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Whose Public?: Parochialism and Paternalism in State Charity Law Enforcement

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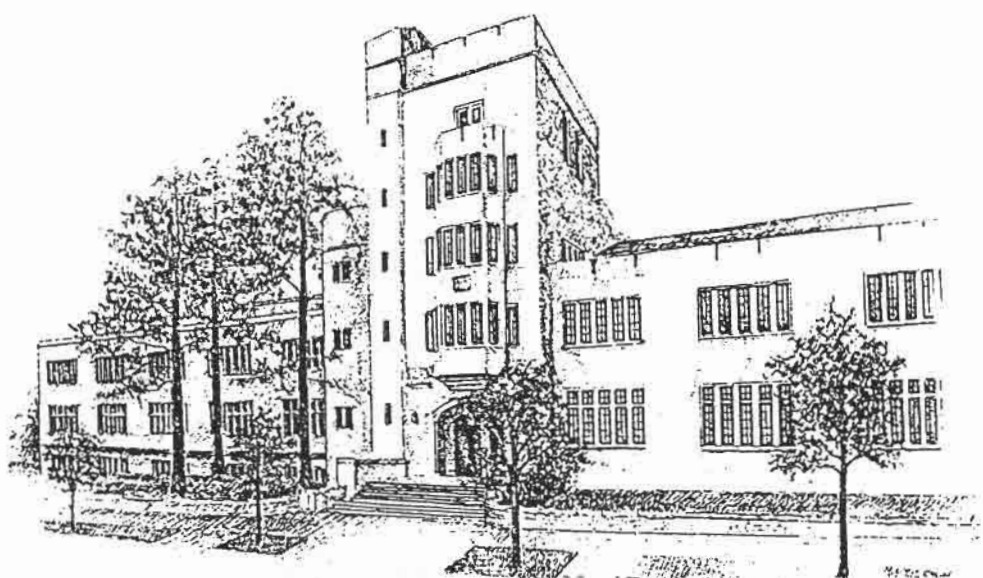
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INDIANA LAW JOURNAL

WHOSE PUBLIC? PAROCHIALISM AND PATERNALISM IN STATE CHARITY LAW ENFORCEMENT

Evelyn Brody



INDIANA UNIVERSITY
SCHOOL OF LAW—BLOOMINGTON



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Whose Public? Parochialism and Paternalism in State Charity Law Enforcement

EVELYN BRODY*

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INTRODUCTION

"[T]he broad interests of the Attorney General necessarily entail protecting the public against any social and economic *disadvantages* which may be occasioned by the activities and functioning of public charities"¹

"I'm there fighting for the people of Hershey and the people of central Pennsylvania. This is the job that I have as the attorney general of Pennsylvania. The fact that I'm running for governor in this great commonwealth of ours has absolutely no role in the action that my office and I are taking in this case."²

"It just wouldn't have been right to have Hershey Park called Wrigley Field."³

Assets of nonprofit organizations are not governmental assets. Anglo-American law recognizes the authority of private parties to create, fund, and operate nonprofit organizations for public purposes. Importantly, the public served by a particular charity is not necessarily—or even often—the general public. Rather, a given nonprofit serves the indefinite class of beneficiaries chosen by its creators, funders, governing board, and, in some cases, members—but not by the state.

Regulation of the two legal forms of charity—trust and corporate—varies somewhat from state to state both as a matter of formal law and in practice. Basically, every state attorney general enjoys the role known as *parens patriae*—inherited from the English view of the sovereign as father of the country—to oversee the performance of charitable trusts and their fiduciaries.⁴ A few state constitutions commit jurisdiction over charitable trusts to the courts rather than to

1. Pennsylvania Attorney General, Petition for Citation for Rule to Show Cause Why a Proposed Sale of Trust Assets Constituting the Controlling Interest in Hershey Foods Corporation Should Not Be Conditioned Upon Court Approval at ¶¶ 16-18, *In re Milton Hershey School Trust* (Orphans' Court Div., Ct. Common Pleas, Dauphin County, Aug. 12, 2002), available at <http://www.attorneygeneral.gov/ppd/charity/PDF/Hershey-Petition.pdf> (emphasis in original).

2. *Business Center* (CNBC television broadcast, Sept. 6, 2002), available at <http://www.lexis.com/research/Transcripts/File>. Subsequently, the voice-over in a Fisher campaign broadcast intoned: "Then he fought to block the sale of Hershey Foods, saving 6,000 more critical jobs." Peter L. DeCoursey, *Pennsylvania Attorney General Will Use Hershey Sale Halt in Campaign Ads*, PATRIOT-NEWS, Sept. 26, 2002 (quoting a new "30-second 'Jobs' commercial for the campaign ad of Republican gubernatorial candidate Mike Fisher").

3. Steven Pearlstein, *For Hershey Trust, the Outcome Is Bittersweet*, WASH. POST, Sept. 19, 2002, at E1 (quoting Attorney General Mike Fisher's explanation for why he sought a restraining order on the Hershey Trust's sale of its stock in Hershey Foods, which abandoned talks with Wm. R. Wrigley, Jr. Co.).

4. See, e.g., *Commonwealth of Kentucky ex rel. Ferguson v. Gardner*, 327 S.W.2d 947, 948 (Ky. App. 1959) ("The asserted right of the Attorney General to intervene . . . is predicated on the ancient English doctrine that the King, as *parens patriae*, superintended the administration of charities and acted by the attorney general, who was his proper officer in that respect."); see generally MARION R. FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATION: FEDERAL AND STATE LAW AND REGULATION 301 (2004).

the legislature, and state laws on nonprofit corporations differ as to the authority specifically granted to the attorney general. Moreover, as a practical matter, few state attorneys general have the funding and inclination to engage in aggressive charity enforcement. Indeed, the very lack of state involvement with the organization and operation of nonprofit entities might explain how legislatures, attorneys general, and even courts can misconstrue their proper roles in the regulation of charities and other nonprofits.

Of course, nonprofit assets and activities exist within a social and political structure.⁵ Nonprofit wealth and operations attract the most attention when the public sector experiences particular financial stress. For example, it is not surprising that the Connecticut attorney general recently charged Yale New Haven Hospital with failing to make adequate distributions from donated "free bed funds" to those who might otherwise draw on the state's overburdened Medicaid system.⁶ More systematically, the ongoing shakeout in the hospital industry and the consequent consolidation of some nonprofit hospitals—or even their "conversion" to for-profit status—has driven many states to seek a more central role in the use of charitable assets. Astonishingly, in New York and possibly elsewhere, the state governor and legislature engineered the conversion of New York's nonprofit Blue Cross entity in a manner that results in ninety-five percent of the conversion proceeds being paid directly to public coffers.⁷

When faced with the flight or loss of significant nonprofit assets from a locality, state regulators, courts, and the legislature sometimes mobilize to secure the border. The manifestation of that uniquely state-level syndrome, parochialism, follows a predictable path. Most generally, the rationale for charity—and, in particular, for the tax exemption that charity has enjoyed—is often expressed as "lessening the burdens of government,"⁸ and in this context charity very much

5. Beyond the scope of this Article are the nonprofit organizations created by, or for the benefit of, governmental bodies. Notably, the now-common practice for public universities to rely on fund-raising by private booster foundations raises troubling issues of governance and disclosure. See, e.g., Julianne Basinger, *Georgia Battle Pits Board Against Board*, CHRON. HIGHER EDUC., Nov. 28, 2003, at A1:

[S]ome boards [of regents] have had to deal with legislative caps on the amount of state money that can be used for presidents' pay. Other boards have worried about the political repercussions of using taxpayers' money to raise presidential compensation. The result has been ever more reliance on private funds. A handful of presidents have even signed two contracts, one for their foundation compensation and another for their university pay.

6. See Press Release, Connecticut Attorney General's Office, Attorney General Sues Yale New Haven Hospital (Feb. 20, 2003), available at <http://www.cslib.org/attygenl/press/2003/health/yale.htm>; see generally Jane Gordon, *At Hospitals, a Cushion for the Poor*, N.Y. TIMES, June 8, 2003, at 14CN.

7. See Part II.D & E.

8. See Evelyn Brody, *Of Sovereignty and Subsidy: Conceptualizing the Charity Tax Exemption*, 23 J. CORP. L. 585, 590 (1998) [hereinafter Brody, *Sovereignty*]. "[L]essening the burdens of government" is only one route to federal income tax exemption as a charity under regulations issued under Internal Revenue Code section 501(c)(3). *Id.* To come within that particular provision, the organization must demonstrate that the government considers the organization's activities to be its burden. Generally, for property-tax exemption, states have not adopted a narrow "'essential government function' test." *Am. Museum of Fly Fishing, Inc. v. Town of Manchester*, 557 A.2d 900, 901 (Vt. 1989) (adopting instead a

begins at home. But this is an incomplete view of the charitable sector. Granted, a trust for governmental or municipal purposes is a charity.⁹ But even the broader conception that charities must further the "public interest" or "benefit the community"¹⁰ oversimplifies the purposes for which the law permits charities to be organized and operated. Notably, in concurring in the *Bob Jones University v. United States* decision, Justice Powell observed that over 106,000 organizations filed information returns as section 501(c)(3) organizations in 1981. He found "it impossible to believe that all or even most of those organizations could prove that they 'demonstrably serve and [are] in harmony with the public interest' or that they are 'beneficial and stabilizing influences in community life.'"¹¹

More subtly, parochialism is built into our conception of private philanthropy. Donor wishes must be honored, and donors often think locally. The attorney general then becomes tempted to extrapolate the local nature of a charity's founding and current operations to all of its assets, explicitly restricted or not, and so seeks to confine the charity to its "community." Now we mix in paternalism. Charity regulation appropriately concentrates on remedying fiduciary self-dealing rather than second-guessing a board's business judgment, but it is not always easy to separate the dual obligations of loyalty and care. An attorney general, court, or even legislature might become convinced that a charity board acting contrary to the wishes of "the community" is breaching the duty of loyalty to the charity.

This Article develops a legal framework for appropriate state enforcement activity in charity matters that tend to invite public parochialism and paternalism. Part I describes the legal structure for state oversight of nonprofits, focusing on charities and the dual strands of charity trust law and nonprofit corporation law.¹² Because the attorney general as prosecutor is only a party in a dispute over charity operations, we also examine the role of the courts. Third, we bring in the legislatures' ambivalence about attorney general oversight of charities, as revealed in budgetary and staffing decisions and jurisdictional impediments. This discussion reminds us that it was ever thus—that regulation of charities' investment assets as well as operating assets can provide a political cushion for the community or the

"public use" test). In whatever form, however, the subsidy theory places charities in a position subordinate to the state, which can decide the parameters of its burdens. See, e.g., *Camps Newfound/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564, 598-600 (1997) (Scalia, J., dissenting).

9. RESTATEMENT (THIRD) OF TRUSTS § 28(e) & cmt. k (2003).

10. See *id.* at § 28(f); see also *id.* at § 29 & cmt. (Purposes and Provisions That Are Unlawful or Against Public Policy); Evelyn Brody, *Entrance, Voice, and Exit: The Constitutional Bounds of the Right of Association*, 35 U.C. DAVIS L. REV. 821 (2002) [hereinafter Brody, *Right of Association*].

11. *Bob Jones Univ. v. United States*, 461 U.S. 574, 608 (1983) (Powell, J., concurring). The *Bob Jones* "public policy" test has not been extended to other forms of discriminatory activity, such as sex discrimination, or to racial discrimination beyond the educational context. See generally Miriam Galston, *Public Policy Constraints on Charitable Organizations*, 3 VA. TAX REV. 291 (1984); see also David A. Brennan, *The Power of the Treasury: Racial Discrimination, Public Policy, and "Charity" in Contemporary Society*, 33 U.C. DAVIS L. REV. 389 (2000) (describing some of the problems and dangers of extending the Treasury's public policy power beyond racial discrimination).

12. In addition, federal tax law provides a uniform, minimum level of regulation. See Evelyn Brody, *A Taxing Time for the Bishop Estate: What Is the I.R.S. Role in Charity Governance?*, 21 U. HAW. L. REV. 537 (1999) (Bishop Estate Symposium Issue) [hereinafter Brody, *Bishop Estate*].

state.¹³

In the last few years, the issues addressed in this Article have played out across the country at an accelerating rate. The case studies in Part II illustrate in detail three troubling levels of increasing state parochialism and paternalism over charity assets:

1. *Near-seizure of assets.* The Fall 2002 Hershey Trust case is a trifecta: eventually all three branches of Pennsylvania government combined to pressure the Milton Hershey School Trust to abandon plans for selling its controlling interest in Hershey Foods as a diversification of an investment worth over \$5 billion, thereby preserving the local operations of the publicly traded company. The attorney general, who was running for governor, had won a preliminary injunction against the sale, and participated in a shakeup of the board shortly after losing the gubernatorial election. The outgoing governor signed a bill that would require the Trust to obtain court approval, with attorney general and community input, before any future sale.

The case study of the Illinois-based Terra Foundation for the Arts illustrates similar issues with respect to operating assets, rather than investment assets. As a result of attorney general action, the board of the financially troubled charity abandoned an exploration of moving to Washington, D.C.; instead, it will close its museum and place its major pieces on long-term loan to the Art Institute of Chicago.

These and other cases described in Part II illustrate the efforts of attorneys general (if not the legislature) to influence the make-up of the nonprofit board. Notably, in the case of Minnesota-based HealthPartners, a court ruled that the attorney general's desired appointee to the board would instead serve as a special administrator, a compromise acceptable to the objecting nonprofit.

2. *Warring States.* The for-profit hospital chain HCA, Inc. submitted a winning bid of \$1.125 billion to acquire the assets of nonprofit Health Midwest, the largest health system in the Kansas City area—and one that straddles two states. Then the fight began over control of an expected \$700-800 million that would create one or more "conversion foundations." Health Midwest brought suit to clarify the jurisdiction of the attorneys general of Missouri and Kansas, both of whom responded by suing to remove the Health Midwest board for abandoning their charitable purpose. In the resulting spring 2003 settlements—after all, no politician really wanted to stop the sale—the proceeds will fund two separate conversion foundations, one in each state and each operating under extraordinary attorney general supervision. After expenses, the foundations will be

13. True to charity's trust law origins, to some degree we are really speaking of property law, not corporate law.

funded with about \$520 million.

3. *Noncharitable, Mutual-Benefit Nonprofits—Singing the Blues.* In 2003 Maryland adopted legislation barring CareFirst from converting to for-profit status for five years, and giving state officials extraordinary power over the board, to the consternation of regulators in Delaware and District of Columbia, whose residents may subscribe to affiliated plans. Blue Cross and Blue Shield of North Carolina abruptly abandoned its plan to convert in the face of continuing regulatory deliberation, as did the plan in New Jersey (Washington state's is faltering). Each of these transactions would have resulted in the funding of charitable "conversion" foundations whose income would have addressed health-care needs of state residents. But the Empire Blue Cross case in New York presents the starkest example of state control: Legislation authorized the conversion on condition that 95 percent of the conversion proceeds are payable directly to the state; proceeds are escrowed pending court challenge.

In all of these cases—as well as several others—the state has blurred the line between private and public by seeking to install local business and political leaders (even political contributors) to the charity board.¹⁴

It is fair to ask whether these situations represent a trend or general threat. As any public-choice scholar would hypothesize, the state may be tempted by a well-financed charity that occupies a unique position, and is politically isolated from its natural allies, both nonprofit and for-profit. However, while not many charities may identify with the fate of the charities in these cases, attorneys general might become emboldened by short-term success, and seek further enlargements of their authority. Moreover, it is the rare private party that has legal standing to complain about attorney general overreaching, and, even when it could fight, the targeted charity usually (if not almost always) prefers a quiet settlement to a court contest.

Thus we do not know whether these well-publicized cases are truly isolated or rather represent the tip of an iceberg. Much (if not most) charity enforcement activity occurs below the radar screen of court decisions.¹⁵ A case that does go to court might result in no written or reported opinion, and published decisions occur so sporadically in most jurisdictions that it is risky to read them as considered state law and policy. More commonly, cases arise and settle without any public attention. Even when one side or the other seeks publicity, news stories might serve as the only source of information. Unfortunately, press accounts sometimes oversimplify (if not contain factual and legal mistakes), and appear only if editors and publishers deem them newsworthy. All of these factors combine to remind us of the old warning that the plural of anecdote is not data.¹⁶ In defense, let me say

14. As described in Part II, appointment power can come through attorney general action (e.g., HealthPartners, Red Sox, Terra, Hershey) or by legislation, particularly relating to health care conversions (e.g., Health Midwest, CareFirst, and Empire Blue Cross).

15. See Evelyn Brody, *The Limits of Charity Fiduciary Law*, 57 MD. L. REV. 1400, 1409-11 (1998) [hereinafter Brody, *Fiduciary Law*].

16. Professor David Hyman likes to add: "It's legislation." This prediction was borne

that the recent proliferation of anecdotes in the area of charity enforcement indicates, if not a trend, then certainly the outer limits of troubling state action. These "big deals," which garner intense press coverage, might inure the public—if not public officials themselves—to the notion that the states' successes reflect appropriate law.

Inevitably, if the proper legal bounds of legitimate enforcement do not become clearer, the role of charities in society could suffer. While our major charities do not face direct seizure of assets—as occurred in England when Henry VIII dissolved the monasteries—strict regulation can accomplish much the same thing.¹⁷ As I once wrote about the Internal Revenue Service in a charity administration matter: "[F]ew charities, small or large, can afford such a high-stakes gamble by challenging the IRS over their very claims to exemption: Until the case is resolved in court, donations could dry up, tax-exempt bond covenants could be breached, and local governments might challenge property-tax exemption."¹⁸ Charities facing state attorney general inquiry similarly worry about loss of donations, loss of contracts and patronage, and retention of staff and volunteers. Nevertheless, should charities too quickly accede to state demands over matters of discretionary governance, the sector as a whole can see a degradation in charities' willingness to take risks, and in volunteer board members' willingness to serve.

I. THE LEGAL FRAMEWORK FOR CHARITY LAW REGULATION

State charity oversight and enforcement, operating within the confines of the federal and state constitutions, involve all three branches of state government. In historic order, the attorneys general (as *parens patriae*) and courts have long overseen charitable trusts. More recently, legislatures have enacted statutes that enable the creation of nonprofit corporations, codify the law of charitable trusts, regulate industries in which nonprofits engage, provide general structures for attorney general and court jurisdiction, and provide specific legal regimes for such transactions as nonprofit hospital "conversions." As we will see, for a variety of institutional reasons, the most important state player is the attorney general, but the attorney general could not enjoy the power he or she does in the absence of an accommodating legal landscape.

A. Constitutional Protections

The powers of the state are not unbounded. Private philanthropy and the nonprofit sector rest on the fundamental constitutional guarantees of private property, liberty of contract, and freedom of worship and expression. These rights are not absolute, however. The government retains the power to regulate the use of property short of a "taking" before having to pay just compensation under the Fifth and Fourteenth Amendments. However, the government can infringe on the First Amendment right of expression only if it has a compelling state interest and neutrally applies the least restrictive means.¹⁹ In 1819, the Supreme Court applied

out in several of the cases discussed in Part II (Hershey, Health Midwest, CareFirst, and Empire Blue Cross).

17. See Evelyn Brody, *Charitable Endowments and the Democratization of Dynasty*, 39 ARIZ. L. REV. 873 (1997) [hereinafter Brody, *Charitable Endowments*].

18. Brody, *Bishop Estate*, *supra* note 12, at 545.

19. Brody, *Right of Association*, *supra* note 10, at 848 (discussing, among other cases,

state parochialism. In 1997, the U.S. Supreme Court struck down a Maine statute that exempted nonprofit summer camps only if they primarily served Maine residents.²⁴ The Court accepted the argument that charitable activity is entitled to protection of the Commerce Clause, which prohibits states from discriminating in interstate commerce. Distinguishing direct governmental grants from tax exemption, though, the Court suggested that it would likely uphold an outright subsidy targeted either to Maine residents or to camps serving residents.²⁵ However, four justices, who could not conceive of charities as businesses, strenuously objected to the application of the Commerce Clause. Moreover, adopting a subsidy approach but rejecting a constitutional distinction between tax exemption and direct grants, the dissenters would also have permitted Maine to target tax exemption to charities whose services lessen the burdens of state government. Scholars are currently debating whether a constitutional distinction between tax subsidies and direct subsidies can be sustained.²⁶

Camps Newfound applies to parochial income tax legislation as well as in the property tax context. The Minnesota Supreme Court cited the case to strike down a state alternative minimum tax deduction that was allowed only for contributions made to charities that serve Minnesota residents.²⁷

Ironically, because the Commerce Clause does not bind Congress itself, the property tax exemption law Congress wrote for the District of Columbia could properly limit exemption to those charities that benefit District residents.²⁸ On this basis, the District of Columbia Court of Appeals confined its role to statutory interpretation in upholding the District's denial of exemption to the Cato Institute.²⁹ Interestingly, the trial court had found that the Cato Institute *does* provide benefits in the District by focusing its charitable activities on educating Congress.³⁰ The

24. *Camps Newfound/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564 (1997).

25. The analysis in this paragraph is drawn from Evelyn Brody, *Hocking the Halo: Implications of the Charities' Winning Briefs in Camps Newfound/Owatonna, Inc.*, 27 STETSON L. REV. 433, 446-50 (1997).

26. See, e.g., Edward A. Zelinsky, *Are Tax "Benefits" Constitutionally Equivalent to Direct Expenditures?*, 112 HARV. L. REV. 379 (1998).

27. *Chapman v. Comm'r of Revenue*, 651 N.W.2d 825, 833-35 (Minn. 2002). The taxpayer had made a lump-sum contribution to a donor-advised fund established by the Fidelity Charitable Gift Fund in Boston, and had argued that future distributions would be made only to Minnesota charities. The supreme court remanded for a determination of remedy: expanding or eliminating the Minnesota AMT deduction so that it applied equally to all charitable donations. In the meantime, the legislature chose the former remedy. MINN. STATS. § 290.091(2) (2002), amended by 2003 Minn. Sess. Law Serv. 1st sp. sess., ch. 21, art. 1, § 9 (West).

28. See *Dist. of Columbia v. Helen Dwight Reid Educ. Found.*, 766 A.2d 28, 37 (D.C. 2001) ("While the dormant commerce clause may prohibit state legislatures and other non-federal legislative bodies from enacting burdens on interstate commerce, that clause imposes no limitations on Congress, even when Congress acts 'like a state legislature' in exercising its plenary power to legislate for the District of Columbia under art. I, § 8, cl. 17 of the Constitution."). However, the court added: "*Cf. Milton S. Kronheim & Co., Inc. v. District of Columbia*, 319 U.S. App. D.C. 389, 394-97, 91 F.3d 193, 198-201 (1996) (although restrictions of dormant commerce clause do not apply to laws enacted by Congress, they do apply to laws promulgated by the District of Columbia Council)." *Id.*

29. *Dist. of Columbia v. Cato Inst.*, 829 A.2d 237, 238 (D.C. 2003).

30. *Cato Inst. v. Dist. of Columbia*, No. 7792-98, 2002 LEXIS STT 148-8 (D.C. Super. Ct. Tax Div., Aug. 1, 2002).

Appeals Court disagreed:

The sharing and dissemination of information to people in or of the District of Columbia does not by itself demonstrate an impact within the District of Columbia; it is simply an activity that occurs within the District. There must be some evidence that through the use of Cato's building and the dissemination of such information there is a benefit, which inures principally to the public in the District.³¹

B. Roles of Branches of State Government

We consider here the role of the three branches of state government in the enforcement of charity law.

1. The Attorney General as Parens Patriae

Political cynics believe that "A.G." stands not for "attorney general" but for "aspiring governor."³² In recent years, state attorneys general have dramatically expanded their role in areas ranging from public health³³ to antitrust³⁴ to Wall Street.³⁵ Critics have complained that these types of prosecutions, while lucrative for the states and politically rewarding for the attorneys general, should be left to the appropriate federal agencies or state legislatures.³⁶

31. *Cato Inst.*, 829 A.2d at 245-46.

32. See, e.g., *N.C. Regulators Deny They Would Have Put Blues at a Disadvantage*, BESTWIRE, July 9, 2003 ("[F]ormer Kansas insurance commissioner Kathleen Sebelius blocked the conversion of the Kansas Blues plan and then used it as part of her campaign to run successfully for governor.").

33. November 1998 brought a \$246 billion settlement agreement signed by forty-six state attorneys general and major tobacco companies. Nat'l Ass'n of Attorneys General, Master Settlement Agreement, at <http://www.naag.org/issues/tobacco/index.php?sdid=919>.

34. In the Microsoft litigation, a few of the states refused to go along with the federal antitrust settlement reached by the Justice Department. See, e.g., Press Release, Office of New York State Attorney General, Statement by New York Attorney General Eliot Spitzer and California Attorney General Bill Lockyer Regarding a Remedy in the Microsoft Case (Sept. 10, 2001), available at http://www.oag.state.ny.us/press/2001/sep/sep10a_01.html (last visited Feb. 24, 2004). On November 1, 2002, a federal district court judge rejected most of the remedies sought by the hold-out state attorneys general.

35. See, for example, Merrill Lynch's \$100 million fine and agreement to separate research from investment banking. See Press Release, Office of New York State Attorney General, Spitzer, Merrill Lynch Reach Unprecedented Agreement to Reform Investment Practices (May 21, 2002), available at http://www.oag.state.ny.us/press/2002/may/may21a_02.html. But see Matt Fleischer-Black, *Independent Means: Eliot Spitzer Can Act Like a Real Lone Wolf: That Could Be a Problem If He Ever Wants to Be the Leader of the Pack*, AM. LAW., Sept. 2002, at 92 (describing Merrill's insistence that the deal be contingent on the assent of all fifty states, and acceptance, as of August 2002, of only thirty-one). See also Shawn Young, *MCI Restates Away \$74.5 Billion*, WALL ST. J., Mar. 15, 2004, at B2 (reporting that "the state of Oklahoma dropped its criminal case against [MCI for accounting fraud] after MCI agreed to cooperate in prosecutions against former executives and to add 1,600 jobs in Oklahoma over 10 years"; the attorney general's office defended the jobs demand on the ground that because the fraud had victimized the state's pension fund, the state treasury should benefit).

36. See, e.g., Jaret Seiberg, *Spitzer Again Outpoints SEC*, THE DEAL, Feb. 26, 2004

By contrast, only a few state attorneys general have been active in a realm firmly committed to state regulation and enforcement: the monitoring and oversight of charities. According to a survey, top state charity officials conceive of themselves primarily as consumer protectors: their "biggest problem" relates to charitable solicitations, and whether charities spend their money as represented to donors.³⁷ And, as described below, those attorneys general who do maintain an active charities bureau—and the ones housing the most charities and the most charitable assets—suffer from chronic under-funding and under-staffing.³⁸ Despite these handicaps, the state attorneys general have achieved important successes in educating the public about fraudulent fund raising and challenging wrongdoing, educating fiduciaries and staffs in meeting their legal obligations and improving charity governance, rectifying self-dealing and other breaches of fiduciary duty by charity insiders, and assisting charities that have lost their way to restructure or dissolve.

Even with regard to nonprofit organizations, though, the state attorney general remains an inherently political creature.³⁹ The incentives of this nearly universally

(describing action on February 25, 2004, by the House Committee on Financial Services to strip from H.R. 2179, the Securities Fraud Deterrence and Investor Restitution Act of 2003, a provision that would have pre-empted state securities laws that contradicted federal policy, and reserved enforcement power to the SEC to the exclusion of state regulators); New York Attorney General Eliot Spitzer, *Whose Side Are They On? The Federal Government's Effort to Curtail State Enforcement of Predatory Lending and Other Consumer Protection Laws*, Lecture at Georgetown University (Feb. 24, 2004), available at http://www.oag.state.ny.us/press/statements/georgetown_university.html; see also Martin Morse Wooster, *How State Attorneys General Police Nonprofits: Court Actions Sometimes Distort Charity, Restrict Free-Market Activity*, CAPITAL RESEARCH CTR'S ORG. TRENDS (Aug. 2000), available at <http://www.heartland.org/pdf/64751b.pdf> (while generally praising attorney general role, criticizing the use of "forced donations" to charities in settlements with businesses charged with wrongdoing); see also, *infra* note 149 (discussing *Dardinger*).

37. Thirty-eight states responded. Connecticut mentioned the improper use of charitable assets and management self-dealing; Massachusetts mentioned "board stewardship"; Oregon found "that a lot of small and medium-sized charities are being run . . . by one or two people rather than a board, or the board is not involved, or there is self-dealing in terms of benefits"; Pennsylvania offers "training sessions for charities"; Texas reported that "[m]oney is misspent or even outright stolen." Many complained of a lack of resources. Dean Mehegan et al., *Charity Regulation Today: How the States See It*, NONPROFIT TIMES, Mar. 1994, at 1.

38. But see Tamar Lewin, *Alumni Fight for "Soul" of Richest Orphanage*, N.Y. TIMES, Nov. 30, 2000, at A18 ("Nationally, with mushrooming philanthropic assets providing an increasingly important pool of money for the public good, attorneys general have become more active in monitoring how the money is used: the number of lawyers in the Pennsylvania attorney general's charitable trust section has doubled in the last three years.").

39. Notably, New York attorney general Eliot Spitzer has claimed oversight over a range of actors from securities analysts to mutual funds to charities to, most recently, the New York Stock Exchange. In January 2004, the board of the nonprofit (but not tax exempt) NYSE asked the attorney general to investigate the \$187 million compensation package granted to ousted chief executive Dick Grasso by the previous board. See Susanne Craig et al., *Spitzer and SEC Open Probes Into Grasso's Pay*, WALL ST. J., Jan. 9, 2004, at C1. It is hard to see, however, where the attorney general's jurisdiction lies against what is essentially a for-profit cooperative. Perhaps the NYSE is reluctant to sue former board members for breach of fiduciary duty. Indeed, the NYSE's letter to the attorney general stated, in part: "While we believe that you are more capable of pursuing the matter than the Exchange itself, we assure you that we will participate or cooperate in any way that is appropriate." Press Release, New York Stock Exchange, NYSE Board Asks SEC and NYS Attorney General to

elective office⁴⁰ impel the incumbent to ignore cases that are politically dangerous and to jump into matters that are politically irresistible but implicate only "business" decisions of charity managers.⁴¹ Of course, as described below, it is unfair to single out the attorney general for blame—after all, in the absence of powers granted in the state constitution, what the attorney general does is a function of what the legislature and courts grant or permit.⁴²

In carrying out its supervisory role, the attorney general (or other designated state official), can investigate charges of improper charitable activities, view books and records, and subpoena witnesses. Unfortunately, we are unable to judge the level of charity oversight because few cases involving nonprofit fiduciary issues have reached the courts—often as much because of the concerns of charity fiduciaries as those of the attorney general. Reform rather than punishment is generally the goal of the charity regulator, and board members as well prefer a chance to improve their behavior while avoiding embarrassment and personal liability. Settlements have traditionally been kept confidential,⁴³ although regulators are increasingly requiring disclosure where the transgression reflects more than a minor infraction by a single bad actor.⁴⁴ Thus it is impossible to

Pursue Webb Report Findings of Unreasonable Compensation of Grasso (Jan. 8, 2004), available at <http://www.nyse.com/press/p1020656068695.html?displayPage=%2Fpress%2F1073561404497.html> (last visited Feb. 25, 2004).

40. According to the website of the National Association of Attorneys General: "The Attorney General is popularly elected in forty-three states, and is appointed by the governor in five states (Alaska, Hawaii, New Hampshire, New Jersey, and Wyoming) and in the five jurisdictions of American Samoa, Guam, the Northern Mariana Islands, Puerto Rico, and the Virgin Islands. In Maine, the Attorney General is selected by secret ballot of the legislature and in Tennessee, by the state Supreme Court. In the District of Columbia, the Mayor appoints the Corporation Counsel whose powers and duties are similar to those of the Attorneys General of the states and jurisdictions." See http://www.naag.org/naag/about_naag.php (last visited Feb. 26, 2004).

41. Over forty years ago, Kenneth Karst observed, "and this is by no means an indictment of our attorneys general, any high political official may be expected to approach rather cautiously the investigation of charges that respectable trustees are guilty of wrongdoing or even mismanagement." Kenneth L. Karst, *The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility*, 73 HARV. L. REV. 433, 478-79 (1960).

42. See NATIONAL ASSOCIATION OF ATTORNEYS GENERAL, STATE ATTORNEYS GENERAL: POWERS AND RESPONSIBILITIES 27-39 (Lynne M. Ross ed., 1990) [hereinafter NAAG, STATE ATTORNEYS GENERAL] (reviewing common law powers as bounded by state constitution, legislation, and judge-made law).

43. Even where reports of complaints are kept, Swords and Bograd found that "[o]ften, investigations of specific abuses are disposed of by settlement, in which the charity does not admit to having committed any abuse; thus the files do not show whether or not the allegations were found to be true." PETER SWORDS & HARRIET BOGRAD, ACCOUNTABILITY IN THE NONPROFIT SECTOR: WHAT PROBLEMS ARE ADDRESSED BY STATE REGULATORS? (Nonprofit Coordinating Comm. of N.Y. ed., 1996) [hereinafter SWORDS & BOGRAD, ACCOUNTABILITY], available at http://www.charitychannel.com/forums/cyb-acc/resources/ag_prob.html (last visited Mar. 30, 2004).

44. Notably, in recent years, regulators conditioned settlement on disclosure by Boston University (Massachusetts), Adelphi University (New York), and the Kamehameha Schools/Bishop Estate (Internal Revenue Service). See, too, the numerous press releases on the New York attorney general's website, at <http://www.oag.state.ny.us/charities/press>.

Moreover, prosecutions for embezzlement and other crimes are very public affairs. See *infra* note 46 (discussing the Hale House). In a startling case, the Pennsylvania attorney general criminally prosecuted the former chief executive, chief financial officer, and general

determine how well government is doing to address malfeasance and misfeasance by charity fiduciaries.

Separately, attorney general action might reflect a rivalry between a state's regulatory agencies, because, depending on the industry in which it operates, a given nonprofit organization might also be regulated by such other agencies as the insurance commissioner, the department of health, education, or commerce, or the corporations commission. The case studies of the Blue Cross conversions in Part II, below, illustrate how the insurance commissioner might play a more central role than the attorney general—who might be conflicted between representing the public as to the charitable assets and representing the insurance commissioner or defending the conversion legislation itself.

Finally, regulators might simply be uninformed about their responsibilities in overseeing the charitable sector—or, as described above, reluctant to carry them out. Several recent cases illustrate this problem. For example, an investigation by the staff of the Pennsylvania Assembly into the spectacular collapse of the Foundation for New Era Philanthropy found that the failings of the attorney general's office were not so much the fault of inadequate staffing as deference to a well-connected, charismatic founder.⁴⁵ Despite his claims of inadequate resources,

counsel of the Allegheny Health, Education and Research Foundation, the largest nonprofit bankruptcy in history. The unprecedented indictment charged that the officers invaded the endowments and restricted charitable gifts in order to maintain general charitable operations, and by so doing they committed thefts by failure to make required disposition of funds received (a felony), misapplications of entrusted funds (a misdemeanor), and conspiracy to do the same. In May 2002, after a preliminary hearing that lasted for months, the judge narrowed the charges against the chief executive, Sherif Abdelhak, to several hundred allegedly misapplied restricted gifts (apparently some \$50 million), and dismissed all charges against the other former officers (the judge also threw out the conspiracy charges, since Abdelhak could not conspire with himself). See Cinda Becker, *Settling Down; AHERF to Pay \$93.7 Million to Creditors, Trusts*, MODERN HEALTHCARE, Jan. 21, 2002, at 14. An attorney general press release acknowledged that the court "dismissed felony theft charges against Abdelhak, saying he did not use the endowment money for his own personal gain." Press Release, Pennsylvania Office of Attorney General, *Former AHERF Official Pleads to Raiding Endowments; CEO Sentenced to 11 to 23 Months* (Aug. 29, 2002), available at <http://www.attorneygeneral.gov/press/release.cfm?p=00D4F106-2A92-42CF-BB86D1A6C7268849>. On August 29, 2002, Abdelhak pleaded no contest to a single misdemeanor of misapplication of entrusted funds; of his sentence for eleven to twenty-three months, he served three. See Cinda Becker, *Early Release: Abdelhak Wins Parole After Serving Three Months*, MODERN HEALTHCARE, Feb. 3, 2003, at 18.

45. PENN. GEN. ASSEMBLY, JOINT STATE GOV'T COMM'N, THE COLLAPSE OF THE FOUNDATION FOR NEW ERA PHILANTHROPY 49-50 (1995):

Of course, more quality employees can do more quality work; however, with this section enforcement was not a question of staffing.

The Commonwealth's Office of Attorney General and Department of State learned of the foundation's existence and novel scheme approximately 23 months prior to the foundation's collapse. . . . Given the foundation's initial refusal and subsequent reluctance to comply with the Solicitation of Funds for Charitable Purposes Act along with a novel demand that potential grantees surrender funds to the foundation in order to receive a grant that could double these funds in six months, both should have been more vigilant. . . . [New Era founder John] Bennett became acquainted with and pursued multimillionaires; some people representing the traditional establishment fell into his

the same charge could be made of the New York attorney general's failure to act sooner in the Hale House case.⁴⁶

Indeed, it is not always possible to reach consensus over whether the proper response to a particular charity governance dilemma is government enforcement action. The question of the "accountability" of charities is a hotly debated one in the philanthropic world today.⁴⁷ Equally important is the accountability of the regulator: Invisibility at the informal end of the regulatory spectrum makes it hard to judge the level and the effectiveness of regulators in influencing charity behavior—and whether regulators are motivated by their own or the public's interest. Perhaps state (and federal) regulators should be encouraged to issue reports of their own, describing their regulatory efforts, settlements, and judicial outcomes.⁴⁸

2. Adding in the Legislature

Schizophrenia sometimes better characterizes the states' approach to the regulation of charities: if under the common law, the attorney general seems untethered, under recent statutes and current practice, the attorney general seems alternately omnipotent and impotent. At the same time, as we read press reports of aggressive attorneys general, we might be surprised to learn that legislatures typically have granted them few tools to provide effective oversight and

confidence. A man with these references might have been too intimidating for regulators who should have been more aggressively curious.

