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The Common Law Power of the Legislature: Insurer Conversions and Charitable Funds

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New York's Empire Blue Cross and Blue Shield conversion from nonprofit to for-profit form has considerable legal significance. Three aspects of the conversion make the case unique: the role of the state legislature in directing the disposition of the conversion assets, the fact that it made itself the primary beneficiary of those assets, and the actions of the state attorney general defending the state rather than the public interest in the charitable assets. Drawing on several centuries of common law rejecting the legislative power to direct the disposition of charitable funds, this article argues that the legislature lacked power to control the conversion and direct the disposition of its proceeds and that its actions not only undermined the nonprofit form but also raised constitutional concerns.

Key Words: Organizations, nonprofit, Blue-Cross plans, legal aspects, for-profit conversions.

NEW YORK HOSPITAL AND NURSING HOME employees have been waiting for nearly two years for the release from an escrow account of nearly $800 million, much of it marked for pay raises (Hevesi 2004). The money, which represents proceeds from both an initial public offering by which Empire Blue Cross and Blue Shield converted from nonprofit to for-profit form and a later sale of additional stock, is the subject of ongoing litigation regarding the legislature's role in health insurer conversions and the ownership of nonprofit assets.[1] The case has drawn considerable attention not only because Empire is New York's largest

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health insurer but also because, with corporate valuations reaching $3 billion and the state holding the majority of the stock, the funds could help New York's ailing state budget (Hammond 2004). Hoping to supplement the state treasury, New York Governor George E. Pataki has championed legislation easing the way for other insurers to convert and direct proceeds to the state. In addition, the HIP Health Plan, estimated by hopeful legislators to be worth $1 billion to $3 billion, has expressed interest in following Empire's example (Baker 2005; Epstein 2004).

Conversions of health care organizations from nonprofit to for-profit form, even of the magnitude of Empire's transaction, are not a new phenomenon. Over the past ten years, Blue Cross plans in at least 13 other states have converted, including the record-setting California Blue Cross conversion that generated more than $3 billion in proceeds, which subsequently were used to establish a new health care foundation (Fox and Isenberg 1996; Hall and Conover 2003). The significance of health care conversions and corporate ownership to accessibility, affordability, and institutional behavior has attracted considerable attention (Gray 1997; Hall and Conover 2003; Horwitz 2003; Sloan 2000).

The Empire case is noteworthy not only for its health policy implications but also for its atypical legal process. We focus on three aspects of the conversion. First, the New York legislature, rather than the courts, directed the disposition of the assets by conditioning its approval of the conversion on the asset transfer. Second, because the legislature ordered that 95 percent of the conversion assets be transferred to the public treasury, the state itself was the primary beneficiary. Third, the state attorney general did not exercise his usual power over charities as protector of the public interest in charitable assets. Rather he represented the legislature in its appropriation of charitable funds to the public treasury. In addition, we believe that the statute may violate the U.S. Constitution. In support of our claims, this article explores federal and state constitutional law and legal principles, dating back to the 16th century, which reject the power of the legislature to direct the disposition of charitable funds.

Why should contemporary policymakers care about centuries-old English law? As a practical matter, the English common law of trusts is the foundation for American laws applicable to nonprofit charities. If the courts ultimately affirm the power of the legislature to claim the conversion proceeds, the move will represent an important change for the worse in this legal doctrine. In its weakest form, our argument

suggests that the New York legislature was reckless in how it dealt with charitable funds. The state moved from protecting private funds for the benefit of future generations to appropriating them as public funds and applying them to meet a current budget shortfall. In addition, the attorney general should not have abandoned his traditional role as protector of charitable interests in favor of supporting the action of the legislature. Alternatively, if he had been compelled to uphold the validity of the conversion, he should have not opposed efforts, by parties representing the public interest in this matter, to have the issue litigated. In its strongest form, our argument suggests a constitutional claim against the legislation authorizing Empire's conversion.

The Conversion Process

In the typical conversion, a process derived from the common law of charitable trusts dictates the use of the organization's assets. Since the mid-1990s, however, more than half the states have enacted conversion statutes codifying the common law rules to ensure that they can be easily enforced. The common law principles and the new statutes are based on trust rules requiring that conversion proceeds be directed to charitable purposes similar to those of the converting organization (Fremont-Smith 2004). Although the specific mechanics of an insurance conversion vary considerably by state, many begin by filing a conversion plan with the state attorney general and insurance department and, less often, with the state health care regulators. The plan specifies the conversion method, such as a merger, acquisition, asset sale, dissolution, or restructuring. A valuation, often the most controversial step in the conversion, is performed to determine the fair market value of the converting organization. Assets equal to that amount are then typically transferred to a new charitable organization, such as a foundation, whose purpose is substantially similar to that of the converting entity. In essence, the purpose and the financial value remain intact.

