California State Auditor

BUREAU OF STATE AUDITS

# Office of the Attorney General:

## *It Diligently Investigated the Legality of Downey Community Hospital Foundation's Transactions, but Questions Remain About Sound Business Practices*

CALIFORNIA STATE AUDITOR
BUREAU OF STATE AUDITS

July 2000
99101

The first five copies of each California State Auditor report are free. Additional copies are $3 each, payable by check or money order. You can obtain reports by contacting the Bureau of State Audits at the following address:

**California State Auditor**
**Bureau of State Audits**
**555 Capitol Mall, Suite 300**
**Sacramento, California 95814**
**(916) 445-0255 or TDD (916) 445-0255 x 216**

**OR**

**This report may also be available on the World Wide Web**
**http://www.bsa.ca.gov/bsa/**

**Alternate format reports available upon request.**

# CALIFORNIA STATE AUDITOR

MARY P. NOBLE
ACTING STATE AUDITOR

STEVEN M. HENDRICKSON
CHIEF DEPUTY STATE AUDITOR


July 17, 2000 99101

The Governor of California
President pro Tempore of the Senate
Speaker of the Assembly
State Capitol
Sacramento, California 95814

Dear Governor and Legislative Leaders:

As requested by the Joint Legislative Audit Committee, the Bureau of State Audits (bureau) presents its audit report concerning the Office of the Attorney General's (attorney general) investigation of the Downey Community Hospital Foundation (foundation).

This report concludes that the attorney general's investigation appropriately determined whether officers or directors of the foundation diverted charitable assets, acted to defraud the charity, or committed other unlawful acts that resulted in a loss of charitable assets. State law, however, prohibits both the attorney general and the bureau from publicly reporting any details of the investigation.

However, it was not within the attorney general's enforcement scope to determine if foundation directors and officers used good business judgment. Therefore, additional evaluation would be necessary to determine whether the foundation's business practices adequately considered risk when it committed charitable resources in some business transactions.

Respectfully submitted,

Mary P Noble

MARY P. NOBLE
Acting State Auditor


BUREAU OF STATE AUDITS
555 Capitol Mall, Suite 300, Sacramento, California 95814 Telephone: (916) 445-0255 Fax: (916) 327-0019

# CONTENTS

# SUMMARY

*Audit Highlights . . .*

***Our review of the Office of the Attorney General's (attorney general) investigation of the Downey Community Hospital Foundation (foundation) revealed that:***

- ☑ ***The attorney general's investigation adequately determined whether foundation officers or board members committed a breach of charitable trust, breach of duty, or other unlawful acts.***
- ☑ ***Although not within the scope of its investigation, the attorney general would need to perform additional work to determine whether foundation directors and officers used sound business judgment in certain ventures.***

## RESULTS IN BRIEF

Responding to complaints from citizens of the city of Downey, the California Office of the Attorney General (attorney general) in 1998 conducted an investigation of Downey Community Hospital Foundation (foundation), which has directed the hospital since it became nonprofit in 1956. Complaints against the foundation focused on its partnerships with for-profit entities, its use of charitable resources in these alliances, and its compensation of its chief executive officer. The attorney general's investigation was diligent in determining whether the foundation officers or board members committed any unlawful acts that caused the loss of charitable assets. However, because the California Public Records Act states that any investigation conducted by the attorney general is exempt from public disclosure, we are prohibited from commenting on the specific conclusions reached in its confidential report. Also, California Government Code provisions prohibit the release of private records obtained in the course of an investigation unless in a legal proceeding. The attorney general cited these provisions in refusing our written request to include in our report any of the information it had gathered or the conclusions it had reached.

Had the scope of the attorney general's investigation included determining if foundation directors and officers used good business judgment, its staff would have had to more thoroughly evaluate some actions of those individuals. For example, to determine whether the foundation exercised sound business discretion, auditors would have looked for evidence that officers and directors adequately analyzed the financial risks and viability of certain business ventures before committing the foundation's charitable resources. The attorney general's mandate was only to evaluate whether the foundation used its resources properly and legally, and additional scrutiny would be needed to show whether sound business practices dictated the allocation of those resources.

