NONPROFIT CONVERSION TRANSACTIONS: EXISTING FIDUCIARY DUTIES AND NECESSARY REFORMS

by Harvey J. Goldschmid*

I. Overview

The sharp increase in the number and magnitude of conversion transactions (e.g., acquisitions of nonprofit corporations by for-profit corporations) has focused attention on whether the existing fiduciary duties of nonprofit directors and officers will adequately protect the public's interest in these transactions. Traditional fiduciary legal doctrines -- the duty of care, the business judgment rule, and the duty of loyalty -- provide significant protection with respect to for-profit mergers and acquisitions, and, with the modifications set forth in Section III infra, should work reasonably well in the nonprofit context. But when other safeguards available in the for-profit context are taken into account, the picture with respect to nonprofit conversion transactions darkens dramatically.

Nonprofit conversions suffer when compared to for-profit acquisitions because of the nature of nonprofit directorships, the nonexistence or inadequacy of disclosure requirements, the limits on standing to sue and other legal safeguards, and the general difficulty of valuation in the nonprofit conversion context. In making acquisitions, for-profit corporations like Columbia/HCA Healthcare Corp.[1] have been negotiating with

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* Dwight Professor of Law, Columbia University.

1 Columbia/HCA Healthcare Corp. is the nation's largest for-profit hospital chain with over 350 hospitals; it purchased or started joint ventures with 41 nonprofit hospitals in 1995 alone, and was reported to be accelerating its acquisition pace in 1996. Robert Tomsho, Ohio Blue Deal Raises Questions of Who Gets the Green, Wall St. J. May 1, 1996, at B4.

nonprofit directors who: (i) may have little or no acquisition experience and, unlike many for-profit directors, were selected for reasons wholly unrelated to their ability to obtain fair value from a purchaser; (ii) usually have limited time to devote to their institutions and are unpaid; (iii) sometimes have serious conflicts of interest; and (iv) usually are hesitant to spend nonprofit dollars on investment bankers, accountants, lawyers, and others associated with for-profit acquisitions. Even more important, in an acquisition of any size in the for-profit sector, extensive disclosure to the SEC,[2] and, in effect, to the public is required. Except for a relatively few instances (e.g., special legislation in California and effective use of leverage of the type described by Messrs. Boisture and Varley[3]), no disclosure is required in the acquisition of a nonprofit corporation. Even where disclosure is mandated, it appears to involve the production of documents to understaffed state charity regulators, and not the detailed disclosures in accordance with carefully conceived disclosure schedules -- subject to a spectrum of effective remedies -- required under our federal securities laws.

Moreover, no protection analogous to the shareholder vote of approval, required in a for-profit acquisition, is available in the nonprofit context. In general, the absence of private rights of action and of class and derivative actions (when compared to the for-

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[2] In general, the SEC regulates public corporations, which means corporations with at least 500 shareholders and $5 million of assets. There are now roughly 14,000 public corporations in the United States.

[3] See Robert A. Boisture & Douglas N. Varley, State Attorneys General's Legal Authority to Police the Sale of Nonprofit Hospitals and HMOs (1995) (Tab D) [hereinafter 'the Boisture & Varley Paper"].

profit sector) seriously undermine the effectiveness of fiduciary doctrines.

Finally, the valuation of a nonprofit entity is often a far more complex task than the valuation of a comparably-sized, for-profit public corporation. The nonprofit entity: (i) has no readily ascertainable stock market value; (ii) is not being regularly scrutinized (i.e., as compared to large public corporations) by armies of security analysts and investment advisers; and, most significantly, (iii) may well change substantially as a result of an acquisition and its future "earning capacity" (e.g., used in capitalized earnings approaches and discounted cash flow analyses) will be extremely difficult to measure. The current bottom line in most states is captured in recent testimony by Linda B. Miller, President of the Volunteer Trustees Foundation:

> Confidentiality agreements are signed early in the negotiation--and the community never knows what the deal looks like. It never knows what the hospital considered by way of other offers, how the asset was valued, what the for-profit buyer actually paid out and what it got in return, what portion of the proceeds were redeployed to a charitable foundation or under what terms. Everything is secret. (Three years after Nashville Memorial in TN was sold, the incorporators of the hospital are still in court trying to find out what the hospital was sold for!) [4]

The proposals in the Boisture & Varley Paper and their proposed guidelines (see Tab D) would significantly improve the current situation. Boisture and Varley creatively and pragmatically work within the present system, and urge state charity regulators to use their leverage (created by the cy pres doctrine and fiduciary duty standards) to obtain advanced review and approval of conversion transactions under groundrules that are

[4] Linda B. Miller, Statement before the Committee on Health and Human Resources of the Nebraska State legislature (Feb. 1, 1996).

outlined. But I do not believe these proposals go far enough. For example, the kind of comprehensive mandatory disclosure system that is needed for large conversion transactions -- patterned on what the SEC would require in the acquisition of a for-profit corporation -- requires new legislation. So does the need for a spectrum of remedies for disclosure failures. A sketch of my proposals for reform is set forth in Section III infra.

