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Responsibilities of Directors of Not-for-Profit Corporations Faced with Sharing Control with Other Nonprofit Organizations in Health Industry Affiliations: A Commentary on Legal and Practical Realities

*L. Edward Bryant, Jr.*

This Commentary addresses the issue of defining the legal responsibilities of directors of health industry not-for-profit corporations considering mergers and other types of affiliations with other not-for-profit organizations. With numerous hospital consolidation transactions taking place in recent years and many more on the horizon, directors are appropriately asking about their duties, their constraints, their discretion, and their legal or financial exposure. The decisions being made on proposed affiliations both threaten and assure substantial change in the way long-standing nonprofit community institutions will relate to and serve the public in the future. Therefore, it is important to analyze and clarify the roles of directors participating in these crucial decisions.

The law on director responsibilities is fairly clear. However, the emotions and the psychology accompanying transactions involving not-for-profit institutions sometimes obscure the legal analysis. Too often, a would-be transaction is framed and announced and subsequently fails to meet some unanticipated legal constraint.

It is not sufficient simply to say that the nonprofit director is a fiduciary, meaning that he or she makes affiliation decisions on behalf of others. Knowing that the decision whether or not to affiliate is neither personal nor proprietary does not say enough about how the affiliation decision should be addressed or what decision-making criteria should be considered. Much more is required.

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This Commentary will not address the entirely different question of transactions through which a not-for-profit hospital sells its assets to or joint ventures its operations with a for-profit hospital. In these cases, the law is equally clear, but the directors have substantially less discretion. Moreover, in an affiliation with a for-profit entity, the directors find themselves in the proverbial "goldfish bowl," under increasingly intense legally required scrutiny from state and federal agencies to assure that the transaction is conducted at arm's length and for fair market value. Nonprofit directors' mandated legal duties in transactions or joint ventures with for-profits are not the same as for nonprofit transactions; they vary substantially from state to state because of recently enacted state statutes regulating conversions of nonprofit organizations. They are also colored by external factors such as the reputation of the for-profit buyer and the current political agenda of the state's attorney general.

Similarly, the substantial body of corporate law defining the duties of directors of publicly held companies to hold out for the best price in a sale of the company or its assets in order to serve the best interests of the shareholders does not apply to nonprofit organizations. In a transaction between two not-for-profit corporations, much more than money is at stake, and directors are given greater discretion for that very reason.

The two foregoing caveats do not address the impact upon an affiliation transaction between two nonprofit hospitals in which one or both hospitals have for-profit affiliates or subsidiaries. Nonprofit organizations utilize for-profit subsidiaries for a number of reasons, usually for tactical tax-planning purposes not available if the subsidiary's activities produce income that would be considered unrelated business taxable income ("UBTI") if conducted within the tax-exempt organization.

1. For-profit affiliates of nonprofit corporations are neither new nor controversial. A nonprofit corporation invests its reserves like any organization having reserves, and there is no conceptual difference between owning 1000 shares of publicly traded Baxter International and all the shares of ABC, Inc. Most nonprofit health systems in the United States own the controlling interest in one or more taxable business organizations which qualify as subsidiaries. See, e.g., Priv. Ltr. Rul. 91-31-058 (May 9, 1991); Priv. Ltr. Rul. 93-05-026 (Nov. 12, 1992).


3. For example, income over expense from the sale of pharmaceuticals to hospital inpatients and outpatients does not produce taxable income for a tax-exempt hospital. However, if the same patient with the same physician, the same diagnosis, and the same prescription returned to the hospital pharmacy later as a so-called "referred outpatient" of the pharmacy, income over allocable expense would be taxable under
Whatever the reason, the stock of a for-profit affiliate or subsidiary is an asset of the not-for-profit organization and should be viewed as one of its investments. The hospital director, in considering an affiliation, should determine whether the hospital’s investments will be included in the affiliation transaction. While this could go either way, excluding a for-profit affiliate which has operations integral to the hospital (such as a physician-hospital organization established to arrange managed care contracts or a controlled self-insurance group purchasing organization) could be a terrible mistake for the future of the affiliated organizations.

Although the presence of a for-profit affiliate affects the due diligence process, it usually does not complicate the legal aspects of the transaction any more than if the hospitals owned 1000 shares of General Motors. Practically, the most frequent impact of a for-profit affiliate is the likelihood that due diligence will bring to light how unsuccessfult hospital personnel have operated the for-profit business. Often the subsidiary is heavily in debt to the tax-exempt shareholder because hospitals frequently undercapitalize a subsidiary’s equity and then lend it substantial sums in a manner which, upon repayment with interest, creates unwanted UBTI for the shareholder.

