

# Good as Gold

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Preserving Community  
Resources in Nonprofit  
Conversions

JULIE SILAS FOR  
CONSUMERS UNION OF U.S.,  
INC.  
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**Consumers  
Union**

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# Introduction

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This country is in the midst of a revolution in the health care industry, with the mass transformation of hospitals, HMOs, and Blue Cross and Blue Shield health insurance plans from nonprofit organizations to for-profit businesses. Other nonprofit sectors have started to convert as well. Student loan companies, job training and placement organizations, agencies providing services for juvenile offenders and at-risk youth, and even the New York Stock Exchange and the NASDAQ stock exchange have all joined the rush to become profit-making, stockholder-owned corporations.

Turning a nonprofit organization into a for-profit business, often called a “conversion,” can have a tremendous impact on community assets and resources. A nonprofit operates in the public interest and for the benefit of the community it is organized to serve. Nonprofit hospitals and clinics, for example, may provide emergency services and free “charity care” to the indigent. Conversion transaction players mindful of the potential loss of such services can preserve these community benefits. This can be done by the creation of a new foundation that holds the former nonprofit’s assets for the benefit of the community. Or, a community can decide to create and permanently fund a new nonprofit, such as a clinic or revolving student loan fund, with these assets. If a conversion neglects to protect the public’s interest, it can result in the loss of millions, if not billions, of dollars that would otherwise have been available for community resources such as indigent health care services, adult literacy programs, day care facilities, and job training centers. Consumer advocates, regulators, lawmakers, the media, the courts, and those in the nonprofit sector must be diligent in order to ensure that the nonprofit’s resources are protected for the public’s benefit when a conversion occurs.

The requirement to preserve the money and resources of nonprofit corporations for the greater good is not just a theory dreamed up by community advocates. It is based on an old legal doctrine, called

the “charitable trust doctrine,” which rests on the principle that the assets of a nonprofit must be used for the benefit of the public. It requires that nonprofit assets must continue to be used for nonprofit purposes, even if the mission or purpose of the nonprofit corporation holding those assets changes. That is why, in most states, when a nonprofit corporation changes to for-profit status, state law requires obtaining court approval. The court has the duty to ensure that the nonprofit’s assets are not used for the private gain of insiders or other investors, but instead are preserved for the public’s benefit. Unfortunately, regulators and the courts often fail to thoroughly review these transactions and the public ends up the loser.

Although nonprofit organizations create nearly one-eighth of the total U.S. gross national product, Congress and state legislatures have been almost silent on the issue of nonprofit to for-profit conversions. Increased publicity about health care conversions at the state level, has prompted some state legislatures to enact conversion legislation to govern health care organizations. Yet, many of these same states have remained silent on conversions that occur in other nonprofit sectors.

We are aware of only one nonprofit sector where Congress has explicitly addressed conversions and articulated some obligations to the public: the student loan secondary markets. These organizations buy federally-insured student loans from lenders, giving lenders the capital to make more student loans. Since the 1996 passage of the federal statute governing these conversions, at least five nonprofit student lending companies have converted to for-profit businesses. Even with the federal law in place, the state Attorneys General in these cases did not protect the public’s interest adequately.

This guidebook describes opportunities for communities to hold onto resources that really belong to them and that can provide much needed community services when their nonprofits become businesses. The guidebook illustrates the consequences when communities and/or regulators are caught unprepared and sets forth practical recommendations that communities can use to build their resources if and when a nonprofit to for-profit conversion is proposed.

The first section of this guidebook provides a context for con-



# What is a Nonprofit Corporation: Why the Public Owns Charitable

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version transactions, identifying the differences between nonprofit and for-profits, the legal bases for strong regulatory and judicial oversight, and the history of the health care and student loan secondary markets, two industries that have experienced a number of conversions within the last decade. The second section identifies five areas that require active involvement by policymakers and community advocates in order to avoid abuses by the converting organization's officers, directors, and other executives. This section highlights the lessons learned from health care conversions that have led to communities receiving literally billions of dollars for health care services. It also shows what happens when lessons are ignored altogether, with specific examples from the student lending arena. Most importantly, this section sets forth recommendations that should be adopted by policymakers and communities working to protect the public's interest in conversions. The final section provides recommendations regarding the potential community gains and losses when a nonprofit becomes a for-profit business.

## Differing Purposes of Nonprofit and For-Profit Corporations

**S**ome for-profit board members and executives argue that the only difference between for-profits and nonprofits is the amount of taxes that they pay. But the contrasts are much more significant than differing tax obligations. Most charitable, humanitarian, and social service organizations are organized as nonprofit corporations. Organizations such as Goodwill Industries, The United Way, Catholic

Key Differences between Nonprofit and For-Profit Corporations		
CHARACTERISTIC	NONPROFITS	FOR-PROFITS
Mission and Purposes	Organized for charitable, benevolent, educational, or social welfare purposes  Serve the broader public	Primary concern is profit-making for shareholders
Ownership	Effectively, the public is the only "shareholder"	Private Individuals: Stockholders Private Investors Policyholders/Members (Mutual)
Use of Assets	Assets generated must remain in nonprofit sector and further nonprofit purposes  No person can benefit personally from assets	Assets and profit generated can be distributed to private individuals and used to increase value of stock and other investments
Dissolution	Assets must be used to further nonprofit purposes	No similar obligation; assets can be distributed to private individuals
Tax Status	Full or partial tax-exemption	No tax-exemption

Charities, even Harvard University, use this legal structure to gain important tax advantages and to do business that is driven by a service, rather than profit, mission.

Nonprofits exist to serve a charitable, public purpose. In most instances, nonprofit corporations were formed to provide services that for-profit businesses or the government could not or would not provide. In the health care arena, local citizens often joined together to establish nonprofit hospitals or health plans to serve people who would otherwise not receive health care because these services were not available or because of their inability to pay. In the student lending industry, the federal government created nonprofit secondary markets to fill the gaps in federal student loan funding, enabling more students to gain access to postsecondary education.

A "conversion" occurs when a nonprofit corporation transfers some or all of the control of its nonprofit assets to a for-profit corporation. When this happens the nonprofit which was operating for charitable reasons becomes a business operating to make a profit. A nonprofit's assets can include everything from its building, furniture, and equipment to its trademarks and customer lists. Conversion transactions include sales or leases of assets, joint ventures, mergers, affiliations, acquisitions, mutualizations, the formation of for-profit subsidiaries and holding companies, or other deals that effectively transform the nonprofit into a for-profit corporation.

