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AFFILIATIONS, SALES, AND CONVERSIONS INVOLVING NON-PROFIT AND FOR-PROFIT HEALTHCARE ORGANIZATIONS IN OKLAHOMA*

William C. Kellough†

I. INTRODUCTION

Whether taxable or exempt from taxation, all businesses, charities, and even governmental organizations, strive to make a profit. However, the social and legal distinctions between non-profit and for-profit organizations are very real and embedded in centuries of law and tradition. Charities have provided for the care and treatment of the sick and injured since at least the inception of this branch of Anglo-American law in 1601 with enactment of the Statute of Charitable Uses.[1] Healthcare in the United States is now a trillion dollar industry dominating no less than 14% of gross domestic product.[2] As the art and science of medical treatment have become more expensive and complex, it is only natural that healthcare organizations have taken on more of the attributes of their for-profit cousins, including the need to merge, sell out, affiliate, or otherwise restructure in ways designed to meet the challenges of a dynamic market.[3]

Until the 1980's there was little occasion to examine the issues raised by creative and aggressive capital enhancement transactions involving non-profit charities. However, as investment dollars have flooded into the healthcare market, traditionally a non-profit economic sector, law and policy governing the relationship between these organizations has taken shape in a nearly frenetic

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1. An Act to Redress the Misemployment of Lands, Goods and Stocks of Money Theretofore Given to Charitable Uses, 1601, 43 Eliz. 1, ch.4 (Eng.).

2. *See Healthcare Crisis: Quest for Efficiency* (visited Jan. 21, 1998) <http://www.cicrad.com/2.html>.

3. From 1994 to 1996 an estimated 140 hospitals converted from non-profit to for-profit status. *See* Harris Meyer, *A Lot Is Not Enough*, HOSPITALS AND HEALTH NETWORKS, Oct. 20, 1997, at 30. The number of partnerships and other joint ventures between profit and non-profit organizations is impossible to calculate.

environment of legislation, regulation, litigation, and public scrutiny. These transactions are only beginning to surface in Oklahoma.

To understand the issues and successfully advise organizations through the process, it is necessary to explore the reasons for non-profit and for-profit affiliations, sales, and conversions (Part II); the forms, levels, and varieties of such affiliations (Part III); the limitations imposed by tax law and the constraints arising from state enforcement of common law and statutory proscriptions (Part IV); and the trend towards such affiliations in the Oklahoma governmental public sector (Part V). In conclusion, the author suggests that Oklahoma's rather restrained regulatory environment provides a good opportunity for the responsible enhancement of this vital economic sector for the improvement of healthcare delivery.

II. REASONS FOR AFFILIATIONS, SALES, AND CONVERSIONS

A. The Purposes and Objectives of Non-Profit and For-Profit Healthcare Organizations are Substantially Similar

All organizations are inhibited by some federal, state, and local regulations restraining their operations. Non-profit organizations, whether desiring tax exemption or otherwise, have additional constraints with which to contend. In addition to its primary objective (e.g., making and selling goods or providing services) a for-profit enterprise exists to earn profits for its owners and investors. The non-profit enterprise exists to provide its goods and services with no return on equity investment. The non-profit must be operated exclusively in furtherance of its charitable mission. Charity, quite broadly, includes the entire spectrum of activities designed to improve quality of life through improving the arts, education, welfare, and health.[4]

Many factors—both economic and strategic—have blurred the distinctions between for-profit and non-profit healthcare providers. First, the nature, size, and scope of services of such providers are virtually the same. For example, Columbia/HCA, Inc., the largest American hospital corporation, consists of subsidiaries and divisions which are virtually indistinguishable from either stand-alone 501(c)(3)[5] facilities or religious affiliated entities. Second, state-of-the-art medical services are or should be virtually identical regardless of the underlying form of business organization. This is, in part, no doubt the result of a malpractice environment which no longer favors charitable organizations.[6] Third, the public mission of for-profit institutions—to treat the sick and in-

4. *See* I.R.C. § 501(c)(3) (1994) [hereinafter 501(c)(3)]. Section 501(c)(3) exempts organizations from taxation which provide "[r]elief of the poor and distressed or of the underprivileged . . . [and those entities engaged in] lessening . . . the burdens of Government . . . and promotion of social welfare." Treas. Reg. § 1.501(c)(3)-1(d)(2) (1960). Promotion of health for the benefit of the community is a recognized charitable purpose. *See* Rev. Rul. 69-545, 1969-2 C.B. 117. These terms are broadly interpreted and allow great flexibility.

5. *See supra* note 4.

6. *See, e.g.*, Gable v. Salvation Army, 100 P.2d 244 (Okla. 1940).

jured—is the same dominant mission which controls its charitable competitors. Therefore, healthcare alliances are, for instance, less difficult to justify than a joint venture between an art museum and a commercial art retail gallery where the motivation to educate squarely confronts the art dealer's profit motive. Adhering to charitable objectives is admittedly an important "deal point" in all affiliation and conversion transactions. But the issue is usually the *quantity* of resources to commit, not the commitment itself.

