Key Learning Objectives

By the end of this chapter, the reader will be able to

• Provide an overview of the organization of the healthcare delivery system.
• Explain the most common legal structures of healthcare entities and how those structures affect the organization and operation of the entities.
• Understand the selection and roles of leadership positions in an organization.
• Address licensing and accreditation requirements for organizations.
• Describe several ways that organizations can be reorganized, changed, or closed.

Chapter Outline

2-1 What Are the Key Characteristics of the Six Types of Organizations?
2-2 How Are Governing Bodies Selected, and What Is Their Role and Responsibility?
2-3 How Are CEOs Selected, and What Is Their Role and Responsibility?
2-4 What Are the Licensing and Accreditation Requirements for Healthcare Organizations?
2-5 What Are the Issues When an Organization Is Converted from One Type into Another?
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2-7 What Are the Issues When an Organization Closes or Relocates a Hospital or Other Delivery Location?
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Introduction

Most health care is delivered within an organized system. Given the clinical and regulatory complexity associated with our system, a well-ordered business or corporate structure is essential for safe and effective delivery of healthcare services. A hospital, practitioner office, or other healthcare organization is a legal entity that derives both its powers and limitations on those powers from its legal structure. Thus, it is essential to understand both the choice of legal entities and related powers of each entity. A hospital or other healthcare entity can be one of six types of organizations: governmental entity, nonprofit corporation, for-profit corporation, partnership (limited or general), limited liability company ("LLC"), or sole proprietorship. There are also special organizations that combine features of more than one of these types. In some cases, the hospital or healthcare organization is not a distinct entity, but is a wholly owned component or division of an entity that is one of these types.

The organization of most healthcare entities, regardless of their type, includes a governing body and a chief executive officer (CEO). Most hospitals also include an organized medical staff. The governing body ("board") has the ultimate responsibility and authority to establish goals and policies, select the CEO, and appoint medical staff members. The board delegates responsibility and authority to the CEO to manage day-to-day business. This delegation provides the CEO some discretion in exercising authority. However, for the most part, the CEO manages the organization in accordance with policies approved by the board. The organized medical staff is delegated responsibility and authority to maintain the quality of medical services, subject to ultimate board responsibility. The duties, authority, liability, selection, and rights of the board, CEO, and medical staff are discussed in more detail in this chapter and in Chapter 5 “Medical Staff.”

A typical, community hospital is a unique organization because many decisions concerning use of its staff, equipment, and supplies are made by physicians who may be employees or agents of the hospital. Physicians are often legally independent of the hospital and accountable primarily through the organized medical staff. Some physicians are employees of hospitals, medical groups, or other entities. Changes in the relationships between physicians and hospitals occur periodically, depending on an organization’s strategic plans, marketplace business dynamics, and regulatory issues.

Changing utilization, payment rules, market conditions, and changing government requirements often drive organizations to voluntarily or involuntarily change their legal structures. Such changes are accomplished through conversions, mergers, consolidations, sales, and other restructurings. In some cases, changes occur through dissolution, closure, relocation, and bankruptcy.

This chapter focuses predominantly on hospitals, but the same principles generally apply to other healthcare organizations.

2-1 What Are the Key Characteristics of the Six Types of Organizations?

The powers and governance structure of a healthcare organization are derived from its legal basis, which also imposes limitations on those powers. Some states do not permit certain forms of ownership. The Rhode Island Supreme Court ruled that the state could ban ownership of healthcare facilities by corporations with publicly traded stock. The Arkansas Supreme Court ruled that ownership of retail pharmacies by nonprofit hospitals could be banned.

A healthcare organization’s powers usually cannot be expanded without changing the underlying legal basis. Moreover, many additional limitations are imposed by government regulations or by private actions, such as restrictions imposed by accepting gifts and bequests, or in the contracts entered into by the organization.

As mentioned previously, the six, basic types of organizations are:

- Governmental entity (2-1.1)
- Nonprofit corporation (2-1.2)
- For-profit corporation (2-1.2)
- Partnership (2-1.3)
- Limited liability company (2-1.4)
- Sole proprietorship (2-1.5)

2-1.1 Governmental Entity

The legal basis of governmental hospitals is found in state and federal statutes and in local ordinances. Many governmental hospitals are not corporations. They are created by a
special statute for the specific hospital or by a governmental unit, pursuant to a statute authorizing such units to create hospitals. For example, some counties and cities create hospitals under laws authorizing counties to establish hospitals. However, some governmental hospitals, such as some public hospital authorities, are considered corporations.

These statutes often include specific duties or limitations. In some states, county hospitals are required to care for indigent residents. In 1997, a Colorado court ruled that hospital service districts in Colorado can only provide care directly; they cannot contract with other facilities to provide the services. Some county hospital statutes prohibit purchases from board members and restrict how and to whom hospital property can be sold or leased. Illinois law gives county commissioners the power to establish a limit on expenditures by county hospitals regardless of the source of funds. Asset transfers, facility leases, and joint ventures of public hospitals with private corporations have been challenged. In 2000, the Tennessee Supreme Court ruled that a county hospital was a quasi-governmental entity and the state constitutional restrictions on lending credit were not applicable to quasi-governmental facilities. Therefore, the hospital could enter a jointventure and guaranty financing for a building project without voter approval.

When a governmental entity acts outside its authority, its actions are usually void. For example, a Missouri court ruled that a hospital district created for certain counties could not operate a home health agency outside those counties. The North Carolina Supreme Court ruled that a three-year contract with a public hospital administrator was unenforceable. The board's authority to enter long-term contracts had been revoked by implication when it adopted a resolution of intent to transfer control to a nonprofit corporation. The Missouri Supreme Court ruled that a bank could not collect on certain debts that a public hospital had endorsed because the hospital did not have authority to endorse them. In some states, governmental hospitals are subject to open meetings and open records laws. For example, a Minnesota appellate court ruled that a county hospital board could not give the CEO a private performance evaluation because of the state open meetings law. States vary as to whether open meetings and records laws apply to governmental hospitals that are leased to or operated by private entities.

2-1.2 Corporations

A corporation is a separate, legal entity distinct from the individuals who own and control it. In the past, each corporation was created by an individual act of the state legislature, granting articles of incorporation. In some states, nonprofit corporations were created under judicial petitions filed by citizens. Today, states have general corporation laws that authorize a state official to create a corporation by issuing articles of incorporation. Legislatures in most states can still create some corporations, especially public corporations. So some corporations do not have articles of incorporation; their legal authority is the statute creating them.

One legal benefit of incorporation is that each owner's liability is generally limited to that owner's investment in the corporation. Usually, an owner is not individually liable beyond this investment, except when the owner causes the injury by personal acts or omissions; fails to observe the corporate formalities; personally guarantees the corporation's debts; or is involved in situations where special statutory liabilities apply, such as environmental and pension laws. The corporation itself is liable to the extent of its resources, which include the owners' investments in that corporation.

To maintain corporate status and the attendant immunity from personal liability, there must be compliance with corporate formalities, such as filing required reports with the state, holding required meetings, and maintaining required records.

Another benefit of incorporation is corporate perpetual life. Death of an owner does not terminate the corporation; only the ownership is changed.

Unless the corporation is tax-exempt or elects another special tax status, the corporation must pay taxes on its earnings. But, in most situations, the owners do not have to pay personal income tax on corporate earnings until the earnings are distributed to them.

Corporations can be nonprofit or for-profit.

**NONPROFIT CORPORATIONS.** The earnings of a nonprofit corporation cannot be distributed for the benefit of private individuals.
Many healthcare corporations in the United States were created as nonprofit corporations. In addition, most of those corporations also are exempt from federal income taxation. Therefore, it is important to understand basic principles and rules that apply to nonprofit, tax-exempt corporations.

Many nonprofit healthcare institutions are also charitable organizations, and many are exempt from some taxes. However, these characteristics are not always linked. The corporation must engage in charitable activities as defined by state law in order to be considered a charity. Some tax exemption usually results from charitable status, but the two are not always linked. In some states, charities are subject to an implied charitable trust to carry out their purposes and protect charitable assets. The charitable trust doctrine is a basis for state challenges to certain actions by a charity.

Nonprofit corporations are held to various standards of public accountability. In most states, the state attorney general or other officials can take steps to compel nonprofit corporations to meet those standards. This issue arises most frequently when a nonprofit corporation seeks to sell or otherwise convert some or all of its assets to a for-profit organization. Examples of challenges to these transactions are discussed later in this chapter. Some states require state approval before nonprofit corporations may engage in certain transactions. In other cases, nonprofit corporations voluntarily seek prior approval to avoid the risk and delay involved with such challenges. For example, in 2002, under state charity laws, the Massachusetts Attorney General approved a complex deal that was designed to continue the operation of a hospital through a sale-leaseback arrangement.

There are limits to a state's control over entities incorporated in other states. For example, in 2003, a Kansas judge ruled that the Kansas Attorney General could not challenge how a Missouri nonprofit corporation compensated its CEO in the sale of the corporation to a for-profit hospital. However, when an out-of-state nonprofit corporation plans to sell assets located in a state, some states where the assets are located will exercise oversight of whether such sales can occur and how the proceeds are used. In 2003, the South Dakota Supreme Court ruled under the Implied Charitable Trust Doctrine that the state could restrict the transfer of out-of-state proceeds from the sale of a hospital in South Dakota. In 2004, a settlement was reached in which a $1.8 million payment was divided among five communities.

FOR-PROFIT CORPORATIONS. A for-profit corporation is operated with the intention of earning a profit that can be distributed to its owners. A for-profit hospital is sometimes called an investor-owned, or proprietary hospital.

For-profit hospitals can be owned in various ways. Some are closely held by a small number of investors. Some are wholly owned by a multihospital system or other parent corporation. The parent can then have publicly traded stock that can be purchased through the equity markets. The stock of some hospitals has been owned by their employees' pension plans through an Employee Stock Ownership Plan (ESOP). In some cases, the parent owns only part of the stock in the hospital, and other local investors, sometimes physicians, own the remainder. Sometimes, the ownership of a hospital is structured as a partnership, which will be discussed later in this chapter.

Securities laws and shareholder rights. There is extensive federal and state regulation of the offering and sale of stock and partnership interests. The details of securities laws, shareholders rights, and other restrictions on for-profit corporate behavior are beyond the scope of this book. Shareholders have various rights, including access to corporate books and records and the right to challenge the failure of a corporation to disclose important information that could affect the value of the shares. Corporate officers and other insiders can be held personally liable when they purchase or sell shares based on important information that only they know, but have yet to disclose to other shareholders and the public. Securities laws require that a formal filing be made before certain transactions.

Sarbanes-Oxley Act. The degree of public scrutiny and regulation of corporations increased substantially in 2002. After a series of corporate scandals, Congress enacted the Sarbanes-Oxley Act (SOA). This law directly applies only to companies with publicly traded stock. Full compliance is very costly; as such some smaller publicly traded companies elected to become private. However, some companies (both nonprofit and private for-profit) are not subject to the law, and have voluntarily elected to comply with some of the Act's provisions to achieve confidence of the public, lenders, bondholders, donors, and others relying on the integrity of the governance and financial status of the institution. A few states have passed laws extending to nonprofit corporations certain requirements that are similar to some of the Sarbanes-Oxley requirements.

Recurring corporate finance scandals, involving publicly traded companies, prompted Congress to pass the Sarbanes-Oxley Act.
Section 101 of SOA establishes a Public Company Accounting Oversight Board to register, regulate, and inspect accounting firms. Section 107 provides for the oversight and authority of the Securities Exchange Commission (SEC). Section 103 establishes auditing, quality control, and independence standards for auditing firms. Section 104 requires inspections of auditing firms. Section 105 provides investigation and disciplinary procedures for auditing firms. Section 108 specifies when the SEC is authorized to recognize accounting standards.

