Balancing Mission and Market:

Nonprofits Walk a Tightrope Between the Public and Private Spheres

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Consumers Union of U.S., Inc.
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This report was prepared by the West Coast Regional Office of Consumers Union of U.S., Inc.

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Acknowledgments

The authors wish to thank the Surdna Foundation for its generous support of Consumers Union's conversion work and for funding this report. We also wish to thank Rhoda Karpatkin, Chuck Bell, Robin Kane, Lynn Lohr, Diana Bianco, Laurie Sobel, Julio Mateo, Elisa Odabashian, and Judith Bell for their helpful comments on earlier drafts, and Harry Snyder and Betsy Imholz for their extensive editing support. We also extend our thanks to Les Chun for his research assistance and to Minerva Novoa, Evaluz Barrameda and Carolina Rivas Pollard for their production assistance.

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Executive Summary: Nonprofits Face The Future

Imagine for a few moments that every hospital in your neighborhood is run by a corporation whose primary goal is to make a profit from providing health care. Gone are the nonprofit hospitals run by religious denominations or universities; gone too are the public hospitals managed by local officials. Would your family or community be affected? Would it matter whether you received health care from a nonprofit rather than a for-profit provider? Should you care? Framed more broadly: What does it mean to be a nonprofit? What are the values and purposes that define nonprofit organizations? To what extent do nonprofits adhere to these values?

These questions have percolated through the public debate about nonprofit health care institutions that decide to abandon their nonprofit status and become for-profit businesses. By their very nature, these transactions – known as conversions – illuminate the fundamental differences between nonprofit and for-profit entities. Consumers Union has been monitoring conversions in the health care sector for nearly fifteen years, and since 1996, has worked in partnership with Community Catalyst, a Boston-based nonprofit organization. We have asked whether each proposed conversion is in the public interest. And we have sought to protect the public interest, primarily by pursuing the immediate goals of preserving the charitable assets accrued by converting nonprofits and ensuring that conversions do not diminish access to affordable, high-quality health care. But our experiences also have raised broader questions about the impacts that conversions will have on both nonprofit organizations and the people they serve. More recently, as Consumers Union has begun monitoring conversions in the student loan industry, and as conversions of nonprofits in other fields are proposed, these questions have become even more pressing.

The genesis of this report lies in our conversion work. The speed and number of conversions among health care institutions prompted us to question whether a broad trend would soon sweep over other segments of the nonprofit sector – as suggested by several recent conversions of nonprofit student loan institutions. For this report, our objective was to determine how pervasive conversions were becoming throughout the nonprofit sector.

We began by examining the sectors of the nonprofit world with which Consumers Union is directly familiar – health care and student loans. As a next step, we broadened our scope to look at nonprofits that provide human services, particularly job training and placement *services, and social services for juvenile offenders and at-risk youth. We then looked beyond these subject matter boundaries and reviewed literature discussing structural changes in the nonprofit sector generally.*

This paper sets forth three key findings. First, our research did not reveal a spate of full-scale conversions occurring among nonprofits in fields other than health care and student lending. Instead of formal conversions from nonprofit to for-profit status, we discovered that other segments of the nonprofit sector are transforming in less absolute ways. Yet even reorganizations that fall short of a change in an organization's legal status are having a substantial impact on the nonprofit sector.

Second, efforts to identify the next conversion wave unearthed important information about the factors causing the transformation of the nonprofit sector. Much of the current debate about the sector revolves around how heightened competition between nonprofits and for-profits has caused nonprofits to become more market-driven. But our research suggests a more complex picture. In some areas, the winnowing of nonprofit organizations may be an evolutionary response to both changing market forces and opportunities for private gain. Some entrepreneurial activities of nonprofits are creative adaptations that allow the continuation of mission-driven services in a highly competitive environment. And government, at all levels, has played a pivotal role in reshaping the nonprofit sector.

This paper describes some of the market forces and government actions that are influencing nonprofit transformations. Further inquiry is needed to explore the factors driving change, including the importance of government – in its twin roles as policymaker and regulator – for the continued vitality of the nonprofit sector.

Lastly, our analysis underscores the need to better understand the impacts of the widespread organizational changes in the nonprofit sector. Many scholars and other nonprofit experts have studied how nonprofit organizations themselves *are affected by restructuring. Yet a key question remains unanswered: Have conversions and the other structural changes sweeping over the nonprofit sector resulted in a loss of services or other less-quantifiable benefits provided by nonprofits? While a definitive answer to this question lies beyond the scope of this report, we will provide an overview of the possible public impacts. In addition, we will describe some of the challenges inherent in assessing public impacts and suggest areas for further inquiry.*

Changing Times: A New Era for the Nonprofit Sector

An understanding of how and why nonprofit organizations are changing requires consideration of a key threshold question: What is the nonprofit sector? The number (roughly 1.2 million nationally) and diversity of organizations that comprise the nonprofit sector complicate efforts to meaningfully analyze any issue on a sector-wide basis. Consider these two dramatically divergent descriptions:

- *The nonprofit sector . . . is composed overwhelmingly of small, community-based entities with meager resources. Even among those organizations that meet the threshold for reporting to the IRS, most have modest budgets, use only volunteer labor, and operate locally.*[1]

- *Many nonprofits operate just like for-profit businesses. They make huge profits, pay handsome salaries, build office towers, invest billions of dollars in stocks and bonds, employ lobbyists and use political action committees to influence legislation.*[2]

While both of these statements are factually accurate, what you see when you look at the nonprofit sector clearly depends on where you direct your gaze. Rather than a monolithic whole, the "nonprofit sector" can more accurately be described as a multitude of subsectors, including health care, education, social services, visual and performing arts, legal services, as well as religious, civic, social, philanthropic, fraternal and advocacy organizations, among others. These subject matter differences represent just one of the fault lines running through the conceptual territory occupied by the sector. As one commentator observed: "The fact is, the subsectors of the nonprofit world . . . are enormously varied. They get their resources from different places, they exhibit varying degrees of independence from the public sector, they are more or less engaged in the market economy, and they have quite distinct corporate cultures."[3] *While this complexity increases the challenge of identifying the distinct values of nonprofit organizations, it also points out the need for such inquiry.*

The Distinct Values of Nonprofit Organizations

Although they defy easy generalizations, nonprofits' common denominator is that they "provide a private means to pursue public purposes outside the confines of either the market or the state."[4] *Nonprofits serve the public good by assisting those who are poor, sick, underserved, or otherwise vulnerable. Some nonprofit organizations, such as the Blue Cross and Blue Shield plans that we studied, took risks that for-profit companies eschewed. Similarly, the nonprofit student loan secondary markets provided funding for higher education that simply was not available from private banks. These nonprofits were truly pioneers and set an example that others – often for-profit companies – would later follow.*

Service delivery is not the exclusive mission of many nonprofit organizations. "They also act as educators, advocates, and vigorous agents of social change, challenging society to respond to human problems in new ways – particularly through public policy."[5] *Nonprofits have been at the forefront of every movement for social change during the last five decades of American history. They led the civil rights movement, the battle for a cleaner environment, the fight for equality for women, and many other social causes that have changed the nation. By working to serve society's unmet needs, nonprofits acquire a unique perspective on these needs. This special window on the world has placed the nonprofit sector at the center of our nation's struggle to achieve a civil society.*

A vigorous nonprofit sector encourages civic participation and strengthens local communities by mobilizing individuals into groups and turning private initiative into public action. Although nonprofits have been under attack from some quarters recently, many contend that these organizations represent the "embodiment of a fundamental national value emphasizing individual initiative in the public good and a means to "foster pluralism, diversity, and freedom."[6] *In this way, nonprofits serve as "the repository of the civic values, virtues, and volunteer spirit that ground American democracy and give it meaning and strength."*[7] *The battles waged by nonprofits to provide services and to strive for a just society need stalwart support; the vitality of the sector is inextricably intertwined with the health of American democracy.*

Blurred Boundaries: New Opportunities and New Challenges for Nonprofits

The conversions and other restructurings that our research uncovered have not occurred in a vacuum. Instead, they are part of a broader trend toward "marketization" or "commercialization" that leading scholars and other nonprofit experts have analyzed over the last few years.[8] *The very words commercialism and commercialize, used throughout much of the recent literature about nonprofit organizations, each have several different meanings. Some are value neutral, while others have strong negative connotations.*[9] *This paper uses the terms "commercialize" and "commercial" simply to describe some of the ways in which nonprofits are applying business methods or principles to their activities or engaging in activities with for-profit enterprises. How "commercial" activity will affect the ability of nonprofits to fulfill mission-related objectives is difficult to determine in the abstract and will vary from organization to organization.*

The causes of the trend toward increased commercial activity are complex, but financial need is a major factor. Securing adequate, stable funding streams has always been a challenge for the vast majority of nonprofit organizations. Traditional sources of nonprofit revenues, such as government subsidies, have waxed and waned over the last thirty years and have not proven to be a dependable source of funding. And competition among nonprofits for foundation grants and charitable donations is intense. Rather than rely on philanthropic or government funding alone, nonprofits increasingly generate revenue by selling goods and services.