B. The Business Justification for Affiliations, Sales, and Conversion

Organizations seek to affiliate for a variety of reasons, such as administrative efficiency, combination of markets, combination of complementary services, and that ephemeral term, "synergy." What has fueled the incredible drive by non-profit health care organizations to affiliate with their for-profit sisters is all of the above, plus, most importantly, the need for capital.[7] Conversion from non-profit to for-profit status and total asset sales are just stages along a continuum, more or less, driving to these same objectives.[8]

The current wave of affiliations and conversions can largely be traced to the early 1980's when many non-profit health maintenance organizations ("HMOs"), formed under the Health Maintenance Organization Act of 1973,[9] began to lose their government subsidies. They needed capital from sales of stock or other market sources. "Affiliations" by these struggling charitable HMOs usually resulted in total conversions or sales to for-profit organizations. To the extent that early HMOs needed capital, they looked to membership fees and conventional, asset-based lending. Originally, Congress provided loans and grants for HMOs. When those sources of funds were eliminated, the Department of Health and Human Services actively encouraged HMOs to convert from non-profit to for-profit status.[10] The scale and suddenness of these transactions spawned a mini-flood of litigation which is still ongoing.[11]

Another factor which has contributed to the increase in affiliations, sales, and conversions is the Tax Reform Act of 1986,[12] which limited to 5% the non-hospital use of bond proceeds and imposed a $150 million total limit on non-hospital uses.[13] The more favorable tax exempt bond interest rate became

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7. *See*, Douglas Mancino, *Converting the Status of Exempt Hospitals and Health Care Organizations*, J. TAX'N OF EXEMPT ORG., July-Aug. 1997, at 16, 17.

8. *See generally*, R. Todd Greenwalt, Joint Venture, Conversions and Other Transactions Involving Tax-Exempt and Proprietary Organizations 426, American Academy of Healthcare Attorneys (June 24, 1996) (presented at the American Academy of Healthcare Attorneys, 29th Annual Meeting) (on file with author).

9. Pub. L. No. 93-222, 87 Stat. 914 (codified as amended at 42 U.S.C §§ 300e to 300e-17 (1994)).

10. *See*, DOUGLAS MANCINO, TAXATION OF HOSPITALS AND HEALTHCARE ORGANIZATIONS, § 21.01 (1997).

11. A case in point is *Thompson v. Midwest Foundation of Independent Physicians*, 117 F.R.D. 108 (S.D. Ohio 1987), in which Choice Care, a Cincinnati-based HMO, attempted to convert to a for-profit entity, resulting in criminal price fixing, racketeering and conspiracy charges against its officers, who diverted a million dollars to themselves prior to sale of stock to physicians.

12. Pub. L. No. 99-514, 100 Stat. 2085 (codified as amended in scattered sections of 26 U.S.C.).

13. This $150 million cap has recently been repealed in the Taxpayers Relief Act of 1997. *See* 26 U.S.C.A. § 145(b)(5) (Supp. 1997).

less attractive to non-profit healthcare systems seeking to expand services beyond the traditional "bricks and mortar" of hospitals.[14]

Since 1983, affiliations and conversions in the health care sector have multiplied nearly geometrically. Non-profit hospitals merging with or being acquired by for-profit hospital systems increased from eighteen in 1993 to sixty-three in 1996.[15] A recent survey commissioned by Grantmakers in Health, a non-profit industry trade association, shows that there are private foundations with total assets of $9 billion created as the byproducts of conversions or sales.[16]

The urge to affiliate is not totally one sided. For-profit hospitals also achieve strategic goals by increasing the size and scope of their prospective patient market and, hence, their bargaining power with managed care payors. In addition, for-profits can enjoy the economies of scale and the market prestige often associated with major non-profit systems and teaching and research institutions.

III. THE TRADITIONAL NON-PROFIT FORMS, LEVELS, AND VARIETIES OF AFFILIATIONS

A. *The Forms of Non-Profit Organizations in Oklahoma*

For-profit business organizations generally fall into one of several categories: corporations, unincorporated business associations, trusts, partnerships, limited partnerships, limited liability companies, and limited liability partnerships. All of these entities are available to taxable organizations. However, only corporations, trusts, and possibly limited liability companies are available to non-profits because of the literal language of IRS Section 501(c)(3) which provides tax exemption only for "[c]orporations, and any community chest, fund, or foundation."[17] Trusts have been interpreted to equate to "funds or foundations."[18] The limited liability company ("L.L.C."), with the limited liability attributes of corporations and the federal tax criteria of partnerships, *may* be an available form for exempt organizations. But, since the primary motive for forming a L.L.C. is tax-driven, there seems to be no compelling reason to organize a non-profit in L.L.C. form.

The non-profit corporation is generally limited by each state's version of a specific non-profit corporation act or by features governing non-profit corporations within the state's general corporation act. Most states have adopted the Revised Model Non-Profit Corporation Act, but Oklahoma abandoned its separate Non-Profit Corporation Act in 1986 when it adopted the General Corpora-

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14. *See* MANCINO, *supra* note 10, § 21.01, at 21-25.
15. *See* Christine Tien, *Asset Storm*, FOUNDATION NEWS AND COMMENTARY, July-Aug. 1997, at 29, 29.
16. *See id.* at 31. *See also*, *Grantmakers in Health Bulletin of Health Philanthropy*, Nov. 3, 1997 (identifying eighty-one conversion foundations, located in thirty states and the District of Columbia).
17. I.R.C. § 501(c)(3) (1994).
18. Fifth-Third Union Trust Company v. Commissioner, 56 F.2d 767, 768 (6th Cir. 1932).

tion Act.[19] However, non-profit corporations formed in Oklahoma before November 1, 1997, arguably were governed by the dissolution mandate of the former Non-Profit Corporation Act because of the provision in the General Corporation Act stating that "all rights of action conferred, and all duties, restrictions, liabilities and penalties imposed or required by and pursuant to laws enacted prior to the adoption or amendment of the Oklahoma General Corporation Act, shall not be impaired, diminished or affected."[20] The formerly applicable section of the Non-Profit Corporation Act provided:

> Upon the dissolution of the corporation, the Board of Trustees shall, after paying or making provision for the payment of all the liabilities of the corporation, dispose of all the assets of the corporation exclusively for the purposes of the corporation in such manner, or to such organization or organizations organized and operated exclusively for charitable, educational, religious, literary or scientific purposes as shall at the time qualify as an exempt organization or organizations under Section 501(c)(3) . . . as the Board of Trustees shall determine.[21]

Thus, for all Oklahoma non-profit corporations formed prior to November 1, 1997, their charitable purposes cannot be exstinguished.