II. Fiduciary Duties of Directors and Officers of Nonprofit Corporations

A. Duty of Care and the Business Judgment Rule

Section 717 of New York's Not-for-Profit Corporation Law states:

> Directors and officers shall discharge the duties of their respective positions in good faith and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions.

Section 8.30 of the Revised Model Nonprofit Corporation Act contains a similar formulation with what appears to be the same substantive content. These formulations parrot for-profit statutes.[5] Since case law and commentaries in the fiduciary duty area are far more numerous and developed in the for-profit context, and would almost certainly be applied in the nonprofit context, I will refer to for-profit and nonprofit case law and commentaries interchangeably. For this reason and for convenience of reference, I will rely heavily on the formulations and commentaries of the ALI Principles.[6] As they are

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[5] See 1 American Law Institute, Principles of Corporate Governance: Analysis and Recommendations 144-145 (1994) [hereinafter AALI Principles"].

[6] I was the Reporter for Part IV (dealing with duty of care and the business judgment rule) of the ALI Principles; Marshall L. Small, a distinguished practitioner from San Francisco, was the Reporter for Part V, which deals with duty of loyalty or, in ALI terminology, the "duty of fair dealing."

cited and quoted herein, the ALI Principles are consistent with the law in almost all jurisdictions.

The nonprofit duty of care formulations would lead a lawyer who advises for-profit corporations to conclude that the business judgment rule would be applied to the consideration of a conversion transaction by the board of a nonprofit corporation. The business judgment rule is a judicial gloss on duty of care standards that sharply reduces exposure to liability for erroneous judgments. Although formulations of the business judgment rule vary, basically the rule requires that decisions be made: (i) in good faith and without a conflict of interest; (ii) on a reasonably informed basis; and (iii) with a "rational belief" (words connoting broad discretion and wide latitude) that the business judgment is in the best interests of the corporation.[7]

The rationale for the business judgment rule -- e.g., it encourages rational risk taking and innovation, limits litigation and unfair exposure, encourages service by quality directors, and limits judicial intrusiveness -- applies as much to nonprofit directors and officers as to their for-profit peers. There is wisdom in protecting nonprofit directors from hindsight reviews of their unsuccessful decisions and encouraging them to change the configuration of their nonprofit enterprises (e.g., expand a nonprofit museum, produce a new educational or health care product, and accept or reject a conversion proposal). It is sound public policy to accept the risk that informed decisions by nonprofit directors -- honestly undertaken (without conflict of interest) and rationally believed to be in the best

[7] See ALI Principles at 172-88; cf. Daniel L. Kurtz, Board Liability 49 (1988).

interests of the nonprofit -- may not be vindicated by subsequent success.

Although there is relatively little case law, a number of courts have applied the business judgment rule to the decisions of nonprofit directors.[8] The Appellate Division in New York, in the recent Scheuer Family Foundation case, assumed the applicability of the business judgment rule, but, because conflicts of interest were involved, found it unnecessary to resolve the issue.[9] The Official Comment to Section 8.30 of the Revised Model Nonprofit Corporation Act states that while "the application of the business judgment rule to directors of nonprofit corporations is not firmly established by the case law, its use is consistent with section 8.30."[10]

The assumption is erroneous, however, that the business judgment rule -- particularly in the context of conversion transactions -- provides directors with an overly protective "free ride" from liability. For the business judgment rule to shield nonprofit directors from liability, the follow must occur:

1. Prerequisite of a conscious exercise of judgment. To be protected under the business judgment rule a decision must be consciously made and judgment must, in

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[8] See, e.g., Beard v. Achenbach Memorial Hosp. Ass'n., 170 F.2d 859 (10th Cir. 1948); Yarnall Warehouse & Transfer, Inc. v. Three Ivory Bros. Moving Co., 226 So. 2d 887 (Fla. Dist. Ct. App. 1969); John v. John, 450 N.W. 2d 795 (Wis. Ct. App. 1989).

[9] See Scheuer Family Foundation Inc. v. 61 Associates, 179 A.D. 2d 65 (1st Dept. 1992); cf. Levandusky v. One Fifth Ave. Apt. Corp., 75 N.Y. 2d 530 (1990).

