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## Defending the Deal: The Attorney General Review Process in Nonprofit Hospital Conversions

By Ken Marlow and Lanta Wang, Waller Lansden Dortch & Davis; and Rex Burgdorfer, Juniper Advisory

As the delivery of health care continues to evolve and hospitals bear additional pressures to adapt to new payment models, more nonprofit hospitals are partnering with for-profit providers, through a sale, joint venture, or other arrangements.

Partnerships between independent nonprofit hospitals and larger health care systems (nonprofit and for-profit) have been growing over the past two decades. As more nonprofits look to the future, many have determined that to continue to offer services to their communities and remain viable under health care reform, they must consider strategies that involve partnering with a larger, well-capitalized system. This is particularly true given the unique handicap imposed on nonprofit organizations; namely, having access to only one source of external capital—debt. This is also in direct contrast with other

large industries in which equity and other capital markets can be readily tapped. As a result, many nonprofit hospitals are considering conversions into for-profit entities to gain access to capital.

When undertaking a conversion from a nonprofit to a for-profit entity, most states require nonprofit hospitals to go through an attorney general (AG) review process, and some states require approval by a court and other regulators before the transactions can close.<sup>1</sup> This can be a particularly unfamiliar and time-consuming part of the transaction, yet it is imperative to consummating the sale or partnership. Adequate preparation and sound process will better equip the parties for success and avoid potential roadblocks to completing the transaction.

## The Role of the Attorney General and Other Regulators in the Conversion Process

Attorneys general are oftentimes the only officials with authority to conduct comprehensive, advance review of hospital conversions. Other governmental agencies may oversee some aspects of conversions, but their authority generally is limited. For instance, a conversion transaction that distributes cash is considered a tax realization event that implicates the oversight of the Internal Revenue Service (IRS). Additionally, hospitals built with Hill-Burton Act funds must provide significant amounts of uncompensated care; thus, a conversion would trigger the oversight by the U.S. Department of Health and Human Services.<sup>2</sup> Furthermore, the Federal Trade Commission (FTC), the Department of Justice (DOJ), and state antitrust units also may analyze conversions to determine whether they jeopardize competition.<sup>3</sup> In contrast, the AG likely will examine all of these factors in his/her review process.

The responsibility of the AG (and in some states, the courts and/or the state regulators) is rooted in state statutes (most commonly under state corporation law) and/or the common law charitable trust and *cy pres* doctrines.<sup>4</sup> As directed by state statutes or as *parens patriae* under common law,<sup>5</sup> the AG must protect the interest of all public beneficiaries of charitable assets—in this case, the assets of the nonprofit hospital. In this protective role, the AG is looking for any indication or evidence of self-dealing, improper use or diversion of charitable funds, or inadequate value for assets being transferred.

To solicit the necessary information to evaluate whether such issues exist, the AG typically requires that nonprofit hospitals and/or the buyer or partner submit an application to approve the transfer of the assets. The preparation of the application is a significant undertaking that entails the gathering of information on many elements of the transaction, such as the process for selecting a buyer or partner, the determination of the hospital assets' value, and the commitment by the buyer or partner with respect to capital investments and charity care spending in the future.<sup>6</sup> The burden of proof to produce a comprehensive packet of information rests most heavily on the seller hospitals. Very commonly, the hospitals and their advisors will prepare a transaction narrative and other documentation to demonstrate the thoroughness and rigor of the decision-making and transaction process.

### Questions to Be Prepared to Answer

The parties to the transaction, and more specifically, the governing board of a nonprofit hospital exploring any strategic alternatives involving a joint venture or a sale with a nonprofit or for-profit company, should be able to provide evidence to address the following questions:

- » Why is the nonprofit hospital evaluating a change-of-ownership option?
- » How did the nonprofit governing board select a particular buyer, partner, and partnership structure?



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- » How did the nonprofit governing board establish the “fair market value” for the assets of the hospital?
- » Were the nonprofit governing board’s actions free of self-dealing and inappropriate personal gain?
- » Does the transaction benefit the public’s interest?
- » If the transaction generates cash proceeds, will such proceeds be used for charitable purposes?

### Common Features of Conversion Review Process

While state law and AG-imposed guidelines that specifically address nonprofit hospital conversions vary widely across states, many common features of the review process are worth noting. Here we detail the crucial steps and considerations of the process from a practical standpoint:

#### » Communication with the AG

Making a positive first impression with the AG and the AG’s staff is critical in the review process. It is important that the parties proactively reach out to the AG early in the transaction to make the AG aware of the potential sale or joint venture. This communication should occur prior to any public announcements of the transaction to ensure that the AG is not surprised by the news. Communicating early also serves to open up a dialogue with the AG with respect to the AG’s expectations and requirements of the review process.