State attorneys general monitor the process, based on their general common law authority and, in many states, their statutory authority as well. In some states, the converting organization is required to obtain court permission before the conversion may proceed. When there are disputes, the attorney general files suit in court as the representative of the public, which is the ultimate beneficiary of the assets. It is

judges who then determine whether the purposes for which the nonprofit was established are impossible, obsolete, wasteful, or impractical to implement. If so, judges use their equitable power—the power to administer justice based on fairness rather than a strict interpretation of legal rules—to direct that the assets be used for similar charitable purposes under a doctrine known as *cy pres* (from Norman French, meaning "as near as possible"). This is what happens, for example, to a medical research foundation when the research succeeds and the disease is cured.

Traditionally, only the charity's fiduciaries and the attorney general have legal standing to challenge the process. In the case of insurance company conversions, an insurance commissioner or health department representative might be allowed to intervene as well. In recent years, four states have adopted the Uniform Trust Code §405(c), which does give standing to donors to enforce charitable trusts and, possibly, by extension to restricted funds held by charitable corporations. New York is not one of the four.

The Empire Case

The Conversion Story

Founded in the 1930s, Empire was organized as a nonprofit company. It provided a safety net of sorts for poor New Yorkers who were unable to find health insurance elsewhere and, in return, received preferential financial treatment from the state until the mid-1990s.[2] In the early 1990s, Empire was beginning to fail (for details, see Robinson 2003). Sloppy management, fraud charges, and high executive turnover rates made its prospects look grim (McCue 2001). A new CEO claimed in 1997 that unless relieved of its nonprofit status, Empire would be unable to compete, grow, and, ultimately, survive[3] (Freudenheim 2001; Stocker 1997).

Empire proposed, and the insurance department approved, a conversion transaction under which the proceeds of an initial public offering would be transferred to a new charity.[4] The then attorney general, however, published a memorandum concluding that new legislation was required before the conversion could proceed. The Greater New York Hospital Association and the hospital workers' union (Local 1199) strongly lobbied against the proposal on grounds that a for-profit Empire would be bad for hospitals and workers, and for several years they

effectively blocked the conversion plans. In January 2002, after Governor Pataki made an agreement with the hospital association and union regarding the assets' disposition, the New York legislature passed a statute authorizing the conversion.

The conversion legislation amended the state insurance laws, establishing a new nonprofit corporation with the statutorily defined purpose of managing a charitable asset fund containing 5 percent of the sale proceeds from the conversion.[5] The remaining 95 percent was to be treated as a public asset managed by a five-member board, three of whom were to be appointed by the governor and one each by the president of the senate and the speaker of the assembly. The statute required the board to direct the proceeds from the public asset, under the direction of the director of the budget, to the tobacco control and insurance initiatives pool. The statute further required that the public asset be paid to hospitals, nursing homes, and other agencies for wage increases for health care employees. The statute assumed that if there was going to be a public stock offering, the asset value would be determined by a market sale.

In August 2002, five consumer and voluntary health organizations and five individual Empire subscribers brought an action against the company, its directors, the state, and individual government officials. The suit sought a declaration that the conversion statute was unconstitutional, an injunction preventing the transfer of Empire's assets to the state, and an order directing that all conversion proceeds be transferred to a private charitable foundation impressed with Empire's former mission. The conversion itself was completed on November 7, 2002, with the sale of more than 16 million shares (approximately 20 percent of Empire's outstanding stock), at $25 per share, for a total of $400 million. The state retained the remaining shares. On that same day, a justice of the New York State Supreme Court (the trial court) ordered the state comptroller to hold the stock and cash in trust, pending the final determination of the suit. In 2004, the state sold an additional 9,075,000 shares at $40 per share, for a total of $363 million, which also was added to the escrow account. By 2005, the company's value had increased to $4.4 billion.

In February 2003, the New York Supreme Court ruled on certain preliminary issues in the case, finding that some of the plaintiffs—the subscribers and consumer advocates, but not the social services organizations—had standing to challenge the statute.[6] Although as explained earlier, the attorney general is usually the only party with standing to enforce the terms governing the use of charitable assets, the court

found an exception. In this case, the court recognized that the plaintiffs had a special interest in the corporation and that the attorney general was defending the statute rather than representing the public's interest in the charity. Regarding the substantive claims, the court granted the state's and Empire's requests to dismiss the plaintiffs' nine causes of action.

