado, New Hampshire and Ohio to regulate these reorganization and conversion activities. These state laws are representative of the variety of legislation available to the states to address conversion applications by nonprofit corporations.

Georgia

The State of Georgia was one of the first states to adopt legislation regarding nonprofit health care corporation conversions.¹ Under Georgia law, a nonprofit health care corporation is required to submit a conversion plan to the insurance commissioner and to provide notice to the state attorney general of its intent to convert.² The law provides for a public hearing at which the attorney general may appear to represent the interests of the public.³ Approval of the plan rests with the insurance commissioner based upon a determination that the conversion is in the best interest of the company, its policyholders and the general public.⁴

North Dakota

Last year, North Dakota adopted legislation that essentially prohibits any nonprofit health service corporation from converting to a for-profit company.⁵ The only conversion activity permitted under the code section allows a nonprofit corporation to convert to a nonprofit mutual insurance company.⁶ The section specifically prohibits a nonprofit mutual insurance company from demutualizing or converting to a for-profit mutual or stock company.⁷ The section further prohibits any nonprofit mutual insurance company from forming a mutual insurance holding company.⁸

Colorado

In 1996, Colorado adopted extensive legislation in its insurance code addressing the conversion of a nonprofit health service corporation to a stock insurance company.⁹ The Colorado provisions require the converting nonprofit to file a conversion plan with the insurance commissioner and to make the plan available to the public.¹⁰ Among other requirements listed, the plan must specify a reasonable treatment of the value of the corporation for the benefit of Colorado citizens.¹¹ The statute states that such treatment is deemed reasonable if consideration equal to the value of the corporation is transferred to one or more qualifying entities.¹² The commissioner is responsible for determining the value of the corporation at the time of conversion and is authorized to retain qualified experts, at the corporation's expense, to assist in reviewing the proposed plan.¹³ The statute also requires that control of the qualifying entity be completely independent of the corporation and that no person employed by or associated with the corporation is allowed to be employed by or associated with the qualifying entity.¹⁴ The statute further prohibits the inurement of any benefit to a director, officer, agent or employee of the nonprofit as

entity.¹⁴ The statute further prohibits the inurement of any benefit to a director, officer, agent or employee of the nonprofit as a result of the conversion.¹⁵

After filing the plan, the corporation must notify the general public and must provide written notice to its current subscribers.¹⁶ The insurance commissioner is required to hold a public hearing before making a final decision regarding the conversion plan.¹⁷ The code provisions require the commissioner to approve the plan of conversion if he finds that: the plan meets the requirements outlined above;¹⁸ the plan is fair and reasonable and coincides with existing law and the interests of subscribers, contract holders and the public; and the converted corporation meets all requirements applicable to stock insurance companies.¹⁹

New Hampshire

New Hampshire enacted legislation last year regarding health care charitable trust acquisitions. This law could be applied to nonprofit health service corporation conversions.²⁰ The act requires that the governing body of the trust act in good faith and consistent with its fiduciary duties, and sets forth minimum standards to be met when a charitable trust is acquired by another entity.²¹ These minimum standards begin by requiring that the proposed transaction be permitted by applicable law.²² The act further requires that the governing body of the trust exercise due diligence in selecting the acquirer, in negotiating the terms and conditions of the proposed transaction and in determining that the transaction is in the best interest of the trust and the community it serves.²³ The act does not prohibit conflicts of interest or pecuniary benefits from the transaction, but any such occurrence must be disclosed and must not affect the decision to engage in the transaction.²⁴ Moreover, the proceeds to be received on account of the transaction must constitute fair value for the sale.²⁵ The act further requires that the assets of the trust and any proceeds from the transaction continue to be devoted to charitable purposes.²⁶ If the trust is acquired by an entity other than a New Hampshire health care charitable trust, the out-of-state entity is prohibited from controlling the proceeds from the transaction.²⁷ This section also requires the trust to provide the community with reasonable public notice along with reasonable and timely opportunity for the community to voice its comments at a public hearing.²⁸

The trust is required to provide notice of the proposed transaction to the Director of charitable trusts in writing at least 120 days prior to consummation of the transaction.²⁹ The act requires that this notice include a statement from the acquirer specifying the manner in which it proposes to continue to fulfill the charitable objectives of the health care charitable trust.³⁰ Within a reasonable time after receiving this notice, the Director is required to act on the notice by either accepting or rejecting the transaction.³¹ In making this determination, the Director is authorized to accept public comment and may conduct public hearings on the matter.³² The act also allows the Director to employ expert assistance in making his determination if the fair value of the acquisition transaction involves assets in excess of \$5,000,000.³³