Another feature of Oklahoma corporate law prohibits private gain, like the so-called private inurement prohibition under 501(c)(3). An Oklahoma non-profit corporation must provide in its Certificate of Incorporation "that the corporation does not afford pecuniary gain, incidentally or otherwise, to its members."[22] Another minor intrusion on the freedom of non-profit corporations provides that, upon dissolution, the corporation must publish this fact one time in a newspaper having general circulation in the county in which its principal place of business is located, which must then be filed with the Secretary of State.[23]

One final provision of the Act restricts corporate power by limiting merger of a non-profit into a for-profit, a rare occurrence and a restriction that can easily be planned around:

> Nothing in this section shall be construed to authorize the merger of a charitable nonstock corporation into a stock corporation, if the charitable status of such nonstock corporation would thereby be lost or impaired; but a stock corporation may be merged into a charitable nonstock corporation which shall continue as the surviving corporation.[24]

These corporation law restrictions on non-profits, taken as a whole, put Oklahoma generally in line with other states. Non-profit corporate assets are

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19. *See* OKLA. STAT. tit. 18, §§ 1001-1144 (1986 & Supp. 1997).

20. OKLA. STAT. tit. 18, § 1003 (repealed 1997). This savings feature was repealed effective November 1, 1997. Even though newly formed Oklahoma non-profit corporations are no longer required to dissolve pursuant to the Non-Profit Corporation Act restrictions, common law considerations, borrowed from the law of charitable trusts, still apply. *See infra* text accompanying notes 25-34.

21. OKLA. STAT. tit. 18, § 864 (1981) (repealed 1986).

22. OKLA. STAT. tit. 18, § 1006(A)(7)(a) (1986 & Supp. 1997).

23. *See* OKLA. STAT. tit. 18, § 1097 (1986 & Supp. 1997).

24. OKLA. STAT. tit. 18, § 1086(F) (1986 & Supp. 1997).

preserved on termination and merger, and private pecuniary gain is prohibited.

As case law develops in Oklahoma in this area of affiliations and conversions, it will most likely derive from the common law of *charitable trusts.* Indeed, the line between non-profit corporation law and charitable trusts is indistinct. The California case of *Queen of Angels Hospital v. Younger*[25] is illustrative. The court noted that:

> the assets of a [non-profit charitable corporation] must be deemed to be impressed with a charitable trust by virtue of the express declaration of the corporation's purposes, and notwithstanding the absence of any express declaration by those who contribute such assets as to the purpose for which the contributions are made. . . . It follows that . . . [a non-profit corporation cannot] legally divert its assets to any purpose other than charitable purposes.[26]

One legal commentator has even suggested that the law from both sources, whether derived from corporate statutes or the law of trusts, is virtually interchangeable.[27]

Trusts are the traditional vehicle for dispensing charitable goods and services. The *Restatement (Second) of Trusts* defines a charitable trust as "a fiduciary relationship with respect to property arising as a result of a manifestation of an intention to create it, and subjecting the person by whom the property is held to equitable duties to deal with the property for a charitable purpose."[28]

In addition, Oklahoma is one of eight states implementing the Uniform Trusts Act.[29] Under this Uniform Act, a trust can be created either orally or in writing whenever there is "[a] transfer inter vivos by the owner of property to another person as trustee for the transferor or for a third person."[30] Another even more expansive and elusive definition of trust is "[a] promise by one person to another person whose rights thereunder are to be held in trust for a third person."[31] Both of these provisions are written broadly enough to infuse the law of trusts into the law of non-profit corporations in Oklahoma. A non-profit corporation is merely the form of business arrangement through which charitable fiduciary duties are exercised. An Oklahoma case which inferentially supports this proposition[32] is *Sarkeys v. Independent School District No. 40.*[33] In *Sarkeys*, the Oklahoma Supreme Court applied common law charitable trust principles to the conduct and affairs of a non-profit corporation without comment or apparent challenge by any party.[34] This was an important "leap of faith" by the court because the law of charitable trusts was used to support

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25. 136 Cal. Rptr. 36 (Cal. Ct. App. 1977).
26. *Id.* at 39 (quoting Pacific Home v. County of Los Angeles, 264 P.2d 539, 543 (Cal. 1953)).
27. *See* Michael W. Peregine, *Charitable Trust Laws and the Evolving Nature of the Non-Profit Hospital Corporation*, JOURNAL OF HEALTH AND HOSPITAL LAW, March 1997, at 11.
28. RESTATEMENT (SECOND) OF TRUSTS §348 (1959).
29. *See* OKLA. STAT. tit. 60, §§ 175.1 to .23 (1994 & Supp. 1997).
30. OKLA. STAT. tit. 60, § 175.6(B) (1994).
31. OKLA. STAT. tit. 60, § 175.6(E) (1994).
32. *See* discussion *infra* Part IV(B).
33. 592 P.2d 529 (Okla. 1979).
34. *See generally id.*

authority of the Oklahoma Attorney General to intervene in a purely private corporate, non-profit transaction with no express statutory authorization.

The common law doctrine of *cy pres* is also applicable here. Under *cy pres*, when a charitable purpose becomes impossible, inexpedient, or impracticable of fulfillment or already accomplished, a court will permit the trustees or board to substitute another charitable object which approaches the original purpose as closely as possible.[35] This doctrine is well established in Oklahoma. In *In re Nuckols' Estate*,[36] the court's holding emphasized the two bases for approving a change of beneficiary from the grantor's original instruction: (1) impracticability of carrying out the grantor's explicit intent; and (2) identification of a charity with a similar purpose, creed, or mission.[37] The *cy pres* doctrine may not be invoked merely on the grounds that it would be more fair, equitable, or efficient to spend trust funds in a manner different from that specified by the original creator. The application of *cy pres* to the healthcare transactions under consideration is obvious. A sale or conversion must simply shift charitable assets (e.g., residual cash) to a new charity with similar goals and objectives.