The court did not rule for the defendants, however, because it found that the alleged facts supported an additional, although unstated, claim. Namely, the statute violates the state constitution because it is a private law applicable only to Empire and not to a class of similar entities. In May 2004, the New York appellate court upheld the decision allowing the plaintiffs to go to trial on this private law issue.[7] The plaintiffs are appealing the dismissal of their other claims.[8]

Empire's Legal Status

Empire's many corporate predecessors were organized and licensed under New York corporate, charities, and insurance statutes. The extent to which Empire has inherited its predecessors' charitable duties remains at issue. In brief, Empire is governed by two statutes—New York Not-for-Profit Corporations Law and Insurance Law—that could have different implications for the disposition of conversion proceeds. First, as a New York nonprofit corporation, Empire was organized exclusively for nonbusiness, nonpecuniary purposes. If a nonprofit corporation wishes to dispose of substantially all its assets, it must follow certain internal procedures in making that decision and then obtain permission from the state supreme court. In its petition to the court, the nonprofit must demonstrate, among other things, that the transaction is "fair and reasonable to the corporation" and promotes "the purposes of the corporation."[9] If a nonprofit corporation wishes to dissolve, it must transfer its assets to a similar corporation, with substantially similar purposes, according to a plan approved by the board and the state supreme court.

In contrast, the new statute explicitly excused Empire from these procedural requirements. Instead it required the superintendent of insurance (the title of the insurance commissioner in New York) to review the Empire conversion plan to ensure that, among other things, it "not negatively impact on the delivery of health care benefits and services to the people of the state of New York."[10] Judicial review of the plan is limited to determining whether the superintendent acted arbitrarily or capriciously in reviewing the plan.

Empire also held an insurance license. As a nonprofit corporation Empire had a general obligation to pursue the company's charitable mission, but as an insurer it had a duty to operate for the benefit of its members, making the company more akin to a mutual than a public benefit corporation. For example, insurers must follow several procedures, including notifying enrollees and obtaining permission before dissolving or discontinuing operations.[11] These corporations were not allowed to convert to for-profit form under New York insurance law; therefore the law does not specify the appropriate use of assets upon conversion. After reviewing a restructuring plan proposed in 1999, however, the insurance commissioner ruled that this prohibition did not apply to the transfer of Empire's assets to a for-profit company because assets of an equal value (the sale proceeds) would be used by an independent entity for nonprofit purposes.[12]

The Power of the Courts versus the Power of the Legislature: Who Can Direct the Disposition of Conversion Proceeds?

English Common Law

To legal practitioners and scholars of nonprofit law, Empire's conversion history seems odd. As noted earlier, conversions have been for centuries under the jurisdiction of the courts rather than the legislatures. Originally, the power to direct the disposition of charitable assets stemmed from the power of the king as *parens patriae* (parent of the country). During the 16th century, the king delegated to the courts some of his power to exercise the *cy pres* doctrine to the courts of equity under the jurisdiction of the lord chancellor (the presiding judge) in all but two circumstances. The Crown retained the power to exercise *cy pres* (1) when the gift was made to charity generally without designating a trustee, a circumstance that included gifts to nonexistent or defunct charities; and (2) when the object of the gift was illegal or void as contrary to public policy. The use of the Crown's retained power to alter the purposes of charitable property was known as the prerogative *cy pres* power. In no cases, however, did Parliament have any power to direct the disposition of charitable funds.

The cases in which gifts were given for illegal purposes were those for the support of religions other than the Church of England. These gifts,

called "gifts for superstitious uses," were most often for saying masses. In some reported cases, the king exercised the *cy pres* power by confiscating these gifts. In most instances, however, the Crown ordered that the gift be used for a legal charitable object.

Over time, in what some viewed as a usurpation of the king's power, the chancellors expanded their judicial power to save outright general gifts to charity when there was no trustee. The chancellors exercised this prerogative power in the king's name. It was not until 1803 that the court's *cy pres* powers were clearly delineated as judicial and prerogative *cy pres*. According to a ruling by Lord Eldon, "where there is a general indefinite purpose, not fixing itself upon any object . . . the disposition is in the King by Sign Manual [under his signature or stamp]: but where the execution is to be by a trustee with general or some objects pointed out, there the Court will take the administration of the trust" (Cy Pres in New York 1957, 273). By that time, the provisions banning superstitious uses had been repealed, thereby effectively voiding the king's power to direct the disposition of gifts for illegal, charitable purposes. Although the court was empowered to apply the *cy pres* doctrine in all instances, the rulings made clear that the court was exercising two distinct powers. One power stemmed from its delegated jurisdiction, and the other, from an exercise of the king's retained powers.

Prerogative Cy Pres *in the United States*

In the United States, the state legislatures are considered to be the inheritors of many of the powers of the English kings. However, despite some contrary authority, the prerogative power of *cy pres* did not pass to the legislatures (Bogert and Bogert 1977, §434; Scott and Fratcher 1987, §399.1). Rather, legislative authority over charities whose purposes no longer serve contemporary needs generally pertains to regulating the extent of the *cy pres* doctrine and framing rules by which courts apply the doctrine. In fact, one of the major legal treatises on the law of trusts suggests that the exercise of the prerogative *cy pres* power in the United States would amount to giving a legislature the power to disregard the rights of a testator and that "no one, whether king or legislature, should have an arbitrary power to apply it to any charitable purposes which to him or it may seem fitting" (Scott and Fratcher 1987, §399.1, 3093).