Section 201 prohibits auditing firms from providing many nonauditing services contemporaneously with an audit, unless they are preapproved by the company's audit committee. Section 203 requires that the lead auditor must change at least every five years. Section 204 specifies certain items that auditors must report to the audit committee. Section 206 precludes the use of any auditing firm that employed individuals in the prior year and who then become key officers of the audited company.

Section 301 specifies the composition of the company's audit committee and requires that the committee members be independent, which means that they cannot be paid fees by the company other than a fee for being on the board. Moreover, they cannot be an affiliated person of the company or any subsidiary. The audit committee must be responsible for the appointment, compensation, and oversight of the auditing firm. The audit committee must also have authority to engage independent advisers. Section 906 requires the CEO and the CFO of the company to certify that financial statements comply with requirements and that each periodic report "fairly presents, in all material aspects, the financial condition and results of operations" of the company. A knowing and intentional violation gives rise to liability. Section 303 makes it a crime to fraudulently influence, coerce, manipulate, or mislead an auditor in an effort to make the financial statements materially misleading. Sections 304 and 305 specify various penalties for violations, including barring a violator from serving as an officer or director of any publicly traded company.

Section 401 specifies additional disclosures that must be made in financial reports, including off-balance sheet transactions and other relationships with consolidated entities that might have a material effect on the financial condition of the company. Section 402 prohibits nearly all personal loans to executives and directors. Section 403 requires reporting of certain transactions with officers, directors, or 10 percent owners. Section 404 requires each annual report to include an internal control report by the management and an attestation by the auditing firm. Companies are required to disclose their codes of ethics and any change or waiver of that code. Section 409 requires prompt public disclosure of information on material changes in the financial condition or operations of the company.

Title VIII extends whistle-blower protections to employees who lawfully disclose information.

The details of the SOA and its implementing regulations are beyond the scope of this book.

Taxation. In standard for-profit corporations, there is so-called double taxation of income through the tax on the corporation and the tax on the individual shareholder when dividends are distributed to the shareholders. This double taxation does not apply to corporations that qualify as Subchapter S corporations; they are taxed similar to partnerships with their income being taxed to the individual owners and not at the company level.

MULTIHOSPITAL SYSTEMS. Many hospitals, both for-profit and nonprofit, are part of multihospital systems. For financial and liability reasons, each hospital is usually owned by a distinct entity, and those entities are owned or controlled by a parent corporation. The parent corporation generally retains control over many aspects of the hospital to take advantage of size efficiencies and to achieve other organizational goals. Nonetheless, the parent usually leaves some business decisions to local control by the individual hospital. Various structures are used to ensure that the parent corporation retains control over other entities within the health system.

An example of this control is illustrated when a parent company's board of directors ousted the board at one of its hospitals and substituted itself as the board for the local hospital. The local board had been opposing a merger that the parent favored.

ARTICLES OF INCORPORATION. The powers of a corporation include only those powers expressed or implied in the articles of incorporation. Some corporations have articles that limit the type of business the corporation can conduct. When a hospital corporation plans to start a new line of business or abandon a present activity, the articles must be examined. Many modern corporations have articles that do not limit the scope of their activities; the articles authorize any business that a corporation can lawfully conduct. Other corporations might find it necessary to amend their articles before substantially changing their scope of business.
Some hospital corporations have articles of incorporation that limit them to hospital-related activities. Activities that provide services for patients, their families, and other visitors, (e.g., gift shops and parking lots) usually are considered hospital-related. The scope of hospital-related activities has tended to expand.

**EXPRESS CORPORATE AUTHORITY.** Any corporation derives authority to act from the state that creates it. The articles of incorporation state the corporation’s purposes and create its express powers to carry out those purposes. State corporation laws also grant some express authority. Activities performed within the scope of this express authority are proper, while expressly prohibited acts are improper.

**IMPLIED CORPORATE AUTHORITY.** In addition to express authority, implied powers are inferred from corporate existence. Examples of implied authority include the power to have a corporate seal and perpetual existence; to enact corporate bylaws; and to purchase and hold property. For some corporations, these powers can be enumerated as an express authority.

Corporations have implied authority to do any acts necessary to exercise their express authority and to accomplish corporate purposes. While the act need not be indispensably necessary, the act must tend to accomplish the corporate purpose in a manner not otherwise prohibited by law. Benefit or profit to the corporation alone is usually not sufficient.

**CONSEQUENCES OF ULTRA VIRES ACTS.** When a corporation acts outside its authority, the act is said to be ultra vires. In some states, an ultra vires contract cannot be enforced. Therefore, courts will not require the parties to perform acts specified in the contract. Courts will not order payments for injuries that result from nonperformance of acts that are “ultra vires” of the corporation’s authority.

In other states, the defense that an action was ultra vires has been abolished, so these contracts can be enforced, unless a corporate member or the state obtains an injunction to prevent performance of ultra vires acts. For example, the South Dakota Supreme Court ruled, in 2003, in the case of *Banner Health System v. Long*, that the not-for-profit corporation was not allowed to transfer its own proceeds in the form of charitable assets across state lines. The court ruled against Banner Health, after it had sold 27 of its healthcare facilities for the purposes of reinvesting assets in other nonprofit organizations in Colorado and Arizona. That sale met with strong opposition from attorney generals in New Mexico, South Dakota, and North Dakota that argued those charitable assets should remain within the community. Although Banner Health strongly believed that it had authority for the sale and transfer of proceeds, the Supreme Court ruled otherwise, and concluded that the actions were “ultra vires.”

In another example, a California appellate court ruled that the articles of incorporation required a nonprofit corporation to continue to operate a hospital, so the board was barred from leasing the hospital and using the rent to operate clinics. Ultra vires acts can also justify revocation of the articles of incorporation by the state, thus dissolving the corporation. If an ultra vires act is already completed, courts will normally permit the act to stand, unless the state intervenes. The state may obtain an order for the corporation to reverse the ultra vires act by disposing of property, discontinuing services, or taking other steps.

Some courts have imposed a stricter standard on nonprofit corporations because of the public interest in their charitable activities. For example, in New York, a nonprofit hospital is required to obtain judicial approval before selling the bulk of its assets. A New York City hospital entered a contract to sell its assets and agreed to pay the purchaser its out-of-pocket expenses of $800,000 if the court did not approve the sale. In 1999, the court found that the sale did not meet the statutory tests and denied approval. When the purchaser sought to collect its out-of-pocket expenses, the hospital refused to pay, and the purchaser sued. The lower courts ruled that the court’s disapproval of the transaction had rendered the entire agreement void, so no money was owed. The highest court reversed this decision and returned the case to the lower court to determine whether the agreement to pay the purchaser was fair, reasonable, and in furtherance of the not-for-profit’s purpose. If the lower court found this to be the case, then that provision of the agreement would be valid and the money would be owed. If the court found otherwise, the provision to pay the out-of-pocket expenses would be beyond the hospital’s authority and invalid.

**CHANGING CORPORATE DOCUMENTS.** Articles of incorporation and bylaws are changed for many reasons, including:

1. authorizing expansion into new activities;
2. reorganizing the corporation; and
3. adapting to other environmental changes.

Corporate document changes can be made if proper legal procedures are followed and if other corporate members are treated fairly.
Articles of Incorporation. When changing basic corporate documents, there is a duty to deal fairly with other members of the corporation. If this duty is violated, changes can be declared void. An Arizona court ruled that an amendment to the articles of incorporation was void because of the unfair way it was adopted. A few hours before the vote on the amendment, the board designated 159 new corporate members from among their associates so that, together, they would have more votes than the sixty physicians who were the other corporate members. Although the board had the authority to appoint new members, the court found the appointment of the new members, plus the way their proxy votes were used, to be unfair.

In some states, the legislature that creates the corporation reserves the power to amend the articles of incorporation. The highest court of New York upheld a legislative amendment to the articles of a hospital requiring outgoing board members to be replaced by persons selected by the remaining board members, rather than by a vote of the corporation’s membership.

Bylaws. Corporations adopt bylaws to define certain elements of their internal operations. Bylaws cannot expand the authority of the corporation. Bylaws can describe how corporate authority will be exercised and by whom.

The corporate bylaws describe how corporate authority will be exercised and by whom.

Bylaws can describe how corporate authority will be exercised. Corporations have broad powers to change their bylaws if they comply with the procedures and restrictions in their articles and in state corporation law. In an Illinois case, the Illinois Supreme Court ruled that, because the corporate articles did not forbid the change, a board could amend its bylaws to change the election process for board members and, instead, provide for the selection of replacement board members by present board members.

Agreements not to change corporate documents. In some circumstances, hospitals can enter enforceable agreements not to change their corporate documents. In 1998, at the request of the state attorney general, a Rhode Island court issued a temporary restraining order prohibiting a hospital from changing its corporate bylaws, allegedly contrary to promises made when the attorney general approved a prior hospital merger.

2-1.3 Partnership

A business can be organized as a partnership of several individuals or organizations.

One benefit of a partnership is that income tax is paid only by the partners; no separate income tax is paid by the partnership, avoiding the double taxation effect that applies to income of most for-profit corporations. A limited liability company (LLC) also avoids double taxation. (See Section 2-1.4.)

It may be more difficult to arrange partnership affairs to survive the death or withdrawal of a partner, when compared to the transfer of shares in a corporation. Often, partnerships are structured so that one or more partners have an option to buy out others or to require others to buy them out.

One disadvantage of the partnership is that there is no limit on the potential liability of general partners. However, the potential liability of some partners can be limited by creating a “limited partnership.” Limited partners are only liable to the extent of their investment, provided they do not participate in the management or operation of the business or interfere with control of the partnership business. Physicians and others who invest as limited partners in hospitals need to limit their involvement in control of the business, unless they are willing to accept the risk of unlimited liability, beyond any insurance coverage that may be in place. There must be at least one general partner whose liability is not limited. Usually, the general partner is a corporation. In multihospital systems, the general partner is usually controlled by the parent corporation.

Liability of general partners can include criminal liability. A New York court ruled that, without any showing of individual culpability, the forty-two partners in a hospital could be charged in an indictment alleging that the hospital permitted an unauthorized person to participate in a surgical procedure and falsified records to conceal the crime.

Partners owe duties to each other. For example, a Texas court ruled that a general partner had a fiduciary duty to notify a limited partner before selling partnership assets.

Some states permit limited liability partnerships (LLPs) that permit partners to fully participate in management and operations, while limiting their individual liability for their partners’ acts to their investment in the partnership.

2-1.4 Limited Liability Company (“LLC”)

LLCs are increasingly common in business.

Some states have authorized the formation of LLCs that function like partnerships, without personal liability of the participants for the acts of the company. Similar to
The most important duties of a board member are the “duty of care” and the “duty of loyalty.”

DUTY OF CARE. The duty of care generally requires that board members be informed and make good faith decisions intended to further the organization’s purposes. Board members must exercise the degree of diligence, care, and skill that an ordinarily prudent person would in similar circumstances. The details of the standard vary among the states and can also differ somewhat between governmental, nonprofit, and for-profit boards.