The transaction legal rules alluded to above are not necessarily implicated when a not-for-profit organization has both for-profit and nonprofit suitors. Directors of nonprofits retain substantial discretion when choosing among competing suitors and dollars are not the sole consideration. The law makes clear that the public interest is the most important factor. There is no duty

Section 511 of the Internal Revenue Code. If a hospital has several sources of taxable income, offsetting operating profits against losses for good tax planning purposes is often easier with a subsidiary business corporation.

4. In the health care lexicon, physician-hospital organizations are known as PHOs. A PHO is usually controlled equally by a hospital and its medical staff. Because the functions of a PHO usually do not serve a tax-exempt purpose, most PHOs are not entitled to an exemption under Section 501(c)(3) of the Internal Revenue Code.

5. See Nonprofits’ Ins. Alliance of Calif. v. United States, 32 Fed. Cl. 277 (1994). The exception would be those specific goods or services described in Section 501(e) of the Internal Revenue Code.

6. Hospital directors negotiating a hospital merger, but holding an important affiliate or subsidiary out of the transaction, may be endangering the future of the merged organization’s operations. Due diligence will usually demonstrate the affiliate’s actual importance.

7. See 26 U.S.C. § 512(b)(13) (1994). Directors might also wish to “clean up” the balance sheet of the for-profit affiliate before due diligence to avoid the appearance that the board neglected a material investment.
to accept the highest bid or to accept a hypothetical $25 million purchase offer from a for-profit proposed purchaser when a competing nonprofit offer might be limited to assuming a hypothetical $10 million in debt and being committed to provide a designated amount of free care to the community.

I. ANCILLARY CONTRACTUAL OBLIGATIONS: THE FIRST SET OF LEGAL DUTIES

There are no purely hypothetical hospital affiliation transactions except on law school examinations. Thus, the legal duties of directors in merger transactions are never exercisable or exercised in a vacuum. Most boards, on behalf of their corporations, enter into contracts that restrict the corporation’s activities and future transactions. These contractual obligations are usually serious and formal enough that the other contracting party has the legal authority to enforce its rights in court. Common examples of these contractual obligations include the following:

- Bond indenture debt service and similar covenants;
- Donor restrictions on gifts for special purposes or uses;
- Possibilities of reverter and reversions on real estate titles for changes in control or purpose;
- Member-reserved powers regarding corporate purposes;
- Member-reserved powers regarding transaction approval procedures;
- Supermajority vote requirements in bylaws that effectively grant a veto to another party;
- Rights of first refusal in favor of others;
- Binding commitments to the Ethical and Religious Directives for Catholic Healthcare Facilities; and
- “Change-in-control” severance provisions in executive employment agreements.

8. The title of this Commentary refers to “affiliations.” This text will treat “mergers” and “affiliations” interchangeably because the transactions being discussed could involve one of several legal formats (i.e., mergers, consolidations, asset transfers, joint operating companies, change in membership, or the creation of new or shared membership), all having the legal effect of a merger. The Federal Trade Commission - Department of Justice merger guidelines, for example, apply to all transactions having the legal effect of a merger. Interestingly, the parties to such nonprofit transactions usually prefer to call them “affiliations” because that term sounds less radical or less final than “merger” or “purchase.”

The first set of legal duties confronting directors\textsuperscript{10} contemplating a hospital merger requires the directors to honor all binding contractual obligations contained in agreements or organizational documents. Preexisting contractual obligations sometimes guide the format of affiliation transactions. For example, although a statutory merger might be preferred,\textsuperscript{11} the parties might instead structure the transaction as a change of membership to avoid refinancing both hospitals' sets of bonds.\textsuperscript{12} The due diligence process is designed in part to identify preexisting contractual obligations. Ignorance of contractual obligations is no excuse, and forming affiliations in violation of them often produces litigation by those who are harmed by such violations.

Many hospital affiliation transactions progress past the public disclosure point without adequate attention having been paid to the identification and resolution of all possible contractual infeasibilities. When this happens, the affiliating parties are often embarrassed or angry for not having alerted each other to the preexisting contractual obligations, increasing the likelihood of an unsuccessful transaction.