#### » Notice/Letter/Application

The primary requirement of the AG review process is a formal notice, letter, or application to the AG.<sup>7</sup> Most states stipulate that the hospital and/or the buyer or partner must notify or submit an application to the AG a certain num-



While the parties typically enter into a confidentiality agreement protecting the disclosure of the terms of the transaction, a full disclosure or partial disclosure of the documents may still be mandated.

ber of days prior to the contemplated consummation of the transaction and may allow the AG additional time for review as needed; some states do not have a specified time period. An open line of communication with the AG with respect to the timeline is vital, as any delays in receiving the approval of the AG will delay the closing of the transaction.

The content of the formal notice, letter or application to the AG may be set forth in statutes or guidelines provided by the AG.<sup>8</sup> In states where neither exists, the parties will need to work closely with the AG's office to determine its expectations. Typically, the application will include all or a combination of the below categories of information; keep in mind, however, that the AG is free to request any additional information that he/she views as necessary to evaluate the proposed conversion:

1. *General information:* In the notice, letter or application, the parties will set forth an overview of the hospital and the hospital assets, the reasoning for seeking a buyer or strategic partner, a description of the bidding process, information regarding the buyer/partner and its current and historical operations, a highlight of the critical terms of the proposed transaction, and information relative to the expected impact of the proposed transaction on the community.
2. *Organizational documents:* The application typically requires governance documents of the parties involved. The application also requires the proposed corporate structure of the hospital post-transaction.
3. *Transaction and related documents:* As a baseline, the AG will require a final or near-final definitive agreement for the sale or joint venture. In some states, the AG may allow the parties to commence the review process with a letter of intent, as opposed to a definitive agreement. In a joint venture structure, the AG oftentimes requests the operating agreement of the joint venture. Other documents may include management services agreements, stock option agreements, profit-sharing agreements, employment agreements, and severance agreements.
4. *Financial information of the parties:* The application may require audited financial statements, business projection data, future earnings information, capital asset valuation, ownership records, fiduciary accounts, and other financial information of the parties.
5. *Tax-related information:* Tax-related information, such as any tax-free debt subject to redemption and any tax liability that may arise as a result of the transaction, may be requested by the AG.
6. *Support for "fair market value":* The AG will require evidence that the hospital assets are being sold at "fair market value." The parties may be required to (a) submit a fairness opinion, (b) engage a third-party consultant to perform a valuation of the hospital's assets, and/or (c) present an analysis of the bidding process and how such process resulted in a determination of fair market value.<sup>9</sup> The determination of fair market value is not an exact science and, therefore, there is some flexibility as to the indications required. In addition, typically the AG understands that the selection of the winning bidder involves numerous factors beyond simply the highest proposed purchase price.
7. *Summary of post-transaction commitments:* The AG has a vested interest in ensuring that the hospital assets will continue to be used to provide quality health care to the community following the transaction. The AG typically requires that the buyer or the resulting joint venture continue to provide the core services currently provided by the hospital and adopt the indigent care policy of the hospital. In some cases, the AG requires commitments by the buyer or the joint venture not to sell the hospital for a set period of time or to offer a right of first refusal to the seller in the event that a sale of the hospital is contemplated. The AG also will require assurances from the buyer/partner as to its ability to satisfy any capital commitments required by the definitive agreement.
8. *Use of proceeds:* The AG oftentimes requires particular disclosures relating to the use of the proceeds from the transaction. The AG will want to understand whether a newly created foundation or other 501(c)(3)

organization(s) will hold the proceeds. The AG also will request information regarding how the proceeds will be used, such as to fund free health clinics, health screenings, health education, or other community needs.

#### » Public Hearing and Public Comment Period

In states that have statutes addressing hospital conversions, a public hearing often is mandated as part of the AG review process.<sup>10</sup> The AG also may independently require a public hearing or a public comment period. Prior to the public hearing, the AG or the hospital will provide a notice of the hearing. Typically, at the hearing, representatives of the hospital and the buyer/partner will make a presentation of the proposed transaction and answer questions from the community. In preparation of the hearing, the parties should consider identifying advocates from the community to attend the hearing in support of the transaction, and also anticipate and plan for any negative feedback or objections.

#### » Public Disclosure of Transaction Terms

The parties may request that the AG maintain the confidentiality of the application and the terms contained in the documents, and perform his/her review of the documents “in camera”; however, state statutes, the Freedom of Information Act, or the AG may require that certain transaction documents be made available to the public. While the parties typically enter into a confidentiality agreement protecting the disclosure of the terms of the transaction, a full disclosure or partial disclosure of the documents may still be mandated. In such instance, the parties may propose to the AG that the documents be redacted to protect confidential or competitively sensitive information, or for other exempt purposes. Notably, if the AG allows redactions, then parties generally must identify the specific basis upon which such information constitutes confidential or competitively sensitive information or is otherwise exempt from disclosure.