While board members are sometimes called trustees, they are usually not held to the strict standards of a trustee of a trust. Instead, they are judged by the standard applicable to directors of other business corporations. Trustees of trusts are generally liable for simple negligence. Directors of business corporations are generally not liable for mere negligence in exercising their judgment concerning
In some settings, the business judgment rule might not apply. For example, in 2003, the Maryland Insurance Administration Commissioner reviewed the proposed conversion of the nonprofit CareFirst health plan to a for-profit entity, followed by acquisition by another for-profit network. The Commissioner ruled that the business judgment rule did not apply in the regulatory review, so he did not have to show deference to the board's judgment concerning the public interest. The board was vested with a public trust to address the economic value of the enterprise as a public asset. The Commissioner found that the valuation process used by the board was deficient, and therefore, the board had not used the requisite due diligence. The reorganization was not approved, and the state adopted legislation exerting more control over CareFirst. When the national Blue Cross organization sought to withdraw use of the Blue Cross trademark, the state reached a settlement modifying some of the state control.

The duty of due care requires each board member to fulfill membership functions personally. The board member must attend meetings and participate in the consideration of matters before the board. All board members assume responsibility for board decisions that they do not oppose. Board members cannot bargain away their duties, nor can they act in ways that would indicate direct, reckless disregard of their fiduciary duty of care. A Minnesota court declared void an agreement by two individuals not to take part in hospital management if elected to the board. A District of Columbia court found that delegation of investment decisions to a committee of board members without any supervision by the board was a failure to use due diligence.

Board members can rely on information and data provided by others, as long as the reliance is reasonable and prudent under the circumstances. When directors know that those presenting the information are not disclosing all relevant information or know that they have a conflict of interest, they have a duty to challenge the information.

The Sarbanes-Oxley Act, discussed earlier in this chapter, places more focus on board responsibility for ensuring appropriate financial controls. The law places this responsibility directly upon directors of publicly traded companies. Preservation of assets. The general duty to act with due care requires reasonable steps to preserve assets from injury, destruction, and loss. Prudent judgment must be exercised to decide and plan how to protect property. That duty can extend to maintenance, adequate insurance, and other protections. The duty applies beyond land, buildings, equipment, and investments to include rights under contracts, wills, and other legal claims and protection against liability losses. In some circumstances, it may be prudent to sell the organization's assets. Such sales are discussed later in this chapter.

Some healthcare organizations have complete or partial immunity from liability based on their governmental or charitable nature. In some states, liability insurance might not be necessary, but purchasing liability insurance is seldom considered beyond the board's authority. Sometimes, purchasing insurance waives immunity from liability, to the extent of the insurance coverage.

The board has a duty to ensure that taxes are paid. The board should treat tax exemption status as a corporate asset, to be preserved and protected like other corporate assets. There are circumstances where it may be prudent for the board to decide to relinquish tax-exempt status, as it might another corporate asset, if that decision is likely to further the purposes of the corporation.

The board should ensure that the organization's rights are being enforced. This includes collection of bills for services and authorizing appropriate legal suits when justified. The board has a corollary duty to defend the organization from claims. The board must act reasonably under the circumstances. Some claims are not worth pursuing, or should be settled out of court. The board's duty generally will be satisfied if the board conforms to sound business practices.

Basic management duties. The board has general authority to manage the organization's business. This authority is absolute when the board acts within the law. Courts generally leave questions of policy and internal management to board discretion. When departure from board duties is clear, courts will intervene.

Some of the basic management functions of the board include:

1. selection of corporate officers and other agents;
2. general control of compensation of such agents;
3. delegation of authority to the CEO and subordinates;
4. establishment of policies;
5. exercise of businesslike control of expenditures;
6. providing for planning; and
7. supervision of and vigilance over the welfare of the whole corporation.

Authority to manage the business can be delegated to the CEO or to committees. In practice, much authority is expressly or implicitly delegated. If authority is not delegated or is not conferred on officers by statute or by the articles or bylaws, the board is generally the only body authorized to exercise that authority and to represent the organization. The board has no obligation to delegate any management functions. Any delegation of policy-making functions is subject to revocation by the board at any time. If revocation breaches a contract, the organization might have to pay for injuries caused by the revocation.

The board cannot delegate its responsibility as a board. The power to delegate authority is implied from the business necessities of managing corporations. To avoid abdicating its responsibility, the board should have some procedure to oversee the use of delegated authority.

The board has inherent authority to establish organizational policies. The board can directly exercise this authority by adopting rules, or it can delegate the authority. An example of this policy-making power is a Georgia Supreme Court decision upholding a hospital rule requiring all computerized tomography (CT) scans of hospital patients to be performed with the internal hospital equipment, not with external equipment. Similarly, the Arkansas Supreme Court upheld a hospital rule prohibiting mega-dose vitamin therapy for allergies. A Florida appellate court upheld a board rule that the surgeon, not the anesthesiologist, makes the final decision on whether to attempt emergency surgery. Hospital CEOs, their subordinates, or hospital committees are often permitted to make policies or formulate rules and regulations.

The duty to provide satisfactory patient care is an essential element of the board’s duty to operate the healthcare organization with due care, applying equally to for-profit and nonprofit organizations. Through fulfillment of this duty, the basic purpose of the organization is accomplished. Actions required by this duty extend from the purchase of suitable equipment for patient treatment (subject to the organization’s financial ability) to the hiring of competent employees. Two important required actions are:

1. selection and review of the performance of medical staff, and
2. selection and supervision of a competent chief executive officer.

The board has the duty to select medical staff members as part of its duty to manage the organization and maintain a satisfactory standard of patient care. The board, while cognizant of the importance of medical staff membership to physicians, must meet its obligation to maintain standards of good medical practice in dealing with matters of staff appointment and discipline.

The Darling Hospital case established an important precedent for the duties of a hospital board.

In 1965, the Illinois Supreme Court ruled in the famous Darling case that a hospital board has a duty to establish procedures for the medical staff to evaluate, provide advice, and, where necessary, take action when an unreasonable risk of harm to a patient arises from the treatment being provided. In 1981, a Wisconsin hospital was found liable for failing to exercise due care in evaluating and checking the claimed credentials of an applicant for medical staff membership. This has evolved into the corporate liability doctrine discussed in Chapter 11 “Civil and Criminal Penalties.” Hospitals should have appropriate procedures for evaluating the competency of candidates for staff appointments and for determining privileges to be given to physicians. Hospital responsibilities and physician rights concerning medical staff matters are discussed further in Chapter 5 “Medical Staff.”

DUTY OF LOYALTY. The board’s duty of loyalty requires directors to act in good faith and in a way that they reasonably believe is in accordance with the best interests of the corporation. Good faith is generally a subjective requirement that looks at the person’s motivation. Reasonable belief in the best interests of the corporation is both a subjective and objective test. Some of the ways that the duty of loyalty can be violated include seizing corporate opportunities, self-dealing, and not disclosing conflicts of interest.

Duty of obedience. Part of the duty of loyalty for nonprofit healthcare organizations is the duty of obedience to the purposes stated in the hospital’s charter. It is not always sufficient that the assets continue to be used for any charitable purpose. They generally need to be used for the stated charitable purpose.

Corporate opportunities. A board member who becomes aware of an opportunity for the corporation has a duty not to seize that opportunity for private gain unless the corporation elects not to pursue the opportunity. On November 12, 1993, the Boston Children’s Heart Foundation charged
Dr. Bernardo Nadal-Ginarde on the misappropriation of corporate funds in excess of $6.562M. Dr. Nadal-Ginarde had been President of the board to BCHF and Chairman for the Department of Cardiology. One of many charges involved him setting his BCHF salary without disclosure to the Board. Ultimately, the court decided in favor of BCHF, and also awarded BCHF two-thirds of the costs of the litigation. Another example of inappropriate seizure of a corporate opportunity involved a professional service corporation that contracted to provide services to a hospital in Illinois. While the corporation was negotiating with the hospital to continue the contract, one of the two board members of the corporation created a competing corporation that contracted with the hospital to provide the services. The court found the new contract was an improper seizure of a corporate opportunity, violating the duty of loyalty to the first corporation.

Not all opportunities are subject to this rule. In 1996, the Delaware Supreme Court ruled that there was no duty to present an opportunity to a corporation when the corporation could not afford the opportunity. As healthcare organizations become involved in corporate ventures with competitors and place their officers on the boards of those corporations, they should structure the relationship so those corporations cannot claim a right to corporate opportunities that the healthcare organization identifies.

Self-dealing. Self-dealing is a contract between the corporation and an entity in which a board member has a financial interest. Statutes in some states specifically forbid some types of self-dealing transactions. One state makes it a crime for trustees or officers of a public hospital to own stock in any company that does business with the hospital. Forbidding all self-dealing can be disadvantageous to the hospital because sometimes the most advantageous contract is with a board member or with a company in which a board member has an interest. Unless there is a statutory prohibition, most healthcare organizations permit contracts between the corporation and a board member if (1) the contract is fair; (2) the interested board member does not speak or vote in favor of the contract; and (3) the board member makes full disclosure of all important facts concerning the interest, including both favorable and unfavorable facts. Courts generally believe the disinterested remainder of the board is able to protect corporate interests.

Courts have the power to declare any self-dealing contract void. On June 25, 2010 Culver Hospital Holdings had a preliminary injunction against defendants, Prospect Medical Holdings, Inc. and Prospect Hospital Advisory Services, Inc. In the beginning all companies had engaged as shareholders with Brotman Medical Company who issued promissory notes. However, Culver, being the minority shareholder, claimed that the majority shareholders were in breach of their fiduciary duties. Most allegations involved Culver claiming that the majority shareholders manipulated Brotman Medical Companies to let them have an unfair involvement with the representation, interests, and control of promissory notes given to all shareholders. For example, there were allegations of self-dealing amongst the majority shareholders related to the promissory notes and the contract terms of certain service agreements. In the end, the court found that no such claims could stand up in court and the injunction was reversed with appeal costs going back to the majority shareholders, Prospect Medical Holdings, Inc. and Prospect Hospital Advisory Services, Inc.

In a South Carolina case, two board members challenged the sale of hospital land to another board member. Although the purchaser did not participate in the final vote on the sale, a board member who was his business associate actively participated. The court declared the sale void because the board members did not meet the standard of loyalty. If the fairness of the contract is questioned, the burden of proving fairness falls upon the board member with the financial interest. For example, the North Carolina Supreme Court required those involved to prove the fairness of a lease of an entire hospital to one board member.

Courts sometimes adopt a strict view of the responsibility of board members of governmental entities. An Arkansas court held that a laundry service contract between a board member and a governmental hospital was improper, even though the board member’s bid was the lowest bid. The court allowed the hospital to pay the fair value of services already performed. Membership on the board of a governmental hospital is a public office. Many courts consider the danger of conflicts of interest of public officers to justify holding all contracts between board members and governmental hospitals improper and invalid even when otherwise advantageous to the hospital. However, the Mississippi Supreme Court ruled that it was not a violation of ethics or the prohibition of contracts with state officers for a public hospital to grant a physician board member medical staff membership and clinical privileges.

Conflict of interest. Conflict of interest is closely akin to self-dealing. There might be a case where no actual self-dealing is involved; however, nondisclosure of conflicting interests can result in statutory penalties or breach of common law fiduciary duties. Boards should require periodic disclosure of all potential conflict of interests.
One of the most extensive judicial discussions of duties of hospital board members concerning self-dealing and conflicts of interest arose out of Sibley Hospital, a nonprofit hospital in the District of Columbia. The board had routinely approved financial arrangements made by two members, the treasurer and the CEO. When the CEO died, the other trustees discovered that substantial hospital assets were in bank accounts drawing inadequate or no interest and the banks were associated with several board members.

