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Nonprofit Hospitals, Once For the Poor, Strike It Rich

With Tax Breaks, They Outperform For-Profit Rivals

By JOHN CARREYROU and BARBARA MARTINEZ April 4, 2008; Page A1

Nonprofit hospitals, originally set up to serve the poor, have transformed themselves into profit machines. And as the money rolls in, the large tax breaks they receive are drawing fire.

Riding gains from investment portfolios and enjoying the pricing power that came from a decade of mergers, many nonprofit hospitals have seen earnings soar in recent years. The combined net income of the 50 largest nonprofit hospitals jumped nearly eight-fold to \$4.27 billion between 2001 and 2006, according to a Wall Street Journal analysis of data from the American Hospital Directory. AHD, an information-service company, compiles data that hospitals report to the federal government.

SEE FULL PRESENTATION Non-Profit Profits Big Profits Combined net income of the top 50 non-profit hospitals in 2006, compared with 2001

The Cleveland Clinic swung from a loss to net income of \$229 million during that period. No fewer than 25 nonprofit hospitals or hospital systems now earn more than \$250 million a year. One nonprofit hospital

system, Ascension Health, has a treasure chest of \$7.4 billion -- more than many large, publicly traded companies.

Nonprofits, which account for a majority of U.S. hospitals, are faring even better than their for-profit counterparts: 77% of the 2,033 U.S. nonprofit hospitals are in the black, while just 61% of for-profit hospitals are profitable, according to the AHD data.

At some nonprofits, the good times are reflected in new

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facilities and rich executive pay. Flush with cash, Northwestern Memorial Hospital in Chicago has rebuilt its entire campus since 1999 at a cost of more than \$1 billion. In October, it opened a new women's hospital that features marble in the lobby, birthing rooms with flat-screen televisions, 1,000 works of art and a roof topped with 10,000 square feet of gardens. In 2006, Northwestern Memorial's former chief executive officer, Gary Mecklenburg, received a \$16.4 million payout.

But Northwestern Memorial has been frugal in its spending on charity care, the free treatment for poor patients that nonprofit hospitals are expected to provide in return for the federal and state tax breaks they receive. In 2006,

WSJ's John Carreyrou provides a tour of Chicago's non-profit Northwestern Memorial Hospital, which underwent a renovation costing more than \$1 billion.

Northwestern Memorial spent \$20.8 million on charity care -- less than 2% of its revenues and a fraction of what it received in tax breaks. By comparison, the hospitals run by Cook County, where Northwestern Memorial is located, spent 14% of revenues on charity care.

Northwestern Memorial says that in addition to charity care, it provides other benefits to its community, such as pioneering research in obstetrics and other areas that improve standards of care nationally.

To be sure, some nonprofit hospitals, particularly ones in inner cities that handle large numbers of uninsured patients, remain under financial strain and are struggling to keep their doors open.

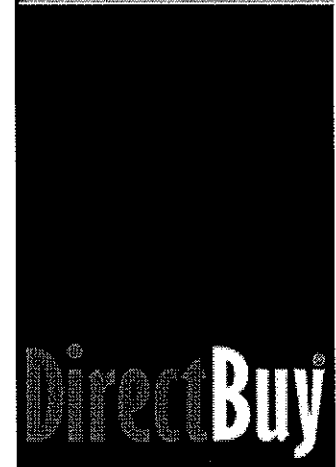
But the growing gap between many nonprofit hospitals' wealth and what they give back to their communities is raising questions about the billions of dollars in tax exemptions they receive.

BACKSTORY

"Some nonprofit hospitals seem to



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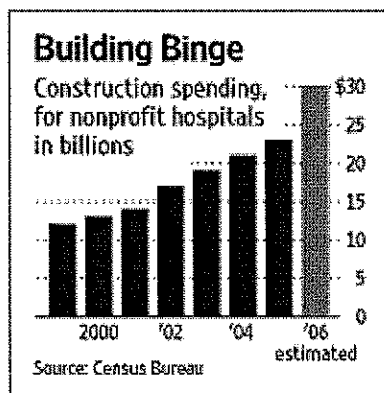
They allow their priorities to get out of whack," says Sen. Charles Grassley. The senior Republican on the Senate Finance Committee threatened last year to introduce legislation forcing nonprofit hospitals to provide a minimum amount of charity care.

Nonprofit hospitals account for about 60% of the more than 3,400 hospitals in the U.S. The rest are either for-profit or government-owned.