#### » Third-Party Involvement and Approval

In some states, AG approval is contingent on the approval of a court and/or state agencies, such as departments of health and departments of insurance.<sup>11</sup> This calls for added diligent coordination and effective communication among the parties. The AG also may condition its decision on the actual receipt of the approval by one or more third parties; thus, the parties should carefully manage timing and expectations. Additionally, open communication with and sensitivities towards other key constituents and advocates in the community, such as hospital associations, may be imperative for a successful application.

#### » Post-Closing Covenants and Monitoring

Upon completion of the review, the AG may (1) issue a letter of no objection, (2) seek to void the transaction, or (3) take other appropriate action.<sup>12</sup>



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If the AG issues a letter of no objection, the AG may exercise post-transaction oversight to ensure that the parties are fulfilling the commitments and covenants that the parties agreed to during the conversion process.<sup>13</sup> More specifically, the AG may impose post-transaction monitoring through the requirement of periodic reports to the AG’s office, the legacy foundation, or a third-party monitoring body of certain terms of the transaction, including the level of indigent care spending, continuation of core services, and fulfillment of capital commitments. In some states, the AG also will stipulate that AG approval or notification is required for any future changes in the ownership structure of the buyer or the joint venture and/or any future amendments to certain terms of the definitive agreement. These terms may include indigent care commitments, capital commitments, elimination or expansion of services, physician recruitment commitments, and any restrictions on further transfers of the hospital.

### Key Elements to a Successful Conversion

The nonprofit hospital should be prepared to “defend” the decision to alter the tax-exempt status of the hospital to employees, medical staff, community members (including patients), local government leaders, interested advocacy groups, and the AG. A successful campaign rests on the extent to which the hospital’s governing board and its advisors and the buyer or strategic partner can positively articulate the benefits of the conversion. Below are some key elements to a successful conversion:

- » Adequately document the hospital’s strategic needs and objectives, as well as the business case for the transaction from the beginning of the process.





In some states, the AG also will stipulate that AG approval or notification is required for any future changes in the ownership structure of the buyer or the joint venture and/or any future amendments to certain terms of the definitive agreement.

- » Act in a manner that is consistent with the fiduciary responsibilities and free from self-interest. The hospital's governing board members with conflicts of interest disclose the conflicts to the governing board (and ultimately, to the AG) and only vote on the proposal so long as they can fulfill the duty of loyalty. In our experience, it is best that the hospital board members recuse themselves when conflicts of interest arise.
- » Implement a comprehensive, rigorous, objective, and competitive process in the search for a buyer/partner. It is paramount to present evidence that multiple potential buyers/partners (typically, approximately 15 to 30) were contacted and alternate ownership forms were considered. Bilateral processes that fail to “clear the market” generally are not acceptable. A recent example of this is the Jameson/UPMC transaction in Pennsylvania (which was conducted on a bilateral basis), where the Pennsylvania Attorney General did not believe the hospital governing board exhausted its duty to consider competing proposals, and challenged the transaction.<sup>14</sup>
- » Demonstrate that “fair market value” was achieved through the market-clearing process. Hospital enterprises contain tens or hundreds of millions of dollars of value. Securing this value for the community rests in the proper execution of a transaction. Hospitals often are required to produce written analyses comparing the range of offers received, their level of economic consideration, and the efforts used to maximize terms and conditions. Note that fair market value is impossible to assess without the input

of alternative offers. Common sense, as well as the more formal 1985 Delaware case law *Smith v. Van Gorkom*, often called the “Trans Union” case, dictates that the hallmark of good decision making is having a basis of comparison.<sup>15</sup>

- » Rigorously consider and address the financial and nonfinancial interests and issues important to the community and affected stakeholder groups throughout the process, including the AG application and public hearings. Here the “purchase price” is far from the dominant figure. Typically, legally-binding commitments to deploy capital in the community to construct new facilities or otherwise further the mission of the hospital, retain existing employees, create new job opportunities, recruit additional doctors and expand service lines to stem patient outmigration, improve the quality of services provided, and exhibit a growth orientation are well received by the community. The AG will assess if the transaction is in the public's best interest and may condition their approval on certain commitments from the buyer/partner that are designed to better serve the public's interest.
- » Commit any cash proceeds for the community's benefit. The duty of obedience requires hospital governing board members to be faithful to the charitable mission and purposes of the nonprofit hospital. Typically the conversion proceeds are directed to a private grant making foundation qualified for tax-exempt status under Section 501(c)(3) of the Internal Revenue Code or other charitable organizations. Post-transaction, the foundation or the charitable organization with the conversion proceeds must be separate and act independently from the hospital (which will be a for-profit entity). Additionally, the funds must usually be spent in furtherance of the original charitable missions of the hospital, i.e., health care-related purposes.
- » Act in a transparent and honest way with competitors, lenders, and payers.