The court ruled that board members have a general financial responsibility and breach their duty to the hospital if they (1) fail to supervise actions of persons to whom responsibility for making those decisions has been delegated; (2) allow the hospital to conduct a transaction with a business in which they have a substantial interest or hold a significant position, without disclosing their interest and any facts that would indicate such a transaction would not be in the hospital’s best interest; (3) vote in favor of or actively participate in decisions concerning transactions with any business in which they have a substantial interest or hold a significant position; or (4) fail to perform their duties honestly, in good faith, and with a reasonable amount of care and diligence. Although the court found that the board members had breached their duty, it did not remove the members from their positions. Written financial procedures and policies were required, and board members were required to disclose their interests in financial institutions with which the hospital dealt. Written financial statements were to be issued to the board before each meeting. In addition, the court required newly elected board members to read the court’s directions.

In 1999, a Delaware court ruled that the board of a health company could be sued for failing to disclose the motives behind an asset sale that favored the majority shareholder. This breach of the duty of loyalty placed the action outside the immunity granted to the directors by the company charter.

Board membership on healthcare entities can be an important service to the community and a rewarding experience, but the days are past when board membership can simply be an honor or a reward for past contributions to the organization. It is increasingly important for board members to be attentive to their duties.

In the healthcare industry, there are several joint publications by the Office of Inspector General of the Department of Health and Human Services and the American Health Lawyers Association that address the responsibilities of boards and directors. Those titles include:

- Corporate Responsibility and Health Care Quality (2007)
- The Health Care Director’s Compliance Duties: A Continued Focus of Attention and Enforcement (2010)

Those publications are intended to help educate board members of healthcare organizations in carrying out their duties and compliance program oversight obligations. The documents emphasize many points, including an increasing focus on quality of care. For example, the 2007 document referenced above states that a director’s obligation to monitor organizational quality of care arises from the following bases:

- Basic duty of care and the director’s obligation to oversee day-to-day corporate obligations. Imbedded in the duty of care is the concept of reasonable inquiry. In short, directors should make inquiries of management to obtain information necessary to satisfy their duty of care.
- The related duty to oversee the compliance program.
- The duty of obedience to corporate purpose/mission.

2.2.2 When Can Board Members Be Personally Liable for Their Actions Related to the Healthcare Organization?

CRIMINAL LIABILITY. Board members may be found individually liable for crimes. A federal court affirmed criminal convictions of several members of a county council that served as the county hospital board. They were found culpable for soliciting and receiving kickbacks from architects in return for awarding contracts for a hospital project financed with federal funds. Each board member was sentenced to one year in prison.

A Texas hospital board member was indicted for violating the state open meetings act, but charges were dropped when she agreed to probation.

CIVIL LIABILITY. As discussed earlier, under the “business judgment” rule, board members usually are not liable for simple negligence in exercising their judgment concerning corporate business. Instead, liability is imposed for “gross or willful negligence.” The “business judgment” rule offers board members wide latitude for actions taken in good faith.
The business judgment rule was applied to hospital board members in the Sibley Hospital case. In that case, board members were not personally liable for the money lost while hospital funds were earning inadequate interest.

Board members sometimes are named as individual defendants in malpractice suits involving hospitals. A board member is generally not personally liable for medical malpractice, unless the member participated in or directed the wrongful act that caused the injury. A South Carolina court ruled that board members could not be sued for a patient’s death during an operation due to erroneous installation of a medical gas system in which the oxygen and nitrous oxide lines were crossed. The court stated that board members would not be personally liable, even if the plaintiff’s claims were true. Those assertions included that board members failed to hold meetings, oversee hospital management, and confirm inspection of the medical gas unit. While the hospital could be found liable for the consequences of the crossed lines, the individual board members could not be found liable. However, when a corporate officer or director knows that the corporation is violating a standard of care and fails to take any action, the officer or director can be personally liable. A District of Columbia court ruled that a corporate officer of a clinic could be personally liable to a person harmed by overnight treatment. The treatment was prohibited by local law, and the officer knew of the practice and did nothing to stop it.

Some federal laws impose personal liability on directors. Directors can be personally responsible for the costs of environmental cleanup of lands owned by the corporation. Board members have been sued under federal law for alleged misuses of pension funds. Sometimes, shareholders bring suits against board members of for-profit corporations.

LIABILITY LIMITS, INDEMNITY, AND INSURANCE. State laws may limit liability exposure of directors of nonprofit corporations for their actions as directors. For example, Illinois forbids suits against uncompensated directors unless their actions are willful or wanton. Even though the liability exposure of board members is limited, defense of these suits can be costly. It is not reasonable to expect board members to serve unless the corporation protects them from defense costs and from liability for good faith actions. Corporations generally can indemnify directors for defense costs, judgments, fines, and other expenses resulting from civil or criminal actions. To do so, the directors must act in good faith and reasonably believe their actions to be lawful and in the corporation’s best interests. Many hospitals purchase insurance to protect board members from these costs. This insurance is generally called directors and officers (D&O) liability insurance. However, some D&O insurance policies might not provide the protection they appear to provide. A federal district court ruled that one officer’s misrepresentations in the insurance application invalidated the coverage for all directors and officers.

If litigation occurs, selection of defense counsel is very important. The person being defended wants a good defense, and the entity wants the fees to be reasonable. In 1999, a Delaware court dealt with a case where the entity paying the defense counsel misused its authority to select defense counsel. The entity coerced the executive, who was charged with wrongdoing, to accept a weak defense. The Delaware Supreme Court found this to be a violation of the indemnity agreement.

2-2.3 How Are Board Members Selected and Removed?

SELECTION OF BOARD MEMBERS. Board members are selected in several ways. Many boards are self-perpetuating. Vacancies are filled by replacement members selected by the remaining board members. Some boards are elected by stockholders or corporate members. Board members for governmental hospitals are frequently elected by a vote of the people in a governmental subdivision or appointed by elected officials. Usually, terms of office are staggered so that all members are not replaced at the same time. Experienced members can provide continuity of governance. If board members are not selected in accordance with applicable laws, articles of incorporation and bylaws, courts can declare board actions void. In a Tennessee case, board members were not selected as specified in the articles, and several members did not satisfy membership qualifications. As a result, the court declared a board vote to transfer ownership of the hospital to the county to be void. In 1997, a New York court ordered a new board not to act. That board was elected by a committee established by the CEO. The court authorized the existing board to act until the next annual meeting.

Composition of the board is one of the factors that the Internal Revenue Service (IRS) uses in determining whether a nonprofit corporation is eligible for tax exemption. Therefore, nonprofit hospitals need to consider IRS guidelines in selecting board members. At least one legislature has controlled the composition of boards. West Virginia requires 40 percent of the board
of each nonprofit or local governmental hospital to be consumer representatives selected in equal proportions from small businesses, organized labor, elderly persons, and lower-income persons. Special consideration must also be given to women, racial minorities, and the disabled. Failure to comply can result in loss of the hospital’s license, a fine, or imprisonment. Federal courts have ruled that the statute is constitutional. Sometimes, board composition becomes an issue in litigation or in state challenges to mergers or other corporate transactions. In 1997, a settlement of a California challenge to alleged self-dealing by directors included an agreement that four directors would resign, the board size would be expanded, and more persons would be made eligible to participate in selection of new directors. In 2003, the hospital chain, HCA, Inc., entered a settlement with state pension funds that included an agreement that at least two-thirds of its board would be independent directors.

REMOVAL OF BOARD MEMBERS. Sometimes a board tries to remove a member. The procedure specified in the articles and bylaws must be followed. In New Jersey, a private hospital board member must be provided with notice of the reason for the action and an opportunity to be heard even if the articles and bylaws do not require these steps. In an Oregon case, the court affirmed the removal of a public hospital board member by the board of county commissioners after he was provided with notice and opportunity to be heard. The court ruled that substantial evidence supported the commissioners’ decision that the member’s lack of candor caused a lack of trust, which diminished his effectiveness as a board member. That was sufficient reason to remove him from the board.

Some board members are removed by public vote. In 2001, it was reported that the behavior of one board member of a California public hospital led to the hiring of a security guard for meetings, installation of a microphone cutoff system, and restrictions on her entering the hospital. In the 2002 election, she was voted out of office.

There are many reasons why boards might want to remove members. Board members who do not attend meetings generally can be removed. Sometimes medical staffs seek to remove board members. In 1997, a California hospital removed two physicians from the board after the physicians filed suit to have the board dissolved.

Sometimes the state attorney general or regulatory agencies seek to change board composition. For example, in 2003, the Minnesota attorney general sought to install additional members on the board of a health system. The system opposed the effort. A compromise was reached where the board agreed to accept an additional person as an adviser, rather than as a board member.

2-3 How Are CEOs Selected and What Is Their Role and Responsibility?

The CEO of the hospital is concerned with all the topics covered in this book. The CEO’s personal intervention probably will be required when certain legal problems arise. In this section, the CEO’s duties, authority, qualifications, and personal liability will be covered.

DUTIES. The CEO is directly in charge of the organization and is generally responsible only to the governing board, but can be responsible to systems officers when the organization is part of a larger system. The CEO is the general supervisor of all operations, and the board delegates to the CEO the authority to fulfill this responsibility. Although areas of responsibility are usually delegated to subordinates, the CEO is primarily responsible for management. The CEO is the agent and usually the employee of the governing board and is subject to its superior authority. Even when the CEO is also a board member or a part owner, the CEO is a board agent and has a duty to carry out board policies.

Many healthcare facilities are part of a larger organization. Both for-profit and nonprofit organizations apply systemwide policies concerning many aspects of management. To promote efficiency, the organization often uses shared services, uniform accounting procedures, centralized support services, and other management methods made possible by the umbrella structure. A CEO in a larger system might or might not be an employee of the larger organization, but will be subject to its policies.
CEOs of governmental organizations are usually appointed public officials. Whether they are public officials or hired supervisors, they are held directly responsible to the governmental body that controls the organization. Their conditions of employment can fall within civil service laws or other statutory requirements.

The CEO has duties imposed by law, delegated expressly or by implication by the board. The CEO is usually charged with certain general management duties. By resolution, bylaw, order, or contract, the board can assign the CEO additional duties.

Chief executive officers sometimes have dual roles in which they also serve as board members. When CEOs are nonvoting members, their positions do not present legal difficulties. When CEOs serve as voting members of a nonprofit hospital board, caution is required; CEOs cannot vote on any question concerning their personal status or compensation.

When a new CEO is appointed, there usually is a duty to abide by the contractual and other commitments of the predecessor until he or she is legally terminated. For example, at one hospital, a new president committed an unfair labor practice by refusing to bargain with a union that the predecessor had voluntarily recognized.

In addition to delegated duties, duties are imposed on CEOs by statutes and regulations.

As discussed in Section 2-2 on the board of directors, there is increasing focus on the personal responsibilities of the CEO for financial controls. The Sarbanes-Oxley Act requires the CEO to personally certify financial statements of publicly traded companies. CEOs of all corporations are increasingly expected to focus attention on these areas and to make sure that there are appropriate financial controls in place. CEOs are expected to avoid conflicts of interest.

In addition, CEOs are expected to assure that their institutions maintain an environment that is committed to compliance with legal requirements. An effective compliance program can be one part of this effort.

AUTHORITY. The CEO’s primary source of authority is the governing board. The board delegates to the CEO the duty, authority and responsibility to manage the hospital. Board resolutions or policies usually specify the CEO’s authority or grant special authority to deal with certain problems. Authority can be granted in legal documents governing the hospital, such as hospital articles or bylaws, while some aspects of the CEO’s authority can be covered in an employment contract. State statutes or regulations can provide for certain administrative powers of the office of the CEO.

Authority can be either express or implied. Express authority is a written or oral grant giving the CEO power to accomplish certain objectives. The scope of the CEO’s express authority can be as broad or as limited as the board desires. Implied authority consists of those powers that are conveyed, along with express authority, so that desired objectives may be accomplished. The CEO possesses powers and duties that may be properly delegated. The board cannot delegate authority that it does not possess, and it cannot delegate certain responsibilities that are nondelegable. For example, in most states, the board usually cannot delegate the power to grant appointments to the medical staff, except on a temporary basis.