## Obligations of Nonprofit Directors

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Executives and a board of directors manage a nonprofit like any corporation. In a nonprofit corporation a board member is a trustee and a steward of the public trust, monitoring and guiding the nonprofit on behalf of the public. Boards and executives of nonprofit corporations do not own the assets and they generally are forbidden from making decisions about the corporation that benefit themselves. In short, a nonprofit is obligated to serve the public, which is, in effect, its only "shareholder."<sup>1</sup>

Every member of a nonprofit board of directors is obligated to ensure that the corporation conforms to its nonprofit purposes. This obligation is commonly referred to as a board member's "fiduciary

duty." A "fiduciary duty," the highest standard of duty imposed by law,<sup>2</sup> is a duty to act for someone else's benefit, putting one's personal interests aside. In most cases, the state Attorney General is charged with ensuring that nonprofit board members meet their obligations. By contrast, board members of a for-profit are expected to generate a return on investment for their private owners or shareholders. Their primary concern is the bottom line.

## Legal Protection of Nonprofit Assets

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In almost all states, when a nonprofit proposes to cease operating or to transform itself into a for-profit, the change automatically triggers procedures to ensure that the public's interests and assets are protected. When the particular purpose for which a nonprofit was created becomes impossible, impracticable, or is frustrated, for whatever reason, the legal doctrine of *cy pres* directs how the assets of the nonprofit can be used. "*Cy pres*" is a common law rule meaning, "as nearly as may be" in French. So, for example, if a nonprofit student loan secondary market entity becomes a for-profit, the assets of the nonprofit must be used as nearly as possible to help students obtain access to education or job training. When a nonprofit becomes a for-profit, the board of directors needs to ensure that another nonprofit corporation or foundation receives the full value of the converting nonprofit so that the nonprofit purpose is fulfilled in the same, or substantially the same, way.

Ordinarily, a major change in the purpose of a trust or other nonprofit requires that the Attorney General and the court approve the change, with the court having final authority to determine whether the assets are being properly used. Communities interested in how the assets will be used can influence the Attorney General and the court's decision.

The solution most commonly selected to preserve nonprofit assets consistent with the charitable trust and *cy pres* doctrines is to create a new foundation that will continue the charitable purposes of

the former nonprofit. Proceeds of conversion transactions are often used to establish a new nonprofit organized as a grantmaking foundation. In some conversions, rather than form a new foundation, assets are transferred to an established community foundation or used to form a "supporting organization" of an existing public charity. In other instances, communities may determine that it is better to use conversion assets to directly fund needed services, for example, funding a community clinic or a student aid fund. Most conversions currently result in the creation of new foundations.

## Conversions By Health Care Companies

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The greatest nonprofit conversion activity to date has been in the health care industry.<sup>3</sup> No other group of nonprofits has experienced such a dramatic shift in resources from nonprofits to for-profits. When the trend first began, regulators were often unwilling or unable to become involved in the conversion transaction. Without strong oversight, the early years of health care conversion activity resulted in the loss of millions of community dollars and vast health resources to the for-profit sector. Many of those dollars ended up in the hands of former executives, board members, and employees of the nonprofit as well as private investors. Rarely were the transactions and documents made public.

In the late 1980s and early 1990s, after watching their communities lose millions of dollars that should have been earmarked for public use, a handful of regulators and consumers gradually joined the conversion debate. Several states passed health care conversion legislation to protect the public's interest in conversions. The first conversion transaction to capture national attention was Blue Cross of California's attempt to transfer its nonprofit assets to a for-profit subsidiary without preserving those assets for the public's benefit. As community members learned about the transaction, they formed a coalition and called on regulators to prohibit the conversion unless community assets were protected. The California controversy lasted more than three years. Although initially the nonprofit board of direc-

tors and its executives denied their public obligations, by the time regulators signed off on the transaction in 1996, more than \$3 billion in nonprofit assets had been set aside in two charitable foundations dedicated to health care. The community groups' efforts paid huge dividends. Today, these two foundations together make \$150 million in grants each year to improve access to quality health care for Californians.

This conversion in California had a domino effect on other Blue Cross and Blue Shield plans. The National Blue Cross Blue Shield Association changed its by-laws to allow its members to become for-profit health insurance companies. Soon after Blue Cross of California proposed its conversion, health plans in Missouri, Colorado, Georgia, and Virginia sought to convert. In some of those transactions, state regulators and the community succeeded in enacting legislation or

# Protecting Charitable Dollars

## When a Nonprofit Gives up its Mission: Tools for Community Advocates

improving requirements to preserve the assets for the public's benefit.

But lawmakers and advocates in other states were not so fortunate. In Georgia, for example, Blue Cross and Blue Shield lobbyists convinced the state legislature to permit the nonprofit health plan to convert to a for-profit business without leaving any assets for the community. It took three years and a lawsuit before the community was able to unravel the damage caused by that legislation. Again, the battle was worth it—an \$80 million nonprofit health foundation was created in Georgia.

### Colorado Regulator Requires Public

#### Disclosure

In Colorado, when the statewide Blue Cross and Blue Shield (BCBS) plan's proposed conversion was under consideration, the board of trustees attempted to quash public debate by keeping important documents confidential. Community organizations argued against confidentiality, urging the hearing officer overseeing the conversion to require public disclosure of transaction related documents. After hearing both sides' arguments, the hearing officer stated, "[w]hile I am willing to accept the need for some form of protection for information that truly qualifies for protection under the Colorado Open Records Act, I am concerned that the need for such confidentiality must be carefully balanced against the public's right to be informed regarding proceedings such as this which will affect the rights and interests of Colorado citizens."\* Ultimately, he ruled in

### Conversions by Student Loan Secondary Market Companies

The next nonprofit industry to go the conversion route was student loan secondary markets. There are some 23 nonprofit student loan secondary market organizations. To date, at least five have converted to for-profit status.<sup>4</sup>

Historically, private lenders, often commercial banks, issued federally-insured student loans to finance college education and job training. In the mid-1970s, in an

effort to supply more money for student loans, Congress created a new type of nonprofit organization. Known as “secondary markets,”

### New Jersey Court Recognizes the Important Public Interest Involved in Conversions

In New Jersey, a large nonprofit health plan, Health Insurance Plan of New Jersey (HIP), was purchased by a for-profit plan, Physicians Health Plan (PHP). Although the Attorney General was involved in the approval process, the conversion occurred behind closed doors without any public notice or disclosure. After the conversion had been completed and was announced to the public, several community organizations tried to obtain documents from the Attorney General’s office. Both HIP and PHP opposed the Attorney General’s effort to release the documents.

Rather than rely solely on the Attorney General to represent their interests, the groups asked to participate in the court proceeding. They argued that conversions involve public assets and that documents regarding conversions should thus be available for public review and inquiry. The New Jersey court ruled in favor of the community groups, stating that “[t]he changing landscape of the medical profession and medical industry requires that the public, more than ever, has available to it those facts and information which will bear directly on their well-being and ultimately on the delivery of medical services”. The dramatic shift from a non-profit medical provider to a profit making entity requires close

these companies bought student loans from private lenders. This provided lenders with money to make more loans to students. Federal law allowed these new nonprofits to raise capital through tax-free bonds and insured up to 100% of the loans. For many years, these companies flourished, creating a multi-billion dollar nonprofit student loan industry.