## AGENCY COMMENT

The Office of the Attorney General stated that it agreed with the conclusions reached in our report. ■

# INTRODUCTION

## THE ATTORNEY GENERAL'S ROLE

The Office of the Attorney General (attorney general) is the chief law enforcer of the State and has an operating budget of over $480 million. Its responsibilities include ensuring California's laws are enforced by providing legal services on behalf of the people of California and representing the people in actions to enforce environmental, consumer, anti-trust, and civil rights laws. Also, it coordinates efforts to address narcotic enforcement throughout the State, assists local law enforcement agencies in the investigation and analysis of crime, and pursues projects designed to protect the people of California from fraudulent, unfair, and illegal activities.

The attorney general also oversees the activities of charitable trusts and nonprofit public benefit corporations (charitable corporations), allotting about $3.2 million of its fiscal year 1999-2000 budget for such oversight. The purpose of charitable corporations is to aid segments of the community that fall outside the general scope of public assistance. These corporations typically establish charitable programs or set aside funds to be used for charitable purposes. The attorney general's Charitable Trusts Section (trust section) provides information and assistance to directors, volunteers, and fundraisers associated with such corporations. It also conducts investigations and audits of charitable corporations to determine if their officers, directors, or trustees are using the trusts' assets for their intended purposes. In its role as legal overseer of charitable corporations, the trust section recently conducted an investigation of the Downey Community Hospital (hospital)[1] and related entities.

## HISTORY OF DOWNEY COMMUNITY HOSPITAL

The hospital is a 151-bed facility located in the city of Downey (Downey) in Southern California. The hospital was originally established in 1920, operating as a for-profit business for over 35 years. In 1956, the hospital was changed to a not-for-profit organization, and the Downey Community Hospital Foundation (foundation) was established to maintain and operate the hospital

---

[1] On September 22, 1999, Downey Community Hospital officially changed its name to Downey Regional Medical Center.

exclusively for charitable purposes and to conduct and engage in various charitable activities. The foundation's articles of incorporation declare that no private shareholder or individual can directly benefit from any of the foundation's accumulated gains or profits or from its sale or dissolution.

The citizens of Downey, seeking to replace the existing hospital, authorized the establishment of a new municipal hospital within the city in 1963; however, voters twice defeated bond propositions aimed at financing its construction. As a result, in 1967, the county of Los Angeles and Downey created a joint powers authority agreement to construct a new hospital. The new Downey Community Hospital opened in 1969.

## THE FOUNDATION'S CONVERSION TO A MANAGED CARE SYSTEM

The hospital operated as an autonomous organization until 1993, when the foundation elected to enter the managed health care market. Managed care governs health care services through various processes—including reviewing the medical necessity for allowable procedures, offering incentives to use certain medical providers, and using aggressive case management—designed to contain health care costs. Managed care organizations include health maintenance organizations, physician-hospital organizations, and integrated delivery systems (IDS). In an IDS, health providers, usually hospitals and doctors, enter into a financial or contractual relationship. In August 1992, the foundation's board of directors (board) authorized the hospital to create an IDS. Although various IDS models exist, the board members opted to create a management services organization (MSO). MSOs provide administrative and management services to one or more medical practices. To create its IDS, the foundation entered into an alliance with two private for-profit entities:

- A group of physicians, CareMore Medical Group (medical group).

- An MSO, CareMore Medical Management Company (management company).

Various groups of citizens criticized the foundation for using charitable resources to create the IDS. They were especially concerned with loans the foundation made to the medical group and management company and the amount of compensation the foundation paid its chief executive officer (CEO). The criticism ultimately led the attorney general to investigate whether the foundation was diverting charitable assets from their intended purpose. The table below shows the time line of events in the foundation's attempt to form its IDS.