The CEO can do many things that are not challenged, either because people are unaware of the actions or because people with the right to challenge or forbid them do not do so. A CEO acting beyond authority is subject to several possible legal consequences, including being dismissed by the board in accordance with its established rules; being sued by the hospital for breach of an employment contract and for any resultant financial damage to the hospital; being held liable by employees or other persons for damages resulting from negligence or intentional wrongdoing; and being subject to prosecution for violating criminal laws.

SELECTION, EVALUATION, AND TERMINATION. Governing boards are responsible for selecting CEOs to act as their agents in hospital management. Boards that try to run hospitals without CEOs are subject to extensive criticism and risk legal liability. Some boards use interim CEOs while searching for permanent CEOs. The board must select a competent CEO who will set and maintain satisfactory patient care standards. Minimum standards for CEOs are contained in some hospital licensing statutes and regulations and in some statutes creating governmental hospitals. Where legal requirements exist, the CEO must satisfy those requirements.

After appointing a CEO, the board must periodically evaluate the CEO’s performance. The board may be liable if it fails to exercise proper oversight of the CEO’s performance. When not satisfied with performance, the board should take appropriate action.

When the board is considering replacement of the CEO, it should follow the procedures under applicable state law, the articles of incorporation, and the bylaws.
However, some courts have declined to intervene when bylaws were not followed. For example, in a Louisiana case, a public hospital CEO was terminated without the warning and opportunity to correct deficiencies required by the bylaws. The Louisiana Supreme Court refused to order reinstatement because the CEO could not show that he had been harmed by the deviation from the bylaws.\textsuperscript{118} Similarly, the Minnesota Supreme Court refused to intervene when a CEO was discharged.\textsuperscript{120} The applicable law provided that the CEO served “at the pleasure of the county board,” and he was not entitled to a hearing. In some circumstances, CEOs of public hospitals may be entitled to due process.\textsuperscript{111}

Generally, courts will not order reinstatement of removed CEOs, but the hospital will generally be liable to pay damages when the removal breaches a contract\textsuperscript{122} or is done in an improper manner.\textsuperscript{123} On the other hand, in certain circumstances, some severance packages can be unenforceable.\textsuperscript{124}

Under some state laws, it is possible for someone other than the board or a court to order removal of a CEO. A New York court ruled that the state’s Department of Health had authority to order removal of a CEO for not being sufficiently qualified by education or experience.\textsuperscript{125} In 2002, the board removed the four top administrators of an Arizona hospital when it received a petition signed by 138 hospital shareholders demanding the removal of the executives and threatening recall of the board if it did not act.\textsuperscript{126} Nursing home administrators are another example because they are licensed under state law. This license can be revoked by the state for patient abuse or other violations of the licensing law.\textsuperscript{127}

LIABILITY. CEOs can be criminally or civilly liable for certain actions related to their employment.

Criminal liability. CEOs involved in fraudulent and other illegal schemes can be held criminally liable, similar to those in other industries.\textsuperscript{128} For example, a Florida CEO caused a hospital to issue twenty-one checks, fraudulently endorsed them, and appropriated the proceeds which exceeded $850,000. He was sentenced to twenty-five years in prison.\textsuperscript{129} Embezzlement or bribery also is a federal crime when committed by an agent of an organization that received over $10,000 under a federal program in a one-year period.\textsuperscript{130} A hospital CEO was convicted under this law.\textsuperscript{131} In 2002, a federal appellate court upheld the conviction of a former West Virginia hospital administrator for misusing hospital funds on a shopping center and other ventures.\textsuperscript{132}

Fraudulent schemes can also result in forfeiture of benefits. An Ohio court ruled that a CEO who had embezzled funds forfeited all compensation, including deferred compensation, during the period of culpable conduct.\textsuperscript{133}

Some prosecutors pursue criminal charges against CEOs for treatment of patients. The Wisconsin Supreme Court upheld the conviction of a nursing home CEO for abuse of residents, but reversed a conviction for reckless conduct causing death.\textsuperscript{134} One resident had died of exposure after walking away from the facility. Other residents lost weight and developed bed sores. The state claimed this was due to understaffing by the CEO. Several other nursing home administrators have been convicted of patient abuse or neglect.\textsuperscript{135}

Civil liability. CEOs, like other members of society, can be individually liable for their own wrongful actions that injure others.

A CEO can be liable for injuries caused by a subordinate when the CEO negligently supervises or carelessly hires the subordinate. If not personally at fault, the CEO is not liable for injuries caused by subordinates.\textsuperscript{136} Employers are liable for the injuries wrongfully caused by their employees since the organization is the employer, not the CEO. Likewise, because CEOs are employees of the organization, the organization can be liable for wrongful acts of CEOs. If the organization pays money to an injured person as the result of a lawsuit, it usually has the right of repayment from the employee who caused the injury. Healthcare organizations seldom exercise this right of indemnification beyond the employee’s individual insurance coverage. Liability issues are discussed in Chapter 11 “Criminal and Civil Penalties.”

CEOs are not personally liable for contracts they make on behalf of the organization when acting within their authority to contract. When CEOs engage the organization in contracts that exceed the CEO’s authority to do so, the organization is not always bound by the contract. CEOs can be personally liable to the other party to the contract for loss resulting from the failure to bind the organization. CEOs are not liable if the organization ratifies the contract and adopts it as its own. CEOs generally are not liable for unauthorized acts if: (1) they innocently believe they have authority to make the contract and (2) the organization presents the CEO’s position with such apparent authority that the other contracting parties reasonably believe the CEO has said authority. If the organization creates this apparent authority and innocent third parties are misled, the law imposes...
liability on the organization. If the other contracting parties should have suspected the CEO lacked authority, they are required to make appropriate inquiries. If the inquiries would have disclosed the lack of authority, no recovery is allowed against the organization.

The CEO can be liable to the other contracting parties, even when the CEO has apparent authority, but makes the contract with intent to defraud. In a Mississippi case, an insurance company sought to recover excessive amounts it had paid to a hospital because the CEO had padded bills. The court found both the CEO and the hospital liable to repay overcharges.

CEOs can be liable civilly or criminally for breach of duties imposed on them by statute. For example, when a license or permit is required before the hospital performs certain acts, often the CEO is required to obtain the license or permit. Failure to obtain it can lead to fine or imprisonment. CEOs can also be required to submit certain reports to the state. While hospital CEOs are seldom fined personally for failure to discharge such a statutory duty, the possibility does exist. In a Mississippi Supreme Court case involving the same CEO and hospital as the case discussed here, a state auditor sought to force the CEO and the hospital board to repay county hospital funds that had been spent without authority. The court analyzed each type of expenditure the state auditor claimed to be unauthorized. The court agreed with the auditor’s findings. The CEO and board members were required to make repayment.

Some laws impose personal liability on CEOs. For example, the CEO can be personally liable for unpaid wages under the Fair Labor Standards Act. A New York federal court ruled that a new CEO could be personally sued for sex discrimination for excluding the vice president/chief nursing officer from vice presidential meetings, refusing to meet with her, and firing her.

The federal government and some states have provided some official immunity from personal civil liability for some public officials when following a legal mandate (i.e., performing a “ministerial duty”) or when exercising administrative judgment (i.e., performing a “discretionary duty”). Rules vary considerably, and courts tend to restrict the application of immunity doctrines.

MANAGEMENT CONTRACTS. Some hospital boards have entered into contracts with other corporations to manage their hospitals. The CEO often is provided by the management corporation. The board retains ultimate authority, so no change is required in the hospital’s license in most states. The authority of the board and the contractor should be carefully defined. The board should preserve authority to terminate the contract without significant, financial penalties.

Management contracts may be difficult to terminate. A Mississippi board tried to terminate a management contract after the management company increased hospital rates and revised the hospital budget without the board approval required in the contract. The court ruled that termination was not justified because the board had authority to nullify the action, without terminating the contract.

Hospitals that have or plan to issue tax-exempt bonds need to consider the IRS requirements limiting the length and other features of such contracts.

Often hospitals enter management contracts because of confidence in individuals who own or manage the management corporation. However, they do not want to transfer management oversight to a third party, so they restrict assignment of the contract. Restrictions on assignment of contracts with corporations can easily be avoided by sale of the management corporation’s stock. Unless provided in the contract, the hospital will not be able to terminate the contract if a stock sale occurs. An Alabama hospital sued when all the stock of a management company was sold to another company, despite a prohibition of assignment of the management contract. The court upheld a temporary injunction of transfer of hospital property, and movement of property out of the hospital. Hospitals should not rely on courts to provide these protections. It is prudent to require the management corporation to inform the hospital of all substantial changes in stock ownership and to give the hospital the option to terminate the contract after such a change.
of underlying conflicts in societal goals. There also are private entities that develop standards and accredit institutions that meet applicable standards.

LICENSE. Licensure differs from accreditation in that a license presumes the presence of a governmental authority. Thus, licensure also implies some degree of governmental regulation. For example, the state legislature grants an administrative agency authority to adopt standards hospitals must meet, grant licenses to complying institutions, and enforce continuing compliance. Hospitals are not permitted to operate without a license. Persons who operate hospitals that violate the standards can lose their licenses or be fined or penalized. Numerous other healthcare entities must obtain state and local licenses and comply with licensing standards. Some of the entities that are licensed include health maintenance organizations, nursing homes, ambulatory surgery centers, hospices, home health agencies, and clinical laboratories.

The discussion of licensure of institutions is divided into:

- Authority to license (2-4.1)
- Scope of regulations (2-4.2)
- Inspections (2-4.3)
- Violations and sanctions (2-4.4)

ACCREDITATION. In contrast, accreditation is granted by nongovernmental organizations and usually is not legally mandated. Accreditation is discussed in section 2-4.5.

Medicare’s Conditions of Participation have an important influence on how healthcare institutions structure administrative and clinical functions and delegate authority within the institution.

MEDICARE CONDITIONS OF PARTICIPATION. Medicare also has standards called Conditions of Participation that apply to healthcare organizations including hospitals; immediate care facilities for the mentally handicapped; home health agencies; comprehensive outpatient rehabilitation facilities; organ procurement organizations; rural primary care hospitals; and providers of outpatient physical therapy and speech-language pathology services. The Conditions of Participation frequently are referred to verbally as the “COPs” (with each letter pronounced individually). These are not licensing standards, per se, but healthcare organizations must meet the COPs to qualify for receipt of Medicare payments. The Medicare law provides that hospitals accredited by The Joint Commission (TJC) or American Osteopathic Association (AOA) are deemed to meet most COPs, unless a special Medicare inspection finds noncompliance. Institutions have mixed results in their efforts to use the courts to stop termination of Medicare participation.

OTHER PRIVATE STANDARDS. Some institutions are subject to other private standards that they have voluntarily accepted. For example, hospitals operated by the Roman Catholic Church are subject to the rules of the Church, including canon law. Canon law has played an important role in many of the decisions of these institutions.

2-4.1 Authority to License

State governments have “police power” that grants them authority to regulate healthcare institutions.

LEGISLATION. All states have enacted hospital and nursing home licensing statutes, and many have statutes that license other healthcare entities.

AGENCY ACTIONS. Licensing statutes usually grant an agency authority to adopt standards, grant licenses, and revoke licenses or impose other penalties when standards are violated. Licensing statutes and regulations must be a reasonable exercise of the police power and must not deny due process or equal protection of the laws.