[10] Revised Model Nonprofit Corporation Act: Official Text With Official Comments 216 (1988).

fact, have been exercised.[11] As the ALI Principles put it:

> There is, however, no reason to provide special protection where no business decisionmaking is to be found. If, for example, ... a director received but did not read basic financial information ... and thus allowed his corporation to be looted [business judgment protection would be manifestly undesirable].[12]

2. Prerequisites of good faith and no interest. It is well settled that good faith and disinterested decisionmaking are perquisites to entry into the business judgment rule's safe harbor.[13] If, for example, a conversion transaction involves a leveraged buyout by the nonprofit's directors and officers, the demanding standards of duty of loyalty case law (discussed infra), not the business judgment rule, would be applicable.

3. Prerequisite of an informed decision. The ALI Principles explain:

> Among the factors that may have to be taken into account in judging a director's reasonable belief as to what was "appropriate under the circumstances" are: (i) the importance of the business judgment to be made; (ii) the time available for obtaining information; (iii) the costs related to obtaining information; (iv) the director's confidence in those who explored a matter and those making presentations; and (v) the state of the corporation's business at the time and the nature of competing demands for the board's attention.[14]

Obviously, the singular importance of a conversion transaction places an appreciable information gathering responsibility on directors. Basic to an understanding of the "reasonably informed" component of the business judgment rule is recognition that

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[11] See ALI Principles at 174-76.

[12] Id. at 174-75.

[13] Id. at 176-77.

it requires "reasonable inquiry" in appropriate circumstances.[15] In the for-profit context, the ALI opined:

> While often helpful, directors should not be required to obtain the opinions of outside experts as to fair value at the risk of incurring personal liability if they fail to do so, unless it is clear that internal resources are unavailable to satisfy the directors' duty of inquiry.[16]

But, in the context of a nonprofit conversion transaction of any size, my view -- with which I believe courts will concur -- is that the opinions of disinterested outside experts will almost always be necessary to meet the "reasonably informed" component of the business judgment rule. As indicated, the difficulty of ascertaining fair value for most nonprofit corporations strongly suggests that disinterested outside experts be retained. If the directors are relying on insiders whose views may be tainted by, for example, promises of future employment, the use of disinterested outside experts would clearly be mandatory.

Finally, it should be carefully noted that the most important recent case dealing

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[14] Id. at 178.

[15] Id. at 161-64, 179. See, e.g., Hoye v. Meek, 795 F.2d 893, 896 (10th Cir. 1986); Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264 275 (2d Cir. 1986); Barnes v. Andrews, 298 Fed. 614, 615-16 (S.D.N.Y. 1924); Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) ("the directors were duty bound to make reasonable inquiry"); Devlin v. Moore, 64 Or. 433, 443, 130 P.35, 45 (1913) ("If nothing has come to knowledge to awaken suspicion that something is going wrong, ordinary attention to the affairs of the institution is sufficient. If, on the other hand, directors know, or by the exercise of ordinary care should have known, any facts which would awaken suspicion and put a prudent man on his guard ... want of that care makes them responsible").

[16] ALI Principles at 394.

with the business judgment rule in Delaware, Cede v. Technicolor, Inc., 634 A.2d 345 (Del. 1993), modified, 636 A.2d 956 (Del. 1995), held that the "informed" component of the business judgment rule "requires a director, before voting on a proposed plan of merger or sale, to inform himself and his fellow directors of all material information that is reasonably available to them." In its Technicolor opinion, the Supreme Court of Delaware suggested that directors make a "prudent search for alternatives." The Supreme Court implied that as an alternative to a formal auction, to be properly informed, directors should provide for a "pre- or post-agreement market check mechanism." As will be explained in Section III infra, I would carry this theme further and expressly require either a formal auction or a "market test" in all nonprofit conversion transactions.

4. The "rationally believes" requirement. The "rationally believes" test is the basis of the legal insulation provided by the business judgment rule.[17] It affords directors and officers wide latitude when making decisions that meet the other prerequisites of the rule. But, as the ALI explained, there are objective outer limits to the protection this test affords:

> There is no reason to insulate an objectively irrational business decision--one so removed from the realm of reason that it should not be sustained--solely on the basis that it was made in subjective good faith. The weight of authority and wise public policy favor barring from the safe harbor of [the business judgment rule] directors and officers who do not believe, or do not *rationally* believe, that their business judgments are in the best interests of the corporation.[18]

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[17] See id. At 179-85.

[18] Id. at 181.