Only a handful of American opinions have dealt with the prerogative *cy pres* power of the legislature. None is from New York. The most

important is a series of 19th-century cases involving the Church of the Latter-Day Saints (the Mormon Church) in the Utah territory (for a historical survey, see Gordon 2002). These cases, discussed in more detail later, held that the Congress retained the prerogative *cy pres* power at least in regard to the territories.

In the few cases dealing with the prerogative *cy pres* power in the states, it was flatly rejected in almost all. The Massachusetts Supreme Judicial Court, for example, responding to a question posed by the state senate in 1921, ruled that the legislature had no power to terminate, change, or control the disposition of charitable funds.[13] Similarly, in a New Hampshire case decided in 1957, the state supreme court held that the legislature could not exercise *cy pres* power and therefore could not pass legislation allowing a fund established to maintain a particular cemetery plot to be used to maintain the whole cemetery. According to the court,

> The power of the courts of equity to administer charitable trusts *cy pres* is so firmly established and so frequently resorted to, that the authority of the Legislature with respect to the disposition of charitable trust funds has not been much mooted. . . . Authorities in the field of trusts have expressed the view that the prerogative power of the Crown has no place in our jurisprudence.[14]

Finally, the Restatement (Third) of the Law of Trusts concludes that the prerogative power has not been adopted as part of United States law but that legislatures may regulate the extent to which the courts use the judicial *cy pres* power (American Law Institute 2003a, §67 cmt. a).

Where Should the Money Go: May the State Claim the Assets?

English Common Law

In England, the state never appropriated charitable funds for its own purposes, except for a few cases in which the charitable purposes were illegal. One of the first reported cases involving prerogative *cy pres* was decided in 1607. The king's power was applied to a gift to a schismatic sect opposed by James I, and the funds were diverted to more acceptable religious uses (Jones 1969; Sheridan and Delany 1959). In other words, they were directed to another charity.

Throughout the 17th and 18th centuries, this pattern was followed, with the exception of a few cases in which funds reverted to heirs or, though the records remain unclear, were forfeited to the Crown for its own use. The question of the proper disposition of funds subject to prerogative *cy pres* was settled in the *Gaynor Jones* case, decided in a series of rulings between 1686 and 1690. The rulings dealt with the proper disposition of funds that the Crown had appropriated because they had been used as a secret trust to support "popish purposes." The case established the rule that the Crown could not appropriate funds for its own use (interestingly, by then James II was attempting to use the funds for the same illegal "popish purposes") but could redirect them only to other valid charitable uses. Therefore, only in the rare occasions when a charitable purpose was illegal did the Crown direct the property to itself. And even then, the practice was short-lived.

United States Law

The Mormon Church cases are similar to the earliest English cases in their approval of the government's seizure and transfer of substantial funds from illegal and disfavored religious uses to state-sanctioned uses. Two statutes formed the basis of the Mormon Church controversy. First, in 1862, "an act to punish and prevent the practice of polygamy in the territories of the United States, and other places, and disapproving and annulling certain acts of the legislative assembly of the territory of Utah" was passed.[15] It extinguished the corporate existence of the Mormon Church and prohibited all religious or charitable corporations in the territories from holding real estate exceeding $50,000, with any property in excess to be forfeited to the federal government. Second, in 1887, Congress amended the previous act by, among other things, ordering the U.S. attorney general to initiate proceedings to dissolve the church corporation and transfer its property to the United States. It also ordered the secretary of the interior to use the proceeds for the "benefit of the common schools in the territory in which the property may be."[16] That year, the Utah Supreme Court entered a decree of dissolution, annulled the church's charter, and appointed a receiver.[17]

Three years later, the U.S. Supreme Court upheld the act, ruling that Congress could lawfully seize church property because its supreme power over the territories included the ability to repeal a corporate charter and dissolve a corporation it had created.[18] Once the corporation was

dissolved, the personal property became "subject to the disposal of the sovereign authority,"[19] while the corporate real property reverted to the grantor which, in this case, was the United States.

The Court also held that the state has power over charitable property when a charitable corporation is dissolved and no donor or founder can be identified that would be entitled to its real estate. Under such circumstances, the Court stated,

> The government or sovereign authority, as the chief and common guardian of the state, either through its judicial tribunals *or otherwise*, necessarily had the disposition of the funds of such corporation to be exercised, however, with due regard to the objects and purposes of the charitable uses to which the property was originally devoted, so far as they are lawful, and not repugnant to public policy [italics added].[20]

Comparing the federal, legislative powers with those of the English king, the Court concluded that some cases, such as those in which the purposes of a gift are declared void, are beyond the judiciary's jurisdiction. The legislature held the same *parens patriae* authority as the king, with the exception of limitations imposed by the Constitution. The Court wrote,

> If it should be conceded that a case like the present transcends the ordinary jurisdiction of the court of chancery, and requires for its determination the interposition of the *parens patriae* of the state, it may then be contended that, in this country, there is no royal person to act as *parens patriae*, and to give direction for the application of charities which cannot be administered by the court. It is true we have no such chief magistrate. But here the legislature is the *parens patriae*, and, unless restrained by constitutional limitations, possesses all the powers in this regard which the sovereign possesses in England.[21]

Finally, the Court distinguished the U.S. prerogative powers from those that might be exercised by irresponsible monarchs. Here, the legislative power was to be exercised only for the benefit of the people.

