

AB 2036 Seeks to Rectify a Loophole in California AG Merger Oversight But Can Go Further

As California continues to shelter in place and limit the spread of COVID-19, the California Legislature is forced to cut the number of bills it can consider this session. However, as hospitals struggle financially and possibly seek mergers to survive, merger oversight over nonprofit hospitals is more critical than ever to maintain health access. Under California law, the state Attorney General (“AG”) can impose conditional approval for mergers or acquisitions involving non-profit health facilities. Two recent bankruptcy court cases have threatened the viability of these conditional approvals by limiting the AG’s enforcement in certain cases. AB 2036 seeks, in response, to strengthen the AG’s conditional approval authority by allowing continued enforcement of any previously imposed condition to ensure health care access for the communities the hospital serves.

Brief Primer on AG’s Merger Oversight and Conditional Approval

The AG’s scope of merger review is specified in California Corporations Code sections 5914 and 5920, which require the AG to be notified and to approve a sale, transfer, or other forms of disposition of a nonprofit corporation’s health facilities’ assets. Specifically, section 5914 allows review of a transaction for assets transferred, sold, or otherwise disposed to a for-profit or mutual benefit corporation or entity, while section 5920 provides review authority for the same type of transaction with another nonprofit corporation or

entity.

Furthermore, under California Corporations Code sections 5917 and 5923, the AG has the ability to conditionally consent to the transaction, which means the AG can impose conditions in exchange for its approval. These consent decrees have been used to impose conditions that ensure healthcare access after a transaction, including a requirement for continued operation of emergency rooms and reproductive health services.

Recent Federal Bankruptcy Cases Limit AG Oversight Authority

Two recent cases, *In re Gardens Regional Hospital* (Mar. 15, 2017) and *In re Verity Health System* (Dec 26, 2018), have revealed limits of the AG's merger oversight. While the sales in both cases arise from bankruptcies, the limits set by these cases could also apply to non-bankruptcy sales.

In Re Gardens Regional Hospital and Medical Center, Inc. Exempts Sale of Closed, Nonprofit Hospitals from AG Oversight

In this case, Gardens Regional Hospital and Medical Center ("Gardens") closed and suspended its general acute care hospital license. Gardens sought approval in bankruptcy court for the sale of its closed hospital to American Specialty Management Group, which would reopen the hospital. While the Attorney General sought to place conditions on the sale, Gardens argued that because the hospital was "closed" and no longer qualified as a "health facility" per definition, the AG no longer had jurisdiction.[\[1\]](#) The federal bankruptcy court agreed.

The court's opinion rested upon the statutory interpretation of whether a closed hospital is within the definition of a "health facility" for the purposes of AG oversight.[\[2\]](#) Prior to 2018, a health facility was defined either as "a facility that provides similar health care" or by Section 1250 of the

Health and Safety Code. Under Health and Safety Code section 1250, a “health facility” means, in part, “a facility, place, or building that is organized, maintained, and operated for the diagnosis, care, prevention, and treatment of human illness, physical or mental, including convalescence and rehabilitation and including care during and after pregnancy.” (emphasis added.) Without any case precedent, the court interpreted the definition of a “health facility” under Health and Safety Code section 1250 in two consequential parts: a health facility must be (1) operating and receiving patients (2) in the present time. The court noted that the use of “is” in Health and Safety Code section 1250 rather than “is or previously was” made it clear that the health facility must be operating in the present.[\[3\]](#) In this case, the court held that the since the closed hospital was no longer operating or receiving patients at the present time,[\[4\]](#) it would not qualify as a health facility that is under the jurisdiction of the AG’s nonprofit merger oversight.

The AG argued that such an interpretation would lead to “other health facilities [] temporarily ceas[ing] operations in order to circumvent the Attorney General’s review of a sale of those facilities’ assets.”[\[5\]](#) The court disagreed for two reasons: (1) as the hospital was not operating at the time of the sale, the “Legislature’s objective of preserving charitable health facilities for the benefit of the uninsured is not implicated by the sale,” and (2) such a strategy “defies credulity,” as hospital closures result in significant value destruction as seen in the case at hand, where the sale value went from \$19.5 million to \$6.6 million, and as the court observed, are “time-consuming, costly, and requires fastidious planning.”[\[6\]](#)

In re Verity Health System of California, Inc. Exempts Sale of Nonprofit Hospitals to Public Entities from AG Oversight

About a year and a half later, the same federal bankruptcy court (and judge) furthered limited AG merger oversight by reasoning in *In re Verity* that the AG’s oversight authority

and previously imposed conditions do not apply when nonprofit hospitals are sold to public entities. In this case, Verity Health Systems, a nonprofit healthcare system, filed for bankruptcy and sought to sell two of its hospitals to the County of Santa Clara, which was already managing the Santa Clara Valley Medical Center. While the main reason the court allowed the sale without conditions is because the AG initially did not contest or impose conditions, the court also stated the AG's merger oversight is limited to sales to for-profit or mutual benefit corporations.[\[7\]](#) The court held that (1) the sale of nonprofit health facilities to a public entity like County of Santa Clara is not subject to AG review and (2) conditions previously imposed on the hospitals for sale would no longer be applicable.[\[8\]](#)

In explaining its reasoning for the first holding, the court stated that "because public entities are required by law to furnish healthcare services to those in need," nonprofit health facilities sold to public entities will continue operations that are consistent with the "charitable mission and ... public interest."[\[9\]](#) Therefore, there is no further need for the AG to review whether a sale to a public entity would be in line with the charitable mission or the public interest.

