

**Fundamental Changes in Charitable Corporations:**

**What Public Interest Standard Should Apply?**

**A Talking Paper Drawing on New York Law**

**by**

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**December 11, 1996<sup>1</sup>**

The cataclysmic events which have overtaken the nonprofit health care world have caused very legitimate concerns about the nature of nonprofit hospitals and health care organizations and how to preserve charitable assets for the public good. All sorts of interesting issues are raised by these events. Perhaps the principal issue is what exactly is the charitable nature of a nonprofit hospital or health insurance organization. But these events raise other issues which are very difficult to resolve, including how to value the charitable assets in the conversion of a nonprofit hospital or health care organization to for-profit status, the adequacy of disclosure about the transaction, how to be sure that the resulting charitable entity will receive full value for the charitable assets, possible conflicts of interest for individuals who receive contracts from the new for-profit entity, and the qualifications of the governing board of the resulting or remaining charitable entity. All of these issues are important, and, because they are difficult to resolve, they are troubling.

My concern, however, is that in trying to remedy them, some fundamental changes may be made in the ways in which charitable organizations are regulated which will have ramifications going beyond the ills the remedies are intended to solve and may ultimately

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<sup>1</sup> That this paper was written at all is due to the assistance of Bill McKeown and the debates we have had over the appropriate standards to be brought to bear on the activities of charitable corporations.

prove deleterious to the charitable world. I believe that within the existing structure, at least in New York, there are adequate safeguards and methods to deal with these conversions and other changes to charitable organizations which may occur in the future.

Certain of the suggestions made in the context of conversions of health care institutions deal with process. There is obvious concern about the valuation of the assets of the charitable entity and determining whether the transaction reflects an appropriate marketplace price. The Attorney General of the State of New York has broad supervisory power over charitable assets under Section 8-1.4 of the Estates, Powers and Trusts Law (“EPTL”) and under the Not-for-Profit Corporation Law (“NPCL”). Given this broad power, the suggestion that independent experts be hired by an entity converting to for-profit status, at the expense of the entity, to assist the Attorney General seems to me both workable and appropriate and well within the authority of the Attorney General’s office. Whether the Attorney General’s office has adequate personnel or sophistication to undertake a thorough examination of such a transaction is a larger question. Perhaps another government agency exists which could play a helpful role, but I do not know of one. Creating a new agency, or a new role for an existing one, other than the Attorney General’s office, seems counterproductive. The question of conflicts of interest is also one which I believe falls squarely within the Attorney General’s purview and that office is probably the most qualified entity to examine the question.

In New York additional legislation should not be required to deal with these questions of process. The more serious issues, however, I believe, go to the standard to be applied in reviewing the use of the charitable assets involved, the function of the nonprofit board and the deference to be given to its decisions, and whether other parties should be empowered to intervene through “relator” actions in order to influence the outcome. This latter suggestion

particularly seems dangerous, inefficient and costly and, I believe, unnecessary. The New York courts have shown themselves quite willing to allow intervention by persons and organizations asserting they have an interest in the outcome of proceedings required by law to be initiated by charitable corporations to obtain court approval of fundamental changes.

The NPCL and the EPTL, as applied by our courts, together provide an adequate structure to deal with the issues raised by fundamental change to charitable organizations. Should we deviate very much from the structure we have developed over the years, some of the voluntary and independent nature of our nonprofit institutions would be threatened. Like the proverbial “bad case” which makes “bad law,” novel measures to exorcize the specter of charitable assets disappearing in the conversion of a health care institution to for-profit status may lead to changes in the law which are not required and are not desirable. The public interest can be protected and new forms of organization for health care can be authorized. The existing New York statutes and case law provide standards grounded in traditional notions of charity which require broad review by the courts and the Attorney General and which allow flexibility in responding to new instances of fundamental change, such as hospital conversions.

### **Charitable Corporations and Charitable Assets**

The conversion of a charitable health care organization, or any other charitable organization, into a for-profit entity presents a new form of an old legal issue. Once assets have been dedicated to charitable purposes in perpetuity, on what grounds, and to what extent, does the law allow the use of those assets to change when circumstances, including the needs which may be met with such assets, change? As have other states, New York has dealt with this general issue.