Two decades later, Congress created the Federal Direct Loan Program (FDLP) administered by the U.S. Department of Education to allow the federal government to make loans directly to students. The proponents of the FDLP hoped to eliminate the huge “middle man” industry that had thrived on federal subsidies including loan guarantors, secondary markets, management companies, servicing agencies, and others. FDLP became a significant competitor to the secondary market business. FDLP student loans do



not benefit the secondary markets and reduce the need for their services.

In response to this challenge, the nonprofit student loan secondary market companies lobbied Congress to change the tax code to allow them to convert to for-profit status, while maintaining the tax-exempt status of student loan bonds they had already issued.<sup>5</sup> Faced with stiff competition, leaders of the nonprofit student loan secondary markets saw conversion to for-profit status as a way to broaden the scope of their business and focus on products and markets that would generate large profits. They would also be able to reap huge windfalls for themselves by taking an ownership interest in the new for-profit business. In order to become for-profit, however, the new law required nonprofit secondary market companies to preserve their nonprofit assets for the benefit of the community. But, how this is done, and

whether students in need of help will benefit, has become a multi-million dollar question.

Communities in which conversions have occurred learned the importance of getting involved and of having laws and procedures in place in order to protect nonprofit assets. Community groups, working together in coalitions have shaped the creation of foundations worth billions of dollars to serve local needs. The following section identifies five key conversion-related issues on which vigilant advocates working for coalitions of concerned community groups can make and have made a difference.

#### Ohio Community Discovers Problems with the Thomas L. Conlan Foundation

Although the Ohio Attorney General denied the community access to documents involved in the conversion of Ohio's nonprofit student loan company, some information has emerged about what happened after the Attorney General approved the conversion. This information, including the following, raises legitimate concerns about the transaction and the failure to genuinely consider and protect the public interest:

- The foundation's largest grant to date, \$1 million, was given to a charitable venture headed by board members of the conversion foundation. In fact, within the first year of its existence, the foundation made more than \$3.24 million in grants, of which more than \$2 million (or 63.5% of the foundation's total awards) went to organizations closely affiliated with the foundation's board of directors, all of whom were formerly associated with the converting nonprofit;
- The foundation was named after the father

## Get the Facts:

### The Need for Public Disclosure

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A key to ensuring that conversions benefit the public, and not just a few highly-placed officers, directors, and executives of the non-profit, is to bring the discussions, financial data, and terms and conditions of each transaction out from behind closed doors and into the light of day. Full disclosure allows the public an opportunity to participate meaningfully in conversion proceedings, to learn the facts, to ask informed questions, and to demand that the public's rights be protected. Public notice and access to all information is essential at the earliest stage of a conversion, not after the regulator's decision, if any, has been made and the plans have been finalized. When the non-profit's board of trustees and state regulators communicate and share all information with the public from the outset, community concerns can be raised and properly addressed.

At every phase of a conversion, it is important that transaction documents be released for public inspection and review. As the intended beneficiary of the nonprofit's assets, the public must have the opportunity to learn about the details of the transaction, to raise concerns, and to influence the process as it unfolds. Without access to information, the public is left in the dark about where the assets will go, how much they are worth, who will control them, and who will benefit from them. Community groups have convinced policymakers in the health care arena that public disclosure is essential when reviewing conversion transactions.<sup>6</sup> However, this has not been the case for the nonprofit student loan secondary markets. Although the first conversion did not occur until 1997—years after regulators and the public had recognized the importance of public disclosure in the health care industry—communities continue to have great difficulty obtaining conversion documents. The story of Ohio's student loan conversion is a case in point.

## n Ohio: An Example of Decisionmaking Under Wraps

The Attorney General in Ohio, Ms. Betty Montgomery, is well-versed in nonprofit conversions. In 1996, she was profiled in an exposé on “60 Minutes” for failing to act in the public interest when a nonprofit hospital converted to a for-profit and summarily fired all the local board members who questioned the conversion plan.<sup>7</sup> By the time one of the state’s Blue Cross and Blue Shield plans proposed to convert to a for-profit, she had become the primary sponsor of legislation to allow for greater public disclosure regarding health care conversions.

One of the most important components of Ohio’s new health care legislation was that it permitted the Attorney General to release to the public any documents involved in a health care conversion proceeding. However, because the new disclosure law only applied to health care organizations, when Ohio’s nonprofit student loan company, Student Loan Funding Corporation, converted to for-profit in 1998, the Attorney General’s office argued that the old law required it to keep documents under wraps. The community was unable to determine whether the public interest was being protected in the transaction.

Although the Attorney General participated in a *cy pres* petition in state court to obtain approval of the transaction, the papers filed by the company disclosed little information. While the conversion transaction involved companies with reported total assets of \$2.7 billion and a proposal to create a \$100 million foundation, the entire court filing was only 13 pages long. To make matters worse, the Attorney General unilaterally negotiated the transaction terms with the nonprofit and appeared in the court proceeding without any notice to

the community. The public was unaware of the proposed conversion or the court proceeding until well after the conversion was completed.

As advocates in Ohio sought to question some of the practices of the new foundation and to inject a community perspective into its activities, the discussion was stifled. Requests to meet as a group with the foundation board were rebuffed. Instead, the Executive Director of the foundation arranged individual meetings with each local community organization in an effort to discourage them from seeking details about the conversion. It was only after much coaxing that the foundation finally agreed to meet with the local organizations as a group. The foundation brought to the meeting a large team of lawyers and investment bankers from Ohio, New York, and Washington

Massachusetts Regulator Proceeds to Court, Yet Keeps Community Engaged in HMO Conversion

By the time the Massachusetts Attorney General consented to the cy pres petition proposing a conversion of a non-profit health maintenance organization in Central Massachusetts, the public had been engaged in the conversion debate. While it was too late for the community to challenge the amount of assets being set aside, advocates were able to question the foundation's mission and governance, as well as the corporate structure proposed by the nonprofit. In response to community concerns, the Attorney General filed a court cy pres petition advocating a two-step approval process. The two-step process allowed the court to approve the purchase and sale as planned, but postponed court approval of where the assets should go and who should control them. This provided the community with an opportunity to critique the converting nonprofit's plan, to suggest alternatives,

D.C. While they agreed to share financial documents with community groups, foundation executives insisted that the groups first agree to a "gag clause" that would prevent them from sharing the information with the public.