\section*{II. Mandatory Statutory Procedural Laws: The Second Set of Legal Duties}

The second set of directors' legal duties is to obey the local, state, and federal laws that apply procedural structure to nonprofit affiliation transactions. These mandatory procedural requirements fall conceptually into five categories.

\begin{itemize}
  \item While this discussion pertains to the legal duties of not-for-profit directors, the same duties apply to corporate officers. In many nonprofit hospitals, some or all of the officers also are directors (e.g., board chairs and vice chairs, chief executive officers who are ex officio directors, and even some corporate secretaries and treasurers). When officers are not directors, they are direct agents of the board in the implementation of board-established policy. This Commentary also uses the term “directors” to describe the participants on a corporation’s governing body because that term is used in the Model Not-For-Profit Corporation Act, \textit{Revised Model Non-Profit Corp. Act}, pt 8 (1986), and in the laws of most states. \textit{See, e.g.}, 805 ILL. COMP. STAT. 105/108.05 (West 1996). Some states still refer to governance participants as “trustees.” The terms “directors” and “trustees” may be used interchangeably.
  \item \textit{See, e.g.}, 805 ILL. COMP. STAT. 105/111.05-111.55 (West 1996).
  \item As long as one hospital is not being asked to guarantee the debt of its new affiliate and is able to meet a specified debt service ratio, most bond indentures do not address changes in membership and therefore allow them to occur without penalty or default.
\end{itemize}
A. Hart-Scott-Rodino Act

First, members and directors contemplating an affiliation must notify several government agencies of pending transactions. The Hart-Scott-Rodino Antitrust Improvements Act of 1976 mandates a thirty day pre-transaction notification to the Federal Trade Commission ("FTC") for affiliations large enough to have the effect of a merger, a purchase, or a corporate joint venture and involving interstate commerce. The FTC, working with the U.S. Department of Justice ("DOJ"), then determines whether the effect of the transaction may be substantially to lessen competition under section 7 of the Clayton Act. Failure to file for pre-transaction review may prompt sanctions, including fines and injunctions. A determination by the FTC or the DOJ that the transaction may lessen competition is likely to produce an action for injunctive relief to stop the affiliation.

B. Certificate of Need

Many changes in control or ownership require the controlling organization to acquire either a Certificate of Need ("CON") with relicensure or an express exemption from CON, without which state licensure may be denied. Assuming that the affiliation transaction itself does not create new institutional services, increase beds, or close health care facilities, experience has shown that CON exemption, if applicable, and relicensure are pro forma and rarely controversial.

14. See id. § 12.
15. See id. § 18a(g).
17. See, e.g., 20 ILL. COMP. STAT. 3960/13.1 (West 1996). Certificate of Need laws are state statutes that require state approval before healthcare institutions may expand their facilities.
18. See id. 3960/5(b) (requiring a CON if the transaction "substantially changes the scope or changes the functional operation of the facility").
19. The Illinois Certificate of Need statute requires an increase of more than ten beds or more than ten percent of total bed capacity. See id. 3960/3.
20. Discontinuance is included within the definition of "construction or modification" (such changes usually occur after the closing date and only upon contemporaneous compliance with all regulatory standards). See id. 3960/3.
21. See id. 3960/6; 77 ILL. ADMIN. CODE tit. 77 § 1130.650 (1991). For a very interesting exception in which the exemption was anything but pro forma, see Franciscan Sisters Health Care Corp. v. Illinois Health Facilities Planning Bd., No. 97 CH 013546 in the Circuit Court of Cook County, Illinois (pending).
Responsibilities of Directors

C. Medicare and Medicaid

The federal Medicare and Medicaid laws provide that changes in control or ownership require notice and recertification for participation in these important programs.²² Like CON procedures, recertification for Medicare and Medicaid is ordinarily neither controversial nor time-consuming and follows relicensure. Both may often be accomplished without special resurvey if the hospital’s survey record is already a good one. The unique “deemed status” of Medicare certification upon a successful accreditation survey by the Joint Commission on Accreditation of Healthcare Organizations (“JCAHO”)²³ assures that JCAHO will always have accreditation rules applicable to hospital affiliations which are acceptable to the Medicare program.²⁴

D. Employment Issues

If affiliations are accompanied by wholesale employee terminations or facilities closures, federal labor law requires that certain notices be given to employees.²⁵

E. Referenda

Referendum approval of affiliations may be required when real property involved in the transaction is owned or controlled by a municipal corporation.²⁶

Directors who participate in authorizing transactions that do not comply with the applicable procedural laws will find that their decisions can be and usually are nullified by legal action, which produces expense, delay, and, on occasion, an inability to complete the transaction. The existence of these procedural duties usually results in a transaction agreement containing several contingencies to deal with the various possible outcomes of one or all of the procedural requirements, which are expressly spelled out in the agreement.