Of course, many nonprofits historically have financed their operations by charging for their services. Particularly in the two most capital-intensive segments of the nonprofit sector – health care and higher education – institutions have always relied on fees for a substantial portion of their revenue. The buzz these days stems not from the mere fact that nonprofits are earning money by selling goods and services, but rather from the extent and nature of the commercial activities in which nonprofits are engaged. Growing numbers of nonprofits, borrowing from the playbook of the business world, pursue strategies that include mergers, acquisitions, for-profit subsidiaries, and joint ventures. Nonprofit organizations more aggressively market their products and services and engage in benchmarking and branding.

These flexible, innovative, entrepreneurial approaches may hold the key to survival and growth for nonprofits.[10] *New sources of income have helped some organizations serve their charitable missions more effectively and become more independent. But the blurring boundary between the nonprofit and for-profit sectors also presents risks.*

> *The reality is . . . that more and more activity is hard to characterize as public, market or nonprofit as partnerships and hybrid forms of organization come to be the rule. The advantage of this shift is that sectoral interpenetration may facilitate social innovation and efficiency. This blurring of sectoral functions may also, however, erode public awareness of, and confidence in, the nonprofit sector and bring into question the values and moral authority of the sector.*[11]

As nonprofits adopt the structures and strategies of their for-profit counterparts, both policymakers and the public may question whether nonprofits will be pulled away from serving charitable purposes and fulfilling civic goals. Indeed, serving the twin masters of mission and market can be difficult – if not impossible – as conversions from nonprofit to for-profit status demonstrate. Nonprofits walk a tightrope suspended delicately between the public and private spheres. Markets are here to stay, but so are market failures and social or non-economic needs. Society needs nonprofits as a distinct sector because they characteristically serve purposes that are not met by market mechanisms.

As the twenty-first century beckons, the nonprofit sector is poised to cross the Rubicon. The gradual transformation of the sector "has happened largely without notice, forethought or national debate about the consequences and public policy implications for the country."[12] *The continued evolution of the nonprofit sector will reverberate widely, however. The key challenge for nonprofits is "to frame a set of civic-based service goals and strategies for the 21st century."*[13] *Foundations, as both grantmaking and operating nonprofits, similarly have a responsibility – and a unique capability – to maintain and support the nonprofit sector.*[14] *Evolving institutional changes should "also prompt a searching review by governments, corporations and nonprofits of their respective responsibilities to the American public."*[15]

Viewing the Nonprofit Sector through the Lens of Conversions

Consumers Union's interest in conversions and the trend toward commercial activity by nonprofit charitable organizations stems in part from its own experience as a strong mission-driven organization operating in an increasingly competitive environment. In addition to providing unbiased information on a host of products and services, Consumers Union serves its mission by advocating for consumer interests in legislative, judicial, and regulatory proceedings. Monitoring conversions among health care and student loan organizations has focused our thinking about the role of nonprofits in a pluralistic economy. Our collaborations with Community Catalyst and local coalitions to ensure that proposed conversions protect the public's interest have provided a vehicle for communities to voice their expectations of nonprofit organizations and to debate what the public may lose when nonprofits convert to for-profit status. When a conversion occurs, the for-profit corporation often operates on the presumption that it has no obligation to the public beyond what it takes to retain customer good will. Regulators and community leaders must work to dispel this notion and ensure that conversions do not result in a net loss of services and other public benefits.

Viewing the nonprofit sector through the lens of conversions is a bit like picking up a novel and reading only the final chapter. One knows how the story ends, but not how the plot develops. Conversion represents the end of the line for a nonprofit; the point at which it seeks to formally inter its charitable, public purposes and to be resurrected as an organization dedicated to maximizing profits and serving private interests. The conversion trend among nonprofit health care and student loan institutions illuminates many of the forces driving nonprofit organizational change generally. The outcomes of these transactions can help explain how market forces and government policy influence the nonprofit sector, and how institutional change affects the public.

Under the Microscope: The Conversion Continuum

Conversion Basics

Any discussion of conversions must begin with an understanding of what they are.[16] *Simply put, a nonprofit has converted to for-profit status if it transfers ownership or control of all (or substantially all) of its assets to a for-profit company. The move from nonprofit to for-profit status is legally significant because it effects a fundamental change in the mission of the organization, as well as in the ownership and use of its assets. Nonprofit corporations have missions to benefit the public, and they cannot be owned by any individual. In addition, nonprofits are prohibited by law from distributing their assets or income to private parties; this principle often is referred to as the "non-distribution constraint" or the prohibition on private inurement.*

For-profit businesses, in contrast, are owned by and operated for the benefit of private investors or shareholders. Their most fundamental obligation, as a matter of law, is to serve shareholders. Money generated by a for-profit business can be paid to private individuals via dividends, reinvested in the venture, or paid to employees through compensation, profit-sharing plans, stock options and the like.

Under federal law and almost all state laws, the assets of nonprofit organizations must be permanently dedicated to charitable purposes. When a nonprofit converts to for-profit status, it will no longer be organized to serve such purposes and instead will be dedicated to maximizing profits. Accordingly, a converting nonprofit must transfer the full value of its assets to another nonprofit organization that will serve similar charitable purposes. Essentially, as an organization crosses the border between the nonprofit and for-profit sectors, the law requires that nonprofit charitable assets must continue to be channeled into public benefits and not fall into private hands. A converting nonprofit may fulfill this requirement by creating a foundation, which is endowed with the net charitable assets of the converting entity.

Health care conversions already have spawned more than one hundred new foundations, with total combined assets valued at more than $13 billion.[17] *And there are billions more where that money came from. In 1991, a U.S. Senate committee report estimated that Blue Cross and Blue Shield (BCBS) plans across the country had assets worth $30.1 billion, a* *number that has increased substantially during the last several years.*[18] *As of 1996, an insurance industry insider estimated the value of assets held by the nation's nonprofit health insurers at $92 billion.*[19] *The value of a nonprofit hospital or hospital system can run into tens of millions of dollars and often hundreds of millions of dollars.*

A Few Examples

Nonprofit corporations in the health care industry have demonstrated that conversions can be effected in a myriad of ways. In fact, the transformation from nonprofit to for-profit status often occurs over an extended period of time and can be difficult to recognize at first glance. A few snapshots from the conversion scrapbook compiled by Consumers Union and Community Catalyst illustrate this phenomenon.

One of the "purest" forms of conversion occurs when a nonprofit sells its assets to, or merges with, a for-profit business. In the health care context, this type of transaction occurs when a for-profit hospital company such as Columbia/HCA Healthcare Corporation or Tenet Healthcare Corporation (the country's two largest for-profit chains) acquires a nonprofit hospital. Conversions of this type are occurring across the country. California, for example, experienced eleven hospital conversions between 1993 and 1998; seven were acquisitions of nonprofit hospitals by Columbia or Tenet.[20] *These transactions also can involve health insurers; for example, Anthem Insurance Companies Inc., a for-profit mutual insurance company, has acquired or is in the process of acquiring nonprofit BCBS plans in Colorado, Maine, New Hampshire, Ohio, Connecticut, and Kentucky.*

Another "pure" form of conversion occurs when a nonprofit corporation transforms itself into a for-profit corporation with no other company involved. In this kind of conversion, the board of directors simply reincorporates the nonprofit as a for-profit corporation. The new for-profit can then begin selling stock to the public. For example, in June 1999, Blue Cross and Blue Shield United of Wisconsin announced that it planned to convert itself from a nonprofit public benefit corporation to a publicly-traded, for-profit stock company. In 1997, Empire Blue Cross and Blue Shield in New York proposed a similar conversion. Both transactions currently are under review by state regulators.

Further along the conversion continuum lie transactions that involve a nonprofit parent corporation and its for-profit subsidiary. For example, nonprofit BCBS plans in California and Missouri each created a for-profit subsidiary, transferred the majority of their nonprofit assets to their respective subsidiaries, and sold stock in the subsidiaries to the public. This type of restructuring constitutes a conversion because the bulk of the nonprofit corporation's value resides in the for-profit subsidiary, and the sale of stock in the subsidiary gives private shareholders an ownership interest in nonprofit assets.