In a report issued in December 2006, the Congressional Budget Office estimated nonprofit hospitals receive \$12.6 billion in annual tax exemptions, on top of the \$32 billion in federal, state and local subsidies the hospital industry as a whole receives each year.

Community Benefit

In return for not paying taxes, nonprofit hospitals are supposed to provide a "community benefit," a loosely defined requirement whose most important component is charity care. But many hospitals include other expenses in their community-benefit accounting to the Internal Revenue Service, including unpaid patient bills. Often, hospitals also include the difference between the list prices of treatment they provide and what they are paid by Medicaid and Medicare, the government programs for the poor, disabled and elderly. Excluding those other expenses, many hospitals spend less on charity care than they get in tax breaks, studies by various counties and states show.



One nonprofit hospital system, St. Louis-based BJC HealthCare, counts the salaries of its employees as a community benefit. BJC, which runs 14 hospitals in Missouri and Illinois, says on its Web site that it provided more than \$1.8 billion in benefits to various communities in 2004. Its payroll, including its CEO's \$1.8 million compensation, accounted for \$937 million of that figure, while charity care represented \$35 million, according to BJC.

"The impact that any organization that's job-producing and buying goods has on a community is of benefit to that community," says BJC HealthCare spokeswoman June Fowler. However, she says BJC won't count its payroll as a community benefit in the future because of new standards adopted by the IRS.

The new standards, due to take full effect in 2009, will require nonprofit hospitals to break out specifics of their community-benefit contributions. But they won't require the hospitals to provide any minimum amount of charity care.

The size of nonprofit hospitals' tax exemptions is coming under scrutiny in part because their incomes have risen so sharply in recent years, and because they represent such a big chunk of America's health-care spending. Thirty-one cents of every dollar spent on medical care is spent on hospitals.

One reason for hospitals' soaring profits is a gradual increase in Medicare reimbursements after federal budget cutbacks during the 1990s. By merging and gaining scale, many hospitals also gained leverage in price negotiations with health insurers.

However, much of the industry's profit growth comes from strategies it honed to increase profits. Among them: demanding upfront payments from patients; hiking list prices for procedures and services to several times their actual cost; selling patients' debts to collection companies; focusing on expensive procedures; and issuing tax-exempt bonds and investing the proceeds in higher-yielding securities.

Untaxed investment gains have greatly increased some hospitals' cash piles. Ascension Health, a Catholic nonprofit system that runs 65 hospitals, mostly in the Midwest and Northeast, reported net income of \$1.2 billion in its fiscal year ended June 30, 2007, and cash and investments of \$7.4 billion. That's more cash than Walt Disney Co. has.

Ascension says it needs to maintain a sufficient amount of cash to pay for charity care, to keep the interest rates it pays on its debt low, to provide retirement benefits to its 106,000 employees, and to make capital and technology investments at its hospitals.

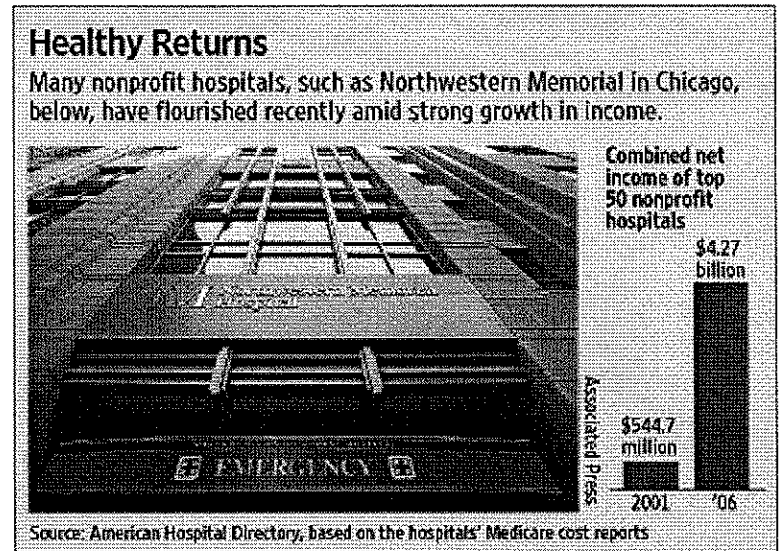
At the University of Pittsburgh Medical Center, which runs 20 facilities, cash and investments totaled \$3.35 billion at the end of last year. UPMC says the money goes toward producing "world-class health care, education and research," citing the \$1 billion it spent over five years to create electronic medical records for patients and an additional \$500 million to build a children's hospital and a network of cancer centers.