Ohio

Ohio is currently considering comprehensive legislation regulating the conversion of nonprofit health care entities.³⁴ Under the proposed legislation, the governing body of the nonprofit corporation must first adopt a resolution stating the reason such a conversion would be beneficial to the nonprofit corporation and to those persons it provides with, or to whom it makes available, health care services.³⁵ The resolution must be filed with The superintendent of insurance and the attorney general along with financial statements and a detailed conversion plan.³⁶ If The superintendent, upon inspection of the plan, considers the conversion beneficial to the nonprofit and its customers, a financial examination of the nonprofit shall be ordered to determine its value and the portion of the nonprofit's value attributable to its tax status.³⁷ This examination is to be conducted by an independent appraisal committee appointed by The superintendent.³⁸

After receiving the appraisal committee's report, the governing body of the nonprofit may call a meeting for a vote on the proposed conversion or sale.³⁹ Notice of this vote and information regarding the conversion or sale must be mailed to each subscriber at least thirty days prior to the meeting.⁴⁰ If a majority of the votes cast at this meeting favor the conversion or sale, the completion of the deal is conditioned upon authorization from the superintendent and the attorney general.⁴¹ If the vote is negative, the superintendent must issue an order prohibiting the sale or conversion from proceeding.⁴²

Following a majority vote favoring the conversion, the superintendent is required to hold a public hearing at which time persons who believe they would be adversely affected by the conversion or sale may present their position.⁴³ Based upon the superintendent's findings at this hearing, if it is determined by the superintendent that the transaction benefits the relevant parties, the conversion or sale may be approved.⁴⁵ Upon authorizing a conversion or sale, the superintendent must notify the

parties, the conversion or sale may be approved.⁴⁵ Upon authorizing a conversion or sale, the superintendent must notify the attorney general and provide all the reports and information acquired during the above stated process.⁴⁵ The attorney general is required to authorize the conversion or sale unless it is found that the requirements of the section have not been met or that the transfer does not meet other legal requirements or that the nonprofit has not met the requirements for distribution of its nonprofit value.⁴⁶

The bill requires that the nonprofit make or provide for a donation equal to the portion of the nonprofit's value attributable to its tax status to be made to a charitable trust established by the insurance department.⁴⁷ The bill also requires that the nonprofit's conversion plan provide for an amount equal to the reduced value of the nonprofit (the value of the nonprofit less the value attributable to its tax status) to be distributed pro rata to the company's subscribers who have been with the company continuously for the five-year period preceding the date upon which the subscribers vote on the conversion or sale plan.⁴⁸ This distribution may be made in the form of cash or shares in the for-profit entity.⁴⁹

Common Requirements

Notwithstanding the varied approaches taken by these states, there are several requirements that each of these statutes have in common. One is a valuation of the existing nonprofit corporation. Second, the nonprofit must contribute funds to some other charitable organization or provide stock to its subscribers. Third, there is a prohibition against any conflict of interest arising in the transaction itself and the operation of the charitable organization. Finally, all the statutes provide for some sort of public hearing to be conducted on the matter.

Valuation of the Nonprofit Corporation's Assets

Consumer advocates have voiced more concerns about the valuation of the corporation's assets in nonprofit conversions than any other issue. Consumer advocates maintain that the amount of the benefit retained by the public and how it should be retained are the central issues in any conversion.⁵⁰ No state has attempted to proscribe a definite formula to be used in determining an existing nonprofit's value,⁵¹ and various methods are employed to determine the value of the nonprofit's assets.⁵² Colorado, for example, focuses on the value of the voting stock of the converted corporation.⁵³ Ohio attempts to identify the value of the nonprofit corporation that can be attributed to its tax exempt status.⁵⁴ Generally, the value determination is made the responsibility of the state insurance department. Most statutes provide for an independent analysis of the nonprofit's value under the direction of the state's insurance regulator.⁵⁵ The insurance commissioner is authorized to employ the services of experts such as accountants, lawyers or financial analysts to conduct this analysis.⁵⁶

Transfer of Value to Charitable Organization

Closely related to the issue of valuation is the demand by consumer advocates that the new for-profit corporation contribute or transfer consideration to a charitable organization.