In summary, Oklahoma courts will, if called upon, intervene to limit and control the way non-profit corporations and charitable trusts use and dispose of their assets. Anticipating such intervention, it is appropriate to examine the forms which such affiliations, sales, and conversions usually take.

B. Forms of Affiliations, Sales, and Conversions

Affiliations, sales, and conversions have and will continue to take a number of different forms depending on the complexity of the transaction and goals of the participants. Certain patterns have begun to emerge among healthcare transactional specialists.

1. Partnerships, L.L.C.s, and Corporations

The vast majority of healthcare joint venture affiliations fall into one of these categories. A *partnership* is two or more persons (or entities) engaged in a business for profit.[38] A *limited liability company* ("L.L.C.") is a product of statute, having members instead of shareholders and governed by an operating agreement rather than bylaws. A *corporation* in Oklahoma has a long and well-established tradition bringing together shareholders governed by directors and under the executive authority of officers. Partners, L.L.C. members, and shareholders themselves can be exempt or taxable organizations. The new entity itself will not qualify as a non-profit since one or more of its participants antici-

35. *See* BOGERT, THE LAW OF TRUSTS AND TRUSTEES, § 431 (2d ed. 1991); RESTATEMENT (SECOND) OF TRUSTS § 399 (1959).
36. 184 P.2d 778 (Okla. 1947).
37. *See id.* at 780.
38. *See* OKLA. STAT. tit. 54, § 206(1) (1991).

pate a profit. However, the ultimate objective (i.e., to engage in a business for a profit) does not *per se* destroy the charitable status of the non-profit participant. As shown in Part IV(A) hereafter, such was not always the case.

2. Lease

Healthcare affiliations are often created by *lease* of real or personal property, especially for long terms, such as ten to fifteen years. Through a lease, a for-profit entity can pay a fair market value rental for the purpose of managing and operating a non-profit corporation. Charitable corporations and trusts own substantial real property with healthcare-related facilities constructed on these sites. Turning them into essentially passive investment assets to generate rental income in furtherance of charitable purposes is a proper form of affiliation.[39] This arrangement would not be appropriate if the non-profit, in essence, leased its entire operation to a for-profit receiving a fixed rental in return for surrender of the net earnings of the non-profit operation.

3. Joint Operating Agreement

A *joint operating agreement* has the characteristics of a lease and management agreement. Real and/or personal property is operated for the benefit of a non-profit entity frequently with net income payable to the operator. These arrangements are *sui generis*. No two are alike. If the operator is to receive full use of net income, impermissible private inurement will result. There is more opportunity to structure operating agreements between or among non-profits.

4. Management Agreement

On the surface, a *management agreement* establishes nothing more than an agency relationship between a non-profit and a for-profit as its agent. If a non-profit hires a for-profit management company, in most instances the relationship will not implicate tax exemption. In the health care area, management companies commonly "manage" a large number of non-profit hospitals throughout the country for a specific management fee without raising any question as to the continuing exemption of those hospitals.

5. Asset Purchase, Conversion, and Merger

Asset purchases, conversions, and mergers are the dominant form of transaction on which most of the recent legal activity has focused. These transactions involve the extinction or abandonment of a non-profit for consideration, usually cash. *Conversions* occur when a charitable corporation amends its bylaws to eliminate the non-profit restrictions. Title to assets does not change.

39. Unrelated business income tax ("UBIT") is always an underlying concern. *See* I.R.C. § 512(a)(1) (1994). In most instances, the same criteria which support change of use of charitable assets also ensure that the income produced by the new affiliated entity is sufficiently *related* to the non-profit so as to avoid UBIT.

Ordinarily, healthcare licenses remain in place. *Mergers* are exclusively corporate transactions governed by statute.[40] *Asset sales* involve transfer of tangible and intangible assets to a for-profit company usually for cash. The cash consideration cannot be diverted to private individuals. A charitable 501(c)(3) foundation, supporting organization or new operating charitable organization must be formed with the residual cash as its primary asset.[41] The non-profit's assets, good will, and future revenue become the sole property of a for-profit enterprise. Typically, the non-profit will cease to operate but a *new* non-profit will use the cash as a *private foundation* or a *public charity.* The planning options all have to be measured against the requirements of 501(c)(3) and state law applicable to charitable trusts.

IV. LIMITATIONS AND PLANNING CRITERIA IMPOSED BY IRS RULES AND STATE COMMON LAW RESTRICTIONS

A. *Preserving the Federal Tax Exemption*

The requirements for federal tax exemption under 501(c)(3) are, simply stated:

(1) The organization must be organized and operated exclusively for certain exempt purposes;

(2) No part of the organization's net earnings may inure to the benefit of a private shareholder or individual;

(3) No part of the organization's activities may constitute intervention or participation in a political campaign on behalf of or in opposition to any candidate for public office; and

(4) No substantial part of the organization's activities may consist of attempts to influence legislation.[42]

Only the first two requirements are relevant to our present discussion.

