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CIVIL DISCOURSE

Nonsense for Nonprofits

By Brietta Clark

Last week, the Internal Revenue Service published results from a study of nonprofit hospitals that are already generating questions about whether these hospitals deserve billions of dollars in tax exemptions. This report follows a controversial IRS decision to revoke a tax exemption for Vision Service Plan, a nonprofit eye-care insurance plan. This decision was challenged unsuccessfully in *Vision Service Plan v. United States of America* in the federal district court and the 9th Circuit. Recently, the Supreme Court denied certiorari.

These developments reflect a sea change in the government's approach to determining whether health care nonprofits deserve tax exemptions. But is this change good health policy?

The short answer: It depends on how the government uses this power. Unfortunately, the *Vision Service Plan* case shows that increasing scrutiny and revocations does not necessarily mean better oversight, more accountability or smarter health policy. The government's approach in *Vision Service Plan* is confusing for nonprofits, and potentially more harmful than helpful to the patients who depend on them.

The [IRS'] decision neither reflects a thoughtful plan to use tax liability to promote better access nor does it give meaningful guidance to nonprofits.

Since 1960, Vision Service Plan had qualified for federal tax exemption as a social welfare organization under 26 U.S.C. Section 501(c)(4). Essentially, nonprofits qualify for tax-exempt status if they provide a significant community benefit, but there is no uniform definition of community benefit or test for measuring it. Historically, this has favored nonprofits. Without clear rules, nonprofits had flexibility to determine how to provide this benefit and measure its value. Nonprofits have cited educational programs, research, training and the general promotion of health care as examples of community benefit. The extent to which nonprofits must provide free services is unclear.

In 2003, however, the IRS revoked Vision Service Plan's exemption without an obvious change in the group's business or the law. Revocation was justified on essentially two grounds: First, Vision Service Plan looked too much like its for-profit counterparts by serving primarily paying customers, amassing huge profits, paying high salaries, spending millions on marketing and using aggressive cost-cutting incentives. Second, the free care it did arrange was minor in relation to its total business activities. In short, Vision Service Plan's primary goal was not to promote social welfare among the community broadly.

The implications of the decision run deep and wide: deep because it strikes at the heart of longstanding business practices; wide because it calls into question the status of other health care nonprofits. Nonprofit hospitals feel particularly vulnerable, with good reason. The social welfare test employs community benefit language also used to determine whether hospitals qualify for tax-exemptions as charitable organizations under 26 U.S.C. Section 501(c)(3). Many of Vision Service Plan's practices found objectionable by the IRS are common among nonprofit hospitals. And legal, political and media scrutiny has increased dramatically.

Increased government scrutiny of nonprofits seems not only desirable, but necessary. Government uses tax subsidies to enlist private actors to provide important services, like health care, and most hospitals in the U.S. are nonprofits. As the uninsured and underinsured grow, government should focus on charity care as an important measure of community benefit. By this measure, nonprofit performance is disappointing.

The IRS study of 487 hospitals reveals that a small number of nonprofits provide most of the uncompensated care. Over half the hospitals provided uncompensated care less than or equal to 5 percent of total revenue, and almost one-fifth provided 1 percent or less. Other studies show that nonprofits do not necessarily provide more free care than for-profits, and, in some cases, provide less. Finally, some nonprofits engage in practices that are inconsistent with their charitable missions: failing to inform patients about charity care programs; charging uninsured patients higher rates than insured patients; using aggressive debt collection practices against those who cannot pay; and closing facilities in high-need urban communities to relocate to affluent suburbs.

Clearly, better oversight is needed. But regulators have not demonstrated a true commitment to ensuring that nonprofits provide adequate community benefit or deliver a significant amount of free care.

First, if expanding free care is the primary concern, there is a simple way to accomplish this: Establish clear standards for nonprofits to follow. A few states have done this for state exemptions, and prior to 1969, the IRS did too. But ambiguity in federal law fuels confusion over whether nonprofits are meeting their legal obligations.