A more murky type of conversion can occur when a nonprofit and a for-profit enter into a partnership or joint venture. Both parties may transfer assets to the venture, or the for-profit may purchase the nonprofit's assets. For-profits often view joint ventures as a way to avoid preserving charitable assets for the public and to dodge the public outcry that may accompany a complete conversion. The terms of these partnerships, and the extent to which the nonprofit controls the venture, vary considerably.

For example, nonprofit Southwest Texas Methodist Hospital (STMH) and for-profit Columbia/HCA created a for-profit partnership in 1994. STMH contributed its hospital and related property and equipment to the partnership. Columbia/HCA contributed four hospitals and $74.7 million in cash, some of which was used to retire STMH's outstanding tax-exempt debt. STMH kept its nonprofit, tax-exempt status as the owner of a 50% share in the partnership, even though its hospital is part of the for-profit partnership. STMH retains an option to sell its share of the partnership to Columbia/HCA after seven years.

But the Internal Revenue Service recently has placed joint ventures in its spotlight, and they may wither under the glare of regulatory attention. The IRS is aggressively auditing joint ventures to determine whether the nonprofit partner retains sufficient control of the hospital's operations to ensure that its charitable purposes are fulfilled.[21] *In July 1999, the U.S. Tax Court affirmed an IRS ruling that a nonprofit corporation cannot maintain its tax-exempt status if it cedes control over the operations of a partnership to a for-profit company.*[22]

At perhaps an even further point on the continuum, nonprofit HMOs and insurance companies have engaged in transactions that are essentially two-step or indirect conversions. The first step, known as "mutualization," occurs when the nonprofit changes its legal status to become a mutual company, which is owned by and organized to benefit policyholders rather *than the general public. In the second step, called "demutualization," the nonprofit mutual company changes to a for-profit company. The resulting company is owned by and organized to benefit its investors or shareholders, without a public benefit component.*

Conversions involving mutual companies usually take many years to complete and, as a result, are particularly likely to evade thorough regulatory review. For example, one BCBS plan in Ohio originally was incorporated as a public benefit corporation. As a result of a new law enacted by the Ohio legislature in 1987, the plan became a mutual company known as BCBS Mutual of Ohio. Ten years later the company proposed to sell a substantial portion of its assets to the for-profit hospital company Columbia/HCA without acknowledging that this transaction would constitute a conversion by transferring nonprofit charitable assets to for-profit ownership. BCBS Mutual of Ohio ultimately abandoned the venture, after both policyholders and the Ohio Attorney General filed lawsuits against the plan because the deal violated policyholder rights and failed to preserve charitable assets for public purposes.

These examples demonstrate the complexity of the conversion transactions transpiring throughout the health care field. Many early conversions among hospitals and HMOs were relatively straightforward; they constituted the classic sale – lock, stock and barrel – of a nonprofit entity to insiders or to a for-profit company. But those conversion prototypes drew the attention of consumer advocates and community leaders who pressed legislators, regulators, and the courts to protect the public's interest by preserving charitable assets. As a result, many converting nonprofits and their for-profit suitors have resorted to increasingly complex and subtle mechanisms for structuring deals to avoid public scrutiny and regulatory oversight. Those who seek to protect the public's interest in the conversion of nonprofit organizations must remain vigilant to ensure that charitable assets and services are not lost.

Student Loan Secondary Markets

The next wave of conversion activity occurred in a less familiar segment of the nonprofit sector. As banks that lend money to banks, secondary student loan companies are not the archetypal nonprofit corporation. Their workaday function is borrowing and lending money, and their income is directly dependent upon loan volume. Nonprofit student loan secondary markets were created pursuant to federal tax code changes in 1976 to fill a need that was *unmet by the market.*[23] *Their function was to increase access to post-secondary education by making more money available to students seeking loans to pay for college. Secondary markets raise money in the private sector to lend to banks that lend directly to students under the federal guaranteed student loan program. Nonprofit secondary markets are authorized to issue non-taxable bonds and to use the proceeds to purchase student loans originated by private banks. Nonprofit secondary markets are essentially arbitrageurs borrowing money (by issuing bonds) and lending it (by purchasing student loans) at a higher rate.*

About thirty secondary market nonprofits formed and flourished over the past two decades, growing into a $15 billion industry. Then, in 1996, Congress changed the rules to permit nonprofit student loan secondary markets to convert to for-profit businesses.[24] *Since then, at least four entities, one each in Massachusetts, Ohio, Nebraska and South Dakota, which collectively hold more than $6 billion in student debt, have converted to for-profit status.*[25] *Each of the converting entities has created a new foundation with a mission devoted broadly to greater access to education. In all, these conversion foundations hold close to $750,000,000 in net charitable assets to be used for educational philanthropy.*[26]

The Changing Face of the Nonprofit Sector

Health care and student loan conversions prompted us to look at other facets of the nonprofit sector to determine whether they too were likely to experience a conversion trend. Our research showed that formal changes from nonprofit to for-profit legal status remain relatively rare outside the health and student loan fields. But other forms of structural change are increasingly common. Nonprofits in a myriad of fields are creating for-profit subsidiaries, entering into joint ventures with for-profit businesses, and becoming subcontractors to large for-profit corporations.

Human Services Organizations

Although nonprofits that provide human or social services have not been the focus of our conversion work, the significance of the blurring lines in this sector is readily apparent. The most focused attention has been paid to nonprofits that provide the job training and placement services that are crucial to "welfare-to-work" initiatives.[27] *In the wake of the 1996 overhaul of the welfare system, nonprofits that provide these services must compete for government contracts with for-profit heavyweights such as Lockheed Martin, Electronic Data Systems, and Maximus. For-profit companies also are moving aggressively into the field of delivering services to at-risk youth. As more for-profit corporations enter these "markets," the nonprofits that traditionally have provided social services are adapting and restructuring - in ways that mirror the structural changes in the health care industry over the last two decades.*

A few nonprofits have taken their cue directly from the health care sector and formally converted to for-profit status. For example, Pennsylvania-based Abraxas Group, Inc. succeeded for nearly twenty-five years as a nonprofit organization operating a broad array of counseling, treatment, and educational programs for at-risk youth and juvenile offenders. But by 1997, as large for-profit businesses sought to gain "market share," Abraxas decided that the best route to continued success was to seek a for-profit buyer. The group's chief executive officer "believed that a conversion deal would enhance Abraxas's access to capital while preventing it from being driven out of the market by a larger competitor."[28] *After hiring a broker to entice suitors, Abraxas was acquired by Cornell Corrections, Inc., a large for-profit prison management company. Abraxas's CEO joined the Cornell Board of Directors, and the former nonprofit became a wholly-owned subsidiary of Cornell, called the Abraxas Group.*[29]

The Abraxas deal seems only to have whetted Cornell's appetite for acquiring nonprofits. Earlier this year, the company announced that it had entered into agreements to purchase two other nonprofits: Interventions, a Chicago-based organization, and Archway Programs, Inc., based in Camden, New Jersey.[30] *Both organizations operate treatment and correctional facilities for juveniles and adults.*

Other nonprofits have collaborated with for-profit companies rather than actually becoming for-profits themselves. The YWCA of Greater Milwaukee, for example, responded to changes in government funding for welfare services by forming a joint venture with two for-profit partners.

> *To handle the demands of a comprehensive, $40-million welfare-to-work contract, [the YWCA] created a for-profit limited liability corporation with two for-profit partners. . . . The new company, YW Works, provides services from 7 A.M. to 7 P.M., staffs a 24-hour resource line, provides transportation assistance, emergency loans, and job-site clinicians, and has better assessment and placement programs with improved information technology.*[31]

This arrangement allows the YWCA to leverage its resources to provide the comprehensive range of services that government contracts increasingly require. Alternatively, some nonprofits have become subcontractors to large for-profit corporations that serve as general contractors to state and local governments. For example, in Baltimore, the Urban League subcontracted with Lockheed Martin to train and find jobs for unemployed parents who owe child support payments.[32]

Still other nonprofits in the social services arena have reacted to the changing marketplace for services by overhauling their own operations. The President of Goodwill Industries of Pittsburgh, for example, "conducted a top-to-bottom review of the charity's work to see how it could better set itself apart from the for-profit counterparts who seek government job-training aid."[33] *Ultimately Goodwill decided to create four nonprofit regional "employment help centers" to make its services more accessible.*[34]

New Horizons: Change in Other Nonprofit Subsectors

Throwing open the shutters to look at the nonprofit world more generally, we saw that change is ubiquitous. Nonprofits in a variety of fields are creating new organizational structures and affiliations, often involving for-profit enterprises. The following are just a few examples of the transformations underway:

