AMERICAN BANKRUPTCY INSTITUTE
JOURNAL
Issues and Information for the Insolvency Professional

Intensive Care

The "Charitable Trust" Doctrine: Lessons and Aftermath of *Banner Health*

Contributing Editor:
Harold L. Kaplan
Gardner Carton & Douglas LLP; Chicago
hkaplan@gcd.com

Also Written by:
Patrick S. Coffey
Gardner Carton & Douglas LLP; Chicago
pcoffey@gcd.com

Rosemary G. Feit
Gardner Carton & Douglas LLP; Chicago
rfeit@gcd.com

In recent years, nonprofit health care entities have experienced increased and highly publicized state attorney general scrutiny of, and sometimes interference with, the sales of facilities, use of assets and other health care transactions.[1] Traditionally, state attorney general review of corporate health care transactions has been reserved for nonprofit-to-for-profit asset conversions and instances of regulatory oversight of transactions involving outright self-dealing or *ultra vires* conduct. Of late, however, the nonprofit health care transactions that have drawn fire from state officials involve straightforward asset transfers to other nonprofit corporations and, in particular, transactions where a nonprofit health care corporation seeks to close a struggling local hospital, merge facilities, exit a community or entirely divest of a portfolio of in-state holdings. Even more recently, state attorneys general have objected to specific expenditures by nonprofit corporations (including fees for hiring bankruptcy professionals)[2] and have suggested that nonprofit corporation funds may need to be expended in accordance with charitable mission objectives rather than made available for creditor recoveries.

In sum, motivated in part by apparent political ends, in addition to policy concerns, the attorneys general who have joined the fray contend that there are (or should be) significant limitations on the ability of nonprofit health care (and other) institutions to independently manage and control their assets. According to the argument advanced by the attorneys general, the assets of a nonprofit health care system are held not as private corporate property, but pursuant to a constructive or implied charitable trust for the benefit of the community or communities that the nonprofit organization serves. Thus, the assets of a nonprofit organization may be viewed as less committed to fund the ongoing operations of the nonprofit organization or to pay creditors and, instead, as designated for the support of underperforming nonprofit assets or for furthering local community enterprises. That position creates potential problems and concerns for parties attempting to effect restructuring and other transactions involving health care entities, as well as creditors seeking recoveries from the assets of nonprofit organizations.[3]

The *Banner* "Charitable Trust" Litigation: Overview and Outcome

The cases between Banner Health, an Arizona nonprofit health care system, and the attorneys general of North and South Dakota offer a paradigmatic example of how the charitable trust controversy has unfolded to date—and of arguments invoked by attorneys general across the board for greater control over the use and disposition of health care facility assets.[4] (One of the authors of this article, Patrick S. Coffey, was Banner's lead litigation counsel in the North and South Dakota Attorney General litigation.) In 2002, Banner implemented a board-level strategic-planning decision to sell its Dakota-based health care facilities to four different nonprofit health care systems and to transfer the net sale proceeds to core operations in the high-growth health care markets of Arizona and Colorado. Although Banner had been led to believe that sales of its facilities to nonprofit (as opposed to for-profit) buyers would not be challenged by state officials, Banner nonetheless quickly found itself the target of claims from the North and South Dakota attorneys general that Banner was restricted from taking sale proceeds out of state and using those monies in furtherance of its charitable mission in other markets.

The attorneys general adopted the same four basic arguments: First, a donation made by a community member to a local health care facility created a constructive or implied charitable trust over that donation that inured to the exclusive benefit of the community served by the facility. The implied terms of such trusts, the attorneys general argued, prohibit the use of such funds outside of the local community—even for uses that are consistent with Banner's overall charitable mission (and nonprofit articles). Second, gifts made by community members to local facilities—either during Banner's tenure or in earlier times when other nonprofit corporations owned the facilities—created a trust relationship between Banner (as trustee) and the particular community (as beneficiary) that would be breached by the removal of assets from the community. Third, contributions by local citizens to local

[1] A contributing factor to the trend has certainly been the default by Allegheny Health System in 1998 on more than $1 billion of outstanding debt—representing the largest default in the history of nonprofit health care systems.

[2] *See In re Nat'l. Benevolent Ass'n. of the Christian Church (Disciples of Christ), et al.*, Case No. 04-50948-RBK (Bankr. W.D. Tex.).