But some of UPMC's expenses are only tenuously related to medicine. In its 2006 fiscal year, UPMC also spent \$10 million on advertising, including \$1 million on ads in the New York Times. Wendy Zellner, a spokeswoman for the hospital, says the ads enable UPMC "to better compete with other leading hospitals."

UPMC paid its CEO, Jeffrey Romoff, \$3.3 million in fiscal 2006. Mr. Romoff also received \$36,995 from the hospital to cover a car allowance, spousal travel and legal and financial counseling. Ms. Zellner says what UPMC pays Mr. Romoff is in line with "nonprofit and for-profit organizations of comparable scope and complexity."

Some nonprofit hospital executives enjoy other perks. Royal Oak, Mich.-based Beaumont Hospitals says it paid \$10,795 for the country-club membership of the president of its foundation last year. A spokeswoman for Beaumont says it pays for the membership to provide the executive "a venue with access to potential donors."

The Cleveland Clinic continued to pay its former CEO, Floyd Loop, more than \$1 million a



year for two years after he retired in April 2005. The Cleveland Clinic says part of that was deferred compensation and vacation pay and the rest was for consulting services.

Hospitable Pay			
Some of the best paid nonprofit hospital CEOs			
CEO	Hospital	Total accrued compensation, in millions	Year
Gary Mecklenburg ²	Northwestern Memorial Hospital	\$16.4	2006
Floyd Loop [†]	Cleveland Clinic	7.5	2006
Mark Neaman	Evanston Northwestern Healthcare	5.4	2006
Lloyd Dean	Catholic Healthcare West	5.3	2006
Philip Incarnati	McLaren Health Care Corp.	5.2	2006
Joseph Trunfio	AHS Hospital Corp.	5.0	2005
Alan Brass	ProMedica	4.1	2005
Herbert Pardes	New York-Presbyterian	3.5	2006
Jeffrey Romoff	UPMC	3.3	2006
Douglas French [‡]	Ascension Health	3.3	2004

²Retired on Sept. 1, 2006, total includes a retirement payout and deferred compensation
[†]Retired in April 2005; \$6.4 million of the \$7.5 million is a split-dollar life insurance policy, the rest is deferred compensation, vacation pay and consulting fees
[‡]Resigned in May 2004
 Sources: Forms 990 filed to the IRS; the hospitals

The University of California San Francisco Medical Center provided its CEO and chief operating officer low-interest mortgage loans of more than \$1 million each, according to the University of California's executive compensation reports. A UCSF spokeswoman says such loans help recruit and retain executives, given the area's high cost of housing.

Catholic Healthcare West, a hospital system based in San Francisco, forgave a \$782,541 housing loan it made to its CEO, Lloyd Dean. Counting the forgiven loan, Mr. Dean's total accrued compensation in 2005 was \$5.8 million. Catholic Healthcare West says his

compensation reflects his skill in turning the hospital system around financially.

One nonprofit hospital executive who has benefited from the industry's good fortunes is Mr. Mecklenburg, the former CEO of Chicago's Northwestern Memorial. The hospital says it paid him \$5.45 million in salary, bonus and deferred compensation in its fiscal year ended Aug. 31, 2006, and an additional \$10.95 million when he retired the next day. The hospital also awarded five other executives a combined \$13.3 million in total compensation in fiscal 2006, according to its filings to the IRS.

Mr. Mecklenburg, now a partner at Chicago private-equity firm Waud Capital Partners LLC, declined to comment, referring questions to the hospital and to the former chairman of its compensation committee, James Denny.

Stellar Results

Northwestern Memorial says a big part of Mr. Mecklenburg's \$16.4 million payout represents retirement benefits and deferred compensation accrued over his 21-year tenure. Mr. Denny, who chaired the hospital's compensation committee from 1995 to January 2008, says Mr. Mecklenburg delivered stellar results, nearly quintupling the hospital's patient revenues. "Our view of it is: This is the best deal we've ever made," he says.

Critics argue that Mr. Mecklenburg's compensation is excessive for a charity organization that gets tens of millions of dollars a year in tax breaks. Northwestern Memorial sits on property on the Gold Coast, Chicago's most affluent neighborhood, abutting Lake Michigan. The Center for Tax and Budget Accountability, a Chicago nonprofit organization, estimates the value of the hospital's annual property-tax exemption at \$37.5 million. Northwestern Memorial is also

exempt from \$12.5 million in sales tax for a total of \$50 million in annual tax exemptions, not counting the taxes it doesn't pay on its investment gains, the center estimates.