The advocates refused to accept this condition. The foundation has continued to demonstrate little willingness to work with community advocates to ensure that the public has the facts about the conversion. They have also resisted the creation of a community advisory committee to help guarantee that the educational needs of the community are addressed. Ohio's student loan secondary market conversion illustrates that without public participation from the start communities face an uphill battle in securing a participatory role.

n What You Can Do: Public Disclosure Recommendations

There are steps communities can take to prevent abuses by converting nonprofits. The following strategies, if implemented, can limit the kinds of violations of the public interest that occurred in the Ohio student loan secondary market conversion.

#### Secure Public Notice Early On

Receiving public notice at the outset of a conversion process will help ensure sufficient time for communities to organize and review the transaction. Advocates should:

- Get regulators to agree to provide public notice as soon as they learn of a proposed conversion;
- Get regulators to maintain a database of interested individuals, organizations, news reporters, and others in order to notify them of a potential conversion when that information becomes available;
- Identify themselves and be sure they are added to the regulator's database;
- Make the media aware of the conversion and keep them informed of developments;
- Seek legal advice to determine whether a nonprofit "restructuring" (e.g. joint venture, creation of a subsidiary) is really a conversion that requires full oversight by the public plus regulators or the courts.

#### Advocate For Public Access to Conversion-Related Documents

There are several ways to ensure that conversion documents are made available to the public. While regulators and policymakers can and should be allies in this effort, community organizations cannot rely on regulators entirely. Advocates should:

- Initiate legislation that requires full public disclosure of a nonprofit conversion proposal and ensure that it explicitly overrules any state

- laws that would otherwise shield such documents from the public;
- Pressure regulators to rule in favor of public disclosure when faced with the task of interpreting state law on confidentiality (as the Colorado hearing officer and the New Jersey court did);
  - Submit public records act (e.g., Freedom of Information Act) requests for documents from federal, state, or local government sources;
  - Obtain all documentation that the law requires be made available directly from the nonprofit, including I.R.S. Form 990s, Annual Reports, etc.;
  - Renew and revisit all public record requests as the conversion proceedings move forward in order to obtain updated documents;
  - Engage reporters in the attempt to release documents.

### Make Government Protect Public Dollars: Pressing Regulators to Play a Strong Role and Require an Open Court Process

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Oversight of nonprofits is within the jurisdiction of state Attorneys General.<sup>8</sup> For years this oversight required minimal effort, mostly policing nonprofits to ensure that they stayed true to their purposes, that their board members exercised their fiduciary duties, and that conflicts of interest did not exist. With the advent of nonprofit to for-profit conversions, however, the responsibility on Attorneys General to exercise more stringent oversight has increased dramatically. Attorneys General, often operating with few resources and little expertise in these matters, have been called on to review,

approve, and defend conversion proposals.

State courts are charged with ensuring that nonprofit assets in a conversion will be used to advance a purpose similar to that of the converting nonprofit. The Missouri Supreme Court stated this succinctly as far back as 1939, when it said: “[t]he protection of (charitable) trusts has been, from the earliest time, a principle function of courts of equity.”<sup>9</sup> But, because the law giving courts authority over

#### Missouri Special Master Recognizes Important Contributions of the Community

One of the best examples of the public making a dramatic difference in the outcome of a conversion is from the state of Missouri. In 1996, the local nonprofit Blue Cross and Blue Shield plan (BCBS) created a for-profit subsidiary and moved virtually all of its business to the for-profit venture, effectively converting nonprofit assets. When the proposal was first presented to the Missouri insurance commissioner, he approved the transaction without evaluating it as a conversion. Local community groups discovered what had occurred and mounted a campaign to recapture the nonprofit’s assets. They wrote a formal petition to the commissioner calling on him to treat the transaction as a conversion.

Once the nonprofit BCBS plan learned of the community’s efforts, its board of directors went to court in an attempt to prevent the insurance commissioner from investigating the conversion. BCBS’s board of directors refused to acknowledge that it was obligated to preserve nonprofit assets. They argued that they could move the assets to the for-profit company without violating the law. Not surprisingly, many of these same nonprofit board members and executives stood to gain millions of dollars from the transfer of assets.\*

After years of protracted litigation and continuing pressure from the community and the Missouri media, BCBS admitted defeat and agreed to preserve roughly \$212 million in a foundation. When the settlement proposal was assigned for review to a court-appointed special master, his first order called on the parties to include the community in the settlement discussions and to revise the settlement resolution to include a strong community role in the mission, governance, and structure of the new foundation.\*\*

\* For example, the salary of the President and Chief Executive Officer of Blue Cross and Blue Shield of Missouri, Roy Heimbürger, almost doubled

changes in charitable trusts<sup>10</sup> is most often “common law” (developed through the court system rather than through legislation), it is often overlooked or ignored.

Once an Attorney General reviews and agrees to the terms of a conversion proposal, he or she should then submit it for court approval in order to gain public confidence in the fairness of a conversion. In the best cases, the court review occurs after the Attorney General has provided public disclosure of all the documents in the transaction and the public has had an opportunity for open debate. Only a handful of Attorneys General, however, have sought court approval of nonprofit to for-profit conversions. South Dakota communities have learned how important it is for there to be a *cy pres* court filing in a nonprofit to for-profit conversion.

#### n South Dakota: An Example of Limited Regulatory Action

In 1998, South Dakota’s nonprofit student loan secondary market converted to for-profit and created the Great Plains Educational Foundation. Two months later, the board of the foundation adopted a mission statement that targeted the foundation’s entire \$85 million for the reduction of underemployment and unemployment among residents of Brown County, South Dakota. The mission statement essentially ignored the original educational goals of the nonprofit. It also narrowed the use of the charitable assets to one small county, in contrast to the statewide geographic scope of the nonprofit’s activities. This new mission was clearly inconsistent with the charitable trust purposes of the original nonprofit organization.

At the time of the conversion and the adoption of this mission statement, it was unclear whether the South Dakota Attorney General had reviewed and approved the transaction. Under a restrictive state law that was enacted years earlier in response to pressure from a national corporation with major business interests in South Dakota, the only documents available to the public were the company’s articles of incorporation that were on file with the Secretary of State’s office. Any transaction-related documents filed with the South Dakota



Attorney General, or requested by the Attorney General in the course of the conversion review, were deemed to be confidential and thus shielded from public disclosure.

When Consumers Union sought access to conversion documents, the Attorney General responded that he was barred from disclosing any of the documents. Consumers Union urged the Attorney General to file a petition for approval of the proposal in state court, but he declined to do so. Had he filed such a petition, all the evidence surrounding the conversion could have been made public well in advance of any scheduled court hearings. The community would have had the opportunity to review the terms of the conversion and make suggestions and request changes.

Although the public was not formally included in the process, advocates convinced the Attorney General to negotiate several important modifications to the nonprofit's conversion plan. Among other things, he convinced the foundation to broaden its geographic focus to cover the entire state of South Dakota. The foundation also agreed to alter its mission statement to address broad educational concerns.