Congress and the U.S. Supreme Court later eliminated the need for the distinctions between judicial and prerogative powers outlined in the cases.[22] In October 1893, Congress approved a joint resolution that was in accord with the wishes of the Mormon Church. It restored the personal property to the control of the church's president:

> for the relief of the poor and distressed members of said church, for the education of the children of such members, and for the building and repair of houses of worship for the use of said church, but in which the rightfulness of the practice of polygamy shall not be inculcated.[23]

The U.S. Supreme Court ordered Utah to issue a new decree so as to avoid the perception that the courts and not Congress had directed the outcome. Thus Congress, and not the court, determined the use of all the seized property.

We described these Mormon Church cases to provide historical background as well as to indicate the limits of the prerogative power. Although the cases represent an application of the prerogative *cy pres* power in the United States, there are several reasons why they offer only limited support for the power of the New York legislature to take Empire's assets. Most important, the prerogative power was applicable in those cases because the purposes of the charity violated public policy, a reason that does not exist in the Empire case. In addition, according to the majority opinion in the cases, Congress's power to rescind the church's charter stemmed from its sovereign authority over the territories. This was unusual because the exercise of inherent powers was usually reserved for the state legislatures. Given their historical context, however, state legislatures should be reluctant to rely on the Mormon cases as good authority for exercising inherent power to claim charitable funds. The use of the prerogative *cy pres* power over Mormon assets in the territories was part of an effort to suppress the Mormon Church and the beliefs of its members through methods such as denying them voting rights (see Cleveland 2002, 200–3). Finally, as discussed earlier, in those cases in which the states considered the prerogative *cy pres*, they found it to be a doctrine not appropriately inherited by the state legislatures.

The Role of the Attorney General

The third unusual aspect of the Empire case is that the attorney general did not exercise his power to protect charitable funds as representative of the public interest but, rather, took the position of the insurance commissioner in arguing for the validity of the statute approving the conversion. A state attorney general has many duties, and it is not unusual for them to conflict. Conflicts commonly occur, for example, when a state

revenue department challenges the deductibility under the state tax laws of a charitable gift and the attorney general must choose whether to represent the state department of revenue or fulfill his role as protector of charitable funds.

In this case, New York law requires the courts to give notice to the attorney general of any case involving a constitutional challenge to a statute and authorizes him to appear in the case to uphold the statute.[24] One way to resolve the dilemma posed when an attorney general has a conflict of this nature is for the state agency involved to be represented by its own staff attorneys or to retain outside counsel, thereby freeing the attorney general to protect the charitable interests. In any case in which an attorney general chooses to appear as an adversary to charitable interests, a strict interpretation of the rule giving him exclusive standing effectively ensures that the public interest will be defeated. The court in the Empire case recognized this difficulty when it granted standing to plaintiffs representing the public to be heard, thus allowing the suit to go forward.

Another anomaly in the Empire situation should be noted. In the lower court hearings, the attorney general not only supported the constitutionality of the statute authorizing Empire's conversion, but he also opposed giving standing to the plaintiffs to argue against the propriety of the conversion legislation. It is questionable whether this was a necessary component of his defense of the statute—particularly since, as noted, if standing were refused, there would be no way in which a court would hear the case for preserving the charitable assets. In short, one must wonder whether such zeal is appropriate in light of his role in preserving charitable funds.

Constitutional Claims against the Empire Statute

There are a number of bases on which it can be argued that the Empire statute violates the Constitution.[25] First, as mentioned earlier, the statute limited the right to convert only to Empire. It was for this reason that the New York Supreme Court ruled that the legislation may have violated a New York constitutional provision prohibiting special legislation—private bills granting exclusive privileges to individual people and corporations—and gave the plaintiffs an opportunity to present this

argument to it.[26] Such a legislative violation, however, might be easily fixed. Although attempts to do so have not yet become law, the state assembly passed a bill in 2003 allowing all New York insurers to convert, and an early version of Governor Pataki's 2004 budget bill authorized future insurance conversions with the new requirement that up to $400 million of proceeds from each conversion must go into the tobacco control and insurance initiatives pool, and the balance would be spent for other state purposes as required by statute.[27]

A second concern is whether the New York legislation violates the contracts clause of the U.S. Constitution, which forbids states from passing a law that retroactively impairs the obligation of contracts. The basis for the argument is that the legislation improperly interferes with property interests arising from Empire's incorporation as a nonprofit corporation. The question of a constitutional constraint on legislative action over private corporations, and in particular nonprofit corporations, was raised in the leading "Dartmouth College" case decided in 1819 by the U.S. Supreme Court.[28] It held that the New Hampshire legislature could not amend the Dartmouth College charter to effectively make it a public institution without the consent of the college's trustees.

