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Introduction to Nonprofit Symposium Issue

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INTRODUCTION TO NONPROFIT SYMPOSIUM ISSUE

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A glance at the titles of the articles in this symposium reveals the hot topic in the nonprofit sector: Many of the contributions have been inspired, at least in part, by the apparent exodus of hospitals from the nonprofit form. James Fishman provides the legal framework for analyzing "conversion transactions" in *Checkpoints on the Conversion Highway: Some Trouble Spots in the Conversion of Nonprofit Health Care Organizations to For-Profit Status.* Harvey Goldschmid uses conversion transactions as one of the case studies in *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms.* Rob Atkinson's piece, *Unsettled Standing: Who (Else) Should Enforce the Duties of Charitable Fiduciaries?*, considers, among other examples, the appropriateness of granting standing to private parties seeking to forestall a nonprofit hospital sale. In *A Proposal for an Exit Tax on Nonprofit Hospital Conversions*, John Colombo suggests that the government should be entitled to some of the sale proceeds in the form of an "exit" tax on the assets removed from the exempt sector.

Nonprofit hospitals account for almost half of the income of the nonprofit sector. They therefore attract a great deal of attention. Should we really be witnessing the wholesale sell-off of nonprofit hospital assets to for-profit buyers, any legal analysis might be too little, too late. Fortunately, as David Hyman discusses in *Hospital Conversions: Fact, Fantasy, and Regulatory Follies*, nationwide the percentage of hospitals which are for-profit has remained fairly stable during the last two decades, although regional differences are obviously important. Thus, the data suggest that we have plenty of time to adopt appropriate legal responses to these developments.

What should those legal responses be? Our symposium authors express a range of views. Both Professor Goldschmid and Professor Fishman would like to see some sort of elevated standard of review. Professor Goldschmid suggests, for conversions as well as similar transactions, applying a modified version of the business judgment rule unless conflicts of interest are present, in which case the transaction would be scrutinized for substantive fairness. Professor Fishman suggests that the conversion decisions of nonprofit boards should be subject to the enhanced scrutiny and fiduciary standards that the Delaware courts apply to directors of business corporations engaged in change-in-control decisions. Professor Atkinson doesn't even reach the question of standard of review, because, in addressing standing, he would leave so many more of these transactions to attorney general decision making with the board enjoying broad discretion in interpreting their duty of care. Finally, expressing skepticism that the nonprofit form is superior to the proprietary form for hospital care, Professor Hyman criticizes the recent wave of state

1. The Nonprofit Symposium participants are grateful to organizer Professor Randall S. Thomas, of the University of Iowa College of Law, and to the hard working student editors of the Journal of Corporation Law: Chris Novak, Jai Singh, Kathleen Sheil, Travis Bachman, Laurie Dawley, Dana Oxley, Colin Witt, Tom DeBoom, James Spolar, Ron Fadness, Jennifer Jevne, and Chad Nicholl.

nonprofit hospital sales statutes that apply only to sales to proprietary acquirers, and not to nonprofit acquirers. Indeed, he asks, if the *sale* of hospital assets merits scrutiny, "[w]hy not subject all nonprofit hospitals to periodic external monitoring to ensure that they are providing sufficient community benefit?" Professor Hyman suggests that the debate over nonprofit hospital conversions "is a distraction from the more significant normative question which should be answered: what services, cross-subsidies, and intangible elements of value do we desire from our hospitals?"

In analyzing the public role in nonprofit hospital conversions, traditional legal analysis has been limited to the "front-end" *cy-pres* inquiry and the "back-end" *cy-pres* inquiry:[2] To what degree should parties (public and private) other than the charity fiduciaries be involved in, first, the decision of whether to sell the assets, and, second, what to do with the resulting money? The difficult and important issues raised by nonprofit hospital sales provide only the leading edge of similar concerns arising in other contexts. The role of charities in society has always involved a sometimes uneasy accommodation between public and private interests, and, within the category of private interests, those of various constituencies of charity. As Professor Fishman asks: "There is a philosophical question in the conversion context—whom do the boards represent: patients, the doctors, a part of the public and which sector, or the community as a whole?" (He could also add donors to this list.)

Professor Atkinson demonstrates how the legal rights and obligations would differ depending on the lens with which we view charities. He finds that the "proprietary" model of nonprofits—pioneered by Henry Hansmann—"over-emphasizes the similarity between nonprofit organizations and for-profit firms." By contrast, the "citizenship" model "errs in the other direction, assimilating charities too closely with government." He favors a "sectarian" model, under which charities are treated as "radically independent, self-sustaining" communities, in which "charitable fiduciaries would enjoy maximum independence from all external controls, both private and public." This last model, he admits, carries the risk of making charity "too distinctive and too independent of the other two sectors." Resolving the public/private conflict differently in the specific context of a hospital conversion, Professor Fishman suggests that "in determining the [resulting] foundation's mission, there should be some public input and representation on the board."