Authority to adopt rules. To be enforceable, agency rules must be within authority properly delegated to the agency by statute. Rules must be adopted using the state procedure for administrative rule-making. This procedure usually includes public notice of proposed rules and an opportunity for public comment before they become final. In some circumstances, emergency rules are exempt from some requirements, but rules can be declared unenforceable when rules are not eligible for the emergency rule process. Some states require additional steps, such as an economic impact statement, before a rule becomes enforceable.

Rules are difficult to challenge if they are within the statutory authority of the agency, do not violate due process by being vague or arbitrary and are adopted through proper procedures. For example, detailed hospital licensing rules were contested in Pennsylvania on the grounds that they were an attempt by the Department of Health to take away “management prerogatives” of hospital boards and administrators. The Pennsylvania Supreme Court decided that the department had statutory authority and upheld the
rules, even though they might supplant part of traditional management authority.150

When rules conflict with statutory law or exceed the rule-making authority granted to the agency, courts will invalidate the rules. For example, in 2004, a Florida appellate court struck down a rule that required supervision of nurse anesthetists in outpatient facilities because the agency had exceeded its delegated authority.151

Not a taking of private property. Most actions that states take under licensing laws have been interpreted not to constitute a taking of private property, so the constitutional requirement of just compensation for takings generally does not apply.152

2-4.2 Scope of Regulations

The scope of licensing regulations varies depending on the entity being regulated.

HOSPITALS. Hospital licensing regulations usually address hospital organization, requiring an organized governing body or some equivalent, an organized medical staff, and an administrator. Regulations can require general hospitals to provide certain basic services, including laboratory, radiology, pharmacy, and some emergency services. Regulations generally require use of adequate nursing personnel. They also can establish standards for facilities, equipment, and personnel for specific services, such as obstetrics, pediatrics, and surgery. Regulations can also address safety, sanitation, infection control, record preparation and retention, and other matters.

Objective versus subjective rules. All standards do not have to be in objective numerical terms to satisfy due process requirements, but some courts are reluctant to uphold overly subjective rules. A New York court found that several nursing home rules violated due process requirements because they were so subjective that they did not provide adequate notice of the conduct required.153

The invalidated rules required sewage facilities, nursing staff, and linen laundering to meet the “approval” and “satisfaction” of the Commissioner of the Department of Health. No objective standard was included in the rules. The court upheld another rule that required nursing staffing be based on “needs of the patients.” The court considered this to be an objective standard because it believed the needs would be “reasonably well identifiable by all competent observers.” Courts recognize that in some areas objective standards either are impossible to develop or, if developed, would be too arbitrary. Thus, courts have upheld enforcement of some subjective standards if fairly applied. This is illustrated by another New York nursing home case in which somewhat vague standards were upheld because the actual violations clearly deviated from the rules’ objective and the agency had provided written explanations of violations to the owners.154

Building integrity. Another focus of hospital licensure is the integrity of hospital buildings. This topic is addressed in Chapter 3 “Regulation of Healthcare Facilities, Equipment, Devices, and Drugs.”

Exceptions and waivers. Administrative agencies usually have authority to permit exceptions to their rules by granting a waiver or variance. Undue hardship can result from unbending application of the rules, and the public’s best interest might not be served by inflexibility. For example, one state required all hospital rooms to have showers for patients. When the rules were written, apparently no one thought of intensive care units where patients could not use showers, so it was necessary for hospitals to obtain waivers until the rule could be changed. Waivers are sometimes needed because some rules, especially building and fire codes, are so complex that individual rules contradict each other when applied to unusual situations. It might be necessary to obtain an official determination of which rule to follow and a waiver for conflicting rules. Waivers also may be necessary to implement innovative practices. Waivers are generally granted only when:

1. there is a substantial need for relief from the rule;
2. the public purpose will be better served by the exception; and
3. the exception will not create a hazard to the health and well-being of patients or others that is excessive in light of the public purpose being served.

Bed count. Hospital licenses usually specify the number of beds the institution is permitted to operate. The license can specify that certain numbers of beds be approved for a specified use. In 1992, a Washington court ruled that a lessee/ operator of a nursing home facility did not breach its lease or other agreements by entering into an agreement with the state agency to reduce its number of licensed beds.155 States usually look to the licensed operator for issues related to licenses. Thus, owners and lenders need to clearly specify in their contracts with operators any limits on their authority to modify the license.

Have regulations gone too far? Sometimes questions are voiced concerning whether the state has gone too far in...
its regulation. Occasionally, courts will ask an agency to reconsider the scope of its regulations. In 1999, a California appellate court ordered a state agency to reconsider regulations that would have required friends of a paralyzed woman to obtain a state license before she could live with them.  

The regulation required any nonrelative to obtain a license before caring for a disabled person. When regulatory agencies act contrary to or beyond the scope of their statutory authority, courts may strike down the regulations. See section 2-4.1 for examples.

2-4.3 Inspections

Generally, licensing agencies have a right to make unannounced inspections of certain licensed entities, including hospitals. Applying for the license is viewed as consent to reasonable inspections, within the scope of the agency's authority. However, some inspections, even with search warrants, can be conducted in such a manner as to violate the rights of those searched. For example, with a search warrant, an agency searched a birthing clinic at 2 a.m., rousting newborns and parents and photographing them. The basis for the search was suspected practice of medicine without a license. A federal appellate court ruled that those involved in the search could be sued for violating the civil rights of the newborns and parents.  

In most jurisdictions, licensing agencies have discretion as to whether and how to inspect. They cannot be held liable for either failure to inspect or failing to discover or correct deficiencies through inspections.

The two basic elements of “due process” are: i. notice and ii. the opportunity to be heard.

2-4.4 Violations and Sanctions

DUE PROCESS. Two fundamental elements of due process are “notice” and “an opportunity to be heard.” Unless deficiencies immediately threaten life or health, the state can close a licensed institution or impose other penalties for licensing law violations only after giving adequate notice of violations and an opportunity to be heard. For example, a New York court ordered the hospital-licensing agency to provide a hearing before deciding not to renew a hospital's license; even though the hospital lacked many basic services.

OPPORTUNITY TO CORRECT DEFICIENCIES. Some state statutes and regulations require licensing agencies to give the licensed entity an opportunity to correct deficiencies before imposing sanctions. Although this opportunity is not constitutionally required, it must be provided when guaranteed by state law. Otherwise, sanctions that are imposed will be invalid, unless immediate action by the licensing agency was justified by deficiencies that threatened life or health.

DEGREE OF VIOLATION AND LESSER PENALTIES. Some licensing statutes recognize that it might not be in the public's interest to revoke a healthcare institution's license for minor violations. These statutes provide a range of lesser penalties, such as monetary penalties, and reserve license suspension or revocation for “substantial” violations. Definitions of substantial violation vary from state to state. However, in every state sufficiently serious violations lead to license revocation.

AGENCY ENFORCEMENT DISCRETION. Generally, agencies have discretion whether to impose penalties authorized by law. Private individuals cannot compel licensing agencies to take action. However, agencies cannot exercise this discretion on discriminatory grounds, such as religion. A federal appellate court permitted the orthodox Jewish operators of a nursing home to sue state officials for allegedly citing their facility for reasons the nursing home viewed as discrimination against their religion.

SCOPE OF JUDICIAL REVIEW. When a licensing agency makes an adverse decision, the institution can generally seek judicial review. In most states, courts will only review the administrative hearing record and generally will not accept additional evidence. Courts will only overrule the agency if the decision was beyond the agency's authority, the agency did not follow proper procedures, or the evidence was insufficient to justify the decision.

CRIMINAL PENALTIES. In addition to fines and license suspension or revocation, some licensing statutes provide criminal penalties for violations. For example, the operation of a hospital without a license can lead to criminal prosecution.

PROTECTION OF THOSE WHO REPORT VIOLATIONS. The law protects persons who report violations to appropriate government agencies. For example, after visiting a nursing home in which they were planning to place a relative, family members reported what they believed to be violations to federal and state officials. The home lost its Medicare and Medicaid eligibility and was not allowed to admit new patients during a state investigation. The nursing home sued the family members, claiming that they had conspired and tortiously interfered with its business
What Are the Issues When an Organization Is Converted from One Type into Another?

Healthcare organizations sometimes change their legal basis and operations. This section discusses some of the legal issues related to conversions between organizational structures. Conversions may be between:

- Private nonprofit and for-profit (2-5.1)
- Public and private (2-5.2)
- Certain types of public organizations (2-5.3)
- Secular and religious organizations (2-5.4)

Many of these conversions stir up controversy and have led to judicial, legislative, and political challenges.

2-5.1 Conversion Between Private Nonprofit and For-Profit

Generally, it is not possible to convert a nonprofit legal entity into a for-profit legal entity. Conversions to for-profit status are accomplished by sale of the business or sale of the assets of the nonprofit entity to a for-profit entity. Likewise, a for-profit entity can sell its business or assets to a nonprofit entity. In the alternative, a for-profit entity can generally be converted into a nonprofit entity if its owners all agree or the contrary minority owners are bought out; in essence, the assets are donated to the charity.
Most of the controversy arises when a for-profit entity takes over a nonprofit facility. The public has contributed to the facility over the years through donations and indirectly through tax exemptions. In most cases, the focus is on whether the price is fair and the public interest will continue to be served. Legal battles have been fought over whether technical legal requirements had been met. Many states have enacted laws that require review and approval of such transactions by state officials, usually the attorney general. For the most part, the focus in such challenges is on fairness of price and ongoing public interest in services.\textsuperscript{170}

Often, after such transactions the nonprofit entity continues and makes grants or supports services with the proceeds from the sale.\textsuperscript{172} These arrangements have generally been upheld.\textsuperscript{172} In 1998, the Kansas Supreme Court upheld such an arrangement.\textsuperscript{172} A church organization founded a hospital and later made the hospital independent to avoid church liability for hospital operations. The church sought to dissolve the hospital corporation after the hospital sold its assets to a for-profit entity. The church wanted a portion of the assets distributed to the church, rather than using the assets for other, local healthcare purposes. The court rejected the challenge.

Nonprofit Blue Cross and Blue Shield plans in many states have been sold to for-profit entities. In some states, this has been controversial. Several states have ultimately permitted the sales to occur.\textsuperscript{174} Some states have barred the proposed sales. For example, in 2003, the Kansas Supreme Court blocked a proposed sale, and it was dropped.\textsuperscript{175}

\textbf{2-5.2 Conversion Between Public and Private}

The legality of the sale, lease, or other transaction that places public healthcare organizations under the control of private entities generally is determined by the scope of the laws that create the public entities. Occasionally, state constitutional principles are invoked to challenge these transactions. For example, a North Carolina court ruled that a county hospital could not be leased to a for-profit management company because (1) there was no statutory authority for the lease and (2) the lease violated a restriction in the deed to the property that would have caused the loss of the property.\textsuperscript{179} A Michigan appellate court upheld the leasing of a county hospital because the patient care management system in the contract fulfilled the county’s duties.\textsuperscript{177} The Kansas Supreme Court upheld the transfer of assets of a county hospital to a nonprofit corporation because the transfer was authorized by statute.\textsuperscript{175} In 1997, the Oklahoma Supreme Court approved a fifty-year lease of the university hospital to a for-profit entity.\textsuperscript{179}

Sometimes the legal analysis focuses on public interest more than on technical statutory issues. For example, the Georgia Supreme Court upheld the restructuring of a county hospital in which the hospital was leased to a nonprofit corporation governed by a board controlled by members of the county hospital authority.\textsuperscript{180} The court found that public hospitals needed to be more competitive and that the lease would enable the hospital to better serve the public health needs of the community.