## TABLE

### Time Line of Events at the Downey Community Hospital Foundation

| Date | Event |
|---|---|
| 1991 | The foundation acquires a second hospital, Rio Hondo Hospital. |
| Aug. 1992 | The foundation authorizes the creation of an integrated delivery system (IDS). |
| Feb. 1993 | The foundation and CareMore Medical Management Company enter into an agreement to finance the IDS. The agreement specifies that the foundation will make a series of loans to the management company. |
| June 1993 | The foundation purchases a 49 percent limited partnership interest in CareMore Medical Management Company.<br><br>CareMore Medical Group purchases a 49 percent limited partnership interest in the management company. Additionally, the medical group and management company enter into an agreement wherein the management company is responsible for billing, collection, and maintenance of patient files and financial records, among other duties. The management company will receive 49 percent of the medical group's monthly collections for performing these services. |
| 1994 | Downey Community Hospital Health Services (parent corporation), a not-for-profit corporation, is formed as the holding company of the foundation. |
| Jan. 1994 | The foundation, through its parent corporation, provides $3 million in start-up funds in exchange for part ownership in VivaHealth, a regional health maintenance organization. |
| 1996 | The parent corporation sells its interest in VivaHealth at a loss of at least $2.5 million.<br><br>Several foundation board members voice concern regarding the direction the Downey Community Hospital (hospital) is moving and are subsequently removed from the board. |
| 1997 | The parent corporation's board and the medical group approve a plan to reorganize the IDS; however, the foundation board later rejects the proposed plan. Shortly thereafter, CareMore Medical Group exercises its option to terminate the existing agreement. |
| Oct. 1997 | Downey citizens question the salary of the foundation's chief executive officer. |
| Jan. 1998 | The parent corporation's board removes an ex-officio member of the foundation's board. |
| 1998 | The foundation closes Rio Hondo Hospital. |
| Mar. 1998 | The foundation announces that it will sell its share of the management company to the medical group.<br><br>The foundation's board does not renew its contract with the head of the hospital's emergency room. The hospital's CEO cites as reasons for not renewing the contract the individual's improper pressure to renew his contract and his being deficient in paying loans owed to the hospital. |
| Jan. 1999 | The financial statements for fiscal year 1997-98 show the foundation suffers a net loss of $2.6 million. Part of this loss is attributed to two one-time costs: $3.6 million in closing costs for Rio Hondo Hospital and the write-off of $7.6 million in start-up loans to CareMore Medical Management Company. |
| May 1999 | The parent corporation, CareMore Medical Group, and CareMore Medical Management Company enter into an agreement wherein the medical group contracts with the hospital. The agreement also includes provisions for loan repayments by the medical group to the foundation. |

## SCOPE AND METHODOLOGY

The Joint Legislative Audit Committee (committee) requested the Bureau of State Audits (bureau) to review the investigation of the Downey Community Hospital Foundation (foundation) by the Office of the Attorney General (attorney general). The committee asked the bureau to review the attorney general's process for overseeing charities and enforcing trust laws and to assess the attorney general's investigation for thoroughness in looking at allegations that the foundation violated such laws.

We interviewed officials of the city of Downey and various concerned citizens to gain an understanding of the events that led up to the attorney general's investigation. We also learned about the hospital and the foundation by reviewing public information in regional newspaper articles and documents filed with the Los Angeles County courts.

We examined the attorney general's confidential report to determine the conclusions it reached regarding its investigation of the foundation. We also reviewed documents the attorney general obtained and questions it asked of the foundation and other entities to support the report's conclusions. Further, we evaluated the analyses and documentation to determine whether the attorney general conducted a thorough enough review of the foundation to ensure the investigation's conclusions were adequately supported. However, as discussed in the next section, state laws limit our ability to discuss the results of the attorney general's investigation. ■

# AUDIT RESULTS

## ALTHOUGH THE ATTORNEY GENERAL DILIGENTLY INVESTIGATED THE FOUNDATION, LAW FORBIDS PUBLIC DISCLOSURE OF THE RESULTS

The Office of the Attorney General (attorney general) properly carried out its duties in investigating the Downey Community Hospital Foundation (foundation). Specifically, the attorney general's investigation appropriately determined whether officers and directors of the foundation committed any unlawful acts that resulted in a loss of foundation assets. State law, however, prohibits both the attorney general and the Bureau of State Audits (bureau) from publicly reporting any details of the investigation.

Because of complaints from various citizens in and around the city of Downey, the attorney general opened an investigation of the foundation in May 1998 to determine whether its officers or directors had breached their legal duties. The investigation considered allegations that the foundation had mismanaged assets, diverted charitable assets of the Downey Community Hospital (hospital) from their trust purpose, and acted to defraud the charity. If the attorney general determines that self-serving or other unlawful acts result in a loss of charitable assets, it may sue officers or directors of the corporation to recover damages. When the bureau requested the attorney general's permission to include the results of the investigation in this report, the attorney general asserted that its investigation results were exempt from public disclosure under the California Public Records Act (act) and objected to publishing any of its conclusions in a public audit report. Moreover, the attorney general asserted that the California Government Code prohibits it from releasing private records obtained in the course of its investigation except for a legal proceeding. Further, the code's provisions make publicly releasing such information a misdemeanor.