These advocates rely on the theory of the *cy pres* doctrine, which may or may not be applicable to these conversions. The advocates maintain that a charitable trust is created when a nonprofit corporation designates in its articles of incorporation some charitable, social welfare or other nonprofit purpose for the assets of the corporation. These charitable restrictions apply even if the corporation converts or dissolves. In that case, the trust must continue to use its assets for exactly the same purposes for which the trust was created. In the event that the original purpose can no longer be carried out, states invoke the *cy pres* doctrine to allow a court to identify another, similar purpose for the assets of the trust. The *cy pres* doctrine holds that when a charitable trust is originally or later becomes impossible, inexpedient or impractical to fulfill, a court may substitute another charitable object that is believed to approach the original purpose as closely as possible.⁵⁷

Some states overseeing the conversion process require that the for-profit corporation transfer a portion or all of its assets to a charitable organization.⁵⁸ There are various approaches taken with regard to the creation of the charitable organization and the transfer of the assets. Some states allow the converting nonprofit to establish the charitable organization while others require the insurance department to establish it.⁵⁹ In either case, the organization must be independent of the for-profit corporation and it must be dedicated to serving the health care needs of the poor in the community.⁶⁰ Regarding the transfer of the assets, states seem to agree that the transfer may be accomplished through a cash donation or the issuance of stock in the for-profit corporation or both.⁶¹

the for-profit corporation or both.⁶¹

Conflict of Interest Eliminated

The conflict of interest issue concerns the need for the charitable organization to operate as a separate and independent entity. The perceived fear is that by allowing board members to serve on the governing body of the charitable entity and the for-profit corporation, there is a high risk that the foundation would be operated to serve the interest of the corporation. Some states addressing the conflict of interest issue have resolved it by eliminating any possibility that such a conflict will arise. Colorado, for example, specifically prohibits any connection between the charitable organization and the new for-profit corporation.⁶² Other states, such as New Hampshire, address the issue by requiring that such matters be fully disclosed and then allowing the insurance regulator to consider the matter in his determination of the acceptability of the plan.⁶³

Another aspect of this issue deals with any pecuniary gain the nonprofit's board or officers may realize as the result of the conversion. This issue is most likely to arise when the nonprofit is being bought out by an existing for-profit company. In Ohio, for example, when Blue Cross Blue Shield executives were to receive contracts for consulting and noncompetition arrangements, consumer advocates came out heavily against the transaction.⁶⁴ In California, Blue Cross withdrew provisions providing its executives numerous stock options when it appeared that the provisions would hold up approval of the conversion plan.⁶⁵ This issue is dealt with in various manners ranging from complete prohibition to complete allowance with full disclosure. The central guideline regarding this issue should be to have any conflicts of interests minimized and that the conversion and the charitable organization be shielded from any appearance of impropriety on the part of the governing authorities of the converted corporation.

Public Hearing Required

Throughout the conversion process, it is crucial that the public be involved.⁶⁶ Consumer advocates assert that in order for the public interest to be protected, one of the essentials is that the transaction be subjected to full disclosure and public scrutiny.⁶⁷ Each state's regulatory efforts call for some form of public hearing on the proposed transaction.⁶⁸ The hearing is conducted by the state insurance department for the purposes of obtaining complete disclosure by the nonprofit corporation and public comment on the conversion. The insurance department must use this information and commentary as a basis for determining whether the transaction will benefit all of the parties involved and therefore meet with approval.

Conclusion

No state has perfected the ideal legislation for reviewing conversions from nonprofit to for-profit corporations. The issues addressed in this article provide a primer for debate in state legislatures and the NAIC. Some of the requirements may present artificial barriers to conversion and should not be accepted by regulators without serious consideration of the consequences. A legal framework for conversion may exist without enacting new legislation. This summary identifies the major issues facing insurance regulators on this subject.

Endnotes

1. Ga. Code Ann. 33-20-34 (Supp. 1997).
2. 33-20-34(a)(1).
3. 33-20-34(a)(1)-(2).
4. 33-20-34-(a)(1).
5. N.D. Cent. Code 26.1-17-33.1 (199?).
6. 26.1-17-33.1.
7. 26.1-17-33.1(5).
8. 26.1-17-33.1(11).
9. Colo. Rev. Stat. Ann. 10-16-324 (West Supp. 1996).
10. 10-16-324(3).
11. 10-16-324(4)(e)(I).
12. 10-16-324(4)(e)(I)(A)-(B). A "qualifying entity" is defined as an independent tax-exempt charitable or social welfare organization, operating under sections 501(c)(3) or 501(c)(4) of title 26 of the United States Code and is dedicated to promoting or serving health care needs of citizens.