Furthermore, in describing its reasoning for the second holding, the court stated that the AG did not provide any "statutory provision permitting his continued enforcement of the Conditions."[\[10\]](#) Most importantly, the court wrote that the AG's "reliance upon provisions purporting to make the Conditions binding upon all successors, regardless of the circumstances under which such successors acquire the Hospitals, is an impermissible attempt to expand his regulatory authority over the Hospital."[\[11\]](#)

AB 2036 and Additional Amendments Can Resolve Loopholes in *In re Gardens* and *In re Verity*

AB 2036, as introduced in the 2020 legislative session, seeks to rectify the loophole in *In Re Verity* by requiring that any previously imposed “condition shall remain in effect for the entire period of time specified by the Attorney General.” (emphasis added) It specifically requires that “an additional or subsequent sale, transfer [. . .], or other disposition of assets” would not affect continued enforcement of the conditions. In doing so, AB 2036 would directly answer the court’s reasoning in *In Re Verity*, which stated that there was no statute that allowed the AG to continually enforce previously imposed conditions.

However, AB 2036 still does not ensure AG review of the sale of closed, nonprofit hospitals (as in *In re Gardens*) or sales to public entities (as in *In re Verity*). It could be argued that the loophole in *In re Gardens*, namely preventing continued enforcement of conditions on previously closed hospitals that were sold and then reopened, was addressed by a pair of bills enacted in 2017 (AB 651 and SB 687) that allow the AG to review transactions “regardless of whether it is currently operating or providing health care services or has a suspended license.” As both bills were amended to include this language post-*In re Gardens*, it may be possible that its inclusion was in response to the court decision.[\[12\]](#) Nonetheless, this amendment applied only to “a facility that provides similar health care” and did not specifically amend the definition of a “health facility”, as defined in Section 1250 of the Health and Safety Code. As such, it’s unclear if the court in *In re Gardens* would have differed in its analysis, which hinged on the definition of “health facilities” rather than “a facility that provides similar health care.”

As such, to cover both exceptions entirely, legislators could amend AB 2036 with appropriate language to allow the AG to review any sale involving assets of a nonprofit health facility, regardless of whether it is continuously operating

or to whom the facility is being sold. Furthermore, legislators should cite both bankruptcy cases discussed above as legislative intent to ensure proper AG oversight despite the court's reasoning in *In re Gardens* and *In Re Verity*.

If passed, AB 2036 would be applicable to federal bankruptcy proceedings, as amendments to the federal Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) provides that federal bankruptcy law would coexist with state, non-bankruptcy laws. This is important as the California Attorney General could continue to enforce conditions even if a hospital tries to release itself from the conditions via bankruptcy proceedings.

Conclusion

The AG review of a sale, transfer, or other forms of disposition of a nonprofit corporation's health facilities assets ensures that these hospitals provide sufficient healthcare access to the community despite budgetary concerns or profit motives. It is important, therefore, that the AG continue to exercise such enforcement authority without limitations.

AB 2036 corrects, in part, the loophole identified in the federal bankruptcy case, *In re Verity Heath System of California, Inc.*, to ensure that the AG may continuously enforce previously imposed conditions on nonprofit hospitals when they are sold to a public entity. Such enforcement would help ensure continued healthcare access. However, the bill stops short and could do more to correct additional loopholes in *In Re Gardens* and *In Re Verity*, which prevent AG review for certain type of sales, such as the sale of closed hospitals and the sale of nonprofit hospitals to public entities. Nonetheless, AB 2036 is an important step to ensuring healthcare accessibility in the midst of increased healthcare

consolidation.

[1] In re Gardens Regional Hospital and Medical Center, No. 2:16-bk-17463-ER at *3 (Bankr. C.D. Cal. May 15, 2017).

[2] *Id.* at *5.

[3] *Id.* at *5-6.

[4] *Id.*

[5] *Id.* at *6.

[6] *Id.* at *7.

[7] In re Verity Health System of California, Inc., No. 2:18-bk-20151-ERat *9, *10 (Bankr. C.D. Cal. Dec. 26, 2018).

[8] *Id.* at *10-11.

[9] *Id.* at *10.

[10] *Id.* at *11.

[11] *Id.* at *11.

[12] The bill analyses for either bill did not indicate the *Gardens* court case as a reason for the amendment.