***The California Public Records Act and California Government Code prohibit the public disclosure of the results of the attorney general's investigation of the foundation.***

Although we have complete access to the records and property of the attorney general and the foundation, state law places the same limitations on the bureau as on the attorney general regarding any public release of information protected by law. Therefore, we have not included any such information in this report. Our audit was limited to reviewing the attorney general's confidential report and the evidence obtained by the attorney general in support of its conclusions. Based on our independent review, the attorney general diligently performed its duties in investigating the foundation and determining if legal action was warranted by unlawful actions of foundation officers or directors. The report that follows does not, however, show why we concluded that the attorney general adequately investigated the foundation, because we would violate the law in giving those reasons. We also directed a series of questions to the attorney general to gain a better understanding of what that office believes constitutes proper and lawful actions on the part of officers and directors of a charitable corporation, especially in relation to the complaints against the foundation.

## OFFICERS AND DIRECTORS OF CHARITABLE CORPORATIONS MUST ADHERE TO DUTIES SPECIFIED IN THE CORPORATIONS CODE

We asked the attorney general about the necessary duties of officers and directors of charitable corporations as defined by the California Corporations Code (code). According to the attorney general, these individuals must adhere to the following four prescribed duties when making decisions that affect a nonprofit corporation:

***Officers and directors of charitable corporations are not liable for any subsequent losses if they act in the best interest of the corporation.***

- The Duty of Care—This duty requires officers and directors to use reasonable care, prudence, and due diligence in managing the charitable assets entrusted to them. In other words, officers and directors must obtain at least the same amount of information that a reasonable person, acting in similar circumstances, would consider material to make business decisions and must reach conclusions that are based on such information. If such individuals act in the best interests of the corporation and make decisions with the same care, including reasonable inquiry, that a prudent person would have in a similar situation, the code states that they will have no liability for losses the charitable corporation might subsequently suffer as a result of those decisions.

- The Duty of Loyalty—This duty may be violated when directors have a material financial interest in a business transaction they enter into on behalf of the charitable corporation. Such a transaction is subject to legal challenge unless it can be shown that the transaction was fair and reasonable to the corporation, that no other more beneficial transaction was reasonably available to the corporation, and that the transaction was approved in advance by a disinterested majority of the charitable corporation's board of directors.

- The Duty of Good Faith—This duty requires that officers and directors must make decisions they believe are in the best interest of the charitable corporation, putting the corporation's interests ahead of other competing interests.

- Duty to Carry Out the Charitable Purpose of the Corporation—This duty requires officers and directors to make decisions that carry out the charitable purposes for which the organization's assets are held in trust—those purposes that are set forth in the corporation's articles of incorporation. A charitable corporation may not use its assets for any other purpose.

***Courts generally will not hold officers and directors liable unless the corporation actually suffered monetary damages because of the breach.***

If the officers and directors of a charitable corporation breach any of the aforementioned duties, courts generally will not hold them liable unless the corporation actually suffered monetary damage because of the breach. When determining whether to file legal action against officers or directors on behalf of the charitable corporation, the attorney general must first evaluate whether the corporation sustained a loss. For example, if the directors made a business decision where they breached the duty of loyalty by engaging in a self-serving transaction, but no loss was incurred by the corporation, no damages are recoverable against those who entered into the transaction. The attorney general must also look at whether there are sources of funds from which losses can be recovered if a civil judgment is granted.

## THE CODE ALLOWS THE FOUNDATION TO FORM PARTNERSHIPS WITH FOR-PROFIT ENTITIES

In 1993, the foundation entered into an alliance with the CareMore Medical Group (medical group) and the CareMore Medical Management Company (management company), two for-profit entities, to form an integrated delivery system (IDS). The foundation and medical group each maintained an equal minority ownership interest in the management company. In response to our questions about whether the code allows a charitable corporation to form partnerships with for-profit entities, the attorney general said the code does allow this as long as all such arrangements are intended to further the charitable purposes of the corporation. However, when entering into these partnerships, the charitable corporation's board must act in good faith and reasonably determine whether the partnership will further the charitable purposes of the corporation. In making this business decision, the board must adequately research the for-profit entity in a manner that satisfies its duty of due care.