²⁴. If the “deemer” clause of 42 U.S.C. § 1395x(e) was repealed, the JCAHO might be thought by many to be a redundant and, therefore, an unnecessary source of expense.
²⁶. Increasingly, municipal corporations, including counties, townships, and special districts, are statutorily repealing referendum requirements. But, when a city council may lack the nerve to make an affiliation decision on its own, it may vote to hold an “advisory” referendum. Advisory referenda have effectively killed some hospital affiliations.
III. CONTEXTUAL LEGAL DUTIES: THE THIRD SET OF LEGAL DUTIES

More important to the eventual success or failure of a possible hospital merger or affiliation than "whom do I notify?" are the questions, "what attitude should both sets of directors bring to the table?" and "does the law require anything of us as we negotiate?" While procedural in nature, the third set of legal duties is contextual; these duties stem more from the nature of the organizations than from the type of transaction.

Both state and federal legal standards apply to the contextual duties. Assuming both not-for-profit and federal tax-exempt status for the hospital parties, the applicable state not-for-profit corporation enabling statute and the Internal Revenue Code establish a context within which the parties must work together in conceiving, designing, and implementing their transaction. Directors are bound by law to follow these contextual rules in considering affiliations, but these rules are less black and white and much more gray than other legal standards. The general duties for directors of nonprofit, tax-exempt corporations govern all corporate decisions and are not specific to affiliation decisions. Therefore, there may be a tendency to assume that directors are already fully aware of these duties. However, directors should be reminded of these fundamentals because all outside parties or observers will certainly measure director performance by these standards.

The contextual legal requirements, taken from state and federal enactments, may be summarized in a series of directives for nonprofit directors, stated as follows: (1) Act in good faith. (2) Remember that it is the public and not the board that "owns" the not-for-profit corporation. (3) Avoid willful or wanton conduct intended to be harmful to others or conscious disregard for the well-being of others. (4) Act in the best interests of the corporation being served.

These generic legal duties, in turn, translate into slightly different, but clear and measurable standards of conduct for nonprofit directors:

27. There are some critically important relationships that hospitals must avoid under the Medicare Fraud and Abuse Act, 42 U.S.C. § 1320a-71(a), (b) (1994), and the Patient Protection Act of 1993, 42 U.S.C. § 1395nn (1993), but these are not unique to hospital mergers or affiliations because they apply even in the absence of a merger. Accordingly, compliance with these standards is primarily a mutual due diligence concern that should be considered prior to the consummation of a hospital merger.
• Identify and deal appropriately with all actual and apparent conflicts and dualities of interest so as to avoid both impropriety and the appearance of impropriety.
• Document precisely why the directors reasonably believe the best interests of both the corporation and the public are served by the specific transaction under consideration.
• Do nothing that could not be published and analyzed in the local print or electronic media, although there may be no legal requirement to disclose details of the decision-making process to the public.

The specific decisions likely to be presented for action by the hospital boards within the context of the foregoing legal duties and standards of conduct are neither simple nor objective. They are often emotional and require the exercise of discretion by the board. Examples include the following:

• Marshaling support and cooperation from the two medical staffs, without which the affiliation may never take place and which, in many cases, will entail consideration of a merger of the staffs; 28
• Adjusting to material changes in governance, perhaps reducing the effective role of the hospital board by increasing the role of a new parent organization; 29
• Losing the services of key and often long-term executives due to redundancy of resources following the affiliation closing date;
• Protecting the integrity of institutional fundraising practices and confidences wherever possible; 30
• Sorting out potentially conflicting affiliations for academic, programmatic, purchasing, or other purposes. 31

28. If the two hospitals are in the same city, experience shows that the medical staffs generally will welcome a merger of staffs in order to minimize their required meetings. Exceptions to this observation are affiliations of teaching and nonteaching hospitals and the presence of hospital-based physicians who foresee difficulty in their differences or redundancy after a merger of the two medical staffs.
29. If the hospital board has had the “final say” in the past, the board members may worry about an affiliation resulting in “subsidiary” status unless they are also the directors of the new parent. Though difficult, this transition is highly desirable to assure that the new post-affiliation system is not governed in the future as if it were simply one hospital.
30. The prospect of losing fundraising ability after an affiliation is often more imagined than real. In a two-hospital town, many donors are pursued by both hospitals and will welcome the affiliation for that reason alone. The most sensitivity is required where the fundraising of one hospital in the past has been integral to a sponsoring church organization.
31. This is a real problem in many cases, because an affiliation may cause one or both of the sets of suppliers or affiliates to lose a major customer or affiliate. Often, third-party interests are represented on the hospital boards and directors representing third-party interests may be inclined to keep the affiliation from happening. Direc-
These are examples of the trouble spots that plague nonprofit hospital boards during the process of negotiating affiliations, whether adversarially or by joint study. Conceptually, however, they are not different from the difficult decisions facing the boards of for-profit organizations, nor do they create new legal duties beyond those identified above and explained below.

