Judicial Enforcement of Charitable Care Requirements for Nonprofit Hospitals' Tax-Exempt Status

by Daniel Rey-Bear

ON 19 FEBRUARY 1993, Austin State District Judge Peter Lowry granted a summary judgment dismissing a two year old case against Houston's Methodist Hospital ("Methodist").[1] The Texas Office of the Attorney General had brought the suit alleging that Methodist had failed in its fiduciary duty to provide charity care as required by its charter and its status as a tax-exempt organization, and sought to enjoin Methodist to fulfill that obligation.[2] Following the District Court's dismissal, the Texas State Legislature worked for the adoption of legislation requiring all nonprofit hospitals to provide certain amounts of charity care. This legislation was eventually passed and became effective September 1, 1993.[3] Even with the passage of this model law, though, the commencement and dismissal of the Methodist case respectively raised significant substantive and jurisdictional issues that still must be resolved in the current national debate about health care reform.

JURISDICTIONAL ISSUES

Unfortunately for discussion of the substantive issues involved, this case was decided on jurisdictional grounds.[4] Methodist was ultimately granted summary judgment based on its argument that the court did not have jurisdiction over the State's claim. In its final motion for summary judgment and dismissal for want of jurisdiction, Methodist made two points on this matter. First, Methodist argued that this was a nonjusticiable political question: Since each of the previous three Texas legislative sessions had rejected the Attorney General's attempts to expand his authority over the regulation of nonprofit corporations, the court should not then let the Attorney General unilaterally exert power over them.[5] It was thus stated that the court should not adopt by judicial ruling what the legislature had rejected. But while two cases were cited for this proposition in Methodist's Motion to Dismiss, neither was on point.[6] Furthermore, in the manner that Methodist presented it, this assertion would lead to unacceptable results; under such logic the courts might well not have authority to pass judgment in favor of any constitutional claim that had not already gained the approval of the relevant legislature, thereby radically diminishing the role of the courts in many areas, such as protecting insular minorities from the will of the majority.

In its second point, Methodist argued that the court did not have jurisdiction because the Attorney General did not have the authority to enforce the tax code.[7] In addition to the already stated evidence that the Texas Legislature had refused to grant such authority to the Attorney General, Methodist claimed that "a political question — especially one involving taxation that is uniquely within the jurisdiction of the legislature and one brought by an entity not charged with the authority to enforce the tax code — is nonjusticiable."[8] In support of this claim, Methodist cited a case which supported the general proposition that a political question is nonjusticiable, but provided no support for the more specifically relevant point that was advocated.[9] Methodist's main point here was that the issue was exclusively one for the Harris County Appraisal District and therefore was outside the Attorney General's jurisdiction. The Attorney General's claim was thus described as a collateral attack.[10] This amounted to an argument that all that was required for property tax-exempt status was to qualify as a nonprofit organization under I.R.C. Section 501(c)(3) and to have the requisite county taxing authority's approval. Once these requirements were met, the organization would have the latitude to do whatever charitable work it deemed appropriate and the Attorney General would not have the authority to question its practices.[11]

In reply, the Attorney General agreed that while the tax code did provide exclusive jurisdiction to the local appraisal district for challenges to tax exemption decisions, this case did not fall within that category because here the designation of tax exemption was not challenged. Rather, the Attorney General only sought to ensure compliance with supposed tax exemption requirements — namely, that Methodist provide some charitable function.[12] To support this assertion, the Attorney General refuted the appositeness of several cases Methodist relied on in support of its claim.[13] More important, however, the Attorney General provided positive support for the State's standing and interpretation of the applicable law by reference to, *inter alia,* Tex. Prop. Code, ch. 123 and Tex. Civ. Prac. & Rem. Code, §65.016, the latter of which provides that "at the instance of the county or district attorney or the attorney general, a court by injunction may prevent, prohibit, or restrain the violation of any revenue law in this state."[14]