For decades, patients' advocates and legal scholars have demanded a uniform definition and measurement test for community benefit, which requires answering the following questions: Does community benefit require charity care, and if so how much? How do we measure charity care? Does it only include "pure charity" — care provided with no expectation of payment? Should it include "bad debt" — bills that could not be collected from patients presumed able to pay at time of service? What about money lost treating the underinsured, such as services to Medicaid patients provided below cost?

Second, the IRS has not used its power to require specific improvements in health care access. Although it has conducted "soft audits" of community benefit, and Congress has held hearings to investigate high-profile claims of price gouging and debt collection practices, there is no specific plan to promote access or prohibit bad practices. By contrast, patients' advocates have tried to leverage charitable care requirements to do this through private lawsuits, but have not been very successful due to standing problems and government neglect.

Third, the government's approach in *Vision Service Plan* could undermine health care access. Charitable programs, such as those provided by Vision Service Plan, fill in gaps left by government inaction. Stripping Vision Service Plan of its tax deduction means it will likely cut existing programs to help pay its new tax liability. This approach imperils an important source of care without ensuring an alternative.

Finally, much of the government's criticism of Vision Service Plan is irrational and hypocritical. The plan is criticized for looking too much like its for-profit counterparts; yet it is a private actor that must compete with for-profits precisely because this is the health care model our government has chosen.

Lawmakers insist that a competitive, private market is better than a publicly financed system, so the government uses tax incentives to encourage private actors to assume this responsibility. One can disapprove of this choice, but once we have adopted this model, it is unfair to criticize nonprofits for acting like those with whom they must compete, without specific guidance as to how they should behave differently.

The *VSP* decision neither reflects a thoughtful plan to use tax liability to promote better access nor does it give meaningful guidance to nonprofits. It simply protects the government's right to revoke exemptions when it chooses, using a mushy test that can support and undermine exemption in most cases.

Regulators can use tax law more effectively to expand health care access by doing three things: adopt clearer standards for defining and measuring community benefit; continue to increase transparency in reporting; and partner with local communities to promote health policies tailored to communities' specific needs.

In our current health care system, nonprofits are necessary, though imperfect, tools for providing health care to the community. Tax law should be used to strengthen these tools, not undermine them.

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Have You Been Served? For Foreign Companies, It's Hard to Tell

By Erin L. Burke, Erik Swanholt and Jason C. Wright

A disturbing trend emerging from both federal and state courts in California has allowed foreign corporations that do not maintain senior officers in the state to be served with service of process through their U.S. subsidiaries. These recent rulings generally concluded that the U.S. subsidiary of a foreign entity is that entity's "general manager" for purposes of service of process. These holdings essentially dispense with long-standing precedent, California service law and a well-known international treaty (the Hague Service Convention). In addition, the rulings appear to ignore both the formalities and realities of corporate relationships by overlooking, or treating as irrelevant, factors relating to how the U.S. subsidiary and the foreign parent are related and how they interact with each other. Are these courts wrong?

To ensure corporations receive proper notice of a lawsuit, California law limits those upon whom service of process may be made on behalf of a corporation. California Code of Civil Procedure Section 416.10(b) lists several high-level officers who may receive service of process on behalf of a corporation, including a general manager. Foreign corporations are not specifically mentioned in Section 416.10(b). Instead, California Code of Civil Procedure Section 413.10(c) requires that foreign corporations that do not maintain high-level officers in California must be served pursuant to the Hague Service Convention. Historically, courts rejected efforts to characterize a foreign parent's U.S. subsidiary as its general manager for purposes of these service provisions.

Those courts held that a subsidiary is not a general manager under the code because it does not have significant and controlling authority within the foreign parent. Years ago the service statute used the term "managing agent," which some California courts interpreted to mean "one in charge of an office of a corporation." Concerned with the breadth of the courts' interpretation, the California Legislature acted in 1931 to replace the term managing agent with the narrower term general manager. Since then, California courts have almost uniformly held that "[t]he term 'general manager of a corporation' indicates one who has general direction and control of the business of the corporation as distinguished from one who has the management only of a particular branch of the business." *Bakersfield Hacienda Inc. v. Superior Court of Kern County*, 199 Cal.App.4th 798 (1962).