Id.

46. In defending New York State's delay in discovering and exposing the looting of Hale House (a children's shelter that attracted millions in donations) by its long-time executive director, "[attorney general] Mr. Spitzer said the charities bureau in his office was charged with helping charities comply with state requirements, rather than aggressively policing them. The bureau has only six accountants to oversee 40,000 charities, he said, and it still must rely on information kept on 3-by-5 index cards to track the organizations. Requests for the money to computerize the operation have been repeatedly rejected." Nina Bernstein, *Officials Overlooked Dire Signs at Charity*, N.Y. TIMES, Feb. 7, 2002, at B1. Moreover, Hale House's founder was the executive director's mother, who "was elevated to sainthood" by Ronald Reagan and popular with other politicians. *Id.* (quoting the senior vice president for agency services at United Way).

47. See generally Evelyn Brody, *Accountability and Public Trust*, in THE STATE OF NONPROFIT AMERICA (Lester Salamon ed., 2002).

48. See, for example, the yearly reports by the attorney general of Pennsylvania for 1997, 1998, and 1999-2000, at <http://www.attorneygeneral.gov/pei/years.cfm>. The website of the Massachusetts Attorney General has made an impressive start in public reporting. For example, the attorney general sets forth statutorily-mandated procedures for nonprofit hospital conversions, see generally *infra* notes 108-20 and accompanying text, as well as information and documents relating to specific transactions. See, for example, the attorney general's report on the Waltham Deaconess transaction, at <http://www.ago.state.ma.us/healthcare/hcdwstatement.pdf>. On the other hand, the attorney general's "Public Charities Database of Final Legal Actions Against Fundraisers and Charities," sounds promising but amounts only to an alphabetical listing of the names of organizations investigated over the last twenty years, and the date and type of resolution (assurance of discontinuance, final judgment by consent, final judgment by default or final judgment) without any identification or discussion of the issues in the case. See <http://www.ago.state.ma.us/charity/judgment.asp> (last visited Mar. 12, 2004).

enforcement. State budgets allocate insufficient resources, and most attorneys general concentrate their charitable firepower on fraudulent and misleading fundraising.⁴⁹ Peter Swords and Harriet Bograd found that, as of 1996, only thirteen states had charities sections within the attorney general's offices, of which eleven employed two or more full-time attorneys.⁵⁰ However, a simple head-count is misleading: "These thirteen states are home to about 55% of U.S. charities, with 62% of national charitable revenues."⁵¹

Variations occur across states in both statutes and court decisions as to the situations—such as will contests involving charitable trusts, *cy pres*, and sale of all or substantially all assets, merger, or liquidation—in which the attorney general must be notified, give approval, or is a necessary or proper party.⁵² While most states require filings from those who solicit for charitable contributions, only twelve states have some form of charity registration.⁵³ New York state has one of

49. See generally Dana Brakman Reiser, *Enron.org: Why Sarbanes-Oxley Will Not Ensure Comprehensive Nonprofit Accountability*, 38 U.C. DAVIS L. REV. (forthcoming 2004).

50. PETER SWORDS & HARRIET BOGRAD, *NONPROFIT ACCOUNTABILITY: REPORT AND RECOMMENDATIONS* (Nonprofit Coordinating Comm. of N.Y. ed., 1996) [hereinafter SWORDS & BOGRAD, *REPORT AND RECOMMENDATIONS*], available at <http://www.charitychannel.com/forums/cyb-acc/resources/accrept.html> (last visited Mar. 30, 2004). For a performance audit of the Charitable Trust Section of the Michigan Attorney General's Office, the Section provided the following 2002 data comparing Michigan with six other states having similar charitable oversight obligations: Michigan had one attorney (for 4125 registered charities); California had ten (8200 each); New York had eighteen (2222 each); Ohio had eight (375 each); Massachusetts had seven (5857 each); Minnesota had three (1834 each); and New Hampshire (which requires only a one-time, not annual, registration) had one (6000 registered charities). MICHIGAN DEP'T OF ATT'Y GEN. AND DEP'T OF CONSUMER AND INDUS. SERVS., *AUDIT OF STATE ACTIVITIES RELATED TO NONPROFIT ORGANIZATIONS* 30 (May 2002), available at <http://audgen.michigan.gov/comprpt/docs/r1120001.pdf> (last visited Feb. 22, 2004). California's website states: "[T]he Attorney General has a small staff and limited financial resources to carry out charitable investigations." Office of Attorney General, State of California, Dept. Of Justice, *Frequently Asked Questions*, at <http://caag.state.ca.us/charities/faq.htm#8> (last visited Feb. 22, 2004).

51. SWORDS & BOGRAD, *REPORT AND RECOMMENDATIONS*, *supra* note 50. Swords and Bograd found the following:

The "integrated" state offices generally provide: registration and reporting systems for charities and for professional fundraisers; an enforcement program that includes inquiries, investigations, negotiations, and litigation to protect charitable assets and prevent fundraising abuse; educational programs to promote more responsible board governance and/or to prevent fundraising fraud; and oversight of charitable trusts or bequests. Some but not all of these offices also oversee certain structural changes such as mergers, dissolutions, or major transfers of assets. Many of these offices have self-sustaining budgets, supported by fairly modest registration and reporting fees.

Id. at 4.

52. For a summary of these statutes, see FREMONT-SMITH, *supra* note 4, app., tbl. 1, at 476-511. Note that where business corporation statutes require shareholder approval of such extraordinary events as merger or dissolution, nonprofit statutes often require the approval of members. Such a mechanism offers no check on the fundamental decisions of the fiduciaries of a charity lacking members—that is, most charities.

53. Fewer than ten states have adopted legislation requiring both registration and reporting from both charitable trusts and charitable nonprofit corporations: California,

the most comprehensive notice and oversight schemes.⁵⁴ Significantly, "in the vast majority of states there is no monitoring of dissolutions—and thus no oversight by a state official interested in preserving the assets of the terminating charity."⁵⁵ Parochialism can be found in the legislation of some of the states with merger statutes: "In some states the merger provisions require that the surviving corporation remain under the jurisdiction of the state in which the charity was originally organized. If the statutes of two states contain this requirement, merger is effectively prohibited."⁵⁶

Not all of the lack of enforcement activity of charity officials can be blamed on poor resources. First, it might simply reflect a sector with relatively few problems. Alternatively, legislation granting few powers or resources to the executive branch might reflect the belief that no good can come from having an attorney general involved in the "business" decisions of a charity, including structural decisions like change in purpose or sale of assets.⁵⁷ As the Assistant Attorney General of Ohio

Illinois, Massachusetts, Michigan, Minnesota, New Hampshire, New York, Ohio, and Oregon. See *id.* at 313-16. These states, however, cover the majority of American charities and charitable assets. The offices in these states maintain charity registries, review financial reports, investigate and prosecute breaches of trust, participate in court proceedings where the attorney general is a named party (such as *cy pres* and dissolution), and regulate charitable solicitations. See *id.* at 351-61. In addition, similar legislation in Rhode Island and South Carolina reaches charitable trusts, but not charities operating in corporate form. *Id.* at 314.

54. New York's Not-for-Profit Corporation Law ("N-PCL") requires a not-for-profit corporation to obtain State Supreme Court approval, upon notice to the Attorney General, before it may (1) amend its purposes or powers (N-PCL Article 8), (2) sell, transfer or otherwise dispose of all or substantially all of its assets (N-PCL Article 5), (3) merge or consolidate (N-PCL Article 9) or (4) dissolve (N-PCL Article 10). See CHARITIES BUREAU, NEW YORK STATE ATTORNEY GENERAL, THE REGULATORY ROLE OF THE ATTORNEY GENERAL'S CHARITIES BUREAU 22 (July 15, 2003), available at <http://www.oag.state.ny.us/charities/outline.pdf> [hereinafter NYAG Outline]. The New York attorney general's website suggests:

It is a common and better practice for organizations to provide the Attorney General with the terms and conditions of their proposed transaction in advance of the actual court filing. Such a procedure enables the Attorney General to review the transaction and raise concerns before the court application is filed. When the court application is filed, the Attorney General may either give a "no objection" endorsement or file objections. The Attorney General ensures that charitable assets are being protected and preserved for appropriate charitable purposes.

NYAG Outline, *supra* at 23.

55. FREMONT-SMITH, *supra* note 4, at 318.

56. *Id.* at 319.

57. Where the desire of attorneys general to protect the public from charity wrongdoing clashes with another social value, the legislature could favor the other policy. In a 1990 study entitled *State Attorneys General: Powers and Responsibilities*, the National Association of Attorneys General notes with unease "the movement to enact legislation designed to reduce the potential liability of directors and trustees." NAAG, STATE ATTORNEYS GENERAL, *supra* note 42, at 193. Acknowledging the relationship of this topic to broader tort reform issues, NAAG cites with disapproval statutes that grant immunity from civil liability to uncompensated directors, trustees, and officers of nonprofit organizations for injury caused by their actions or omissions if undertaken in good faith, within the scope of his or her functions, and not willful or wanton misconduct. *Id.* (citing to Connecticut's

recently wrote: "When charitable enforcement issues arise, many private sector practitioners seem to regard the state attorney general as an unwelcome and meddlesome interloper."⁵⁸ Finally, the oversight that does occur might be of the "wrong" kind, overemphasizing filings, which provide objective and measurable signs of agency activity, while scrimping on investigating.⁵⁹ Even granting the lack of resources for this function, at some point we must concede that the public might not want to pay for more (or different) oversight than is occurring. The media play an important role: When the matter becomes politically pressing or irresistible, the regulator seems to find the resources.⁶⁰

statute). Congress passed a federal Volunteer Protection Act (1997), which preempts any state statute that offers less protection. These statutes are triggered when harm befalls a third party, and do not, by contrast, protect volunteer trustees or directors from suits by or on behalf of the charity, or by the attorney general, for breaches of fiduciary duty. NAAG commented, "This is a departure from existing law governing trustees, who have always been held to a higher standard of care." *Id.*

58. David Villar Patton, *The Queen, the Attorney General, and the Modern Charitable Fiduciary: A Historical Perspective on Charitable Enforcement Reform*, 11 U. FLA. J.L. & PUB. POL'Y 131, 133 n.2 (2000). Patton continues: "Much of this resistance results, no doubt, from an excusable ignorance on the part of many corporate practitioners regarding the history, tradition, and implications of charitable trust law." *Id.*

59. See Renee A. Irvin, *Nonprofit Accountability and State Attorneys General: Trading a Little Fraud for a Lot of Forms*, Paper Presented at the Annual Conference of the Association for Research on Nonprofit Organizations and Voluntary Action (Nov. 16, 2002) (on file with author). According to a study by Peter Swords and Harriet Bograd, "no one has a precise picture of what abuses take place and the extent of the abuses," and state charity officials learn of abuses in one of three episodic ways:

First, they may review the annual reports filed by nonprofits (rules vary from state to state as to exactly which groups, if any, must file). States vary widely in how intensely they review the filed reports, but clearly some review is done and from time to time these reports reveal problems. Second, in some states under various statutes charity officials must oversee certain transactions. These might include incorporation, mergers, dissolution, transfers of substantially all assets, and charitable bequests; these reviews occasionally reveal problems. Finally, informants such as disgruntled employees, disaffected board members or employees, the general public, other government agencies, and the media are a major source of identifying problems. Indeed, a hard news story about some nonprofit abuse in the papers or on a T.V. almost forces state officials to investigate and become involved. Interestingly, our interviews with officials from the IRS also suggested informants and the media as a major source of leads to abuses.

SWORDS & BOGRAD, ACCOUNTABILITY, *supra* note 43.

60. For example, a year-long *Chicago Tribune* investigation found that Save the Children Federation, which pioneered the heart-tugging child-sponsorship appeal, took money for children who were dead, and falsified correspondence to sponsors from children. The charity immediately appointed a former Watergate prosecutor and U.S. inspector general to monitor the promised benefits. Several states also investigated; in a settlement with Connecticut, Save the Children agreed to change its advertising to clarify that donations and government grants are pooled to fund worldwide development. Lisa Anderson, *Relentless Campaigns of Hollow Promises: Charity's Probe Finds Sponsors Funded at Least 24 Dead Children*, CHI. TRIB., Mar. 15, 1998, at 1; Lisa Anderson, *The Road to Reform: Save the Children Redirects Staffers to Closely Monitor Individual Cases*, CHI. TRIB., Dec. 31, 1998, at 1. InterAction, a group of 162 nonprofits, adopted tougher standards

Marion Fremont-Smith finds that state legislatures have been spurred to action in the charitable arena "only after the attorney general exerted strong support," and, once legislation is in place, "if the attorney general initiates changes, they will be adopted if he has a strong voice in the legislature, but not otherwise."⁶¹ Indeed, as discussed below, the state attorneys general achieved significant success in obtaining statutes that provide an expanded role for attorneys general (and the public) in nonprofit hospital and HMO conversions.

3. And the Last Word: The Courts

As the Pennsylvania Supreme Court described the role of the Commonwealth with respect to charitable trusts:

A charitable trust is initially and continuously subject to the *parens patriae* power of the Commonwealth and the supervisory jurisdiction of its courts Moreover, the orphans' court has plenary power to ensure the competency and performance of trustees. Trustees of a charitable trust are fiduciaries, and as such are officers of the orphans' court, subject to its exclusive supervision and control.⁶²

Because attorneys general lack the authority to unilaterally impose or grant legal remedies,⁶³ the courts can offer relief if the charity wants to challenge a position taken by the attorney general in an enforcement action, or, more commonly, when the charity seeks approval for modification of a restriction or for instruction.⁶⁴ Courts usually defer to the charity fiduciaries when the attorney

for child sponsorship agencies, see <http://www.interaction.org/pvostandards/index.html>, and announced plans to hire outside evaluators to monitor compliance through checks of agency financial accounts and regular visits to their international field operations.

More recently, a relentless *Boston Globe* series examining excessive compensation and self-dealing by private foundations has prompted regulators in Massachusetts, New York, California, and Connecticut to announce investigations. See Sacha Pfeiffer & Michael Rezendes, *Mass., 2 Other States to Probe Foundations*, BOSTON GLOBE, Oct. 10, 2003, at A1; Francie Latour & Beth Healy, *AG in Conn. Begins Probe*, BOSTON GLOBE, Nov. 11, 2003, at B1.

61. FREMONT-SMITH, *supra* note 4, at 363.

62. *In re Coleman Estate*, 317 A.2d 631, 634 (Pa. 1974) (citations omitted).

63. See, e.g., *Midkiff v. Kobayashi*, 507 P.2d 724, 745 (Haw. 1973) ("The function of the attorney general, as *parens patriae* of charitable trusts, is to oversee the activities of the trustees to the end that the trust is performed and maintained in accordance with the provisions of the trust document, and to bring any abuse or deviation on the part of the trustees to the attention of the court for correction. The authority of the attorney general over charitable trusts does not extend beyond the performance of that function. M. R. Fremont Smith, *Foundations and Government*, 198 (1965). If a deviation from any trust provision is necessary in the interest of the trust, the power to authorize the deviation rests solely with the court.") (citations omitted). See generally FREMONT-SMITH, *supra* note 4, at 309.

64. The court, on motion of the attorney general or on its own, can "enjoin[] wrongful conduct, rescind[] or cancel[] a transfer of property, appointment of a receiver, replacement of a fiduciary, compel[] an accounting, redress of a breach or performance of fiduciary duties." EDITH L. FISCH ET AL., *CHARITIES AND CHARITABLE FOUNDATIONS* § 711 (1974) (citations omitted). In addition, the court can dissolve a corporation, enforce restrictions on gifts, supervise indemnification awards, and surcharge fiduciaries for improperly received benefits. See JAMES J. FISHMAN & STEPHEN SCHWARZ, *NONPROFIT ORGANIZATIONS: CASES*

general has no objection to the requested relief,⁶⁵ although the court is not bound by a settlement entered into by the attorney general.⁶⁶

The court, too, has its proper realm. The authority of the courts is bound by the Constitution—including the right of due process, pursuant to which a nonprofit corporation “has a property interest sufficient to require that it be given notice and a hearing before it could be deprived of the right to determine disposition of its assets.”⁶⁷ While most charity regulation occurs in the lower courts, whose findings of fact are rarely reversed, courts “may adjudicate only disputes brought to their attention by opposing parties and they are confined to the issues raised by these parties.”⁶⁸ As a separate matter, courts in some states enjoy statutory authority, at the behest of proper parties, to dissolve nonprofit corporations that exceed their powers.⁶⁹ Finally, we have “the well-settled rule that absent ‘the greatest emergency,’ courts are not warranted in interfering with the internal operation of a

AND MATERIALS 255-56 (2d ed. 2000).

65. For example, in *In re Barnes Foundation*, 684 A.2d 123 (Pa. Super. Ct. 1996), the court considered the petition of a supporting and supported foundation to sever their relationship. The court explained why it was reversing the decision of the lower court:

In his opinion in support of his decision, Judge Ott stated that he would not permit the requested deviation from the terms of the de Mazia trust because in his view “the sanctity of the donors’ written intent [was] more compelling than the immediate but short-sighted benefits of approving the agreements *sub judice*.” Although we agree in principle with Judge Ott that the sanctity of the donor’s intent should be honored and upheld whenever possible, we are convinced that the benefits of approving the present settlement will go further to advance Ms. de Mazia’s intent than forcing the parties to continue in what has obviously become a bad marriage: a marriage which threatens to damage or destroy one or both parties’ respective abilities to benefit the citizens of this Commonwealth. This latter concern was obviously at the heart of the position taken by the Attorney General, the statutorily designated guardian of the interest of the general public, who stated: “[T]he public interest would best be served by allowing each [party] to pursue its own program independently rather than be tied to the other with the resultant disharmony, disagreement, and litigation that has ensued.” We are compelled to agree.

Id. at 136 (citation omitted).

66. See, e.g., *In re Barnes Found.*, 683 A.2d 894, 899 (Pa. Super. Ct. 1996) (“[A]lthough the law requires the participation of the Attorney General’s Office in any proceeding to modify the terms of a charitable trust . . . , appellant cites no support for the proposition that the Court is bound by the position espoused by the Office of the Attorney General, and a reviewing judge must exercise his or her independent power of review.”); *In re Will of Fuller*, 636 N.E.2d 1333, 1343 (Mass. 1994).

67. *Kansas E. Conference of the United Methodist Church, Inc. v. Bethany Med. Ctr., Inc.*, 969 P.2d 859, 868 (Kan. 1998) (reversing the trial court which *sua sponte* had permanently enjoined Bethany Medical Center from amending its articles of incorporation to remove the designation of the Kansas East Conference as recipient of its assets on dissolution).

68. FREMONT-SMITH, *supra* note 4, at 304. Fremont-Smith identifies only two exceptions: one, “universally available,” where the charity fiduciaries seek “instructions as to the extent and interpretations of their duties,” and two, exercised rarely in some jurisdictions, where the court may exercise equity power to act on its own motion. *Id.*

69. See REVISED MODEL NONPROFIT CORPORATION ACT § 14.30(a)(1) (1987) (proceeding brought by attorney general).

corporation."⁷⁰ Similarly, "[t]he powers of trustees and the discharge of trusteeship responsibilities regularly involve the exercise of discretion, or fiduciary judgment, with which courts do not interfere except to prevent abuse."⁷¹

Availability of court review can curb inappropriate regulator zeal—or willingness to compromise—but even a process of court review still risks error by both the enforcer and the tribunal.⁷² Moreover, attorneys general could not achieve the success they do in negotiating settlements unless the charity litigates before courts with views of state power similar to that of the attorney general's. As an institutional matter, the judges before whom the charity would appear are often elected.⁷³

C. The Complication of Organizational Form: The Charitable Trust and the Nonprofit Corporation

1. Historical Roots and Contemporary Challenges⁷⁴

To understand the current state of charity regulation, one has to appreciate the effects of history. The American common law powers of the attorney general and the equity courts trace back to English property rules respecting trusts and survived the American Revolution.⁷⁵ A charitable trust, like a private trust, is valid only because someone has the power of enforcement. The power "implies the duty to oversee the activities of the fiduciary who is charged with management of the trust funds, as well as the right to bring to the attention of the courts any abuses that may appear to need correction."⁷⁶ In the charity context, however, this is not as easy to accomplish as it sounds because a charitable trust may not have ascertainable beneficiaries who can sue to enforce their rights;⁷⁷ after all, "the human beings who are favorably affected by the execution of the trust are merely the media through whom the social advantages flow to the public."⁷⁸

70. *Kansas E. Conference*, 969 P.2d at 870. The court cited its earlier decision in *Cron v. Tanner*, 229 P.2d 1008 (Kan. 1951), involving a banking corporation, in which the Kansas Supreme Court had declared:

It is not the function of the court to manage a corporation nor substitute its own judgment for that of the officers thereof. It is only when the officers are guilty of willful abuse of their discretionary power or of bad faith, neglect of duty, perversion of the corporate purpose, or when fraud or breach of trust are involved, that the courts will interfere.

Id.

71. RESTATEMENT (THIRD) OF TRUSTS § 50 cmt. a (2003).

72. A particularly vivid example of this occurred with regard to the Art Institute of Chicago. See *infra* Part II.B.

73. See generally Michael R. Dimino, *Pay No Attention to That Man Behind the Robe: Judicial Elections, the First Amendment, and Judges As Politicians*, 21 YALE L. & POL'Y REV. 301 (2003).

74. This section draws from Brody, *Fiduciary Law*, *supra* note 15, and Evelyn Brody, *The Legal Framework for Nonprofit Organizations*, in THE NONPROFIT SECTOR: A RESEARCH HANDBOOK (Walter W. Powell & Richard Steinberg eds., 2d ed. forthcoming 2004).

75. But this lineage was not without controversy. See, e.g., FREMONT-SMITH, *supra* note 4, at 43-47; Brody, *Charitable Endowments*, *supra* note 17.

76. FREMONT-SMITH, *supra* note 4, at 301.

77. AUSTIN W. SCOTT, THE LAW OF TRUSTS § 364 (2d ed. 1956).

78. George G. Bogert, *Proposed Legislation Regarding State Supervision of Charities*,

It is this absence of parties with a property interest that explains why the law grants standing to the attorney general to enforce the trust's terms (including its charitable purpose) and the fiduciaries' duties. However, such a structure puts pressure on the "inclination and budget of a public official to vindicate [the beneficiaries'] rights."⁷⁹

Finally, unless the trust instrument so provides, a trustee has no legal authority to amend the terms of the trust. This leads to problems where the purposes established by the settlor have become impossible to carry out (or other restriction imposed by the settlor becomes difficult to adhere to), and the trust instrument provides no discretion to the trustee to adapt the purpose to the changed circumstances. Once again, property law comes to the rescue. The most famous rule of charitable trust law—the *cy pres* doctrine—gives the courts power to reform charitable trusts whose purposes have become impossible or impracticable to carry out.⁸⁰

Most American charities take the legal form of a nonprofit corporation, as opposed to a charitable trust. What does this mean for the powers of the attorneys general and courts?

A corporation, even a charitable corporation, owns its assets outright; unlike a trust, legal title and beneficial title reside in the same person.⁸¹ Thus if we view the charity itself as the beneficiary, the corporation does not need the help of the attorney general to enforce the proper use of the charitable assets. Such an approach, however, would leave boards of corporate charities unsupervised. If instead we consider the corporate charity as the means by which the public is benefited, a supervisory role for the attorney general and courts continues.⁸² Some commentators find—and criticize—a recent trend in attempts by attorneys general to enlarge their jurisdiction over nonprofit corporations.⁸³ They cite to "increasing

52 MICH. L. REV. 633, 633 (1954); see generally Mary Grace Blasko et al., *Standing to Sue in the Charitable Sector*, 28 U.S.F. L. REV. 37 (1993).

79. *Oberly v. Kirby*, 592 A.2d 445, 468 (Del. 1991) (quoting the attorney general's brief).

80. "In applying *cy pres* we must be mindful that courts have no more power to make wills for the dead than contracts for the living. Therefore basic to that determination is the intention of the testator." *In re Estate of Edward B. Goehringer*, 329 N.Y.S.2d 516, 520 (Surr. Ct. 1972). This philosophical judge also observed: "But all institutions must ultimately fail, if not soon after vesting then decades later. . . . Those which are in charitable trust and not consumed will invariably be subjected to *cy pres*." *Id.* at 521. The modern formulation of this rule expands relief where adherence to the designated purpose, while possible, would be "wasteful." See RESTATEMENT (THIRD) OF TRUSTS § 67 (2003).

81. See *St. Joseph's Hosp. v. Bennett*, 22 N.E.2d 305, 307 (N.Y. 1939) ("The corporation uses the property, in accordance with the law of its creation, for its own purposes; and the dictation of the manner of its use, within the law by the donor, does not affect its ownership or make it a trustee. A person . . . cannot be a trustee for himself.").

82. See generally FREMONT-SMITH, *supra* note 4, at 301 ("Both the enforcement power, exercised by the attorney general, and the regulatory power, exercised by the courts, extend to all assets dedicated to charitable purpose, regardless of the legal form—corporation, trust, or voluntary association—in which they are held."); see also NAAG, STATES ATTORNEYS GENERAL, *supra* note 42, at 186 ("[A] brief statutory reference to the Attorney General's authority may, if liberally construed, enable the Attorney General to exercise some control over the management and disposition of charitable funds.") (footnote omitted).

83. The National Association of Attorneys General ("NAAG") anticipated this issue in a 1990 study on attorneys general's powers and responsibilities. The section on charity regulation describes the emerging issue of nonprofit hospital and HMO conversions, which

use of charitable trust laws to effect remedies that are unavailable under nonprofit law," resistance to applying the business judgment rule in the nonprofit context, and even asserting "waste" of corporate assets.⁸⁴

Consider the case where the corporation's assets were donated and the donor specifically restricts the gift. Courts agree that the corporate charity must honor the restriction, even where it is not technically a trustee.⁸⁵ As with a charitable trust, though, only the attorney general may bring suit to enforce the restriction,⁸⁶ and the

NAAG accurately predicted would likely continue to be important. *See infra* Part I.C.2. The study notes the distinction between the law of charitable trusts and corporate law, and comments: "The propriety of hospital directors' actions may well depend on which set of principles is applied. If . . . pure corporate law applies, . . . [i]t would represent an erosion of the fundamental authority of the Attorney General to represent the public's interest in the preservation and proper application of charitable funds." NAAG, STATE ATTORNEYS GENERAL, *supra* note 42, at 193.

84. Michael W. Peregrine & James R. Schwartz, *Key Nonprofit Corporate Law Developments in 2001*, 11 HEALTH L. REP. 272 (2002). The authors discuss three 2001 settlements: in Florida (with Intracoastal Health Systems), in Illinois (Terra Museum), and in Minnesota (Allina Health Systems). *See infra* Part II.

Note the definition of "waste" in the American Law Institute's *Principles of Corporate Governance*:

A transaction constitutes a "waste of corporate assets" if it involves an expenditure of corporate funds or a disposition of corporate assets for which no consideration is received in exchange and for which there is no rational business purpose, or, if consideration is received in exchange, the consideration the corporation receives is so inadequate in value that no person of ordinary sound business judgment would deem it worth that which the corporation has paid.

AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 1.42 (1992).

85. *See, e.g., St. Joseph's Hosp.*, 22 N.E.2d at 308. "No authority has been brought to our attention that a gift to a charitable corporation with the express direction that it be applied to a specific corporate purpose in a specific manner may be accepted by the corporation, and then used for a different corporate purpose in a different manner. No trust arises, it is true, in a technical sense, . . . for the trustee and beneficiary are one. . . . [The charitable corporation] may not, however, receive a gift made for one purpose and use it for another, unless the court applying the cy pres doctrine so commands." *Id.* Cf. RESTATEMENT (THIRD) OF TRUSTS (2003):

An outright devise[] or donation to a nonproprietary hospital or university or other charitable institution, expressly or impliedly to be used for its general charitable purposes, is charitable but does not create a trust as that term is used in this Restatement. A disposition to such an institution for a specific purpose, however, such as to support medical research, perhaps on a particular disease, or to establish a scholarship fund in a certain field of study, creates a charitable trust of which the institution is the trustee for purposes of the terminology and rules of this Restatement.

RESTATEMENT (THIRD) OF TRUSTS § 28 cmt. a (2003).

86. *See St. Joseph's Hosp.*, 22 N.E.2d at 306-07. Cf. *Carl J. Herzog Found., Inc. v. Univ. of Bridgeport*, 699 A.2d 995, 1002 (Conn. 1997) (holding that an objecting donor has no standing under the Connecticut Uniform Management of Institutional Funds Act). English charity law still embraces a founder's right of "visitation" over gifts made to charitable corporations. American law generally rejects this doctrine. That the English right is hereditary makes it less appealing here. For example, Professor Bogert writes:

In a country such as the United States, where primogeniture is obsolete,

final word rests with the court.

More generally, unless the state constitution provides otherwise,⁸⁷ the legislature can alter, remove or confirm distinctions between charitable trusts and corporations.⁸⁸ Indeed, statutory authority is needed to form a corporation in the first place,⁸⁹ and some nonprofit corporation laws grant broad authority to the attorney general.⁹⁰ At the extreme, some legislatures have declared that a charitable

the vesting of a power of visitation in the heirs of the donor is not desirable. . . . [I]n many cases they would be either wholly uninterested in exercising the right of visitation, or would be openly hostile to the institution which had deprived them of a part or all of the fortune of their relative.

GEORGE GLEASON BOGERT & GEORGE TAYLOR BOGERT, *THE LAW OF TRUSTS AND TRUSTEES* § 416 (2d ed. 1977) (footnote omitted), quoted in *Wier v. Howard Hughes Med. Inst.*, 407 A.2d 1051 (Del. Ch. 1979). *But cf.* N.Y. EST. POWERS & TRUSTS LAW § 8-1.3(a), (d), & (e) (2002) (allowing anyone "founding, endowing and maintaining" a public library, museum or educational institution in trust to exercise complete control over administration of the trust during his or her lifetime, and, if granted, to pass on these rights to the surviving spouse, without any obligation to account).

87. *See, e.g.*, Opinion of the Attorney General of Connecticut, 1987 Conn. Op. Att'y Gen. 42 ("The Connecticut Supreme Court has consistently held that the administration of a charitable trust is solely a judicial function in which the legislature may not interfere because of the doctrine of distribution of powers as set forth in Article II of the Constitution of the State of Connecticut . . .").

88. *See* NAAG, STATE ATTORNEYS GENERAL, *supra* note 42, at 31 ("Today, Attorneys General derive their power from constitutional and statutory mandates, as well as the common law. No clear lines separate the three sources of authority, for each often supplements the others. In fact, many constitutional provisions and state statutes are merely declaratory of common law.") (footnote omitted).

89. In some states the secretary of state or the courts once played a gate-keeper role, by having discretionary authority to approve certificates of incorporation. Today, however, incorporation is viewed as an entitlement, not a privilege. *See* NORMAN I. SILBER, *A CORPORATE FORM OF FREEDOM: THE EMERGENCE OF THE MODERN NONPROFIT SECTOR* 15-25 (2001).

90. Most notably, see the American Bar Association's Revised Model Nonprofit Corporation Act (1987), which has been adopted in a minority of jurisdictions. The introduction by the reporter, Professor Michael Hone, summarizes the wide powers and rights of the attorney general under this model act:

The Revised Act seeks to fill this void by statutorily clarifying existing common law and statutory authority of the attorney general . . . by authorizing the attorney general to monitor and exercise oversight powers over public benefit corporations. The attorney general has authority to bring, must receive notice of, and may join in, derivative actions on behalf of public benefit corporations. The attorney general may approve conflict of interest transactions and must be made a party to proceedings in which a court is asked to approve conflict of interest transactions. The attorney general may sue former or incumbent directors and officers for ultra vires acts, and may bring an action for breach of their duty of care or loyalty. The attorney general may commence proceedings to hold an annual, regular or special meeting of members.

The attorney general must be given notice of important corporate actions . . . (1) indemnifying directors; (2) merging; (3) selling all or substantially all corporate assets; (4) delivering articles of dissolution to the secretary of state; and (5) transferring or conveying assets as part of the dissolution process.

nonprofit corporation is deemed to be a trust and its directors to be trustees.⁹¹ In some other states it is the courts that treat the charitable class served by the corporate charity as the beneficiaries of a trust.⁹²

The situation where the charity seeks to change its charitable purpose raises additional issues. The charity fiduciaries' twin duties of loyalty and care combine to require charity trustees and directors to keep the funds productive for the benefit of a charitable class.⁹³ Some commentators find a third duty of charity fiduciaries: the "duty of obedience" to the organization's original mission.⁹⁴ Such a duty would have particular application to nonprofit corporations, because of the power typically enjoyed by the directors to amend the articles of incorporation, including the purposes clause. Blind obedience to mission, though, can impede the rational use of nonprofit corporate assets. Consider the case of a college suffering declining applications, but whose alumni and students do not want it to close.⁹⁵ Henry Hansmann describes how regulatory structures—and the combination of history and culture that he calls "institutional inertia"—already lock assets into the nonprofit sector.⁹⁶ Mandating the application of the *cy pres* doctrine to a re-evaluation of corporate mission furthers the expectation that charity managers must honor the original purposes of the charity through thick and thin.

The duty of obedience has been recognized (at least at the trial court level) in New York.⁹⁷ Upholding the attorney general's objection to the sale of assets by one nonprofit hospital to another, the court invoked such a duty of obedience,⁹⁸

REVISED MODEL NONPROFIT CORPORATION ACT, at xxvii (footnotes omitted).

91. Separate from the question of the corporate charity's obligation to honor a restriction is the potential liability of the corporation's directors. The Revised Model Nonprofit Corporation Act explicitly rejects the view that directors of corporate charities are trustees. Section 8.30(e) provides: "A director shall not be deemed to be a trustee with respect to the corporation or with respect to any property held or administered by the corporation, including without limit, property that may be subject to restrictions imposed by the donor or transferor of such property." The comments explain that "the corporation, as distinguished from its director, may hold or be deemed to hold property in trust or subject to restrictions." *Id.* § 8.30(e) cmt. 1.

92. See, e.g., *Holt v. Coll. of Osteopathic Physicians and Surgeons*, 394 P.2d 932 (Cal. 1964) (ruling that a minority director could sue to enforce a charitable trust). See generally Committee on Charitable Trusts, *Duties of Charitable Trust Trustees and Charitable Corporation Directors*, 2 REAL PROP. PROB. & TR. J. 545 (1967). A trust approach makes monetary judgments for breach meaningless—the corporation would have to sue itself; however, equitable remedies would still be available. *Id.* at 547.

93. An attorney general can bring a court action to force *cy pres*. In England, "the assets of charitable corporations are subject to the doctrine of *cy pres* and deviation, regardless of their source. . . ." FREMONT-SMITH, *supra* note 4, at 440.

94. See DANIEL L. KURTZ, BOARD LIABILITY: GUIDE FOR NONPROFIT DIRECTORS 84-90 (1988).

95. Harriet M. King, *The Voluntary Closing of a Private College: A Decision for the Board of Trustees?*, 32 S.C. L. REV. 547 (1981); Hazel G. Beh, *Downsizing Higher Education and Derailing Student Educational Objectives: When Should Student Claims for Program Closures Succeed?*, 33 GA. L. REV. 155 (1998).

96. See HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE 46, 241, 295-96 (1996).

97. *In re Manhattan Eye, Ear & Throat Hosp. v. Spitzer*, 715 N.Y.S.2d 575, 593-96 (Sup. Ct. 1999).

98. *Id.* at 593. The court stated:

It is axiomatic that the Board of Directors is charged with the duty to ensure that the mission of the charitable corporation is carried out.

commenting:

Embarkation upon a course of conduct which turns it away from the charity's central and well-understood mission should be a carefully chosen option of last resort. Otherwise, a Board facing difficult financial straits might find sale of its assets, and "reprioritization" of its mission, to be an attractive option, rather than taking all reasonable efforts to preserve the mission which has been the object of its stewardship.⁹⁹

By contrast, the Supreme Judicial Court of Massachusetts recognized the right of the board of a nonprofit corporate hospital to amend its articles of incorporation to allow it to sell its assets. The court rejected the attorney general's argument that the board of a nonprofit corporation could not amend its articles to adopt new purposes for future activities and gifts.¹⁰⁰ However, some courts have held that *unrestricted* gifts previously donated to a corporation that later amends its charitable purpose are impliedly restricted to the original purpose, and so may be used only for those pre-amendment purposes.¹⁰¹ The classic statement of this position appears in the Massachusetts attorney general's brief in *Attorney General v. Hahnemann Hospital*: "[T]hose who give to a home for abandoned animals do not anticipate a future board amending the charity's purpose to become research vivisectionists."¹⁰²

This duty has been referred to as the "duty of obedience." It requires the director of a not-for-profit corporation to "be faithful to the purposes and goals of the organization," since "[u]nlike business corporations, whose ultimate objective is to make money, nonprofit corporations are defined by their specific objectives: perpetuation of particular activities are central to the *raison d'être* of the organization." (Bjorklund, *op. cit.*, § 11-4[a], at p. 414). Analysis of the duties of charitable directors more commonly arises in an action brought by the AG alleging breach of the duties owed to the corporation under §§ N-PCL 112 and 720, and does not appear to have been discussed in any reported decision under section 511. But the duty of obedience, perforce, must inform the question of whether a proposed transaction to sell all or substantially all of a charity's assets promotes the purposes of the charitable corporation when analyzed under section 511.

Id.

99. *Id.* at 595.

100. *Att'y Gen. v. Hahnemann Hosp.*, 494 N.E.2d 1011, 1020-21 (Mass. 1986); see also *Kansas E. Conference of the United Methodist Church, Inc. v. Bethany Med. Ctr., Inc.*, 969 P.2d 859, 863-65 (Kan. 1998).