1. The Tax Exemption Consequences of Affiliations.

Prior to 1982, the IRS recognized no opportunity for planning to insulate the non-profit from its for-profit partners' business activities and objectives.[43] Various Private Letter Rulings and the case of *Better Business Bureau v. United States*[44] combined to create a *per se* prohibition against non-profit/for-profit partnerships, or other joint venture business associates. Such an affiliation would destroy the exempt status of the non-profit participant. This was the

40. *See* OKLA. STAT. tit. 18, § 1081 (1986 & Supp. 1998).
41. *See* discussion *infra* Part IV(A)(2) (discussing the rules governing the ongoing operation of these residual entities).
42. *See* I.R.C. § 501(c)(3) (1994).
43. *See* Priv. Ltr. Rul. 78-20-058 (Feb. 17, 1998). *See also*, Gen. Couns. Mem. 36,293 (May 30, 1975).
44. 326 U.S. 279 (1945).

IRS's position until *Plumstead Theatre Society, Inc. v. Commissioner*.[45] In *Plumstead Theatre*, a non-profit theatre company entered into a limited partnership as general partner with three for-profit limited partner investors to raise revenue to produce a play.[46] The United States Tax Court held, and the Ninth Circuit Court of Appeals affirmed, that the exempt status of the non-profit would be maintained, essentially because the transaction was made at arm's length and reasonable consideration was paid; the theatre company had no obligation to return capital to the limited partners; the limited partners had little or no control; there was no profit motive by the non-profit; and none of the limited partners representatives were controlling or managing partners.[47]

The IRS officially adopted the *Plumstead Theatre* approach, slightly modified, in its General Counsel Memorandum ("GCM") 39,005 (the so-called "close scrutiny" test).[48] Under GCM 39,005, three considerations are paramount to preserve the tax exempt status of the participating non-profit. First, the joint venture must further the non-profit's exempt purposes.[49] The new organization must provide a community benefit. Its purpose must not be primarily to increase an exempt hospital's market share. There must be evidence that bona fide community benefit is the principal purpose of the venture.[50] Second, the non-profit participant must be able to act (especially if it is a general partner or manager) free of any conflict of interest.[51] The non-profit must not be required to act primarily to further the private financial interests of its non-exempt partners.[52] Finally, the joint venture structure must protect against the non-exempt participants from deriving *improper* financial gain from the venture.[53] As long as the governing structure provides earnings in each participant's proportionate share of ownership or capital investment, then the transaction should be acceptable. This standard applies both at the outset when initial capital contributions are made and on an ongoing basis as additional capital calls are required. These criteria do not create insurmountable barriers to joint venture affiliations but require careful planning and drafting. Unless the transaction fits squarely within an existing Private Letter Ruling or GCM, a new Private Letter Ruling request is advisable.

The IRS has further analyzed the role of the non-profit as general, controlling partner.[54] The IRS reaffirmed its position that a tax-exempt organization could carry out its fiduciary duty to other partners to maximize profits and at the same time be operated exclusively for charitable purposes.[55] The trend,

45. 675 F.2d 244 (9th Cir. 1982), *aff'g* 74 T.C. 1324 (1980).
46. *See id.* at 244.
47. *See Plumstead Theatre*, 74 T.C. at 1333-34 (affirmed by the Ninth Circuit in *Plumstead Theatre*, 675 F.2d at 245).
48. *See* Gen. Couns. Mem. 39,005 (Dec. 17, 1982).
49. *See id.*
50. *See* Gen. Couns. Mem. 39,862 (Nov. 21, 1991).
51. *See* Gen. Couns. Mem. 39,005 (Dec. 17, 1982).
52. *See* Gen. Couns. Mem. 37,852 (Feb. 15, 1979).
53. *See* Gen. Couns. Mem. 39,005 (Dec. 17, 1982).
54. *See* Gen. Couns. Mem. 39,546 (Aug. 14, 1985).
55. *See id.*

therefore, continues to favor these affiliations.

Since GCM 39,005, numerous Private Letter Rulings have been issued authorizing non-profit/for-profit joint ventures.[56] The elements and purposes of a joint venture which will support a finding of continuing tax-exemption are suggested in GCM 39,862 when the venture (1) creates a new health care provider, service, or resources; (2) raises capital for exempt purposes projects; (3) owns or leases a facility; (4) pools expertise; or (5) measurably improves quality of care.[57] However, all of these purposes and features will avail nothing if the non-profit surrenders control as a minority participant with a dominant for-profit co-venturer.[58]

2. The Tax Exemption Consequences of Conversions and Sales of Assets

In the case of outright sales or conversions rather than ongoing business affiliations, the question becomes: Will the new or surviving non-profit which receives the sales proceeds operate in a manner allowing it to obtain and retain tax exemption? There are several options open: (1) continued public charity status; (2) supporting organization; and (3) private foundation. Each option requires its own planning criteria.

When a 501(c)(3) organization converts to a for-profit enterprise, it loses its public charity status. However, if the non-profit sells its assets, it still has the option of remaining in existence and continuing to function with a newly-acquired asset base (i.e., cash). If the old or spinoff non-profit seeks avoidance of private foundation status, with its attendant complications, it must continue to provide a measurable amount of healthcare services.[59]

If continuing charitable services cannot or will not be provided, the residual non-profit entity can attempt to qualify for tax exemption as a supporting organization.[60] This allows the non-profit to continue as a financial resource without the restrictions imposed by private foundation status.

Finally, and most commonly, a private foundation is set up to support other 501(c)(3) organizations. The requirements for maintaining private foundation tax exempt status are beyond the scope of this article. The most restrictive, however, is the minimum payout requirement. Under federal statutes, these organizations must distribute at least 5% of the aggregate fair market value of all foundation assets annually to qualified charitable donees.[61] This presents a challenge for investment strategy and serious problems for foundations which are funded with illiquid sales consideration. Despite the private foundation limitations on operation, this appears to be the conversion and sale entity

56. *See* Priv. Ltr. Rul 93-23-030 (June 11, 1993); Priv. Ltr. Rul. 93-19-004 (May 14, 1993); Priv. Ltr. Rul. 96-37-050 (Sept. 13, 1996).