[3] It must be noted that because nonprofit corporations are organized under state nonprofit corporation laws, a state's nonprofit corporation statutes will always be an important factor in any "charitable trust" controversy. Since the adoption of nonprofit corporation acts, many courts have determined that nonprofit corporation statutes—not trust law—govern the business conduct of a nonprofit corporation. *See, e.g., Persan v. Life Concepts Inc.*, 738 So. 2d 1008 (Fla. App. 1999); *Kansas East Conferences of United Methodist Church v. Bethany Med. Ctr. Inc.*, 969 P.2d 859 (Kan. 1998); *Attorney General v. Hahnemann Hosp.*, 494 N.E.2d 1011 (Mass. 1986); *Stern v. Lucy Webb Hayes Nat'l. Training Sch. for Deaconesses & Missionaries*, 381 F. Supp. 1003 (D. D.C. 1974). Notably, however, in the *Banner Health* cases discussed herein, two state courts concluded that, although nonprofit corporations are not charitable trusts, they are subject to state statutory and common law trust provisions.

[4] *See Banner Health System v. Stenehjem*, Civ. No. A3-02-121 (D. N.D.); *State of North Dakota ex rel. Stenehjem v. Banner Health System*, Civ. No. 09-02-C4093 (Cass County District Court); *Banner Health System v. Long*, Civ. No. 02-5017-KES (D.S.D.); *State of South Dakota ex rel. Long v. Banner Health System, et al.*, Civ. No. 02-0024 (Gregory County, Sixth Judicial Circuit); and *State of South Dakota ex rel. Long v. Banner Health System*, Civ. No. 02-232 (Lawrence County, Fourth Judicial Circuit).

health care facilities—again, either during Banner's tenure or its predecessor's ownership—enhanced the value of these assets to potential purchasers such that Banner's out-of-state transfer of the proceeds from the sales of the facilities would unjustly enrich Banner at the expense of the local communities. Fourth, Banner's tax-exempt status enhanced the value of its facilities because it allowed Banner to retain funds that would have otherwise been used to pay taxes. If Banner were permitted to move the sale proceeds out of state, it was argued, Banner would be unjustly enriched because assets and added value attributable to local taxpayers would be diverted to out-of-state communities.[5]

On these bases, and despite the minimal overall amount of local charitable giving to the facilities at issue, the North and South Dakota attorneys general alleged that the proceeds from the sale of Banner's facilities in North and South Dakota must remain in-state under charitable or constructive-trust principles. The two attorneys general also claimed that Banner succeeded to the trust obligations and liabilities of its nonprofit predecessor with respect to donated assets that Banner ultimately acquired in arm's-length transactions for fair value. Not surprisingly, the asserted claims did not fully address the fact that a significant portion of the assets donated to local facilities decades prior to Banner's ownership had already been expended in furtherance of Banner's predecessor's charitable mission and/or had depreciated to little or no value.

Banner defended itself on a number of grounds and with a measure of success. The state trial court in North Dakota dismissed the North Dakota attorney general's suit to impress a constructive trust over the net sale proceeds derived from Banner's sale of in-state facilities. Dealing a blow to the North Dakota attorney general's principal argument, the court found that community donations to local Banner facilities did not create a fiduciary or confidential relationship between Banner and the community. Because the existence of a fiduciary or confidential relationship is an essential element of a constructive trust claim, the North Dakota attorney general's claim had to fail. The decision is significant because it squarely addresses and rejects the notion that gifts and donations to a nonprofit corporation somehow impose fiduciary—or trustee-like—obligations on the non-profit corporation that receives them.[6]

[5] The arguments of the North and South Dakota attorneys general gave little weight to the respective state nonprofit corporation laws, which recognize a legal distinction between nonprofit corporations and charitable trusts, and which further recognize that nonprofit corporations are generally free to sell, transfer or dispose of assets so long as they are not diverted from the corporation's charitable purposes.

The South Dakota litigation progressed along a more complicated procedural route and produced somewhat less-definitive results. In South Dakota, the federal court sought the state Supreme Court's opinion on the following question: Does South Dakota law recognize a legal basis for subjecting the assets of a nonprofit corporation—or proceeds from the sale of those assets—to an implied or constructive charitable trust even in the absence of an express trust agreement? The South Dakota Supreme Court answered that question in the affirmative, but failed to provide any additional guidance as to the factual scenarios that might give rise to the imposition of such a trust.[7] Fundamentally, the ruling established that the "charitable trust" theory might be appropriately applied in the presence of misrepresentation, fraud or where other wrongful conduct had occurred.[8]

In late 2003 and early 2004, favorable settlements were reached with the attorneys general of North and South Dakota. Under the terms of the North Dakota settlement, Banner paid the state $1 million—to be distributed at the North Dakota attorney general's discretion for health care activities in the local communities that Banner had served (and that continue to be served by Banner's nonprofit successors). Under the South Dakota settlement, Banner will pay $1.8 million into a community fund devoted to elder care and general health care in the South Dakota communities where Banner had operated facilities (and where its nonprofit successors continue to do so).