But Judge Lowry did not agree with the Attorney General's argument in favor of jurisdiction. In his decision from the bench he essentially restated Methodist's final point: "The attorney general of the State of Texas does not have the power to tell charitable organizations how to allocate their resources."[15] The judge gave four reasons to support his ruling: (1) the case presented a nonjusticiable, political question; (2) the defendant directors did not breach their fiduciary duty to the hospital; (3) the case constituted a nonjusticiable collateral attack on the appraisal district's determination of Methodist's tax-exempt status; and (4) the Attorney General did not have standing to bring the suit because the Attorney General did not have the authority to tell a charitable organization how to allocate its resources.[16] As Judge Lowry said in summary: "I think we all agree with the Attorney General that there is a need for more indigent health care, both in Houston and across the country. . . . But in my opinion this case presents a political question. It's a question for the legislative branch of government — either [for] our Texas legislature or Congress, or both."[17]

But this disposition of the case by summary judgment concealed the greater complexities of the issues involved. The first point of the judge's decision likely referred to the argument concerning the supposed exclusive authority of the legislature; but as was discussed above, that argument does not seem very forceful in this context. The second point accepted Methodist's argument that — as a matter of law without an examination of the facts — (a) an ultra vires act was required to establish a breach of fiduciary duty, and (b) the Attorney General's assertion that Methodist failed to operate in accordance with its charitable purpose, if proven, could not constitute such an ultra vires act.[18] But such an evaluation would seem to require a greater determination of both the facts of the case as well as the state of the law concerning what hospital services are required, if any, for the fulfillment of charitable fiduciary duties.[19] The third point accepted Methodist's assertion that the local tax appraisal district had exclusive authority to enforce property tax laws and rejected the appositeness of both the Attorney General's cited statutory authority and the distinction concerning the nature of the case at bar.[20]

Given the nature of taxing authorities, this point in conjunction with point four — that the Attorney General did not have the authority to regulate charitable institutions' allocations of resources — would limit enforcement of any charitable requirements for tax-exempt status to simply withdrawing that designation and would not permit injunctive relief to force an organization to comply with those requirements. This holding would therefore leave the State powerless to enforce compliance with charitable trusts despite the common law status of the Attorney General as the protector of the public interest.

While it seems that the Attorney General would have had a fair chance to have this decision overturned on appeal, and to at least reach the merits of the case, ultimately such action was not necessary. Even before the judge had made this ruling, the Texas Legislature had begun working on the

model legislation that would require just the kind of charitable duty that the judge stated he was powerless to enforce.

SUBSTANTIVE MATTERS

Beyond the jurisdictional issues that decided the case in court, *Texas v. Methodist Hospital* raised the important issue of the motivation for granting tax-exempt status to nonprofit institutions: Just what ought to be required of tax-exempt organizations in exchange for the benefits conferred by that status?[21] The two leading cases on this matter are *Eastern Kentucky Welfare Rights Ass'n v. Simon*[22] and *Utah County v. Intermountain Health Care*,[23] which take opposing views.

Simon involved a suit brought by and on behalf of indigents challenging the I.R.S.'s granting of tax-exempt status to a nonprofit hospital that offered only emergency room services to indigents. The Internal Revenue Service had changed the requirement for federal tax-exempt status from one requiring charity care to the extent of an organization's financial ability,[24] to one requiring only that the institution be engaged in the promotion of health for the general benefit of the community.[25] The plaintiffs in *Simon* argued that providing free emergency care, and nothing more, did not constitute giving true charity care — free and complete medical care for those who could not afford it — that should be required for federal tax-exempt status. The U.S. Court of Appeals for the District of Columbia held that the I.R.S.'s change in policy was appropriate given the ongoing structural changes in the health care industry with the advent of Medicare and Medicaid, government programs that significantly lightened the burden on charitable medical institutions.[26] Nonprofit hospitals were thus per se charitable and tax-exempt regardless of whether they provided free care, because the definition of "charity care" had to change along with the changing health care environment.[27]