- *Pioneer Human Services, a nonprofit organization located in Seattle, Washington, "has become the largest and most self-sustaining human service agency of its kind."*[35] *Pioneer generates annual revenues of more than $50 million by operating enterprises and programs that provide a comprehensive package of social services to at-risk individuals. For example, Pioneer's ventures include a wholesale food distributorship that serves four hundred food banks, a real estate division that develops and manages both residential and commercial properties, a café, and a hotel that serves both tourists and recovering substance abusers. Pioneer's workforce is comprised of "ex-offenders and former substance abusers."*[36]

- *Earlier this year, the University of Nebraska at Lincoln started a for-profit company, Class.com, that will allow students to earn a high school diploma by completing on-line classes. Class.com aims to do more than just sell courses to individual students; it will attempt to sign contracts with entire school districts and even state departments of education. These large markets are where the company sees the potential for "huge profits" in the long term.*[37]

- *Last year, New York University created a for-profit subsidiary – and provided it with $1.5 million in start-up funds – to develop and sell on-line courses. The new venture, NYU On-line, Inc., provides NYU with flexibility in its efforts to raise capital and allows it to compete with the for-profit University of Phoenix and other companies that sell courses designed for working adults.*[38]

- *The American Association of Retired Persons (AARP) recently settled a 14-year-long dispute with the Internal Revenue Service over whether certain types of income were taxable. The settlement provides that the royalties that insurance companies, banks, and other companies pay to AARP for the use of its name and logo in marketing the companies' services will remain tax-exempt. AARP also agreed to establish a for-profit subsidiary called AARP Services, Inc., which will handle income-generating businesses such as the health insurance that the association sells to its members.*[39]

- *The National Geographic Society, the nonprofit publisher of* National Geographic *magazine, was founded in 1888 with its stated mission "the increase and diffusion of geographic knowledge." For more than a century, the Society "projected a sedate, semi-academic air, largely detached from the marketplace."*[40] *Organizational change began in 1994, when the Society created a for-profit subsidiary called National Geographic Ventures. This business pursues a variety of new media opportunities,* *including television programs, CD-ROMS, the Internet, and map publishing. And in January 1997, National Geographic Ventures' map division purchased a $2 million map company called Trails Illustrated - the first time the National Geographic Society had ever acquired another company.*[41]

- *Nonprofit Minnesota Public Radio (MPR), the largest state public radio system, started a catalog business called Rivertown to market products related to Garrison Keillor's popular radio program, "A Prairie Home Companion." Rivertown subsequently was separated from MPR and reorganized as one enterprise within a for-profit company called Greenspring. Both the nonprofit MPR and the for-profit Greenspring are owned by an entity known as Minnesota Communications Group (MCG).*

  In March 1998, MCG announced that it would sell Rivertown to the Dayton Hudson Corporation for $120 million, $90 million of which was added to MPR's endowment. Any nonprofit would consider a windfall of this size to be good news. But two aspects of the deal raised eyebrows. First, the sale was announced only after *MPR finished soliciting donations from the public. In addition, three Greenspring executives, two of whom were also top officers of MPR, received approximately $6.6 million from the transaction. The relationship between MPR and Greenspring previously had made headlines because the two entities shared the same president, William Kling. MPR disclosed to donors that Kling's annual salary as president of the nonprofit was about $74,000. But MPR declined to divulge that Kling was paid an additional $380,000 per year by Greenspring. This information was not available to donors until 1996, when a new state law required its disclosure.*[42]

- *Some nonprofit charitable organizations allow for-profits – particularly pharmaceutical companies – to use their names and logos to market drugs or devices. Nonprofits earn more than $500 million each year for this "cause marketing." As just one example, the American Cancer Society receives more than $1 million a year from SmithKline Beecham, P.L.C., for the use of the Society's name and logo in advertisements for SmithKline's Nicoderm nicotine patch.*

  But cause marketing has raised the ire of regulators. In April 1999, the Attorneys General from sixteen states issued a report entitled, "What's in a Nonprofit's Name: Public Trust, Profit and the Potential for Public Deception," in which they call for stricter rules governing cause marketing. The report expresses concern that nonprofits are trading on their trusted names in a way that may mislead consumers. Although most nonprofits claim that they do not make product endorsements, the advertisements often suggest that a particular company's product is better than its competitors', even when there is no evidence to support such a distinction.[43]

These examples only scratch the surface, but they demonstrate the wide scope and rapid pace of organizational change in the nonprofit world. One of the hallmarks of nonprofits is their ability to respond creatively to new problems and circumstances. Clearly, many nonprofits are doing just that: responding to changing market forces and social needs in innovative, entrepreneurial ways. How such change will affect each organization – as well as the nonprofit sector as a whole – remains as yet undetermined, primarily because so much has happened so quickly. Ultimately, the measure of success for nonprofits is whether such strategic and structural change allows them to continue to serve their public purposes.

Many who study nonprofits have tried to predict where the next conversion bonanza may lie.[44] *But those who search for the next bevy of conversions may be unable to see the forest for the trees. In fact, major organizational change of all types is rampant throughout the nonprofit sector and shows no signs of slowing anytime soon. Outright conversions to for-profit status garner the greatest attention from regulators and the public because they are the most dramatic type of change. But even outright conversions are complicated business transactions that may occur in phases stretching over several years; as a result, they may be difficult for the casual observer to recognize. By comparison, restructurings that stop short of altering a nonprofit organization's legal status are nearly invisible, and they are occurring with little public debate about their ramifications. Heightened public awareness of the evolution in major sectors of the nonprofit world is a prerequisite to the public's ability to both voice opinions about such change and, ultimately, to safeguard nonprofit assets and services.*

Considering Causes: Forces Driving the Conversion Trend

The Influence of Market Forces on Health Care Institutions

Chronicling the full-scale conversions and other restructuring activities that are prevalent throughout the nonprofit sector raises an obvious question: Why are these changes occurring? Commentators have offered several explanations for the health care conversion phenomenon.[45] *Among the most frequently mentioned reasons are the managed care revolution and the increasingly competitive nature of the health care industry. These market forces have made consolidation a rallying cry among health care institutions, which in turn has heightened the need for capital. As health policy experts have explained:*

> *Competitive forces in the marketplace have forced hospitals and health plans to be more efficient, and many have sought efficiencies through consolidation via mergers and acquisitions.*
>
> . . .
>
> *In today's competitive environment, increasing market share is often a necessary strategy. Hospitals need increased market share to build networks that will guarantee patient flow and to increase their bargaining power with managed care plans and physician groups. Health plans seek to build large enough networks to serve regional and national employers and to give them increased leverage in their negotiations with providers. Network building is expensive and often is accomplished through merger and acquisition, regardless of organizational form.*[46]

In this context, the legal constraints on nonprofits may be a disadvantage. Nonprofits cannot raise money through the sale of stock. Nor can they offer their executives stock options plans, profit sharing or the other types of incentive compensation that are routine in the business world. These constraints may hamper nonprofits' efforts to compete with for-profits for managerial talent.

The surge in conversions and consolidations in the mid-1990s itself generated momentum and reinforced the notion that big is best and that only large, integrated delivery systems would thrive. Some argue that: "Access to capital is particularly important in a managed care environment, in which substantial investments may be necessary for information systems, network development, utilization management, and expanding market share. . . . For-profit firms can acquire competitors by issuing stock, thereby expanding their market shares without reducing their reserves or accumulating substantial debt."[47]

Yet even in this competitive environment many nonprofit institutions continue to thrive. Nonprofit hospitals, responding to competition from large for-profit hospital chains, are linking together to form their own networks. These arrangements allow the hospitals to experience the benefits of consolidated management and services without relinquishing their nonprofit status. And some believe that nonprofit institutions are in a better position to respond to market dynamics. For example, Kaiser Permanente, America's largest nonprofit HMO, considered converting to for-profit status a few years ago but ultimately rejected the idea.[48] *According to the chief executive officer of Kaiser Foundation Health Plan, "Kaiser Permanente has adequate capital and sufficient discipline to compete effectively without converting. However, the primary reason the organization chose to remain nonprofit is that we believe the marketplace and public policy needs that will emerge in health care over the next several years will best be met by nonprofit organizations."*[49]

Market forces can create an atmosphere of greed, which may also motivate some nonprofits to convert to for-profit status. In some conversions, nonprofit insiders, both top management and members of the board of directors, reaped substantial financial gains as a result of the transactions. For example, some managers and directors obtained valuable stock options and high salaries as employees of the new for-profit company, while others received "golden parachute" severance packages when they left the employ of the converting nonprofit.[50]