\textbf{EMINENT DOMAIN.} Federal and state governments have the power to take property for public uses. This is called the power of eminent domain. States can authorize local governmental entities to exercise eminent domain. This power can be used in some circumstances to involuntarily convert a private healthcare facility into a public facility. The Fifth Amendment to the Constitution requires the payment of just compensation in exchange for the property. When there is no agreement on compensation, generally courts set the compensation. Eminent domain can be used to take ongoing businesses as well as land.\textsuperscript{181}

Hospitals are usually confronted with eminent domain only when highway authorities take a strip of land to widen a bordering road or when a public hospital authority takes neighboring land for expansion. There have been a few cases where the taking of whole hospitals has been proposed and even completed. In 1981, the Michigan Supreme Court approved the taking of a neighborhood to build an automobile manufacturing plant. A hospital was taken as part of the project and was demolished.\textsuperscript{182} In 1985, the city and county of St. Louis, Missouri decided that they needed to replace their inner-city public hospitals. Instead of building a new hospital, they proposed to use eminent domain to take a hospital from a for-profit chain and convert it to a public hospital. Faced with the takeover, the chain sold the hospital to a new nonprofit corporation organized by the city and the county to operate the hospital.\textsuperscript{183} In 1991, there was a proposal in Miami, Florida to use eminent domain to take a hospital for public use, but the proposal was abandoned.\textsuperscript{184} In 2002, in California, the newly formed North Sonoma County Hospital District acquired the Healdsburg General Hospital through eminent domain.\textsuperscript{185}

In 1998, a Missouri appellate court ruled that a city could not use eminent domain to take over a nonprofit private hospital after it reduced services and entered a lease to
another operator. The court found the property already committed to a public use and ruled that eminent domain could not be used to convert such property to another public use without specific statutory authority. 186

2-5.3 Conversion Between Types of Public Organizations

Some states have converted hospitals that were state agencies into separate public entities, frequently called hospital authorities. 187 The hospitals remain public, but are governed by a separate public board rather than by the state administrative structure. These reorganizations are usually done to give the institutions more flexibility to deal with market forces than is generally permitted for state agencies.

2-5.4 Conversion Between Secular and Religious Organizations

Conversions from secular to religious and from religious to secular organizations have led to controversies. Some controversies have arisen over control and distribution of proceeds from the transaction. 188 The controversy has often arisen from the desire of religious organizations to prohibit the use of their facilities for certain procedures that violate their beliefs. 189 Religious organizations have had difficulty entering into transactions that result in the loss of that control. 189 However, some sales of religious hospitals have occurred with loss of control. 190 Mergers present more difficulties because religious organizations generally will not participate in the ongoing operations of facilities that violate their beliefs. This has led to community concerns about the loss of the availability of services, especially when alternate providers are not available. 192 In some cases, it has been possible to offer alternate providers.

2-6 What Are the Issues When an Organization Is Merged, Consolidated, Sold, or Dissolved?

MERGER OR CONSOLIDATION. Merger occurs when two or more organizations combine and one organization is the survivor. Consolidation (sometimes, referred to as a merger in a nonlegal sense) occurs when two or more organizations combine and the result is an entirely new organization. 193 In a merger or consolidation, the resulting organization assumes the assets and liabilities of the former organizations.

SALE. As distinguished from a merger or consolidation, an organization or facility can be sold to an entirely new owner. Sometimes the new owner is a large organization, 194 and sometimes it is another local organization. Usually, the organization or facility is sold as an ongoing enterprise, with the buyer assuming the assets and liabilities. Sometimes only the assets are sold, and the liabilities are not assumed. 195 This is often not feasible, if the intention is to continue to operate the facility, due to requirements for new licenses, other regulatory approvals, and Medicare, Medicaid, and other payer contracts.

When the owner of a facility is excluded from Medicare and Medicaid participation, one way for the facility to restore Medicare and Medicaid participation is to change the ownership of the facility to an owner that is not excluded. Sometimes, the Center for Medicare and Medicaid Services (CMS) will permit a facility to participate during a transition period while the sale is arranged, provided the facility is operated by independent management that is acceptable to CMS. 196 PROCEDURES. Proper procedures must be followed in a merger, consolidation, or sale, including procedures required by statutes applicable to constituent organizations, by their articles of incorporation, and by their bylaws. Some governmental organizations have special requirements that can include a vote of the residents of the governmental unit, such as a county. When one or more of the organizations is dissolved in the process, the applicable procedures for dissolution must be followed.

The selection of the proper approach requires a careful analysis that is beyond the scope of this book. 197 Combination or sale of organizations is often difficult in practice due to (1) philosophical differences, especially religious orientations; (2) reduction in the number of leadership positions; (3) necessary changes in established relationships with physicians, employees, suppliers, the community, and others; and (4) the technical complexity of developing an acceptable approach and obtaining necessary approvals.

Some of the legal considerations in developing the proper approach are restrictions in state statutes, articles of incorporation, bylaws, deeds, grants, gifts, loans, collective bargaining agreements, and other legal documents. For example, if certain changes are made, Hill-Burton hospital construction grants must be repaid to the government, 198 some loans can require accelerated repayment, 199 and some
depreciation can be recaptured by governmental payers.202 There are also complex tax and reimbursement implications. One hospital had to take its case to the California Supreme Court to establish that it did not have to pay sales tax on the sale of its furnishings and equipment as part of the sale of all the assets of the hospital.203 Proper notification must be given to licensure, certificate-of-need, and other regulatory authorities, and in some cases licenses, certificates, or permits must be obtained. Some types of changes may even involve federal securities law.

In 1950, the Attorney General of Missouri challenged a proposed affiliation of Barnard Free Skin and Cancer Hospital with Washington University Medical Center that involved relocation of Barnard Hospital.204 The Attorney General asserted that the proposal violated several provisions of the gifts and will of Mr. Barnard that established and supported Barnard Hospital. The Missouri Supreme Court found the affiliation contract to be a reasonable exercise of board powers that did not violate any conditions imposed by gifts and bequests of Mr. Barnard.

In any merger, consolidation, or sale, consideration must be given to antitrust implications.

Dissolution can be voluntarily initiated by the organization. In appropriate circumstances, dissolution of a corporation can be involuntarily initiated by outside parties, such as the state attorney general, shareholders, directors, and creditors.206 A person called a receiver can be appointed to operate the organization during the process of involuntary dissolution. Appointment of a receiver is not limited to dissolutions. For example, as mentioned earlier in this chapter, receivers can be appointed on a temporary basis while a court sorts out who should control the organization.

The corporation continues for a period of time after it ceases to operate the facility so that the affairs of the organization can be concluded. After satisfying any debts and liabilities that have not been assumed by other organizations, the assets of the corporation must be distributed. Some assets might have to be returned to those who gave them to the organization or to others designated by the donor because of restrictions imposed on the grants or gifts. All other assets are distributed under a plan of distribution that might have to be approved by an administrative agency or court. Assets of for-profit corporations are distributed to their shareholders. Assets designated for charitable purposes usually are distributed to a corporation or organization engaged in activities that are substantially similar to those of the dissolving corporation.

Some nonprofit corporations choose not to dissolve after selling their assets. They continue as independent foundations and use the proceeds of the sale of the business for other charitable purposes, such as paying for indigent patient care.207

2-7 What Are the Issues When an Organization Closes or Relocates a Hospital or Other Delivery Location?

A hospital building or other healthcare facility can close:

1. as part of relocation of functions, or
2. without transfer or replacement of the functions because they are viewed as excess capacity or are otherwise not viable.
Some communities have challenged planned closures, causing costly delays. Although courts have seldom found the plans illegal, some of the challenges have resulted in modifications of the plans. It is important to determine community concerns when planning relocations and closures and to consider reasonable accommodations to avoid protracted challenges.218

One example that illustrates the extent of such opposition to closure is the Wilmington Medical Center cases. Two private hospitals in Wilmington, Delaware planned to replace a large portion of their inner-city facilities with one suburban hospital. Various opponents conducted an extensive legal challenge. The plaintiffs claimed that the Medicare law had been violated,219 that the relocation discriminated against minorities in violation of Title VI of the Civil Rights Act220 and against the handicapped in violation of section 504 of the Rehabilitation Act of 1973,217 and that an environmental impact statement was required under the National Environmental Policy Act of 1969.219 A court required the Secretary of the Department of Health, Education, and Welfare (HEW) [now known as the Department of Health and Human Services] to determine whether there had been any violation and report to the court.217 The court ruled that an environmental impact statement was not required because no major federal action was involved.214 The court also ruled that it was constitutional to provide different administrative appeal procedures for recipients and complainants under Title VI and section 504.215 The court ruled that the approval of the project by HEW was not subject to judicial review and that it was constitutional not to provide an appeal mechanism for opponents.215 In the fifth reported decision, the court ruled that there was a private right of action to challenge discrimination that violated Title VI or section 504 and ordered a trial.217 After the trial, the court ruled that the evidence was adequate to justify the reorganization and relocation plans, so they did not violate Title VI or section 504.216

In 1998, a federal appellate court rejected a challenge to a municipal hospital’s relocation of services for disabled children, finding that neither the Rehabilitation Act of 1973 nor the Americans with Disabilities Act guaranteed a level of medical care for the disabled.219

In June 2001, the inpatient services at D.C. General Hospital were closed. The closure was challenged in court by two city council members and a union representing medical residents. In 2001, a federal court rejected the challenge finding that the union did not have standing and the city council members did not state a legal claim because the closure was properly authorized.220

Some courts find that neither patients nor citizens have a right to challenge decisions to close public hospitals.221 However, when a court ordered consultaion with a community board, failure to do so was contempt of court.222

In the 1960s, a New Jersey city sought to enjoin a hospital from relocating outside city limits.223 The court denied the injunction because the hospital had legally amended its articles of incorporation to give the board authority to relocate and the board had found relocation to be in the hospital’s best interests.

Sometimes, a hospital is forced to close. In 2001, Edward- water Medical Center in Chicago closed. Medicare had stopped making payments after a grand jury indicted three doctors, an administrator, and a hospital management firm for an alleged kickback scheme. When a federal judge refused to order reinstatement of Medicare payments, all patients were discharged or transferred and the hospital closed.224

Frequently, public hospitals must obtain voter approval before closing. Some consumer groups have attempted to use these requirements to preclude the hospital from changing its services. For example, a group in Texas sought to bar the closure of an emergency room of a public hospital. The group asserted that closing the emergency room was equivalent to closing the hospital, so the requirement of a vote before the hospital could be closed should apply. In 1984, a Texas appellate court ruled that they were not equivalent, so no vote was required.220

Some states impose a duty on local government to provide certain healthcare services. In 2004, a federal appellate court affirmed a preliminary injunction stopping Los Angeles County from closing a county rehabilitation center or reducing the number of beds at the USC Medical Center. The court said that the proposed closures could violate the state law duty of California counties to provide healthcare services.226

Contractual barriers to closure can also arise. An Arkansas court ordered a corporation to continue to operate a nursing home on a certain property because it had promised to do so in the lease to the property.227 In many circumstances, federal law requires that employees be given sixty days’ notice of closings or large layoffs.228 Employee challenges to closure have generally been unsuccessful.229 However, a federal appellate court ruled that a union was entitled to obtain copies of some transactional documents from a hospital that was closing so that the union could determine worker rights and union responsibilities.226
Care must be taken in carrying out the closure. In 1994, all the patients were discharged from a small Florida hospital, but the hospital did not relinquish its license or its Certificate of Need while it pursued sale or consolidation. The city sued to stop the closure. After the hospital refused to treat an emergency patient, the state initiated proceedings to revoke the hospital license. The owner settled with the state, agreeing to transfer ownership by a specified date or lose the license.219

2-8 What Is the Impact of Bankruptcy Law?