Intermountain Health Care similarly addressed a challenge to the granting of tax-exempt status, but here the action was brought by a county government and involved state tax-exempt status. (While there are some differences between state and federal tax-exempt status, the former is usually based almost exclusively on the latter, so that the substantive issues are essentially the same.) Here, a county government sought review of a state taxing commission's reversal of a county board of equalization's denial of tax-exempt status to two nonprofit hospitals, where the denial had been based on their apparent failure to provide sufficient charity care. The Utah Supreme Court rejected the view of *Simon* by holding that simply providing health care to paying patients was not enough for a charitable nonprofit hospital to qualify for tax-exempt status. Merely operating as a nonprofit institution was not enough; some additional contribution or "gift" to society was required beyond the community benefit that for-profit institutions could likewise provide.[28] *Intermountain Health Care* thus challenged *Simon*'s presumption that nonprofit hospitals should continue receiving tax-exempt status despite structural changes in the health care system that reduced the need for their charitable services.[29] Despite this significant decision though, subsequent efforts to follow this ruling both in the courts and in state legislatures have had little success.[30] That is, at least until now.

Although the Texas Attorney General was not able to persuade Judge Lowry to let them reach the merits of the case in *Texas v. Methodist Hospital*, some of the State's substantive arguments made before the summary judgment dismissal applied the *Intermountain Health Care* reasoning. The Attorney General's claim was based on Article VIII, Section 2 of the Texas Constitution and Section 11.18(d)(1) of the Texas Tax Code, as well as the Texas Trust Code, the Texas common law of charitable trusts, and Methodist's own charter and bylaws. First, the Attorney General argued that since Methodist's charter specified that the hospital was formed for "benevolent, charitable, and educational purposes," the directors had an affirmative legal duty to carry out those purposes, and this included providing true charity care. Thus, they were required to provide complete and uncompensated medical care by the dedication of hospital

resources, either through patient services or community outreach, to those who could not pay for it.[31] For the constitutional and statutory arguments, the Attorney General then pointed out that while the Texas Constitution authorizes exemption from ad valorem taxation on all buildings owned and used exclusively by "institutions of purely public charity,"[32] the State Tax Code should provide tax-exempt status for hospital systems only if medical care is provided without regard to ability to pay.[33] The Attorney General thus argued that while Methodist had gained the benefit of being exempt from paying property taxes worth approximately $35 million per year, they had not and did not intend to satisfy their corresponding duty of providing charity care to the public commensurate with their ability to do so.[34] Support for the State's claim against Methodist came both from affidavits of numerous health care experts as well as statements of an indigent minor and others who had been turned away from Methodist.[35]

In its Answer and subsequent Motion for Summary Judgment, Methodist countered that it had met the minimal requirements for tax-exempt status described above and that no affirmative duty to provide general charitable care existed under either statutory or common law. Though it did not explicitly challenge the Attorney General's assertions concerning its admittance policies, Methodist claimed that it qualified for tax-exempt status under both Texas Tax Code Section 11.18(d)(1), by providing care without regard to ability to pay, and Section 11.18(d)(16), by performing biomedical research and education through its affiliated research institutions and Baylor College of Medicine.[36] More specifically, Methodist pointed out that neither the hospital's charter nor any Texas case or statute specified the requirement of "charity care" that the Attorney General had proposed.[37] Thus, while the Attorney General followed the reasoning of *Intermountain Health Care*, Methodist followed some of the implicit reasoning of *Simon*. The Attorney General suggested that the basis for granting the benefits of federal or state tax-exempt status is whether, or to what extent, a nonprofit institution provides specific social benefits for the poor of the community in proportion to the monetary value of that tax-exempt status. On the other side, Methodist argued that tax-exempt status is appropriately conferred and held so long as the nonprofit charitable institution provides some benefit to the community, which may include research, education, and some limited charity care.

CONCLUSIONS

The two sides of this case suggest rather different roles for the nonprofit medical institution in the current health care environment. Beyond the context of any particular case, there is evidence that for-profit hospitals may well be providing greater charity care than nonprofit ones.[38] This suggests that nonprofit hospitals generally see no problem with a nonprofit medical institution having an almost identical role to a for-profit medical venture, with the only real differences being in corporate structure, the compensation of its board of directors, and a possibly greater role in medical education and research.[39] Opposing this view, of course, are those who do not have sufficient access to health care and their advocates; their views seem to harken back to the idea of almshouses and truly voluntary religious hospitals, in demanding that charitable institutions live up to their ideals to help those who are not capable of providing for themselves. But while it seems understandable that there should not be only minimal differences between nonprofit and for-profit hospitals, it does not seem entirely appropriate to require such singular pursuit of charity care, particularly in an age when the health care industry is so complex and the U.S. Government may soon be establishing some form of minimum universal health care. In this case, the Attorney General was understandably advocating the position that nonprofit hospitals should provide both community benefits (as through medical education and research) and charity care for the poor of the community.

