HINKLE
LAW FIRM LLC

MEMORANDUM

TO: Jeff Chanay
Chief Deputy Attorney General

FROM: Hinkle Law Firm LLC

DATE: October 23, 2017

RE: Sale of St. Francis Health Center

As requested, this Memorandum represents a high-level, plain-language summary of the legal research and conclusions of our firm. A more detailed report with extensive citations can be made available upon request. We understand that this report may be publicly released by the Kansas Attorney General's Office in conjunction with its final review of the proposed sale of St. Francis Health Center ("SFH") in Topeka, Kansas.

In May 2017, the Kansas Attorney General's Office retained our law firm to analyze whether the Sisters of Charity of Leavenworth Health System ("SCL"), which established and controls the non-profit SFH, may have violated its fiduciary duties or contravened any other state laws when it transferred more than $250 million dollars of SFH's assets to itself to pay off certain bond obligations and other expenses for which it – and not SFH – was responsible in connection with other non-profit hospital facilities in the SCL network. Our analysis did not reveal any viable avenues of liability, particularly in light of SCL's imminent sale of SFH to a joint venture between the University of Kansas Health System and Ardent Health Services.

Part of the difficulty here is the organizational structure between SCL and SFH. SCL is the sole member of an Obligated Group in which it exercises significant control, pursuant to a Master Trust Indenture, over each of its hospital facilities, which it identifies as "Affiliates" or "Restricted Affiliates." SFH is one such Restricted Affiliate. Under the terms of the Restricted Affiliate Agreements, SCL enjoys virtually unfettered discretion to transfer funds to itself from the Restricted Affiliates. In other words, the funds ultimately belong to SCL and not to SFH.

The Restricted Affiliate Agreement does prevent transfers of assets from SFH to SCL if such a transfer would either (i) lead to a cessation or discontinuation of health care or other services previously provided by SFH, or (ii) cause SFH to become insolvent. If SFH simply shut down as opposed to being sold, SCL might have a problem because it would be transferring the funds in contravention of the Restricted Affiliate agreement. But if the sale goes through, it is difficult to see why SCL would be prohibited from transferring any of SFH's assets to SCL for

Wichita Office
1617 North Waterfront Parkway, Suite 400 • Wichita, Kansas 67206-6639 • 316.267.2000 • Fax 316.630.8466

Overland Park Office
6800 College Boulevard, Suite 600 • Overland Park, Kansas 66211-1533 • 913.345.9205 • Fax 913.345.4832

other legitimate non-profit purposes.

Notably, the Restricted Affiliate Agreement's mission statement does not even reference SFH serving the Topeka community; its sole focus is the servicing of SCL. Likewise, both SFH's bylaws and articles of incorporation make clear that its primary purpose, other than operating SFH, is to support and carry out the charitable health care mission of SCL. The articles further provide that, in the event of a sale or dissolution of SFH, all assets revert to SCL.

The structure of the 2010 Kansas bond issuance is equally telling. SCL set up the bond structure so that SCL itself is the only obligor to any of the tax exempt bonds. The Restricted Affiliates (like SFH) are not obligated on the bonds at all. SCL's only recourse to ensure that the Restricted Affiliates direct sufficient cash flow to SCL to pay the bonds is that SCL controls the Restricted Affiliates' boards of directors. One might ask, "If SFH wasn't legally obligated to repay the bonds, how is it that SCL could use SFH's assets to repay the bonds?" But as noted above, the assets technically belong to SCL inasmuch as SCL has the right to transfer operating funds/revenue - other than actual charitable contributions - from SFH to SCL at any time and in any amount it wants. (Naturally, restricted charitable contributions would be excepted, and any transferred funds would have to be used for charitable purposes. But no suggestion has been made that the transferred funds were restricted or allocated to any of SCL's for-profit entities. To the contrary, as consultant David Whelan noted in his report, the St. Francis Health Foundation, which had net charitable assets of $10.8 million as of June 30, 2017, is not included in the sale and has proposed to transfer its net assets to the Topeka Community Foundation and Washburn University upon closing of the transaction.) In short, we see no sound basis for arguing that any funds transferred by SCL in anticipation of a sale must stay in the State of Kansas.