#### n What You Can Do: Recommendations on Pressing Regulators

Few states have statutes that explicitly require Attorneys General to file court petitions in order to obtain approval of a nonprofit to for-profit conversion. To overcome this problem, enacting a statute that includes a requirement to file a *cy pres* petition in a conversion transaction is very helpful. Regardless of whether such a statute is in place, communities should:

- Publicly demand that the Attorney General file a *cy pres* petition before allowing a conversion proposal to become final;
- If the Attorney General does not indicate willingness to present the conversion to the appropriate state court, file an administrative petition calling on the Attorney General to proceed with the *cy pres* filing. The right to petition government can be found in the constitution and/or state statutes;
- Demand that the Attorney General notify the public and interested

individuals about a cy pres petition prior to the filing, giving sufficient opportunity for the community to participate;

- Pressure the Attorney General to represent the broad public interest, rather than just promoting the interests of the converting organization in any cy pres proceeding;
- Ask the Attorney General to describe the process for determining the mission, value, Board of Directors, and other governance provisions;
- Educate the public and the media about the important opportunity for public disclosure and involvement the court review provides;
- With legal representation, ask the court's permission to intervene in the court proceeding in order to represent the community's interests. Be prepared to fight for the right to participate in the court proceeding—this is known as gaining “standing” in the case.

## Play a Leading Role: Ensuring Public Participation

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Public participation can help ensure the likelihood that a non-profit conversion is fair and that it serves the public interest. There are four key elements to public participation:<sup>11</sup>

- Timely public disclosure of the conversion proposal, including transaction agreements and valuations;
- Public hearings to explain the conversion and respond to questions and concerns from members of the community;
- Public scrutiny to alert regulators to new and possibly better methods for getting the highest valuations and distributing assets;
- Public input informing the structure, purpose, governance, and community accountability of a conversion foundation.

While public participation has been commendable in some health care industry conversions, the picture has not been as bright in the student loan industry conversions. Even in the most public of the five student loan secondary market conversions that has occurred to date, Nellie Mae in Massachusetts, the broad public was not apprised

Undervaluation of HMOs			
HMO	Amount to Charity at Time of Conversions	Value One-Two Years Later	Value Ten Years Later
Family Health Plan (FHP)	\$38,456,000 (1984)	\$135,628,000 (1986)	\$1,711,000,000 (1994)
Foundation Health	\$78,000,000 (1984)	\$302,500,000 (1985)	\$1,873,000,000 (1994)
PacifiCare Health	\$360,000 (1984)	0 (1985)	0 (1994)
Inland Health Care	\$663,000 (1985)	\$45,300,505 (1985)	\$2,193,000,000 (1994)
		\$37,500,000	

Anne Lowry Bailey, "Charities Win, Lose in Health Shuffle," *The Chronicle of Philanthropy*, June 14, 1994, p. 12.

of and brought into the process.

#### n Massachusetts: An Example of Gains and Losses

Although the Nellie Mae transaction in Massachusetts represents something of a high water mark (at least a limited number of community groups participated early on, providing greater public scrutiny and involvement than other student loan secondary market conversions), it still did not provide a meaningful role for the community in the conversion process or in the governance of the resulting nonprofit foundation. Nellie Mae is the only student lender conversion where public involvement began prior to the start of the transaction. The Massachusetts Attorney General actively participated during the planning stage of the conversion, and once approached by Consumers Union and local community groups, provided them with an opportunity to press for improvements in the transaction. Furthermore, transac-

tion-related information was more freely provided to the public than in any other state.

Yet, public involvement in the conversion process occurred only informally. The Attorney General did not convene hearings to engage the broad community, nor did he inform the educational community of the transaction or encourage community participation in the development of the mission, governance, and structure of the new foundation. The Attorney General took the position that he lacked jurisdiction over the foundation's planning process and was not responsible for promoting community participation.

Not satisfied with what they perceived as an exclusionary posture by Nellie Mae, 25 community groups formed a coalition to press for greater community involvement in the foundation. They made two requests to the Board:

- The new foundation should create a "community advisory committee" that would have a meaningful role in the formation and governance of the new foundation, including recommending grantmaking priorities and identifying new board members;
- The new foundation should assemble a racially and ethnically diverse staff and board of directors that reflected broad knowledge and experience in the educational arena (from pre-kindergarten through graduate school, and including issues such as adult literacy and job training).

The coalition held a series of discussions with Nellie Mae representatives to discuss its concerns. In addition to pressing the other issues, the coalition asked Nellie Mae to convene community discussions throughout New England to give the public a chance to learn about the new foundation and to provide input into its governance, funding priorities, and grantmaking. While Nellie Mae agreed to the coalition's request for regional meetings, these sessions basically con-

sisted of lengthy presentations of the foundation's plans by the Interim President, providing minimal opportunities for real dialogue.

To its credit, the Nellie Mae Foundation did assemble a racially and ethnically diverse board and staff who possess a strong grasp of a wide range of educational issues. While the foundation has not formed a community advisory committee, the new President and her staff are reaching out to local community representatives to engage them in the grantmaking process. The next few years will show whether, despite an unacceptable start and conflicts of interest, the foundation will meet the communities' educational needs to the foundation's fullest potential.

#### n What You Can Do: Recommendations for Public Involvement

There are many points in the conversion process at which community members should participate in order to help guide the best outcome. These opportunities might only arise, however, if the community demands a dialogue. Advocates should:

- Organize local groups to identify and set priorities for the community's highest needs related to the mission of the nonprofit;
- Hold workshops for the public, community organizations, and community leaders to explain the opportunities and process for engaging in a conversion transaction;
- Meet with nonprofit board members to focus on your issues and the community's needs. Talk about the community's needs, whether a conversion is in the future or not;
- Meet with nonprofit board members once they have announced a proposed conversion;
- Meet with the regulator to learn how s/he intends to handle the conversion, what her/his process will be, what opportunities will exist for community participation, what the time frame will be, etc.;
- Participate in public hearings;

- Try to become a formal party to any administrative proceedings. If unsuccessful, attend the proceedings and work with the media to raise community awareness of the conversion;
- File position papers with the Attorney General and demand that these documents be considered part of the public record of the conversion;
- Participate in court proceedings;
- Advocate for a formal role for community members in the ongoing work of the nonprofit foundation, e.g., a community advisory committee that identifies nominees for the foundation board and advises on funding priorities for the foundation.<sup>1 2</sup>

#### Jackson Foundation Wastes Vital Health Dollars

In one of the worst case examples, Goodlark Hospital in Dickson, Tennessee converted to for-profit status in 1995 and created the Jackson Foundation with an \$80 million endowment. Two brothers from the family that founded the nonprofit hospital were named President and Chair of the new foundation and their father had a seat on the board. Douglas Jackson, President, received more than \$200,000 per year of nonprofit assets to run the foundation. He and the board used the health care assets to buy airplanes and run a flight-training program for high school students.\*

\* "Health Care Dividend-A

#### Protect the Public's Dollars: Assuring Full and Fair Valuation

Valuation is a financial analysis that calculates the purchase price or value of the converting nonprofit. Determining the proper value of a nonprofit corporation and/or the reallocation of assets is critical in the review of any conversion because valuation determines how much money must be preserved for the public's benefit. These nonprofit assets are dollars that by law belong to the public because of the favorable tax treatment and other advantages the public bestowed on the nonprofit over the years. The higher the valuation, the more money will be set aside to benefit the public, for example, through providing student aid or keeping open a hospital emergency room.