57. *See* Gen. Couns. Mem. 39,862 (Nov. 21, 1991).

58. *See* Priv. Ltr. Rul. 97-36-039 (Sept. 5, 1997).

59. I.R.C. § 170(b)(1)(A)(iii) (1994) establishes the requirements for public charity status for hospitals.

60. I.R.C. § 509(a)(3) (1994) provides tax exemption for an organization which supports another 509(a)(1) or 509(a)(2) organization.

61. *See* I.R.C. § 4942 (1994).

choice. The size of these conversion foundations alone virtually guarantees intensive community and state interest as discussed in the following section.[62]

B. The State's Role in Supervising Affiliations, Sales, and Conversions

Although there is no expressed statutory authority, the Oklahoma Attorney General has the power and duty, under the common law, to enforce charitable trusts or prevent their misuse.[63]

In *Sarkeys v. Independent School District No. 40*,[64] a charitable corporation, Sarkeys Foundation sold a large block of stock in Sarkeys, Inc., an oil and gas company, back to Sarkeys, Inc.[65] Both the foundation and the purchasing company shared certain common directors.[66] At the request of a Cleveland County school district, the lead class plaintiff on behalf of a class of Sarkeys Foundation beneficiaries, the Oklahoma Attorney General intervened in a suit the beneficiaries brought to challenge the transaction as a self-dealing breach of fiduciary duty.[67] The case was settled, and the Attorney General approved the settlement based on a sales price of $14.5 million.[68] The standing and authority of the Attorney General were challenged by certain Sarkeys family members.[69]

The court supported the Attorney General's standing and authority to intervene, citing the prerogative of the state, as *parens patriae*, to supervise charitable trusts.[70] Further, this authority is exclusive except as to grantors, trustees, and actual or potential beneficiaries.[71] In other words, citizen action generally cannot be maintained. "If a third party were permitted to sue as a matter of right, the charity could be subjected to frequent, unreasonable and vexatious litigation, the court dockets could become clogged, and the trust assets could be wasted in unnecessary attorney fees."[72] Armed with this authority, what standards exists for the Attorney General to enforce?

As stated previously, the Oklahoma Trust Act defines "trust" broadly enough to encompass arrangements that are obviously trusts and those that may appear to be something else.[73] For example, the law in other jurisdictions has developed, and Oklahoma would not contradict the trend, to the extent that corporations are deemed to be charitable trusts. To protect charitable interests, courts typically do not make fine distinctions. In *Queen of Angels Hospital v.*

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62. The five largest conversion foundations are: California HealthCare Foundation, Oakland, CA, $2.2 billion; California Endowment, Woodland Hills, CA, $975 million; California Wellness Foundation, Woodland Hills, CA, $880 million; Kansas Health Foundation, Wichita, KS, $377 million; Colorado Trust, Denver, CO, $320 million. *See* Meyer, *supra* note 3.

63. *See* Sarkeys v. Independent Sch. Dist. No. 40, 592 P.2d 529 (Okla. 1979).

64. 592 P.2d 529 (Okla. 1979).

65. *See id.* at 532.

66. *See id.*

67. *See id.*

68. *See id.* at 532 n.3.

69. *See id.* at 532-33.

70. *See id.* at 533.

71. *See id.*

72. *Id.* at 534.

73. *See supra* notes 30-32 and accompanying text.

Younger,[74] the court entered a declaratory judgment that the articles of incorporation of Queen of Angels Hospital in Los Angeles prevented abandonment of hospital activity in favor of out-patient medical clinics.[75] Similarly, in *Holt v. College of Osteopathic Physicians and Surgeons*,[76] the original articles of incorporation called for creation of an osteopathic college.[77] A majority of the board voted to allow for allopathic and osteopathic medical education.[78] Three dissenting trustees brought an action to prevent the breach of a charitable trust.[79] The court held that the change amounted to a significant departure from the original purpose and prevented the modification.[80] By contrast, in *Taylor v. Baldwin*,[81] the court held that there was no substantial departure from original intent when the University of Washington Medical Center affiliated with a for-profit cancer treatment facility.[82]

In the governing documents, whether creating a trust or a corporation, certain ground rules apply before the charitable purposes can be changed. First, the process of sale or conversion must be free of conflicts of interest. Sweetheart deals involving trustees or key administrators, "golden parachute contracts"—all are highly suspect. Second, the trustees must exercise sound business judgment. Affiliations are appropriate for any number of strategic purposes. However, the governing board must enter into a sale or conversion only out of absolute necessity. Typically, conversion or sale is necessary to keep the organization, or the needed service, in existence. These are life-or-death business judgments. Reliance on legal counsel and qualified appraisals is also highly recommended. Third, the conversion must not involve a change of use dramatically different from the original corporate purpose.

Most health care conversions will satisfy the *cy pres* doctrine. If the residuary non-profit or foundation created to receive converted funds makes grants or otherwise assists in the promotion of health care in the community, the change of corporate purpose will not destroy the transaction. One can, however, question the activities of surviving conversion foundations which have a broad and diverse public mission, providing benefits to education and the arts, as well as health services.