In the course of our analysis, we also looked at whether SCL's actions in connection with the sale of SFH and the transfer of SFH's assets might have implicated other Kansas statutes or breached other common law duties. Our research bore no fruit on this issue.

Finally, we also examined whether the frozen SCL Health Consolidated Retirement Plan (the "SCL Retirement Plan") is facing any funding deficiencies that might adversely impact SFH participants in the plan. The scope of our review on this issue was necessarily quite limited. All we were in a position to do was review the Aon Hewitt Actuarial Valuation Report of the SCL Retirement Plan from October 2016. Once again, though, we saw no major red flags.

Cy Pres

We first reviewed Kansas authority to determine if the Attorney General could maintain an action against SCL for violating the *cy pres* statute, K.S.A. § 59-22a01. This statute applies to restricted gifts. Essentially, the statute operates to control restricted gifts in the event that it becomes impossible or impracticable to fulfill the restricted gift. *Id.*

In *Health Midwest v. Kline*, No. 02-CV-08043, 2003 WL 328845, at *19 (Kan. Dist. Ct. Feb. 6, 2003) (citing K.S.A. 58-3607(b) and 59-22a01), the Johnson County District Court explained that

the *cy pres* statute is applicable and may be enforced by the Attorney General when "holders of charitable funds propose to modify the purposes to which a charitable fund is devoted." But when the assets at issue are not assets of a charitable trust, the *cy pres* statute does not apply. *Id.*

Our review of the tax documents provided by SFH indicates that the funds transferred to SCL were comprised of operating revenue. There is no evidence to support a finding that the funds were part of a restricted gift to SFH for a specific purpose. It does not appear, therefore, that a viable action could be maintained against SCL in order to recover any of the transferred funds for violating the *cy pres* statute.

Charitable Organizations and Solicitations Act

We next examined whether SCL might have violated the Charitable Organizations and Solicitations Act ("COSA"). *See* K.S.A. § 17-1767. Under COSA, the Attorney General has the authority to seek declaratory relief to insure that solicited donations are used for the purpose for which they were solicited. *See id.* § 17-1768(a); *Kline*, 2003 WL 328845, at *19. K.S.A. § 17-1769 prohibits solicitations that use exaggeration of a material fact, fail to state a material fact, or utilize any unconscionable act or practice in solicitation. Examples of unconscionable practices in the statute include using donations for purposes other than those stated in solicitations or using them for other than charitable purposes. *Id.* We thoroughly reviewed SFH's financial documents to determine if any of the funds transferred to SCL included solicited funds, and we found none. Instead, the funds appear to have been comprised exclusively of SFH's operating revenue, which would not trigger a violation of COSA. *See Kline*, 2003 WL 328845, at *19.

Did the SFH Board Conduct Unauthorized Business in the Transfer?

We additionally reviewed whether SCL's transfer of funds from SFH could somehow be challenged as an unauthorized action on the part of SFH's board of directors.

Pursuant to K.S.A. § 17-6104, the Attorney General has the authority to "enjoin the corporation from the transaction of unauthorized business." To do so, however, the Attorney General must prove that "the decision [of the board] was ultra vires or a perversion of corporate purpose." *Kline*, 2003 WL 328845, at *18. "The Attorney General is limited to reviewing the decisions of the board of directors of the Kansas corporations under the business judgment rule." *Id.* at *17.