There are many examples of the undervaluation of a nonprofit corporation's assets, particularly where regulators and communities have not been vigilant. In each of these cases, the nonprofit corporation did not preserve the full fair market value of its assets for nonprofit purposes, but instead

used some of the assets to benefit private individuals and investors, or support the new for-profit's endeavors. In some cases, insiders (officers, directors, and executives) walked away with millions of community dollars.

Because a nonprofit corporation has many types of assets, the valuation process tends to be complicated. It can be particularly complex if a nonprofit chooses to transfer some of its assets to a for-profit subsidiary or otherwise align itself organizationally with other entities over the course of its existence. Assets include not only the "bricks and mortar" of a nonprofit (buildings, equipment, etc.), but lists of subscribers, good will, reputation in the community, the value of its trademark, past and projected revenue and profit, as well as surplus it has accrued. The "cross" and "shield" service marks of the Blue Cross and Blue Shield plans are well-known and carry with them value as a distinct product, similar to the product trademark "Coca Cola."<sup>13</sup> Similarly, student loan companies have established reputations that create a benefit for the new for-profit corporation that will use their name. A thorough valuation should include everything, including the value of a nonprofit's intangible assets, such as good will and name recognition.

Defining the value of a nonprofit corporation's assets is best done by the market through competitive bidding. Without open, competitive bidding, valuation experts, such as investment banking firms, must estimate the value of the organization. Because a variety of valuation methods and formulas are used in particular industries, a valuation price can fall within a wide range.<sup>14</sup> The best way to ensure that the valuation is full, fair, and reasonable is for regulators to engage independent experts to review any proposed valuation and where possible to confirm its validity through a public bidding process.

#### n Student Loans: An Example of Inadequate Valuation, No Independence

Only one of the five nonprofit secondary market lending company conversions, Nellie Mae, involved a publicly available valuation process. In the Ohio and South Dakota conversions, the Attorney General's review process was confidential and remains so today. In the

Nebraska conversion, only a portion of the nonprofit was subject to a valuation. Although local and national community organizations urged the Nebraska Attorney General to commission an independent valuation, he chose not to do so.

When Nellie Mae elected to convert, it commissioned its own valuation. Rather than commission an independent expert to review it, the Massachusetts Attorney General's office relied on its charitable trust division staff to review the complicated financial documents. To our knowledge, there was no independent valuation.

Within nine months of the Nellie Mae conversion, the nation's largest for-profit secondary market company, the Student Loan Marketing Association, also known as Sallie Mae, purchased the for-profit Nellie Mae Corporation from its parent company, the Nellie Mae Foundation, for \$320 million. This represented a premium of approximately \$80 million above the original valuation figure that had been placed on the nonprofit at the time of the conversion. The foundation's sale of its for-profit subsidiary to Sallie Mae resulted in significantly increased assets for the new foundation. It also generated a huge windfall for the executive staff of the for-profit, individuals who had been on the payroll of the nonprofit secondary market company less than a year earlier. The windfall came about as a result of generous compensation packages, including stock options that these executives had negotiated for themselves when they became employees of the new for-profit Nellie Mae Corporation. A small handful of executives received \$5.7 million in stock options upon the sale to Sallie Mae.

#### n What You Can Do: Recommendations for Obtaining the Highest Value for Assets

While community groups on their own cannot determine the full and fair market value of the converting nonprofit and probably cannot afford to hire their own valuation experts, they are certainly able to ask the right questions about the valuation process. When the conver-



# Conclusion

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sion moves toward valuation, communities should demand that:

- The regulator engage an independent valuation expert, paid for by the nonprofit as a fee to review the transaction, in order to get maximum value for the community;
- "Fair value" is at the high end of any range suggested, not the low end;
- The intangibles, subsidiaries, affiliates, and prior changes made in anticipation of a conversion of the corporation should all be included in the valuation;
- The regulator retains her/his oversight authority over valuation issues to ensure the assets are protected;
- Consideration is given to a portion of the stock of the for-profit business being held by the remaining nonprofit or foundation;
- The impact of any employment contracts, stock options, or any other commitments of the for-profit on the value of the nonprofit.

## Decide How to Use the Money: Creating Community Responsive Foundations and Endowments

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One of the key considerations in a conversion transaction is how to distribute the nonprofit assets consistent with their original nonprofit purposes and in keeping with the *cy pres* doctrine. The most common use has been to create and fund a foundation to carry out similar purposes. Another option is to create and permanently fund a community-based service organization, such as a health clinic, to carry out that purpose. But, without an explicit conversion law that requires that assets be preserved, the nonprofit dollars are at risk of being lost for use to further community goals. For example, when Blue Cross and

Blue Shield of Virginia converted from nonprofit to for-profit, the legislature wrested control of the assets and applied them to the state's general operating budget for that fiscal year. The assets were not dedicated to health care.

Even when there is a legal requirement or an agreement that the assets will be preserved in a foundation, involvement by regulators and consumer groups is necessary to ensure that the foundation will meet the highest standards for community engagement, accountability, and philanthropic practices. As a threshold step, the foundation's incorporation papers must include provisions to insure that the public's interest is protected and that conflicts of interest are avoided.

One of the greatest concerns in the establishment of the foundation is the independence of the new foundation's board. In early health care conversions, the board of the converting nonprofit—the same board that arranged and executed the conversion—frequently continued as the board of the newly created foundation. The overlap led to conflicts of interest and the new foundation being used to further the business interests of the for-profit corporation.

Many new health care conversion statutes require that there be no overlap among the boards of directors of the new foundation, the former nonprofit agency, and the new for-profit corporation.<sup>15</sup> In a settlement of a case involving Blue Cross and Blue Shield of Missouri, all parties agreed on full independence of board members and created an outside community advisory committee to nominate all new board members for the foundation.