Recent rulings have caused a schism. In *Gray v. Mazda Motor of America Inc.*, 560 F. Supp. 2d 928 (C.D. Cal. 2008), the court relied on several outdated and inapplicable case law to distort the term general manager. The court held Mazda-Japan, a Japanese corporation, received the benefit of conducting business in California via Mazda-America, its U.S. subsidiary, and that Mazda-America was "of sufficient character and rank to make it reasonably certain defendant will be apprised of the service made." In holding that Mazda-America was Mazda-Japan's general manager, the court concluded that the plaintiff could avoid the Hague Service Convention and complete service upon Mazda-Japan by serving summons and complaint upon Mazda-America at its California office. Although not all courts that considered the issue followed *Gray*, a few have.

The court in *Gray* based its conclusion on *Eclipse Fuel Engineering Co. v. Superior Court*, 148 Cal.App.2d 736 (1957). Although *Eclipse Fuel* and its progeny broadly interpreted the term general manager, they did so in the context of determining amenability to service (involving minimum contacts analysis) and in situations where there was generally no other way to serve the foreign entity. In other words, if the court did not broaden the definition of the term general manager, the case would be dismissed. Of course, parties today can bring foreign entities to court by serving them under the Hague Service Convention; thus, they do not face the draconian consequences confronted in *Eclipse Fuel*. Nevertheless, the *Gray* court used *Eclipse Fuel* as the basis for its opinion. The rulings in Gray and its progeny ignore or undervalue at least three key issues: the effect of the Hague Service Convention on the *Eclipse Fuel* line of cases; the California Legislature's prior rejection of the *Gray* court's broad approach; and the functioning of corporate relationships in today's world.

First, the California Legislature has provided that if a foreign entity has senior corporate officers in California then it may be served under 416.10(b), but if it does not, then the Hague Service Convention must be followed. When *Eclipse Fuel* was decided, the U.S. had not ratified the Hague Service Convention.

Second, when it replaced the term managing agent with general manager, the California Legislature rejected the broad definition of general manager now employed by the *Gray* court. For years, courts interpreted that revised provision to require some level of control by the general manager of the foreign corporation. The *Gray* court ignores the issue of control entirely.

Third, the *Gray* court's interpretation of general manager seemingly forgets to treat corporations as legally separate entities. The court assumed that the U.S. subsidiary had some control of or degree of authority over the parent. But the holding ignores the notion of corporate separateness and did not address whether the related Mazda entities shared officers or executives or whether one had control over the others' activities. In addition, the *Gray* court provided no basis for a finding that such entities share duties relating to "notice."

Instead, the court held that Mazda-America's role as "distributor" of Mazda products in California was sufficient to find that it was "giving the defendant the advantages of doing business in the state" and therefore was the foreign corporation's "general manager." That threshold is so low that it could be extended to apply to any entity acting as a distributor for a foreign corporation, even without a corporate relationship. What other kinds of business activities, and at what level, could lead to a similar finding is unclear but troubling.

In creating laws regarding service of process, the Legislature balances the needs of plaintiffs (who need their day in court) and the need of defendants (who need proper notice of a suit). The loose definition of general manager relied on in *Gray* does not follow the balance struck by the Legislature or the jurisprudence developed over decades of interpreting legislative language. Rather than requiring that parties serve a select few individuals who owe a duty to the corporation to notify it of the service, the *Gray* court would allow service on any agent who *could* reasonably notify the foreign corporation of service, regardless of any duty to do so. Most surprising about this trend is that the distortion is unnecessary — if the *Gray* court had interpreted the California service statutes correctly, the plaintiff still could have had its day in court by serving the foreign entity under the Hague Service Convention.

Even as parties now seek any California-based relatives of foreign entities in order to effect service of process without resort to the Hague Service Convention, at least one California appellate court is reviewing this issue. In the interim, the question of whether your foreign corporate client has effectively been served remains difficult to answer.

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