Currently there is no generally satisfactory solution to this problem. If the charitable care requirement for tax-exempt sta-

tus is set at the level of need within the community or, alternatively, based on the per se charitable community benefit of providing general health care, the direct benefits provided to the poor might well decrease as government mandated care increases. On the other hand, even if the charitable care requirement is set at a value commensurate with the monetary value of tax-exempt status, as the Attorney General suggests, one still wonders what happens when the specific needs of the community fall below that amount. While the former view fails to consider any proportionality between the benefits conferred and the requirements imposed by tax-exempt status, the latter seems to take an overly restrictive view of charity care. Greater resolution of this issue will have to wait until President Clinton's proposed national health care plan is either passed or rejected by Congress and the American public.

While this particular case has been settled and Texas seems to have resolved some of the central issues for the time being, its broader implications remain: Just how much direct charity care can be and should be provided to the community by a nonprofit health care organization, especially one the size of Methodist? And if the federal and state taxing authorities fail to properly address the issue, is it proper for the courts to intervene? In a time of such massive budget deficits and pressing need for health care reform, it seems the American public cannot afford to help those less fortunate, while it is simultaneously compelled to do so. Despite the passage of the recent Texas legislation, it remains to be seen how the larger policy questions within this case will be resolved at the national level. ❖

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ENDNOTES

[1] *Texas v. Methodist Hospital*, No. 494,212 (126th Dist. Ct., Travis County, Tex., Feb. 19, 1993).

[2] Count I concerned alleged breaches of Methodist's fiduciary duty of obedience; Count II concerned alleged breaches of their fiduciary duty of due care; Count III involved an allegation of a violation of the Texas Tax Code requirements for maintaining tax-exempt status. Petion for Relief at 2-5.

[3] For a review of the significant aspects of this legislation, see the accompanying article, "Tax Exemption and Public Accountability," by Ann Kitchen and Catherine Fant. The bill was originally filed in the Texas House of Representatives while the case was pending. The Texas Legislature then began working in earnest on the bill while the Attorney General was working on an appeal of the District Judge's ruling. Once the legislation was passed and signed by the Governor, the Attorney General settled and dismissed the case. The settlement required, *inter alia*, that Methodist follow the mandate of the new law. Statement by Ann Kitchen, Assistant Attorney General, Charitable Trusts Section, Consumer Protection Division, Office of the Attorney General of Texas (26 October 1993).

[4] While substantive issues concerning the nature of Methodist's fiduciary charitable duty based on its charter and tax-exempt status were raised and decided upon, such discussion in the ruling was only dicta because the case was legally dismissed on the several jurisdictional grounds discussed below. Given this, a brief discussion here of the substantive issues raised in the case will be provided in a review of the specific ruling, *infra* notes 18-19 and accompanying text, as well as in more general terms in Part II, *infra*.

[5] *See* Methodist's Motion for Summary Judgment and to Dismiss for Want of Jurisdiction at 8 [hereinafter Motion for Summary Judgment] *citing, inter alia*, Tex. H.B. 2700, 72d Leg., R.S. (1991).

[6] Motion for Summary Judgment, *supra* note 5, at 8. In the first case cited by Methodist, the Texas Supreme Court held that the Texas Legislature could not have changed the franchise tax allocation formula in a revision of the relevant statute since there was no evidence of legislative intent to do so. *Humble Oil & Refining Co. v. Calvert*, 414 S.W.2d 172, 180 (Tex. 1967). In the second, the Fifth Circuit held in a simple case of supremacy that where the Secretary of Treasury was authorized by federal statutes to permit national banks to open and maintain banking facilities on federal military installations in Texas, the State could not place limitations upon such facilities under Texas constitutional

and statutory provisions against branch banking. *Texas v. National Bank of Commerce of San Antonio,* 290 F.2d 229, 234 (5th Cir. 1961), *cert. denied,* 368 U.S. 832 (1961). Such general propositions regarding statutory interpretation and supremacy do not support the assertion here that the judiciary cannot address issues not definitively resolved by the legislature.