Finally, the most important question is what use will be made of the sales or conversion proceeds? The dollars involved in these transactions are usually so large and the change of ownership so significant for communities, even statewide interests, that Attorneys General have taken a very active role. The National Association of Attorneys General and the National Association of State Charity Officials have organized an Internet linkage to assist each other in

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74. 136 Cal. Rptr. 36 (Cal. Ct. App. 1977).
75. *See id.* at 41.
76. 394 P.2d 932 (Cal. 1964).
77. *See id.* at 937.
78. *See id.* at 938.
79. *See id.* at 934.
80. *See id.* at 938.
81. 247 S.W. 2d 741 (Mo. 1952).
82. *See id.* at 751-52.

examining and intervening in conversions.[83]

As the states' attorneys general continue to intervene and scrutinize conversions, the focus may shift from the propriety of the conversion itself to the use made of the proceeds. States can be expected to insist upon greater support for indigent care and basic hospital services rather than more exotic and lucrative healthcare "products." In addition, the states can be expected to demand community participation and control over use of the residual resources. The amount of negotiating leverage available to the Attorneys General will depend on the strength and explicitness of state law. Oklahoma's law—statutory and common law—does not currently provide a significant platform for intervention.

The instances of sale or conversion have produced no definite pattern. State interventions have generally served as roadblocks or detours in transactions resulting in settlements arguably more favorable to the public interest.

A few of the more notable transactions recently occurring in other states are:

> (1) Blue Cross/Blue Shield of Georgia. Nine consumer groups have sued the Georgia Insurance Commissioner and Blue Cross/Blue Shield of Georgia, Inc., to recoup $400 million dollars from private investors after a legislatively-authorized conversion. Plaintiffs claim the legislation was unconstitutional.[84]
>
> (2) Blue Cross/Blue Shield of Texas—Illinois Merger. The Texas Attorney General has sued to enjoin a merger with BC/BS of Illinois, a converted for-profit, claiming this would divert $700 million in charitable assets from the state.[85]
>
> (3) Good Samaritan Health System—sale to Columbia/HCA. The California attorney general insists that $72 million proceeds from sale to Columbia/HCA be maintained for acute care hospital services for indigents rather than medical residency scholarships.[86]
>
> (4) In *Kelly v. Michigan Affiliated Healthcare System, Inc.*,[87] the trial court held that a fifty/fifty joint venture between an non-profit healthcare system and Columbia/HCA would violate the Michigan Non-Profit Corporation Act, which prevents "co-mingling" of non-profit and for-profit assets. This deal involved the entire hospital system co-venturing with a for-profit.

These cases are undoubtedly expensive, time consuming, and contentious and do not represent creative teamwork between the public and private sectors.

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83. *See Non-Profit Conversions: State AGs Share Data, Approaches to Charitable Assets Conversions*, 5 BNA'S HEALTH L. REP. 1413 (1996).

84. *See Consumer Groups Sue to Recover Assets Retained by Blue Cross of Georgia*, 6 BNA'S HEALTH L. REP. 1378 (1997).

85. *See State Asks Court to Block Texas-Illinois Blues Merger*, 6 BNA'S HEALTH L. REP. 1181 (1997).

86. *See* Michele B. Blecher, *Show Us the Money*, HOSPITALS AND HEALTH NETWORKS, June 20, 1997, at 52.

87. No. 96-83848 CZ (Mich. Cir. Ct. Sept. 5, 1996).

VI. GOVERNMENTAL AND QUASI-GOVERNMENTAL HEALTHCARE ORGANIZATIONS IN OKLAHOMA MAY AFFILIATE OR COMMIT THEIR OPERATIONS TO FOR-PROFIT VENTURES

Oklahoma, like most states, has public sector organizations created to deliver healthcare services. These facilities which are owned, operated, or sponsored by the state, are not-for-profit and tax exempt; but they do not derive their charitable status from corporate or trust law or 501(c)(3). Rather, they are created expressly under statutory authority. Like private charitable organizations, however, these creatures of state law are also seeking for-profit partnerships and conversions.

A. Public Trusts

The most commonly encountered statutory healthcare entity is the public trust formed for the benefit of the state, a county, or a municipality.[88] Public trusts are formed primarily as entities authorized to issue bonds.[89] Hospital construction in Oklahoma was greatly assisted in the immediate post war era by funds available under the federal Hill-Burton Act.[90] As those funds became less accessible, many Oklahoma hospitals in smaller cities and towns turned to hospital bond issuance to finance expansion, modernization, new equipment, and services.[91] Following final payment or early refunding of such bonds, the public trust remains as a quasi-governmental entity with its distinct governing trust indenture, bylaws, and board of trustees. In many respects, these hospitals function as agencies of the state. For example, the Oklahoma Public Meeting and Records Acts applies to their deliberations and documents.[92] However, their revenues and assets are *not* controlled by Article X, Section 15 of the Oklahoma Constitution, which prohibits the State of Oklahoma from entering into any for-profit venture. Section 15 states:

> The credit of the State shall not be given, pledged or loaned to any individual, company, corporation or association, municipality or political subdivision of the State; nor shall the State become an owner or stockholder in, nor make donation by gift, subscription to stock, by tax, or otherwise to any company, association or corporation.[93]

In *Sublett v. City of Tulsa*,[94] the Oklahoma Supreme Court held that a public trust could lease the Port of Catoosa, Oklahoma, storage and docking

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88. Such public trusts are formed pursuant to OKLA. STAT. tit. 60, § 176 (Supp. 1998).
89. *See* OKLA. STAT. tit. 60, § 176(a) (Supp. 1998).
90. Hospital Survey and Construction Act (Hill-Burton Act) of 1946, Pub. L. No. 79-725, ch. 958, 60 Stat. 1040 (codified as amended in scattered sections of 24 U.S.C., 31 U.S.C., 33 U.S.C., 42 U.S.C., 46 U.S.C., 48 U.S.C., and 49 U.S.C.).
91. Examples include hospital trust authorities in Cushing, Cleveland, Poteau, Henryetta, and Pryor.
92. *See* Okla. Op. Att'y Gen. No. 81-109 (1981).
93. OKLA. CONST. art. X, § 15.
94. 405 P.2d 185 (Okla. 1965).