101. See, e.g., *Pac. Home v. County of Los Angeles*, 264 P.2d 539, 542-43 (Cal. 1953); *Queen of Angels Hosp. v. Younger*, 136 Cal. Rptr. 36, 41-42 (Cal. Ct. App. 1977) (ruling that a charitable corporation may not "abandon" its purpose). This approach was confirmed by Section 5820 of the California Nonprofit Corporation Law: "Amendment of the articles of a corporation . . . does not, of itself, abrogate any requirement or limitation imposed upon the corporation, or any property held by it, by virtue of the trust under which such property is held by the corporation." Subsection (b) provides: "The Attorney General may, at the corporation's request, and pursuant to such regulations as the Attorney General may issue, give rulings as to whether the Attorney General will or may oppose a proposed action, or article amendment, as inconsistent with or proscribed by the requirements of a charitable trust." CAL. CORP. CODE § 5820(b) (2004).

102. 494 N.E.2d at 1021 n.18. See, too, the description of New York law in the outline

Generally stated, where state law permits a charity to sell its assets and alter its purpose (the "front-end *cy pres* issue"), the next question is whether resulting funds must be used for the original purpose (the "back-end *cy pres* issue")¹⁰³—and who decides. Despite the examples in the cases discussed in Part II, it is illegitimate for the state legislature to dictate where the assets are to go.¹⁰⁴ Moreover, because of the language of the state statute providing for a more lenient standard, New York courts apply a "quasi-*cy pres*" standard to distributions by liquidating corporate charities.¹⁰⁵ The New York Court of Appeals found that under the N-PCL, "it is the board of directors which adopts the plan of distribution" and that the legislature "intended also that not-for-profit corporations have 'a strong board of directors.'"¹⁰⁶ Pragmatic practitioners will, prior to the *cy pres* filing, negotiate proposed changes with the attorney general's office, which has a similar interest in arriving at a useful restructuring in order to avoid multiple trips to court.¹⁰⁷

2. Nonprofit Hospital and HMO Conversion Legislation

As suggested by the examples given above, a nonprofit hospital can be one of the largest charities in a community. Communities have been worrying about behind-closed-doors sales of nonprofit hospital assets: the community might be short-changed either in the amount paid for the assets (and hence the funds available for future charity) or in the quality and price of future for-profit hospital services. Some also suspect conflicts of interest on the part of the nonprofit's trustees and officers, who might receive positions either in the new hospital

by attorney general office's of its obligation to "[a]ssure that where the charity's new purposes do not overlap with its original purposes, the charitable assets obtained by a charity for its original corporate purpose continue to be used for that restricted purpose, pursuant to the doctrine of *cy pres* (the subject of the 1985 Court of Appeals decision in *Alco Gravure, Inc. v. Knapp Foundation*, 479 N.E.2d 752 (N.Y. 1985))." NYAG Outline, *supra* note 54.

103. These phrases are Richard Allen's, former top charity official in Massachusetts.

104. The term *parens patriae* is often used uncritically to refer to the regulatory authority of the state over charitable assets, but in England the term embodies two distinct powers—one legislative and the other oversight—and only the second survives in the democratic United States. Because the monarchical power of "prerogative *cy pres*" did not survive the Revolution, courts rather than the legislatures have the power, when necessary, to direct the disposition of charitable funds. See generally MARION FREMONT-SMITH & JILL R. HORWITZ, THE POWER OF THE LEGISLATURE: INSURER CONVERSIONS AND CHARITABLE FUNDS (Hauser Center on Nonprofit Organizations, Working Paper, 2003) (analyzing the Empire Blue Cross transaction in the legal framework of American *cy pres*). Fremont-Smith and Horwitz reject as aberrational a series of nineteenth-century Supreme Court decisions involving the Mormon Church's forfeiture of property on account of its practitioners' adherence to the illegal practice of polygamy, back when Utah was a federal territory. *Id.* at 16; see also RESTATEMENT (THIRD) OF TRUSTS § 67 cmt. a (2003) ("The prerogative power (or its legislative counterpart) has not been recognized in the United States, although legislation may reasonably regulate the extent and exercise of the *cy pres* power of the courts.").

105. *In re Multiple Sclerosis Serv. Org. of N.Y., Inc.*, 496 N.E.2d 861 (N.Y. 1986).

106. *Id.* at 868. Some commentators urge an elevated standard of review for organic changes. See, e.g., Harvey J. Goldschmid, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms*, 23 J. CORP. L. 631 (1998); James J. Fishman, *Checkpoints on the Conversion Highway: Some Trouble Spots in the Conversion of Nonprofit Health Care Organizations to For-Profit Status*, 23 J. CORP. L. 701 (1998).

107. See *supra* note 54 and accompanying text.

management or the resulting foundation. In response, states began to adopt versions of a "Nonprofit Hospital Sale Act."¹⁰⁸ The National Association of Attorneys General ("NAAG") produced a model nonprofit health-care conversion statute in July 1998.¹⁰⁹ Today, almost half the states have enacted legislation addressing these transactions.¹¹⁰

Typically, these conversion statutes require that the nonprofit hospital inform the attorney general of the terms of the proposed deal, and, after a public hearing, give the attorney general the right to disapprove it as against the public interest (disappointed parties may appeal to court).¹¹¹ As NAAG comments on the

108. See generally Evelyn Brody, *Introduction to Nonprofit Symposium Issue*, 23 J. CORP. L. 581 (1998); John D. Colombo, *A Proposal for an Exit Tax on Nonprofit Conversion Transactions*, 23 J. CORP. L. 779 (1998); James J. Fishman, *Checkpoints on the Conversion Highway: Some Trouble Spots in the Conversion of Nonprofit Health Care Organizations to For-Profit Status*, 23 J. CORP. L. 701 (1998); Harvey J. Goldschmid, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms*, 23 J. CORP. L. 631 (1998); David A. Hyman, *Hospital Conversions: Fact, Fantasy, and Regulatory Follies*, 23 J. CORP. L. 741 (1998).

109. *Model Act for Nonprofit Healthcare Conversion Transactions*, reprinted in National Association of Attorneys General, *Resolution Adopting Legislation on Conversion of Nonprofit Health Care Entities to For-Profit Status* (Summer 1998), available at http://www.naag.org/naag/resolutions/res-sum98-healthcare_conv.pdf (last visited Feb. 24, 2004) [hereinafter NAAG MODEL ACT]. Section 9.02 of NAAG's model statute provides: "Nothing in this Section shall be construed to limit the common law authority of the Attorney General and the [director of charitable trusts] to protect charitable trusts and charitable assets in this state." *Id.* § 9.02. Section 9.01 provides that a conversion transaction entered into in violation of the statute

shall be null and void and each member of the governing boards and the chief financial officers of the parties to the nonprofit healthcare conversion transaction may be subject to a civil penalty of up to \$1,000,000, the amount to be determined by the [court of competent jurisdiction] in the county in which the nonprofit healthcare entity's assets to be transferred are located.

Id. § 9.01. The penalties and remedies provided in the statute, section 9.02, are in addition to, and not a replacement for, any other civil or criminal actions which the Attorney General may take under either the common law or statutory law, including rescinding the nonprofit healthcare conversion transaction, granting injunctive relief or any combination of these and other remedies available under common law or statutory law.

Id. § 9.02.

110. Marion R. Fremont-Smith & Jonathan A. Lever, *State Regulation of Health Care Conversions and Conversion Foundations*, 9 HEALTH L. REP. 714 (2000).

111. Section 2.01 of NAAG's model statute requires:

At the time of providing notice to the Attorney General [Court], the nonprofit healthcare entity shall provide the Attorney General [Court] with written certification that a copy of this statute has been given in its entirety to each member of the board of trustees of the nonprofit healthcare entity.

NAAG MODEL ACT, *supra* note 109, at § 2.01. Section 4.01 requires the attorney general to publish notice of the public meeting not only in the newspaper of the "affected community" and provided to the county board of supervisors, but also, "if applicable, to the city council of the city where the nonprofit healthcare entity's assets to be transferred are located." *Id.* § 4.01.

NAAG's model statute does not provide for an appeal of an adverse decision by the

desirability of community input:

An open process maximizes the public's confidence in the review process and reduces any concerns that these charitable assets are not being adequately protected. The role of the Attorney General's Office is to enforce the provisions of the charitable trust laws so as to fully protect the charitable assets for the benefit of the public. The charitable trust laws are built upon the principle that charitable trusts are not private business entities, like fast food franchises and indoor plumbing supply companies.¹¹²

The parties must usually pay for the attorney general's costs of investigating the fairness of the deal, including expert appraisers. Legal problems remain because statutes define "hospital" and "conversion" differently, and political problems can arise if different state officials have overlapping jurisdictions.¹¹³ NAAG emphasizes the importance of educating the legal and healthcare community on the attorney general's interpretation and procedures, adding: "The Attorney General should seek to reassure directors, not intimidate them or cause good individuals to avoid serving on governing boards."¹¹⁴ In general, though, the process set forth in these statutes can make it even harder for a struggling nonprofit hospital to liquidate its assets and redeploy the proceeds to a more socially useful purpose.

Should the deal be allowed to proceed, under the typical nonprofit hospital sale statute the resulting funds must be used for "health care purposes" in the community that the hospital served.¹¹⁵ Moreover, some states are considering

attorney general; however, its drafters commented, "With respect to judicial review, under most state Administrative Procedure Acts, arbitrary and capricious acts can be challenged. In addition, *mandamus* actions are available to parties aggrieved in this way." Christine Milliken, *Comments to the Proposed Health Care Conversion Model Act*, reprinted in National Association of Attorneys General, Resolution Adopting Legislation on Conversion of Nonprofit Health Care Entities to For-Profit Status (Summer 1998), available at http://www.naag.org/naag/resolutions/res-sum98-healthcare_conv.pdf (last visited Feb. 24, 2004).

112. *Commentary to the Proposed Model Act for Nonprofit Healthcare Conversion Transactions*, reprinted in National Association of Attorneys General, Resolution Adopting Legislation on Conversion of Nonprofit Health Care Entities to For-Profit Status (Summer 1998), available at http://www.naag.org/naag/resolutions/res-sum98-healthcare_conv.pdf (last visited Feb. 24, 2004). NAAG also observes: "Adoption of this statute will place significant demands upon the resources and staff of an Attorney General's office and consideration should be given to these additional demands." *Id.*; see also SWORDS & BOGRAD, ACCOUNTABILITY, *supra* note 43 ("These cases are complex and can require significant commitment of state officials' resources, and are complicated by the problem that too often the charity has not kept adequate records of restricted funds and restricted assets.").

113. NAAG's model statute contains an "optional" section 5.02 "for Attorneys General who deem it appropriate to also consider issues of health impact in their review." NAAG MODEL ACT, *supra* note 109, at § 5.02 note. NAAG notes that "[i]f adoption of this optional section is deemed to be inappropriate [because exceeding the scope of the attorney general's abilities and resources], it is strongly recommended that oversight for these issues be placed within an existing public health authority for review by that agency." *Id.*

114. *Id.* § 6.01 note.

115. Not all states have such a "back-end" *cy pres* requirement. NAAG notes that "if your state has . . . a *cy pres* statute [which requires court approval for such conversions], you must consider the options available: substituting the Attorney General for the court procedure and approval; requiring both court and Attorney General approval; or retaining

barring the old hospital trustees from controlling the board of the resulting foundation; in any event, foundation leaders recommend that new members be brought in to provide grant-making expertise and avoid potential conflicts of interest. NAAG recommends that "the Attorneys General should consider taking an active role in the drafting of the articles and bylaws [of the conversion foundation], the identification of the disadvantaged groups to be served, the defining of the charitable mission, and the critical selection of the members of the first governing board."¹¹⁶

The recent experience in Virginia illustrates the confusion that remains in this area. A few years ago, the Virginia legislature adopted a targeted statute granting the attorney general and the courts detailed powers over health care conversions. This prompted the state supreme court—in a 4-to-3 decision—to declare, based on the wording of the statute, that only the state corporations commission (and not its attorney general and circuit courts) has jurisdiction over nonprofit corporations (as opposed to charitable trusts).¹¹⁷ The majority opinion reasoned that the legislature must have meant at the same time to constrict attorney general authority involving other types of nonprofit corporations.¹¹⁸ The dissenting opinion highlighted the attorney general's common law jurisdiction over charitable assets, whether held by trusts or nonprofit corporations. Within months, the Virginia legislature overturned this decision and explicitly applied charitable trust doctrine to nonprofit corporations.¹¹⁹ Michael Peregrine and James Schwartz commented: "Thus,

only court approval." *Id.* § 2.01 note. NAAG also notes that its standard is more flexible than that of the *cy pres* statutes, "and how to proceed is a policy question for each state to decide." *Id.*

116. *Id.* § 5.01(9) note. Section 5.01(9) lists as a factor for the Attorney General to consider in approving or disapproving the proposed conversion: "Whether any foundation established to hold the proceeds of the sale will be broadly based in the community and be representative of the affected community, taking into consideration the structure and governance of the foundation." *Id.*

117. *Commonwealth of Virginia ex rel. Beales v. JOCO Found.*, 558 S.E.2d 280, 284, 287 (Va. 2002); see also Rex Bowman, *Judge's Power to Remove Foundation Chief at Issue*, RICH. TIMES-DISPATCH, Aug. 15, 2000, at B2; Jay Conley, *Philanthropist's Case Near End*, ROANOKE TIMES & WORLD NEWS, Jan. 25, 2002, at A1; cf. *Van de Kamp v. Gumbiner*, 270 Cal. Rptr. 907, 925-26 (Cal. Ct. App. 1990) (no attorney general jurisdiction over health care plan, even if settlement with plan predated statute).

118. *JOCO Found.*, 558 S.E.2d at 285.

119. Section 2.2-507.1 sets forth the authority of the attorney general:

The assets of a charitable corporation incorporated in or doing any business in Virginia shall be deemed to be held in trust for the public for such purposes as are established by the donor's intent as expressed in governing documents or by other applicable law. The attorney general shall have the same authority to act on behalf of the public with respect to such assets as he has with respect to assets held by unincorporated charitable trusts and other charitable entities, including the authority to seek such judicial relief as may be necessary to protect the public interest in such assets.

S. 676, 2002 Leg. Sess. (Va. 2002) (emphasis added). Section 17.1-513.01 sets forth the jurisdiction of circuit courts: "The circuit courts shall have the same subject matter jurisdiction over matters pertaining to assets of charitable corporations, incorporated in or doing any business in Virginia, as the circuit courts have with respect to assets held by unincorporated charitable trusts and other charitable entities, including the power to require accountings, appoint receivers, award damages and enter injunctive relief against such

Virginia nonprofit corporations experienced both extremes of charitable trust law interpretation in a mere six month period."¹²⁰

Separately, tailored conversion legislation has been prompted by specific events, as illustrated by the cases of HealthPartners (Kansas), CareFirst Blue Cross (Maryland), and Empire Blue Cross (New York), discussed in Part II below.

3. Multi-Entity Structures

Attorneys general, courts, and legislatures can impede the ability of multi-state hospital systems to rationalize their structure and operations. For the fiduciary of a system affiliate, the corporate law does not appear to recognize duties to the system, as opposed to a duty to the affiliate on whose board the fiduciary sits.¹²¹ (But see the case study in Part II of CareFirst.¹²²) As explained by practitioner Douglas Mancino:

If there is a difference between the desires of the parent corporation and that of the subsidiary, the parent corporation must take the step of removing the board if it is legally empowered to do so and replace that board with new directors, before it can take full control over the assets [of the subsidiary].¹²³

Practitioners Michael Peregrine and James Schwartz warn that the possibility of legal challenge to multi-entity structures "has the potential of creating a significant conflict of interest when the best interests of the local hospital may be perceived to be different from those of the system, *e.g.*, closure of local hospitals, reductions in services at such hospitals, assessments to pay for system-wide initiatives, etc."¹²⁴ In particular, Peregrine and Schwartz focus on the concern that

charitable corporations, their officers, directors, agents, employees and others may be necessary to protect the public interest in such assets." *Id.* The language in italics did not appear in the bill as introduced on January 18, 2002, but was apparently added out of a concern that the attorney general's discretion would otherwise be too broad. I thank Michael Peregrine for this interpretation. Email from Michael W. Peregrine, to Evelyn Brody (June 7, 2002) (on file with author).

120. Michael W. Peregrine & James R. Schwartz, *Key Nonprofit Corporate Law Developments in 2002*, 12 HEALTH L. REP. 324, 327 (2003).

121. Because nonprofit corporations cannot issue stock, a parent-subsidiary type relationship is often replicated through the device of naming the "parent" nonprofit as the sole member with the power to appoint the board of the "subsidiary" nonprofit, perhaps with overlapping board membership. As to the duties of a sole corporate member of a nonprofit, see Dana Brakman Reiser, *Decision-Makers Without Duties: Defining the Duties of Parent Corporations Acting as Sole Corporate Members in Nonprofit Health Care Systems*, 53 RUTGERS L. REV. 979 (2001).

122. In May 2003, the Maryland legislature passed a bill aimed at CareFirst, the Maryland nonprofit holding company of Blue Cross plans in Maryland, Delaware, and the District of Columbia. The legislation, in part, requires the board of directors of a nonprofit health service plan to act "in a manner that is reasonably believed to be in the best interests of the corporation AND ITS CONTROLLED AFFILIATES OR SUBSIDIARIES THAT OFFER HEALTH BENEFIT PLANS." S.B. 772, 417th. Gen. Assem., Reg. Sess. (Md. 2003) (emphasis in original).

123. Douglas M. Mancino, *Following the Money*, HEALTH SYS. REV., May/June 1997, at 10, 12.

124. Peregrine & Schwartz, *supra* note 120, at 328.

"the Board of Directors of the independent affiliate has a legal obligation to protect the interest of its corporation to the potential detriment of the system and state attorneys general have been very active in demanding that affiliate directors meet this obligation."¹²⁵ Such a view of fiduciary duty leaves the board of the affiliate vulnerable "to suit by state attorneys general for a failure to challenge actions that they believe run counter to local interests."¹²⁶ Accordingly, these authors recommend:

[I]t is imperative that corporate counsel to health care systems take substantial care in drafting and updating both parent and affiliate governance documents (Articles and Bylaws) in order to insure that all the relevant corporate documents accurately reflect the nature of the relationships between the system parent and the individual affiliates. Dealing with this effectively in advance can mitigate, although likely not wholly prevent, such issues from reaching a crisis point downstream.¹²⁷

Whether a particular organic change opens the door to attorney general involvement depends on the statute. In *Nathan Littauer Hospital Ass'n v. Spitzer*,¹²⁸ a hospital wanted to restructure to create a sole member that, in turn, would adhere to Catholic directives for health care. Abortion rights groups protested and the attorney general asserted the right to intervene based on his approval powers over the disposition of nonprofit corporate assets. The court ruled that the attorney general "has failed to offer any persuasive authority in support of the proposition that a change in the composition of Littauer's membership is the functional equivalent of a sale, lease, exchange or other disposition of corporate assets."¹²⁹ The New York Court of Appeals denied the attorney general's appeal.¹³⁰ The attorney general's website states: "Administratively, the Attorney General continues to insist that not-for-profit corporations that affiliate through a change of membership are disposing of control over the corporation, a substantial asset itself of the corporation, as well as control over the corporation's assets."¹³¹

4. Transporting Trust Doctrine to Nonprofit Corporation Law

In sum, due to the lack of judicial precedents—and on the theory that charitable activities should be governed by the same legal standards regardless of organizational form—trust law doctrine often finds its way into the administration and adjudication of the law of nonprofit corporations. In practice, the differences between the organizational forms often diminish, because corporate donees must still obey any restrictions in a gift, and trust settlors typically waive strict trust standards. More broadly, particularly in states with a strict interpretation of the *cy pres* doctrine, the conservative desire to hew to the wishes of donors exerts its pull on regulators and courts throughout the life of all charities, trust and corporate.

125. *Id.*

126. *Id.*

127. *Id.*

128. 734 N.Y.S.2d 671 (N.Y. App. 2001).

129. *Id.* at 676.

130. *Nathan Littauer Hosp. Ass'n v. Spitzer*, 771 N.E.2d 835 (N.Y. 2002).

131. NYAG Outline, *supra* note 54, at IV.D.3.c.

D. Sources of Parochialism in Charity Enforcement

The charitable sector fits oddly into traditional public/private distinctions. While charities represent privately held and managed assets, they perform public services. Furthermore, like other enterprises, they face government regulation. In tying these concepts together, the question becomes: Which public can the state appropriately regulate a charity to serve, and who decides this question? These issues apply to both operating assets and investment assets.

1. Operating Assets: Geography Is Destiny

Attorneys general and courts commonly administer the law by assuming that donors to an existing charity mean those funds to "stick" to the community in which the charity operates. However, a community in which charity operations occur is not necessarily congruent with the donor's conception of the beneficiary class. State-level rivalry steals from other states, and interstate moves usually provoke protests from the incumbent community.¹³² What is the proper role of the attorney general in these matters? Most worrisome, when attorneys general act parochially, no state regulator exists whose interest it is to look out for the beneficiaries of a national or international charity. In terms of the national public interest, however, relocation could be a positive-sum game: The governing board of a charity might determine that the overall social benefit can be increased by moving its activities from a state with a low utility to a state with a higher one.

Notably, for example, the fate of hospital sale proceeds includes *where* they will be expended. Consider one recent case from the courts of both North Dakota and South Dakota. Banner Health System, an Arizona nonprofit that operates an eight-state system of hospitals and nursing homes, has been seeking consolidation through sales of facilities in these states and refocusing "on the higher-growth

132. Compare state business development efforts, where one state's loss is another's gain. See Part II for a discussion of the Terra Foundation, the Hershey Trust, and Health Midwest. See also the case involving the Museum of the American Indian, most of whose collection moved from New York to Maryland and Washington, D.C. when the Smithsonian rescued the financially troubled charity. *Museum of the Am. Indian v. Huntington Free Library*, 610 N.Y.S.2d 488 (Sup. Ct. 1994), discussed in FISHMAN & SCHWARZ, *supra* note 64, at 130-34.

In an earlier case, the New York attorney general opposed the move by the Sailor's Snug Harbor, a centuries-old retirement home for seamen, from Staten Island to North Carolina, where it would be operated in cooperation with Duke University. *In re Estate of Robert R. Randall*, 338 N.Y.S.2d 269 (Sur. Ct. 1972). The surrogate court granted the charity's *cy pres* petition over the objection of the New York attorney general that the new site "is remote, that Sea Level is a very small community, that the town of Morehead City some 30 miles distant does not afford the opportunities available in New York City." *Id.* at 272-73. The court countered by observing:

The average age of the residents is 77 years. Approximately 85% of these residents suffer from some sort of respiratory disease; 25% of them require intensive infirmity care, some are confined to wheel chairs. 75% of these residents were born in foreign countries and of the remaining 25%, most were born in states other than New York. In recent years less than 15% of the residents of the Harbor lived in New York City at any one time before they entered the Harbor.

Id. at 272-73.

markets of Arizona and Colorado."¹³³ Banner seeks to use the sale proceeds to support its operations in other states, but the North and South Dakota attorneys general object.¹³⁴

Moving first in North Dakota, Banner responded by suing in federal district court for "declaratory or injunctive relief from what it claims to be unconstitutional threats from the AG. The AG later filed a parallel case in state court, which is stayed pending a decision from this Court."¹³⁵ The federal court, however, ruled that it lacked jurisdiction over a suit against a state in these circumstances:

Banner asserts that the AG intends to use the state court system to prevent it from selling its property and moving the proceeds out of the state, in violation of the Takings Clause of the Fifth and Fourteenth Amendments, and the dormant Commerce Clause of Article I, Section 8. However, the state court provides an adequate forum to vindicate federal constitutional interests.¹³⁶

Banner appealed that decision to the Eighth Circuit.

Meanwhile, in South Dakota, "[w]hile the sale was in progress, the Attorney General informed Banner that he believed the facilities were restricted by constructive charitable trusts and therefore the proceeds could not be removed from the communities in which the facilities were located."¹³⁷ A week after the North Dakota decision, Banner filed a complaint in federal district court in South Dakota for a ruling that it is governed solely by the state's nonprofit corporation law with respect to the sale of its facilities in South Dakota, and that charitable trust doctrine does not apply. The district court certified the following question to the South Dakota Supreme Court: "Whether the laws of South Dakota recognize any legal theory that would subject any of the assets of a nonprofit corporation or proceeds from the sale of those assets to an implied or constructive charitable trust in the absence of an express trust agreement."¹³⁸ On certification, the South Dakota high court rejected the attorney general's argument "that the common law allowed imposition of an implied charitable trust when the purpose of the gift is narrower than the purpose of the receiving corporation."¹³⁹ However, the court declared that, on remand,

should the court find that Banner was unjustly enriched by the sale of the assets and removal of the proceeds from the local communities at the expense of those communities, the court would retain power to impose a constructive trust on those proceeds. . . .

Furthermore, should the court find that an implied trust is

133. *Judge Dismisses Lawsuit Against Banner Health*, PHOENIX BUSINESS JOURNAL, Aug. 14, 2003, available at <http://phoenix.bizjournals.com/phoenix/stories/2003/08/11/daily49.html>.

134. *Id.* Banner also faces similar legal challenges in New Mexico. *Id.*

135. *Banner Health Sys. v. Stenehjem*, No. A3-02-121, 2003 U.S. Dist. LEXIS 2702 (D.N.D. Feb. 25, 2003).

136. *Id.*

137. *Banner Health Sys. v. Long*, 663 N.W.2d 242, 246 (S.D. 2003) (on certification of question of law from the United States District Court for the District of South Dakota).

138. *Id.* at 243.

139. *Id.* at 248.

warranted under SDCL 55-1-11, Banner and its corporate predecessors may be held accountable for breach of fiduciary duties to the communities.¹⁴⁰

Back to the North Dakota attorney general's suit in state court. In August 2003, the trial judge granted Banner's motion to dismiss on the grounds that the facts alleged in the complaint failed to establish the two elements of a constructive trust: a confidential relationship and unjust enrichment. As to the latter claim, the court rejected Banner's claim "that it had not been enriched because the proceeds from the sales of the nursing homes are used in furtherance of other charitable purposes".¹⁴¹

Plaintiff claims that the local communities surrounding the nursing homes helped create and enhance the value of the nursing homes by the tax-exempt status and the contributions from community members. . . . It could be further argued that the reputation of Defendant has been enriched in other states by its use of the proceeds from the sale of the nursing homes to benefit other charitable programs in those other states.¹⁴²

However, the court found that the attorney general did not show that the enrichment lacked a justification¹⁴³ and that the attorney general lacked a remedy at law.¹⁴⁴ The state appealed to the North Dakota Supreme Court.

The North Dakota disputes (both federal and state) ended in December 2003, when Banner agreed to pay \$1 million, settlement being desired by the parties in recognition of "the expense, time, and risk associated with litigation, particularly where, as here, the claims at issue involve novel and untested legal theories and corresponding legal uncertainty."¹⁴⁵ The attorney general's press release declared: "This \$1 million payment by Banner will now be available as charitable assets in the state of North Dakota. I anticipate the North Dakota communities at issue will receive a substantial benefit from the settlement as the proceeds will be dedicated to healthcare or healthcare-related purposes in North Dakota'"¹⁴⁶

2. The Temptation of Charitable Investment Assets

Some of the cases of state enforcement relate to investment, rather than

140. *Id.* at 248-49.

141. Order Granting Defendant's Motion to Dismiss at 5, *North Dakota v. Banner Health Sys.*, Civil No. 09-02-C-4093 (Cass County, N.D., Aug. 12, 2003) (order granting defendant's motion to dismiss) (on file with author) (footnote omitted).

142. *Id.*

143. *Id.* at 6 ("Plaintiff argues simply that '[t]he diversion of funds would be inequitable, and there would be no justification for allowing [Defendant] to betray the trust and confidence placed in it by the Local Communities").

144. *Id.*

145. Settlement Agreement and Mutual Release of All Claims between Banner Health and Wayne Stenehjem, Attorney General of North Dakota, at 3 (Dec. 12, 2003) (copy on file with author).

146. Press Release, North Dakota Attorney General, Stenehjem Announces Settlement of Banner Health Lawsuit (Dec. 15, 2003), available at <http://www.ag.state.nd.us/NewsReleases/2003/12-15-03.pdf>.

operating, assets of charities. Of course, investment assets are in a very real sense charitable assets, and not just for private foundations, whose only assets might be investments that produce grant income.¹⁴⁷

The wealth held in charitable endowments, like private wealth, must be invested somewhere, and by someone.¹⁴⁸ A serious imbalance of resources towards the nonprofit sector inevitably attracts attention.¹⁴⁹ A revenue-hungry sovereign cannot ignore the wealth held in the tax-exempt sector.¹⁵⁰ In the twentieth century, American would-be dynasties used private foundations to control family business enterprises. Moreover, foundations "provided a framework in which beneficiaries of family trusts could themselves become private fiduciaries, not of family fortunes, but of the public order in general."¹⁵¹ Required to divest control of family businesses by the Tax Reform Act of 1969,¹⁵² the private foundations, along with other charities, now hold a fair-sized proportion of the equity and debt issues of publicly traded corporations.¹⁵³ As of March 2004, Congress was considering a proposal that would prohibit private foundations from counting some of their administrative expenses in the percentage of assets they must distribute to charities each year¹⁵⁴—motivated in part by the desire to free up more current private funds

147. See, for example, the fascinating case of the multi-billion Bishop Estate in Brody, *Bishop Estate*, *supra* note 12.

148. The discussion in this section draws substantially from Brody, *Charitable Endowments*, *supra* note 17.

149. Of course, adding to charity resources is often regarded as superior to private wealth enhancement in the case of wrongdoing. For an unusual and extreme case of judicial activism, consider the 4-3 decision by the Ohio Supreme Court in *Dardinger v. Anthem Blue Cross & Blue Shield*, 781 N.E.2d 121 (Ohio 2002). A widower had won a \$49 million punitive damage award (and \$2.5 million in compensatory damages) against an insurance company that had refused to pay for treatment for his dying wife (it claimed the treatment was experimental). The court gave Dardinger the choice of a new trial or the remittitur of the punitive damages down to \$30 million—with \$20 million going to the Ohio State University for cancer research (after funding all the attorneys fees), into a fund named for the deceased wife. At no stage in the proceedings was this approach raised or considered, and the plaintiff had no say in the choice of charity or the charitable purpose. Nor does Ohio have a statute (as a few states do) that permits or requires some of the punitive damages to be paid into a fund to benefit others. Dardinger is quoted as saying that he had already made charitable arrangements (and is now unsure of their effect), but that, rather than funding research, he would prefer to pay for patients whose insurance companies are denying treatment. *The Early Show* (CBS television broadcast, Dec. 30, 2002) (on file with author); Adam Liptak, *Court Dictates How to Spend Award*, N.Y. TIMES, Dec. 28, 2002, at A12. As of January 1, 2003, the composition of the Ohio Supreme Court changed slightly, perhaps enough to have made a difference. Lee Leonard, *Ruling Highlights Court's Split*, COLUMBUS DISPATCH, Jan. 3, 2003, at 1C.

150. See generally Brody, *Sovereignty*, *supra* note 8; Evelyn Brody, *Charities in Tax Reform: Threats to Subsidies Overt and Covert*, 66 TENN. L. REV. 687 (1999).

151. GEORGE E. MARCUS WITH PETER DOBKIN HALL, *LIVES IN TRUST: THE FORTUNES OF DYNASTIC FAMILIES IN LATE TWENTIETH-CENTURY AMERICA* 69 (1992).

152. I.R.C. § 4943 (Taxes on Excess Business Holdings).

153. The influence of any particular institutional investor on any particular company is no doubt much less, on average, than in the 19th century. For example, as of the mid-1990s, Harvard owned nearly 5000 different securities, including U.S. stocks and bonds, foreign stocks and bonds, real estate, and private placements. Martin Baker, *Universities Are Often Smart Investors*, INT'L HERALD TRIB., Feb. 13, 1996, at 20.

154. See H.R. 7, 108th Cong. (2003). A conference has not yet been appointed to

and reduce the load on overburdened governments.

Charity trust law being partly property law, the *cy pres* doctrine can be variously applied to preserve or alter current beneficiaries' expectations. Perhaps the poster child for a movement to liberalize the American *cy pres* doctrine would be the Buck Trust. In 1975 Beryl Buck bequeathed \$10 million worth of oil company stock to a trust for the benefit of the needy of Marin County, one of the richest in the country.¹⁵⁵ Ten years later, when the stock had ballooned in value to \$400 million, the trustee possessing distribution powers—the San Francisco Foundation—sought court approval to spend some of the income to benefit the greater San Francisco Bay area. The attorney general opposed on the ground that the original restriction was not impossible to carry out. The court agreed, and denied *cy pres* relief; the trustee resigned and was replaced.¹⁵⁶

While a trustee's duty of care includes the duty to make trust assets productive, most states took many years to accept the "prudent investor" rule (for private as well as charitable trustees), which originated in the 1830 decision of Justice Putnam in Massachusetts.¹⁵⁷ The legislative and judicial quest to distinguish permissible "investing" from impermissible "speculating" led to extreme conservatism. Some courts and legislatures relied instead on "legal lists"—generally consisting of government bonds, and excluding both equities and debt issued by corporations as too risky—until, by the turn of the 19th century, trust companies had developed to provide "a rational, institutional base for legal and business experience in drafting, forming, managing and perpetuating long-term trusts."¹⁵⁸ In 1990, the American Law Institute adopted and promulgated volume I of the *Restatement (Third) of Trusts*, which is devoted exclusively to revisions in the Prudent Investor Rule.¹⁵⁹

resolve differences with the Senate's CARE bill, which does not contain such a provision.

155. There is some skepticism about how seriously to take this low valuation; because the stock was left to charity, no estate tax applied to the bequest, and so the precise value was not an issue. See Harvey P. Dale, *The Buck Trust*, 4d & n.14 (Mar. 18, 1987) (unpublished manuscript, on file with author).

156. *In re Estate of Buck*, No. 23259 (Cal. Super. Ct. 1986), reprinted in 21 U.S.F. L. REV. 691 (1987); see also *Estate of Buck v. Marin Cmty. Found.*, 35 Cal. Rptr. 2d 442, 443-44 (Cal. App. 1994):

The petition for modification and the petition for removal of trustee were tried before the court beginning in February of 1986. After a six-month trial, the probate court issued a one hundred thirteen-page statement of decision. In its written decision, the probate court refused to apply the *cy pres* doctrine to modify the Marin-only restriction. The court reasoned that all of the Buck Trust income could be spent effectively and efficiently in Marin County. Moreover, the court found that the geographic restriction in the Buck Trust was "unequivocal."

Id.; see generally John G. Simon, *American Philanthropy and the Buck Trust*, 21 U.S.F. L. REV. 641 (1987). Compare *United States v. Cerio*, 831 F. Supp. 530 (E.D. Va. 1993). In that case, the district court granted the *cy pres* petition of the Coast Guard Academy for a donated fund whose income was to be awarded each year to the graduating cadet with the highest grade in physics and chemistry. The income was so high that the Academy declared that it would refuse the gift unless the court permitted most of the income to be used for science fellowships and visitorships.

157. See *Harvard Coll. v. Armory*, 26 Mass. (9 Pick.) 446 (1830).

158. Lawrence M. Friedman, *The Dynastic Trust*, 73 YALE L.J. 547, 561, 563 (1964).

159. RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 227 (1992). The Restatement embodies modern portfolio theory in its amended Section 227. The general

Not coincidentally, though, legal lists that restrict investments to government bonds (among other approved securities) conveniently provided a source of funds for the public sector.¹⁶⁰ Describing the hazards of relying on the legislature to authorize particular investments, Professor Friedman observed, "It must have been clear to all where the impetus for these laws arose. This was not a plain and narrow path but an invitation to corruption. The power to prescribe 'legals' was a power to control or at least to influence the flow of investment money."¹⁶¹ Professor Friedman concluded that the Depression provided the spur to final repeal of legal lists: "One might seriously question . . . the social utility of rules which kept funds out of channels which might conceivably restore business confidence, enhance stock prices, and help get the country back on its feet."¹⁶² As Mark Sidel comments on the Hershey saga:

The Pennsylvania statute adopted in the environment of revenge and victory after the collapse of the Hershey sale returns us, at least in Pennsylvania, to an era that trusts and trustees might have long assumed gone, when charitable trust investments were subject to more severe restrictions than in the modern era. The Pennsylvania statute may even be seen as a modern, sophisticated version of the old "legal list," when states limited the permissible investments trustees were allowed to make, publishing allowable investments on statutory lists.¹⁶³

Can a charitable trust, consistent with the duty of care, accept a lower return if to do so would benefit the community? The *Third Restatement of Trusts* permits a charity to take "social considerations" into account only "to the extent the charitable purposes would justify an expenditure of trust funds for the social issue or cause in question or to the extent the investment decision can be justified on grounds of advancing, financially or operationally, a charitable activity conducted by the trust."¹⁶⁴ "Program-related investments" are made to advance a charitable purpose rather than to earn a financial return.¹⁶⁵ At the other extreme, a charity

standard of prudent investment "requires the exercise of reasonable care, skill, and caution, and is to be applied to investments not in isolation but in the context of the trust portfolio and as a part of an overall investment strategy, which should incorporate risk and return objectives reasonably suited to the trust." *Id.* § 227(a).

160. See John H. Langbein & Richard A. Posner, *Market Funds and Trust-Investment Law*, 1 AM. B. FOUND. RES. J. 1, 5 n.18 (1976). See generally Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795 (1993).

161. Friedman, *supra* note 158, at 562.

162. *Id.* at 570-71. See generally WILLIAM L. CARY & CRAIG B. BRIGHT, *THE LAW AND THE LORE OF ENDOWMENT FUNDS* 6-8 (1969) (In 1939, Stanford University sought court approval to buy equities for an endowment that had been invested exclusively in fixed-income securities for 51 years.).

163. Mark Sidel, *The Struggle for Hershey: Community Accountability and the Law in Modern American Philanthropy*, 65 U. PITT. L. REV. 1, 45 (2003) (footnote omitted).