"The hospital's tax benefit is more than two times greater than the charity care provided," says Heather O'Donnell, the center's health-care policy director.

Northwestern Memorial says it hasn't calculated the value of its tax exemptions. Robert Christie, the hospital's vice president for government relations, notes that the Center for Tax and Budget Accountability receives funding from the Service Employees International Union, which represents numerous hospital employees and frequently clashes with hospitals in labor disputes. Ms. O'Donnell says her organization receives funding from many foundations besides SEIU.

Peter McCanna, Northwestern Memorial's chief financial officer, says the hospital's contribution to its community should be judged more broadly. "We fundamentally disagree with narrowing [the definition of] our community-benefit contribution to charity care," he says. He says Northwestern Memorial's research and education expenses should also be counted. The hospital is the primary teaching hospital for Northwestern University's Feinberg School of Medicine.

Taking into account educational and other expenses, such as bad debt and unreimbursed Medicaid costs, Northwestern Memorial values its total community-benefit contribution at \$230 million for fiscal 2006.

Room Service

Around Chicago, Northwestern Memorial is known as a hospital that attracts the well-heeled. It's a short walk from the Magnificent Mile, the famous thoroughfare lined with expensive shops and restaurants. At Northwestern Memorial's new Prentice Women's Hospital, expectant mothers can watch TV or browse the Internet on 42-inch flat-screen televisions, order room service 24 hours a day and page nurses and doctors via a wireless system. Some birthing rooms have views of Lake Michigan. Only 6% of Northwestern Memorial's patient revenues come from Medicaid.

By comparison, Sacred Heart Hospital, a small for-profit hospital in a poor neighborhood on the west side of the city, gets 62% of its revenues from Medicaid and pays several million dollars a year in taxes, according to its president, Edward Novak. Parts of Sacred Heart date back to 1928, when the hospital was founded. Another wing was built in 1950. Mr. Novak says he would like to replace the aging hospital with a new facility, but is struggling to figure out how to pay for it. He says his compensation is less than \$220,000 a year.

At John H. Stroger Jr. Hospital -- formerly known as Cook County Hospital -- 56% of patients don't have any insurance when they are admitted, says John Cookinham, the hospital's chief financial officer. At Northwestern Memorial, the percentage of uninsured patients is less than 5%. Stroger's chief operating officer earned \$204,485 in 2007, according to Cook County budget records.

In recent years, some nonprofit hospitals have decided to stop using the courts to collect from patients who owe them money. But Northwestern Memorial pursues patients such as Iris Ayala who haven't paid their bills. While running an errand for her employer, the 50-year-old Ms.

Ayala fainted and collapsed in the street one day in 2006. A friend rushed her to Northwestern Memorial's emergency room.

Ms. Ayala says her insurer paid for the bulk of her 24-hour hospital stay, but she was responsible for a \$1,035.39 co-pay. Working only part-time because of health issues and with a daughter in college, she says she couldn't afford her portion of the bill.

After representatives for Northwestern Memorial repeatedly called her to ask for payment, Ms. Ayala says she promised she would settle the bill once she got her annual tax refund. But Northwestern Memorial sued her in Cook County Circuit Court in July 2007. To make the lawsuit go away, Ms. Ayala says she borrowed the money and paid the hospital. "They didn't want to hear my sob story," she says.

Northwestern Memorial declined to discuss Ms. Ayala's case, citing patient privacy laws. Mr. McCanna says the hospital sued only 82 patients in 2006 and 2007, a number he says is small compared with the more than one million accounts it billed over that period. He says the hospital tries to determine whether patients who are behind on bills qualify for assistance, but some can't be reached or refuse to volunteer information about their finances. "Absent of information, a lawsuit is sometimes the only recourse," he says. Mr. McCanna adds that, in some cases, the hospital has waived patients' bills after later learning that they did qualify for aid.

Northwestern Memorial says its strong balance sheet allows it to provide outstanding care and conduct innovative research. As of Aug. 31, 2007, its cash and investments totaled \$1.82 billion, making it one of richest individual nonprofit hospitals in the country. With such a treasure chest, it could operate for a year and two months without any revenue -- a gauge of financial strength Mr. McCanna highlights in presentations to bond investors and analysts.

"Nonprofit is a misnomer -- it's nontaxable," says Sacred Heart Hospital's Mr. Novak. "When you're making hundreds of millions of dollars a year, how can you call yourself a not-for-profit?"

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