Government Policies Create Incentives For Conversions

Changing laws and policies also have played a role in the conversion trend, particularly when government has modified tax preferences and eliminated subsidies for nonprofit institutions. Consider the HMO industry. Federal loans and grants to nonprofit corporations under the HMO Act of 1973 were an important source of capital for development. The end of federal funding in 1983 sparked the first round of conversions in the health care industry.[51] *The HMO industry's subsequent shift to for-profit domination was fast and emphatic. In 1981, 82% of the nation's HMOs were nonprofit institutions; by 1998, the number of nonprofits had dropped to 26%.*[52]

The nation's Blue Cross and Blue Shield (BCBS) plans, which for decades have been nonprofit organizations, are experiencing a similar trend. Like nonprofit HMOs, the BCBS plans lost one of the primary advantages of nonprofit status – full exemption from federal taxes – with the enactment of the 1986 Tax Reform Act. The 1986 law subjected the plans to taxation, but created a special deduction for them that was not available to for-profit insurers.[53] *This change was largely due to the lobbying efforts of for-profit companies, who argued that the BCBS plans did not provide public benefits that justified tax exemption. Even the Internal Revenue Service advised Congress "'that the significant differences between nonprofit and for-profit insurers that may have justified the initial tax exemptions have been eroded by competitive developments.'"*[54]

The loss of the primary benefit of nonprofit status, combined with the competitiveness of the insurance market, made conversion to for-profit status an increasingly attractive option. Historically the national BCBS Association, which controls the valuable blue "cross" and "shield" trademarks, required all Blues plans to be nonprofit organizations in order to use those trademarks. In June 1994, however, the national BCBS association changed the rules to allow its member plans to become for-profit companies, citing changing marketplace dynamics and the plans' need to access equity capital as reasons for the new policy.[55] *Blues plans across the country have responded eagerly to the siren song of the stock market. By 1996, three plans – in California, Virginia and Georgia – had completed conversions to for-profit status; at present, more than twenty-five plans have either converted or taken affirmative steps toward conversion.*

State government policies have sometimes added to the incentive to convert. Georgia's legislature, for instance, virtually propelled its state's BCBS plan towards conversion. In that case, legislation enacted in 1995 authorized the health insurer to convert "into a for-profit company without any obligation to use its assets for public benefit. Rather than requiring a transfer of assets to charitable purposes, the Georgia insurance commissioner approved [the distribution] of stock to Blue Cross Blue Shield policy holders."[56] *Ultimately, several nonprofit community groups sued the BCBS plan for converting charitable assets to private use; the lawsuit was settled when the plan agreed to transfer approximately $80 million to a new charitable foundation.*

Student Loan Secondary Markets: The Evolution of an Industry

Both marketplace competition and changes in government policy are factors underlying conversions of nonprofit student loan secondary markets. In this case, the primary competition comes not from for-profit enterprises, but rather from the federal government's Direct Student Loan Program (DSLP).

Begun as a pilot program in 1992 and expanded dramatically in 1994, the DSLP simplifies student loan practices by lending federal money directly to college students.[57] *Because the federal government does not borrow money to fund student loans, its direct lending program obviates the need for secondary markets, as well as loan originators and guarantors. The entire student loan market has grown by about 20 percent or more during the last few years.*[58] *Yet in just five years, the DSLP has captured approximately one-third of all new loans to college students, presenting a serious competitive challenge to nonprofit secondary markets.*[59]

Like their counterparts in the health care industry, student loan executives also cite a decline in the comparative advantages of nonprofit status as a cause for conversions. The principal advantage of being a nonprofit secondary market is the authority to issue non-taxable bonds, which can reduce interest expenses by as much as 20 percent.[60] *Beginning in 1986, however, Congress placed limits on the states' ability to authorize borrowing through the use of non-taxable bonds. In states where competition for available tax-free bonds is intense, such as Massachusetts, federal lending caps effectively eliminated new non-taxable borrowing by student loan secondary markets. As non-taxable borrowing declines, the advantage of being nonprofit correspondingly decreases.*

Another unique advantage given to nonprofit secondary markets to encourage their participation was a favorable, federally-guaranteed rate of return on loans. In the early 1980s, Congress had permitted the nonprofit student loan secondary markets to earn a high return rate designed to "protect the [nonprofit] agencies at a time when the economy was bad and the costs of making [student loans] were soaring."[61] *But what Congress gives Congress also can take away. In 1993, in an effort to cut federal costs, federal legislation discontinued the special payments for nonprofit student loan secondary markets, grandfathering in loans already made.*[62]

By the 1990s, the market gap that had prompted creation of the nonprofit student loan secondary markets largely had been filled. Lenders were tripping over themselves to provide loan capital in order to secure the government-guaranteed return on student loans. According to a 1991 United States Department of Education study, only credit cards and commercial and industrial loans were more profitable to lenders.[63] *After experience proved that this banking function was extremely profitable, managers of some of the nonprofits were motivated to own the engine of profits.*

Amendments to the Internal Revenue Code tucked into the 1996 minimum wage bill provided the green light for conversions. This provision followed complaints by student lenders that the special advantage of being a nonprofit secondary market had diminished or disappeared altogether, and that nonprofit status instead had become a handicap. Within twenty-four months of enactment of the statutory amendments, four companies holding almost six billion dollars in student loans had converted to for-profit status, and more conversions are rumored to be on the way.

Is Government at the Fulcrum of the Conversion Trend?

Government influences the nonprofit sector in myriad ways, three of which are particularly relevant to understanding the causes of conversions and other forms of restructuring: funding, other incentives, and regulatory oversight. Government spending is the most visible measure of state power and may have the most immediate impact on nonprofits. But in addition to the power of the purse, government pursues an array of programs and policies that affect nonprofit organizations. Exemption from income and property taxation is the most familiar, and possibly the most important, government benefit conferred on nonprofits. The state may provide other benefits including: relief from regulations as far ranging as worker safety and parental leave; free and reduced-cost supplies and equipment; tax-free borrowing authority; and eligibility to receive tax-deductible contributions. Government also determines which organizations receive nonprofit status and oversees the activities of charitable entities. In its regulatory role over conversions, government is responsible for safeguarding the accumulated value of the charitable assets held by the hundreds of thousands of nonprofit entities located in virtually every community in America.

Although the benefits of being nonprofit can be substantial, there are strings attached; charitable preferences come with powerful constraints. For example, nonprofit entities are prohibited from distributing earnings or assets to individuals and cannot, therefore, issue stock or raise equity capital. The law imposes limits on legislative lobbying for most nonprofit groups. Direct involvement in electoral politics is also off-limits for many nonprofits. At times, substantive restrictions are imposed on day-to-day operations, as in the case of local nonprofit organizations funded by federal government initiatives such as the Legal Services Corporation or the National Endowment for the Arts.

The law also charges charitable nonprofits with a duty to promote public welfare or to serve "religious, charitable, scientific, testing for public safety, literary, or educational purposes[.]"[64] *State and local governments have begun focusing more on the activities of nonprofits, rather than on their organizational form or broadly-stated purpose, to determine whether they are entitled to tax exemptions. Pennsylvania, for example, recently enacted legislation that establishes specific criteria that a nonprofit must meet to be considered a tax-exempt, "purely public charity."*[65] *One of the statutory requirements is that the organization "must donate or render gratuitously a substantial portion of its services."*[66]

Nonprofit hospitals in particular face increased scrutiny of whether the community benefits that they provide justify their tax-exempt status. Since 1990 eight states have enacted community benefit laws for nonprofit hospitals.[67] *These laws typically require nonprofit hospitals to assess community health needs and formulate plans to meet them. In addition, the hospitals must report on the community benefits they provide. Some laws go a step further and require nonprofit hospitals to meet a minimum level of spending on community benefits to qualify for tax exemptions.*[68]

While the vast majority of organizations evidently find that the benefits of nonprofit status exceed the burdens, the increasing number of conversions suggest that the tide may be turning. If it is, government policy may bear a significant share of the responsibility.