164. RESTATEMENT (THIRD) OF TRUSTS § 227 cmt. c.

165. Compare the debate over the Department of Labor's rules for "economically targeted investments" by pension funds. See Dep't of Labor Interpretive Bulletin 94-1, 29 C.F.R. 2509.94-1 (2003) (this would have been nullified by H.R. 1594, which passed the House on Sept. 12, 1995, but died with the 104th Congress). See generally Alvin D. Lurie, *ETIs: A Scheme for the Rescue of City and Country With Pension Funds*, 5 CORNELL J.L. & PUB. POL. 315 (1996); Edward A. Zelinsky, *ETI, Phone the Department of Labor:*

might divest or shun holdings in corporations whose activities clash with the charitable purpose. In the 1980s, institutions divested stock in companies doing business in South Africa;¹⁶⁶ some campus groups today call for divestiture from businesses in Israel.¹⁶⁷ More broadly, some institutions apply screens or invest in "conscience funds" to avoid investments in stocks of companies producing tobacco, alcohol, and munitions.¹⁶⁸

Prudent investment generally includes a requirement to diversify.¹⁶⁹ Donors to charitable trusts and to corporate charities may direct the entity to retain an investment in particular assets, such as stock in the donor's business. Legislatures and courts have not yet unequivocally interpreted "charitable purpose" to exclude any right of a donor to require investment of charity assets in the donor's business—except for the narrow rules passed by Congress for "private foundations."¹⁷⁰

D. Ascertaining the Proper Role of Charity Enforcers

Finally, we seek to set forth principles to guide the exercise of state authority over charities, and to highlight open issues. The seemingly unconstrained powers of the attorney general, and the hazards of litigation for targeted charities, can induce attorneys general and courts to step over the line between oversight and management. The flip side of meddling—reticence to monitor and investigate—

Economically Targeted Investment, IB 94-1 and the Reincarnation of Industrial Policy, 16 BERKELEY J. EMP. & LAB. L. 333 (1995).

166. See generally RESTATEMENT (THIRD) OF TRUSTS § 227 reporter's note c (discussing social investing cases and commentaries); Daniel R. Fischel & John H. Langbein, *ERISA's Fundamental Contradiction: The Exclusive Benefit Rule*, 55 U. CHI. L. REV. 1105 (1988). See also *Basich v. Bd. of Pensions, Evangelical Lutheran Church*, 540 N.W.2d 82 (Minn. Ct. App. 1995) (noting the courts could not constitutionally interfere with the church's and pension board's policy, based on social and doctrinal grounds, to divest stock in companies doing business in South Africa).

167. See, e.g., Rachel P. Kovner, *Anti-Israel Drive Seeks To Revive Financial Tactic*, N.Y. SUN, May 13, 2002, at 1 (reporting that "Students for Justice in Palestine has collected 250 to 300 signatures of Columbia affiliates calling on the university to divest from companies that do business with Israel. . . . A chapter of the group has also been formed at New York University, and petition drives are in progress at Princeton, Harvard, Yale, MIT and the University of California."). This story adds: "The divestment campaign appears to be the largest since a campaign targeted at South Africa during apartheid in the 1980s, from which organizers draw their inspiration, and a similar campaign apposing the Burmese military regime. But unlike those campaigns—where the government had few defenders—this one is drawing heated opposition from Jewish student groups, including some who argue the protests are motivated by anti-Semitism." *Id.*

168. One wonders how far charities will take this "tainted money" concern—recall Shaw's Salvation Army Major Barbara, and her repugnance at accepting a donation proffered by a wealthy distiller and arms merchant. GEORGE B. SHAW, *MAJOR BARBARA* (Dodd, Mead & Co. 1941).

169. RESTATEMENT (THIRD) OF TRUSTS § 227(b) ("In making and implementing investment decisions, the trustee has a duty to diversify the investments of the trust unless, under the circumstances, it is prudent not to do so."); see also *id.* § 229 cmt. d.

170. See the prohibition against excess business holdings in section 4943 of the Internal Revenue Code, and the prohibition on jeopardizing investments in section 4645. Congress intentionally crafted these rules to ensure that the Hershey Trust would not be classified as a private foundation. See *infra* notes 222 and 230.

might reflect a different kind of paternalism, the desire not to discourage charity managers from serving, but political considerations operate at this end of the spectrum as well. The terms in the title of this Article are, of course, pejorative, but they mean to suggest that one can objectively distinguish between appropriate and misguided prosecutorial, judicial, and legislative behavior.

The typical state legal regime and political pressures produce the twin weaknesses of the charitable sector: the lack of energy and initiative on the part of many nonprofit managers, and the lack of resources and zeal in enforcing the public's interest on the part of many charity regulators. Occasionally, though, we find the reverse problem: a board trying to do the right thing, but thwarted by an overreaching regulator. Sometimes, too, cooperation between a board and an attorney general can produce unwarranted results. Or the charity and the attorney general might reach the right result, but the court misapplies the law. Finally, the legislature can enact "bad" law, raising issues of the appropriateness of attorney general and court enforcement action. Even assuming the law is clear and proper, we thus variously find cases where the attorney general and courts:

- A. Know the law, and enforce that law.
- B. Know the law, and do not enforce the law (either by doing nothing or by misapplying the law):
 - 1. For neutral reasons appropriate to prosecutorial discretion (e.g., budget allocation, or hazards of litigation on the merits).
 - 2. For paternalistic reasons:
 - a. Leniency, to avoid discouraging board service.
 - b. Meddling (i.e., acting as a "super director").
 - 3. For parochial or other "political" reasons.
- C. Do not know the law, and do not enforce the law (either by doing nothing or by misapplying the law, as described above in B).

Of course, "the law" is often unclear. Moreover, just because an attorney general does nothing does not mean nothing happened. The governing boards' own advisers play a large role in crafting the legal environment for charity behavior. More significantly, donors and other stakeholders upon whom the charity depends bring far more pressure upon charity fiduciaries than can the law.¹⁷¹

171. See the news accounts of the management scandal involving the United Way of the National Capital Area, and the response by area corporations to withdraw from workplace fundraising for the charity. See, e.g., David Cay Johnston, *Directors Say Records Hidden At United Way*, N.Y. TIMES, Apr. 29, 2002, at A19; David Cay Johnston, *Former Head of United Way in the Washington Area Pleads Guilty to Theft*, N.Y. TIMES, Mar. 5, 2004, at A17. Despite having made drastic leadership changes, at the end of January 2003 the organization reported that major corporations and their employees have pledged only about \$4.5 million since fall of 2003, a fraction of the approximately \$20 million pledged in 2001. Jacqueline L. Salmon, *United Way's Donations Plummet; Charity Will Cut 40% of Workforce*, WASH. POST, Jan. 31, 2003, at A1. A month later, the organization announced that, for the first time in 25 years, it would not participate in the federal workplace solicitation program, the Combined Federal Campaign, which in recent years has brought in more than half of its annual collections. Jacqueline L. Salmon, *United Way To Suspend Federal Role; DC Charity Wants Md. Group to Fill In*, WASH. POST, Feb. 14, 2003, at A1.

1. Focus on Fiduciary Duties, Not Ends

Public oversight of charity activity could more properly be termed oversight of the activities of the charity fiduciaries. The other primary focus of state interest relates to consumer-protection statutes that govern charitable solicitations, to prevent fraud and the diversion or waste of donated funds.¹⁷² Researchers Peter Swords and Harriet Bograd find a disconnection between those who focus on one or the other of these two realms of state oversight.¹⁷³

The role of the attorney general and courts is to guard against charity fiduciaries' wrongdoing, and to enforce charitable obligations without interfering in discretionary decisionmaking carried out in good faith. An attorney general is vested with the authority to seek to correct breaches of charity responsibilities and of fiduciary duty that have not otherwise been remedied by the board, but the attorney general is not a "super" member of the board.¹⁷⁴ The courts are needed to guard against possible opportunism by the charity's fiduciaries, but have no particular familiarity, much less expertise, with the charity's operating needs. Consistent with these principles, the attorneys general and courts should endeavor to reach settlements with charities, in order to preserve charitable assets and to support good-faith fiduciary decisionmaking.¹⁷⁵ If the court has concerns about possible conflicts of interest or lack of independence, the court can appoint master or special-purpose trustees (or special-purpose directors) to make a recommendation with respect to the matter.¹⁷⁶

As Marion Fremont-Smith explains, the right of *parens patriae* enjoyed by the attorney general "does not, however, include a right to regulate, or a right to direct

172. The Internet revolution highlights the longstanding problems of state charity regulators faced with the interstate activities of both look-alike and legitimate charities. Where is Internet charitable solicitation taking place for legal purposes, and who can regulate it? In September 2000, the National Association of Attorneys General/National Association of State Charities Officials (NAAG/NASCO) released a proposal on this topic—called the "Charleston Principles" after the conference at which it was developed. See <http://www.nasconet.org>.

173. "Many law professors and practitioners who specialize in nonprofit law focus on the themes listed here under 'protecting charitable assets.' On the other hand, professional fund-raisers, their attorneys and clients, and many journalists focus attention mainly on fund-raising issues. There seems to be little communication between the two camps." SWORDS & BOGRAD, *ACCOUNTABILITY*, *supra* note 43. One official, commenting on a draft version of their paper, suggested that "you might want to point out that our offices spend considerable time on fund-raising problems because the public is outraged by misconduct in this area and demands that its public officials take enforcement action." *Id.*

174. See, e.g., *In re Estate of Horton*, 90 Cal. Rptr. 66, 68 (Cal. Ct. App. 1970) ("We are cited no statutory or case law authority placing the Attorney General in the position of a super administrator of charities with control over, or right to participate in, the contractual undertakings of the charities. He has undoubted standing to seek redress in the courts of contracts entered into by charities which are collusive, tainted by fraud or which demonstrate any abuse of trust management.").

175. See, e.g., *id.* ("No doubt it may become 'necessary or desirable' for a charity to compromise litigation when it becomes involved in a good faith dispute which may affect its assets, or, in this case, its expectancies.").

176. For example, the probate court overseeing the Bishop Estate appointed special-purpose trustees to handle the tax dispute with the Internal Revenue Service. See Brody, *Bishop Estate*, *supra* note 12, at 538 & n.5.

either the day-to-day affairs of the charity or the action of the court."¹⁷⁷ After all, state attorneys general have no necessary expertise, much less the resources, to address the myriad concerns of the hundreds of thousands of charities that function in the United States today. A posting of frequently asked questions on the website of the attorney general of California nicely delineates between proper oversight and inappropriate interference:

The Attorney General investigates and audits charities to detect cases in which directors and trustees have mismanaged, diverted, or defrauded the charity. . . . The Attorney General does not review matters involving internal labor disputes, contested elections, disagreements between directors and members over policy and procedures, and most legal actions between charities and third parties regarding contracts or torts.¹⁷⁸

A New York case illustrates the differences between an attorney general acting as the fiduciary and proceeding against the fiduciaries. New York has a statute providing: "The attorney general shall represent the beneficiaries of . . . dispositions [of property] for religious, charitable, educational or benevolent purposes and it shall be his duty to enforce the rights of such beneficiaries by appropriate proceedings in the courts."¹⁷⁹ In *Lefkowitz v. Lebensfeld*,¹⁸⁰ the New York attorney general invoked this statute to sue corporations whose preferred stock was owned by certain charities, and sought to compel the payment to the charities of dividend arrearages. The courts held that the attorney general has no authority to bring direct suit against third parties on behalf of charities. Declared the trial court: "[N]ot-for-profit corporations . . . have the right to prosecute an action in their own names for the protection of their ultimate beneficiaries . . . and thus no need exists for the Attorney General to act in their behalf."¹⁸¹ The appellate division distinguished the situation in which a restricted gift made to a charitable corporation may be enforced at the instance of the attorney general. By contrast, "a donor who has attached no conditions has no such expectation. He is, in effect, relying on the good will and judgment of the donee charity to utilize his gift in what the donee perceives to be the most appropriate manner."¹⁸² Instead, the attorney general may, if warranted, proceed against the fiduciaries. "Standing to sue and supervisory powers are entirely separate legal principles."¹⁸³ The New York Court of Appeals affirmed: "[The statute] does not authorize a large scale incursion into the everyday affairs of charitable corporations. Indeed, in these circumstances, to confer standing upon the Attorney-General . . . would be to grant all but unlimited and uncontrolled power to act as the alter ego of the charitable organization."¹⁸⁴

177. FREMONT-SMITH, *supra* note 4, at 301.

178. State of California Office of the Attorney General, *Frequently Asked Questions*, at <http://caag.state.ca.us/charities/faq.htm> (last visited Mar. 10, 2004).

179. N.Y. EST. POWERS & TRUSTS LAW § 8-1.1(f) (McKinney 2002).

180. 415 N.E.2d 919 (N.Y. 1980).

181. *Lefkowitz v. Lebensfeld*, 408 N.Y.S.2d 216, 219 (Sup. Ct. 1978).

182. *Lefkowitz v. Lebensfeld*, 417 N.Y.S.2d 715, 720 (App. Div. 1979).

183. *Id.* at 721.

184. *Lefkowitz*, 415 N.E.2d at 922. Compare *Estate of Janes*, 681 N.E.2d 332 (N.Y. 1997) (permitting attorney general suit for breach of fiduciary duty by the trustee of a private

At the same time, more enforcement against wayward fiduciaries—even, or perhaps especially, politically well-connected fiduciaries—might be salutary, with the sanction perhaps being reputational rather than monetary. For example, in recent years, all investors, including nonprofits, became more conscious of asset allocation. In the mid-1990s, the bull market attracted the smallest charity; foundations, due to their payout requirement, were particularly conscious of their portfolio values. Now, posting the first losses after years of positive investment returns, charities seem to be struggling to maintain their endowments—perhaps overly struggling. As of June 30, 2001, the Art Institute of Chicago had invested nearly \$400 million of its \$667 million endowment in lightly regulated “hedge funds,” only to discover in the fall that a \$23 million investment had nearly vanished, and another \$20 million was at similar risk.¹⁸⁵ In a lawsuit, the museum complained that the hedge fund in which the loss occurred had promised that the museum “could not lose any of [its] investment, even in a declining market, unless the particular stocks in which the fund assets were invested fell in value by more than 30 percent,” but that the investment involved a “highly proprietary trading strategy” that could not be disclosed.¹⁸⁶ The museum’s finance committee included, among others, department-store heir Marshall Field V, the chief executive of the Chicago Board of Trade, and a former chairman of Sears, Roebuck & Company. A former chairman of Sara Lee Corporation and the current chairman of Hyatt Hotels Corporation also sit on the board.¹⁸⁷ Commented trustee Field: “This is the risk of the game. And we lost. And so what?”¹⁸⁸ We have no information as to whether the Illinois attorney general is investigating the actions (or inactions) of the museum’s board.

The question remains whether a change in purpose is or should be a special case.¹⁸⁹ This subject is being examined by the ongoing American Law Institute’s

trust with charitable remaindermen; holding it imprudent to retain a high concentration of Kodak stock in the estate—seventy-one percent—for seven years given the needs of the beneficiaries; and assessing damages for the value of the lost capital but not lost profits), *with Commonwealth ex rel. Ferguson v. Gardner*, 327 S.W.2d 947, 948 (Ky. 1959) (“It is significant that no record has been produced of any attempt by an attorney general, during the entire 167 years of the Commonwealth, to intervene in the many contests about the validity and establishment of wills involving charities.”). Surprisingly, in this latter case, the court also commented:

If the present will is declared valid, bequests thereunder for the ultimate benefit of charity will be nontaxable, and the state will be deprived of a substantial amount in inheritance tax revenue and in future taxes. Certainly, it was not the intention of the Legislature to place the Attorney General in the inconsistent position of being under the duty of seeking to establish the validity of a will when the state will benefit from its invalidity.

Id. at 949.

185. Barbara Rose, *Museum Defends Investing Strategy*, CHI. TRIB., Dec. 12, 2001, at 3:1.

186. *Id.*

187. Ianthe Jeanne Dugan et al., *Chicago Art Institute Learns Tough Lesson About Hedge Funds*, WALL ST. J., Feb. 1, 2002, at A1.

188. *Id.*

189. See NAAG Model Act, *supra* note 109 (citing proposals by Professors Goldschmid and Fishman).

project on Principles of the Law of Nonprofit Organizations.¹⁹⁰

2. Parochialism by Charities: What Is the Effect of Foreign Incorporation?

A charity operating across state lines becomes subject to the jurisdiction of the state in which it maintains assets and solicits contributions. Similar problems can arise for an affiliated group of separately incorporated charities formed in more than one state, as already described with respect to Banner Health System and as illustrated in Part II by the Heath Midwest case. But the lines of jurisdiction are not clear, particularly over decisions by the board to make organic changes in purpose and governance.

A matter may be heard in one jurisdiction while applying the law of another. The law is generally settled for charitable trusts: Unless the trust designates a jurisdiction, issues of interpretation are governed by the law of the state of organization and issues of administration are governed by the law where the trust is administered (where the trust has the most contacts). Matters appear more complex for nonprofit corporations.

Even for charities intending to operate in a single state, the desire to operate free of unreasonable governmental oversight has led savvy advisers to choose the state of incorporation carefully. While their laws tend to resemble each other, states sometimes have different policy goals, or even compete with each other by providing more hospitable legal environments for certain activities.¹⁹¹ Nonprofits might then shop for a favorable state of incorporation.

For example, New York practitioners, seeking to avoid the delays and involvement of the attorney general and the courts, routinely incorporate their nonprofit clients in Delaware (which does not have a separate nonprofit corporation statute).¹⁹² Those starting a charity in California might be reluctant to submit to California's requirement that "not more than 49 percent of the persons serving on the board of any [nonprofit public benefit] corporation may be interested persons."¹⁹³ Finally, many states offer limitations on the "monetary damages that could be recovered from directors of [nonprofit] business corporations who breach their duty of care."¹⁹⁴

190. See Principles of the Law of Nonprofit Organizations §§ 240, 245 (Council Draft No. 1, 2003). Note that this draft has not been adopted by either the ALI council or the membership. See *supra* note * (stating that I am the Reporter of this project).

191. While the powerful institutional force of isomorphism (conformity) operates on legislation, there is sometimes a "race to the bottom" to attract desired enterprises. See Roberta Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709 (1987).

192. See FISHMAN & SCHWARZ, *supra* note 64 (explaining that incorporators of charities intending to operate in New York, which has a strict regulatory regime, prefer to incorporate in Delaware).

193. CAL. CORP. CODE § 5227(a) (West 1996). Subsection (b) defines "interested persons" as either "[a]ny person currently being compensated by the corporation for services rendered to it within the previous 12 months . . . excluding any reasonable compensation paid to a director as director," or any specified family member of such a compensated person. *Id.*; see also ME. REV. STAT. ANN. tit. 13-B, § 713A(2) (West 2003.).

194. REVISED MODEL NONPROFIT CORP. ACT at xxxv (1987); see also FREMONT-SMITH, *supra* note 4, app. at 514-17 (identifying 21 states allowing for optional elimination of liability).

At the federal level, in 2002 Congress enacted the Sarbanes-Oxley legislation,¹⁹⁵ generally affecting only publicly traded companies, in response to the corporate governance scandals of Enron, WorldCom, and others. Proposals have followed for similar reform at the state level. Similar changes are being adopted by self-regulating bodies.¹⁹⁶ The desirability of extending some of these reforms to the nonprofit sector is a subject of much debate, and could influence the choice of form (as trust or corporation), as well as the choice of state of organization.¹⁹⁷ However, the broadly-applicable standards adopted by the BBB Wise Giving Alliance recommend that no more than one person who directly or indirectly receives compensation from the charity should serve as a voting member of the board—and should not serve as chairman or treasurer.¹⁹⁸

Typically, a foreign corporation (for-profit or nonprofit) must register to obtain a certificate of authority in states in which it operates.¹⁹⁹ It is not always clear, however, what requirements a state may impose on a charity formed elsewhere, and the degree of state oversight over foreign charities remains largely untested in the courts. The state of operations should not be able to impose requirements on foreign charities more onerous than those imposed on its domestic charities. The issue remains about which requirements imposed on domestic charities can also be imposed on a foreign charity formed in a state with less strict requirements, such as the number of directors or their independence.

A charity operating across state lines becomes subject to the jurisdiction of the state in which it maintains assets or solicits contributions. If a charity formed in one state operates exclusively in another, ordinarily the attorney general of the state of organization does not oversee operations, and the attorney general in the state of operations does not oversee internal affairs. But the boundaries of jurisdiction can

195. Sarbanes-Oxley Act of 2002, Pub. L. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

196. See New York Stock Exchange, Final NYSE Corporate Governance Rules (approved by the SEC in Nov. 2003), available at <http://www.nyse.com/pdfs/finalcorpgovrules.pdf> (last visited Mar. 23, 2004).

197. For example, the New York legislature is considering a proposal to apply certain of the provisions of Sarbanes-Oxley to nonprofit organizations receiving over \$1 million in annual revenues or having over \$3 million in assets. See Press Release, Office of New York State Attorney General Eliot Spitzer, Attorney General Spitzer's Proposed Reforms to State Corporate Accountability Laws: Proposals Would Protect Public Against Abuses by For-Profit and Non-Profit Corporations (Mar. 12, 2003), available at http://www.oag.state.ny.us/press/2003/mar/mar12a_03.html; Nonprofit Coordinating Committee of New York, *Sarbanes-Oxley for Nonprofits* (Aug. 2003), available at <http://www.npcny.org/info/gti10.htm>. Note that Drexel University made headlines by voluntarily adopting many of the requirements of Sarbanes-Oxley. See Memorandum from Tobey Oxholm of the Drexel University Office of the General Counsel, to NACUA Colleagues (March 10, 2003), available at http://www.nacua.org/documents/Drexel_Sarbanes-Oxley_Memo.doc.

198. See BBB Wise Giving Alliance, *Standards for Charity Accountability* (effective Mar. 3, 2003), available at <http://www.give.org/standards/spring03standards.pdf>; BBB Wise Giving Alliance, *Implementation Guide to the BBB Wise Giving Alliance Standards for Charity Accountability* (effective Mar. 3, 2003), available at <http://www.give.org/standards/impguide03.pdf>.

199. See *generally* People v. Jewish Consumptives' Relief Soc'y, 92 N.Y.S.2d 157, 158 (N.Y. Spec. 1949) ("[M]ost of the norms prescribed for doing business by commercial corporations appear to apply with equal validity to non-profit corporations.").

be indistinct, particularly regarding decisions by the board to make organic changes in purpose and governance. Problems can be acute for an affiliated group of incorporated charities formed in separate states—notably multi-state health care systems. The attorney general of the state of operations can be expected to argue, at the very least, that contributors to the domestic charity intended not only to further the purposes of the organization, but also to benefit the community in which the charity has been operating. Assuming that an attorney general could successfully assert oversight over donated assets (including intangible assets), the next question is whether that oversight is severable. Consider, for example, a nonprofit theater incorporated in Delaware and operating in Trenton, whose assets have resulted from a mix of contributions, government grants, and ticket sales. If the organization decides to move to Philadelphia, what authority does the New Jersey attorney general wield over (1) the decision to sell the assets, (2) the decision to move the resulting funds to another state, and (3) the decision to devote those funds to a use other than as a theater? Apparently, while data are sparse, attorneys general seek to keep operations in the state, but would settle for keeping the entire net asset value in the hands of other state charities.²⁰⁰

Under long-standing (although sometimes criticized) conflict-of-laws principles, the “internal affairs doctrine” holds that the law of the state of incorporation applies to regulate the intra-corporate matters of a foreign corporation authorized to transact business in the state of operation.²⁰¹ Enshrined in

200. See, e.g., Press Release, New Mexico Office of the Attorney General, Attorney General Will Not Oppose the Sale of St. Joseph's Hospital (July 19, 2002), available at http://www.ago.state.nm.us/PIO/Archived_Press_Releases/2002/AGwillnotOpposeSaleofSt.JosephHospital.htm (announcing the issuance of a “no objection” letter in the sale of St. Joseph Healthcare Systems by its member organization, Catholic Health Initiatives of Denver, to Ardent Health Services of Nashville, Tennessee). The press release stated:

“St. Joseph's Hospital has had a 100 year tradition of service to unmet health needs in the Albuquerque area. That tradition will continue because Catholic Health Initiatives has agreed to use an estimated \$21 million, *the net proceeds of the sale*, and an additional estimated \$7 million from St. Joseph Foundation assets to serve the health needs of the people of Albuquerque and New Mexico. I appreciate the fact that Catholic Health Initiatives worked with my office and as a result New Mexico's charitable assets will remain in New Mexico,” Madrid said.

Id. (emphasis added). The press release added that “[t]he exact mission and structure of the new [nonprofit] health ministry will be determined through a planning process that will include public input”; the “New Mexico Charitable Registrar of the Attorney General's office will have oversight of the new health ministry's planning process”; and the “governance board of the new health ministry will reflect the geographic, cultural and linguistic diversity of New Mexico.” *Id.*

201. The Restatement looks to the “local law of the state of incorporation . . . , except in the unusual case where . . . some other state has a more significant relationship to the occurrence and the parties.” RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 302(2) (1969). Comment a states:

Many of the matters that fall within the scope of the rule of this Section involve the “internal affairs” of a corporation

Matters falling within the scope of the rule of this Section and which involve primarily a corporation's relationship to its shareholders include steps taken in the course of the original incorporation, the election or appointment of directors and officers, the adoption of by-laws, . . . the holding of directors and shareholders' meetings, methods

the *Restatement (Second) of Conflict of Laws*, the doctrine has been adopted in the corporations code of over half the states.²⁰² However, a few states are particularly concerned about the "pseudo-foreign corporation"—the entity whose only tie to the state of incorporation is incorporation itself. California and New York, in particular, have adopted statutes applying much of their domestic corporate law to foreign corporations operating in-state that meet a threshold test.²⁰³

But the *Restatement* and these statutes explicitly do not apply to nonprofit corporations.²⁰⁴ What, then, can we say about the level of authority that a state attorney general and courts wield over a foreign nonprofit corporation?²⁰⁵ Case law is sparse. A California appeals court ruled: "The election and removal of officers are matters involving the internal affairs of a corporation, and California courts generally apply the laws of the place of incorporation in such instances."²⁰⁶

of voting . . . , shareholders' rights to examine corporate records, charter and by-law amendments, mergers, consolidations and reorganizations.

Id. §302 cmt. a. See generally Note, *The Internal Affairs Doctrine: Theoretical Justifications and Tentative Explanations for Its Continued Primacy*, 115 HARV. L. REV. 1480 (2002).

202. See MODEL BUS. CORP. ACT ANN. § 15.05 (2002) (identifying 29 state codes that contain an exception for the internal affairs of a foreign corporation doing business in the state).

203. I am grateful to Tom Silk for a helpful discussion of the California approach to the internal affairs doctrine.

204. The Introductory Note to Chapter 13 of the *Restatement (Second)* begins:

This Chapter deals with business corporations. It is concerned with the choice-of-law problems that arise when a business corporation extends its activities beyond the borders of the incorporating state. On the other hand, this Chapter does not deal with municipal or other public corporations or with nonprofit corporations, charitable or otherwise.

RESTATEMENT (SECOND) OF CONFLICT OF LAWS ch. 13 introductory note (1969).

205. Space does not permit a full explanation of worthy enforcement action by the Hawaii attorney general against the self-dealing trustees of the Bishop Estate. See generally Brody, *Bishop Estate*, *supra* note 12; Evelyn Brody, *Administrative Troubles for the Intermediate Sanctions Regime*, 92 TAX NOTES 423, 423 (2001). Relevant to our inquiry is the report that the Bishop Estate considered moving out of Hawaii in order to escape the oversight of the Hawaii attorney general—indeed, it contemplated reforming in the Cheyenne River Sioux Reservation in South Dakota to get out from under IRS jurisdiction as well—but, as a trust, hesitated because of the necessity of obtaining court approval. See Interim Trs.' Trial Mem. at III.B.1, *In re Estate of Bishop* (Haw. Prob. Ct. Dec. 13, 1999) (Equity No. 2048) ("The Incumbent Trustee Investigated Moving KSBE's Domicile to Escape Oversight of their Activities By the Hawai'i State Courts, Legislature, and Executive Branch."); Interim Trs.' Proposed Findings of Fact, Conclusions of Law and Order at ¶¶ 55-63, *In re Estate of Bishop*, Equity No. 2048 (Haw. Prob. Ct. Dec. 13, 1999) ("Possible Changes in Domicile and Tax Status"); see also Rick Daysog, *Bishop Eyed Move to Dakota*, HONOLULU STAR-BULL., Oct. 12, 1999, at A1.

206. *Am. Ctr. for Educ., Inc. v. Cavnar*, 145 Cal. Rptr. 736, 742 (Cal. Ct. App. 1978). If the charity takes the trust form, the court continued, it would usually be governed by the laws of the state in which the trust is administered. *Id.* at 743. "Factors to be considered in determining the place of administration are the domiciles of the trustees, the physical location of the assets constituting the res of the trust, and the place in which the business of the trust is carried on." *Id.* (internal citation omitted). However, administration is not necessarily the same thing as governance.

As for corporations formed in another country, compare a decision by the U.S. Supreme Court involving a Cuban bank, which argued that under the law of Cuba it would be viewed as a government instrumentality entitled to sovereign immunity. In *First National City Bank*

Nevertheless, the court went on to rule:

Where a charity has been organized by California residents, is located in this state and has all of its assets and most of its activity here, we believe that actions taken in California concerning the administration of that charity should not escape the scrutiny of California law merely because the founders chose to incorporate elsewhere. Consequently, we hold that the law of California, to the extent it exists, is controlling.²⁰⁷

The court noted:

This holding, however, is not of great consequence because the differences between California and the District of Columbia law in the relevant areas are not so significant as to dictate opposite results in this case. Moreover, because the case presents issues which have not been definitively settled by the courts of California or of the District of Columbia, we shall have to seek guidance from the decisions of other jurisdictions as well.²⁰⁸

The high court of Maryland declined to become involved in a membership issue involving the NAACP, a foreign corporation, citing the internal affairs doctrine. Referring to the business corporation context, the court cited a definition by the United States Supreme Court:

[T]he internal affairs doctrine is a conflict of laws principle which recognizes that only one State should have the authority to regulate a corporation's internal affairs—matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders—because otherwise a corporation could be faced with conflicting demands.²⁰⁹

v. Banco Para El Comercio Exterior de Cuba, 462 U.S. 611 (1983), the Supreme Court declined to apply Cuban law, explaining:

As a general matter, the law of the state of incorporation normally determines issues relating to the *internal* affairs of a corporation. Application of that body of law achieves the need for certainty and predictability of result while generally protecting the justified expectations of parties with interests in the corporation. See Restatement (Second) of Conflict of Laws § 302, Comments *a & e*, (1971). Cf. *Cort v. Ash*, 422 U.S. 66, 84, 95 S.Ct. 2080, 2090, 45 L.Ed.2d 26 (1975). Different conflicts principles apply, however, where the rights of third parties *external* to the corporation are at issue. See Restatement (Second) of Conflict of Laws, *supra*, § 301. To give conclusive effect to the law of the chartering state in determining whether the separate juridical status of its instrumentality should be respected would permit the state to violate with impunity the rights of third parties under international law while effectively insulating itself from liability in foreign courts. We decline to permit such a result.

Id. at 621-22 (emphasis in original) (footnotes omitted).

207. *Cavnar*, 145 Cal. Rptr. at 743.

208. *Id.* (footnote omitted).

209. *NAACP v. Golding*, 679 A.2d 554, 559 (Md. 1996) (quoting *Edgar v. MITE Corp.*, 457 U.S. 624, 645 (1982)). The Maryland court continued:

We further explained the rationale for the doctrine in *Condon v. Mutual*

In conclusion, the court held:

Applying these principles to the facts of the instant case, we first observe that the national NAACP is a foreign corporation. As such, applying the internal affairs doctrine, we decline to interfere with its internal management decisions. Moreover, even under Maryland corporations law, applying the business judgment rule, we would not interfere with the organization's decision because the NAACP did not engage in any fraud, arbitrariness, or bad faith.²¹⁰

3. Inappropriate Involvement in Charity Governance

One final area of vulnerability in the proper relationship between the state and charity has been highlighted by recent events: the insistence by attorneys general on having appointment or veto power over the members of a charity board. This is further discussed in the following case studies.

II. CASE STUDIES

This Part applies the principles discussed above to several recent enforcement or regulatory actions that resulted in at least preliminary court review—and, in nearly all the cases, targeted legislative activity.²¹¹ These cases present a continuum of issues, beginning with public control over charity investment activities (the Hershey Trust) and control over charitable operating assets (the Terra Foundation). The remaining cases deal with health care institutions—hospitals, which are charitable trusts or charitable nonprofit corporations, and Blue Cross entities, which are usually mutual-benefit nonprofits rather than charitable entities. Health Midwest illustrates what happens when warring attorneys general address a single multi-state health care system. Finally, events in several states illustrate very different—and troubling—outcomes in desired conversions of Blue Cross plans to for-profit status: One state legislature mandated nonprofit status for five years; another state conditioned permission to convert on the plan's agreeing to pay the

Reserve Fund Life Ass'n, 89 Md. 99, 42 A. 944 (1899), stating that:

Our courts . . . can enforce no forfeiture of charter for violation of law, or removal of officers for misconduct; nor can they exercise authority over the corporate functions, the by-laws, nor the relations between the corporation and its members, arising out of, and depending upon, the law of its creation. These powers belong only to the State which created the corporation.

Id. at 116-17, 42 A. at 948, *Accord Moore v. NAACP*, 425 Pa. 204, 229 A.2d 477, 478-79 (1967) (upholding trial court's decision that it did not have jurisdiction over internal affairs of the NAACP, a New York corporation, and thus could not enjoin the NAACP from establishing additional chapters in Philadelphia).

Golding, 679 A.2d at 559.

210. *Id.* at 562-63.

211. In addition to citing to attorney general press releases and available court decisions and legislation, the case studies draw heavily from the extensive press coverage these events received.

sale proceeds directly to the state coffers; and in three states, the Blue Cross plan abandoned the attempt.²¹²

A. Hershey Trust's Aborted Sale of Control in Hershey Foods Corp.

Hershey, Pennsylvania is a company town with a vengeance,²¹³ perfumed with the aroma of roasting chocolate and festooned with Kiss-shaped hoods on the street lamps. The vision of Milton S. Hershey lives on in Hershey Foods Corporation, the Hershey Trust Company, Hershey Entertainment and Resorts Company, and the Milton Hershey School, which owns most of the foregoing. The school's decision to sell its multi-billion dollar investment in the New York Stock Exchange-listed food company provided a summer's worth of delight to headline writers, from "Blood and Chocolate" to "Judge Issues Hershey Bar" to eventual "Meltdown," "Kiss Off," and "Sweet Victory" when the board retreated. All this from the utopian community that Milton Hershey dreamed of having "no poverty, no nuisances, and no evil."²¹⁴

In 1909, Milton and his wife Catherine created a trust for the founding of the Hershey Industrial School "for the residence and accommodation of poor white male orphans";²¹⁵ the deed of trust required that the orphans be indentured to the school.²¹⁶ Over time, Milton Hershey's vision yielded to changing social and economic conditions, as reflected in a series of *cypres* decisions. No longer only a vocational school, the now-named Milton Hershey School is open to any "poor" child, regardless of race and sex, so long as at least one parent is unable to provide

212. As described below, it is not always clear whether, in a particular state, the pre-conversion Blue Cross is a charity or some other form of nonprofit, and thus it is not always clear what law applies.

213. Steven Pearlstein, *A Bitter Feud Erupts Over Hershey Plant: Plan to Sell Candy Empire Divides a Company Town*, WASH. POST, Sept. 2, 2002, at A1 [hereinafter Pearlstein, *Bitter Feud*].

Milton S. Hershey and his famous candy company not only provided residents with steady jobs and free medical care but also a swimming pool, theater, dance hall, zoo, parks, hockey arena and a junior college. He personally financed the school buildings and paid off the mortgages of every church. And Hershey-owned entities provided residents with subsidized electricity, water, phone and trolley service, and operated the town's newspaper, drug store, hotel and department store.

Id.

214. JOËL GLENN BRENNER, *THE EMPERORS OF CHOCOLATE: INSIDE THE SECRET WORLD OF HERSHEY AND MARS* 89 (1999) (quoting Milton Hershey).

215. Trust Indenture, Milton S. Hershey et ux. to Hershey Trust Company, Hershey Industrial School, pmbl. (Nov. 15, 1909), available at <http://www.miltonhersheyschool.com/mhsaa/Lib/The%20Hershey%20Industrial%20School%20Deed%20-%20Nov%2015%201909.pdf>.

216. *Id.* at § 15.

No orphans shall be admitted until the surviving parent, guardian, or other competent authority shall have given by indenture, release, relinquishment, or other lawful acquittance, . . . adequate power to the Managers . . . to enforce, in relation to each orphan, every proper restraint, and to prevent relatives, friends, or others from interfering with, or withdrawing such orphans from the institution.

Id.

adequate care, and does not require the surrender of parental rights.²¹⁷ The 1990s produced a radical restructuring from a farm-based residential education to a centralized academic campus.²¹⁸ The school still offers free tuition, room and board, clothing, and medical care. However, some dismayed alumni feel that even poverty is no longer required of applicants.²¹⁹

Catherine Hershey died in 1915, and Milton Hershey died in 1945; they had no children. Shortly after his wife's death, Milton had transferred thousands of acres of land and all of his stock in the then-Hershey Chocolate Company (then valued at over \$60 million) in trust for the school.²²⁰ The trustees are limited to spending

217. See Milton Hershey School Second Restated Deed of Trust, at 7 (Nov. 15, 1976) [hereinafter Trust Indenture], available at http://www.mhs-pa.org/docs/webdocs/Deed_of_Trust.pdf. Section 13 now provides, in part:

Consistent with the purposes of this deed, only a child deemed poor and healthy by the Managers, and who, in the opinion of the Managers, is not receiving adequate care from one of his or her natural parents, is of good character and behavior, has potential for scholastic achievement, and is likely to benefit from the program then offered by the school, in addition to meeting the other qualifications set forth herein, shall be admitted to the School.

Id. § 13.

218. In 2000, former Pennsylvania Governor and U.S. Attorney General Richard Thornburgh, retained by the boards of the trust and the school, exonerated the boards from complaints brought by the Milton Hershey School Alumni Association that the boards failed to carry out the intent of Milton Hershey and otherwise breached their fiduciary duties. Richard Thornburgh et al., Independent Evaluation of Fiduciary Compliance: Findings and Conclusions of Special Counsel (Sept. 1, 2000) [hereinafter Independent Evaluation] (on file with author); Richard Thornburgh et al., Independent Evaluation of Fiduciary Compliance: Summary of Findings and Conclusions of Special Counsel (Sept. 1, 2000) [hereinafter Independent Evaluation Summary] (on file with author).