After this case was decided, it became customary for corporations to be established under general enabling statutes in which the legislature reserved the right to amend charters, thereby limiting the holding in the case. This reserved power, however, "is not unlimited and cannot be exerted to defeat the purpose for which the corporate powers were granted, or to take property without compensation, or arbitrarily to make alterations that are inconsistent with the scope and object of the charter."[29] Whether the New York legislature exceeded its powers under the state statute in claiming the charitable assets remains undecided.

The Empire conversion may also be distinguished from the facts in the Dartmouth College case, and therefore the New York legislature may not be constrained by its holding. Empire's directors *chose* to convert to for-profit form. Consequently, their actions could be characterized as voluntary. The legal objection to this position, however, is that the directors of Empire had no power to accept the conditions set by the legislature. As directors of a charity they could abandon their charitable mission only when authorized to do so by the courts in a *cy pres* proceeding. In other words, their action exceeded their powers and, therefore, had no legal effect.

A third constitutional objection is that the legislation may violate the takings clause of the Fifth Amendment, which forbids the government's taking private property for public use without just compensation. Empire's directors had initially hoped to convert and establish a new, private, nonprofit charity, but that choice was removed by the legislature (Cowan and McKinley 2003). The directors wished above all else to convert, and in New York, the price of conversion was turning the funds over to the state. A separate question is whether the directors' actions violated their duty of loyalty. This question of directors' governance duties in the context of conversions is of great public importance.

One recent case may support the claim that the Empire statute was an impermissible taking.[30] In 1999, the Illinois legislature authorized the creation of the Illinois Clean Energy Community Foundation (ICECF). The foundation, funded by Commonwealth-Edison when it earned large profits from the sale of some power plants in the late 1990s, was established to support energy efficiency and environmental projects. There is some dispute about whether the foundation's establishment, the result of a compromise between the parties, was entirely voluntary or a quid pro quo for permission to sell the power plants. Subsequently, the legislature amended the authorizing act to require the foundation to transfer $125 million, slightly more than half its original assets, to the state treasury. The U.S. district court granted summary judgment to the foundation, finding that the amendment amounted to an unconstitutional taking of private property. In upholding the lower court's decision, the U.S. Court of Appeals found that

> Illinois [c]annot lawfully amend its corporation law to confiscate the assets of all corporations incorporated . . . in Illinois by virtue of that law. The fact that the state legislature authorized the creation of the plaintiff foundation does not make the foundation a state agency; for the legislature also authorizes the creation of business and professional corporations, not to mention religious and charitable corporations, without thereby acquiring a right to confiscate such entities' assets.[31]

In some respects, the case against the validity of the Empire legislation is stronger than that against the Illinois legislation. Although the appellate court decided that the specific terms of the ICECF incorporation did not make it public, unlike Empire, ICECF was specifically chartered by the state, and state officials held some control over the foundation through its power to appoint, though not to remove, trustees. By

contrast, Empire is a creation of New York law only by virtue of its incorporation under the general nonprofit and insurance statutes.

In other respects the case against New York may be weaker than the case against Illinois in ICECF. To the extent that the decision by Empire's directors to convert did not exceed their authority, the decision could be characterized as voluntary. Therefore, the money transfer would better be described as *giving* to the government than as *taking* from the charity. But even if the directors gave the proceeds to the government voluntarily, the legislation could still be considered an impermissible taking if a court found that the price of the conversion—95 percent of the proceeds—was too high. Requiring that Empire turn over almost all the proceeds to the state for the privilege of converting could be considered sufficiently coercive or such an intrusion into private property rights as to be an unconstitutional condition (see generally Epstein 1988; Sullivan 1989).

Discussion and Conclusion

Many important policy implications raised by the Empire case have nothing to do with the behavior of English kings in the 1600s, and these modern-day considerations have drawn substantial attention elsewhere (see, e.g., Robinson 2003). Commentators have correctly wondered whether Governor Pataki's closed-door deal with the hospitals and union regarding the conversion proceeds was a legitimate way of conducting health policy. With budget deficits estimated in the billions, the governor has encouraged other insurers to convert (Cowan and McKinley 2003). Using one-time infusions of conversion proceeds to fix structural budget shortfalls has, and should, give pause to New Yorkers. In fact, the state comptroller has "warned that the use of such nonrecurring revenue sources to pay operating expenses breaks a cardinal rule of municipal finance. The revenue runs out, but the costs continue" (Baker 2005, B1). While important, these are not the only significant issues raised by the case.

