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# Abnormal returns and the regulation of nonprofit hospital sales and conversions

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## Abstract

During the 1990s, concerns that nonprofit (NP) hospitals were being sold at below-market prices to investor-owned (IO) chains helped to prompt the widespread adoption of state laws regulating the sale and conversion of nonprofits. In this paper, we provide a simple test of under-pricing using the IO acquirer's abnormal stock market returns at the time of the acquisition. Prior to regulation, we find that IO chains did not earn abnormal returns from their acquisitions of NPs and earned greater returns from purchasing other IO and privately owned hospitals. In states that subsequently adopted regulations, acquisition activity slowed significantly and acquirer returns became negative. Efficient markets theory suggests that, absent regulation, expected merger synergies were already being transferred to the NP target and that regulation may have reduced expected synergies or increased the costs of acquiring NP hospitals.

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## 1. Introduction

During the decade of the nineties, numerous nonprofit (NP) hospitals were acquired by investor-owned (IO) hospital chains.<sup>1</sup> In some of these transactions, regulators voiced concerns that the NP targets were being sold at prices below their market value. For example, in 1996 the California Attorney General halted the sale of Sharp Memorial Hospital to Columbia/HCA. He threatened to hold the board liable, in part because they accepted an offer from Columbia/HCA that was \$200 million less than competing offers.<sup>2</sup> Shortly thereafter, California passed a law regulating the sale and conversion of NP hospitals. Ultimately, 24 states and the District of Columbia enacted legislation to regulate the sale and conversion of nonprofit hospitals, primarily during the time period from 1997 to 1998. In virtually all cases, the legislation contained provisions to ensure that the acquirer paid a fair market price for the NP target.

In this paper, we test the hypothesis that NP hospitals targeted for acquisition by IO chains were priced below their market value, especially prior to 1997. Specifically, we test whether IO chains earned excess returns from NP acquisitions prior to 1997 and whether these returns abated in the aftermath of the state legislation. The topic we propose is important for at least two reasons. First, there is a long-standing concern that NP assets are frequently sold at below-market prices, resulting in transfers from donors and the government to private parties.<sup>3</sup> Second, under-pricing and the effects of regulation may help to explain the cycle of acquisition activity in the hospital sector over the past decade.

The concerns of regulators are consistent with the view that nonprofit managers and boards lack incentives to bargain for a fair price because they do not share in the proceeds from the sale. Parties such as the IRS are also concerned that financial promises of highly-paid employment further weaken the incentives of NP CEOs to bargain with their IO acquirers.<sup>4</sup> However, if there are many bidders for the target, an IO acquirer will be forced to offer a fair market price for the target's assets to outbid its rivals. Moreover, NP boards realize benefits "in kind" from realizing higher bids. For example, a generous bid is frequently used to fund a charitable foundation that board members manage. These benefits provide NP boards with their own incentives to demand fair market prices before approving a sale.

We use event studies to test for fair market pricing both before and after the passage of the state regulations. We argue that if IO chains fail to realize abnormal returns from their

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<sup>1</sup> Our data, which are a virtual census of transactions involving publicly traded hospital companies, show 189 IO purchases of domestic, acute care NP hospitals from 1990 to 2001 (we have valid stock returns for 135 of these transactions). It is worth noting that IO chain acquisitions of nonprofit hospitals are currently on the rise, once again. In 2001, there were 22 transactions of this type, up from 11 in 2000.

<sup>2</sup> See, "Some states taking steps to protect not-for-profit hospitals," 11/20/96, Gannett News Service.

<sup>3</sup> More recently, this concern has been raised over conversions of nonprofit health insurers to for-profit status. For example, the sale and conversion of the Maryland Blue Cross plan was blocked amid concerns that its assets had been under-priced. Our evidence in this paper is confined to NP hospital sales.

<sup>4</sup> For example, the IRS put out a training manual that urged its agents to be on the lookout for instances of improper inducements to sell NP hospitals, such as overcompensated employment at the acquirer. In this paper we, in effect, test whether this type of behavior existed on a widespread basis.

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