#### n Nebraska: An Example of Conflict of Interest

Some of the most serious problems in student loan conversions have been the lack of foundation independence and the resulting conflicts of interest that have occurred in the foundations' priorities and grantmaking processes. Federal law authorizing student loan secondary market conversions requires that 80 percent of the board be "independent" directors.<sup>16</sup> Independence, however, is loosely defined and does not bar as directors of the new foundation former board

# Appendices

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members of the nonprofit that converted. The Nebraska conversion serves as an example of why complete separation and true independence should be required.

In 1998, Nebraska's secondary student loan market converted from nonprofit to for-profit and created the charitable organization, the Foundation for Education Funding (FEF). The conversion occurred with no public scrutiny until community groups brought the issue to the attention of the Attorney General. The board of FEF was created entirely from the former nonprofit's board of directors. The legal counsel for the nonprofit secondary student loan market corporation became the President and Chairman of the Board of FEF.

In its first year of grantmaking, FEF launched a grant program for low-income students, with the funds distributed through the state's postsecondary schools. In order to receive the grants, however, a student had to get her/his loans from the Federal Family Education Loan Program (FFELP), which did most of its student lending business with the new for-profit corporation. The FEF grant program was unavailable to students attending schools that participated in the Federal Direct Loan Program (FDLP), the FFELP lenders' direct competitor. Students wishing to attend the University of Nebraska-Lincoln (UN-L), the largest higher education institution in the state and a participant in the FDLP, were excluded from the new foundation's grant program.

The FEF board also used \$800,000 per year of foundation dollars to fund educational planning centers in Nebraska. The centers provided information on schools, scholarships, and financial aid programs for prospective students. The FEF board permitted only the for-profit to advertise its student loans in these centers. The only application form available at the centers was for a program that was operated by a subsidiary of the new for-profit. No other lender information was directly available at the center's three sites. Not surprisingly, the information that was disseminated at the centers served as marketing vehicles for the new for-profit company.<sup>17</sup>

When they learned that the largest nonprofit organization in

the state had quietly converted to for-profit, Consumers Union and local community groups called on the Attorney General to investigate the transaction. Soon after the Attorney General initiated his review, he confirmed conflict of interest problems with the FEF board and preferential treatment for the new for-profit. At a meeting with for-profit lenders and UN-L officials, the foundation proposed that UN-L students could become eligible for the special scholarship funds in exchange for an agreement by school officials to switch from the FDLP to the FFELP. This change would have translated into millions of dollars in new business for the for-profit affiliated with the FEF.<sup>18</sup>

The Attorney General's investigation concluded that when the foundation "promoted the use of FFEL loans in exchange for scholastic grants provided by [the foundation], a benefit was received by the for-profit FFEL lenders through the use of charitable grants given by the nonprofit [foundation]. The charitable assets were being used for the benefit of the for-profit corporation."<sup>19</sup> He also found that the foundation operated its educational planning centers improperly by promoting loans by the for-profit. To his credit, the Attorney General required that FEF agree to make its scholarships available to UN-L students, regardless of whether UN-L remained in the FDLP program. He also required the educational loan centers to provide information about all types of student loans.

#### n What You Can Do: Recommendations for Independent, Community Responsive Foundations

There are a number of important factors to consider when a foundation is formed in a conversion. Many of these, such as defining the mission, developing a board of directors, and drafting incorporation documents, have not been addressed in this guidebook. You can learn more about them, however, from other publications by Consumers Union listed on the order form at the back of this guide-

book. See, for example, "Building Strong Foundations: Creating Community Responsive Philanthropy in Nonprofit Conversions," a manual by Consumers Union and Community Catalyst on best practices for the use of conversion proceeds. This guidebook also does not discuss options for conversion proceeds that do not result in the creation of a foundation, but are instead used for other nonprofit purposes such as endowing a clinic or establishing a revolving student loan fund or student financial counseling center.

This guidebook focuses on the need for independence between the foundation's board and the boards of both the former nonprofit and new for-profit. Advocating for such independence is key to avoiding conflicts of interest. Advocates should demand:

- Foundation independence from both the former nonprofit and the new for-profit;
- A community process for determining the mission, governance, and structure of the new foundation;
- Strong conflict of interest provisions in the foundation's incorporating documents;
- A formal, ongoing role for the community in the foundation itself, to ensure that the foundation understands what the community's needs and priorities are;
- Regulatory oversight of the foundation after the conversion is approved;
- Disclosure of all grants and contracts made by the foundations.

**C**ommunity advocates can create valuable resources for their communities by being prepared and organized, thoughtful and engaged. You can increase the likelihood that nonprofit corporations will comply with their public benefit obligations if you:

- Require public disclosure of conversion transactions, from the initial consideration of conversion through the establishment of the foundation;
- Demand sufficient oversight, including pressuring regulators to file conversion proposals with a court before a nonprofit corporation is allowed to become a for-profit company;
- Pursue strategies that promote public participation at every stage

of the conversion process;

- Expect independent, arms-length valuations of the converting company's assets;
- Encourage regulators to engage outside experts to review and critique those valuations;
- Become involved in the process to establish a foundation or other endowment and insist on formal mechanisms that ensure community involvement throughout the life of the foundation.

This guidebook touches on the big issues that confront advocates facing a conversion in their communities. A list of materials which address particular aspects of conversions and which suggest strategies for community coalitions in greater depth are available from Consumers Union. An order form can be found in the back of this guidebook.

We do not know which nonprofit organizations will be the next to convert. What we do know is that communities can make a significant difference in nonprofit to for-profit conversions. Advocates across the country have used the strategies we have identified in this guidebook with great success. We hope that this guidebook will give you the tools to get answers, get involved, and get results.

## Endnotes

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- 1 Letter from California Department of Corporations Commissioner Gary Mendoza to J. Kendall Anderson, May 6, 1994.
- 2 Black's Law Dictionary 625 (6th ed. 1990).
- 3 For an analysis of the factors leading health care and other nonprofits to become for-profit businesses, and the policy implications of conversions, see "Balancing Mission and Market: Nonprofits Walk a Tightrope Between the Public and Private Spheres," Consumers Union (1999).
- 4 Five nonprofit student loan secondary market companies that have converted to date are: New England Education Loan Marketing Corporation ("Nellie Mae"), Braintree, MA; Student Loan Funding Corporation, Cincinnati, OH; Nebraska Higher Education Loan Program, Lincoln, NE; Student Loan Finance Corporation, Aberdeen, SD; Abilene Higher Education Authority, Abilene, TX.
- 5 26 U.S.C. § 150(d) (Supp. 1999), Appendix pp. 32-34 hereto.