We have considered the legal implications of the Empire conversion and summarized its historical context in the hope that future discussions will recognize more fully what is at stake. First, retaining the traditional limitation of the power to administer charitable assets in the judiciary, rather than expanding it to the legislature, is good policy for both intrinsic and consequential reasons. The common law of charities has looked

to the courts as the best arbiters of this issue. Although they may behave with considerable partiality in some matters (Hills 2002), they are further removed than legislators from budgetary pressures or the pull of special-interest groups, such as hospitals and health workers, which would like to use the funds for their particular projects.

Second, in the Empire case the legislature not only directed the use of the funds but also claimed them as its own, much as the king did during a brief period hundreds of years ago. Even the English kings, however, claimed charitable funds for the Crown only when a charity's purposes were illegal, a circumstance that does not apply here. If this precedent is upheld, we believe it will undermine the nonprofit form. Nonprofit organizations are not government organizations, and their assets do not belong to the public. They exist to allow citizens to use their energy to carry out their private visions of the common good. The sphere of charitable activity is different from the sphere of public activity; it is valuable in its own right and should be sustained, not preempted, by the state. Again, it is unlikely that judges sitting in relative remove from self-interested constituents and the immediacy of policy pressures would have been as imprudent as the New York legislators when they effectively confiscated charitable assets to cover a budget shortfall. For this reason, too, courts may have more institutional competence in overseeing conversions and exercising *cy pres* power than legislatures do.

Aside from these intrinsic reasons for fearing legislative claims on charitable assets, there are instrumental reasons for objecting to the Empire legislation. The public may not support the special status of nonprofits if their funds can be converted into donations to the state treasury by a state legislature ratifying a political deal. Unfortunately, New York is not the only state that has claimed conversion proceeds. In 1996, in compliance with a state statute requiring proceeds to be paid to the state treasury, $175 million was transferred to the state treasury when Trigon (Blue Cross and Blue Shield of Virginia) converted from a nonstock mutual insurer to a stock corporation.[32] The proceeds of a Wisconsin conversion were directed to two medical schools in Wisconsin, including the public medical school at the University of Wisconsin.[33]

More recently, having observed the Empire transfer, the governor of New Jersey tried to balance his state budget by urging the state's largest insurer to convert (João-Pierre 2004; McAlpin 2005; Washburn 2005). In a very different context, the Maryland general assembly enacted legislation in 2003 that effectively blocked a proposed conversion

by requiring the local Blue Cross affiliate to maintain nonprofit status for five years. The statute included a schedule for replacing board members with others to be nominated by a state-appointed committee (Fremont-Smith 2004, 366–7; Brody 2004).

The third unprecedented aspect of the Empire situation is the opposition of the attorney general to any grant of standing to parties representing the public interest. The New York court appropriately recognized that the Empire case was one of the rare instances in which the rule granting exclusive standing to the attorney general to protect charitable funds must be relaxed in order for the beneficial interest of the general public to be heard, thereby setting an important precedent in that jurisdiction.

A few objections to our arguments should be noted. First, there is debate about the extent that trust law in some states applies to converting corporations.[34] The extent of the power of the judiciary in the case of a corporate change of charitable purpose also remains unsettled in some jurisdictions (American Law Institute 2003b). This is not to say that the legislatures rather than the courts have the authority. Rather, the difference lies in the degree of autonomy given to the corporate board or the members to redirect the use of assets, other than explicitly restricted donated assets, after a change in purpose.

Second, some people question why charities law should apply in this case. Empire is an insurer, operating in a competitive industry and charging for its services, and in many states, Blue Cross insurers are not legally charities. Health insurer conversions, it may seem, do not raise the same substantive concerns regarding government intrusion into private activity that the conversions of traditional charities raise. It was this view of health care insurers that led Congress, in 1986, to remove tax-exemption status from organizations that provide commercial-type insurance, even though they were legal charities under state law.[35] We reject the argument that charity law is not applicable to Empire or similar insurers. Despite its commercial nature and the fact that it does not qualify for federal tax exemption, Empire is legally a charity. It was formally incorporated as a New York nonprofit corporation, founded with charitable contributions, and, since its inception, has been operated in the public interest.

Finally, it is possible that the attorney general and the courts would have reached the same conclusion as the New York legislature regarding the appropriate use of the proceeds. Perhaps salary increases for health care workers in New York hospitals advance some of the same goals

advanced by nonprofit insurers. Nonetheless, the process by which those proceeds find their way to advance charitable goals does matter. Charitable funds and purposes are protected by careful procedures that restrict claims on charitable assets. The courts are required to apply these, but the legislature has no need to consider them.

Some people may find our arguments conservative, excessively concerned with preserving the historical purposes of charities in an era of increasing competition, small and shrinking profit margins, and dire capital needs. Our interests are just the opposite. We are concerned with the freedom of individuals, without excessive state interference, to operate in the public interest, respond to contemporary needs, and enact their creative visions.