The attorney general used the example of a hospital whose charitable purpose is to furnish health care services to members of the public. Any partnerships that a charitable hospital would enter into must continue to provide those health care services to the public. Before the hospital enters into a partnership, its board would be required to gather information sufficient to determine whether forming a partnership with a specific entity is in the best interest of the corporation. Such information could include reviewing business plans, obtaining independent analyses of the entity, and consulting with experts in the medical field, especially in the areas of health care trends and economics. The board would then make its decision on the partnership based on the information it has gathered.

## THE CODE ALLOWS THE FOUNDATION TO USE CHARITABLE RESOURCES TO PARTNER WITH THE MEDICAL GROUP AND THE MANAGEMENT COMPANY

We also asked the attorney general several questions about the appropriateness of lending the assets of a charitable corporation. Staff responded that California law generally allows the board of directors of a charitable corporation to loan funds to a for-profit entity when the charitable corporation owns part or all of the entity. Further, if the loans are intended to directly further the corporation's charitable purposes, there is no requirement that the assets of the entity receiving the loans be used to secure such loans. However, in making the loans, the charitable corporation's board is required to meet the duties of good faith, due care, and loyalty.

***Charitable corporations may make unsecured loans to for-profit entities if they are intended to further the corporation's charitable purposes.***

Some Downey citizens were concerned with the amount of charitable resources being used to implement a decision by the foundation's board to form an IDS comprised of the foundation, a medical group, and a management company. Specifically, these citizens believed the foundation's loans to the medical group and management company represented an improper use of these resources, and the residents were also concerned with the possibility that the loans would not be repaid because they were not adequately secured. Therefore, the attorney general was asked to determine whether the officers and directors of the foundation violated any charitable trust laws in approving the loans.

During a time when other small hospitals were being bought up by large health care conglomerates or forced out of business altogether, the foundation sought a way for the hospital to stay open and remain an independent, nonprofit community hospital responsive to local needs. The foundation's board members attended various seminars and consulted experts in the health care industry before coming up with a strategy to form an IDS comprised of their own health maintenance organization (HMO), home health care, and a partnership with a medical group. In forming the IDS, the foundation entered into an alliance with the medical group in 1993. The foundation and medical group in turn purchased a management company, which was partly owned by the foundation and partly owned by the medical group. The management company's purpose was to manage the medical group's practice and handle various administrative activities, including billing patients and insurance companies for services provided by the medical group. The foundation ultimately made loans totaling about $14 million to the management company and medical group for start-up costs and for further expanding the IDS.

***Loans are not required to be secured if they directly further the corporation's charitable purpose.***

According to the attorney general's response to our questions, the board of directors of a charitable corporation may loan funds to for-profit entities that the corporation partly or wholly owns. Further, although the charitable corporation's board must adhere to the standards of good faith, due care, and loyalty when making the loans, the law does not require that such loans be secured by assets of the entity receiving them if those loans directly further the corporation's charitable purposes. The attorney general also said there is a difference between loans used for program expenditures and loans used for investments. Program expenditures are intended to directly further the charitable purposes of the corporation. For example, program expenditures for a charitable hospital would include personnel costs, equipment purchases, and maintenance and construction expenses related to furnishing health care to the public. An investment, on the other hand, is an expense made solely for the production of income or capital appreciation to be used for furthering the charitable purpose of the corporation. Based on its review of the foundation's transactions, the attorney general stated the loans made by the foundation appeared to be for program expenditures.

The board of Downey Community Hospital Health Services (parent corporation) sought to reorganize the IDS arrangement with the medical group and other entities in 1997. Under a proposed reorganization plan, a new medical management company would be created and jointly owned by the parent corporation's board and the medical group. Downey citizens expressed concern that if the proposed reorganization were approved, loans from the foundation made to the original management company would be forgiven, and the foundation would have no authority over issues of management or control of the hospital. However, although the parent corporation's board and the medical group approved the proposed reorganization, the foundation's board subsequently rejected it.

After the foundation board failed to approve the reorganization, the medical group exercised its option to terminate its existing agreement with the foundation. Also, in 1998, the foundation announced that it would sell its share of the management company to the medical group. The foundation and medical group finalized the terms for disengaging in 1999. Under these terms, the parent corporation will be entitled to a percentage of the management company's net taxable income (but not any net losses) as a means of paying on the existing debts owed by the medical group and management company. Further, the parent corporation is guaranteed to receive a minimum cash distribution from the management company each month. The agreement also requires the medical group, the management company, or both together to repay a portion of the intercompany charges previously owed to the parent corporation, to be decided by binding arbitration. Finally, the medical group agreed to contract back to the hospital for services.