Practical Lessons from the *Banner* "Charitable Trust" Litigation

It is important to recognize that because the *Banner* litigation was resolved by settlement and not by the judicial resolution of the underlying "charitable trust" theory advanced by the North and South Dakota attorneys general, similar controversies are likely to arise again in other states. Nevertheless, several important lessons for the future can be gleaned from Banner's experience, and from the experience of other nonprofit health care entities who have confronted similar attorney general challenges—such as Intracoastal Health System, Menninger, Health Midwest and, most recently, National Benevolent Association of the Christian Church (NBA).[9]

[6] The court's decision is also consistent with the basic nonprofit corporate law concept that nonprofit institutions own their assets outright, and may freely deploy, allocate and dispose of those assets so long as such activity is consistent with the nonprofit's corporate charter.

[7] *See Banner Health System v. Long*, 2003 S.D. 60.

[8] The ruling also established that, although nonprofit corporations are governed principally by nonprofit corporation law, they are also subject to South Dakota's common law and statutory trust provisions. The North Dakota state court, in the context of granting Banner's motion to dismiss, reached an identical conclusion about the applicability of state statutory trust provisions to nonprofit corporations.

Lesson One: Expanded Attorney General Scrutiny and Continuing Nonprofit Challenges. The *Banner* cases signal that attorneys general, acting on behalf of the beneficiaries of charitable trusts, will likely continue to aggressively expand their oversight of nonprofit transactions. Over time, and particularly if the "charitable trust" theory gains legal acceptance, increased state oversight activity in the nonprofit context will threaten nonprofit health care's ability to autonomously determine how to operate their businesses. That attorney general scrutiny—and incursions into nonprofit organizations' autonomy—may be asserted ever more expansively is illustrated by the chapter 11 case involving NBA.[10] In *NBA*, the Texas attorney general—invoking his authority as "representative of the public interest in charity"—filed an objection to NBA's petition for court approval to engage, and pay from estate funds, restructuring professionals and consultants on the grounds that "[t]he mass employment of so many case professionals at this early stage of the case appears to be imprudent and a misuse of charitable assets."[11] Notably, in defending his efforts to restrain the debtor's expenditures, the Texas attorney general employed the same broad-brush statements used by the North and South Dakota attorneys general in the *Banner* litigation: "A nonprofit, charitable foundation or corporation itself also is a fiduciary to the public of the state and holds its assets in trust for the public."[12] The thrust of the Texas attorney general's objection would be to prevent NBA from expending such funds as it deems necessary to put an appropriate workout team and restructuring plan into place—a further example of how increased state oversight may be asserted to exert pressure on independent nonprofit decision-making.

Lesson Two: Complicated Market Exits. Irrespective of whether the

[9] In the *Intracoastal Health System* litigation, the Florida attorney general sued a two-hospital nonprofit system to block a board decision to consolidate inpatient care at one facility and devote the other facility primarily to outpatient services. Even though the hospitals were only one and a half miles apart, the attorney general argued that the board had violated its trust duties to one community to benefit the other. The attorney general sought to seize one hospital and threatened to sue the directors in their individual capacities. *See Butterworth v. Intracoastal Health Sys.*, Case No. CL 01-0068 AB (Circuit Court of Palm Beach County, Fla.). On charitable-trust grounds, the Kansas attorney general challenged Menninger's decision to join forces with Baylor College of Medicine and Methodist Hospital in Houston. The dispute was settled by Menninger's creation of a foundation to support local mental health care. In a slightly different context because a nonprofit-to-for-profit conversion was at issue, the Missouri and Kansas attorneys general challenged HCA's purchase of the Health Midwest system, which straddled state lines. That controversy, too, was resolved by the creation of two health care foundations—one in Kansas, the other in Missouri—that were funded by net proceeds of the sale—some $500 million.

[10] *See In re Nat'l. Benevolent Ass'n. of the Christian Church (Disciples of Christ), et al.*, Case No. 04-50948-RBK (Bankr. W.D. Tex.).

[11] Omnibus Objection to Retention of Case Professionals, filed on March 15, 2004, in *In re Nat'l. Benevolent Ass'n. of the Christian Church (Disciples of Christ), et al.*, Case No. 04-50948-RBK (Bankr. W.D. Tex.) at ¶1.

[12] *Id.* at ¶12.