facilities to private entities.[95] Article X, Section 15 of the Oklahoma Constitution was not violated because the lease did not involve pledging the state's credit or appropriating money for a private enterprise.[96] The pivotal issue was whether the "public" property was to be used for a private purpose. The court found the purpose consistent with public ownership.[97]

The tendency of the Oklahoma Supreme Court to measure the degree of continued public use and benefit is highlighted by the more recent case of *Burkhardt v. City of Enid*.[98] The City of Enid bought Phillips University, a private facility, and transferred it to the Enid Economic Development Authority ("EEDA"), a public trust.[99] The EEDA then leased the university to a private foundation.[100] The lease provided only nominal rental to the public trust, thus suggesting that the public trust had made a "gift," unconstitutional under Article X, Section 15.[101] However, transfer of assets at less than fair market value did not diminish the effect of continued public use and benefit.[102]

B. The University Hospitals Trust Authority/ HCA Joint Operating Agreement

A notable recent conversion of a public trust involves the healthcare system operated by the University Hospital Authority ("Authority")—University Hospital, Children's Hospital of Oklahoma, the Child Study Center and the O'Donoghue Rehabilitation Institute. The Authority is a public trust which controls the University Hospitals, formerly a state agency. In a complex transaction, recently upheld by the Oklahoma Supreme Court as valid,[103] HCA Health Service of Oklahoma, Inc., a subsidiary of the giant, for-profit hospital company, Columbia-HCA, Inc., now operates the University Hospitals governed by the Authority. HCA has paid in excess of $40 million dollars for these long-term, and potentially financially lucrative, operating assets sanctioned by special legislation.[104] Under the Joint Operating Agreement, the mission and purpose of the University Hospitals are realized. A Governing Committee, comprised of balanced representation from the governmental side and the for-profit side will establish long range policy and make certain defined major decisions. Day to

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95. *See id.* at 201-02.
96. *See id.* at 204.
97. *See id.* If the public trust facility has issued tax exempt bonds, the change of use caused by a lease to a for-profit facility would have to be carefully analyzed.
98. 771 P.2d 608 (Okla. 1989).
99. *See id.* at 609-10.
100. *See id.* at 611.
101. *See id.*
102. *See id.* at 611-12.
103. *See In re* Petition of Univ. Hosp. Trust Auth., No. 90-212, 1997 WL 819439 (Okla. 1997).
104. *See* University Hospitals Authority Act, OKLA. STAT. tit. 63, § 3201-27.1 (1997 & Supp. 1998). The Act empowers the Authority to "maintain, use and operate or to contract for the maintenance, use and operation of or lease of any and all property of any kind, real, personal, or mixed or any interest therein." OKLA. STAT. tit. 63, § 3208(B)(9) (1997). In a 1997 amendment to the Act, agreements such as the HCA Joint Operating Agreement must be reviewed by a Contingency Review Board. *See* OKLA. STAT. tit. 63, § 3225(A) (Supp. 1998). If approved (which did occur in the HCA deal), the Authority may file a petition with the Oklahoma Supreme Court seeking a declaratory judgment in favor of the transaction. *See* OKLA. STAT. tit. 63, § 3225(B) (Supp. 1998).

day operations will be the responsibility of HCA. HCA will pay rental/operating consideration from net earnings but will initially receive and own all the revenue. Certain side agreements requiring various levels of indigent care, medical education, and student and faculty health services are also part of the transaction.

The Authority filed its mandatory declaratory judgment action in the Oklahoma Supreme Court seeking a preclusive judgment of: (1) the appropriateness of the HCA transaction, and (2) the constitutionality of the transaction under Article X, Section 15.[105] The briefing in support and opposition[106] focused on the degree of public benefit preserved or enhanced. The Oklahoma Supreme Court held that the transaction was "not in discord with the [University Hospitals Authority] Act and other Oklahoma law."[107] The court refrained from enjoining all future challenges, however, stating: "It is impossible to say what circumstances not evident from the record before us today might arise at some future time that would expose a critical infirmity in the Transaction."[108]

Public trust and state agency healthcare facilities are creatures of statute. However, their freedom to affiliate, sell or convert to for-profit entities is subject to much the same policy standards applicable to private 501(c)(3) corporations or trusts. The pressure of healthcare change is stronger than the tradition and public perception of an impregnable wall between public and private enterprise.

VII. CONCLUSION

Taxable and non-taxable organizations can affiliate successfully and for obvious mutual advantage. The tax exemption of the non-profit venturer and its parent and affiliates can and should be maintained. The IRS has become familiar with and tolerant of these transactions if properly structured to protect the exempt purposes of the non-profit. Conversions and sales also are permissible under tax law, with the greater scrutiny on the operations of the surviving non-profit entity or foundation. Oklahoma, through its Attorney General, can and will continue to intervene to protect charitable assets. Oklahoma has sufficient corporate statutory and trust common law to enable these transactions to occur in a relatively favorable environment. The litigation spawned in other jurisdictions has thus far (blessedly) not made its way to Oklahoma. There is no reason why, under the existing regulatory system, Oklahoma's experience cannot be less contentious, thus saving precious charitable resources for more beneficial uses.

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105. This unusual procedure was specifically created under the Act which provides for exclusive, original jurisdiction in the Oklahoma Supreme Court. *See* OKLA. STAT. tit. 63, § 3225(B)(1) (Supp. 1998).

106. Opposition surfaced from Common Cause of Oklahoma, the N.A.A.C.P. (Oklahoma City Branch), and Oklahoma Coalition for Health Security, arguing, in essence, that the entire transaction amounted to an unconstitutional "donation" of public property to a private corporation.

107. *Petition of Univ. Hosp.*, 1997 WL 819439, at *3.

108. *Id.* at *6.