- 6 The National Association of Attorneys General (NAAG) took a strong position in favor of public disclosure in their model act for health care conversions. The model requires that all documents submitted to an Attorney General must be made public. "Model Act for Nonprofit Health Conversions," Adopted by the National Association of Attorneys General through a resolution passed July 13-16, 1998. A copy of NAAG's Model Act is available from Consumers Union.
- 7 "Not for Profit Hospitals," "60 Minutes" segment, originally aired October 1996.
- 8 In some rare instances, such as Nebraska, county Attorneys General have concurrent authority.
- 9 Parsons v. Childs, 136 S.W.2d 327, 330 (Mo. 1939) (citations omitted).
- 10 Despite its name, the charitable trust doctrine applies to certain nonprofit corporations as well as trusts. Under the doctrine, all the assets of a nonprofit corporation exist within a charitable trust and these assets must be used only for the charitable purposes articulated in the nonprofit's articles of incorporation.
- 11 Bell, J., Snyder, H., Tien, C., Silas, J. "Preservation of Charitable Health Care Assets," Health Affairs (March/April 1997), pp. 125-130.
- 12 For further information about forming a conversion foundation, see "Building Strong Foundations: Creating Community Responsive Philanthropy in Nonprofit Conversions," Consumers Union (2000).
- 13 Friedman, E., "What Price Survival? The Future of Blue Cross and Blue Shield," Journal of the American Medical Association, Vol. 279, No. 23, pp. 1863-69, June 17 1998.
- 14 For more detailed information on valuations, see "Is the Selling Price Too Low?," Consumers Union (1998).
- 15 See, for example, Colorado Revised Statute §10-16-324. Added by laws 1996, S.B. 96-100, §1, eff. June 6, 1996. Amended by laws 1999, ch. 255, § 1, eff. May 29, 1999.
- 16 26 U.S.C. §150(d)(3)(C)(iii) (Supp. 1999), Appendix p. 33 hereto.
- 17 Omaha World Herald, Sunday, May 9, 1999.
- 18 Ibid.
- 19 Letter from Nebraska Attorney General Don Stenberg to Consumers Union, June 17, 1999.

## Checklist of Actions Communities Can Take

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If a conversion is contemplated, community advocates should:

- Call on nonprofit board members to meet with the community before the board formally files a proposal to convert;
- Research and learn more about the local nonprofit proposing con-

version as well as the potential for-profit buyer or partner. Obtain filings from regulators, and get the nonprofit's annual I.R.S. Form 990 filings;

- Inform regulators of community concerns through meetings, letters, and communication with the media;
- Request public hearings;
- Demand access to conversion-related documents;
- Urge regulators to conduct an independent valuation of the nonprofit's assets;
- Make sure the sale proceeds are properly distributed and preserved for charitable purposes in the nonprofit sector, with community input and needs in mind, particularly the needs of vulnerable and underserved populations.

Ask the following questions of regulators and other policymakers:

- Is the deal in the public's interest? That is, has fulfilling the nonprofit's purpose truly become untenable so as to warrant approval of a conversion?
- Did board members fulfill their fiduciary duties?
- Who advocated for the deal?
- What other options did the board consider? How did they arrive at the deal they are pursuing?
- What is the fair market value of the charitable assets that are at stake in the transaction? Does the proposed plan preserve them for charitable purposes?
- Did an independent expert conduct a valuation or at least review the valuation?
- Will board members or executives get new jobs, stock options, "golden parachutes," and/or severance payments?
- What happens if the new company becomes insolvent?
- Are services provided by the nonprofit likely to be lost?
- What organization will control the charitable proceeds? Will a new foundation be established?

### Checklist of Steps Regulators Can Take to Protect the Public

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Regulators with power to reject or require changes in a nonprofit organization's proposed transaction should follow standardized pro-



# Glossary

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cedures and rigorously review all proposed transactions. When reviewing conversions, regulators should do the following:\*

- Provide public notice of the proposed conversion and broadly disseminate such notice;
- Make all documents related to the proposed conversion available for public review;
- Determine whether the proposed conversion is in the public interest by a thorough analysis of the entire transaction;
- Hold at least one public hearing, timed to ensure that public input will be meaningful to the decisionmaking process;
- Require that the full fair market value of the converting entity is preserved for charitable purposes;
- Require that the converting entity submit a plan for the proper use of charitable assets similar to the purposes of the converting nonprofit;
- Ensure that the board and executives of any nonprofit foundation receiving the charitable assets are independent of the old nonprofit and lack ties to the new for-profit corporation;
- Analyze the planned compensation for the new board of directors to ensure it does not exceed that received by board members at similar institutions;
- Prohibit any economic benefits to staff or directors of the nonprofit as a result of conversion.

\* This list of required steps is largely taken from: Daniel M. Fox and Phillip Isenberg, "Anticipating the Magic Moment: The Public Interest in Health Plan Conversion in California," Grant Watch Essay; Health Affairs, Vol. 15, No. 1, pp. 202-209.

## Checklist of Questions to Ask When Evaluating Conversion Legislation

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An increasing number of states have, or have proposed, legislation governing conversions. Some proposals are comprehensive and provide for significant oversight and public participation in the regulatory process. Other bills are not as extensive and lack important consumer protections. Below are key questions communities should ask when analyzing conversion legislation. In states where conversion legislation has already been passed, the following questions can be used to determine whether the law needs to be amended. Keep in mind that "conversions" can take many restructuring forms, from the obvious (e.g. sale to a for-profit) to the subtle (e.g. nonprofit assets transferred to joint venture with a for-profit). Any analysis of conversion legislation should address the following questions:\*

- Which state agency is responsible for reviewing proposed conversions?
- Which conversions are covered? That is, is the statute limited to one sector, such as healthcare, or does it cover all nonprofits?
- What are the standards for reviewing and approving the conversion?
- Are there time frames for the review? Do they allow adequate time

# Other Conversion-Related Materials Available from Consumers Union

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**P**lease check the materials you would like to receive and fax/send with the order form on back of this page. Also, you can find this guidebook and more information regarding our work on our web

for review by and input from the community?

- Can regulators extend the review period?
- How will the public be involved in the review of the transaction?
- How will the conversion affect the community?
- How are valuation and other financial issues handled?
- Are charitable assets adequately protected?
- Does the legislation prohibit conflicts of interest and private inurement?
- Do regulators have significant powers of enforcement and the ability to monitor the conversion after it has been approved?
- Can a court review a regulator's decision? Who can bring a lawsuit?
- Is the converting entity responsible for paying the costs of any expert assistance received by regulators?

- Does the legislation allow regulators to make rules and regulations to help enforce the law?
- Does the legislation allow regulators to engage independent experts to aid in review of the proposed transaction, especially to provide an independent financial analysis of the transaction (including independent valuation)?

\* See also "Questions to Ask When Evaluating Conversion Legislation: Detailed Analysis and Explanation," available from the order form at the back of this guidebook.

Internal Revenue Code 26 U.S. Code § 150(d) (Supp. 1999)

§ 150. Definitions and special rules

(d) Qualified scholarship funding bond.—For purposes of this part and section

103—

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