The Power of Government as Funder

From modest beginnings in the nineteenth century, government investment in the nonprofit sector "expanded massively in the 1960s and 1970s when the federal government entered the scene in response to continued poverty and distress, limited growth in private charitable support, and a changed political climate."[69] *This rise in government spending fueled* *rapid growth in the nonprofit sector, particularly in the human services subsector. In fact, three-fifths of all nonprofit human service agencies that existed as of 1982 were created after 1960.*[70]

While Medicare and Medicaid funds were not touched by cutbacks in the 1980s, most other pools of federal government money for nonprofits dried up when President Ronald Reagan took office in 1981. And, while government funding began growing again in the late 1980s and early 1990s, it has not returned to its former heights. Instead, "nonprofit organizations outside of the health field . . . lost a cumulative total of $38 billion in federal revenue between 1982 and 1994 compared to what they would have had available if 1980 spending levels had been maintained. At the same time, overall federal spending in these fields initially declined by 12-13 percent below 1980 levels and did not return to its 1980 level until 1991."[71] *Of course, not all nonprofit organizations depend on government funding; some decline it altogether to avoid paperwork requirements and potential government intrusion into their operations.*

But when nonprofits that were accustomed to receiving government money faced losing it, they had to seek funding elsewhere. Although private giving (including donations from individuals, foundations, corporations, and bequests) is a desirable source of financing, it has proven to be neither a stable nor a sufficient source for many nonprofits. The most obvious problem is that the total quantity of private grants and donations is not sufficient to fund the activities of the entire nonprofit sector. Even with the U.S. economy booming during the last several years, charitable donation rates have not kept pace with rising incomes. In fact, in 1997 donors gave proportionally less of their personal income to charity than they did in 1967.[72]

And digging a little deeper reveals a more complicated picture. In fact,

> *. . . the* composition, *as opposed to the scale, of giving does not seem to match the profile of government spending sufficiently to suggest that one could be a substitute for the other* even if the amounts were equivalent. *Generally speaking, giving is greatest where wealth is greatest, rather than where need is greatest. [And] much of private giving flows not to those in greatest need but to functions with a significant "amenity" value to the givers (e.g., education, culture).*[73]

Therefore, particularly in the health and human services area, private giving cannot be expected to replace government funding.

The decline in government funding did not spell disaster for the nonprofit sector. Instead, between 1982 and 1992, overall nonprofit revenue jumped 42%, compared to the United States economy as a whole, which grew by 32%.[74] *This seeming paradox is explained by the tremendous surge in revenue from service fees and charges, which "alone accounted for 52 percent of the growth of the nonprofit sector during the 1982-92 period."*[75] *Still, as of 1996, government spending accounted for 32 percent of the nonprofit sector's total annual funds.*[76] *By providing nearly one-third of the sector's funding, government can exert substantial influence over nonprofit organizations.*

How Government Spends Money Matters Too

Nonprofit service providers that contract directly with the government are concerned about both the amount of funding that they receive, and the manner in which funds are disbursed. Health policy experts, for example, have pointed to the influence of different forms of Medicare reimbursements on organizational behavior among hospitals.[77] *Before the 1980s, hospitals received Medicare payments on a retrospective cost or charge basis. But beginning in 1983, the federal government implemented the Medicare Prospective Payment System, which set fixed payments for inpatient care, with price varying according to diagnosis-related groups. Under this new payment system, hospitals had to lower their costs to meet the fixed payments. The tremendous cost-cutting pressure that resulted was one factor fueling the drive for market-share acquisitions and consolidation among hospitals.*[78]

Federal and state adoption of performance contracts in the human services arena has also added new financial stress for many nonprofits. "Unlike more traditional cost-reimbursement contracts, which protect providers of services by covering their costs regardless of outcomes, performance contracts shift the risk to providers, which only get paid for successfully completed assignments."[79] *While performance-based contracts serve worthwhile policy goals, they may also put nonprofit organizations at a competitive disadvantage because they typically are smaller and less well-capitalized than their for-profit competitors. Performance contracts may also have qualitative effects on service delivery as nonprofits, or competing for-profits, seek to contain costs by screening out more difficult clients and declining to provide more labor-intensive services.*

Opening the bidding for block grants and social services program contracts to for-profit businesses has also had dramatic effects. Lockheed Martin, for instance, has moved aggressively to win government contracts to provide a comprehensive package of welfare-to-work services; the company already has more than twenty such contracts. Lockheed Martin's contract in Dade County, Florida, is typical. The corporate giant has a "master contract" to both deliver services and manage the county's entire system of service delivery. Essentially, Lockheed Martin acts as a general contractor and has hired "nearly 30 agencies to supply various welfare-to-work services – including transportation, child care, mental health services, and treatment for drug and alcohol abuse, . . . job readiness, skill training, and job placement services."[80] *Many of these subcontractors are community-based nonprofits that have experience with and access to the "clientele" receiving the services. Rather than financing their services through direct government funding, these nonprofits now depend on their contractual relationship with Lockheed Martin for their continued operation.*

Welfare-to-work services are not the only social programs that are ripe for competition between nonprofit and for-profit entities as a result of altered government policy. The 1996 welfare reform law also put federal funding for foster-care programs – amounting to $3 billion annually – up for grabs.[81] *And Congress is considering the same approach for the Head Start program, which has an annual budget of $4.4 billion for day care and educational services for poor children.*[82] *Indeed, for-profit companies like Maximus inform prospective investors that government-funded social service programs constitute a "$21 billion market."*[83]

Government Oversight of Conversions Is Inconsistent and Often Inadequate

Government also has the power and duty to protect charitable assets and promote the public's beneficial interests. Critical failures in government oversight of early conversion transactions allowed public dollars to fall into private hands. When Pacificare (a California HMO) converted in 1984, regulators accepted a valuation of $360,000. But less than a year later, the market value of the new for-profit company was $45 million.[84] *Similar undervaluations occurred in transactions across the country. For example, Greater Delaware Valley Health Care was valued at $100,000 in 1984, but after it converted, the new for-profit was worth $20 million by 1986.*[85] *The value of Group Health Plan of Greater St. Louis increased tenfold within a year after it converted.*[86] *By failing to require converting nonprofits to preserve the full value of their assets, regulators allowed millions of public dollars to be pocketed by the new for-profit companies' executives and investors.*

In the last few years, community coalitions and consumer advocates have demanded more careful and thorough scrutiny of conversion transactions to protect charitable dollars and services. As a result, recent conversions have not suffered from the egregious undervaluation of assets that characterized earlier transactions. Despite these positive steps, however, concerns about undervaluation have not vanished entirely. During the last year, consumer advocates have questioned whether the public received full market value for the assets of converting BCBS plans in Missouri, Ohio and Connecticut.

Government's failure to adequately regulate conversions and preserve charitable assets can create a powerful financial incentive for conversions. Nonprofit executives and board members can make millions of dollars on a single transaction. When the California HMO HealthNet converted in 1992, thirty-three executives purchased 20 percent of the company for a mere $1.5 million. By April 1996, their shares were worth roughly $315 million.[87] *One former top executive of HealthNet paid only $300,000 for stock that within a few years was worth $31 million, a gain of 10,000 percent.*[88]

Insufficient Regulatory Resources and Authority

Several factors contribute to the government's limited ability to protect charitable assets effectively. Attorneys General, the state officials charged with overseeing nonprofit organizations, often lack adequate staff, funding, and training to oversee complex conversions. The time required to effectively review even a single conversion transaction can run into hundreds of hours. Similarly, the cost of an expert, independent valuation of a health plan or student loan secondary market easily can extend to six figures. Even in cases where a converting charity may be required to pay the costs of oversight, Attorneys General are faced with an uncomfortable choice. They can require a converting nonprofit to spend tens of thousands of dollars on lawyers and accountants – money that would otherwise fund charitable programs – or approve the deal without adequate information.

While state regulators generally lack adequate funding, for-profit investors spend freely to consummate a conversion. The high potential payoff has for-profit buyers employing the nation's leading investment bankers, accountants, and lawyers to broker the deals. In some cases, the nonprofits themselves spend millions to complete a transaction. For example, when Massachusetts' new student loan conversion foundation sought to sell its wholly-owned, for-profit secondary market, the board approved a $2 million fee for a finance firm to close the deal.

State laws that regulate health care conversions have improved oversight by making the requirements for regulatory approval more stringent.[89] *As of 1998, twenty-three states had enacted legislation governing conversions among health care entities.*[90] *These statutes typically tighten the rules of review by requiring public disclosure of transaction data, verification of the value of the converting nonprofit's charitable assets, and assessment of the impact of any proposed conversion on community benefits. These laws have helped to increase the availability of public information and reduce charitable losses.*

Unfortunately, these laws are too often narrowly drawn for particular nonprofit sectors. Thus, conversions of nonprofit hospitals to for-profit status may elicit enhanced oversight, while transactions involving nonprofit health insurers or student loan secondary markets do not. In Ohio and Nebraska, for example, conversion legislation rewrote the rules for regulatory oversight of nonprofit hospitals.[91] *But because these laws applied only to health care institutions, the nonprofit student loan secondary market conversions in both states proceeded with far less rigorous scrutiny.*

Some legislative reforms even fail to cover diverse transactions within a particular regulated sector. For instance, California enacted a hospital conversion law in 1996 in response to the rising number of transactions.[92] *This law created a thorough review process for nonprofit to for-profit conversions, including: (1) providing mechanisms to ensure that the full value of the converting hospital's assets is preserved, (2) requiring the commissioning of a health impact statement to assess the proposed transaction's effects on the availability and accessibility of health care in the community involved; and (3) mandating at least one public hearing on the proposed transaction. But the statute does not apply to consolidations among* nonprofit*hospitals, even though such transactions may present issues of purpose, governance, community benefits, and antitrust impacts just like nonprofit to for-profit conversions.*[93]

Government Influence: What Does the Future Hold?