A. Conflicts of Interest: Putting the Public First

Every legal source of scrutiny for nonprofit, tax-exempt entities is justifiably concerned about conflicts of interest. This legitimate concern is based upon the desire that nonprofit, tax-exempt organizations performing a public service not be abused by private interests or give the impression that they are permitting private interests to abuse the public interest. If nonprofit, tax-exempt organizations cannot be trusted by the public or by the government from which their nonprofit and tax-exempt status are conferred as a privilege, then they might as well be closed down and replaced by government.32 Put another way, those who act on behalf of nonprofit, tax-exempt organizations enjoy the conditional privilege of a special legal status which will be revoked if the public-interest conditions to the privilege are not observed fully, both in letter and in spirit.

Although every state and the federal government has asserted this “public-first” or “no conflicts of interest” policy, no one has yet stated it perfectly. The most recent effort is that of the Internal Revenue Service (“IRS”) by virtue of the new I.R.C. section 4958,33 enacted in July of 1996. Directors must be particularly aware of this new law, which expands the power of the IRS by introducing a new level of penalties, called intermediate sanctions. The intermediate sanction provisions create an intermediate step between revoking exempt status and no sanction at all.34

32. Since the classic analysis of American life by Alexis de Tocqueville in the late 1820s, analyzed in his momentous Democracy in America, first published in 1935, the use of private organizations (“public associations”) to perform public functions has been a cornerstone of American law, economics, and sociology. Changing this would be a major modification of our social fiber.
Section 4958 establishes a 25% federal excise tax on activities that produce an "excess private benefit" and a 200% excise tax when the private benefit transaction is not undone. The tax is assessable against all officers, directors, and other "disqualified persons" (also known as "insiders") who in the five years prior to the transaction were in a position to exercise substantial influence over the affairs of the organization. While nonprofit hospital mergers do not always present opportunities for "private benefit," there is no dearth of possible examples of potential private benefit arising out of such mergers. For example, a "change-of-control" severance package negotiated for the top managers, a "buyout" of the duplicative hospital-based physician contracts, or a banker or insurance broker or construction manager on the board who negotiates a "sweetheart" deal for his or her company (or his or her spouse's or child's company) as part of the merger may all create excess private benefits and invoke intermediate sanctions by the IRS under section 4958.

The tactical value of the procedures found in I.R.C. section 4958 cannot be overstated. The intermediate sanction provisions give the directors of an exempt organization both a duty to disclose and an opportunity to defuse the time bomb of potential conflicts of interest. The disclosure occurs in two ways: (1) through timely compliance with the disclosure forms of the hospital's conflicts of interest policy, and (2) through well-drawn

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35. The tax is on the amount of the excess benefit. For example, if a fair market value item of $25,000 were sold by a hospital to a disqualified person for $15,000, the initial tax would be $2500 (25% of the $10,000 excess benefit). If the deal is not undone within that taxable year, the tax becomes $20,000. Although the liability of a member of the organization's management or governance is 10%, limited to $10,000, the liability of others is joint and several and is not so limited. See 26 U.S.C.A. § 4958(e) (1994). That amount must be remitted to the federal government via the IRS. See id. § 4958(a)-(b). The exempt organization and the state's attorney general would also have claims against the disqualified person.


37. The IRS, prior to the enactment of Section 4958, took the position that all physicians on a hospital's medical staff were insiders for purposes of the inurement prohibitions of Section 501(c)(3) of the Internal Revenue Code. The "substantial influence" test of Section 4958 makes much more sense legally, but actually requires greater ongoing attention and discretion. As a result, it is better to err in favor of identifying individuals with enough influence that "conflicts policies" apply and require disclosure of potential conflicts. Experience shows that a hospital must administer its disclosure system conscientiously, because individuals are often slow to volunteer an apparent or potential conflict. See, e.g., Stern v. Lucy Webb Hayes Nat'l Training School for Deaconesses and Missionaries, 381 F. Supp. 1003 (D.D.C. 1974).
board minutes whenever a transaction occurs between the exempt organization and a disqualified person. The defusing takes place through following the exact statutory procedure for dealing with potential conflicts. There must be a documented and good-faith finding by the board that the transaction is in the best interests of the corporation; the disqualified person must not be present; express reference must be made to comparable data in the board’s possession; and the transaction must be reasonable after consideration of all relevant factors. When documented, this procedure establishes a rebuttable presumption of reasonableness, which the IRS would have difficulty overturning. Left unsaid in the statute or the committee report, but present in the minds of many, is the inexorable evolution of the obverse, namely, a possible presumption in the absence of such findings that there was some excess benefit to the disqualified private person involved. Eventual case law or IRS regulations might clarify that Congress did not intend such a result is not intended, but perhaps the IRS would actually prefer that such a presumption does evolve.