B. Duty of Loyalty

The legal obligations of directors and officers have traditionally been divided into the categories of duty of care and duty of loyalty. Allegations of neglect, mismanagement, and improper (but disinterested) decisionmaking are dealt with under the duty of care and the business judgment rule. Fraud, self-dealing, misappropriation of corporate opportunities, improper diversions of corporate assets, and similar matters involving conflicts between a director's or officer's interest and the corporation's welfare are considered under duty of loyalty statutes and case law.

Dr. Bradford H. Gray has described conversion transactions as "often involv[ing] leveraged buyouts by a group of insiders, who may themselves have a role in setting the price of the transaction or who negotiate with regulators over that price."[19] Manifestly, duty of loyalty law, not duty of care law, should govern any such transaction. ALI §5.15 provides the following rule of law:

> If directors or principal senior executives of a corporation are interested in a transaction in control ... then those directors or principal senior executives have the burden of proving that the transaction was fair to the shareholders of the corporation....[20]

State cases use tests like "entire fairness," "intrinsic fairness," and "inherent

[19] Bradford H. Gray, Conversion of Nonprofit Health Plans and Hospitals: An Overview of the Issues and the Evidence 3 (1996) (Tab A).

[20] ALI Principles at 359.

fairness" in these situations.[21] In general, what these terms mean is that the directors and officers will have to carry a heavy burden of showing that the acquisition process and price were fair (i.e., the best price reasonable available was received) to the corporation. This is just about the most rigorous and intrusive test (in terms of judicial oversight) used in corporate law.

Similarly, Dr. Gray indicated that conflicts can also arise because a nonprofit's administrators, directors, or legal advisers may be "given fees or promises of future employment by the acquiring organization."[22] Section 5.04 of the ALI Principles states that a director or officer "may not use corporate property ... non-public corporate information, or corporate position to secure a pecuniary benefit...."[23] Many difficult and subtle issues exist in this area, for example, with respect to: (i) how to define "interested" or "disinterested"; (ii) the legal effect of disinterested approvals; and (iii) the legal effect of "some taint" on the process. But, for present purposes, the important point to recognize is that all of these issues present duty of loyalty questions.[24] Moreover, while there are powerful arguments for higher loyalty standards in the nonprofit area than in the for-profit area (particularly given the public benefit purposes of nonprofit institutions and the

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[21] See, e.g., id. at 325-72; Paramount Communications Inc. v. QVC Network, 637 A.2d 34, 39 n. 9 (1994) ("When actual self-interest is present and affects a majority of the directors approving a transaction, a court will apply even more exacting scrutiny to determine whether the transaction is entirely fair to the stockholders.").

[22] Bradford H. Gray, Conversion of Nonprofit Health Plans and Hospitals: An Overview of the Issues and Evidence 3 (1996) (Tab A).

[23] ALI Principles at 254.

current ineffectiveness of accountability mechanisms), there is no plausible rationale for applying less demanding loyalty standards in the nonprofit context than are applicable to the for-profit sector.

III. A Sketch of Necessary Reforms

A. A New Mandatory Disclosure System

Even the few states that now require some disclosure with respect to conversion transactions seem to focus on key documents like the acquisition agreements and collateral arrangements with the nonprofit's directors and officers. I am skeptical that a realistic picture with respect to the fairness of a transaction can be obtained from these documents. I am even more skeptical about the current capacity of state charity regulators to analyze and evaluate such disclosure.

Compare the situation with respect to the acquisition of a for-profit public corporation. Extensive disclosure would be required under the federal securities laws -- in accordance with detailed SEC schedules -- with, for example, respect to: the background of and reasons for the merger; the specifics of the negotiation with respect to the price to be paid; the material terms of the transaction; the nature of discussions with other potential purchasers; the reasons for the board's decision to sell; and the details concerning compensation, collateral arrangements, and all material conflicts of interest.

If these disclosures contained a material misrepresentation or omission, the corporation involved, its directors and officers, and other participants (including lawyers

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[24] See generally, ALI Principles at 205-382.

and accountants) would have been subject--depending on culpability and other factors--to criminal penalties, injunctive relief, civil money penalties, administrative sanctions, and private damage actions. For those who believe as I do, in the words of Justice Brandeis, that "sunlight is . . . the best of disinfectants; electric light the most efficient policeman," a comparable system of disclosure for significant nonprofit conversion transactions is a necessity. State charity regulators should not, however, underestimate the difficulty of formulating effective disclosure schedules with respect to conversion transactions.