## Summary and Learning Lessons

The attorney general approval process in hospital conversions can be complicated and varies across states. This article outlines the process and ways in which a hospital can prepare for the many steps to the process. Like most things, experience is important—both for the AG and those applying for approval. As you or your client begin the conversion journey, consider the below:

- » Seek out assistance from specialists—including legal counsel and financial advisors
- » Dedicate sufficient resources to prepare the application, and more importantly, frame the story
- » Follow a clear, rational, and transparent decision-making process
- » Set realistic time expectations
- » Maintain an open dialogue

## About the Authors



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## Endnotes

- 1 See generally U.S. GOV'T ACCOUNTABILITY OFFICE, GAO/HEHS-98-24, NOT-FOR-PROFIT HOSPITALS CONVERSION ISSUES PROMPT INCREASED STATE OVERSIGHT 23 (1997).
- 2 Titles VI and XVI of the Public Health Service Act (42 U.S.C. §§ 291 and 300). See also The Hospital Survey and Construction Act of 1946.
- 3 FTC and DOJ derive their oversight powers from the Federal Trade Commission Act of 1914 (15 U.S.C. §§ 41-58, as amended), the Sherman Antitrust Act (15 U.S.C. §§ 1-7), and the Clayton Antitrust Act of 1914 (15 U.S.C. §§ 12-27, 29 U.S.C. §§ 52-53).
- 4 BLACK'S LAW DICTIONARY 354 (9th ed. 2009). U.S. GOV'T ACCOUNTABILITY OFFICE, GAO/HEHS-98-24, NOT-FOR-PROFIT HOSPITALS, *supra* note 1.
- 5 BLACK'S LAW DICTIONARY 114 (9th ed. 2009). See, e.g., Consumers, Review Protocol for Fundamental Change Transactions Affecting Health Care Nonprofits, PA. OFFICE OF THE ATTORNEY GEN., available at [https://www.attorneygeneral.gov/Consumers/Charitable\\_Trusts\\_and\\_Organizations\\_Sections/Review\\_Protocol\\_for\\_Fundamental\\_change\\_transactions\\_affecting\\_health\\_care\\_nonprofits/](https://www.attorneygeneral.gov/Consumers/Charitable_Trusts_and_Organizations_Sections/Review_Protocol_for_Fundamental_change_transactions_affecting_health_care_nonprofits/); 15 PA. CONS. STAT. 57 §§ 5901-5980.
- 6 See, e.g., Consumers, Review Protocol, *supra* note 5; [http://www.michigan.gov/ag/0,4534,7-164-17337\\_61487-277835--,00.html](http://www.michigan.gov/ag/0,4534,7-164-17337_61487-277835--,00.html).
- 7 See, e.g., Consumers, Review Protocol, *supra* note 5; Wis. STAT. § 165.40(3)(a); Wis. STAT. § 165.40(3)(b); CONN. GEN. STAT. § 19a-486a(c)-(d); ORC ANN. § 109-34(B); VA. CODE ANN. § 55-532; GA. CODE ANN. § 31-7-401, 402.
- 8 *Id.*
- 9 *Id.*
- 10 *Id.* See generally U.S. GOV'T ACCOUNTABILITY OFFICE, GAO/HEHS-98-24, NOT-FOR-PROFIT HOSPITALS, *supra* note 1.
- 11 See, e.g., Wis. STAT. § 165.40 and Wis. STAT. § 165.35; CONN. GEN. STAT. § 19a-486a.
- 12 See, e.g., attorneys general decision listed at <https://www.doj.state.wi.us/news-releases/doj-approves-joint-venture-between-watertown-regional-medical-center-lifepoint-health>; [http://www.michigan.gov/ag/0,4534,7-164-17337\\_61487-277835--,00.html](http://www.michigan.gov/ag/0,4534,7-164-17337_61487-277835--,00.html); and <http://www.jamesonhealth.org/mergerprogress>.
- 13 See, e.g., annual monitoring reports required by the Michigan Attorney General listed at [http://www.michigan.gov/ag/0,4534,7-164-17337\\_61487-277835--,00.html](http://www.michigan.gov/ag/0,4534,7-164-17337_61487-277835--,00.html).
- 14 See Jameson-UPMC Merger Progress Center, available at <http://www.jamesonhealth.org/mergerprogress>.
- 15 *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

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