It may appear that because this is a Commentary discussing directors’ duties in nonprofit rather than for-profit hospitals, conflict of interest issues are being overemphasized. However, the conflicts discussion is particularly relevant because most directors’ and officers’ liability insurance policies exclude coverage for actions not taken in good faith and for actions clearly contrary to public policy (for example, violations of the Sherman Act). Thus, it would appear that (1) directors are “on their own” when they act despite a conflict of interest, and (2) a finding of conflict and a recovery by any of the interested overseers, including the IRS, the attorney general, or the exempt organization itself, would virtually assure an uninsured recovery by the others as well. Because of the serious consequences of failure to confront and document possible conflicts of interest,
directors should be aware of such consequences and conduct affiliations to avoid intermediate sanctions and other criminal and civil penalties.

State law pertaining to conflicts of interest on the part of non-profit directors is more problematic because it is less clear. Practitioners must research state law to ensure that their conduct conforms with applicable state conflicts laws. For example, the Illinois General Not for Profit Corporation Act ("Illinois Act") requires three fundamental courses of action of directors considering a transaction.

Both the individual directors and the board as a whole have a clear duty to watch for, identify, disclose, and resolve possible and existent conflicts of interest. The Illinois legislature wisely concluded that conflicts of interest cannot always be avoided and that the most important issue is how boards process and resolve possible conflicts. The Illinois Act allows transactions involving interested directors so long as the transactions are fair to the corporation and the board follows specific procedures. Next the involved director has the burden of proving that a particular transaction was fair, and that a decision was rendered after disclosure of the material facts. Further, the board must approve the transaction by a majority vote of disinterested directors.

43. 805 ILL. COMP. STAT. 105/101.01-116.10 (West 1996).
44. See id. at 105/108.60.
45. The interested director may be counted in determining whether a quorum is present. The Illinois Statute reads as follows:

Sec. 108.60 Director conflict of interest. (a) If a transaction is fair to a corporation at the time it is authorized, approved, or ratified, the fact that a director of the corporation is directly or indirectly a party to the transaction is not grounds for invalidating the transaction.

(b) In a proceeding contesting the validity of a transaction described in subsection (a), the person asserting validity has the burden of proving fairness unless:

(1) The material facts of the transaction and the director's interest or relationship were disclosed or known to the board of directors or a committee consisting entirely of directors and the board or committee authorized, approved or ratified the transaction by the affirmative votes of a majority of disinterested directors, even though the disinterested directors be less than a quorum; or

(2) The material facts of the transaction and the director's interest or relationship were disclosed or known to the members entitled to vote, if any, and they authorized, approved or ratified the transaction without counting the vote of any member who is an interested director.

(c) The presence of the director, who is directly or indirectly a party to the transaction described in subsection (a), or a director who is otherwise not disinterested, may be counted in determining whether a quorum is present.
Although some may imagine that addressing conflicts is easy, it often is not. Lawyers, physicians, bankers, consultants, and others do not always identify or disclose their own conflicts or those involving family members. If they have a duty to disclose conflicts and fail to do so, they may be subject to personal liability under both state and federal laws.

B. Dualities of Interest

Dualities of interest, as opposed to conflicts, are perhaps best defined as competing fiduciary nonproprietary interests, whether inside or outside the corporate family of the affiliating organizations. An example of a duality of interest within the corporate family would be a member of a religious order who serves simultaneously on the boards of the religious order, a sponsored health system, a hospital within the system, and a sponsored local college receiving an annual subsidy from the system’s bottom line. The specific question before the director might be whether or not to vote to involve the system’s flagship hospital in an integrated delivery system with a large tax-exempt clinic of physicians located next door to the hospital. Though all directors on the various boards of the institutions involved in this example are technically nonprofit fiduciaries, it does not take much imagination to envision good-faith differences of opinion on what the priorities should be at each institution. Another example is a person who serves simultaneously on both a parent board and a subsidiary board. Although all institutions are part of the same corporate family, a duality of interest arises because the various institutions may have divergent interests in differing outcomes. A director who serves simultaneously on multiple boards within a corporate family must be aware of the resulting duality of interest and the possible conflicts that may arise.

Dualities outside the corporate family also frequently exist for busy individuals who are pillars of the community. This kind of duality occurs when a director is a board member of several charitable organizations. It is not unusual, for example, for a...
person to be on the board of his or her local church, local hospital, local school, local United Way, Catholic Charities, or Jewish Federation. The person's spouse, parents, or adult children might also be active with several different charities, all of which compete for funding, contracts, publicity, and volunteers. Dualities surround nonprofit health care transactions, but neither state law nor federal law has adequately addressed this issue.