Although charitable trusts may now be formed in New York, for historical legal reasons charities have been and continue to be formed in this state principally as charitable corporations. Under the NPCL, such a corporation now is classified as a type B corporation (NPCL Section 201(b)). The assets held by a charitable corporation are charitable assets.

A charitable corporation formed in New York may hold two different kinds of charitable assets — those held for its general purposes, that is, without stated additional purpose restriction, and those dedicated to a specified charitable purpose or purposes otherwise within the corporation’s general purposes, that is, subject to a stated purpose restriction. The former may be called “general purpose assets,” while the latter are sometimes called “particular purpose assets.”

Under NPCL Section 513(a), a type B corporation holds “full ownership rights in any assets consisting of funds or other...property of any kind, that may be given, granted, bequeathed or devised to or otherwise vested in such corporation in trust for, or with a direction to apply the same to, any purpose specified in its certificate of incorporation, and shall not be deemed a trustee of an express trust of such assets.” Under Section 513(b), the governing board of a type B corporation is required to apply all such assets “to the purposes specified in the gift instrument and to the payment of the reasonable and proper expenses of administering such assets,” except as otherwise may be permitted under the *cy pres* provisions of the EPTL or under NPCL Section 522, the “release of restriction” provision incorporated into the NPCL from the Uniform Management of Institutional Funds Act.<sup>2</sup>

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<sup>2</sup> According to the official comment to Section 7 of the Uniform Act, from which Section 522 is derived, the reach of the release of restriction provision is intended to be narrower than the reach of the doctrine of *cy pres*, and the provision is not intended to encroach on that judicially created doctrine in any state where the Uniform Act may be adopted.

## Standards Applied in New York

Notwithstanding that a charitable corporation in New York has full ownership rights in its charitable assets, its dealings with those assets may be subject to court supervision, as under the law of other states, and as Section 513(b) indicates. However, there is far more to the role of the courts than suggested by Section 513.

To make any of several fundamental changes in a type B (charitable) corporation under the NPCL requires approval by a Justice of the Supreme Court, normally in the judicial district in which the corporation has its principal office or place of activity, on notice to the New York State Attorney General. Corporate changes authorized under the NPCL which require such court approval include (1) amending the certificate of incorporation to change, add or delete a purpose (Section 804(a)(ii)), (2) the sale or other disposition of all or substantially all the corporate assets (Sections 510 and 511), (3) the merger of the corporation with another corporation (Section 907),<sup>3</sup> and (4) the dissolution of the corporation and disposition of its assets (Sections 1005 and 1008). In each such instance, the court has an explicit or implicit duty to assure that existing charitable purposes or activities continue to be maintained and that the assets devoted to such purposes or activities continue to be available to support those purposes and activities. That this duty may be implicit rather than explicit is demonstrated by *Alco Gravure, Inc. v. The Knapp Foundation*, 64 N.Y.2d 458, 490 N.Y.S.2d 116 (1985) (“*Alco Gravure*”). In *Alco Gravure*, the Court of Appeals drew from NPCL Sections 513 and 522 the principle that a corporation cannot amend its corporate purposes under Section 802 to change its charitable purposes in their entirety without adhering to what the Court called *quasi cy pres* principles.

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<sup>3</sup> Although other types of not-for-profit corporation may merge with business corporations under the NPCL, type B corporations may not (Section 908(a)).

New York statutes and case law suggest three standards which can be applied in reviewing such fundamental transactions affecting the charitable assets of charitable corporations.

The *cy pres* Standard - Particular Purpose Assets.

As Section 513(b) indicates, if a charitable corporation holds charitable assets subject to a use restriction (particular purpose assets), and circumstances change, the governing board may wish to initiate a *cy pres* proceeding to seek court authorization to use the assets for a different purpose from that directed by the donor. Alternatively, an application can be made under NPCL Section 522 to “release a restriction.” Absent such a decision, the assets are to be devoted forever to the donor’s original purpose.