Endnotes

1. We use the terms *nonprofit* and *charity* to refer to entities conventionally described as having no owners. They are legally required to operate for the public benefit, broadly defined. They are not government institutions and, therefore, are not public in that sense of the word. Most of these entities are also exempt from federal income taxes.
2. *New York State Conference of Blue Cross & Blue Shield Plans v. Travelers Insurance Co.*, 514 U.S. 645 (1995).
3. Testimony of Empire Blue Cross Blue Shield CEO Michael Stocker, Public Hearing, *In the Matter of Empire Blue Cross and Blue Shield*, New York City, August 6, 2002, 15–17.
4. Opinion and Decision of the New York Superintendent of Insurance, *In the Matter of the Plan of Restructuring of Empire Blue Cross and Blue Shield*, December 29, 1999.
5. Health Care Workforce Recruitment and Retention Act, S.6084/A.9610, 2002 N.Y. Laws Ch. 1.
6. *Consumers Union of U.S., Inc. v. State of New York*, no. 11699/02 (N.Y. Sup. Ct. Feb. 28, 2003).
7. *Consumers Union of U.S., Inc. v. State of New York*, 7 A.D. 3d 416, 777 N.Y.S. 2d. 444 (N.Y.A.D 1 Dept. May 20, 2004).
8. *Consumers Union of U.S., Inc. v. State of New York*, 783 N.Y.S. 2d. 279 (N.Y.A.D 1 Dept. Oct. 12, 2004) (granting leave to appeal).
9. N.Y. Not-for-Profit Corp. Law §511(a)(6) (McKinney 2005).
10. N.Y. Ins. Law §7317 (McKinney 2002).
11. In re Plan of Restructuring of Empire Blue Cross and Blue Shield, Opinion and Decision, ¶¶60–62 (Dec. 29, 1999) (Gregory V. Serio, Acting Superintendent of Insurance) (outlining permissions and notifications needed to discontinue various plans).
12. In re Plan of Restructuring of Empire Blue Cross and Blue Shield, Opinion and Decision, ¶¶82–85 (Dec. 29, 1999) (Gregory V. Serio, Acting Superintendent of Insurance).
13. In re Opinion of the Justices, 237 Mass. 613, 131 N.E. 31 (1921).
14. Opinion of the Justices, 101 N.H. 531, 133 A.2d 792 (1957) (citing *Restatement (Second) of the Law of Trusts*, §399 cmt. e).
15. *Late Corporation of the Church of Jesus Christ of Latter-Day Saints v. United States*, 136 U.S. 1 (1890) (citing Act of July 1, 1862, ch. 126, 37th Cong., 12 Stat. 501).
16. Id. at 7.

17. *United States v. Church of Jesus Christ of Latter-Day Saints*, 5 Utah 361, 15 P. 473 (1887).
18. *Late Corporation of the Church of Jesus Christ of Latter-Day Saints v. United States*, 136 U.S. 1 (1890).
19. Id. at 47.
20. Id. at 48.
21. Id. at 56–57.
22. *United States v. Late Corporation of the Church of Jesus Christ of Latter-Day Saints*, 150 U.S. 145 (1893).
23. Id. at 148.
24. N.Y. Exec. Law §71 (McKinney 2005).
25. We thank participants in the State Authority over Charitable Assets Conference, particularly Professor Clayton Gillette, for their insights on these issues.
26. *Consumers Union of U.S., Inc. v. State of New York*, no. 118699/02 (N.Y. Sup. Ct. Feb. 28, 2003).
27. 2003 NY A.B. 6849; 2003 NY SB 6058 (Version Jan. 21, 2004).
28. *Dartmouth College v. Woodward*, 17 U.S (4 Wheat.) 518 (1819).
29. *Phillips Petroleum Co. v. Jenkins*, 297 U.S. 629, 634 (1936); see also *Board of Regents of University of Md. v. Trustees of Endowment Fund of University of Md.*, 206 MD 559, 112 A.2d 678 (1955), *cert. denied*, 350 U.S. 836 (1955).
30. *Illinois Clean Energy Community Foundation v. Filan*, 2004 U.S. Dist. LEXIS 7615, 2004 WL 1093711 (N.D. ILL) *aff'd.*,—F.3d—(7th Cir. Ill. Dec. 22, 2004) (No.04-2277). We thank Professor John Simon for bringing this case to our attention.
31. *Illinois Clean Energy Community Foundation v. Filan.*,—F.3d—(7th Cir. Ill. Dec. 22, 2004) (no.04-2277).
32. Prehearing Brief of the Division of Consumer Counsel Office of the Attorney General, Application of Blue Cross and Blue Shield of Virginia for Conversion from a Mutual Insurance Company to a Stock Corporation (Aug. 30, 1996) (no. INS950103).
33. *ABC for Health v. Commissioner of Insurance*, 640 N.W.2d 510 (Wis. App., 2001) (Petition for Review denied March 19, 2002).
34. *AARP v. Commissioner of Insurance*, 640 N.W.2d 510 (2002).
35. Internal Revenue Code §501(m) (2004).

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