[7]The specific assertion was that "the Court lacks jurisdiction over the claim because (1) the Tax Code vests exclusive jurisdiction over tax exemption rulings in the Appraisal District and the Appraisal Review Board, (2) the Court lacks jurisdiction over collateral attacks on Appraisal District and Appraisal Review Board rulings, and (3) the Attorney General has no authority or standing to challenge the Appraisal District and Appraisal Review Board rulings that Methodist is exempt from local property taxes." Motion for Summary Judgment, *supra* note 5, at 7. *See also* Methodist's Summary Judgment Brief at 22-23.

[8]Motion for Summary Judgment, *supra* note 5, at 8-9.

[9]*Texas Ass'n of Concerned Taxpayers, Inc. v. United States,* 772 F.2d 163, 165-166 (5th Cir. 1985), *cert. denied,* 476 U.S. 1151 (1986) *citing Baker v. Carr,* 369 U.S. 186 (1962). Both sides briefed the general issue in the summary judgment proceedings, but only the Attorney General dealt with it in detail in the final motions. *See* Corrected State's Opposition to Defendants' Motion for Summary Judgment and to Dismiss for Want of Jurisdiction at 27-31 [hereinafter Opposition to Motion for Summary Judgment]. The cited case actually held that an issue regarding the meaning of the constitutional provision concerning the origination of bills for raising revenue, U.S. Const., Art. 1, §7, cl. 1, was not justiciable because Congress had already given it an interpretation that was consistent with the limitations of its authority. *Texas Ass'n of Concerned Taxpayers, Inc.,* 772 F.2d at 167. Thus, while that case did involve an issue regarding taxation that was within the jurisdiction of the legislature, it was only one of interpreting a constitutional clause concerning its internal operation, and not about the proper subject of taxation or tax-exempt status given set statutory requirements. Furthermore, the court there did not assert that the adjudication of the issue was "uniquely within the jurisdiction of the legislature"; indeed, the court explicitly reaffirmed that "the judicial branch is, of course, the final arbiter of the constitutionality of a statute." 772 F.2d 163, 165 *citing Marbury v. Madison,* 1 Cranch (5 U.S.) 137 (1803). Finally, the court there made no mention whatsoever of a relationship between who initiates a cause of action and the justiciability of the issues that it presents.

[10]*See supra* note 7.

[11]As has been noted elsewhere, most similar cases in the past have been brought by local taxing agencies, with various results depending on the particular circumstances. *See* Mark A. Hall & John D. Colombo, *The Charitable Status of Nonprofit Hospitals: Toward a Donative Theory of Tax Exemption,* 66 Wash. L. Rev. 307, note 63. In the Supreme Court decision of *Eastern Kentucky Welfare Rights Ass'n v. Simon,* 426 U.S. 26 (1976), the merits of which are discussed *infra,* text accompanying notes 16-19, the Court held that the plaintiffs, several indigents and indigent rights advocacy organizations, did not have standing as taxpayers to challenge an I.R.S. ruling because the relationship between that government ruling and the alleged denial of medical care to the given class of people was too speculative to constitute a case or controversy. *Simon,* 426 U.S. 26 at 43. *Compare United States v. Students Challenging Regulatory Agency Procedures (SCRAP),* 412 U.S. 669 (1973) (standing exists for law students challenging ICC approval of a nationwide railway freight rate increase based on the allegation that it would increase the cost of recycling and thereby cause them to pay more for finished products and would impair their enjoyment of the environment in Washington, D.C.) *with Allen v. Wright,* 468 U.S. 737 (1984) (parents of black children do not have standing to challenge I.R.S. procedures for denying tax-exempt status to racially discriminatory private schools absent allegation of a specific injury fairly traceable to the challenged government conduct which could be redressed by the requested relief).