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13. 10-16-324(4)(e)(I)(A). & 10-16-324(5).
 14. 10-16-324(4)(e)(I)(E).
 15. *Id.*
 16. 10-16-324(6).
 17. 10-16-324(7).
 18. The plan must meet the requirements specified in 10-16-324(4).
 19. 10-16-324(9).
 20. S.B. 101, 1997 Sess. (New Hampshire). The bill was passed by the legislature and signed into law on June 19, 1997. Acquisition of a health care charitable trust means the "transfer of control, direct or indirect, . . . of 25 percent or more of the assets thereof, including, but not limited to purchases, mergers, leases, gifts, consolidations, exchanges, joint ventures, or other transactions involving transfer of control of 25 percent or more of assets . . . of a charitable trust organized to provide health care services." S.B. 101 280:1(I)(a)& (d).
 21. S.B. 101, 280:1(II).
 22. 280:1(II)(a).
 23. 280:1(II)(b).
 24. 280:1(II)(c).
 25. 280:1(II)(d).
 26. 280:1(II)(e).
 27. 280:1(II)(f).
 28. 280:1(II)(g).
 29. 280:1(III).
 30. *Id.*
 31. 280:1(IV).
 32. *Id.*
 33. *Id.*
 34. H.B. 301, 122nd Leg., Reg. Sess., 1997-98 Ohio. The bill is presently in the insurance committee. The bill amends sections 3913.25-29 of the Ohio Revised Code. All footnotes refer to these sections as amended by the Act.
 35. 3913.26(A).
 36. 3913.26(A).
 37. 3913.26(B)(1). The plan must appear on its face to be of benefit to all parties.
 38. 3913.26(B)(2). All expenses associated with the appraisal are born by the nonprofit corporation.
 39. 3913.27(A).
 40. 3913.27(A).
 41. 3913.27(C).
 42. 3913.27(C).
 43. 3913.27(C)(1). The nonprofit must mail a notice of the hearing to its subscribers and the superintendent is required to publish notice to the general public by way of newspaper.
 44. 3913.27(C)(2).
 45. 3913.28(A). This material and information includes a record of the vote, minutes of the public hearing and a copy of the appraisal committee's report.
 46. 3913.28(C)(1).
 47. 3913.28(C)(1). A sale differs from a conversion in that the amount donated is based upon a pro rata share of the value of the nonprofit being sold. (If a complete sale is involved then the full amount of the nonprofit's value attributable to its tax status would be donated.)
 48. 3913.28(C)(2). A sale is treated in the same manner as specified above.
 49. 3913.28(C)(2).
 50. Judith Bell et al., *The Preservation of Charitable Health Care Assets*, 16 HEALTH AFFAIRS 2, March/April 1997.
 51. Colorado statute provides that the fair market value of the corporation is determined as if it had voting stock outstanding and one hundred percent of its stock was freely transferable and available for purchase without restrictions. However, the statute does not specify how the value of the stock itself is to be determined.
 52. Bell, *supra* note 50.
 53. 10-16-324(4)(e)(I)(A).
 54. 3913.28(C). It is important to note that Ohio does require the remaining value to be distributed to the nonprofit corporation's subscribers.
 55. Donald Shriber, *State Experience in Regulating a Changing Health Care System*, 16 HEALTH AFFAIRS No. 2, March/April 1997.

56. *Id.*
57. Eleanor Hamburger et al., *The Pot of Gold: Monitoring Health Care Conversions Can Yield Billions of Dollars for Health Care*, CLEARING HOUSE REVIEW JOURNAL OF POVERTY LAW, August-September, 1995, 489.
58. *See* Ohio, Colorado and New Hampshire laws above.
59. Colorado seems to allow the corporation to establish the charity. (The statute is silent on the matter.) Ohio expressly requires the insurance department to establish the charity. 3913.28(C)(2).
60. Bell, *supra* note 50.
61. Bell, *supra* note 50.
62. 10-16-324(4)(e)(I)(E) (Col).
63. This is inferred from the provisions requiring the charitable trust regulator to make the determination in a charitable trust acquisition. 280:1(II)(c).
64. Shriber, *supra* note 55.
65. Hamburger, *supra* note 57, at 481.
66. Bell, *supra* note 50.
67. Lisa McGiffert & Reggie James, Editorial: *Merger Mania Imperils Health-care Safety Net*, THE AUSTIN AMERICAN-STATESMAN, August 23, 1996.
68. *See* state analysis above.