Some believe that there is reason to be optimistic that the relationship between the federal government and the nonprofit sector may be entering a new, more collaborative era. In August 1999, Congress passed a tax bill that contained numerous benefits for nonprofit organizations.[94] *Pundits suggest that the bill manifests a desire by Congress to help nonprofits raise more money. According to one Washington lawyer who represents nonprofit organizations: "In recent years there has been an aggressive mood in Congress against* *charities – attacks on them[.] . . . But what I see in this legislation is more of the government creating a partnership with the nonprofit community and individuals to work together to carry out the concept of a civil society."*[95]

Other signs suggest a less rosy future for nonprofits. In the United States, the closing years of the twentieth century have been marked by a buoyant economy and an unprecedented era of wealth creation. This economic prosperity has propagated an unquestioning faith in the market and a new fervor for business practices as the means to solve any and all societal problems. This market milieu may encourage some nonprofit entrepreneurs to move from working for a social service organization to owning the organization and operating it as a profit-making government contracting business. Indeed, the rhetoric of private enterprise has moved well beyond corporate boardrooms and now peppers the speech of those in both government and the nonprofit sector. Consider President Bill Clinton's July 1999 "New Markets" tour, in which he visited distressed regions of the country that have not experienced the benefits of the booming economy. President Clinton "cast the whole trip as a domestic trade mission aimed at keeping the economy humming by opening new markets at home."[96] *And Jesse Jackson, the well-known civil rights leader, declared to a reporter that: "This isn't a War on Poverty, it's a War for Profits."*[97]

In contrast to the veneration of the for-profit model, the image of nonprofits has been tarnished in recent years. "Because they do not meet a 'market test,' nonprofits are always vulnerable to charges that they are inefficient in their use of resources and ineffective in their approaches to problems."[98] *For-profit businesses can measure and tout their success in terms of earnings and profitability. Nonprofits, on the other hand, often seek to accomplish broadly stated missions, the success of which cannot readily be quantified and assessed.*

General concerns about the effectiveness of nonprofits have been exacerbated by public sentiment against "big government" and "tax and spend" liberalism. When nonprofits, such as those that provide human services, receive a large portion of their funding from government subsidies, they may be viewed as part of the problem rather than as a solution to social problems. And a few widely publicized scandals at trusted nonprofits, such as the criminal charges of fraud and money laundering brought against former top officials at the United Way *of America, have further damaged the public perception of nonprofits. As two nonprofit scholars studying Canadian charities engaged in commercial ventures recently noted: "The language of the market place has put management at the centre of our organizations, corporate business at the centre of society and defined government and nonprofit organizations as nonproductive or burdensome."*[99] *Their observation is equally applicable to the influence of market ideology in this country.*

Assessing Outcomes: Analyzing the Public Impacts of Conversions

The terms of conversion transactions themselves so far have received the lion's share of public attention. In comparison, there is relatively little information available about how conversions affect communities in the long run. Now that so many conversions among health care and student loan institutions have been completed, greater attention should be directed toward assessing the public impacts of these transactions. The next challenge for advocates and policymakers is to ensure that communities actually realize the benefits they are owed when valuable nonprofit institutions convert to for-profit status.

Conversion Foundations

Working to preserve charitable assets in health care and student loan conversions has resulted, to date, in the creation of more than 100 new foundations worth close to $14 billion collectively. These foundations now have the opportunity to channel this enormous wealth into grants that will serve the unmet health and educational needs of communities around the country.

It is not yet clear whether grantmaking foundations are adequate substitutes for nonprofits that actually provide services, however. Because the conversions of student loan secondary markets have occurred only in the last two years, the impacts of grantmaking by the four newly-created foundations are undetermined at present. More information is available about health care conversion foundations.[100] *In a 1998 survey conducted by Grantmakers In Health, "over 65 percent of new health foundations reported that at least half of their grant funding was made exclusively in health."*[101] *These figures indicate, however, that a large percentage of grants are not serving health needs, even though these new foundations are endowed with the charitable assets accrued by converted nonprofit health care institutions. Similarly, a recent study by Consumers Union on nonprofit hospital conversions in Texas found that:*

> *While some foundations created from the disposition of the sale proceeds continue to support health projects in the community, as required by law, not all communities benefit in this way. One foundation uses its funds to support a number of non-health-related causes, while another large nonprofit absorbed the proceeds into its statewide system and removed them from the community[.]*[102]

The preservation of charitable assets will always be a crucial issue in conversion transactions. But the outcomes of conversion transactions should also be scrutinized to determine how the resulting charitable foundations serve the public.

Insiders from converting nonprofits often are interested in retaining control over conversion foundations, which are endowed with public money. These insiders may deny that the foundations are accountable to the public. Those who seek to protect the public's interest must ensure not only that the charitable assets of converting nonprofits are preserved, but also that these assets are reinvested in the community. The practices of student loan conversion foundations, in particular, highlight this issue. These four new foundations, governed by boards of directors comprised of five to eleven members each, control almost $750 million worth of charitable assets. They manage the money with no formal public input and, so long as they do not personally benefit, they are virtually unaccountable to the public for how the money is used.

The combination of large amounts of money and little accountability creates the potential for abuses. In Nebraska, for example, the directors of the student loan conversion foundation restricted access to grants and scholarships to students at schools participating in the guaranteed loan program in an apparent attempt to steer business to the newly-created, for-profit secondary loan corporation. This policy excluded students attending the University of Nebraska, Lincoln (UNL), the state's flagship public university and a Direct Lending school (in which students borrow directly from the federal government rather than from banks). According to news accounts, "during a meeting in the office of UNL Chancellor James Moeser, the head of the charity made an offer: UNL could get a share of the scholarship funds, but only if school officials started doing business with private student loan providers."[103]

And in Ohio, during the spring of 1999, the new student loan conversion foundation had "awarded $2.7 million divided among 56 grants. But some $2.1 million of that went to organizations closely tied to foundation board members."[104] *In an illuminating bit of back room dealing, the Ohio conversion foundation gave $500,000 to a "charity that the foundation's President . . . used to head."*[105] *Ensuring that conversion foundations are accountable to the public doubtless will be a continuing challenge.*

Community Benefit Obligations

In addition to a new foundation, conversions also bear another offspring – a new for-profit enterprise. In a number of hospital conversions, Consumers Union's and Community Catalyst's work with local coalitions has resulted in commitments from the new for-profit owners to continue to serve community health needs by providing needed services. Because services such as charity care and emergency room care tend to be less profitable, without public pressure and effective regulatory oversight, they might otherwise have been headed straight for the chopping block after a conversion. The 1998 conversion of nonprofit Queen of Angels Hospital in Hollywood, California, illustrates this principle. Tenet Healthcare, the for-profit buyer, originally offered terms that put the community's access to health care services at risk.[106] *A coalition of community groups and consumer advocates sprang into action and challenged the deal. Their efforts bore concrete results. Before approving the conversion, the Attorney General retained the full price originally agreed upon and negotiated much-improved charity care, emergency room, and obstetrical care commitments from Tenet.*[107]

Community Benefits Analysis Pre-Conversion

In the health care context, some efforts have been made to assess the quantifiable public benefits provided by a nonprofit institution before *it converts to for-profit status and as a prerequisite to conversion approval. California's hospital conversion legislation, for example, mandates that a nonprofit seeking approval to convert must prepare a health impact statement.*[108] *These reports are intended to evaluate how a potential conversion will affect the quality and quantity of services provided by a converting hospital. And, in particular, they identify the services that are at risk of being cut post-conversion. Nonprofits also provide valuable benefits that are not quantifiable, such as making quality health care available to those less able to pay and not viewing health care primarily as a profit center. The intangible public benefits that nonprofits provide should be included in the assessment of a conversion's impact.*

A health impact statement can be an effective means to educate the public about what is at stake. It can also serve as a tool for regulators to negotiate transaction terms that mitigate potential adverse impacts, and for the public to hold regulators accountable for addressing the true impacts of nonprofit conversions. A potential weakness, however, is that health impact *statements contain data that is self-reported by the converting entity and is not audited. Nonetheless, requiring that the converting entity gather information about probable health impacts, and that the Attorney General consider such information before approving a conversion, are important first steps toward accountability.*

Applying a "health impact statement" type of analysis to a broader array of conversions, and possibly to other forms of restructuring, would greatly increase our understanding of the public impacts of nonprofit reorganizations. And thorough study of post-conversion community benefit outcomes could provide the data and foundation to inform policymakers and persuade them of the wisdom of pre-conversion "community impact statement" legislation. An analysis of the intangible benefits that nonprofit institutions provide to the community would allow a more complete understanding of the public impacts of conversions.