One way to establish an effective disclosure system would be to give the SEC jurisdiction over significant conversion transactions. Unlike state charity regulators, the SEC (which has an annual budget of about $300 million) has the resources to effectively monitor these conversions and has acquisition disclosure regulations (which could easily be tailored to nonprofit conversions) already in place.

The other basic alternative, which is more in keeping with our regulatory traditions in the nonprofit area, would be to establish a mandatory disclosure system by collaboration among state charity regulators. The SEC could provide help to the collaborative effort, and implementation would be most effectively imposed by legislation in each state. A sanctioning scheme for disclosure failures and express permission for relator actions[25] should be part of a legislative package. For efficiency reasons, it would be highly desirable for the states to form a "joint venture" for the filing and evaluation of disclosure documents. I would also cautiously open room for donor, member, and

[25] See the Boisture & Varley Paper at 4, 17.

recipient derivative actions. If a material disclosure failure occurs and the nonprofit corporation is damaged, it should be the nonprofit corporation (or a nonprofit successor)--not a class--that should be the recipient of any monetary recovery.

B. State Fiduciary Standards

As Section II indicates, the traditional legal fiduciary rules -- the duty of care, the business judgment rule, and the duty of loyalty -- should work reasonably well in the conversion transaction context. The word "business" in the business judgment rule sometimes causes confusion in the nonprofit context. For the policy reasons articulated in Section II, the business judgment rule should simply be thought of as a deferential review standard for the judgmental component of a decision.

In the for-profit context, the business judgment rule is applied to complex, non-profit- maximizing decisions -- e.g., (i) whether to take account of ethical considerations and forgo profits, (ii) how to deal with various constituencies of the corporation, and (iii) how many dollars to devote to humanitarian and philanthropic purposes, even when these will lower profits over the long term.[26] In the nonprofit context, the business judgment rule should be applicable to all of the key decisions in a conversion transaction -- e.g., whether to enter into an agreement; the fairness of the price and terms of the agreement; a decision by the board of a nonprofit hospital, for example, not to maximize the profit from a conversion transaction if the community would lose essential health services;[27] and

[26] See ALI Principles at 55-76.

[27] In my view, any trade-off between maximum price and community needs should involve an informed and conflict-free choice by the nonprofit's board and be governed by

where -- in the nonprofit community -- to put the funds received in a conversion transaction.

But four modifications should be made in the traditional analysis used in the for-profit context:

1. The retention of disinterested outside experts should in almost all instances be required in significant conversion transactions.

2. Because of the difficulty of valuing nonprofit enterprises (see Section I supra), new legislation, new regulations by state charity regulators, and court decisions should impose a "market test" requirement before any conversion transaction can be consummated. The "market test" should provide for: (i) public disclosure of the proposed transaction; (ii) the provision of relevant information (subject to appropriate confidentiality safeguards) to responsible persons interested in making a competing offer; and (iii) adequate time for competing offers to be made.[28] A fair formal auction would, of course, meet the "market test" requirement.

3. The absence of a process analogous to the shareholder approval process in the for-profit context and the importance to the public of nonprofit entities suggest that courts should give special emphasis -- enhanced scrutiny -- to allegations of conflict of interest in conversion transactions. Subtle conflicts or "taints" to the process, which might

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the standards of the business judgment rule.

[28] Other provisions (e.g., dealing with lock-up concerns and break-up fees) -- both to facilitate the "market test" and to provide appropriate safeguards -- could usefully be added to new legislation or regulations.

be considered marginal in the for-profit context, should be resolved in favor of duty of loyalty (not business judgment) treatment in the nonprofit conversion context.

4. Similarly, enhanced scrutiny of conflicts should be used with respect to the placement of the proceeds of a conversion transaction into a new nonprofit foundation and with respect to any joint venture undertaken by the nonprofit entity (or its successor) and a for-profit purchaser.

C. Process Reforms

We should increase the capacity of state charity regulators to monitor conversion transactions and to litigate where necessary. But, in general, it is unlikely that badly understaffed state charity regulators will be able to effectively handle the current "conversion mania." Express approval of relator actions[29] and the formulation of less restrictive standing rules should be part of any reform package. Donor, member, and recipient derivative actions would be particularly appropriate in the conversion transaction area because, by definition, nonprofit conversions are one-shot, decisive transactions in the life of the nonprofit entity. Except in the most unusual of circumstances, the nonprofit entity -- not a class -- should receive any monetary recovery. As is true in all class and derivative actions, but would be particularly true of cases involving conversion transactions, courts (and state charity regulators) should play an active role in reviewing the fairness of settlements and the award of attorney's fees.

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[29] See the Boisture & Varley Paper at 4, 17.