The business judgment rule, meanwhile, presumes "that in making business decisions not involving direct self-interest or self-dealing, corporate directors act on an informed basis, in good faith, and in the honest belief that their actions are in the corporation's best interest." *Kansas Heart Hosp., L.L.C. v. Idbeis*, 286 Kan. 183, 209, 184 P.3d 866, 885 (2008). As the party challenging SFH's transfer of funds, the Attorney General would be required to establish facts that would rebut the presumption that the board members of SFH acted in good faith. *Id.*

With respect to a non-profit entity such as SFH, its board members "have a special duty to advance its charitable goals and protect its assets, and any action that poses palpable and

identifiable threat to those goals, or that jeopardizes its assets, is contrary to certificate of incorporation and hence ultra vires." *Kline*, 2003 WL 328845, at *17. "The assets of a charitable corporation cannot be used for purposes that are not in accord with their Articles of Incorporation and the enabling statutes under which they organized." *Blue Cross and Blue Shield of Kansas, Inc. v. Stovall*, 2000 WL 34001584, at *3 (Kan. Dist. Ct. Apr. 5, 2000).

SFH has a duty to use its assets for purposes that are in accord with their stated purpose. To determine whether the transfer of funds to SCL was unauthorized such that it was *ultra vires* or a perversion of corporate purpose, SFH's formation documents must be examined. As noted earlier, however, SFH's articles of incorporation and bylaws reflect that one of SFH's primary purposes is to support SCL's mission.

Moreover, SFH is a Restricted Affiliate of SCL and has agreed to provide funds to repay the bonds. There are, as discussed above, limited restrictions on asset transfers to SCL under the Master Trust Indenture. But none of those restrictions are implicated here. The transfer did not result in a cessation of health care as the hospital continued to operate and it will continue to do so following the sale. Nor did the transfer result in SFH's insolvency (assuming that the sale is consummated, of course). And the transferred funds were not allocated for any specific purpose (e.g., establishment of a new wing at the hospital).

In sum, given that SFH's transfer of funds to SCL was in accordance with SFH's articles of incorporation and the Restricted Affiliate Agreement, we do not believe that the Attorney General would have a legal basis to challenge the business judgment decision of SFH's board of directors.

Is it legally problematic that SFH's funds were transferred out of Kansas?

We carefully probed whether SFH's transfer of funds to SCL could be challenged due to the fact that the funds were transferred out of the State of Kansas, where SCL had enjoyed a tax-free status. We reviewed legal authority from both Kansas and an array of other states. The foreign authority was ultimately not very helpful, however, because each state tends to have its own corporate statutes that govern corporate actions. Those statutes would not be applicable or persuasive in an action brought in Kansas.

We were unable to identify any Kansas authority addressing (let alone restricting) the ability of a non-profit entity to transfer funds out of state to be used to pay bonds of another non-profit entity. However, in *Kline*, the court addressed the ability of a non-profit to sell its assets to an entity out of state. The court held that K.S.A. § 17-6801 "expressly authorizes a nonprofit corporation to sell substantially all of its assets, *with no restriction on the geographic location of the purchaser*." *Kline*, 2003 WL 328845, at *25 (emphasis supplied). While this holding is obviously focused on section 17-6801, the reasoning is helpful here.

Kansas corporation law also mandates that a non-profit must act in accordance with its bylaws and charitable purposes. There is, so far as we are aware, no further judicial or statutory gloss that would circumscribe a non-profit's actions or stated purposes to the State of Kansas.

As long as SFH was acting in accordance with its stated purposes – and it clearly appears to have been doing so in light of the unequivocal language of its articles of incorporation and the Restricted Affiliate Agreement – the fact that the funds were transferred out of Kansas does not equate with a finding that the SFH board's actions were unauthorized, *ultra vires*, or otherwise in tension with K.S.A. § 17-6104.

We also reviewed legal authority from outside the State of Kansas, but it was ultimately not very helpful because those other states have their own corporate statutes that govern the type of transaction at issue here. Connecticut, for example, gives the state attorney general and district court broad latitude to allocate the proceeds from the sale of a non-profit hospital. No such statutory analogue exists in Kansas.