Community Benefits Analysis Post-Conversion

The second step in measuring the impact of conversions on public benefits is to assess whether charitable services and values previously provided by a nonprofit remain available to the public after the conversion. For transactions that are already completed with charitable dollars set aside, this will require examination of the services provided by the post-conversion company, the activities of the conversion foundation, and changes in other less tangible factors.

In theory, when a nonprofit converts, the charitable assets that are transferred to a foundation (or to another nonprofit institution) should replace lost services, and in some cases, even extend benefits beyond what the original nonprofit provided. In addition, some community benefit obligations may be assumed by the new for-profit entity, particularly in hospital conversions. But examining the outcomes of completed conversions reveals that this theory may not be in sync with practical reality.

A study by Consumers Union of ten acute care hospital conversions in California from 1993 to 1998 found that, once hospitals converted to for-profit status, the amount of charity-care provided generally declined in the absence of tight charity-care guarantees. At some hospitals, the decline was quite substantial. For example, Good Samaritan Hospital in San Jose, California, experienced a decrease of 88% in charity care between its last year as a *nonprofit and its first year as a for-profit.*[109] *This conversion took place before enactment of the California statute requiring public notice of hospital conversions, Attorney General oversight, and submission of a health impact statement by the converting entity.*

Others interested in the health care conversion phenomenon, and the increasing "corporatization" of health care generally, also are turning their attention to studying how these changes affect the affordability and quality of health care. A recent study, published in the Journal of the American Medical Association, found that for-profit HMOs were consistently "associated with reduced quality of care." After comparing data on 329 nonprofit and for-profit HMOs, the authors concluded that the "drive for profit is compromising the quality of care, the number of uninsured persons is increasing, those with insurance are increasingly dissatisfied, bureaucracy is proliferating, and costs are again rapidly escalating."[110]

And a study published in August 1999 in the New England Journal of Medicine reported that adjusted per capita Medicare cost "in for-profit areas was greater than in not-for-profit areas in each category of service examined: hospital services, physicians services, home health care, and services at other facilities."[111] *This study found that hospital service areas that converted from nonprofit to for-profit ownership from 1989 to 1995 had larger increases in total per capita costs than did areas in which all hospitals retained their nonprofit status.*[112] *According to the study's authors, when direct costs to communities are considered, "our data do not demonstrate any cost savings associated with for-profit ownership. Our findings are consistent with the possibility that for-profit hospital ownership itself contributes to higher per capita costs for the Medicare populations served by these hospitals."*[113]

Still another recent study by the American Association of Retired Persons (AARP) focused on a different aspect of the public impacts of hospital conversions. AARP found that management instability was often a by-product of these transformations. "'When a hospital is in the throes of management instability, it isn't a community player the way a hospital that is more stable can be,'" remarked one of the authors.[114]

Two years ago, reflecting on the public policy implications of health care conversions, one commentator catalogued the factors to be considered to ensure integrity in the conversion process. "It will be interesting to see if the wave of conversions continues under *circumstances in which procedures are in place to bring public awareness to the matter, to ensure that a proper price is being paid, to make provisions for conflicts of interest, and to protect communities from the loss of community benefits."*[115] *Vigorous advocacy has been dedicated over the past several years to each of these four factors, emphasizing the first three: public education, fair valuations, and conflicts of interest. Now, with statutes on the books in many jurisdictions, resources should be dedicated to the fourth factor, assessing changes in community benefits post-conversion (including an assessment of changes in intangible benefits). Ultimately, our aim should be to make the protection of all public benefits part of the conversion approval process.*

The Territory Ahead: Assessing the Public Benefits Provided by Nonprofits

The prevalence of conversions and other restructuring activity throughout the nonprofit sector underscores the need to understand better how nonprofit organizational change affects all types of public benefits, both tangible and intangible. Assessing outcomes will be neither a simple nor a straightforward task. The public benefits provided by nonprofits include an astonishing array of direct services, including: meals for the homebound, shelter for the homeless, medical care for indigent patients, low-cost loans to college students, day care for low-income workers, Saturday and Sunday church services, scouting for boys and girls, care for abandoned pets, job readiness training, and advocacy for everything from preserving the right to bear arms to eliminating pollution in the environment. Measuring these diverse benefits will require new thinking and methodologies. Indeed, prominent nonprofit organizations such as Independent Sector, The Urban Institute, and United Way of America currently are engaged in groundbreaking research on how to best measure the contributions that nonprofit organizations make to society.

The magnitude of the job is daunting. Nonprofit conversions and reorganizations of all types are occurring at a dizzying pace. Nearly every day, stories emerge about planned conversions, mutualizations, mergers, joint ventures, or affiliations. Just last month, the nonprofit organizations that operate the nation's stock exchanges burst out of obscurity onto the nation's front pages showing every indication of becoming the next candidates for industry-wide conversion to for-profit status.[116]

But with so many conversions happening so recently, an inadequate track record of outcomes has hampered meaningful analysis of the true public impact of these transactions. The first student loan company converted, for example, only in 1997. To date, nearly $750 million has been set aside for charitable purposes as a result of the four student loan company conversions. It is still probably too early to tell whether the shift of these players to for-profit companies will affect access to student loans. It is also too early to tell what effect the new philanthropies will have on educational opportunities.

Assessing public impacts is further impeded by substantial gaps in information.[117] *Base data about the level, extent, and value of services provided by a converting nonprofit health care institution are often unavailable, for example. Some hospitals collect and report data regarding health services provided at cost, below cost, or at market rates. Some data combine patient bills that are not collectible with charity care provided without any expectation of payment. The former accounting merely reflects the cost of extending credit to customers, or the cost of "bad debts." Only the latter constitutes charitable services.*[118]

Even in cases where quantification of benefits is possible, problems arise in evaluating the quality of services. In the health care arena generally, quality measurement continues to be a contentious issue.[119] *Questions of quality can be especially nettlesome when replacement services are different than original services. For example, if a converting hospital's reproductive services are replaced by foundation grantmaking for health education programs, serious concerns emerge about inappropriate, or at the very least inequitable, "apples to oranges" comparisons.*

Much of the work on community benefits, to date, has been done by nonprofit institutions to facilitate their community benefits planning.[120] *More could be gained from looking at these issues from the perspective of the public beneficiaries or consumers, drawing on the hard data now available from conversions that have already taken place. This data would allow for quantitative pre-and-post-conversion community benefits analyses that could both inform and drive public policy on the issue.*

Given the formidable barriers to measuring and assessing outcomes accurately, some may question whether the effort ought to be a priority. Free-market advocates may argue, for instance, that increased competition will lead to lower costs and improved services.[121]

Greater competition, they declare, will realize efficiency gains that make society better off despite changes in community benefits. But throughout modern history, nonprofits have provided services to those whom the competitive marketplace has failed. Free-market concepts like competition and efficiency do not attempt to address questions of equitable distribution of society's wealth. Larger societal benefits of fostering charitable enterprises and volunteerism, and providing opportunities for individuals to work collectively for a greater good must not be lost, let alone diminished in value. Further in-depth research is warranted to ensure that conversion transaction outcomes realize the goal of maintaining community benefits and values. The need—and opportunity—to pay close attention to public outcomes has never been greater.

Conclusion: Three Key Findings

Searching for the overarching context of the myriad changes taking place within the nonprofit sector, three lessons emerged. First, outright conversions from nonprofit to for-profit status were just the tip of the iceberg. Many forms of restructuring are transpiring across a broad cross-section of nonprofit organizations. The complexity and subtlety of these reorganizations complicate efforts to identify and evaluate them.

Second, market forces, opportunity for private gain, and government policy are all factors causing nonprofit transformations. In particular, the role of government, as policymaker and regulator, in shaping the nonprofit sector merits further attention. The government's ability to influence nonprofit reorganizations – through funding, incentives, and oversight – represents a powerful engine for change.

Third, those who care about the future of nonprofits and the public purposes that they serve must redouble their efforts to make communities aware of the changes affecting their local charities, and help them protect charitable values, as well as charitable assets and benefits. The key to engaging the public in the debate about the future of the nonprofit sector is to enable people to recognize their stake in nonprofit organizations: the monetary value of the assets they accrue, the community benefits they provide, and the societal values they foster. Toward this end, more attention must be paid to the outcomes of conversions and other forms of restructuring. We should broaden the focus of research on nonprofits to examine not only organizational change, but also the impacts of such change. These efforts are necessary both to engage the public in the issues and to inform public policy.

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