219. See, e.g., David Olive, *Bittersweet: The Failed Sale of Hershey Foods Suits its Spiritual Shareholders—The Townsfolk*, TORONTO STAR, Sept. 21, 2002, at C1 (quoting one Hershey worker: "They've turned it into a damn prep school. Every time the trust does something controversial, like trying to sell the company, they say it's for the orphans. But it's not an orphanage any more. It's a very rich Ivy League school where the kids don't get dirt under their fingernails."). The Thornburgh report explains that "the Deed of Trust does not define 'poor,' so the Managers have approved a policy of limiting admission to students from families with incomes below 150 percent of the federal poverty index." Independent Evaluation Summary, *supra* note 218, at 84. On July 31, 2002, the Hershey School and Trust entered into a closing agreement with the attorney general, calling for, among other things, the school to adhere to this 150 percent cap. This agreement was modified on June 27, 2003. See Press Release, Pennsylvania Office of Attorney General, AG Fisher Announces New Agreement with Milton Hershey School and Hershey Trust; Prohibiting Conflicts of Interest and Ensuring that Poor Children Are Served (June 27, 2003), available at http://www.mhsaa.org/docmanager/applications/DocumentLibraryManager/upload/OAG_press_release_july212002_agreement_062703.pdf; see also *infra* note 297 and accompanying text.

220. BRENNER, *supra* note 214, at 134-35. Brenner continues:

[I]t was five years before the press got wind of the donation. On November 9, 1923, *The New York Times* ran a front-page story detailing Hershey's philanthropy, creating a sensation throughout the business community. . . . At sixty-one, Milton Hershey was still very much alive, and yet he had given away virtually everything he owned.

Id. at 135.

only the income, but are not directed to hold specific investments.²²¹ Stock in Hershey enterprises today makes up almost sixty percent of the Trust's assets.²²²

From the beginning, accumulation of income beyond the needs of the school concerned the boards. Meanwhile, "[i]n the years after Hershey's death . . . the company and town slowly started to move apart."²²³ "It was subtle at first, like when the company stopped providing the town's garbage pickup, snow removal and electricity."²²⁴ In 1963, the Trust—with the attorney general consenting—obtained court approval to transfer \$50 million from accumulated income to Penn State University to build a medical school in Hershey. Funding the medical center "completely changed the nature of the town. Suddenly, there were thousands of new residents who had nothing to do with the chocolate company and had little in common with the town's established citizenry."²²⁵ "Many believed that if Milton Hershey were still in charge, that money would have been used to improve the two-year Hershey Junior College, which provided a free education to town residents and company employees"; instead, the junior college closed down.²²⁶ The 1970 razing of the Cocoa Inn—the historic landmark that once served as the town's "drugstore, department store, bank, post office, restaurant and hotel"—confirmed "feelings that the Hershey enterprises no longer cared for the town as Milton Hershey had."²²⁷ In subsequent years, the free park closed (to be replaced by a commercial theme park); factory tours were replaced with a simulation ride; and, in the community center, only the theater remained open to the public.²²⁸

In 1969, Congress adopted significant legislation that could have jeopardized the Hershey Trust holdings. The Tax Reform Act of 1969 prohibits a private foundation from owning more than 20 percent of any single business (35 percent if no party related to the donor or the trust owns any stock).²²⁹ Congress worried that if a donor could use his foundation to control the stock, the foundation would focus more on providing support for the company than on maximizing its charitable program. The statutory scheme that Congress wrote, however, deems certain types of section 501(c)(3) organizations—including schools—as automatically public charities. But the Hershey Trust is not itself a school; it is simply an endowment that supports a school. So in the same legislation Congress created a class of non-private foundations called "supporting organizations, and had the Hershey Trust in

221. The deed of trust gives the trustee and the school's managers "full power and authority to invest all or any part" of the principal and unexpended income of the trust estate "in any securities which the Trustee and the Managers together may consider safe . . . and neither the Trustee nor the Managers shall be held accountable for the exercise of its and their discretion, exercised in good faith . . ." Trust Indenture, *supra* note 217, at § 5.

222. Congress had the Hershey Trust in mind when it wrote the rules in Internal Revenue Code § 509(a)(3) on "supporting organizations," and thus the Trust is not subject to the prohibition in § 4943 on "excess business holdings." See *infra* notes 229-31 and accompanying text.

223. BRENNER, *supra* note 214, at 264.

224. *Id.*

225. *Id.* at 265.

226. *Id.* at 264-65.

227. *Id.* at 265.

228. *Id.* at 266-67. "In one stroke the town lost its bowling alley, indoor swimming pool, gymnasium, pool hall and party room." *Id.* at 267.

229. I.R.C. § 4943 (2002).

mind when it did so."²³⁰ As a result, unlike the large foundations that had to divest their majority holdings of business corporations, the Hershey Trust has been under no federal pressure to diversify.²³¹

Despite the Hershey Trust's wealth, in 1999 the Orphan's Court denied a detailed *cy pres* application to spend \$25 million a year out of accumulated and current income on an institute to train teachers in educating at-risk children, to be known as the Catherine Hershey Institute for Learning Development (CHILD).²³² The attorney general, who had initially supported the petition, took the position in court that there had been no failure of the trust. The court found that: "Except for a few years in the late 1970s, the income of the fund has always exceeded the expenses of operating the School and at the close of the 1998 fiscal year, the

230. The legislative history is recited in a case of the U.S. Tax Court:

[T]he House and Senate reports further indicate that the purpose of section 509(a)(3) was limited, namely, to exclude from private foundation status, organizations which were theoretically separate from publicly supported organizations but were not thought of as private foundations because they were operated in close association with publicly supported organizations. The reports give, as examples of section 509(a)(3) organizations, religious organizations other than churches, the Hershey Trust (which is organized and operated for and in connection with a specific school), and university presses.

Quarrie Charitable Fund v. Comm'r, 70 T.C. 182, 190 (1978) (citing 115 Cong. Rec. 37,514-15 (1969)).

231. An undiversified portfolio might constitute a "jeopardy investment" subject to another private foundation tax, but the regulations ignore investments gratuitously received.

One group of supporting organizations recently made news when the attorney general of New York persuaded them to dissolve and distribute their assets to their supported public charities. In this unusual case, seven supporting organizations were established by *Reader's Digest* founders DeWitt and Lila Wallace and funded with nonvoting stock of the company for the benefit of the Metropolitan Museum of Art, Lincoln Center, Colonial Williamsburg, and ten other charities. See generally Mark Rambler, Note, *Best Supporting Actor: Refining the 509(A)(3) Type 3 Charitable Organization*, 51 DUKE L.J. 1367, 1368-69 (2002). In the 1990s, *Reader's Digest* stock plummeted and slashed its dividends; meanwhile, company executives dominated the supporting organizations' boards. The New York attorney general succeeded in obtaining the dissolution of the organizations; the beneficiary charities are now free to reinvest these holdings, worth a combined \$1.7 billion. Ralph Blumenthal, *13 Institutions Obtain Control of Vast Bequest*, N.Y. TIMES, May 4, 2001, at A1; see also Press Release, Office of New York State Attorney General, Spitzer Announces Resolution Involving \$3.2 Billion Legacy Left by Founders of *Reader's Digest* (May 4, 2001), available at http://www.oag.state.ny.us/press/2001/may/may04a_01.html.

Mark Sidel notes the uncomfortable position occupied by these supported charities during the process: "Comments by the recipient groups—some of which had complained earlier of investment and *Reader's Digest* stock sale restrictions—were considerably more muted, as the recipients tried to antagonize neither the Wallace Funds nor the Attorney General." Mark Sidel, *The Nonprofit Sector and the New State Activism*, 100 MICH. L. REV. 1312, 1323 n.35 (2002) (reviewing SILBER, *supra* note 89).

232. See Reply Brief for Petitioner, *Milton Hershey School et al.*, No. 712 (Orphans' Ct. Div., Ct. C.P., Dauphin County 1999), available at <http://www.miltonhersheyschool.com/mhsaa/Lib/Reply%20Brief%20-%20Oct%2021%201999.pdf>; *Milton Hershey School et al.*, No. 712, slip op. (Orphans' Ct. Div., Ct. C.P., Dauphin County 1999) [hereinafter 1999 Adjudication], available at <http://www.miltonhersheyschool.com/mhsaa/Lib/Adjudication%20and%20Decree%20-%20Dec%207%201999.pdf>.

amount of available accumulated income was 608 million dollars."²³³ However, the court ruled that "[a]ny discretion of the Board of Managers is servient to the dominant intent of the Hersheys to care for as many children at the School as the income will permit."²³⁴ The court distinguished the 1963 *cy pres* proceeding by noting the attorney general's support of that earlier petition, and the absence of public notice, hearing and opinion in that matter.²³⁵ In conclusion, "our [*cy pres*] discretion is not unfettered and, if exercised, must be within the limits of approximating the dominant intent of the Hersheys. The proposed Institute does not come close."²³⁶ Today, "even after spending \$93,000 a year to educate, house, clothe, feed and nurture each of its 1200 students, the school still has a reserve fund of more than \$850 million from all the money it could not spend over the years."²³⁷

Diversification was another concern of the Trust's. In 1980, eighty percent of the Trust's portfolio was in Hershey Foods stock.²³⁸ A restructuring of the company that year created "A" shares (with one vote) and "B" shares (with ten votes). Following four company buybacks in the 1990s, the Trust has whittled its Hershey Foods holdings down to fifty-two percent of its assets, representing thirty-one percent of the total stock and seventy-seven percent of the voting shares. However, should the Trust's ownership drop below fifteen percent of the company, the "B" shares would convert to "A" shares and the Trust would lose control of the company. The IRS Form 990 filed by the Milton Hershey School and School Trust, for the year ending July 31, 2001, valued its Hershey Foods ownership at \$2.6 billion.²³⁹

The attorney general's office, too, had concerns about lack of diversification.²⁴⁰ At a December 2001 meeting with the Hershey Trust, as part of

233. 1999 Adjudication, *supra* note 232, at 5.

234. *Id.* at 7.

235. *Id.* at 8-9.

236. *Id.* at 15. It was to this same judge, Warren G. Morgan, before whom the Trust and the attorney general were to return in the summer of 2002.

237. Pearlstein, *Bitter Feud*, *supra* note 213.

In addition to three classroom buildings and modern library, the school boasts several theaters, a lavish gymnasium, a visual arts building and 120 group homes where 10 to 12 children live with full-time house parents. For vocational training there is an up-to-date television studio, a computerized printing and design shop, a mock hospital ward, and working dairy and vegetable farms. The school also operates its own inpatient infirmary, an extensive network of psychological services and a dental clinic with eight stations. And every student gets a laptop computer.

Id.

238. Information in this paragraph comes from an interview of Robert Vowler, president and chief executive officer of the Hershey Trust Company, and A. John Gabig, chairman of the Milton Hershey School Trust board of directors, by the editorial board of the Harrisburg *Patriot-News*. See *Why the Decision Was Made*, PATRIOT-NEWS (Harrisburg), July 27, 2002, at A4.

239. Form 990, available at <http://www.guidestar.com>, also reported one hundred percent ownership of Hershey Trust Company (valued at \$46 million), and a one hundred percent common stock ownership of Hershey Entertainment & Resorts Company (valued at \$6.6 million), in addition to other securities and real estate investments. Total investments assets were valued at nearly \$4.7 billion.

240. In 1999, the Pennsylvania legislature had adopted a version of the Uniform

discussions on a range of governance issues, an official in the attorney general's office suggested diversification. The trustees understood this to mean that in order to avoid exposure for breach of fiduciary duty, they should consider selling their controlling interest in Hershey Foods.

Several months later, in May 2002, the Hershey Trust rejected a proposal by Hershey Foods to buy back the Trust's remaining shares.²⁴¹ In July 2002, the Trust announced that it would explore selling its ownership in the company. "[T]he choice to us was either (go below) 15 percent and lose control, or to just sell it outright."²⁴²

Back in the early '70's, the price of Hershey Foods stock dropped considerably back when you had price wage controls from President Johnson. Hershey Foods, at that point, was more than 80 percent of the portfolio. They cut their dividends and the trustees at the time had to sell real estate off to pay the bills of the Milton Hershey School. When you saw a precipitous drop in the population of the school from the early '70's in to the '80's, that was the reason.²⁴³

Evidently, the Trust's board reached its decision to sell reluctantly: "Members of the board are graduates of this community. My heart is not in it, but my head is."²⁴⁴

Prudent Investor Act, 20 PA. CONS. STAT. ANN. §§ 7201-14 (Supp. 2003), which provides in relevant part:

§ 7204 *Diversification*

(a) Requirement—Except as provided in section 7205 (relating to retention of inception assets), a fiduciary shall reasonably diversify investments, unless the fiduciary reasonably determines that it is in the interests of the beneficiaries not to diversify, taking into account the purposes, terms and other circumstances of the trust and the requirements of this chapter.

....

§ 7205 *Retention of Inception Assets*

A fiduciary, in the exercise of reasonable care, skill and caution, may retain any asset received in kind, even though the asset constitutes a disproportionately large share of the portfolio.

Id.

241. According to the president of Hershey Trust, "The company's offer, which was to take us out of the entire holding completely, involved a long period of time—3-5 years to take us out. And that involved to us, market risk, price risk. . . . In other words, the stock could have dropped down, and we would have been subject to the same market conditions we were trying to solve in the first place." *Why the Decision Was Made*, *supra* note 238, at A4. Another reported reason was the fear that such a transaction would "require Hershey Foods to borrow money, putting the company at risk of a hostile takeover." Bill Sulon, *Kellogg to Hershey: Ownership is Grrrrreat!*, PATRIOT-NEWS, Sept. 15, 2002, at A1, available at http://www.pennlive.com/news/patriotnews/index.ssf?/news/hershey/stories/hersey_73.htm

242. *Why the Decision Was Made*, *supra* note 238, at A4.

243. *Id.*

244. *Id.* (comment of the chairman of the board of the School Trust). He elaborated:

When I came on board in 1996 and saw 52-55 percent of the assets in one security, the bells went off. I said, what happens if that falls on my shift. I don't carry that kind of liability insurance.

This was discussed over a period of time where we had to evaluate what the alternatives were—stock swap, sell on the open market. . . . [I]

The possibly naive board (only seven out of fourteen lived in the Hershey area) was shocked by the explosive opposition.²⁴⁵ Workers fearful for their jobs produced "Derail the Sale" lawn signs and internet petitions sprang up. The Alumni Association remobilized. Members of the public were invited to affix their signatures to a petition to remove the trustees. The board of supervisors of Derry Township voted to change the official name of the town to "Hershey." One resident complained: "I don't see why a town should be ruined so underprivileged kids can be privileged."²⁴⁶

The legislature and the attorney general began drafting legislation that would require, among other things, a charitable trust considering a sale of a controlling business interest to consider the welfare of affected communities, as well as require attorney general and judicial approval.²⁴⁷ Invoking the proposed legislation, the attorney general—the Republican candidate for governor—filed suit to halt any sale without court approval.²⁴⁸ When reminded that in the last year his office had pressed the trust to diversify its holdings and remove conflicts of interest between the board of the school and other Hershey enterprises, he responded that he had not meant that they should sell the company.²⁴⁹ Some trustees felt "betrayed at Fisher's

was very, very hard for, particularly, the alumni to make that decision.

I don't think the kids that will come in here in the future, 25 years from now, should be subject to a decision that I made to keep a stock, when I don't know how that stock is going to do. And the only way I know how to handle that is to fully diversify.

Id.

245. See, e.g., Pearlstein, *Bittersweet*, *supra* note 3; Amy Barrett, *How Hershey Made a Big Chocolate Mess*, BUS. WK., Sept. 9, 2002, at 54.

246. Pearlstein, *Bitter Fued*, *supra* note 213, at A1.

247. See, e.g., *Suggested Law Change Could Hinder Hershey Sale; Welfare of Community Might Have to Be Weighed*, PATRIOT-NEWS, Aug. 9, 2002, at A1; Brett Lieberman & Jan Murphy, *Stopping Hershey Sale Becomes Legal Challenge*, PATRIOT-NEWS, Aug. 18, 2002, at A1.

248. Attorney General's Petition for Citation for Rule to Show Cause Why a Proposed Sale of Trust Assets Constituting the Controlling Interest in Hershey Foods Corporation Should Not Be Conditioned Upon Court Approval, *In re Milton Hershey School Trust*, No. 712, slip. op. (Orphans' Ct. Div., Ct. C.P., Dauphin County, Aug. 12, 2002), available at <http://news.findlaw.com/hdocs/docs/hershey/pavhershey081202pet.pdf> [hereinafter *Petition*]. The petition reads, in part:

20. Existing trust law requires a fiduciary to make decisions that are in the best interests of the charitable trust.

21. The Attorney General is currently engaged in an expedited legislative effort to require that fiduciaries administering charitable trusts consider the impact of their investment decisions on the community.

Id.

249. See, e.g., Pearlstein, *Bitter Feud*, *supra* note 213 ("In the past few years, in response to complaints by the alumni association, Fisher's office forced the changes in the makeup of the board. His office also pushed the trust to cut its traditional ties to other Hershey-related businesses and entities. As a result, only a handful of the 17 board members now live in town or have any connection to its major institutions."); see also Press Release, *supra* note 219; Press Release, Pennsylvania Office of the Attorney General, AG Fisher Reaches Agreement with Milton Hershey School to Restructure Its Operations and Admittance Policies (July 31, 2002), available at <http://www.attorneygeneral.gov/press/release.cfm?p=3EAC5F90-ABAE-4ECC-BCE36F7225659B3F>.

emergence as the prime impediment to the sale, after his office privately encouraged it."²⁵⁰

The attorney general's petition asserted:

Any public sale of the controlling interest in Hershey Foods Corporation by the School Trust, *while likely to increase the value of the trust*, could also result in profound negative consequences for the Hershey community and surrounding areas, including, but not limited to, the closing and/or withdrawal of Hershey Foods Corporation from the local community together with a dramatic loss of the region's employment opportunities, related businesses and tax base.²⁵¹

Invoking case law granting the attorney general authority "to inquire into the status, activities and functioning of public charities" and the view that "the ultimate beneficiary and real party in interest of all charitable trusts is the general public to whom the social and economic advantages of the trusts accrue," the petition declared:

Accordingly, the broad interests of the Attorney General necessarily entail protecting the public against any social and economic *disadvantages* which may be occasioned by the activities and functioning of public charities²⁵²

In the attorney general's view, this transaction "does not equate with the typical investment decisions that trustees make on a daily basis."²⁵³ The petition invokes the court's equity power "to protect and promote to the fullest extent possible as many of the competing interests as can be equitably achieved."²⁵⁴

The Orphans' Court granted the attorney general's motion for a preliminary injunction on September 4, 2002.²⁵⁵ Using such language as "pray tell"²⁵⁶ and

250. Brett Marcy & Jan Murphy, *State Urged Hershey Sale; Fisher Deputy Was a Force Behind Move to Put Company on Block, Sources Say; He Disputes It*, PATRIOT-NEWS, at A1, Aug. 23, 2002. The news story quotes Fisher: "They should have called me to check my position. They never hesitated to call before and come and meet with me . . . I'm at a loss as to how they got to where they are." *Id.*

251. Petition, *supra* note 248, ¶ 14 (emphasis added).

252. *Id.* ¶ 16-18 (emphasis in original) (citations omitted).

253. *Id.* ¶ 19.

254. *Id.* ¶ 25-26. In later oral argument on appeal, a news story reported the following exchange between President Judge James Garner Colins and Deputy Attorney General Jerry Pappert:

"What makes the attorney general's office better financial managers than the board of the Hershey Trust, and literally the worldwide experts they have hired as well?" Colins asked.

Pappert replied: "Because we're managing different clients. We're managing the interests of the public, and we have an opportunity and a duty under the law to make sure that the ultimate beneficiary of the trust, the public, is not harmed."

Bill Sulon, *Attorneys Debate Role of Hershey Trust Co.*, PATRIOT-NEWS, Sept. 12, 2002, at D1. Pappert "added that the attorney general's office would 'absolutely' try to intervene even if an acquiring company chose to move Hershey operations elsewhere in the state." *Id.*

255. The opinion is reproduced at the end of the majority opinion in the appeal. *See In re Milton Hershey Sch. Trust*, 807 A.2d 324, 327 (Pa. Commw. Ct. 2002).

"This needs looking into!"²⁵⁷ Judge Morgan explained that he told the parties:

we do not view our role in this matter . . . as "a passive instrument of the parties"; that the public interest in the controversy and this Court's inherent plenary powers of supervision over trusts may lead us to add to our consideration of the issues such facts not offered by the parties as might aid our determination; and we particularly referenced . . . judicial notice of adjudicative facts disclosed in . . . prior proceedings involving the Milton Hershey School Trust wherein the respondents here were the moving parties.²⁵⁸

Judge Morgan concluded the factual recitation by commenting that a competitive merger or acquisition process usually results in a bid price with a premium. "This leads the acquiring company to introduce management efficiencies . . . [that likely] will result in reduced work forces with a potential for plant location changes."²⁵⁹

The Orphans' Court began its discussion by ruling that "[p]roperty given to a charity is in a measure public property," and held that "the Attorney General has the authority to inquire whether an exercise of a trustee's power, even if authorized under the trust instrument, is inimical to the public interest."²⁶⁰ The court invoked its "broad visitatorial and supervisory powers over charitable trusts": "The Court 'within its appointed orbit is exclusive, and therefore necessarily as extensive as the demands of justice.'"²⁶¹

While the immediate issue was the preliminary injunction, the court also addressed the merits, declaring: "The business was not, during Mr. Hershey's life, is not now, nor foreseeably in financial difficulty, and the School, according to statements by officers of the Directors/Managers has ample funds in its accumulated income to carry out its purposes."²⁶² The court found lacking an "explanation why, if any need for funds exists for which a sale is necessary, it could not be met while still keeping control," raising the question "whether an immediate premium share price obtained in losing control is a reasonable trade-off for permanently retaining it."²⁶³ The court concluded that a further investigation was warranted into whether a sale comports with Milton Hershey's intent, and whether "the act of . . . the Directors/Managers[] is so unreasonable as it relates to their duty to the School Trust that it amounts to a capriciousness that is an abuse of their discretion."²⁶⁴ Dismissing the argument that a trustee is always to administer

256. *Id.* at 331.

257. *Id.* at 332 n.3.

258. *Id.* at 328 (footnote omitted).

259. *Id.* at 329. Later in his opinion, Judge Morgan stated: "We would add that this Court is not required to be blind and deaf to that which has been commonplace information to the public during the recent past period of numerous mergers and acquisitions of public companies." *Id.* at 331.

260. *Id.* at 330.

261. *Id.* (citation omitted).

262. *Id.* at 332.

263. *Id.* The court noted the 1999 *cy pres* proceeding "based on an allegation that there was a pro tanto failure of the School Trust because it had more accumulated income (\$750,000,000) than it was ever going to need," and the court's denial of the petition "on the ground that the proposed Institute was not within the Settlers' intent." *Id.* at 333 n.4.

264. *Id.* at 332. The court had earlier stated: "The symbiotic relationship among the School, the community, and the Company is common knowledge." *Id.* However, a

the trust solely for the benefit of its beneficiaries, the court wrote:

The duties of a trustee and the Attorney General are concomitant in so far as assuring that the benefits of a charitable trust are delivered in accordance with the Settlor's intent; but because the socio-economic benefits of a charitable trust extend beyond the designated beneficiaries to the public itself, although ordinarily compatible with each other, the Attorney General has an added responsibility of assuring that compatibility.²⁶⁵

The Hershey Trust appealed to the Commonwealth Court,²⁶⁶ which on September 18, 2002, affirmed the grant of a preliminary injunction. At the oral argument, President Judge James Gardner Colins commented: "If we create this doctrine that the attorney general becomes sort of a super trustee, we're putting all the public at risk to the next person who might benefit from that position."²⁶⁷ However, Judge Colins, in writing for the court, did not reach the merits of the Trust's arguments, but rather concluded: "A review of the record and Judge Morgan's opinion does not immediately convince us no apparently reasonable grounds exist to support the order as one that restores the status quo . . . before the issues raised by the parties are resolved [in court] . . ."²⁶⁸ The court "direct[ed] that the Orphan's Court rule on the merits of the controversy expeditiously."²⁶⁹ The vote was five to one (with one judge recusing himself).

In dissent, Judge Pellegrini "disagree[d] that the Attorney General has authority to become fully involved under a *parens patriae* theory to protect the 'public' regarding the proposed sale" prior to a decision by the trustees to sell.²⁷⁰ "If that were the case, then the Attorney General could become fully involved in the decisionmaking process of every charitable trust or, for that matter, in every

subsequent filing by the Trust asserted that control of Hershey Foods could not have been an overriding interest to Milton Hershey because only the stock market crash of 1929 prevented him from merging Hershey Chocolate with the Kraft-Phenix Cheese Corporation and Colgate-Palmolive-Peet Corporation. Jack Sherzer, *Hershey Planned Merger in 1929; Trustees Tell Court Stock Market Crash Prevented Deal*, PATRIOT-NEWS, Sept. 10, 2002, at B1. As the news story quotes the trustees' filing:

[The deal] would have required the exchange of the shares of the Hershey Chocolate Company in the school trust for shares in the new company and would not have resulted in the school trust having voting control in the new company, clearly evidences that [Milton Hershey] did not intend to limit his fiduciaries in the exercise of their discretion in making trust investment decisions.

Id.

265. *In re Milton Hershey Sch. Trust*, 807 A.2d at 334.

266. The Commonwealth Court is "an intermediate appellate court in Pennsylvania that hears appeals in all cases that have been commenced by the Commonwealth government or officers thereof acting in their official capacity. In Pennsylvania, most appeals involving trust and estate matters are referred instead to a different intermediate appellate court, the Superior Court." Christopher H. Gadsden, *The Hershey Power Play*, EST. & TR., Nov. 2002, at 8, 12, available at http://trustsandestates.com/ar/estate_hershey_power_play/index.html.

267. Brett Marcy, *Stating Their Cases; Judges Ponder Moves to Block Sale of Hershey*, PATRIOT-NEWS, Sept. 12, 2002, at D1.

268. *In re Milton Hershey Sch. Trust*, 807 A.2d at 327.

269. *Id.*

270. *Id.* at 335 (Pellegrini, J., dissenting).

charity in Pennsylvania."²⁷¹ The preliminary injunction was not in accordance with law, he wrote, because nowhere in the Probate, Estate and Fiduciaries Code "is there any authority for the Attorney General to essentially act as co-trustee or co-manager of the Trust and be part of the process leading up to a decision by the Trustees to take a certain action."²⁷² Moreover, "for the Attorney General to properly exercise *parens patriae* powers, his concern must be on behalf of the public and tied to the express desires of the Trust settlor."²⁷³ In sum, "[a]bsent a showing that the Trustee's actions are against the terms of the Trust or that the Trust provisions themselves are against public interest, the *parens patriae* powers of the Attorney General do not apply."²⁷⁴

By coincidence, literally on the eve of this decision, two decisive events occurred. First, Hershey Foods received two offers for its stock, one of which, from gum manufacturer Wm. R. Wrigley, Jr. Co., totaled \$12.5 billion in stock and cash, as well as a promise to maintain jobs in and support the Hershey community.²⁷⁵ Second, the board of the Hershey Trust held a ten-hour meeting, at the end of which it voted 10-7 to abandon its exploration for a sale. The Trust asserted that the Wrigley offer failed to provide sufficient diversification, since the Trust would still have 36 percent of its assets in the new combined company.²⁷⁶ One skeptic sensed rationalization: "If God had walked in and offered \$110 a share, they still wouldn't have taken it."²⁷⁷

"Our cash cow is safe; we're feeling really great," was the reaction of one local leader, adding: "But there's still a lot of interest in getting rid of the Hershey trustees for ever trying this in the first place."²⁷⁸ The attorney general was quoted as saying: "We did what we could to try to make sure people knew how hard it was going to be to buy Hershey Foods."²⁷⁹ By contrast, Hershey Foods executives were furious. The company is viewed as weakened by the perception that it can never be sold,²⁸⁰ and fears lawsuits over whether the Wrigley offer, which reflected a 42-percent premium on share price, should have been presented to shareholders.²⁸¹

Hoping to put an end to the dispute, the Hershey Trust sent a letter to the attorney general declaring that the board "will not agree to any sale of the School Trust's controlling interest in Hershey Foods without the approval of the Dauphin

271. *Id.*

272. *Id.* at 337.

273. *Id.* at 338.

274. *Id.*

275. "In a moving presentation to the Hershey trust . . . , [William] Wrigley promised to uphold the company's commitment to the community. 'If you think it's hard for you to do what you're doing tonight, consider how hard it's been for me and my family to put someone else's name on the door of our company,' he said, a reference to the proposed new company's name, Wrigley-Hershey" Robert Frank & Sarah Ellison, *Meltdown in Chocolatetown; Controlling Trust Calls Off Sale of Hershey to Wrigley*, WALL ST. J., Sept. 19, 2002, at B1.

276. See, e.g., Sherri Day & Andrew Ross Sorkin, *Candy Giants Both Show New Faces in Failed Deal*, N.Y. TIMES, Sept. 19, 2002, at C1.

277. *Id.*

278. Francis X. Clines, *Whiff of Chocolate, and the Sweet Smell of Success*, N.Y. TIMES, Sept. 19, 2002, at C6.

279. See Craig R. McCoy & Wendy Tanaka, *Bid for Hershey Not Sweet Enough*, PHILA. INQUIRER, Sept. 19, 2002, at A1.

280. Frank & Ellison, *supra* note 275, at B1.

281. Pearlstein, *Bittersweet*, *supra* note 3, at E1.

County Orphans' Court, following advance notice to the Office of the Attorney General."²⁸² The letter further says to Mr. Fisher: "We look forward to your ideas and support for our diversification efforts."²⁸³ A *Wall Street Journal* story commented, though, that "the trust's options for diversifying are limited as the company's management, which is now at loggerheads with the trust, is unlikely to be willing to offer a significant premium to buy back the trust's shares."²⁸⁴

The attorney general, however, still sought confirmation that the Hershey Trust, should it change its mind, must inform the office about a future sale, and whether the court must give its approval. On October 16, 2002, Judge Morgan issued a decree dismissing the case as moot.²⁸⁵ However, the court noted, a future board could

ignore the resolutions and not disclose to the Attorney General, thereby evading judicial review of their action. Such deception would be an act of bad faith that would lead to removal of the Board members but in order to further resolve the Attorney General's concern we shall include in our Decree the provision for notice he requests.²⁸⁶

The judge added the following "observations":

The memorials of a good and generous man have not been well served by events surrounding this litigation. In this midstate area, Hershey is everybody's town; there is a shared pride in identifying with that community, its industry and the School, all founded by Milton S. Hershey. . . . It appears to many that the Directors/Managers, whatever their skills and however well-intentioned their efforts, have become detached from [Milton Hershey's] philanthropic scheme, not the least significant reasons for this being that the membership of each Board is unusually large and the residences and daily lives of too many members are distant and disconnected from the charitable interests they serve.²⁸⁷

Meanwhile, on October 9, 2002, the Pennsylvania Senate passed—by a 48-1 vote—the attorney general's bill to require a charity to, among other things, consider "as asset's special relationship or special value, if any, to the purposes of the trust . . . , including . . . the special relationship of the asset and its economic impact as a principal business enterprise on the community"²⁸⁸ Declared the senate majority leader, whose district includes 1700 Hershey Foods employees: "We've all learned an important lesson here. . . . We have to be active and protect our economic assets."²⁸⁹ On October 28, the house overwhelmingly approved the

282. Sarah Ellison, *Hershey Foods' Controlling Trust Says It Has "No Intentions to Sell"*, WALL ST. J., Sept. 27, 2002, at B5 (quoting Hershey Trust chairman John Gabig).

283. *Id.*

284. *Id.*

285. Decree and Adjudication, *In re Milton Hershey Sch. Trust*, 807 A.2d 324 (Pa. Commw. 2002), available at <http://www.mhsaa.org/docmanager/applications/DocumentLibraryManager/upload/OrphansCourt20021016.pdf>.

286. *Id.* at 3.

287. *Id.* at 4.

288. See Charles Thompson, *Future Hershey Sale Obstacles OK'd*, PATRIOT-NEWS, Oct. 10, 2002, at B1.

289. *Id.*

bill.²⁹⁰ The governor, despite concerns raised by the business community, signed it on November 6, 2002.²⁹¹

Attorney Christopher Gadsden contrasts the mandatory duty in this new statute with the permissive language that Pennsylvania applies in its nonprofit corporation statute.²⁹² In general, nonprofit corporate directors may consider "the effects of any action upon any or all groups affected by such action, including members, employees, suppliers, customers and creditors of the corporation, and upon communities in which offices or other establishments of the corporation are located."²⁹³ Indeed, this nonprofit corporation statute echoes "corporate constituency" provisions in some states' business corporation statutes that permit (or, in some states, require) the board to take these other interests into account—although "[s]keptics see corporate constituency laws as thinly disguised anti-takeover statutes, enacted at the behest of incumbent managers of threatened corporations."²⁹⁴ Moreover, Gadsden observes that the Pennsylvania Prudent Investor Act (which the new act amends) may be overridden by specific terms in the governing instrument, and so "a savvy donor may try to stipulate in the trust instrument that the trustee is excused from compliance with this new requirement."²⁹⁵

The day the governor signed the new legislation, Mike Fisher resoundingly lost his bid for governor to former Philadelphia mayor Ed Rendell.²⁹⁶ Nine days

290. The vote was 154 to 43. Professor Sidel quotes the reservations raised by one dissenting legislator, Representative Steven Nickol, including the following:

I really agreed with the Attorney General's original proposal for a court review and approval of an agreement when it is reached to protect community interest. This proposal seems to go far afield to what his original proposal was. I am not sure whom it applies to and whom it does not, and I am not sure many of you do. I think there are numerous drafting ambiguities. . . . And it also challenges provisions in Federal law and the U.S. Constitution.

Sidel, *supra* note 163, at 42 & n.169 (quoting 2002 Legislative Journal—Pennsylvania House, at 1935-38 (Oct. 22, 2002)). Of the bill's provision for Attorney General review of a covered transaction "before a decision is even made," Nickol said: "I am not sure at that point in time how you can have a judicial review over something like this . . . in which the fiduciary must prove the economics of a deal before it has even been negotiated . . ." *Id.* at n.168. See also Bill Sulon, *Bill on Charitable Trusts Signed*, PATRIOT-NEWS, Nov. 7, 2002, at D1 (writing that the original sponsor of the bill voted against it, calling the final version "drastically and hastily altered from the version he first proposed last fall. 'My concern is that at some point, it will have an impact on Hershey Foods shareholders, and in my mind I wasn't prepared to have the Pennsylvania attorney general serving as chief investment officer for one of the largest corporations in Pennsylvania.'").

291. See Sidel, *supra* note 163, at 39-43 & nn.157-70. H.B. 2060 amends section 7203 (Prudent Investor Rule) of Title 20 of the Pennsylvania Consolidated Statutes. H.B. 2060, 185th Gen. Assem. Reg. Sess. (Pa. 2002).

292. Gadsden, *supra* note 266, at 14.

293. 15 PA. CONS. STAT. ANN. § 5715(a)(1) (West 1995).

294. See Evelyn Brody, *Agents Without Principals: The Economic Convergence of the Nonprofit and For-Profit Organizational Forms*, 40 N.Y.L. SCH. L. REV. 457, 477 (1996).

295. Gadsden, *supra* note 266, at 14.

296. With 99 percent of the vote counted on November 6, 2002, the *New York Times* reported 53 percent for Ed Rendell and 44 percent for Mike Fisher. *The 2002 Elections: Results in Pennsylvania*, N.Y. TIMES (Nov. 7, 2002), available at <http://www.nytimes.com/ref/elections2002/2002PA.html> (last visited Feb. 24, 2004).

miles from Hershey in Carlisle."³⁰³ Finally, the legislature singled out the Trust and effectively appropriated to the local community locked-in control of a publicly traded corporation—without, of course, rising to the level of a “taking” requiring payment of compensation.

And what of the attorney general’s goal to protect the town’s jobs? Protectionism has its dangers. One business columnist observed that Wrigley, which is not “a big player in the chocolate business,” would have needed to keep the existing factories going. “And if at the same time the Hershey Trust had been able to free billions of dollars of capital, think what it could have done with the money.”³⁰⁴

Of course, this assumes that the Hershey Trust could get attorney general and court approval to *spend* the extra money. Judge Morgan applied an inappropriately crabbed application of the *cy pres* doctrine in 1999, and then bootstrapped that decision to deny Hershey the right to maximize its investments by declaring that Hershey has more resources than it can use for its legitimate charitable purposes. The Hershey case illustrates the lesson that the value of narrowly-confined charitable assets does not disappear—it just gets appropriated by those with power over their disposal.³⁰⁵

B. The Terra Foundation for the Arts

Hershey involved investment assets. Another case illustrates similar issues involving assets used in the direct conduct of charitable operations.³⁰⁶ In September

303. David Marcus, *Welcome to the Real World, Jimmy Stewart, CORP. CONTROL ALERT*, Nov. 23, 2002.

304. Avrum D. Lank, *Hershey Should Have Mimicked Milwaukee*, MILWAUKEE J. SENTINEL, Sept. 22, 2002, at 1D (describing the takeover of the Allen-Bradley Company, with the result that the “Bradley Foundation saw its endowment, and national influence, soar”).

305. The Trust’s answer to the attorney general’s petition stated, in part, that in asserting a fiduciary obligation to further community benefit, “the Attorney General . . . effectively [is] undertaking his own form of ‘cy pres’ . . . to redesignate the beneficiary of the School Trust by taking away value from the School Trust (the sole designated beneficiary) and transferring that value to the community . . . directly contrary to prevailing charitable trust law.” Trust Answer to Attorney General’s Petition for Citation for Rule to Show Cause at ¶¶ 60 & 61, *In re Milton Hershey School Trust*, No. 712, slip. op. (Orphans’ Ct. Div., Ct. C.P., Dauphin County, Aug. 12, 2002).