"charitable trust" theory takes hold, Banner's experience in the Dakotas indicates that nonprofit corporations can expect to encounter significant obstacles as they attempt to exit underperforming or secondary markets, divest or close facilities, or take any other action, even if in furtherance of charitable missions, particularly where these activities may result in movement of assets across state lines. Moreover, as the *Banner* cases illustrate, a sale of a facility to a fellow nonprofit corporation is no longer a shield against state scrutiny and interference. Indeed, all signs point to increased monitoring of nonprofit institutions as state attorneys general and federal officials seek to push through legislation to enhance accountability, limit executive compensation and place tighter controls on nonprofit boards.[13] As a result, nonprofit health care entities, both on the "buy" and "sell" sides, may have far less certainty in the marketplace. Parties to nonprofit health care transactions should anticipate possible delays and increased transaction costs occasioned by state involvement in, and review of, transactions and, in worst case scenarios, efforts by a state attorney general to enjoin sales or closures that purportedly run afoul of "charitable trust" principles.[14] Moreover, even if a market-exit transaction is permitted to move forward, as was Banner's experience, there is no real ability to predict whether or not litigation will ultimately ensue.

Lesson Three: Anticipated "Charitable Trust" Claims. There are several steps nonprofit hospitals and health care entities can take in order to protect against potential "charitable trust" claims. First, while current corporate record-keeping may be adequate to track restricted gifts, careful documentation must also be made of outright gifts of money and property to reflect that title has passed to the nonprofit corporation free and clear of any conditions or encumbrances. Second, in the course of fundraising solicitations, drives and capital campaigns, great care should be taken to disclose to potential donors that contributions may be used for broader charitable purposes than what might be otherwise assumed. Nonprofit organizations must remind donors of the national scope of mission objectives so that charitable giving takes place without any expectation that monies will be used exclusively for local health care operations. In this same vein, nonprofit health care institutions should scrutinize and, if necessary, amend corporate articles so that they reflect the true breadth of the system's charitable mission. Third, as nonprofit health care entities merge with other systems or acquire new facilities, prudence dictates that buyers should obtain appropriate seller representations and warranties as to the history, provenance and nature of any donated assets being transferred to the buyer. Certainly, the unpredictability of the current climate also militates in favor of buyers seeking protections, including indemnification for charitable-trust claims that may arise out of donated assets received in the course of an asset transfer or merger.

Lesson Four: Repercussions on Nonprofit Finance and Creditor Recoveries. Among the many areas of health care (and other) law that could be affected by widespread assertion of the charitable-trust theory are nonprofit health care financing and creditor recoveries. Taken to its logical conclusion, the charitable-trust theory suggests that individual facilities within a multi-state nonprofit health care system should be treated as individual trust assets to be used solely for the benefit of the local community. Clearly, adoption of this view would imperil a nonprofit health care entity's ability to shift assets around interstate or intrastate—from well-performing assets (in metropolitan areas) to struggling ones (in rural, underserved areas) or from a sparsely populated state to a high-growth market. Likewise, the presence of trust obligations could hamper a system's access to inexpensive sources of capital: Facility assets that are covered by trust obligations could be unavailable as collateral to secure debt, including for use in cross-state mortgages, which could have the effect of driving up the cost of borrowing. For this same reason, master trust indenture financing, a common health care bond financing structure that pools the creditworthiness of multiple facilities across a system and secures bond obligations through cross-guarantees (and joint and several liability) among constituent facilities, could be rendered impossible if the facility were made subject to individual trust obligations. Relatedly, in the insolvency context, application of the "charitable trust" theory could severely limit the ability of creditors, including tax-exempt bondholders, to recover against system assets that are encumbered by trust obligations—inasmuch as such assets could be deemed only available for designated charitable purposes and thereby even excluded from a bankruptcy estate.

Conclusion

The far-reaching impacts of the charitable-trust theory on the operation of nonprofit health care organizations, particularly those in multiple state markets, cannot be overstated. At present, while the law remains in flux, nonprofit health care entities are well advised to keep the potential for charitable-trust claims in mind as they plan for the divestiture or closure of existing facilities—or the acquisition of other nonprofit facilities with a history of community contribution. And, in the present environment, nonprofit health care institutions and their creditors must brace for an ever-increasing level of potential government intrusion into health care transactions and into decision-making about the use of nonprofit assets. ■

Reprinted with permission from the ABI Journal, *Vol. XXIII, No. 4, May 2004.*

[13] *See* Strom, Stephanie, "Questions About Some Charities' Activities Lead to a Push for Tighter Regulation," N.Y. Times, March 21, 2004.

[14] Nonprofit corporations should also understand that in any prolonged dispute, the attorney general may invoke such enforcement remedies as board removal or director surcharges, and assert allegations of corporate mismanagement against individual officers and directors (regardless of the "business judgment rule"), in an effort to resolve the matter in the state's favor.