SENIOR CONSULTANT

THE VOICE OF THE INVESTMENT MANAGEMENT CONSULTANT

January 2000 | Volume 3, No. 1 | PCT Publishing

Foundations and Endowments:
Hospital Conversion Foundations

Sandra J. Champion

Sandra J. Champion is a vice president of Madison Investment Advisors, Inc., located in Madison, Wisconsin, and Scottsdale, Arizona. The firm manages $3.8 billion in fixed income, core equity and concentrated equity strategies. She is a member of The National Society of Fund-Raising Executives and has given presentations on this topic to the Investment Management Consultants Association (IMCA).

The concept of healthcare conversion is not new; it's simply gained momentum over the past decade. The first hospital conversion foundation, one that was formed as a result of a non-profit organization converting to a for-profit entity, occurred in Cleveland in 1973. The next foundation like this wasn't created until almost 10 years later. Since the early 1980s, the number of hospital conversion foundations has grown to a total number exceeding 100 organizations that control in excess of $13 billion in assets (see Table 1). The philanthropic influence in the community has expanded and is now no longer focused strictly on the hospital itself. This concept receives as much scrutiny as does it applause.

When consulting to hospital foundations, it's important to recognize that each conversion is not identical to the next and that all hospital foundations are not created equal. There are a variety of structures that surround the conversions. The proceeds from the sale of the non-profit hospital or healthcare agency must be maintained in a non-profit organization. That organization can be represented as a private foundation, a public charity, a supporting organization or a social welfare organization. The IRS has the determining vote, but a few of the differences as well as statistics might be enlightening.

During the mid-90s, healthcare conversions were in full swing. This restructuring occurred for a variety of reasons, but simply stated, it allowed the hospitals to compete more effectively in the newly evolving world of healthcare. As the conversions hit full stride, a study was released that broke down the options chosen by various healthcare agencies. Because hospital conversion foundations didn't reach significant numbers until recently, that study still remains the primary disclosing document in that area of foundations. The study was released in 1998 and only slightly modified this year.

All of the foundations resulting from conversions in various states were classified as tax-exempt organizations under the IRS code 501(1)(3) or 501(c)(4). The majority of these conversions were set-up as private foundations, which means they receive funding from primarily one source and derive their income from their investments. The organization's primary purpose is grantmaking rather than fundraising. As a rule, a hospital foundation that is classified as a private foundation must pay out 5% of its assets each year for charitable purposes and are subject to a 2% excise tax on earned income. The IRS classifies most hospital conversion foundations as "private foundations" unless the organization can demonstrate it should be classified as a "public charity."

Table 1.
Pace of Conversions
(Dollar figures in millions)

Year	Number Converting To For-Profit Status	Total Asset Size of Conversion Foundation
1973	1	$ 36.1
1981	1	2.3
1983	2	30.7
1984[1]	11	421.3
1985	8	1,226.9
1986	3	125.0
1987	2	87.7
1988	1	18.9
1990[2]	1	127.1
1991	1	102.3
1992	3	1,189.1
1993	2	62.1
1994[3]	13	1,088.4
1995[2]	20	2,145.4
1996	21	5,185.3
1997[4]	12	960.9
1998[5]	6	389.4
1999[3]	1	80.0
Total	109	13,278.8

[1]Includes one foundation that reported assets as of December 31, 1996.
[2]Includes one foundation that reported assets as of December 31, 1997.
[3]Includes one foundation that reported assets as of December 31, 1998.
[4]Includes one foundation that reported assets as of December 31, 1997, and another as of December 31, 1996.
[5]Includes one foundation that used year of foundation formation rather than year of conversion.

Source: *Grantmakers in Health*

A hospital foundation that is "publicly supported" is one that derives its income from several sources. Generally one third of its support must come from public contributions or government funding. This would change the status to a public charity via 501(c)(3) of the IRS code. Under this classification of 501(c)(3), the foundation is not required to pay out 5% of its earned income annually.

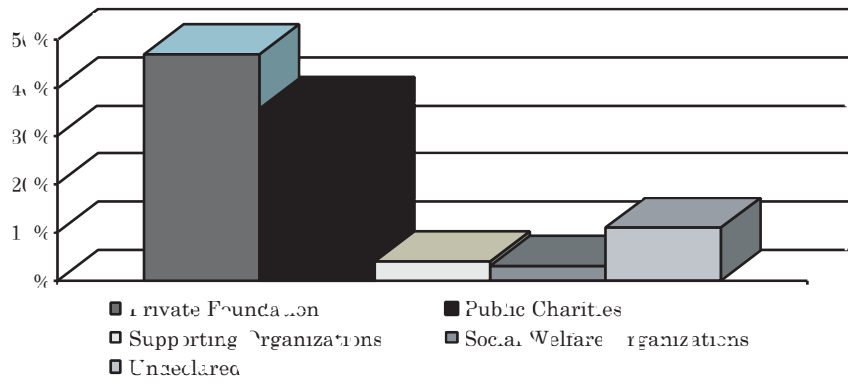
Less than 10% of the conversion foundations fall into the following two categories:

- 501(c)(3) classification, a supporting organization; or
- 501(c)(4) classification, a social welfare organization.