306. See also Missouri Attorney General Jay Nixon, Review and Recommendations Regarding the Ewing Marion Kauffman Foundation (Mar. 2004), available at <http://www.ago.state.mo.us/newsreleases/2004/030404.htm>. The report on the \$1.6 billion foundation contains good discussions of the role of the board vis-a-vis officers, conflicts of interest, and the desirability of increased public disclosure. However, the attorney general makes far reaching demands regarding the geographic reach of the foundation:

Founders of charitable corporations often include geographical limitations or areas of emphasis in their articles of incorporation, as well as statements establishing the foundation’s purposes. Despite Mr. Kauffman’s great love for and devotion to Kansas City, no such limitations are found in the Articles of Incorporation of the Kauffman Foundation

Many sources have relayed to us his vision that programs could be designed and founded on a “test basis” in Kansas City, and the best and

2000, a rift arose within the board of the foundation that operates the Terra Museum, which houses a modest collection of American impressionist art.³⁰⁷ The widow of the founder and her allies (including former senator Alan Simpson) wanted to discuss with other board members the possibility of moving the assets of the struggling Chicago museum to Washington, D.C., perhaps to combine with the Corcoran Museum. Before any vote could occur, two directors—prominent Chicago businessmen—brought suit to block a move, charging that its proponents were breaching their fiduciary duties.

Filing a complaint on the side of the plaintiffs, and asserting jurisdiction under the Illinois Charitable Trust Act,³⁰⁸ the attorney general sought to read into the purposes of the corporation the desire to benefit primarily "the people of Illinois."³⁰⁹ (The articles of incorporation contained no geographic restriction;

most workable of these could then be "exported" around the country. Accordingly, we have found no basis for concluding that Mr. Kauffman intended that the Foundation would limit its work to the Kansas City area to the exclusion of every other community in this country.

This is not to say, however, that Mr. Kauffman intended to permit the Foundation to become so national in scope as to leave behind its Kansas City roots. Mr. Kauffman, when he was alive, insisted that the Board have some members with strong ties to Kansas City, and that the Foundation have a significant and lasting impact on the city he loved. The Kauffman headquarters he envisioned for Kansas City opened in 1999, and both he and his wife are interred in the gardens on the headquarters grounds. Accordingly, based on the totality of the evidence, we conclude that Mr. Kauffman intended that, although the Foundation would not be limited in its actions to Kansas City, its work and presence in Kansas City would be substantial and, barring an extraordinary convergence of circumstances, permanent.

Id. at 5-6. The attorney general "recommends" (1) that the board amend the Articles "to reflect that a substantial portion of the annual programmatic expenditures of the Foundation would be dedicated to initiatives intended to have a positive impact on the Kansas City area"; (2) that the board amend the Articles or Bylaws to provide that a specific substantial number of the members of the Board of Directors shall have, and maintain throughout their services, significant ties . . . to the Kansas City community"; and (3) that the Board amend the "Articles or Bylaws provide that the headquarters of the Foundation shall not be moved from the Kansas City area without the unanimous vote of its Board of Directors at a meeting called for this purpose not less than 30 days following a public meeting by the Foundation held for the purpose of receiving public comment regarding such a move." *Id.* at 7-8. According to a news report, "Nixon did not say what he will do if the foundation doesn't comply . . . 'I have a number of tools in my arsenal,' he said." Stephen Roth, *Kauffman Tussles with Spirit, Letter of Nixon's Report*, BUS. J. KANSAS CITY, Mar. 15, 2004, available at <http://kansascity.bizjournals.com/kansascity/stories/2004/03/15/story2.html>.

307. I served as an advisor to the Terra Foundation defendants with respect to a filing made in July 2001.

308. 760 ILL. COMP. STAT. 55/1-19 (1992 & Supp. 2003).

309. As the *Chicago Tribune* reported on the settlement reached with the Regenstein Foundation:

The fact that the new directors lived elsewhere had concerned the state attorney general's office, which intervened in the case and insisted the settlement say that most of the money would be disbursed here.

"We're happy to get it *locked in* for the Chicagoland area," said Assistant Atty. Gen. Floyd Perkins. He noted that his office has intervened in another case to prevent the Terra Museum of American

moreover, the Terra Foundation operates a sister museum in Giverny, France.) During the course of the litigation, the defendant directors charged, the attorney general brought pressure to bear on two individual directors to switch their votes and support keeping the assets in Chicago.³¹⁰ Indeed, a settlement ensued when a majority of directors voted to obligate all current board members to step down; to require, for at least twenty-five years, that a majority of the board be residents of Illinois; and to prohibit the assets from leaving the state for fifty years.³¹¹

The new board members took office in September 2002, headed by Marshall Field V.³¹² The foundation's primary concern was whether to attempt to build its

Art on Michigan Avenue from moving out of town.

J. Linn Allen, *Foundation Truce a Boon for Charities*, CHI. TRIB., Apr. 28, 2001, at 14 (emphasis added).

310. The defendants unsuccessfully sought recourse in federal court. In *Terra Foundation for the Arts v. Perkins*, the district court rejected their claim that the attorney general violated their constitutional rights:

[T]he conduct being induced (a changed vote) is not itself unlawful Essentially the plaintiffs argue that Mr. Perkins used his undoubtedly legitimate authority to name Dr. Stebbins in a complaint and to investigate Dr. Marshall's school in order to get them to do something lawful, which the plaintiffs argue will have unfortunate effects. If the directors had just changed their minds, the plaintiffs would just have to live with it. What difference, as far as their status as potential § 1983 defendants goes, does it make if they changed their votes because of the inducements by Mr. Perkins?

151 F. Supp. 2d 931, 937 (N.D. Ill. 2001). As a threshold matter, the court also rejected plaintiffs' assertion that federal court protection is needed against (elected) state judges: "Moreover, there is no reason to think that the plaintiffs require the special protections of federal court even though the state is a party to the state court action. The only basis that the plaintiffs give for thinking there may be a problem with the state court is that the very able state court judge is elected. That is not a reason to think that she cannot fairly resolve charges of misconduct made against the state and its officers, such as Mr. Perkins." *Id.* at 935.

311. Press Release, Terra Foundation, Joint Press Release re *Buntrock et al. v. Terra Foundation et al.* (July 26, 2001) (on file with author):

The plaintiffs and the Foundation are pleased to announce that a settlement has been reached and adopted by the Court.

The settlement will preserve the public's access, here in Chicago, to The Terra Foundation's collection for no less than 50 years. The Foundation will continue to manage its affairs, to operate its museum and programs in Giverny, France, and to promote understanding of and appreciation for American art. The Attorney General is satisfied that the settlement upholds the interests of the people of the State of Illinois. The plaintiffs and the Foundation are pleased that a settlement could be reached.

The plaintiffs and the Foundation have agreed to let this statement stand alone. No further statements are to be made.

Id.; see also Alan G. Artner, *Terra Founder's Deeds May Not Reflect Desires*, CHI. TRIB., Feb. 25, 2001, at 1:1; Jon Yates, *Judge to OK Museum Accord: Appeal Likely*, CHI. TRIB., July 25, 2001, at 2:1.

312. See Jerry Mullman, *Terra Explores Art of Mag Mile Move; Relocating Is Cheaper than Revamp*, CRAIN'S CHI. BUS., Sept. 16, 2002, at 1 ("Mr. Field, along with four other board members, was appointed last year by Attorney General Jim Ryan's office, which monitors the running of charities and non-profits, after it weighed in on the Terra controversy. Subsequently, Mr. Field selected the other 10 directors.").

endowment and stay independent, or, alternatively to merge its \$100 million Illinois collection with the Art Institute of Chicago or the University of Chicago's Alfred Smart Museum of Art. (The foundation would retain control over its \$200 million endowment and the Giverny museum.) The new board also worried about a decision by Chicago's Commission on Landmarks to give preliminary landmark protection to the Michigan Avenue building housing the museum; this could limit the foundation's options if it wants to sell the building.³¹³

Meanwhile, the original defendants—Judith Terra, Paul Hayes Tucker, and Alan Simpson—have filed an appeal of the court's acceptance of the settlement.³¹⁴ Their appeal charges that the lower court's acceptance "proclaims Illinois a cultural backwater, so unsure of its patrimony and its place in the world that it cannot allow great works of art, once housed in Illinois, to be removed from the state. . . . It declares that Illinois is too provincial a place to permit the free flow of artistic effort and creation."³¹⁵ The appeal also charges the attorney general with pressuring two board members to change their votes, an action that the attorney general denies.³¹⁶ The appellants asked the appellate body to rule that "the Terra Foundation may not lawfully be confined within Illinois"; that "it may not be stripped of its collections"; and that "its board may not be handpicked by the attorney general."³¹⁷ The Terra Foundation itself, acting through its new board, is expected to file a brief in support of the settlement.³¹⁸

On June 21, 2003, the Terra Foundation issued a press release announcing that by the end of 2004 it would close its Michigan Avenue facility and place its most important paintings and its entire collection of works on paper on long-term loan to the Art Institute of Chicago. Rather than being displayed together in a distinct gallery, the paintings will be integrated into the Art Institute's galleries of American art.³¹⁹ According to a news story, the director "said the remainder of the 300 paintings now in the collection either will be placed in storage, shown in a sister museum in Giverny, France, or be lent for exhibitions at other institutions."³²⁰

Terra's press release sets forth the following statement by Terra's director:

313. Jon Yates, *Terra Fight Set for New Chapter; 11 to Leave Board, but Art Museum's Fate Still Unclear*, CHI. TRIB., Sept. 6, 2002, Metro section at 1.

314. *Lawsuit Challenges Museum Settlement*, CHI. TRIB., Aug. 1, 2001, Metro section at 4.

315. Jon Yates, *Appeal Disputes Deal on Terra; State Pressured Board, Widow Says*, CHI. TRIB. (West Edition), Feb. 19, 2003, at W1 (internal quotes omitted).

316. *Id.*

317. *Id.*

318. Nancy Moffett, *Terra Widow Disputes Order to Keep Art Here*, CHI. SUN-TIMES, Feb. 19, 2003, at 26.

319. Specifically, Terra "will place approximately 50 paintings on a renewable 15-year loan and allow for a rotation of the paintings on view to accommodate the various needs for installation, exhibitions and loans to the Giverny museum. Works on paper will be housed in the Art Institute's Department of Prints and Drawings to be shown in changing exhibitions and made accessible through the Department's Study Center." Press Release, Terra Museum of American Art, Terra Foundation to Place Major Paintings and Works on Paper on Long-Term Loan to the Art Institute of Chicago, at http://biz.yahoo.com/pmnews/030621/cgsa001_1.html.

320. Charles Storch & Jon Yates, *Terra Giving Up, Closing Doors in '04: Treasures to Go to Art Institute*, CHI. TRIB., June 21, 2003, at 1.

Our collaboration with The Art Institute of Chicago enables both organizations to increase the understanding of American art and culture among the people of Chicago and visitors to the city. It will also allow the Terra Foundation to foster increased research in American art. This innovative relationship catapults the realization of Daniel J. Terra's vision to a level of service that the Foundation could never achieve on its own. On behalf of the people of this region and across the country—the ultimate beneficiaries—we thank the Art Institute for helping us to achieve this goal.³²¹

A source contacted by the *Chicago Tribune* reported that the Terra board's decision was not unanimous. This news story also quoted Judith Terra's lawyer: "It would be a bitter irony if the actual result of that coup was to take a great art collection, lovingly assembled and put on public display by the Terras, and stick most of it in a warehouse."³²²

Interestingly, the Art Institute of Chicago provides a startling illustration of the dangers of weak judicial oversight, although in that earlier case, involving the B.F. Ferguson Monument Fund, the charity was the party needing skeptical supervision. The trustee of the Ferguson Fund was the Northern Trust Company, but the funds were to be expended on those statuary and monuments chosen by the Art Institute. In 1933, the Art Institute obtained a decree construing the word "monument" to include a memorial building and authorizing the Art Institute to spend Fund moneys on its own building expansion program.³²³ By 1955, the Art Institute was ready to build and returned to court to confirm its plan to construct an administrative wing.³²⁴ A colorful history by the attorney for the plaintiff in the subsequent 1958 case recounts the 1933 proceeding:

On May 22, 1933, at 10:02 A.M. the Art Institute filed a Complaint in the Circuit Court of Cook County At 10:04 A.M. on the same day the Attorney General's Answer was filed, making only a nominal defense and conceding all the points raised by the Art Institute. Minutes later, at 10:17, a seventeen-page decree was entered declaring that the word "monument" in the Benjamin Ferguson will could indeed include a building, and that the Art Institute could use the accumulated and future income . . . [for] an addition to the Institute. . . . [I]t was subsequently discovered that the Art Institute's Complaint, the Attorney General's Answer, and the court's Decree were all typed on the same typewriter, all bore the same watermark, and the Attorney General's Answer was enclosed in the reversed blue backing of the Art Institute's counsel. . . , who was himself a member of the Art Institute's Board.³²⁵

In an addendum to this Article, the author noted that the then-new attorney general re-examined the case, and that the Art Institute of Chicago agreed that the

321. Press Release, *supra* note 319.

322. Storch & Yates, *supra* note 320, at 1.

323. See *Art Inst. of Chicago v. Castle*, 133 N.E.2d 748, 750 (Ill. App. 1956).

324. *Id.* (holding also that the National Sculpture Society lost its bid to intervene); see also *Greene v. Art Inst. of Chicago*, 147 N.E.2d 415 (Ill. App. 1958) (dismissing taxpayer's complaint for lack of standing).

325. Luis Kutner, *The Desecration of the Ferguson Monument Trust: The Need for Watchdog Legislation*, 12 DEPAUL L. REV. 217, 219-20 (1962-63) (emphasis in original).

"accumulated income" from the \$1 million principal of the Ferguson Monument Fund would be used to erect statuary in Chicago.

C. HealthPartners

Recent years have brought numerous examples of state officials seeking appointment power over the makeup of a nonprofit board. Usually this phenomenon takes the form of attorney general demands to approve appointments to the board: the shakeup of boards of the Hershey Trust and the Terra Foundation in favor of local interests;³²⁶ the sale of the Boston Red Sox for the benefit of the Yawkey Trust, with the appointment of an expanded board of trustees;³²⁷ and the settlement of charges over excessive and improper expenses by Allina Hospitals and Clinics, which resulted in the nonprofit's agreeing to allow the attorney general to name the board of a newly spun-off subsidiary.³²⁸ The *New York Times* observed

326. See *supra* Parts II.A & B.

327. On the grounds that the Yawkey Trust, a charity, was the remainder interest of the majority owner of the Boston Red Sox, the attorney general of Massachusetts actively participated in the 2002 sale of the club. See Press Release, Office of the Massachusetts Attorney General, AG Reilly Announces Agreement to Bring \$30 Million More to Charities from Sale of Red Sox (Jan. 16, 2002), available at <http://www.ago.state.ma.us/txt/bosoxdeal.htm> (last visited Mar. 4, 2004). Specifically, the estate of Jean Yawkey owned a 53 percent general partner interest in the Red Sox. John Harrington was both the Red Sox chief executive and the executive director of the Yawkey Foundation—as well as one of the limited partners. While conceding that "[t]he trust set up by the Yawkeys to operate the ballclub and Fenway Park is private and its actions were not subject to our regulatory approval," the attorney general asserted "it is prudent to get the facts so we can determine whether the Yawkey Trust has appropriately discharged its fiduciary responsibility to the charities that stand to benefit from the sale of the team." Press Release, Office of the Massachusetts Attorney General, AG Reilly Seeks Facts on Proposed Sale of Red Sox (Dec. 21, 2001), available at <http://www.ago.state.ma.us/txt/bosox2.htm> (last visited Mar. 4, 2004).

More of a potential deal breaker was the attorney general's insistence that the Yawkey Foundation expand its board and make new policies and procedures subject to his office's review. Under the agreement, though, the attorney general cannot reject new board members, "even if he feels they are not qualified, and his advisory role will be limited to the selection of the five trustees to be named in the next six months. . . ." See Greg Gatlin, AG "Blinked" on Sox Deal, BOSTON HERALD, Jan. 18, 2002, at 25. The *Globe* noted that "the attorney general's office has called for special governance agreements with foundations only where there has been evidence of mismanagement of the organizations or their money," and there "are no such allegations in the case of the Yawkey Foundation." Beth Healy, Foundation Faces Greater Oversight AG Sets Bar Higher for Yawkey Trust than for Other Charities, BOSTON GLOBE, Jan. 18, 2002, at C1. With the appointment of six new trustees, including one recommended by the attorney general, the dispute has come to an end. "'All is well that ends well,' Reilly said, adding that he believes his 'goals have been accomplished.'" Scott Van Voorhis, Yawkey Charity Has New Trustees, BOSTON HERALD, May 31, 2002, at 29.

328. See Stephanie Strom, Strong-Arm Shaking of Charities Raises Ethics Qualms, N.Y. TIMES, May 11, 2003, at 22 ("In 2001, Mr. Hatch reached a settlement with one, Allina Health System, that resulted in it spinning off operations to a new subsidiary company, Medica Health Plans. He then selected eight 'special administrators' as Medica's board of directors, and the court signed off on them the next day."); see also notes 343-53 and accompanying text.

that many attorneys general "are becoming headhunters as well, shaking up scandal-tainted charities with new board members and administrators they pick themselves—often friends, colleagues and even political contributors and allies."³²⁹

In these cases, the attorney general obtained his desired results from jaw-boning—but in the case of another Minnesota HMO, the nonprofit challenged the attorney general's motion to appoint two members to its board. Attorney General Mike Hatch's investigation of HealthPartners uncovered questionable expenses for travel, consulting, and compensation.³³⁰ An attorney general filing charged that the current board "did little to exercise independent judgment concerning the lavish activities of management."³³¹ Hatch's desired appointees—who would serve for 12 to 18 months—were Glen Taylor, owner of the Minnesota Timberwolves professional basketball team, and real-estate businessman Ed Flaherty; Hatch petitioned for Taylor to be named chairman of the board.³³² HealthPartners objected, contending that its governing documents require directors to come from the plan membership, and that "[a]nyone who comes on the board deputized by the attorney general has the first duty of loyalty to the attorney general and not to our members."³³³ An editorial in the *Minneapolis Star-Tribune* was critical:

There are any number of remedies that seem appropriate to these lapses: quarterly public audits; an observer from the attorney general's office at board meetings; or Gov. Tim Pawlenty's proposal to consolidate health-plan regulation under skilled auditors at the Commerce Department. But using the courts to turn HealthPartners management over to one elected official is a thoroughly bad idea.³³⁴

329. Strom, *supra* note 328. This story reported that, in the Hershey case, two of the four board members replacing the ten departing members had served on the Pennsylvania attorney general's transition team; that one new member recommended and elected to the Terra board by the Illinois attorney general had contributed \$750,000 to the attorney general's campaigns from 1994 through 2000, about \$250,000 after he joined the board; and four of the eight appointees to the Medica board had contributed to the Minnesota attorney general's campaign.

330. The attorney general's 100-plus page findings charging a "culture of luxury" can be found at http://www.ag.state.mn.us/consumer/PDF/HealthPartners_ExecComp_.pdf (last visited Mar. 4, 2004), http://www.ag.state.mn.us/consumer/PDF/HealthPartners_Consulting_Expenses.pdf (last visited Mar. 4, 2004), and http://www.ag.state.mn.us/consumer/PDF/HealthPartners_Travel_Entertainment.pdf (last visited Mar. 4, 2004).

331. Glenn Howatt, *HealthPartners Vows to Be Trustworthy to Deflect Hatch Move*, STAR TRIB. (Minneapolis, Minn.), May 1, 2003, at D3.

332. Glenn Howatt, *Flaherty Is Hatch's Next Selection for HealthPartners Board*, STAR TRIB. (Minneapolis, Minn.), Feb. 4, 2003, at D3.

333. Glenn Howatt, *HealthPartners Uses Web Site to Rebut Hatch's Plan; HMO Raises Issue of Loyalty of Appointed Board Members*, STAR TRIB. (Minneapolis, Minn.), Jan. 30, 2003, at B3 (quoting chief executive officer Mary Brainerd). The contest attracted the attention of an association of cooperatives, which are also member-controlled. The National Cooperative Business Association wrote to attorney general Hatch: "While your interest in ensuring that Minnesota consumers are well-served by HealthPartners is laudable, your effort to subvert the control consumers have over the healthcare business they own is an unprecedented challenge to the first and most important principle of cooperative ownership—democratic member control." *NCBA Warns CUs to Watch Case of Minnesota HMO*, CREDIT UNION J., Feb. 10, 2003, at 2.

334. Editorial, *HealthPartners; Hatch, Board Need to Compromise*, STAR TRIB. (Minneapolis, Minn.), Jan. 31, 2003, at A18.

Writing about the attorney general's position, attorneys Michael Peregrine, Ralph DeJong, and James Schwartz write that:

what is most noteworthy . . . is that he appears to lack any statutory authority for the proposition that an attorney general may appoint (as opposed to remove) directors of a non-profit corporation. Furthermore, the entire concept raises substantial conflict of interest issues (e.g., does the 'appointed director' owe a fiduciary duty to the corporation or to the attorney general?).³³⁵

These authors also believe that Minnesota law authorizes appointment of a "special administrator" "only in unique circumstances (e.g., to assist in winding up corporate affairs) and not to act in a role tantamount to a director."³³⁶

In early June 2003, the Hennepin County District Court ruled that Taylor is to be appointed as a special administrator rather than a board member, and—while he can attend board meetings and have access to information—he may not share any proprietary or confidential information with Hatch, and may only make recommendations to the board on issues relating to travel and entertainment, consultants, executive compensation, corporate governance, and "other matters he believes may be of benefit to HealthPartners."³³⁷ (The court did not address the attorney general's other nominee.) Taylor's tenure is to last twelve months, as is the court's jurisdiction over the matter; "[t]he parties further agree that no extensions of this Stipulation and Order shall be sought."³³⁸ If during that period Taylor "reasonably believes" that HealthPartners has withheld access to information or, without acting in the good faith exercise of its business judgment, rejected one of his recommendations, Taylor may, through the attorney general, seek court relief.³³⁹ This settlement is consistent with the belief of some current and former charity officials that judicial rather than attorney general oversight is the proper route. Marion Fremont-Smith, former top charity official in Massachusetts, commented on settlements that result in attorney general authority over board appointments: "The attorney general has the clout to force people to let him do it, but he has no legal right to do it."³⁴⁰ Similarly, the Texas attorney general commented: "We really don't have the authority to say to a board, you must hire or appoint someone That's a decision that belongs to the courts."³⁴¹

335. Michael W. Peregrine et al., "Hot" Developments in Non-Profit Corporation Law: Health Midwest, HealthPartners and Attorney General Spitzer, HEALTH LAW, NEWS, June 2003, at 50, 55.

336. *Id.*

337. Stipulation and Order for Appointment of Special Administrator, *In re HealthPartners, Inc.*, No. MC 03-001587 (Hennepin County, Minn., June 10, 2003) (on file with author). See also *HealthPartners Reaches Agreement with Attorney General*, Attorney General Audit Updates, at <http://www.healthpartners.com/Menu/0,1598,5574,00.html> (last visited Mar. 4, 2004).

338. Stipulation and Order for Appointment of Special Administrator, *In re HealthPartner*, No. MC 03-001587, at ¶ 8.

339. *Id.* at ¶ 5. See also Patrick Reilly, *Health Plan Scrutiny: Ruling May Restrict Oversight by Attorneys General*, MOD. HEALTHCARE, June 23, 2003, at 44; Mark Wolski & Peyton Sturges, *HealthPartners Agrees to Accept AG's Choice as Special Administrator*, 12 HEALTH L. REP. 959 (2003).

340. Strom, *supra* note 328.

341. Quoted in *id.*

The bond-rating agency Standard & Poors, which had placed HealthPartners on credit watch "with negative implications," reacted to the settlement by restoring HealthPartners' rating.³⁴²

In a different HMO enforcement matter, Medica Health Plan had agreed that Attorney General Hatch could name eight special administrators to Medica's board. In 2003 Medica petitioned to terminate its 2001 settlement with Hatch.³⁴³ Medica charged the attorney general with micromanaging and pursuing his own interests; the Attorney General countered by characterizing Medica's petition as a "hostile takeover."³⁴⁴ Four of the special administrators named by the attorney general subsequently won election to the board, and the remainder were appointed by the board.³⁴⁵ As described in a May *Star Tribune* editorial: "Mike Hatch's long and vigorous campaign to tame Twin Cities HMOs took a bizarre twist this week, when the very people he installed to run Medica Health Plans accused the attorney general of meddling in their business and asked a Hennepin County judge to release them from his supervision."³⁴⁶ The editorial noted the unease of some observers when the attorney general proposed to install his own board: "Some said it would give one elected official too much power over the health care of 1 million Minnesota consumers; others said it would be a conflict of interest for the state's top consumer watchdog to supervise a company run by his own appointees."³⁴⁷ The editorial described the "paradox": "If Hatch appointed competent and honorable people, then a judge should ask why the attorney general continues to second-guess their judgment. If Hatch appointed directors who are bungling the job, then a judge should ask why the attorney general should be allowed to repeat the experiment."³⁴⁸ Attorney General Hatch, however, called the fours' election a sham: The seats were uncontested (an almost universal practice in Minnesota HMOs), and three of the incumbents, not being members of the health plan, were issued free policies in order to qualify under State law.³⁴⁹ In August 2003, the court ruled: "This is a company cited in a compliance report for gross mismanagement and corporate waste Under the circumstances, the AG . . . would be remiss if he did not critically review Medica's ongoing management practices and current

342. Compare Glenn Howatt, *HMO's Bond Rating Put on Credit Watch*, STAR TRIB. (Minneapolis, Minn.), Feb. 8, 2003, at 10D ("The New York-based ratings agency this week cited the investigation of the company by Minnesota Attorney General Mike Hatch and his subsequent moves to place two new members on the company board as the reasons to review the BBB+ credit and financial strength ratings."), with Yvette Shields, *Minnesota: Regions in Recovery*, BOND BUYER, June 18, 2003, at 31 ("Standard & Poor's last week affirmed Regions Hospital's BBB credit and took it off its negative CreditWatch list, following its parent entity's announcement of a settlement with the state attorney general's office regarding a critical audit.").

343. See Glenn Howatt, *Medica Is Still Subject to Hatch*, STAR TRIB. (Minneapolis, Minn.), Aug. 16, 2003, at A1.

344. Glenn Howatt, *Medica Seeks to Cut Ties to Hatch; Attorney General Call Move "Hostile Takeover"*, STAR TRIB. (Minneapolis, Minn.), May 8, 2003, at A1. "If they don't like it, get off the board, Hatch said." *Id.*

345. See Glenn Howatt, *Hatch, Medica Fight Centers On What Vote Did or Didn't Do*, STAR TRIB. (Minneapolis, Minn.), May 14, 2003, at D1.

346. Editorial, *Hatch vs. Medica; Attorney General Should Let It Be*, STAR TRIB. (Minneapolis, Minn.), May 10, 2003, at A22.

347. *Id.*

348. *Id.*

349. Howatt, *supra* note 345, at D1.

administration."³⁵⁰ The court also ruled that Medica had voluntarily entered into a contract with the Attorney General, and that the agreement would remain in effect until the parties jointly sought for the court to terminate it.³⁵¹ Finally, the court invalidated the 2002 election of three of Hatch's appointees and the remainder who were appointed to the board; all retain their status as special administrators, and Hatch is free to replace them.³⁵² Medica intends to appeal.³⁵³

D. Health Midwest

In the fall of 2002, the for-profit, Tennessee-based chain HCA, Inc.—formerly known as Columbia/HCA—submitted a winning bid of \$1.125 billion to acquire Health Midwest. HCA also agreed to invest an additional \$450 million in capital improvements, to maintain at least Health Midwest's recent level of indigent care, and to keep its existing hospitals open. Explained a spokesman for Health Midwest: "Nonprofits are at a decided disadvantage at acquiring necessary capital to expand and strengthen themselves Our board of directors decided the only responsible way to proceed would be to listen to offers from for-profit companies."³⁵⁴ Owning seven hospitals, leasing two, and managing four, Health Midwest is Kansas City's largest hospital system, treating one in three area patients.³⁵⁵ The acquisition is HCA's largest.³⁵⁶

As has happened with many nonprofit hospital conversions, the fight then shifted to the question of what to do with the sale proceeds, which must remain in the charitable sector.³⁵⁷ In this case, an expected \$700-800 million would fund one or more "conversion foundations," "sparking a philanthropic tug of war between advocates of indigent health care and proponents of life sciences research."³⁵⁸

To complicate matters, Health Midwest had to contend not just with one attorney general but two, given that the multi-community system operates within a 150-mile radius of Kansas City, and so straddles Missouri and Kansas. Health Midwest brought suit to clarify the jurisdiction of both attorneys general. The attorneys general's responses were severe.

Missouri Attorney General Jay Nixon counterclaimed by moving to dissolve Health Midwest as a nonprofit corporation and to remove its board for abandoning the entity's charitable purpose in agreeing to a sale to a proprietary buyer.³⁵⁹ He

350. Howatt, *supra* note 343, at A1.

351. *Id.*

352. *Id.*

353. *Id.*

354. Richard Williamson, *HCA, Midwest Come Together for \$1.6 Billion Deal*, BOND BUYER, Oct. 17, 2002, at 3.

355. Vince Galloro, *Some Loose Ends; HCA Deal Worries Missouri Attorney General*, MOD. HEALTHCARE, Nov. 25, 2002, at 12.

356. *Id.*

357. See also the case involving Banner Health. See *supra* notes 133-46 and accompanying text.

358. Paul Wenske & Julius A. Karash, *Health Midwest Sale Prompts Gold Rush Rival Interests Seek Foundation's Funds*, KANSAS CITY STAR, Nov. 9, 2002, at A1.

359. "By disposing of the very facilities it exists to 'establish, operate and maintain,' Health Midwest has put itself in a position in which it can no longer carry out or fulfill its purposes." [Missouri] Attorney General's Answer, Counterclaims, and Cross-Claims to Plaintiff's Petition for Declaratory Judgment at ¶ 98, *Health Midwest v. Nixon*, No.

declared:

The Attorney General of Missouri may bring an action for removal of directors of a public benefit corporation . . . when the directors have engaged in a gross abuse of authority or discretion with respect to the corporation, including a breach of their fiduciary duties owed to the corporation and the people it exists to serve, and removal is in the best interests of the corporation.³⁶⁰

As an affirmative defense, Nixon stated:

WHEREFORE, Plaintiff's Petition should be dismissed under the doctrine of laches and estoppel because, having enjoyed the benefits of non-profit, charitable status since its inception, and having conceded the Attorney General's authority and sought his review and approval, Health Midwest may not now challenge that authority or seek to prevent a determination on their proposal which the Attorney General has not yet made³⁶¹

Carla Stovall, attorney general of Kansas—where Health Midwest operated two subsidiaries and managed a county hospital—similarly reacted angrily to Health Midwest's declaratory judgment suit. She issued a press release stating:

It is unconscionable for Health Midwest to waste money belonging to the citizens of the two states in filing this lawsuit, and to deny those same people the ability to benefit from or have any say in this proposed sale. The Health Midwest board members have the arrogance to believe that this money is theirs, when in reality it belongs to the people of Kansas and Missouri. . . .³⁶²

In her answer, Attorney General Stovall raised several counterclaims, including (1) a petition for the conduct of a judicial *cy pres* proceeding; and (2) the removal of the directors, and the appointment of a receiver to take over the charitable assets in a *quo warranto* proceeding due to *ultra vires* acts by a nonprofit corporation.³⁶³ She also asked for a jury trial.³⁶⁴ Her counterclaim declared:

The Kansas assets of Health Midwest, which are vested in Kansas tax

02CV326118 (Cir. Ct. Mo. filed Dec. 5, 2002), available at <http://ago.missouri.gov/health/HMW-ANS.pdf> [hereinafter Missouri Answer]; see also Press Release, Office of Missouri Attorney General Press Release, Nixon Asks Court to Dissolve Health Midwest (Dec. 5, 2002), available at <http://www.ago.state.mo.us/newsreleases/2002/120502b.htm> (last visited Feb. 27, 2004). The attorney general's answer characterizes Health Midwest's suit as "an unconscionable waste of corporate assets." Missouri Answer, *supra*, ¶¶ 73 & 75.

360. Missouri Answer, *supra* note 359, at ¶ 102.

361. *Id.* at ¶ 76.

362. Press Release, Office of the Kansas Attorney General, Stovall Responds to Health Midwest Lawsuit (Nov. 27, 2002), at http://www.accesskansaskansas.org/ksag/contents/news-releases/2002news/hca_lawsuit_react.htm.

363. Answer, Counterclaim, and Cross Claim of Defendant Carla J. Stovall in Her Official Capacity as the Attorney General of the State of Kansas at Counts III, IV, and V, Health Midwest v. Stovall (Kan. Dist. Ct. filed Dec. 10, 2002) [hereinafter Kansas Answer].

364. *Id.* at ¶ 53.

exempt not-for-profit corporations are the property of the people of the state of Kansas. Any proceeds from the sale of any Kansas assets are property of the people of the State of Kansas and no person or entity can divest, alienate or exercise dominion over these assets without specific Judicial approval.³⁶⁵

Stovall asserted that Health Midwest "waived the right to contest the authority of the Kansas Attorney General to review the transaction" by, for example, providing such a right in their bylaws; through statements to that effect made by its general counsel at board meetings; and through a term in the asset purchase agreement giving the Kansas attorney general the right to request a delay in the closing date of the transaction.³⁶⁶

Finally, Stovall's counterclaim also included her own proposal for a post-closing foundation, with a fifteen-person board appointed by her.³⁶⁷ Yielding to criticism, Health Midwest subsequently proposed two conversion foundations, one for each State, and to prorate the sale proceeds 80 percent to the Missouri foundation and 20 percent to the Kansas foundation in accordance with current operations. Under Health Midwest's modified proposal, a common twenty-five-person board would govern both foundations. According to Health Midwest's memorandum describing the structure and governance of the foundations: "Because a separate entity will be chartered in each state, each Attorney General will be able to assert such jurisdiction as permitted by laws of their respective states over the entity chartered in his or her respective state."³⁶⁸ However, the Missouri and Kansas attorneys general continued to contest the authority of the Health Midwest board to structure the foundation boards and to determine how the funds will be used.³⁶⁹

Out of fear that the attorneys general's wrangling over the foundations would delay the financially-needed sale, a third of Health Midwest's physicians took out an ad in the *Kansas City Star* in December 2002 supporting the transaction.³⁷⁰ Kansas's Carla Stovall, however, told the press that she wanted Health Midwest executives to pay half of their closing bonuses to the charitable foundations, and has asked for experts to determine what percentage of the sale's proceeds should go to each State's foundation.³⁷¹ When Stovall's term was ending, incoming attorney

365. *Id.* at ¶ 17.

366. *Id.* at ¶ 10.

367. *Id.* at ¶¶ 74-79.

368. Health Midwest, Structure and Governance for Foundations 2 (Dec. 19, 2002), at http://ago.missouri.gov/health/HMW_proposal_19dec02.pdf. As a separate matter, ten existing foundations that support the Health Midwest system could continue to operate independently if they choose. *Id.* at 6; see also M. Steele Brown, *Some Health Midwest Foundations Consider Independence After Sale*, BUS. J. OF KANSAS CITY, Jan. 3, 2002, available at <http://kansascity.bizjournals.com/kansascity/stories/2003/01/06/story7.html>.

369. Nor would separate statewide foundations address concerns of how and where within Health Midwest's current operating area the funds should be expended: "Kansas City officials want [the sales proceeds] spent only in the central city. The mayor of adjacent Independence, Mo., has his own detailed plan for spending some of it in the suburbs." Bill Lewis, *HCA Finds "Tough Crowd" in K.C.*, THE TENNESSEAN, Nov. 22, 2002, at E1.

370. Mike Norbut, *Physicians Back HCA Purchase of Nonprofit Hospital Chain*, AM NEWS, Jan. 20, 2003, available at <http://www.ama-assn.org/sci-pubs/amnews/avantgo/content/bb0120.htm>.

371. *Attorney General Negotiating with Health Midwest*, DODGE CITY GLOBE, Jan. 11,

general Phill Kline reaffirmed her position that the Health Midwest board should be replaced.³⁷² Nor did Missouri attorney general Jay Nixon seem moved by concerns over delay, telling the editorial board of the *Kansas City Star* he did not feel bound to settle by the called-for March 31, 2003 closing date.³⁷³ He charged Health Midwest with having filed suit in order to keep sale documents secret, commenting: "It's a stunning thought that Health Midwest would think that public documents in the hands of the attorney general are not public."³⁷⁴

In January 2003, Health Midwest and Missouri Attorney General Nixon agreed to create a foundation whose board would be chosen by Nixon, Health Midwest and the community.³⁷⁵ The proposal established a minimum of 10 percent of the conversion proceeds for the benefit of Kansas. Declared the Missouri attorney general: "This new foundation will exist for the purposes of improving community health in the metropolitan Kansas City area without regard to state lines or political subdivisions."³⁷⁶

This did not sit well across the border. The Kansas legislature swiftly passed a bill requiring a nonprofit hospital corporation to forfeit its Kansas hospital assets to a new foundation—with the board of the foundation to be appointed by the governor, attorney general, and legislative leaders.³⁷⁷ The new Kansas attorney general urged the legislature not to let Missouri keep control over all the sale proceeds. One news story reported: "'The attorney general of Missouri has said through his actions that he has the right to spend your money,' Kline told legislators . . . 'This money is in trust with the people of the state of Kansas.'"³⁷⁸ One legislator later commented: "The way it was explained to us, since they are non-profit and do not pay taxes, the state is entitled to a substantial amount of the proceeds from the sale."³⁷⁹ In an interview, Missouri Attorney General Nixon denied the metaphor of a "border war," asserting that the Missouri foundation would benefit those living in the entire Kansas City area, and noting that under the

2003, available at http://www.dodgeglobe.com/stories/011103/sta_healthmidwest.shtml (last visited Feb. 26, 2004).