## THE CODE ALLOWS GOVERNING BOARDS OF CHARITABLE CORPORATIONS DISCRETION IN SETTING SALARIES FOR OFFICERS AND DIRECTORS

***Although residents expressed concerns over the amount paid its CEO, the law grants the foundation's board discretion in establishing compensation.***

Downey residents also raised concerns about the amount of compensation paid to the chief executive officer (CEO) of the foundation and parent corporation. Some individuals were alarmed by the amount of the salary, reportedly more than $400,000, paid to the CEO in fiscal year 1995-96. It was also alleged that the CEO received three lump-sum payments totaling over $1,600,000 from fiscal years 1995-96 through 1997-98. These payments were in lieu of receiving benefits through a supplemental executive retirement plan.

We asked the attorney general to describe the criteria a charitable corporation must follow in establishing compensation packages for officers. According to staff, California law generally allows a charitable corporation board discretion in fixing compensation for its officers and directors. However, in establishing the compensation, the board must be able to demonstrate it acted in good faith and that the compensation is reasonable and in the best interests of the corporation. Because the fixing of compensation is generally within the business discretion of the board of directors, courts ordinarily will not interfere with or second-guess such decisions. The attorney general noted that when courts do hear cases involving compensation disputes, they determine whether compensation is reasonable by considering a variety of factors, including difficulties involved in the work and compensation paid for similar work by comparable companies.

**Factors Courts Have Considered When Determining the Fairness of Employee Compensation**

- Employee's ability
- Quantity and quality of services rendered
- Difficulties involved in the work
- Employee's responsibilities
- Time employee has devoted to the corporation
- Employee's success
- Profitability resulting from the employee's efforts
- Corporation's financial condition
- Compensation paid for comparable work by similar companies
- Whether the compensation is related to attracting or retaining qualified executives
- Whether any self-interest influenced the compensation

For example, the attorney general referred us to a 1993 case where a court found the salary increase received by a nursing home president and director was not unreasonable. The court's decision was based on the testimony of a CPA who stated that the salary increase was reasonable when compared to salaries paid by other nursing homes. The attorney general referred to another case where the defendant, who was a member of the board of directors and the president of the corporation, entered into a contract with the corporation that included a large salary increase as well as a deferred compensation plan. The court determined that the defendant had devoted nearly 30 years to the company and that the business had prospered under his leadership although it was located in an economically depressed area. Further, the defendant's expert witness testified that the effective cost to the corporation was significantly less than the actual salary because the Internal Revenue Service had determined the compensation was reasonable and had allowed it to be claimed as a business deduction. Therefore, the court determined the salary was reasonable. Concerning the deferred compensation, the court found that state law allows corporations to establish deferred compensation plans and that approval of pension benefits based in whole or in part on past services is proper as long as the benefits contribute to the profit-making power of the corporation.

## FURTHER REVIEW WOULD HAVE BEEN NEEDED TO EVALUATE MANAGEMENT'S BUSINESS JUDGMENT IN USING THE FOUNDATION'S CHARITABLE RESOURCES

The attorney general's investigation was limited to determining whether sufficient evidence exists to file suit against the officers and directors of the foundation for any breach of charitable trust, breach of duty, or other unlawful acts and to recover damages on behalf of the charity's beneficiaries. However, it was not within the attorney general's enforcement scope to report weaknesses in the foundation board's planning or execution of transactions for which directors are generally shielded from personal liability under the business judgment rule. The business judgment rule as described in case law presumes that, in making business decisions, directors of a charitable corporation act on an informed basis, in good faith, and in the honest belief that actions taken are in the best interests of the corporation. Additional evaluation would have been necessary to determine whether the foundation's business practices allowed it to adequately consider risk when it committed charitable resources in some business transactions.

***It is not within the attorney general's enforcement scope to investigate and report on weaknesses in business judgment.***

In considering whether the foundation's business management practices were sound, we would question whether the officers and directors sufficiently analyzed the financial risks before spending foundation funds on partial ownership of an HMO and before subsidizing pharmaceutical services for the medical group. In making this inquiry, we would not be limited to considering whether the officers' and directors' conduct breached their respective duties to the charitable corporation but whether they used best business management practices in making those decisions.