Going beyond the traditional analysis, Professor Colombo proposes that selling hospitals should share some of the gain with their "partner", the government that funded tax subsidies. Under his "recapture" theory, "the conversion transaction can be viewed as 'ex post facto' confirmation that for some considerable period of time, the converted enterprise has not needed tax exemption to operate." In addition, Professor Colombo views the exit tax as a mechanism that could relieve the resulting charitable foundation from the yoke of the *cy pres* doctrine: "An exit tax ... would provide communities with a method of addressing a much broader range of community issues than would be possible under zealous enforcement of current law." Professor Hyman disagrees that such an exit tax is appropriate, on the ground that it retroactively changes the deal between the government

2. Richard Allen, Massachusetts Deputy Attorney General, Comments at a Conference on "Nonprofit Conversions," Program on Philanthropy and the Law, New York University School of Law (Oct. 18, 1996) (author's notes).

and nonprofit hospitals, and describes the theoretical difficulties of setting the correct tax rate. However, Professor Hyman would reexamine the basis on which nonprofit hospitals are granted exemption, and suggests that targeted incentives might be more appropriate.

Even getting to the merits of the case of an asserted violation of fiduciary duty depends on how society determines the boundaries of the public interest in charity operations. After all, who guards the guardians when a nonprofit, by definition, lacks shareholders (and often members) to look after their own interests? Some critics view the exclusive enforcement powers of the attorney general as stifling the potential monitoring benefits of a system of litigation initiated by private parties. Over the years, reformers have urged that standing to bring derivative suits against nonprofit fiduciaries be extended to a variety of private persons. Again, though, one's view of standing depends on one's view of the role of charity in society, and how private should private philanthropy be. Professor Goldschmid would modify the standing rules, and believes that awarding legal costs and fees "against plaintiffs and their lawyers if an action is unreasonably brought or litigated could moderate some of the danger" of "weak (but lawyer driven) or spiteful litigation." Similarly, Professor Fishman notes a "cautious" willingness to open the door to more derivative actions. However, Professor Atkinson questions whether donor, member and beneficiary standing is appropriate where the remedy is an injunction to enforce the duty of obedience, because he would generally leave "mission" decisions to the fiduciaries. He writes of his sectarian model: "This model, in effect, would abolish the duty of obedience entirely and leave the attorney general alone with standing to enforce the remaining duties of care and loyalty."

More explicitly addressing the public sector is Ellen Aprill's article, *The Integral, the Essential, and the Instrumental: Federal Income Tax Treatment of Governmental Affiliates*. This piece considers the often-confused tax schemes that apply when government engages in charitable activities, either directly, through instrumentalities, or through separately incorporated "section 501(c)(3)" charities. She reconsiders the recommendation, made in her definitive study of the federal tax exemption of state and local governmental activity, that Congress should undertake to rationalize this area. In her symposium piece, she instead calls for regulatory reform to reduce confusion and inconsistency, and suggests that the Internal Revenue Service could model regulations on newly-enacted statutory criteria for exemption of Workers' Compensation Act companies; this statute determines the state interest based on the factors of creation, control, initial financial commitment, and destination of assets upon dissolution.

The broad financial relationship between the public and the charitable sectors is explored in Evelyn Brody's contribution, *Of Sovereignty and Subsidy: Conceptualizing the Charity Tax Exemption*. Observing that tax exemption operates as a peculiar subsidy (offering the greatest benefits to charities carrying on the most profitable activities and owning the most valuable property), this piece suggests that the property-tax and income-tax exemption of charities can be explained by a "sovereign" view of the charitable sector. Resembling the federal tax treatment of state and local governments, exemption for charities respects the independence of the nonprofit sector, and minimizes the involvement of charities in the political process. Unfortunately, the long history of Anglo-American philanthropy also contains a great deal of mistrust by the state of the economic power of charities, and a sovereign view of charity can explain as well some of the peculiar rules that reduce, rather than enhance, the value of tax exemption.

In the end, there are limits on what the law can achieve. Professor Goldschmid emphasizes that "self-help" educational efforts to improve nonprofit governance are as important as governmental monitoring and enforcement. Indeed, Professor Goldschmid observes with approval that in the duty of loyalty area, conduct specifications such as conflicts-of-interest policies "can be more restrictive than current loyalty law." He also urges the development of guidelines for internal audit procedures, information systems, legal compliance programs, and board committee operations. Public confidence in a private charitable sector must be earned by fiduciary behavior conducted at a higher level than the law requires.