372. M. Steele Brown, *New AG Kline: He'll Stay Course on Sale to HCA*, BUS. J. OF KANSAS CITY, Jan. 13, 2003, available at <http://kansascity.bizjournals.com/kansascity/stories/2003/01/13/story.html> (last visited Feb. 24, 2004).

373. Paul Wenske, *Nixon: Time Isn't of the Essence; Health Midwest Case Ignores Clock*, KANSAS CITY STAR, Jan. 15, 2003, at C1.

374. *Id.*

375. See Press Release, Office of the Missouri Attorney General, Nixon Announces Agreement with Health Midwest to Establish \$700 Million Foundation for Health Care Needs (Jan. 22, 2003), available at <http://www.ago.missouri.us/newsreleases/2003/012203.htm> (last visited Feb. 26, 2004).

376. Patrick Reilly, *One Down, One to Go; Mo. Settles Health Midwest Case; Kansas Still in Court*, MOD. HEALTHCARE, Jan. 27, 2003, at 10.

377. The bill was introduced on January 22, 2003, and signed by the governor on January 24. See S.B. 44, 2003 Leg. Reg. Sess. (Kan. 2003). As reported in *The Newton Kansan*, "the House passed the measure . . . on a 114-5 vote about an hour after the Senate approved, 37-1." Chad Frey, *Legislators After Funds from Sale of Hospitals*, NEWTON KANSAN, Jan. 25, 2003, available at http://thekansan.com/stories/012503/fro_0125030010.shtml (last visited Feb. 24, 2004). The lone dissenting vote in the Senate was cast by David Adkins, "who lost last year's GOP primary for attorney general to Kline." *Id.*

378. Frey, *supra* note 377.

379. *Id.* (quoting Representative Carl Krehbiel, R-Moundridge).

settlement, six of its twenty-five directors are to come from Kansas.³⁸⁰

Separately, the new Kansas Attorney General Kline persisted in court. On February 3, 2003, Judge Thomas Foster issued a lengthy opinion.³⁸¹ He held that nonprofit corporate law applied.³⁸² The court rejected the application of *cy pres* doctrine to the decision of the board of a nonprofit corporation to change its purposes:

The Kansas *cy pres* statute . . . governs changes to the purposes of charitable trusts, devises, and bequests. The *cy pres* statute does not apply to changes to the purposes of nonprofit corporations. The *cy pres* statute applies only to any restricted gifts and not the entity as a whole. *Bethany Medical Center*, 266 Kan. at 372-73. No restricted gifts have been identified herein and therefore the *cy pres* statute does not apply.³⁸³

Citing "the comprehensive process undertaken by the Health Midwest Board," Judge Foster found that "each board unanimously approved the sale in good faith and in the best interests of those Kansas not-for-profit corporations"—and that "[t]he Attorney General has failed to identify a missed detail or conflict of interest in the process that would prohibit or place conditions on the sale of assets."³⁸⁴ Judge Foster addressed the Kansas attorney general's challenge to the executive compensation packages by finding: "Health Midwest's decision to approve the compensation is an internal matter of the Missouri company and is subject to review by a Missouri court."³⁸⁵ The court additionally concluded that the "funds here are either generated by the corporation's business or are proceeds from the sale of the corporate assets and are not 'solicited' funds as defined by [the Kansas Charitable Organizations and Solicitations Act]", or "managed funds or donations as defined by [the Uniform Management of Institutional Funds Act]."³⁸⁶

However, Judge Foster overruled the board's decision to allow the sale proceeds to be paid into a single Missouri foundation, applying the Health Midwest board's own determination that 20 percent of the sale proceeds were attributable to its Kansas corporations: "The Missouri Attorney General will control the Missouri Foundation," and his consent will be required to adjust the provision in the Memorandum of Understanding calling for a minimum of 10 percent of the

380. *Id.*

381. *Health Midwest v. Kline*, No. 02-CV-08043, 2003 WL 328845, at *1 (Kan. Dist. Ct. Feb 6, 2003).

382. *Id.* at *2. Citing *Kansas E. Conference of the United Methodist Church, Inc. v. Bethany Medical Center, Inc.*, 969 P.2d 859 (1998), the court declared: "Kansas corporate law, which applies to Health Midwest . . . by virtue of *Bethany*, includes the presumption that boards of directors act on an informed basis, in good faith and in the honest belief their decisions are in the best interests of the corporations." *Id.*

As to the Kansas corporate members of the Health Midwest system—which are to be merged into Health Midwest, a Missouri corporation—Judge Foster found that Kansas nonprofit corporate law permits their merger into a foreign nonstock corporation, is so provided for, and that such mergers "necessarily permit the 'transfer' of assets out of state if the foreign corporation absorbs the Kansas corporation." *Id.* at *25.

383. *Id.*

384. *Id.* at *17.

385. *Id.* at *19.

386. *Id.*

spending to benefit Kansas residents.³⁸⁷ Judge Foster concluded: "Health Midwest's approval of the Missouri foundation, in light of its position that a[n] 80/20 split of the net proceeds is the appropriate division, is a breach of its duty and a violation of trust as it relates to its obligations to the residents of its Kansas service area."³⁸⁸

At the same time, Judge Foster ruled the new Kansas legislation amounted to an unconstitutional taking, declaring "no authority remotely suggests that assets of a nonprofit charitable or public benefit corporation may be confiscated without compensation." Finding that "confiscation without compensation is the whole purpose of the Bill," Judge Foster rejected the attorney general's assertion that this statute instead constitutes permissible regulation: "The key distinction lies in whether the law leaves the property owner impaired but with some degree of dominion in each of the three rights associated with ownership of property; the right to possess, use and to dispose."³⁸⁹

Health Midwest appealed the ruling on the merits; the attorney general appealed the ruling on the constitutionality of the legislation.³⁹⁰ The continued dispute threatened to kill the golden goose by extending beyond HCA's March 31st deadline. The Kansas Supreme Court turned down Health Midwest's motion for an expedited hearing.³⁹¹ With only weeks to go, though, the Kansas attorney general and Health Midwest reached a settlement that provides for 20 percent of the expected \$700 million net sale proceeds to fund a separate Kansas foundation.³⁹² According to the Kansas attorney general, this would create the largest foundation in Kansas.³⁹³ "When I took office as attorney general in Kansas," Kline asserted, "Kansas had zero assets. Now, 60 days later, Kansas' interests are protected."³⁹⁴

The post-closing action shifted back to Missouri. In early April, the attorney general solicited public nominations for the members of the new Missouri foundation's board, which he would be naming.³⁹⁵ A press release quoted his

387. *Id.* at *17.

388. *Id.*

389. *Id.* at *24.

390. See Julius A. Karash & Paul Wenske, *Kansas Attorney General Files Appeal in Health Midwest Case*, KANSAS CITY STAR, Feb. 26, 2003, at A1.

391. *Late News*, MOD. HEALTHCARE, Mar. 10, 2003, at 4.

392. Press Release, Whitney E. Watson, Kansas Office of the Attorney General, Attorney General Kline Announces Settlement with Health Midwest (March 13, 2003), available at <http://www.ksag.org/contents/news-release/2003news/mar13hca.htm> (last visited Feb. 27, 2004); Patrick Reilly, *Healthy Settlement; Kansas Reaps 20% of Proceeds in Health Midwest Sale*, MOD. HEALTHCARE, Mar. 17, 2003, at 22; *HCA's CEO Says March 31 Deadline Firm on Health Midwest Deal*, MANAGED CARE WEEKLY DIG., Mar. 17, 2003, at 42.

393. *Kansas, Health Midwest Strike Deal on HCA Purchase*, NASHVILLE BUS. J., Mar. 13, 2003, at <http://nashville.bizjournals.com/nashville/stories/2003/1/daily30.html>.

394. Quoted in *id.*

395. Press Release, Attorney General of Missouri, Nixon Asks Public for Nominations to Board of Directors of New KC Foundation Created from Sale of Health Midwest (April 7, 2003), available at <http://www.ago.missouri.us/newsreleases/2003/040703b.htm> (last visited Feb. 27, 2004);

The Missouri Attorney General will appoint the initial board of directors from among nominations received from local governments, Health Midwest and the community at large. Once the initial board is chosen, the foundation board will choose all future directors based on

declaration that "[t]his new foundation will exist for the purposes of improving community health in the metropolitan Kansas City area without regard to state lines or political subdivisions."³⁹⁶ The *Business Journal of Kansas City* reported that the Kansas foundation will have twenty-seven members, with Health Midwest having "one-time authority to appoint five members[;] Kansas elected officials will make the rest of the appointments according to guidelines of a bill passed earlier this year

...³⁹⁷

Finally, on July 23, 2003, the Missouri attorney general announced the final settlement with Health Midwest and the creation of the new foundation, dubbed "A Rising Tide—the Greater Kansas City Health Care Foundation."³⁹⁸ The final settlement provides that until the seating of the Missouri foundation's initial board, its board of directors "shall be comprised of two representatives of the Attorney General and one representative of Health Midwest" ³⁹⁹ The foundation's initial articles of incorporation set forth a variety of health purposes, and state that the purposes are to be carried out in the Kansas City area, specifying three counties each in Missouri and Kansas.⁴⁰⁰ The bylaws specify the number of board members who must be from Missouri and from Kansas; public officials are not eligible to serve as directors.⁴⁰¹

The articles also contain provisions that blur the line between private and public, and give extraordinary oversight authority to the attorney general. First, article 8.7 declares that, with certain modifications, "[i]t is the policy of the Corporation to subject itself to the provisions of [Missouri's Sunshine Laws] as though the Corporation were a public governmental body," and that the "Attorney General of the State of Missouri will have the exclusive authority to enforce this provision." Second, article 10 provides that "[u]ntil March 31, 2006, the Articles of

nominations from a community advisory committee appointed by local areas that are currently served by the Health Midwest hospitals.

Id.

396. *Id.*

397. M. Steele Brown, *Health Foundations Should Be Set up in Matter of Days*, BUS. J. OF KANSAS CITY, Apr. 4, 2003, available at <http://kansascity.bizjournals.com/kansascity/stories/2003/04/07/story6.html>; see also M. Steele Brown, *Names Emerge for Spots on Health Foundations' Boards*, BUS. J. OF KANSAS CITY, July 11, 2003, available at <http://kansascity.bizjournals.com/kansascity/stories/2003/07/14/story5.html> (reporting on flood of nominations and progress on appointments).

398. Press Release, Missouri Attorney General's Office, Nixon and Health Midwest Sign Settlement to Form "A Rising Tide" Health Care Foundation from Sale to HCA (July 23, 2003), available at <http://www.ago.missouri.gov/newsreleases/2003/072303.htm>. The release states, in part: "The purposes of the foundation are to increase access to, and the quality of, health care services in Kansas City; Jackson, Lafayette and Cass counties; and three counties in Kansas. Nixon said the foundation will strictly adhere to Missouri's Sunshine Law." *Id.* The release contains a link to the final Settlement Agreement, and to the Articles and Bylaws of the Missouri foundation.

399. Settlement Agreement, A Rising Tide—The Greater Kansas City Health Care Foundation, at 4, available at <http://www.ago.missouri.gov/newsreleases/2003/healthmidwestpdf/hmw4.pdf> [hereinafter Agreement] (last visited Apr. 26, 2004).

400. Articles of Incorporation, A Rising Tide—The Greater Kansas City Health Care Foundation, art. 7.2, available at <http://www.ago.missouri.gov/newsreleases/2003/healthmidwestpdf/hmw5.pdf> [hereinafter Articles] (last visited Apr. 26, 2004).

401. Bylaws, A Rising Tide—The Greater Kansas City Health Care Foundation, art. 4, available at <http://www.ago.missouri.gov/newsreleases/2003/healthmidwestpdf/hmw6.pdf> [hereinafter bylaws] (last visited Apr. 26, 2004).

Incorporation and Bylaws of the corporation may only be amended with the written consent of the Attorney General of the State of Missouri." The bylaws elaborate on the attorney general's authority to oversee appointments.⁴⁰²

The bylaws set forth detailed requirements for diverse and knowledgeable community representation on the Missouri foundation's board and for a "Community Advisory Committee" (which will nominate candidates to the board).⁴⁰³

402. Section 7.9 of the bylaws provides the following with regard to attorney general enforcement:

If any Appointing Authority fails to make a timely appointment to the Community Advisory Committee, the Attorney General shall make an appointment from the community represented by such Appointing Authority. . . . If, at any time following the appointment of the initial Community Advisory Committee, the Attorney General determines that the Committee lacks appropriate diversity or otherwise has become unable to fulfill its function, the Attorney General may petition the Circuit Court of Jackson County for an order dissolving the sitting Committee and compelling the CAC Appointing Authorities to make appointments to reconstitute the Committee.

Id. § 7.9. Section 4.5 of the bylaws sets forth with regard to the nomination and appointment of the initial board:

Health Midwest will nominate 14 persons to serve on the initial board, and the Community Advisory Committee Appointing Authorities (defined below) will nominate 22 persons to serve on the initial board. The Attorney General shall select 8 persons from the Health Midwest nominees and 8 persons from the Appointing Authority nominees to serve as members of the Initial Board. The remaining 9 directors will be appointed by the Attorney General following an outreach program of his design. The Attorney General can reject a nominee only for duplication (i.e., when a nominee has been nominated by two sources, the Attorney General can reject one nomination but not both) or for cause, in which case the party that nominated the rejected nominee will nominate a replacement nominee. . . . Before making appointments, the Attorney General will interview all nominees and other persons under consideration for appointment and Health Midwest will be permitted to participate in those interviews and offer to the Attorney General its recommendations with respect to the qualifications of the candidates.

Id. § 4.5. Under Sections 7.1 and 7.2 of the bylaws, the Community Advisory Committee will be appointed, in specified numbers, by over a dozen mayors, local government executives, and the attorney general. *Id.* §§ 7.1-7.2.

403. Article 8 of the bylaws, entitled, *Diversity of Nominees and Appointments*, provides:

All nominees for appointments to the initial board, all appointments to the initial board, all appointments to the Community Advisory Committee, and all nominations made by the Community Advisory Committee shall be made in consideration of ensuring that the board and Community Advisory Committee collectively represent the gender, racial, cultural, geographic, socio-economic, age, professional and ethnic diversity of the Foundation service area. . . . The Community Advisory Committee, in making nominations for future vacancies on the board, bears the responsibility not only for perpetuating the diversity of the board in all respects set forth above, but also for ensuring that each nominee has demonstrated expertise, education, or experience in

As for the border issue, the articles of incorporation provide:

The corporation is encouraged to cooperate with the Kansas Foundation created pursuant to the Memorandum of Understanding between Health Midwest and the Attorney General of the State of Kansas dated March 13, 2003, for example, (a) by forming a joint committee of directors to review and make recommendations relative to metropolitan-wide grant making . . . and to indigent care needs throughout the greater Kansas City Metropolitan area; (b) by participating in a joint metropolitan-wide community needs assessment process; and (c) by sharing of staff and resources.⁴⁰⁴

Interestingly, Kansas appears to wind up double-dipping, given the outright transfer of 20 percent of the sales proceeds to the Kansas foundation and the coverage of the Kansas portion of the Kansas City area in the charitable purposes of the Missouri foundation. After payment of expenses and debts (as well as amounts retained by existing independent foundations of the Health Midwest system), the net amount for both foundations comes to about \$520 million.⁴⁰⁵

Neither Missouri nor Kansas has adopted hospital conversion legislation, forcing both attorneys general in the Health Midwest matter to assert their common-law and general corporate jurisdiction over the nonprofit corporations.⁴⁰⁶ Attorneys Michael Peregrine, Ralph DeJong, and James Schwartz applaud the Kansas trial court for:

(a) Upholding the applicability of non-profit corporation law (as distinguished from charitable trust law) to the board's decision-making process; . . .

(c) Rejecting the "predominant purpose" test and affirming the right of charitable corporations to use the proceeds from the sale of their assets for any authorized corporate purpose;

(d) Rejecting the claimed rights of a state Attorney General to regulate the internal functions or decision-making of a foreign non-profit corporation (including payment for executive compensation, whether or not excessive); . . . and

(f) Affirming the "private" nature of non-profit corporate assets and determining that a state law mandating the transfer of the sale proceeds of a non-profit health system to a governmentally established and controlled foundation constitutes an unconstitutional "taking" under the 5th and 14th Amendments to the United States Constitution.⁴⁰⁷

the provision of health care, asset management and investment strategies, philanthropic administration, or community health care, and that the board as a whole possesses the necessary skills in asset management, philanthropic administration, and in assessing and improving health care in the Foundation's service area to enable the board to fulfill its responsibilities. . . .

Id. art. 8.

404. Articles, *supra* note 400, at art. XI.

405. Paul Wenske, *Missouri, HCA Finalize Structure of Kansas City-Area Health Foundation*, KANSAS CITY STAR, July 24, 2003, at C1.

406. Peregrine et al., *supra* note 335, at 51.

407. *Id.*

These authors worry, however, about Health Midwest's agreeing to so much public—and political—input into the makeup of the new foundation's board:

[W]hile the purposes of the proposed new foundation, its broadly based twenty-five person membership (eight members appointed from nominations by Health Midwest; eight members appointed from nominations by a Community Advisory Committee; and nine members appointed by the Attorney General), its requirements of gender, racial, ethnic, cultural, and socioeconomic diversity on Board appointments, its prohibition on "public officials" serving as Board members, and other provisions may well constitute enlightened public policy and benefit the communities served—a substantial concern must have existed that there was no legal basis for either the Attorney General's demands in this respect or Health Midwest's acquiescence.⁴⁰⁸

They urge:

while it is always advisable for non-profit health systems to attempt to work cooperatively with state Attorneys General to resolve regulatory issues surrounding major transactions of this kind, health systems and their counsel should recognize their obligations to abide by non-profit corporation law. On occasion, this may require resisting extra-legal demands by activist state Attorneys General.⁴⁰⁹

E. The Increasing Difficulty of Converting Blue Cross Plans

In contrast to nonprofit hospitals, the various Blue Cross and Blue Shield entities typically are insurance plans for given pools of subscribers.⁴¹⁰ Indeed, based on the belief that federal tax exemption is no longer appropriate for commercial-type insurance plans, Congress repealed the Blues' exemption in 1986.⁴¹¹ Loss of favored tax status spurred action across the country to transform the nonprofit plans to for-profit status. However, the Blue Cross conversion transactions fit awkwardly within the traditional framework for analyzing nonprofit conversions. Who should control the decision to convert the organization, and who

408. *Id.* at 53.

409. *Id.*

410. For example, CareFirst's articles of incorporation describe its corporate mission as one to:

establish, operate and maintain a nonprofit health service plan as authorized by Title 14, Subtitle 1 of the Insurance Article of the Annotated Code of Maryland and any and all amendments thereto, whereby hospital, medical, dental and other health care is provided by hospitals, physicians, dentists, and other providers to persons who become subscribers to such plan, so that such health care and service may be obtained at a minimum cost and expense.

Md. Ins. Admin., Legislative Report of the Maryland Insurance Administration on MIA Order No. 2003-02-032, at 31 (2003) [hereinafter MIA Report], available at <http://www.md.insurance.state.md.us/documents/LegislativeCareFirstReport07-03.pdf> (last visited Apr. 26, 2004).

411. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1012, 100 Stat. 2085, 2390-94 (codified at I.R.C. § 501(m) (2000)).

should benefit from the conversion proceeds?⁴¹² An argument could be made that these types of mutual nonprofits are more like cooperatives and less like charities.⁴¹³

Indeed, the status of the local nonprofit Blue Cross plans varies: Where the issue has been adjudicated, in some states the Blue Cross plan is held to be a charity, while in some states it is a non-charitable nonprofit organization. What difference does it make? In Texas, for example, the court of appeals rejected the attorney general's claim that "Blue Cross/Texas is a common-law charity that must preserve its assets for charitable purposes and the merger is prohibited by the Texas Non-Profit Corporation Act"; the parties had agreed that if the entity were held to be a charity, "the merged entity would ultimately pay to one or more charitable trusts or foundations designated by the attorney general the sum of \$350,000,000 plus interest."⁴¹⁴ Similarly, the Wisconsin appeals court upheld the insurance commissioner's determination that neither the common law nor statutory codification of the *cy pres* doctrine applied to the conversion of Blue Cross/Blue Shield United of Wisconsin.⁴¹⁵ In this case, the plan of conversion called for the sale proceeds to be donated to two Wisconsin medical schools.

412. One might wonder where such large values arise, given that over time a nonprofit insurer would seek to set rates to cover expenses. The Maryland insurance commissioner's report discusses the role of State oversight of the rating practices of insurers and HMOs in Maryland:

Maryland law does not dictate a particular profit margin that insurers may build into their rates. This is something that is often disputed and negotiated in the course of the submission of a rate filing So long as a health insurer has proposed rates that exceed the minimum 60% loss ratio and at the same time are not based on an unsupported or excessive medical trend, the carrier has some discretion in terms of setting the profit margin included in its rates. . . . Given that even CareFirst's own expert acknowledged that a for-profit company has a paramount duty to its shareholders to maximize profits, one cannot ignore the possibility that a for-profit CareFirst would seek even higher profit margins in its rate filings.

MIA Report, *supra* note 410, at 170.

413. See generally HANSMANN, *supra* note 96.

414. *Abbott v. Blue Cross & Blue Shield of Tex., Inc.*, 113 S.W.3d 753, 756 (Tex. App. 2003). In affirming the trial court's fact-finding as to the organization's purpose, the court observed: "Blue Cross/Texas's articles of incorporation propose no general charitable purpose directed toward the public as a whole or toward any indefinite or undefined segment of the public." *Id.* at 765. The parties had stipulated that the entity's surplus and reserves come exclusively from premiums, fees, and investments; has not provided any charitable insurance; and charges competitive market rates. *Id.* at 765-66. The court cited similar holdings in Georgia, Illinois, and Wisconsin. *Id.* at 766 n.13.

The Texas Attorney General for the Charitable Trust Section recently commented on this case: "The Attorney General is seeking review in the Texas Supreme Court. If the Attorney General prevails, more than \$590 million, paid over twenty years, will become available for charitable health-related purposes in Texas." John W. Vinson, *The Charity Oversight Authority of the Texas Attorney General*, 35 ST. MARY'S L.J. 243, 273 n.156 (2004).

415. See *ABC for Health, Inc. v. Comm'r of Ins.*, 640 N.W.2d 510, 512-13 (Wis. Ct. App. 2001). The court found that the plaintiff failed to show that "BC/BSUW is an entity operated exclusively for charitable purposes . . . and that the assets of BC/BSUW were gifts to an entity which operated exclusively for charitable purposes." *Id.* at 515.

Conversion of a Blue Cross plan also highlights intrastate tensions: within the executive branch between the insurance commissioner and the attorney general, and between the legislature and the executive branch. The insurance commissioner understandably conceives of the "public interest" as the interests of the subscribers and policyholders. The attorney general, by contrast, has the broader, common law role of focusing on the governance and purpose of the resulting conversion foundation. It can thus be a conflict of interest—although not the ordinary personal financial one—for the attorney general to act as legal counsel to the insurance commissioner. Moreover, the legislature's concept of public interest can differ from that of either the subscribers or the beneficiaries as determined by the board of the conversion foundation, as illustrated to the extreme in New York state.

In the 2003 cases that follow, Maryland imposed nonprofit status on its Blue Cross entity for five years; New York conditioned approval to convert on payment of ninety-five percent of the proceeds to the state; and plans to convert were abandoned in North Carolina and New Jersey, with Washington state's in jeopardy.

1. CareFirst: Conversion Prohibited

CareFirst is the sole member of the Blue Cross Blue Shield plans of Maryland, Washington, D.C., and Delaware.⁴¹⁶ CareFirst's desire to convert to a for-profit company and to be acquired by WellPoint Health Networks set off an explosion of opposition from the public, the Maryland Assembly, and the Maryland Insurance Administration—as well as the threat to CareFirst of expulsion from the Blue Cross system; still-ongoing counteractions from regulators in Delaware and the District of Columbia; civil charges under Maryland insurance law against CareFirst and its top officers; and an as-yet unspecified federal criminal investigation.

At the time CareFirst proposed the transaction, Maryland had two applicable statutes: a Conversion/Acquisition Statute, which applies to nonprofit health service plans, and an Insurance Acquisitions Act.⁴¹⁷ Both required CareFirst to obtain approval by the Maryland insurance commissioner, although the standards differ somewhat.⁴¹⁸ On March 5, 2003, the commissioner, Steven Larsen, rejected

416. *In re* Consol. Application for the Conversion of CareFirst, Inc. & CareFirst of Md., Inc. to For-Profit Status & the Acquisition of CareFirst, Inc. by WellPoint Health Networks, Inc.; Order, MIA No. 2003-02-032, at 1 (Md. Ins. Admin. Mar. 5, 2003), available at <http://www.mdinsurance.state.md.us/documents/MIA-2003-02-032CareFirstConversion.pdf> [hereinafter Order] (last visited Feb. 26, 2004).

417. For a detailed discussion of the application of Maryland's Conversion/Acquisition Statute and Insurance Acquisitions Statute to the CareFirst case, see the MIA Report, *supra* note 410, at 62-197.

418. See 87 Op. Md. Att'y Gen. No. 02-019 (Md. 2002), available at <http://www.oag.state.md.us/Opinions/2002/02-019.pdf> (Nov. 12, 2002). The Maryland attorney general had confirmed the commissioner's approval power, particularly authority over the transaction involving the affiliate licensed in Maryland but domiciled in the District of Columbia. *Id.* at 17. Among other things, the Opinion concludes:

If the Commissioner determines that public or charitable assets that serve health care needs in Maryland "will be adequately protected" by review of the GHMSI [the D.C. affiliate] portion of the transaction in the District of Columbia, the Commissioner may dispense with a detailed review of that part of the transaction. SG § 6.5-307. On the other hand, if the Commissioner determines that the District of Columbia review will not focus on the preservation of Maryland assets

the conversion and the acquisition as not in the public interest.⁴¹⁹ The commissioner made specific findings that the transaction could result in private inurement to CareFirst officers; that the sale price does not reflect fair market value; that "[t]he procedures that CareFirst used in making the decision to convert and to be acquired were flawed"; and that, based on WellPoint's refusal to produce critical documents, he was "unable to conclusively determine on this record whether the Proposed Transaction has the likelihood of creating a significant adverse effect on the availability or accessibility of health care services in the affected communities, but there is evidence that the proposed transaction could have such an impact"⁴²⁰ As more colorfully reported in a later news story: "Larsen blasted the board of directors for agreeing to a deal that he said undervalued the company, was rife with conflicts of interest, and would have enriched executives with bonus and severance packages worth up to \$119 million."⁴²¹

The commissioner attached a 342-page report to his order. As to process, the report concludes:

While it is true . . . that the Board followed an elaborate strategic planning process . . . , on a superficial level, it appears that the Board was deliberative in its decision, and sought the advice of experts, including lawyers, consultants, and investment bankers. However, the process used by the Board was based on faulty assumptions which in

or health care needs to the same degree as would the Commissioner's own review, then it would not be appropriate to defer. In any event, the decision whether to defer to the foreign regulator's determination is left to the discretion of the Commissioner. In deciding whether to review—and whether to approve—the transaction, the Commissioner must consider not only the price offered for charitable assets, but the effect of the transaction on the availability of and accessibility to health care in Maryland.

Id. at 16; see also 88 Op. Att'y Gen. No. 03-002, at 12 (Md. 2003), available at <http://www.oag.state.md.us/Opinions/2003/03-002.pdf> (Jan. 27, 2003) (upholding 2002 anti-bonus provision legislation, and noting "the Commissioner should consider the anti-bonus provision in assessing whether the proposed CareFirst transaction is in the public interest").

419. Press Release, Md. Ins. Admin., Maryland Insurance Commissioner Denies CareFirst Conversion and Sale (Mar. 5, 2003), available at <http://www.mdinsurance.state.md.us/documents/CFannouncement1-3-5-03.pdf> (last visited Feb. 26 2004); Order, *supra* note 416, at 2, and MIA Report, *supra* note 410, at 3. The commissioner also relied on advice from experts that his office retained at the expense of the would-be acquirer, as provided by law. See Order, *supra* note 416, at 2; MIA Report, *supra* note 410, at 11. The commissioner's press release explains:

The decision concludes a 14-month process undertaken by the Maryland Insurance Administration. That process, outlined in the Maryland State Government Statute, Title 6.5-101, included 15 days of hearings, eight Opportunities for Public Comment held across Maryland, seven expert reports, and more than 87,000 pages of documents reviewed. Commissioner Larsen heard from more than 250 people during the Public Comment sessions and received more than 300 written comments via email and letters from citizens.

Press Release, *supra*, at 30.

420. Order, *supra* note 416, at 3.

421. Jo Becker, *CareFirst's BlueCross Affiliation at Risk*, WASH. POST, April 12, 2003, at E1.

turn meant that however "diligent" the board was in following that process the result would not satisfy the applicable legal standards. . . . The record shows that the Board has misapprehended, or simply ignored, its overriding responsibility to the mission of the company and its insureds.⁴²²

Despite the commissioner's finding of a flawed process, his report also rejects CareFirst's argument that the business judgment rule protects the board's decision to convert and sell to WellPoint:

The business judgment rule was designed to limit judicial interference in corporate affairs and to insulate corporate directors from personal liability that might arise from suits filed by disgruntled shareholders. The "rule", as such, has no place in this regulatory proceeding.

This case does not involve personal liability. It is not a civil lawsuit in which disgruntled shareholders are seeking to overturn the decisions of corporate management. More importantly, oversight of the Insurance Administration over insurance regulatory matters without exception involve [sic] evaluation of substantive outcomes rather than the process through which those outcomes were derived.⁴²³

The report analogizes the insurance commissioner's power to that of an attorney general's regarding enforcement of the fiduciary duties of nonprofit corporations, although the cited authority itself concerns a case where the fiduciaries were engaging in self-dealing.⁴²⁴

422. MIA Report, *supra* note 410, at 111.

423. *Id.* at 71-72 (footnote omitted).

424. *Id.* The report quotes the following paragraph from a decision by the Tennessee Court of Appeals addressing the application of the business judgment rule in enforcement matters:

While the business judgment rule reflects a judicial policy of declining to substitute a court's judgment for that of a corporation's directors when they have acted in good faith and in the exercise of honest judgment in furtherance of corporate purposes, that policy has no application to allegations that a public benefit corporation has abandoned any charitable purpose and has pursued private, rather than public, interests. Similarly, while Tennessee courts have adopted a non-interventionist policy with regard to internal corporate matters, that policy is inapplicable here because the legislature has specifically given the Attorney General and the courts authority and responsibility to ensure that nonprofit public benefit corporations operate in the public interest and not for private gain. The public policy of this state, as expressed by the legislature, is that the Attorney General and the courts intervene in such situations because the public interest is involved and the activities involved are not merely "internal corporate matters."

Id. (quoting *Summers v. Cherokee Children & Family Servs., Inc.*, 112 S.W.3d 486, 529-30 (Tenn. Ct. App. 2002) (citations omitted)). In the cited case, however, the court upheld the authority of the attorney general of Tennessee to dissolve two nonprofit corporations whose fiduciaries were essentially looting its assets. The founder and top officer was eventually indicted. See Marc Perrusquia, *Feds Charge Madisons with Fraud—26 Counts Cite Cherokee Day Care Corruption*, COM. APPEAL (Memphis, Tenn.), Nov. 21, 2002, at A1. The Tennessee court held:

[T]he Attorney General, acting in the public interest, has authority to

Moreover, in explaining his role, the insurance commissioner cited to an opinion by the highest court in Maryland that rejected an asserted right by the members and subscribers of CareFirst to bring a derivative suit:

The thrust of the opinion is that it is the Insurance Administration, rather than shareholders that serves the "watchdog function" over the actions of the Board. While the Insurance Commissioner's authority is generally circumscribed by specific statutes, the Court of Appeals has noted that "we have strongly inferred the visitorial power at least embraces preventing conduct that is violative of public law or the charter and bylaws of the corporation."⁴²⁵

This discussion ends by declaring, "The MIA's responsibility is to determine whether the statutory criteria have been satisfied, not simply to assess whether the Board engaged in a process which it reasonably hoped would result in the satisfaction of the criteria."⁴²⁶

In short order, the Maryland General Assembly ratified the commissioner's report by unanimously enacting legislation⁴²⁷ to require CareFirst to maintain its nonprofit status for five years, declaring "that it is in the interest of all Marylanders to protect and preserve CareFirst in its nonprofit form."⁴²⁸ In addition, the statute provided a schedule for removing the ten Maryland members of the twenty-one-member board, with replacements chosen by a nominating committee appointed by the governor, the House speaker, and the president of the Senate;⁴²⁹ further, one

seek dissolution of a nonprofit public benefit corporation which fails to devote its assets to a public, rather than a private, interest. Where such a corporation is operated for the private benefit of an individual in contravention of the principles governing nonprofit status and its accompanying benefits, or where, as the trial court phrased it, the corporation has abandoned its public benefit, charitable purpose, action by the Attorney General and the courts is warranted.

Summers, 112 S.W.3d at 507. In the paragraph prior to the one quoted by the Maryland report, the court declared:

The business judgment rule has application as a potential defense in two situations: (1) where officers or directors face personal liability; and (2) where the corporation (generally through shareholders in a derivative action) seeks to void a decision of or transaction approved by the board. Neither situation is present herein. The Attorney General does not seek monetary damages from any member of the board for breach of fiduciary duties. Neither does he seek to set aside or invalidate any particular transaction. Instead, this action is maintained under Tenn. Code Ann. § 48-64-301 under which the Attorney General is authorized to act in the public interest to ensure that a nonprofit public benefit corporation is not operated for private gain.

Id. at 529.

425. MIA Report, *supra* note 410, at 73 (footnote omitted) (discussing *O'Donnell v. Sardegna*, 646 A.2d 398 (Md. 1994); quoting *Ins. Comm'r v. BlueShield of Md., Inc.*, 456 A.2d 914 (Md. 1983)).

426. *Id.* at 72.

427. Act of May 22, 2003, ch. 356-57, 2003 Md. Laws 2474; see also M. William Salganik, *Assembly Welds "Nonprofit" to CareFirst*, BALT. SUN, April 8, 2003 at 1C ("The Senate vote was 46-0. The House of Delegates vote was 139-0.").

428. Act of May 22, 2003, ch. 356, § 3, 2003 Md. Laws 2474, 2523.

429. Becker, *supra* note 421, at E1.

member is to be appointed by the president of the senate and another by the speaker of the house. The governor signed the bill on May 22, 2003.

A tangle of lawsuits ensued.⁴³⁰ Viewing the legislation as a threat to the independence of a Blue Cross affiliate, the Blue Cross and Blue Shield Association terminated CareFirst's right to use the Blue Cross trademark. CareFirst declared itself "caught in a huge tug of war between the new CareFirst reform law in the state of Maryland, the trademark license removal by the Blue Cross and Blue Shield Association (BCBSA) and obligations of local regulators relative to the affiliation agreements in Washington, D.C. [sic] and Delaware."⁴³¹ The state sued the association, and CareFirst sued the State, contesting the constitutionality of the statute, in part because of the extraterritorial provisions. On June 6, a federal district judge accepted a settlement signed by the Blue Cross and Blue Shield Association and by the entire top echelon of Maryland executives and legislators: the attorney general, the governor, the insurance commissioner, the speaker of the House, and the president of the Senate. The settlement grants the legislatively-created nominating committee to replace five of the twelve Maryland board members when their terms end, and those new members will select seven new directors to replace the remaining members at the expiration of their terms.⁴³² "To the extent practicable, the directors selected to replace the Outgoing Directors shall represent the racial and gender diversity of the State and the geographic regions of the State and shall have experience in accounting, information technology, finance, law, large and small businesses, and organized labor."⁴³³ "[T]he Maryland Attorney General's Office said it will likely recommend that the General Assembly confirm the changes in the law agreed to in the settlement."⁴³⁴

And what of the conversion foundation? The Maryland insurance commissioner's report discusses state legislation that in 1997 had created the Maryland Health Care Foundation "to receive monies resulting from the conversion of non-profit health care entities in the State . . . to 'expand access to health care services for uninsured and underinsured Marylanders.'"⁴³⁵ The report added:

However, since the enactment of that law, the Maryland General Assembly has modified the role of the Maryland Health Care

430. See the litigation summary in: Order and Consent Judgment at pmb1., CareFirst v. Ehrlich, No. JFM 03-1521, State v. Blue Cross and Blue Shield Ass'n, No. JFM 03-1510 (D. Md. June 6, 2003) [hereinafter Order and Consent Judgment].

431. Press Release, Statement of CareFirst Regarding New "Reform" Law and Blue License Removal (May 22, 2003), at http://carefirst.onlinepresskits.com/news_archive_052203.html (last visited Feb. 26, 2004).

432. Order and Consent Judgment, *supra* note 430, ¶ 1, at 5; see also Bill Brubaker, *CareFirst Weathers Storm; Deal to Retain Insurer's Blue Cross License Could Pose Control Issues*, WASH. POST, June 9, 2003, at E1; Dan Thanh Dang, *CareFirst's Chief Alters Views, Seeks to Remain at Helm*, BALT. SUN, June 29, 2003, at 1A.

433. Order and Consent Judgment, *supra* note 430, ¶ 1, at 5. This paragraph also provides: "The directors shall include two consumer members, one of whom shall be a subscriber and one of whom shall be a certificate holder of CareFirst." Note that these terms echo requirements in the May legislation, whose provision for two nonvoting members named by the speaker of the House and the president of the Senate continues in effect. *Id.* at 8.

434. Dan Thanh Dang, *Maryland Legislators Castigate CareFirst: Implement Reform or Face Tougher Deal, Insurer Told*, BALT. SUN, June 12, 2003, at A1.

435. MIA Report, *supra* note 410, at 203.

Foundation and given itself a role in the process. . . . [A]lthough the Maryland Health Care Foundation serves as trustee of the Trust, money will be spent from the Trust only as determined by the General Assembly.⁴³⁶

But these efforts were all in vain. As reported in the press, "[n]ow that the CareFirst deal has been derailed by controversy over executive bonuses, and the sale of hospitals has cooled, the foundation is out of money . . . [and] plans to close Oct. 1."⁴³⁷ Echoing the insurance commissioner's report, the news story continued:

Even the General Assembly began having second thoughts as early as 2001 about whether it wanted to turn over to the foundation all of the \$1 billion in public proceeds from a CareFirst sale. It considered whether it might use some of the money for another public purpose, such as covering families that can't afford health insurance.