A supporting organization is a nonprofit corporation that has an existing relationship with an existing public charity. The supporting organization receives funding and support from the public charity and therefore does not have to pass the public support requirements. A social welfare organization, which is the least common classification among conversion foundations, has the ability to more actively participate in lobbying and political activities than do other nonprofit organizations (see Figure 1).

Additionally, about 20% of the foundations created as a result of a conversion were created out of joint ventures (see Table 2). Of those joint ventures, Columbia/HCA Healthcare was involved in all but one, Dakota Medical.

Figure 1.



Asset size and board structure are critical elements in understanding hospital foundations. As previously noted, there are more than 100 total existing foundations resulting from hospital conversions. According to *Grantmakers In Health,* the most recent count is 119 such organizations. The total asset size for the group is just $13 billion dollars. Singularly, the largest is the California Healthcare Foundation with $2.2 billion in assets, and the smallest is the Grotta Foundation in South Orange, New Jersey with $885,000. The average size of a foundation created through a hospital conversion is $76 million, while the average size created through a health system conversion in $126 million.

Generally as these foundations are created, they receive cash because of the conversion/sale of the non-profit organization. However, they can also receive real estate. I have always advocated that an organization with assets around $50 million is ripe for the broker consultant. In total, 46 of the 109 reported in the 1998 study had assets at $50 million and under (see Table 3).

The next question would deal with what to expect from the board. In the majority of the conversion foundations, many of the board members come from the hospital or the original healthcare organization. There is seemingly a question of conflict of interest as the trustees of the foundation sit on the boards of the for-profit hospitals and the financial interests, as well as other concerns, diverge. Many of the communities where these conversions have occurred are requesting broader participation by the community. This seems appropriate since the majority of these foundations have relatively small staffs with minimal experience in dealing with the issues at-hand. Initially, you'll see familiar and recurring faces in dealing with both the hospital and the foundation, but expect a subtle change in the future.

Of the 30 states in which conversion foundations have been formed, California leads in terms of numbers and assets. The other states that have multiple conversion foundations are Florida, Ohio, South Carolina, Virginia, Texas, Colorado, Illinois and Tennessee.

Table 2.
Conversion Foundations Established from Joint Ventures

Arlington Health Foundation (VA)
Dakota Medical Foundation (ND)
Health Foundation of South Florida (FL)
HealthOne (CO)
Methodist Health Care Ministries of SW Texas (TX)
Rapides Foundations (LA)
Community Health Corporation - Riverside (CA)
St. David's Health Care Foundation (TX)
The Share Foundation (AR)
Sisters of Charity Foundation of Canton (OH)
Sisters of Charity Foundation of Cleveland (OH)
Sisters of Charity Foundation of South Carolina (SC)
Winter Park Health Foundation (FL)

Table 3.
Assets of New Health Funds

Assets in Millions	Number	Conversion Foundations
$0 - $10	16	14.7%
$11 - $100	62	56.9%
$101 - $500	28	25.7%
Greater than $500	3	2.8%

Source: *Grantmakers in Health*

The philanthropic community has suggested that these foundations are in desperate need of education from the standpoint of mission statements, evaluation procedures and most importantly, investment advice. Here lies a tremendous opportunity.

With each opportunity there also seems to be a need for caution. The hospital conversion foundations have been somewhat scrutinized by a variety of groups ranging from the general public to the IRS. The general public can be aggravating, but the IRS can be hurtful. Recently in Mississippi, the IRS levied fines of $11.5 million to $40 million against three healthcare organizations and its officers because it believed that the non-profit organizations were undervalued when the conversion transactions occurred. Needless to say, the organizations have stated that the fines are unjust and that the non-profit groups were fairly valued by a well-respected certified public accountant. They are seeking to overturn the decision. ■

Notes

SENIOR CONSULTANT

THE VOICE OF THE INVESTMENT MANAGEMENT CONSULTANT

James P. Owen
Co-Founder

Stephen C. Winks
Co-Founder, Publisher &
Editor-in-Chief

Mamie Woo McNeal
Production Editor

Jenny L. Herring
Associate Editor

Sydney LeBlanc
Consulting Editor

Nita Alvarez
Design Consultant

THE SOCIETY of SENIOR CONSULTANTS