Although it has a checkered history in New York, the *cy pres* doctrine has been codified in New York for years, and now is set out in Section 8-1.1 of the EPTL. *Cy pres* may be applied to assets held with “full ownership rights” by a charitable corporation, as well as assets technically held in trust; see *Matter of Goehringer’s Estate*, 69 Misc.2d 145, 329 N.Y.S.2d 516 (Sur. Kings Co. 1972); *Matter of Brundrett’s Estate*, 87 N.Y.S.2d 851 (Sur. NY Co. 1940).

The standard the New York courts apply in *cy pres* proceedings requires that any newly approved restricted use must approximate “as nearly as possible” the original restricted use of those particular purpose assets. See *Matter of Multiple Sclerosis Service Organization of New York, Inc.*, 68 N.Y.2d 32, 505 N.Y.S.2d 841 (1986) (“*Matter of MSSO*”).

Obviously, circumstances may change in a number of respects which may give rise to a *cy pres* application; see the discussion in *Matter of Goehringer’s Estate*, above. These would include a conversion from a charitable corporation to a for-profit corporation, where at the outset the charitable corporation held “particular purpose assets.” But a court would not deal in a

*cy pres* decision itself with a proposed corporate or organizational change or transaction, rather the *cy pres* decision would address the use to which those particular assets could be put after the change or transaction.

Absent any modifications a court may authorize by applying the *cy pres* standard, any successor holder of particular purpose assets would be governed by the same use limitations as any predecessor. For example, NPCL Section 907(c) requires that a court order approving a merger include a direction to the successor corporation to hold any particular purpose restricted assets “subject to such purpose or use.”<sup>4</sup> Thus, in any kind of conversion, the ultimate holder of particular purpose assets would hold those assets subject to the same original restrictions or restrictions modified by application of the *cy pres* doctrine. *See also Alco Gravure.*

### **Two Other Standards.**

The New York courts apply two other standards to corporate changes affecting charitable assets that are not particular purpose assets.

### **Promoting Corporate Purposes.**

In some transactions, those where a charitable corporate entity will continue to exist, the standard applied requires that the purposes of the corporation (or the interests of its members) will be promoted by the proposed transaction. These transactions include a sale or other disposition of substantially all corporate assets under NPCL Sections 510 and 511. *See* Section 511(d) and *Church of God of Prospect Plaza v. Fourth Church of Christ, Scientist*, 76 A.D.2d 712, 431 N.Y.2d 834 (Second Dep’t, 1980) (“*Church of God*”); *Manhattan Theatre*

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<sup>4</sup> Alternatively, the court may direct that such assets be conveyed to the survivor or “to one or more other domestic or foreign corporations or organizations engaged in substantially similar activities, upon an express trust the terms of which shall be approved by the court” (NPCL Section 907(c)). This would allow, but not require, the court to apply *cy pres* principles. In a merger as in other events which vest assets in type B corporations, upon vesting Section 513 would apply, and the successor corporation would hold the assets received “in trust” by the court order not as trustee, but as owner, subject to any use restriction. Regarding “substantially similar,” see the discussion below of the *quasi cy pres* standard.

*Club, Inc. v. Bohemian Benevolent and Literary Association of the City of New York*, 120 Misc.2d 1094, 467 N.Y.2d 143 (Sup.Ct.Tr.T., New York Co., 1983).<sup>5</sup> (The same principles applied under the now superseded statutes, Section 21 of the Membership Corporations Law and Section 52 of the General Corporation Law, see *Matter of St. Luke's Hospital*, 33 Misc.2d 888, 228 N.Y.2d 25 (Sup.Ct. Spec.T., 1962).)

The provisions governing mergers seem to apply the same standard, although stating it in the negative and expanding it to embrace the public interest. Section 907(e) provides that, if “it shall appear, to the satisfaction of the court, . . . that the interests of the constituent corporations and the public interest will not be adversely affected,” the court shall approve the merger. In *Matter of Sackerah Path Girl Scout Council, Inc.*, 272 N.Y.2d 34 (Sup.Ct. West.Co., 1966), a case arising under the Membership Corporations Law, which contained the same standard, the court stated the standard had been met but did not explain its conclusion. Thus, while there appear to be no cases construing this standard, it clearly expands the considerations beyond the general corporate purposes to the wider community and public interest.