The Illinois statutory language on conflicts of interest covers some, but by no means all dualities of interest. A director is indirectly a party to a transaction if the other party "is an entity in which the director has a material financial interest or of which the director is an officer, director or general partner." Thus, a duality by a director would be covered under the Illinois statute, but a proprietary interest owned by a close relative would not. Furthermore, for the Illinois conflicts statute to apply, the other entity must be a party to the transaction in question, rather than simply have an interest in it, for a statutory conflict to exist.

A director's fiduciary duty should extend at least to disclosing all dualities because a director with a duality conflict may place charity A's interests ahead of the interests of charity B. The other directors of charity B are entitled to be aware of the potential effects of the dualities within their ranks. Most conflicts policies do not reach this far, and only require disclosure of direct conflicts of interest.

Too little is written on the subject of dualities, which generally do not rise to the status of a statutory conflict of interest. To the extent that there is no applicable statute, directors with dualities should comply with the second statutory obligation of nonprofit directors in Illinois: They should conduct the corporation's affairs in good faith and in the absence of willful or wanton conduct.

1. Acting in Good Faith: The Avoidance of Willful or Wanton Conduct

It should be easy for a nonprofit director to act in good faith and without willful or wanton misbehavior. These duties are sometimes honored in the breach for several reasons. First, these duties often are not clearly defined or definable, and dualities of interest are not always seen as relevant. Second, the real reasons for directors' votes ordinarily are not disclosed or

46. Id.
recorded and fellow pillars of the community do not want to hurt the feelings of peers by questioning their motives. Finally, there are certain motivations behind various decisions that are not always consciously considered.

Nonetheless, good faith conduct and the avoidance of willful or wanton conduct are legal prerequisites under Illinois law for immunity from legal exposure for nonprofit directors. Particularly, the Illinois Act provides that uncompensated directors of tax-exempt, nonprofit organizations cannot be sued for making decisions and exercising judgment unless their actions involve willful or wanton conduct.47 "Willful or wanton conduct" is defined as "a course of action which shows an actual or deliberate intention to cause harm or which, if not intentional, shows an utter indifference to or conscious disregard for the safety of others or their property."48 Board orientation, therefore, should always include references to both the good faith obligation and the avoidance of willful or wanton conduct as defined in the statute.

The obverse of acting in good faith and without willful or wanton conduct is essentially the statutory test by which Illinois circuit courts, upon application by members or the nonprofit corporation itself or the attorney general, may sanction or remove directors. If the court finds that a director is engaged in fraudulent or dishonest conduct or has grossly abused his or her position to the detriment of the corporation, the court may enter a decree sanctioning the director and requiring the transactions be reversed.49 While directors have great discretion under these standards, acting in good faith is generally the best way to prevent potential problems.

2. Acting in the Best Interests of the Corporation

The third and last applicable statutory obligation for Illinois nonprofit directors is the standard of conduct under which a corporation may indemnify its directors for expense incurred when acting on the corporation's behalf. By statute, a nonprofit corporation in Illinois may indemnify its directors (and others) "if such person acted in good faith and in a manner he or she reasonably believed to be in, or not opposed to, the best interests of

47. See 805 ILL. COMP. STAT. 105/108.70 (West 1996).
48. Id. 105/108.70(d ) (emphasis added).
the corporation . . . ." 50 While this may appear to be a perfectly clear standard in theory, the standard is difficult to apply in practice for several reasons.

First, people may, and often do, disagree on what is reasonable. It is not unusual for opposing groups, or opposing individuals, to resort to litigation to determine what is in the best interests of a nonprofit corporation. 51 This is especially relevant when the nonprofit organization’s assets are cash, and the disputed issue is over what other organizations should receive cash distributions after dissolution. 52

Second, the Illinois Act’s “best interests” test of asset management extends substantial discretion to nonprofit governance participants. This discretion resulted in part because of the disastrous litigation against trustees growing out of the Great Depression and in part because of the legislative desire to encourage American volunteerism on behalf of nonprofit organizations. The best interests test is generally comparable to the so-called “business judgment” test used for for-profit business corporations. 53 At a minimum, “the best interests” test requires directors to take good faith affirmative steps to avoid negligent, uninformed decision-making. Directors must demonstrate that they are acting in the corporation’s best interests by creating evidence in board minutes or other documents showing that the individual director’s vote is reasonably thought to be in the corporation’s best interests. 54

Directors do not make decisions in a vacuum. The decision whether or not to affiliate should always be measured under the circumstances at hand. This means that the best interests of the corporation might change from time to time for the nonprofit director. 55 It also means that it becomes very desirable legally to document accurately and in a timely fashion the basis on which big decisions in the life of nonprofit corporations are made. 56