When healthcare entities and those with whom they do business become insolvent, it is important to understand the impact of bankruptcy law. Even large hospital systems can become insolvent and enter the bankruptcy process. In 1998, a multihospital system, the Allegheny Health, Education & Research Foundation, entered bankruptcy.220

There is a specific definition of “bankruptcy” under the law that is important to understand. For bankruptcy purposes, the Federal Bankruptcy Reform Act of 1978 (called the Bankruptcy Code) defines an entity as being “insolvent”...

...when the sum of such entity’s debts is greater than all of such entity’s property, at fair evaluation, exclusive of (i) property transferred, concealed, or removed with intent to hinder, delay, or defraud such entity’s creditors, and (ii) property that may be exempted.221

When a healthcare organization discovers that it is insolvent and cannot work out other arrangements with creditors, it might need to consider bankruptcy to settle its accounts and obligations on an equitable and final basis. Because bankruptcy proceedings are entirely a matter of federal law, they are conducted in the federal district courts under the provisions of the Bankruptcy Code. A petition for bankruptcy can be voluntary (by the debtor) or involuntary (by creditors).

Nonprofit corporations, including charitable hospitals, are not subject to involuntary bankruptcy, so they cannot be forced into bankruptcy by creditors. Domestic insurance companies are not subject to bankruptcy. This restriction has led to numerous cases addressing whether health maintenance organizations and life care facilities are insurance companies and, thus, not subject to federal bankruptcy. The answer depends on how they are treated under state law.222

The only remedy available to creditors of a nonprofit organization or insurance company is through applicable state law proceedings.223 Nonprofit corporations, but not insurance companies, can voluntarily petition to be adjudicated bankrupt. Petitions can be filed with the federal court even after state insolvency proceedings have been instituted.

Bankruptcy does not necessarily require the corporation to dissolve. While bankruptcy under Chapter 7 of the Bankruptcy Code does include dissolution, bankruptcy under Chapter 11 permits the corporation to continue to operate through modification of its operations and debt structure.

Most lawsuits and other actions against a debtor must stop when the petition for bankruptcy is filed. This is called the automatic stay.224 There are some exceptions,225 and there are procedures creditors can follow to seek permission from the bankruptcy court to pursue their suits, which is generally called “relief from stay.”226 There are also restrictions on others changing their relationships with the debtor. For example, a federal appellate court ruled that a malpractice insurance company could not cancel insurance without notice to the court and creditors.227Clauses in contracts that purport to permit termination of the contract if a party becomes bankrupt are not enforceable in most situations.

When the healthcare organization is a creditor, it is important to file in the bankruptcy court most claims against the debtor, or the claims might be lost.

In bankruptcy proceedings, the debtor or bankruptcy trustee has an opportunity to either assume or reject most ongoing contracts.228 This has been most controversial when debtors have sought to reject collective bargaining agreements, so the Bankruptcy Code was amended to permit rejections of collective bargaining agreements only after a court finds that certain conditions exist and approves the rejection or modification.229 Limits have also been placed on the modification of insurance benefits to retired employees.230

The bankruptcy court has broad powers to undo many transactions that occurred before the filing if they are considered to be preferences that favor one creditor improperly or fraudulent transfers that tried to place assets improperly beyond the reach of creditors.231

When a provider continues to operate after filing for bankruptcy, the state Medicaid agency can recoup prior overpayments by reducing current payments. Even though this would be forbidden if done by a private payer,232 in 1989, the U.S. Supreme Court ruled that a state agency can do so. This is because the Eleventh Amendment to the
Constitution grants states immunity from money judgments, even those handed down by bankruptcy courts. The bankruptcy court cannot order the state to make full payment unless the state waives its immunity by filing a claim against the provider.\textsuperscript{245} The U.S. Department of Health and Human Services (HHS) is also permitted to recoup Medicare over-payments.\textsuperscript{246} While bankruptcy courts have broad powers to extend contractual deadlines in some circumstances, they generally cannot extend Medicare deadlines.\textsuperscript{247}

While a debtor is in the bankruptcy process, it must obtain court approval for some major business transactions.\textsuperscript{248} In some cases, the bankruptcy court appoints a trustee to operate the business.\textsuperscript{249}

For the debtor to successfully leave Chapter 11 bankruptcy, the bankruptcy court must approve a plan for its reorganization.\textsuperscript{250} The debtor has the first opportunity to propose a plan. If the plan is not approved, the creditors can develop a plan.

In a Chapter 7 bankruptcy, the assets of the debtor are sold, and the proceeds are distributed to the creditors in a priority order specified by the Bankruptcy Code.

An important aspect of either Chapter 7 or Chapter 11 is that the court can discharge some debts so that the debtor is protected from personal liability on those debts.\textsuperscript{251} Liability for willful and malicious injuries is not discharged in bankruptcy. But in 1998, the U.S. Supreme Court ruled that medical malpractice judgments generally do not fit in this exception, so they are discharged in bankruptcy.\textsuperscript{252}

In 2005, the bankruptcy law was extensively amended to reduce the opportunity for the discharge of debts and to make other changes.\textsuperscript{253}

Another extraordinary power of the bankruptcy court is that it can authorize the sale of property free and clear of prior interests in the property. Thus, it can extinguish liens, mortgages, judgment, writs of garnishment, and the like. The applicability of bias claims and settlement obligations to the property can also be extinguished. In 2003, a federal appellate court upheld a bankruptcy court ruling that the purchaser of the assets of a bankrupt airline company would be free and clear of twenty-nine bias claims against the bankrupt company. Those claims were pending before the Equal Employment Opportunity Commission for ongoing obligations arising out of settlement of prior claims.\textsuperscript{254}

The bankruptcy court has broad latitude in the sales arrangements that can be approved. In 2003, a federal bankruptcy court authorized an auction to sell a hospital in the District of Columbia.\textsuperscript{255}

Healthcare organizations facing insolvency need to evaluate their options in order to avoid personal liability for directors and to use the available bankruptcy proceedings to optimize the outcome. Directors can be personally liable for voting to authorize improper distribution of corporate assets when the corporation is insolvent.\textsuperscript{256} Bankruptcy proceedings can often be used to implement changes that permit the institution to survive.

**Chapter Summary**

This chapter covered many topics that are essential for a basic understanding of legal and business principles that form the foundation for the organization of healthcare resources in America. The topics interrelate to a certain degree. That is because health care is both an essential industry that involves many parties and interests and is also heavily regulated. Therefore, it is important to understand sources of legal authority, such as licensure laws and federal oversight activities, and responsibilities assumed by individuals (e.g., officers and directors) who manage and govern healthcare organizations. The content in this chapter did not require extensive updating, in part, because many of the principles, including those established by certain court decisions, are fundamental to the organization of healthcare organizations. However, it is important to bear in mind how the law changes over time and places specific responsibilities on those who dedicate their working lives to serving patients and overseeing healthcare organizations.
Key Terms and Definitions

**Articles of Incorporation** – A document required to be filed with a government agency, usually the Secretary of State, if the owners of a business want it to be recognized as a corporation. The “articles” (sometimes called a Certificate of Incorporation) must contain certain information, as required by state law.

**Bankruptcy** – A federally authorized procedure that allows a debtor (e.g., person, corporation, or municipality) to discharge all liability for debts in return for making court-approved arrangements for partial repayment. In general, one is “bankrupt” when one is unable to pay debts as they are due (referred to as “cash flow insolvency”) and a court issues a legal order intended to remedy the bankruptcy.

**Board of Directors** – A body of individuals, elected or appointed, who jointly oversee the activities of a company or organization. The board's activities are determined by the powers, duties, and responsibilities typically delegated to the board by the bylaws of the company or organization. In short, the board “governs” the company, but does not “manage” it.

**Duty of Care** – As used in corporate law, this is part of the fiduciary duty owed to a corporation by its directors. It means that a director owes a duty to exercise good business judgment and to use ordinary care and prudence in the operation of the business.

**Duty of Loyalty** – As used in corporate law, this duty requires fiduciaries of the company (principally, its directors) to put the corporation's interests ahead of their own.

**Police Power** – This is the basic authority of governments to make laws and regulations for the benefit of their communities. The police power is granted to the states through the Tenth Amendment to the U.S. Constitution.

**Subchapter S** – A choice, under the Internal Revenue Code, that allows a small corporation to be treated like a partnership for taxation purposes.

**Ultra Vires Doctrine** – In the law of corporations, if a corporation enters into a contract that is beyond the scope of its corporate powers, the contract is illegal.

Instructor-Led Questions

1. What are six types of organizations, and what are their major differences?
2. How do government organizations differ from other organizations?
3. How does government control nonprofit corporations?
4. What rights do shareholders have in for-profit corporations?
5. Discuss the impact of Sarbanes-Oxley on for-profit corporations and nonprofit corporations.
6. What is the source of corporate authority, and what happens when a corporation acts outside that authority?
7. What are the duties of board members? Discuss the “business judgment” rule. When can board members be held personally liable?
8. What are some of the potential self-dealing and conflicts of interest of board members, and how should they be addressed?
9. What are the duties of CEOs, and what is the source of their authority? When can CEOs be held personally liable?
10. What is the difference between licensure and accreditation? What is the role of the Medicare Conditions of Participation?
11. When can licensing rules be successfully challenged?
12. What are the consequences for violating licensing rules?
13. Discuss the issues involved in converting an organization from one type to another. What approvals are usually required?
14. Discuss the issues involved when an organization ceases to exist due to merger, consolidation, sale, or closure. What approvals are usually required?
15. Discuss the issues involved when a service delivery site is closed or relocated. What are the grounds for challenging such changes?
16. What is the effect on the provider and others when a healthcare provider seeks protection under the bankruptcy law?
Endnotes

1 In re Advisory Opinion to House of Representatives, 519 A.2d 578 (R.I. 1987).


7 Rowe v. Franklin County, 318 N.C. 344, 349 S.E.2d 65 (1986).

8 Fulton Nat’l Bank v. Callaway Mem. Hosp., 465 S.W.2d 549 (Mo. 1971); accord Board of Trustees v. Peoples Bank, 538 So. 2d 361 (Miss. 1989) [copier lease void because not approved by purchasing department].

9 Itasca County Bd. of Comm’rs v. Olson, 372 N.W.2d 804 (Minn. Ct. App. 1985).


12 E.g., WIS. STAT. § 165.40 [certain hospital acquisitions].

13 J. Chesto, AG approves Waltham Hospital deal, BOSTON HERALD, May 25, 2002, 20. Unfortunately, the plan did not succeed, and the hospital was closed about a year later. E. Swenneq, Hospital draws last breath: The sad end of an era for patients and employees, BOSTON GLOBE, July 27, 2003, 1.


18 E.g., J. Jacob, Shareholders file class-action lawsuit against United, AM. MED. NEWS, Sept. 7, 1998, 18 [alleged withholding of information about Medicare HMO losses].


22 A.R. Sorkin, Kissing the public goodbye, N.Y. TIMES, Aug. 8, 2004, 48U [first year of Sarbanes-Oxley = 99 public companies became private; second year = 59].


24 E.g., Uniform Supervision of Trustees for Charitable Purposes Act, CAL. GOV. CODE §§ 12581 et seq.


34 15 U.S.C. § 728(j)i.

35 15 U.S.C. § 78j.1m.


43 15 U.S.C. § 78m.l.

44 18 U.S.C. § 1514A.

45 P.A. McKay, Health system trustees oust hospital’s board, WASHINGTON POST, Apr. 10, 1999, V3.
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47 In re Manhattan Eye, Ear & Throat Hosp., 186 Misc. 2d 126, 715 N.Y.S.2d 575 (Sup Ct 1999).


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