For instance, in 1994, the foundation, through its parent corporation, acquired an ownership interest in VivaHealth, a regional HMO, for $3 million. After the acquisition, however, the HMO experienced problems, including failure to obtain significant enrollment in its health plan. Therefore, the parent corporation sold its interest in the HMO at a reported loss of at least $2.5 million. In reviewing this business decision, we would seek additional proof that foundation management took the necessary precautions to minimize risk before committing resources to this venture. Specifically, although the documentation we reviewed demonstrated the foundation had obtained marketing materials from the HMO and discussed the acquisition at several of its board meetings, to conclude that its

***Additional evidence would be necessary to determine whether the foundation used sound business judgment when it purchased VivaHealth and subsidized the medical group for pharmaceutical services.***

management used the best business practices, we would have required evidence that the officers of the foundation or an independent consultant adequately analyzed the HMO's viability, or we would have performed a substantive review of the financial projections or anticipated enrollment figures given in the marketing materials. Further, unless we found evidence that the foundation obtained a valuation of the HMO using an acceptable industry standard before agreeing to the $3 million purchase price, we would have questioned its business practices.

In response to a series of questions we asked concerning the planning and research conducted by the foundation prior to the acquisition, the attorney general stated that although hiring an independent consultant may have been a reasonable thing to do, it is not a necessary condition for compliance with the duty of due care. However, in terms of making a sound business decision, the lack of an independent financial analysis would be particularly disturbing for two reasons: (1) the entity acquired by the foundation was a relatively new HMO that had not yet obtained its license and (2) the geographic area was already being served by at least nine major HMOs. Based on the evidence reviewed by the attorney general, we believe additional procedures would have been necessary to address whether the foundation board's decision was sound from a business standpoint.

Also, the foundation's management may have made an unwise business decision when they modified the original agreement with the medical group, thereby subsidizing its pharmaceutical services. Because of the amended agreement, in calendar years 1996 and 1997, the foundation suffered losses of over $1 million that would otherwise have been assigned to the medical group. In assessing the foundation's business decision to modify the agreement, we would have required evidence that it performed an analysis of the pharmacy operation to identify key cost components, trends, or other data that pointed to the causes for pharmacy cost overruns. Without such an analysis, the officers and directors of the foundation may not have minimized the business risk associated with taking full responsibility for the pharmacy.

We conducted this review under the authority vested in the California State Auditor by Section 8543 et seq. of the California Government Code and according to generally accepted government auditing standards. We limited our review to those areas specified in the audit scope section of this report.

Respectfully submitted,

Mary P Noble

MARY P. NOBLE
Acting State Auditor

Date: July 17, 2000

Staff: Doug Cordiner, Audit Principal
Steve Cummins, CPA
Laneia Grindle

*(Agency's comments provided as text only.)*

Department of Justice
300 South Spring Street, Suite 5212
Los Angeles, CA 90013

July 5, 2000

Mary P. Noble
Acting State Auditor
Bureau of State Audits
555 Capitol Mall, Suite 300
Sacramento, CA 95814

<u>By Overnight Delivery</u>

RE: Downey Community Hospital Foundation (DCHF)

Dear Ms. Noble:

Enclosed herewith are the Attorney General's comments to your audit report on our investigation of Downey Community Hospital Foundation. These are submitted as requested by your letter dated June 29, 2000 to Attorney General Lockyer. In accord with your instructions, our comments have been copied onto the enclosed diskette in text format. A hard copy of such comments is also enclosed.

Sincerely,

*(Signed by: James M. Cordi for Bill Lockyer)*

James M. Cordi
Supervising Deputy Attorney General

For Bill Lockyer
Attorney General

ATTORNEY GENERAL'S COMMENT TO
STATE AUDITOR'S REPORT

The Attorney General is pleased that, after conducting an extensive audit of our investigation of Downey Community Hospital, the State Auditor concluded that we diligently examined the issues concerning whether officers and directors of the hospital committed any unlawful act that caused the loss of charitable assets.

cc: Members of the Legislature
Office of the Lieutenant Governor
Milton Marks Commission on California State
Government Organization and Economy
Department of Finance
Attorney General
State Controller
State Treasurer
Legislative Analyst
Senate Office of Research
California Research Bureau
Capitol Press