The Assembly created an entity called the Maryland Health Care Trust to hold money from any conversion and that would be under its control more than would the foundation.⁴³⁸

With the conversion blocked, governmental interest shifted to the CareFirst fiduciaries. On July 8, 2003, the Maryland Insurance Administration issued a report calling for civil fines against CareFirst and its top officers, and charging that the board engaged in "corporate mismanagement." As reported in one news story, "[t]he board members will be spared civil fines for violating their fiduciary duties in approving incentive bonuses for CareFirst executives, according to the report, because they already face a more appropriate punishment—removal."⁴³⁹ The insurance commissioner's new report lists seven allegations, including CareFirst's abandonment of its nonprofit mission for withdrawing from Medicare and Medicaid; corporate waste for making a multimillion dollar subsidy of an affiliate without permission of the commissioner; and breach of fiduciary duty for failure to consider the financial risks of a merger. The commissioner would have to prove the allegations at a hearing.⁴⁴⁰ A *Baltimore Sun* columnist suggested that the CareFirst bill and the ensuing controversy "could have been avoided, of course, if Maryland had allowed CareFirst's planned merger with WellPoint Health Networks, minus the bonuses."⁴⁴¹

436. *Id.* at 204. The report then alludes to events in New York, discussed in the final case study, *infra* at Part II.E.2.

437. M. William Salganik, *Health Foundation Closing in October*, BALT. SUN, Aug. 12, 2003, at D1. "[T]he foundation's board, appointed by the governor and heavy with public officials, wasn't structured to have the connections and skills for the fund-raising that would be needed to keep the foundation going on its own, said [Marilyn] Maultsby, the director." *Id.*

438. *Id.*

439. Nancy Kercheval, *Civil Actions, Fines Possible for CareFirst*, DAILY REC. (Baltimore), July 9, 2003, at B3.

440. See Dan Thanh Dang, *Insurance Chief Targets FirstCare Executives*, BALT. SUN, July 9, 2003, at A1.

441. Jay Hancock, Editorial, *CareFirst Ready for a Change at the Top*, BALT. SUN, June 8, 2003, at D1. He added:

CareFirst's big problem is its legal structure. As a nonprofit corporation, CareFirst has no shareholders. Because it has no shareholders, there are

Worse, in August 2003, CareFirst and others confirmed that they received subpoenas as part of a federal investigation of the aborted conversion. "Other government and private sources said . . . that the U.S. attorney for Maryland, a federal grand jury and the FBI are involved in the probe, which was initiated after a sharply critical report on CareFirst was released by the Maryland Insurance Administration."⁴⁴² The *Baltimore Sun* reported, "The broad scope of the initial phase of the investigation made it difficult to determine what, if any, federal statutes authorities suspect were violated, experts said, but the investigation is in keeping with U.S. Attorney Thomas M. DiBiagio's stated mission of pursuing allegations of white-collar fraud and public corruption."⁴⁴³ CareFirst and the Maryland insurance commissioner's office had been meeting to attempt to work out a consent decree on the potential state charges, but that effort will be shelved, the commissioner announced, "until the federal investigation is complete or I determine it is time to move forward with the charges."⁴⁴⁴ Separately, still due is a legislatively-mandated report by the Maryland attorney general into whether CareFirst violated any criminal or civil laws in the course of planned conversion.

Meanwhile, authorities in the two other jurisdictions that CareFirst serves have not acceded to the extraordinary level of Maryland oversight. The Delaware insurance commissioner complained about the "extraterritorial effect" of the Maryland legislation, including the possibility that the statute's requirement that CareFirst provide insurance at the lowest cost to Maryland residents would in effect siphon assets from the financially healthy Delaware Blue.⁴⁴⁵ The District of Columbia insurance commissioner, Lawrence H. Mirel was quoted in the *Washington Post*: "Who the hell are they? . . . CareFirst is not a Maryland government property. . . . Either the Maryland legislature changes the law or we go to court and contest it."⁴⁴⁶ The D.C. insurance commissioner worries that the newly appointed Maryland members would pressure the board to offer discounted insurance to Maryland residents at the expense of the D.C. residents. Mirel also worries about the five-year bar on CareFirst's converting to for-profit status: "If the choice is that CareFirst gets sold or it goes out of the business, I don't want to be stuck with a Maryland law that says they can't be sold."⁴⁴⁷ The Maryland federal court's June 6 order provides: "if conflicting orders by the District of Columbia and

no property rights associated with the company's equity. And with no property rights—as any good libertarian should know—there is often chaos.

At CareFirst, a big, disembodied chunk of capital, the buck stops—nowhere. Hence the disengaged board and extramural meddling.

Id.

442. M. William Salganik, *U.S. Subpoenas CareFirst*, BALT. SUN, Aug. 14, 2003, at A1.

443. M. William Salganik, *Insurer Says Subpoenas Are Received*, BALT. SUN, Aug. 15, 2003, at D1. One critic of the proposed conversion called the federal probe "a puzzlement" and lamented: "This is everybody's worst nightmare. . . . I was hoping for an orderly transition from a for-profit orientation to a nonprofit orientation. . . . I can understand the anxiety if you're an executive out there and you're being investigated by the FBI." *Id.*

444. *Id.*

445. Maureen Milford, *CareFirst Law Prompt Talks*, NEWS J. (Wilmington, Del.), June 17, 2003, at B10.

446. Bill Brubaker, *CareFirst Oversight Questioned: District Wary of Maryland Control Over Nonprofit Health Insurer*, WASH. POST, July 7, 2003, at E1.

447. *Id.*

Delaware Insurance Commissioners are issued, this Court retains jurisdiction on the motion of any party (including CareFirst) or the District of Columbia or Delaware Insurance Commissioner to resolve such conflict."⁴⁴⁸

2. Empire Blue Cross: Proceeds Paid to State

Beginning in 1996, the large New York health-insurance nonprofit Empire Blue Cross Blue Shield sought to convert to for-profit status. That year the Empire board negotiated with the attorney general and the department of insurance over the form of such a transaction. Consistent with one typical form of conversion in other states, Empire proposed creating a new for-profit insurance company whose stock would be held 100 percent by a new nonprofit "conversion foundation," which would then sell off shares of stock over time in order to diversify its assets and raise funds for making grants. From 1997 through 1999, the attorney general and the insurance department held public hearings on Empire's proposal.

Over 130 community organizations endorsed a set of principles calling for an independent, community-responsive foundation to be established with Empire's nonprofit assets in the event the conversion were permitted. Empire drafted a conversion petition largely consistent with these principles and outlined its plan to use the assets generated by the conversion to expand access to health insurance and health care for the medically underserved.⁴⁴⁹

In May 2000, Attorney General Eliot Spitzer described his role as "determining whether a particular conversion proposal properly protects the public interest," and outlined changes that he obtained to the Empire plan.⁴⁵⁰ In April 2001, Empire issued a press release describing that the new "independent charitable foundation that would be created as part of its proposed plan to restructure as a for-profit company is estimated to be at least \$1 billion."⁴⁵¹ The foundation "would be dedicated to providing funds to expand access to more affordable health insurance coverage for those New Yorkers who need it the most: children, the elderly and individuals who purchase their own coverage."⁴⁵² Michael Stocker, MD, President and CEO of Empire stated in the release: "Historically, Empire has provided coverage to these New Yorkers when they could not afford coverage elsewhere. Dedicating the charitable value of Empire to this population is consistent with the

448. Order and Consent Judgment, *supra* note 430, ¶ 13, at 9.

449. Press Release, Consumers Union, Advocates Blast Amended Empire Blue Cross Conversion Plan, Urge NY Department of Insurance to Reject For-Profit Bid (Aug. 5, 2002) (on file with author).

450. Press Release, Statement by Attorney General Eliot Spitzer Regarding the Proposed Conversion of Empire Blue Cross and Blue Shield (May 24, 2000), available at http://www.oag.state.ny.us/press/2000/may/may24b_00.html; Press Release, Statement by Attorney General Eliot Spitzer Regarding Legislation to Protect the Public Interest in Health Insurer Conversions (May 31, 2000), available at http://www.oag.state.ny.us/press/2000/may/may31a_00.html.

451. Press Release, Empire Blue Cross, \$1 Billion to Care for the Uninsured Provided by New Charitable Foundation (April 2, 2001), available at <http://www.empireblue.com/pdf/empire.pdf> (last visited March 2, 2004).

452. *Id.*

historical mission of the company."⁴⁵³

However, because of opposition from health care unions and hospitals, legislation to authorize the conversion remained stalled for years. Finally, in early 2002, the state legislature authorized the conversion as part of a multi-billion dollar health care package⁴⁵⁴ in which 95 percent of the proceeds from Empire's initial public offering would be paid to the state budget,⁴⁵⁵ and only 5 percent deposited in a conversion foundation for the health care needs of the poor. "The deal was protested as a shallow attempt by [Governor] Pataki to curry favor with a 200,000-member union headed by Dennis Rivera, one of the most powerful labor leaders in the state and one of its most influential Hispanic figures. Pataki, indeed, later received the union's endorsement for his re-election bid."⁴⁵⁶

None of the traditional parties complained about this removal of an expected \$1 billion in value from the nonprofit to the public sector. Apparently, the Empire board had its eyes on its future operations as a for-profit business (they would no longer have controlled the conversion proceeds in any case). The Attorney General's motives for not opposing the result are unknown, although Eliot Spitzer has a reputation for being politically ambitious.⁴⁵⁷ Consumer groups were furious, but faced the threshold issue of whether they had standing to complain in court—indeed, under the legislation, the courts are deprived of jurisdiction to enjoin the transaction, as explained below.⁴⁵⁸

453. *Id.*

454. On January 25, 2002, the Governor signed Chapter 1 of the Laws of 2002, codified as N.Y. INS. LAW § 4301(j) (McKinney Supp. 2004) (permitting certain not-for-profit health care corporations to convert to for-profit corporations) and N.Y. INS. LAW § 7317 (McKinney Supp. 2004) (establishing the process and standards for the superintendent of insurance's review and approval of a proposed conversion plan).

455. The legislation designates 95 percent of the stock to fund "work-force recruitment and retention." According to the subsequent Consumers Union complaint:

82. The remaining 95 percent of the conversion proceeds is treated as a Public Asset and required to be deposited in a "Public Asset Fund" managed by a five member board appointed by the Governor, Senate Majority Leader and Speaker of the Assembly, and paid over to the Director of the Budget for deposit in a Tobacco Control and Insurance Initiatives Pool, from which in excess of \$700 million dollars, more than two thirds of the anticipated value of Empire, is required to be paid to hospitals, nursing homes and certain personal care agencies to fund pay raises for their nonmanagerial health care workers over a three year term.

Complaint, Consumers Union, Inc. v. State of New York at ¶ 82, No. 118699/02 (N.Y. Sup. Ct. 2002).

456. Editorial, *The Empire "Heist"*, J. NEWS, Aug. 31, 2002, at 8B; see also Elizabeth Greene & Meg Sommerfeld, *\$1-Billion Conversion Plan Draws Criticism in N.Y.*, CHRON. PHILANTHROPY, Jan. 24, 2002, at 25; James C. McKinley, *Before Bills Move in Albany, 3 Leaders Cut Deals in Secret*, N.Y. TIMES, Oct. 21, 2002, at A1.

457. The governor's insurance commissioner commented: "What you would have had is 12 to 15 board members appointed by the Attorney General doling out money as they see fit . . . Now what you have is the duly elected members of the Legislature, who represent districts all across the state, determining what the health care purposes should be." A spokesman for the attorney general claimed "unusual circumstances," and denied that this action "sets rock-solid precedent." Andrew Metz, *Conversion's Missed Chance*, NEWSDAY, Jan. 19, 2002, at A8.

458. The *New York Times* reported that a private lawsuit has few legal precedents: "In

On June 18, 2002, Empire filed an amended plan of conversion with the New York State Department of Insurance for approval to convert from a not-for-profit health service corporation to a for-profit accident and health insurance company. Consumers Union charged, among other things, that this "plan would spend 95% of Empire BCBS's resources over three years, instead of establishing a permanent endowment to continue Empire's charitable mission. If instead all the funds were put in a health care foundation, the foundation could award \$50 million in grants to expand health access and coverage per year in perpetuity."⁴⁵⁹

In comments filed with the superintendent of the department of insurance, the attorney general focused on issues of maximizing the value of Empire's stock.⁴⁶⁰ Referring back to the earlier conversion contemplated under the Not-for-Profit Corporations Law,⁴⁶¹ the attorney general asserted that "the Empire Conversion Legislation is apparently silent, as is Empire's Amended Plan, with respect to shareholder rights and other protections of the kind we pursued under Empire's former proposal."⁴⁶² Accordingly, the attorney general concluded, the department of insurance "should approve a conversion plan only if it is accompanied by sufficient shareholder rights and other protections which will ensure that the fair market value is not substantially diminished, and the statutory mandate to 'maximize the value of the public asset' is achieved."⁴⁶³ The attorney general did not comment on the percentages allocated to the State and to the foundation.

Unsatisfied with this course of events, Consumers Union and other parties filed a lawsuit in August 2002 seeking a permanent injunction prohibiting the conversion or, in the alternative, requiring all conversion proceeds to be paid to a foundation that will carry on Empire's charitable mission.⁴⁶⁴ The plaintiffs charged the legislature with engaging in an unconstitutional taking of private property without just compensation and other constitutional violations. As to the actions of the board, the complaint charged: "In their eagerness to secure for-profit status, however, Empire's directors have now chosen to acquiesce in the State's taking of

one case, consumer organizations sued Blue Cross and Blue Shield of Georgia and the state insurance commissioner after the health plan converted to a for-profit. In a settlement in 1998, the conversion went ahead but the health plan agreed to give some assets to a public health foundation." Milt Freudenheim, *Suit Attacks Plan to Change Blue Cross Status*, N.Y. TIMES, Aug. 21, 2002, at B2. See also FREMONT-SMITH & HORWITZ, *supra* note 104, at 7 ("In 1996, the Virginia legislature passed a bill requiring the de-mutualization proceeds to be paid to the state treasury rather than to a new charity. As a result, \$176 million from the conversion of Trigon (Blue Cross and Blue Shield of Virginia) was transferred to the Virginia treasury with the approval of the Attorney General.") (footnotes omitted).

459. Press Release, *supra* note 449.

460. Letter from Eliot Spitzer, Attorney General, New York, to George V. Serio, Superintendent, New York State Department of Insurance, Aug. 2, 2002 [hereinafter Spitzer Letter] (on file with author).

461. See *supra* notes 454-55 and accompanying text.

462. Spitzer Letter, *supra* note 460, at 3.

463. *Id.* at 4.

464. Complaint, Consumers Union, Inc. v. State of New York, No. 118699/02 (N.Y. Sup. Ct. 2002). As to standing, the complaint asserts: "Upon information and belief, no member of the Board of Directors, no appointed member of the corporation, and no public official with authority to require that Empire's Directors act in accord with their fiduciary duty to the corporation, including the office of the Attorney General, has challenged or will challenge the Amended Plan of Conversion as inconsistent with their fiduciary duties." *Id.* at ¶ 141.

Empire's charitable assets. They have thus violated the duties of loyalty, obedience and care which they owe to Empire and its charitable mission."⁴⁶⁵ As to the actions of the attorney general, the complaint charged that "the Attorney General has declined to challenge the Legislation, the actions of Empire's Board, or the taking of Empire's assets by the State."⁴⁶⁶

On September 20, 2002, the attorney general (on behalf of the state defendants) and Empire filed a motion to dismiss, on the grounds that the plaintiffs lacked standing and failed to state a cause of action. On the merits, the attorney general's memorandum in support of its motion quoted the legislation to show that the provisions of the act preempt the ordinary process for adopting and approving the disposition of nonprofit assets:

Notwithstanding any other provision of law, the superintendent's approval of the conversion transaction shall constitute final approval of the transaction and no further authorizations or approvals shall be required. Notwithstanding any other provision of law, sole jurisdiction for any challenge of the superintendent's final determination regarding the conversion transaction shall rest with the New York supreme court and shall be commenced within thirty days of the superintendent's final determination. *Judicial review shall be limited to a determination as to whether the superintendent acted in an arbitrary or capricious manner with respect to reaching a determination.*⁴⁶⁷

As to the plaintiffs' charge of an unconstitutional taking, the attorney general replied that "the conversion by Empire from a non-profit to a for-profit entity does not result in a state taking of anything: it is a voluntary, discretionary decision by those responsible for Empire—the board of directors."⁴⁶⁸ Moreover, Empire's memorandum asserts that the board is insulated from a charge of breach of duty by the statute: "if the Superintendent approves the amended plan of conversion, New York Insurance Law § 7317(f)(ii) effectively declares that the board's decision to authorize the conversion cannot constitute a breach of fiduciary duty *as a matter of law*."⁴⁶⁹

465. *Id.* at ¶ 3. The complaint also charged: "Empire's Directors abdicated and breached their fiduciary duties of care, loyalty and obedience by, inter alia: (i) abandoning the Restructuring Plan which the Board originated in 1997 as best meeting its fiduciary obligations and then pursued through 5 years of regulatory hearings and approvals; (ii) asking the Legislature to substitute its judgment in determining the disposition of Empire's assets; and (iii) ignoring requests to exercise its fiduciary duty and instead simply acquiescing in the Legislature's taking of Empire's value for purposes other than carrying out Empire's mission." *Id.* at ¶ 143.

466. *Id.* at ¶ 97.

467. N.Y. INS. LAW § 7317(f)(i) (McKinney 2002) (emphasis added).

468. State Defendants' Memorandum of Law in Support of Their Motion to Dismiss the Complaint at 26, *Consumers Union of U.S., Inc. v. State of New York*, No. 118699/02 (N.Y. Sup. Ct. 2002).

469. Empire's Memorandum in Support of Defendants' Motion to Dismiss at 25, *Consumers Union of U.S., Inc. v. State of New York*, No. 118699/02 (N.Y. Sup. Ct. 2002) (emphasis in original). Specifically, the statute provides that compliance with the new act shall be deemed to constitute compliance with and shall supercede [sic] all such other legal requirements, including, but not limited to, statutory, common law and any other requirements relating to not-for-profit

In their reply brief, the plaintiffs declared:

It is ironic that the AG cites its own role as "parens patriae" and protector of charitable assets as a basis for denying plaintiffs' standing in this case. . . . Indeed, the unusual circumstances of this case—where the AG has been legislatively defrocked of its parens patriae robe and has been saddled with an irreconcilable conflict of interest by virtue of its statutory obligation to defend legislative enactments—provide an additional basis for plaintiffs' standing. With the AG removed from its customary office as protector of the public's (as opposed to the government's) interest in charitable property, and the Directors walking away from their fiduciary role, no one but plaintiffs remain to stand up for Empire and the charitable mission of its assets.⁴⁷⁰

The plaintiffs refined their "takings" argument by characterizing the legislation as an "unconstitutional condition," in which New York State granted the Empire board's desire to convert to for-profit status on condition that it surrender nearly all of its assets.⁴⁷¹ "When the Directors have been left with no option but to sell Empire's charitable soul in order to save its commercial enterprise skin, this hardly makes their forfeiture 'voluntary.'"⁴⁷²

The November 2002 initial public offering raised twice as much as expected for about 25 percent of the stock of the new publicly traded company, WellChoice, thus doubling the total value of the Empire conversion to \$2 billion.⁴⁷³ And there might be more on the way for the financially-strapped state. *The New York Times* reports:

Now at least two other nonprofit insurers in the state are weighing whether to become publicly traded corporations, handing Albany lawmakers the possibility of two more big windfalls at a time when the state is trying to close a cumulative budget deficit estimated at \$12 billion next year out of a \$90 billion budget. To that end, Mr. Pataki submitted legislation along with his proposed budget on Wednesday that would give blanket authorization to other nonprofit insurance companies to convert to profit-making entities if they wish.⁴⁷⁴

corporations and fiduciary requirements applicable to the board of directors of any company filing a plan pursuant to this section. In addition, and not in limitation of the foregoing, a transaction approved by the superintendent shall be deemed for all purposes to be a transaction that is fair and reasonable to an applicant . . . and the use of proceeds as described herein shall be deemed for all purposes to be a use for a purpose that is consistent with and as near as may be to the purposes for which the applicant was originally organized and subsequently operated.

N.Y. INS. LAW § 7317(f)(ii) (McKinney Supp. 2004).

470. Memorandum of Law in Opposition to Defendants' Motion to Dismiss at 35, *Consumers Union of U.S., Inc. v. State of New York*, No. 118699/02 (N.Y. Sup. Ct. 2002).

471. *Id.* at 36 n.32 (quoting *Dolan v. City of Tigart*, 512 U.S. 374, 316-17 (1994)).

472. *Id.* at 36.

473. Alison Leigh Cowan & James C. McKinley, Jr., *Critics Say Albany Is Wasting Insurance Windfall*, N.Y. TIMES, Feb. 1, 2003, at B1.

474. *Id.*

On March 6, 2003, Judge Gammernan issued a ruling that granted standing to the plaintiffs (including Consumers Union) who faced premium increases, but dismissed all of their enumerated claims on the merits.⁴⁷⁵ The court commented that while the attorney general generally has exclusive standing to enforce charitable assets, anyone with a "special interest" also has standing. Moreover, the court noted that the attorney general is, as required, defending the statute, and so "the beneficiaries . . . are here cast upon their own devices."⁴⁷⁶ However, the court ruled that constitutional claims cannot be raised against the Empire defendants, who are private parties, and refused to find that they violated their fiduciary duties.⁴⁷⁷ The court also dismissed the claims against the state defendants. As to the takings charge, the court elaborated: "Even if it is assumed, without deciding, that plaintiffs have a property interest in Empire's assets [a highly dubious assumption], the claims alleging a taking must fail because the Statute does not require Empire to convert. The Statute presented Empire with a choice, albeit a Hobson's choice, of whether to convert, given the terms that the Statute imposed."⁴⁷⁸ Surprisingly, though, the court identified a new cause of action, allowing the plaintiffs thirty-days to amend their complaint to invoke a provision of the New York Constitution barring private laws that grant any single corporation an exclusive privilege or franchise. The judge also extended the stay on the expenditure of proceeds from the sale of stock held by the conversion foundation. On April 1, 2003, the plaintiffs

475. *Consumers Union v. State of New York*, N.Y.L.J., Mar. 12, 2003, at 18 (N.Y. Sup. Ct. Mar. 6, 2003).

476. *Id.* The court concluded:

In any event, the rules limiting standing to enforce the terms of charitable trusts, and the exceptions to those rules, apply to lawsuits brought against the directors or managers of such trusts. Defendants have adduced no case, and I know of none, that holds, or even suggests, that those rules limit the general rules that govern standing to challenge the constitutionality of a state statute. The individual plaintiffs and CU have shown that they, or the members whom they represent here, are likely to suffer injury-in-fact, as a result of the conversion of Empire, which injury will not be shared by the general public. Accordingly, these plaintiffs have standing to challenge the Statute.

Id.

477. *Id.* Specifically, the court ruled:

Inasmuch as plaintiffs' constitutional claims are not, and cannot, be alleged against the Empire defendants, the fifth cause of action, alleging a violation of 42 USC §1983, must be dismissed as against those defendants. As seen above, the Statute supersedes all inconsistent common-law and statutory duties. Consequently, the sixth and seventh causes of action, which allege that the Empire defendants failed to comply with provisions of the NFPCL, and that they violated their fiduciary duties, must also be dismissed. Accordingly, the motion of the Empire defendants to dismiss the complaint, as to them, should be granted.

Id.; see also FREMONT-SMITH & HORWITZ, *supra* note 104, at 5 ("Although the court accepted the characterization of Empire as a charity and the application of trust principles to this case without discussion, it rejected the plaintiffs' claim that the defendants violated their fiduciary duties; it stated, without further explanation, that the State supersedes all inconsistent common-law and statutory duties.").

478. *Consumers Union v. State of New York*, N.Y.L.J., Mar. 12, 2003, at 18 (brackets in original).

filed both an amended complaint and an appeal of Judge Gammernan's ruling.⁴⁷⁹

In October, Consumers Union survived WellChoice's motion to dismiss; while WellChoice promptly appealed, \$418 million from stock sales remain escrowed.⁴⁸⁰ However, the court dismissed the claims against the individual members of Empire's board, a move Consumers Union did not oppose.⁴⁸¹ New York State still owns 70 percent of the stock, an investment that appreciated more than 40 percent as of October 2003.⁴⁸² The state appears on the verge of finding a happy constitutional way out of the court challenge: Another nonprofit health plan, worth as much as \$1 billion, is seeking legislative approval to convert, and the revenue-starved state is salivating over the potential conversion proceeds.⁴⁸³

3. Fallout and Analysis

Planners of other contemplated Blue Cross conversions have reacted to this regulatory climate by abandoning their intentions. Blue Cross and Blue Shield of North Carolina abruptly withdrew its application to convert, purportedly because of delay by the insurance department and the likelihood of unacceptable conditions, including the desire for state influence over appointments to the conversion foundation board.⁴⁸⁴ The attorney general of North Carolina had rendered an opinion that the insurance commissioner generally "has the authority to enter an approval order imposing continuing conditions on the conversion, provided each

479. See James M. Odato, *Lawsuit Deals Another Blow to State in Crisis*, ALBANY TIMES UNION, Apr. 3, 2003, at A1.

480. See Tom Perrotta, *Suit to Challenge Conversion of Empire Allowed to Proceed*, N.Y.L.J., Oct. 2, 2003, at 1.

481. *Id.*

482. See Mary Sisson, *WellChoice Earns Clean Bill of Health; Insurer Is Thriving a Year After IPO*, CRAIN'S N.Y. BUS., Nov. 24, 2003, at 3.

483. See Richard Perez-Pena, *Many Sides Await Deal on Insurer*, N.Y. TIMES, Dec. 22, 2003, at A1. The *Times* reports: "This time, the political forces are far less unified about what to do with the money, and since every member of the Legislature is up for re-election in 2004, the issue is highly charged. No one involved expects the dispute to be resolved easily." *Id.* The story suggests that state interests will likely override the interests of those in New York City, despite claims that the conversion of this entity, HIP Health Plan, might be different from Empire:

[New York City Mayor] Bloomberg administration officials and municipal unions argue that HIP is unique and that the money should not automatically revert to the state. The insurer was created in the 1940's to cover city employees, and while it has long covered other clients, city workers remain a big part of its enrollment. The city and its workers have contributed much of HIP revenues over the years, and four municipal unions are represented on its board. As a result, city and union officials say, they have a particular claim on any conversion money.

Id.

484. See, e.g., Kristi E. Schwartz & Danielle Deaver, *Blue Cross of North Carolina Drops For-Profit Plan: CEO Refers to Length of Process, Possibility of More Restrictions*, WINSTON-SALEM J., July 9, 2003, at A1 ("[CEO Bob] Greczyn said that the trustees were worried that the insurance department would want to directly appoint many of Blue Cross' board members, interfere with the board's management responsibilities, impose rate caps and limitations and push for the release of such confidential business information as membership and financial projections.").

condition is reasonably related to the accomplishment of one or more of the legislative goals found in the conversion law."⁴⁸⁵ According to press coverage, the public was pleased with this outcome, although some lamented that failure to sell would mean no new conversion foundation.⁴⁸⁶ Of course, the same dollar cannot be counted twice, and one conversion opponent commented: "No foundation is worth making 2.8 million people in North Carolina pay substantially more for their health coverage."⁴⁸⁷ Other opponents are not done: They're seeking reform legislation to make Blue Cross "act like a nonprofit," even though the North Carolina Blue Cross is not chartered as a charity.⁴⁸⁸

Regulators nationwide are sharing information on these events—the June 2003 meeting of the National Association of Insurance Commissioners hosted a Blue Cross Blue Shield Conversion Working Group.⁴⁸⁹ Maryland's success in imposing nonprofit status on CareFirst:

also has heartened officials at the Washington State Hospital Association, which filed a lawsuit in January to block the proposed conversion of Premera Blue Cross "Now there's mounting evidence from other states that these conversions have negative consequences and should be denied," said [one advocate]. "This may be the beginning of a trend."⁴⁹⁰

485. Power of Commissioner to Approve Conversion Plans with Conditions; Limits on Conditions, Office of the Attorney General of the State of N.C. (Feb. 18, 2003), available at 2003 N.C. AG LEXIS 2.

486. For example, an editorial in the Durham *Herald-Sun* identified the "down side to stay not-for-profit. Conversion would have spun off an independent health care foundation valued at more than \$710 million in Blue Cross stock. Now that won't happen, and it's a big loss for the state." Editorial, *Blue Cross Should Get More Scrutiny*, HERALD-SUN (Durham), July 10, 2003, at A8.

487. Anne Krishnan, *Limits Kill Blue Cross Change*, HERALD-SUN (Durham), July 9, 2003, at B1. In the meantime, the state, anticipating the conversion, had enacted legislation requiring Blue Cross to pay the same state tax rates as other insurance companies—for an estimated total of \$18.6 million more this year. "They're going to be stuck with that one," commented one state senator. *Id.*; see also David Rice, *Reaction in Raleigh Mixed to BCBS Decision*, WINSTON-SALEM J., July 9, 2003, at A1.

488. Jean P. Fisher, *It's Not Over for Blue Cross*, NEWS & OBSERVER (Raleigh), July 10, 2003, at D1. "The question becomes one for the Legislature and whether the Legislature wants to have a company cloaked as a nonprofit that is in effect acting as a for-profit," said Peter Kolbe, general counsel for the N.C. Department of Insurance. "That's not something we have the authority to deal with now that the conversion has been pulled." Anne Krishnan, *Scrutiny of N.C. Insurer Not Over*, HERALD-SUN (Durham), July 9, 2003, at A1. This story concludes: "The DOI currently doesn't have the authority to make Blue Cross lower its premiums or its profit margins, Kolbe said. Regulators achieved the rate stabilization program in 1986 as the result of 'arm twisting,' he said." *Id.*

489. See *As Consumers Wield Influence, Blues Conversions Don't Go As Smoothly*, BESTWIRE, June 23, 2003.

490. Laura B. Benko, *Curtain Falls: CareFirst Settlement Dims Hope for Blues Conversion*, MOD. HEALTHCARE, June 16, 2003, at 14; see also Alan Greenblatt, *Regulators Say No to the Blues*, GOVERNING MAGAZINE, June 2003, at 44. The Washington State conversion might also be vulnerable to an as yet unspecified charge by a whistleblower. See Laura B. Benko, *Out In the Open: Long-Secret Whistleblower Suit Could Harm Premera's Attempt to Go For-Profit*, MOD. HEALTHCARE, Aug. 18, 2003, at 18.

Even where a Blue Cross plan had previously switched from nonprofit to for-profit, the state might find that a sale is not in the public interest (i.e., in the interest of its policyholders). Notably, the Kansas Supreme Court unanimously upheld the decision of the insurance commissioner (and now governor) to reject the conversion of the state's (now for-profit) Blue Cross plan to a stock corporation and subsequent sale to Anthem, Indianapolis.⁴⁹¹ Most recently, New Jersey's largest health insurer called a halt to its two-year project of conversion.⁴⁹²

As mentioned above, the Blue Cross conversions can be difficult to fit into the general charity-state relationship. Moreover, as the court's opinion in the Empire case reveals, applying normal doctrine leads to the unsatisfying legal result that neither the state nor the governing board acted illegitimately, and that there is no avenue for obtaining judicial relief. Technically, the conversion legislation was not a "taking" because the Empire board voted to accept its terms. Nor, in the abstract, could the board's decision to transfer the conversion proceeds to the state be attacked—after all, charitable purposes have always included relieving the burdens of government. One is left with the abiding reservation, however, that this transfer was not made voluntarily by those with an interest in any other outcome—that is, the board was not going to be in control of the conversion proceeds, and was simply looking forward to when it could operate more efficiently in proprietary form. The question remains, then, of the appropriate beneficiary class: the subscribers, the uninsured and underinsured, the needy, or some other group—and who decides?

CONCLUSION

The state—at the first instance through its attorney general—has the obligation to provide oversight of the charitable sector. Where discretion is conferred on a charity's board, proper state enforcement action over fiduciary decisionmaking reduces to a single rule: The role of the attorney general and courts is to guard against charity fiduciaries' wrongdoing, and not to interfere in decisionmaking carried out in good faith. To this end, an attorney general is vested with the authority to seek to correct breaches of fiduciary duty that have not otherwise been remedied by the board. However, the attorney general is not a "super" member of the board.

Complicating the issue, the talisman of donor intent seems to permeate decisions over all of a charity's activities, regardless of the other sources of charity assets, and how small a percentage of those assets might consist of donations. (It is

491. *Blue Cross and Blue Shield of Kan., Inc. v. Praeger*, 75 P.3d 226 (Kan. 2003). "In 1992, BCBSKS terminated its nonprofit status and became a mutual insurance company. In order to extinguish its charitable obligations, BCBSKS made a one-time special payment of approximately \$75 million for charitable purposes which was judicially approved." *Id.* at 231. Immediately following the high court's decision, the entity announced that it was abandoning plans to seek to affiliate with a larger plan, prompting the director of the Kansas Medical Society to declare: "It keeps a pretty precious asset—a homegrown Kansas insurer—here." Associated Press, *Kansas Blue Cross-Blue Shield Won't Seek New Anthem Offer*, DOW JONES NEWSWIRES, Aug. 7, 2003.

492. *Horizon Blues: Staying Nonprofit Is Better for the Company*, BESTWIRE, Aug. 25, 2003. The State of New Jersey might be unhappy with this outcome. *The New York Times* has suggested that "New Jersey . . . is said to be intrigued by the New York-Empire deal." Cowan & McKinley, *supra* note 473, at B1.

sometimes also asserted that the public is entitled to a say over the use of the assets because of the indirect public contribution through tax exemption.) The law needs to clarify the extent to which donor intent can bind the charity beyond the immediate terms of the gift, and who gets to decide. That is, is a determination to alter the purposes of a charitable corporation a matter for the board, to be reviewed only for abuse of discretion?

Is there any way to take politics out of the mix? To what extent is it desirable to do so? Proposals have emerged from time to time to create a variously-conceived "charities board," either at the state level⁴⁹³ or at the federal level.⁴⁹⁴ Joel Fleishman recently revisited this debate by urging:

For the long-run good of the sector, we cannot continue to rely on an inadequately staffed and insufficiently powerful IRS, the vagaries of inadequately staffed and usually not-very-interested offices of state attorneys general which, in any event, have difficulty in policing a sector which routinely crosses state and national boundaries many times a day, the limited scope and vision of voluntary watchdog agencies, the new information-providing organizations, and the investigatory, inflammatory press.⁴⁹⁵

More recently, James Fishman set forth a detailed proposal for improving charity accountability through the creation of local charity commissions of "unpaid citizens, eight appointed by the governor and seven by the attorney general":

The commissions would serve under the control and guidance of the state attorney general. . . . The charity commissions would be public-private partnerships which would be imbued with a legal and moral authority that a wholly private body or state agency could not engender. They also could serve an educational or remedial, norms inculcation function more easily than a governmental enforcement agency alone.⁴⁹⁶

However, creating a new body has risks of its own: each regulator's particular

493. See Avner Ben-Ner, *Who Benefits from the Nonprofit Sector? Reforming Law and Public Policy Towards Nonprofit Organizations*, 104 YALE L.J. 731 (1994) (book review); Karst, *supra* note 41, at 476-83.

494. See Commission on Private Philanthropy and Public Needs (Filer Commission), *Commentary on Commission Recommendations*, in 1 FILER COMM'N RESEARCH PAPERS 38 (U.S. Treas. Dep't ed., 1977); see also David Ginsburg et al., *Federal Oversight of Private Philanthropy*, in 5 FILER COMM'N RESEARCH PAPERS 2640-44 (U.S. Treas. Dep't ed., 1977); Adam Yarmolinsky & Marion R. Fremont-Smith, *Preserving the Private Voluntary Sector: A Proposal for a Public Advisory Commission on Philanthropy*, in 5 FILER COMM'N RESEARCH PAPERS 2857 (U.S. Treas. Dep't ed., 1977); Regina E. Herzlinger, *Can Public Trust in Nonprofits and Governments Be Restored?*, 74 HARV. BUS. REV. 97 (1996).

495. Joel L. Fleishman, *Public Trust in Not-for-Profit Organizations and the Need for Regulatory Reform*, in PHILANTHROPY AND THE NONPROFIT SECTOR IN A CHANGING AMERICA 172, 185 (Charles T. Clotfelter & Thomas Ehrlich eds., 1999). The closest we come to a national charity regulator is the Internal Revenue Service, although I note that the IRS focuses its resources on issues relating to the rules of tax-exemption; is generally indifferent to geographic location; and operates more as a bureaucracy than do those attorneys general who are more influenced by immediate political considerations.

496. James J. Fishman, *Improving Charitable Accountability*, 62 MD. L. REV. 218, 272-73 (2003).

priorities can lead to over-regulation in some cases and under-regulation in others.⁴⁹⁷

So, whose public does a charity serve? This Article does not reach the substance of that question, but rather focuses on the process. I argue that this decision is legitimately made by private parties—donors, charity boards, and members—and so a charity's public is not necessarily the local community, the state, or any other public that constitutes the constituents of an attorney general, a legislature, or a judge. Still remaining is an examination of how such private parties wrestle with the difficult issues of setting the mission for and governing the charity—within the scope of a properly constituted and administered legal regime.

497. See Brody, *Accountability and Public Trust*, *supra* note 47. Professor Sidel has a more benign view of the political process:

[T]he representational choices of the attorney general in the Hershey struggle, and the fact that the Attorney General had to make such choices, were not necessarily inappropriate given the limited institutional actors available for oversight and supervision of the nonprofit sector, the importance of public perception and views in the actions of the sector, and the indisputable fact that we have chosen to retain oversight and enforcement of the charitable system within the political realm rather than handing it over to purportedly "non-political" charity commissions or boards.

Sidel, *supra* note 163, at 34 (footnote omitted).