50. 805 ILL. COMP. STAT. § 105/108.75(a)(West 1996) (emphasis added).
52. See id.
53. See, e.g. Mile-O-Mo Fishing Club, 210 N.E.2d at 12.
54. All of these factors were absent in Mile-O-Mo Fishing Club. See id.
56. The suggested documentation is comparable to the mandated documentation in Section 4958.
IV. THE DECISION TO SHARE OR CHANGE CONTROL

The title of this Commentary suggests that there may be something special or legally important about a hospital board's decision to enter into a transaction that may result in the hospital losing some control. Directors often phrase their most serious misgivings in such terms as "turning our hospital over to them" or "selling out to them." Analysis, however, shows that this concern is not a legal issue; rather, it is an emotional issue, an expression of concern that culture clashes between the two organizations might bring about unwanted changes in the day-to-day operations of the hospital.

The power to materially change a nonprofit institution is generally retained within its own power structure so that its members or directors, if so inclined, could substantially change the institution's culture. While this may be less true of some religious-sponsored nonprofit hospitals, change has been inexorable for them, too; without periodic change, the economy and the competition often bring religious-sponsored hospitals to financial ruin.

If members and directors are routinely granted the power to materially change both the people and the purposes of a nonprofit corporation, then they certainly have the power to both share authority and abdicate it to other fiduciaries of the public interest. Applying all the appropriate tests, it is entirely possible that a board could conclude that corporate dissolution is in the best interests of both the corporation and the public. Similarly, a board might determine that a merger or other corporate affiliation is reasonably necessary or desirable.

57. For example, the Illinois Act states that if the corporation has voting members and unless the organizational documents provide otherwise, the voting members shall have substantial powers over the board of directors. See 805 Ill. Comp. Stat. §§ 105/107.03-.05 (West 1996). If, on the other hand, discretion lies in a so-called self-perpetuating board without members, then the statute clearly grants the directors substantial authority to bring about change in the corporation. See id. § 105/108.15; see also Westlake Hospital Ass'n v. Blix, 148 N.E.2d 471, 476-78 (Ill. 1958). The person or entity with the power to materially change the corporation holds total control over the corporation, subject only to its duty to conduct the corporation in furtherance of the public interest.

58. See 805 Ill. Comp. Stat. §§ 105/110.05-.15 (West 1996); Holden Hospital Corp., 174 N.E.2d at 797-98.

V. APPLICATION OF ALL LEGAL DUTIES TO BOARD DECISION-MAKING

Fortunately for nonprofit hospital directors, an identifiable process emerges from the analysis of the three sets of legal obligations in their practical application. The resultant process both permits and encourages the proper participants in affiliation decision-making to document the following process: who made the decision, what the options were, and why the particular decision was made. Although the benefit of documenting board decisions is clear, even the best intentioned decision-makers sometimes resent being asked to demonstrate that they have done no wrong and recoil from lawyers who suggest that documentation procedures, which may be perceived by directors as prophylactic measures, are highly desirable.

There is, however, a middle ground. For cases in which all actual, apparent and potential conflicts and dualities of interest have in fact been identified and dealt with appropriately, the participating decision-makers should adopt a formal written list of reasons for the transaction. The list might be short or long, but it should be honest and reviewed closely by counsel.

In the context of a hospital merger, prudence arguably consists of little more than a specific finding that there are sufficient valuable results from the transaction that justify any risks associated with a change in control at the board or membership level. In some cases, the value to the communities being served may lie not only in efficiencies or cost savings, but also in enhanced, coordinated sponsorship or combined governance mechanisms. If these reasons support the transaction and concurrently pass the "straight face test" and the so-called "smell test," then they ought to be placed on the formal list of reasons as evidence of the directors' deliberate search for a prudent affiliation in the best interests of the corporation and the community.

Along with inquiries from state and federal governmental agencies, nonprofit directors are inevitably subject to appropriate inquiry from their fellow citizens. Innocent inquiry may turn into

60. This documentation usually comes in the form of formal written documents including a memorandum of understanding, a definitive transaction agreement, and board findings and resolutions.

61. Legal review of board documents is important to ensure that the boards decisions do not rest on illegal rationale. For example, some first drafts have been known to include anticompetitive rationale, such as "getting rid of destructive competition," a motivation that, if scrutinized, would be sure to attract the attention of the federal antitrust agencies.
intense scrutiny. If directors cannot give compelling and consistent reasons for their proposed actions to those who care enough to ask, perhaps their conduct is imprudent. Few directors look forward to being remembered for imprudence in their service to their community and to the public. However inexact an art it may be, documentation of prudence is the answer for nonprofit directors. It is the indelible sign of legal duties honored in fact.