[12]Opposition to Motion for Summary Judgment, *supra* note 9, at 24.

[13]*Id.* at 25-27.

[14]*Id.* at 24.

[15]*Texas v. Methodist Hospital,* No. 494,212, as quoted in Gary Taylor, *Lawsuit Doesn't Resolve Care Issue,* Nat'l Law J., March 15, 1993, at 10. *Compare Texas v. Methodist Hospital,* No. 494,212 *with* Motion for Summary Judgment, *supra* note 5, at 7, reproduced here at *supra* note 7.

[16]*Texas v. Methodist Hospital,* No. 494,212.

[17]*Id.*

[18]*Compare id. with* Motion for Summary Judgment, *supra* note 5, at 3 *and* Opposition to Motion for Summary Judgment, *supra* note 9, at 9-13.

[19]This, of course, assumes that the Attorney General did have the authority to make this assertion contrary to point four, as discussed below. The substantive aspects of points two and four are discussed in greater detail in Part II. *See infra* notes 31-37 and accompanying text.

[20]*Compare Texas v. Methodist Hospital*, No. 494,212 *with supra* notes 8-9 and accompanying text *and supra* notes 10-12 and accompanying text.

[21]As discussed above, the Attorney General here advocated the position that such nonprofit organizations should provide some general community benefit as well as more specific charity care.

[22]506 F.2d 1278 (D.C. Cir. 1974), *vacated on other grounds*, 426 U.S. 26 (1976).

[23]709 P.2d 265 (Utah 1985).

[24]Rev. Rul. 56-185, 1956-1 C.B. 202, 203.

[25]Rev. Rul. 69-545, 1969-2 C.B. 117.

[26]*Simon*, 506 F.2d at 1288-89.

[27]*Id.* at 1889

[28]*Intermountain Health Care*, 709 P.2d at 276.

[29]*Id.* at 274.

[30]For a review of some of these efforts see Hall & Colombo, *supra* note 11, at notes 62-67 and accompanying text (but note misconstrual of *Methodist* in note 63).

[31]Petition for Relief at 9; Opposition to Motion for Summary Judgment, *supra* note 9, at 10-11.

[32]Tex. Const. art. VII, § 2.

[33]*See* Tex. Tax Code Ann. §11.18 (West 1993); Petition for Relief, at 14-15; Opposition to Motion for Summary Judgment, *supra* note 9, at 14-23.

[34]The $35 million represented the average value of Methodist's total exemption from state and federal taxes for each year from 1988 to 1992. In the most recent year for which data was available, Methodist was exempted from a total of $44 million worth of taxes ($19 million in state taxes and $25 million in federal taxes). Kitchen, *supra* note 3.

[35]Opposition to Motion for Summary Judgment, *supra* note 9, at 35-46.

[36]*See* Tex. Tax Code Ann. §11.18 (West 1993); Motion for Summary Judgment, *supra* note 5, at 4.

[37]*Id.* at 5-7.

[38]*See* U.S. Government Accounting Office, Nonprofit Hospitals and the Need for Better Standards for Tax Exemption, Rep. No. 90-84, at 2 (May 30, 1990), *cited in* Hall & Colombo, *supra* note 11, at note 143 (for 1988, the voluntary hospital sector provided 4.8% of its total care for free while for-profit hospitals provided 5.2% free care).

[39]Methodist pointed out that under the traditional legal definition of charity care, a nonprofit hospital is a charity institution by definition so long as the hospital's assets are not used for the profit of the owners, even if the patients pay for their care. According to Methodist then, medical care provided by a nonprofit organization was per se charitable. Motion for Summary Judgment, *supra* note 5, at 9, and sources cited therein. Indeed, in his deposition, Methodist CEO Larry Mathis went on to state that "in my view, it is a charitable purpose to provide care to a rich man or a poor man." Deposition of Larry Mathis, Chief Executive Officer, Methodist Hospital System (1992). It was just this sort of statement made by people involved in the case that fueled the public controversy surrounding it. *See, e.g.,* Taylor, *supra* note 13.