We were unable to identify any authority requiring a non-profit entity to invest funds received from the divestiture of a subsidiary operating in Kansas, in the State of Kansas. In this vein, we reviewed the 1985 purchase of Wesley Medical Center, a non-profit entity in Wichita, by Hospital Corporation of America for $265 million. As a result of the sale, $230 million of the proceeds stayed in the State of Kansas and was used to establish The Kansas Health Foundation and the Kansas United Methodist Health Ministry Fund. But the Wesley sale is of no import here because SFH's primary purpose is to service the mission of SCL and, as such, there is no legal authority to force SCL to re-invest the proceeds of SFH's divestiture (or sale) in the State of Kansas. In short, it is our opinion that there is no sound legal basis to challenge the transfer of funds from SFH to SCL.

Does the Funding Level of the SCL Retirement Plan Pose any Roadblocks to the Sale of SFH?

Finally, you asked that we review the October 2016 Aon Hewitt Actuarial Valuation Report of the SCL Retirement Plan to determine if this frozen defined benefit plan – in which an unknown number of SFH employees apparently participate – suffers from funding shortfalls such that the SFH employees' benefits would be in jeopardy.

It is critical to note at the outset that there is no conceivable liability to SFH (which will be dissolved after the sale) or to the State of Kansas from any pension plan funding deficiencies. The SCL Retirement Plan is sponsored by SCL and is governed by the Pension Benefit Guaranty Corporation ("PBGC"). In the event there were a funding deficiency, participants would look to SCL primarily and, assuming SCL was unable to pay the benefits, the PBGC would step in. Further, according to page 30 of SCL's 2016 Consolidated Financial Report, the SCL Retirement Plan has been frozen for nearly two decades and thus no new participants are accruing benefits therein. The ensuing discussion, therefore, is largely immaterial for purposes of the Attorney General's review of the proposed transaction.

We also hasten to add that defined benefit plan accounting and the rules for determining required funding levels under ERISA and the Internal Revenue Code are extremely complex. Our law firm has a robust employee benefit practice focusing on qualified retirement plans (including defined benefit plans), but we defer to actuaries on funding level issues. So assessing the true adequacy of the SCL Retirement Plan's funding level is simply outside our expertise.

Having said all that, the information in the Aon Hewitt report, combined with certain other references in SCL's 2016 Consolidated Financial Statements, suggest there is likely little to be worried about here.

ERISA requires employers to fund pension plans using an actuarial funding method. The Financial Accounting Standards Board has promulgated two statements in an attempt to standardize employer reporting for pensions. The first is ASC 960. Greatly simplified, ASC 960 largely measures a plan's accumulated benefit obligation ("ABO"). That is, it is a snapshot of the plan's current liability for benefits and does not consider any future salary increases. Page 28 of the Aon Hewitt Actuarial Valuation Report notes that the SCL Retirement Plan has a more than 116% funded ratio as of January 1, 2016. In other words, the plan has *ample* resources as of now to pay all participant accrued pension benefits. The current funding level also explains why page 7 of the Aon Hewitt report points out that the SCL Retirement Plan is not at risk and, in fact, significantly exceeds the annual funding target mandated by ERISA and Section 430 of the Internal Revenue Code.

The other accounting statement used by the Financial Accounting Standards Board for defined benefit pension plans is ASC 715. This report uses much more conservative interest rates than ASC 960 and it also takes into account future salary increases for participants. It is true that page 21 of the Aon Hewitt report reflects a $20 million funding shortfall on a PBO basis. But given that the plan's projected benefit obligation is nearly $358 million, a $20 million shortfall does not seem terribly significant. Moreover, internal financial statements for SFH through March 31, 2017 appear to show that $20.6 million was used to fund "unrecognized pension prior service cost." As David Whelan noted, that funding presumably covered any underfunding or the SFH employees and, perhaps, the entire plan.

The bottom line, therefore, is that, based on the limited scope of our review, we do not believe that there is cause for concern at this time that SFH employees who are participating in the SCL Retirement Plan are at risk of not receiving their full pension benefits.

If you have any additional questions or would like further explanation regarding any of our legal conclusions, please feel free to call.