The “promoting the corporate purposes” standard is appropriate where the fundamental event or transaction may change the form of the general charitable corporate assets (*e.g.*, land may be sold for cash, which is then invested in securities) but the value of the assets remains in the corporation, and the same charitable corporation continues to exist. These outcomes would follow from a sale of all corporate assets, not followed by dissolution, or from a merger, where normally the surviving corporation receives the general corporate assets and

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<sup>5</sup> Section 511(d) also requires that the court determine that “the consideration and the terms of the transaction are fair and reasonable to the corporation”; this requirement has been construed to apply as of the time the bargain is struck, while the promoting corporate purposes standard applies as of the time the court reviews the transaction, see *Church of God, supra*, 76 A.D.2d at 717. Section 511(a)(4) requires the corporation to state to the court “the fair value of [the] assets” subject to sale or disposition. These two provisions normally require an appraisal of the assets be submitted to the Attorney General and to the court.



continues the existence of all its constituent corporations. The purposes restricting the assets would be the same as the corporation's general charitable purposes before the event or transaction, and after the event or transaction those corporate purposes would be the same as they were before. The court need only be assured that the transaction or change will promote the existing corporate purposes. However, where a sale or other disposition of all corporate assets is to be followed by the dissolution of the corporation,<sup>6</sup> separate proceedings are required, and a different standard applies.

**The “*quasi cy pres*” Standard - General Purpose Assets.**

In transactions where the charitable corporation will cease to exist, and general charitable corporate assets must be transferred to another entity to permit them to continue to be used for their charitable purposes, the New York courts apply what has come to be called the “*quasi cy pres*” standard. In such a transaction, the standard requires that the transferee be “engaged in activities substantially similar to those of” the transferor charitable organization. *Matter of MSSO* is the leading case; *see also Alco Gravure*.

The *quasi cy pres* standard has developed most fully in the distribution of general charitable corporate assets upon the dissolution of a charitable corporation, now governed by NPCL Sections 1005 and 1008. This is the standard that should be applied to evaluate the conversion of a charitable corporation into a for-profit corporation, because such a conversion is the functional equivalent of a dissolution.

*Matter of MSSO* dealt with the second step of a two step transaction, the first of which was a sale of all assets under Sections 510 and 511. The sale of assets had been approved

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<sup>6</sup> Section 511(a)(5) requires the corporation to inform the court whether or not dissolution is contemplated after the sale or other disposition, but the court does not address the issues raised by dissolution in a proceeding under Section 511.

by a court apparently without challenge. The second step, the distribution of the assets after dissolution under Section 1005, was challenged by an organization which had not been included in the plan of distribution by the governing board of the dissolving corporation but believed that it should receive all of the dissolving corporation's general charitable assets.

The Court of Appeals held that the lower courts had misinterpreted the law and applied the wrong standard, requiring reversal and a remand to the Supreme Court for a hearing at which the factual record could be developed and the correct standard applied. The Court of Appeals also gave the lower courts guidance as to how to apply the standard.

The Court first explained that the NPCL granted the governing board of the distributing corporation a substantial role in selecting the distributees. The Court noted that the role of a court in approving such distributions is not perfunctory, but that the plan is to be recommended by the board to the court, both of which are to exercise discretion in carrying out their distinct functions. Moreover, the legislature intends that a not-for-profit corporation have “a strong board of directors.” “Therefore, [the board's] choice of acquiring organizations and corporations should not be lightly set aside,” 505 N.Y.2 at 868.

The Court also said the hearing court should consider how the general charitable assets were acquired by the distributing corporation. Were they received in response to one or more public solicitations? If so, what was said to the donors or by the donors? (The Court again noted that nothing in the record indicated that the corporation had received any particular purpose assets, so such assets were not in issue.)

Finally the Court said the activities of the corporation in furtherance of its general charitable purposes would be relevant. Indeed, these would be more relevant than its stated corporate purposes. Finally, the Court suggested the hearing court consider what charitable

purposes were emphasized by the corporation's actual activities. In all, the Court of Appeals appears to indicate that, in considering or determining the restrictions on general charitable assets of a charitable corporation, the actual activities of the corporation have more bearing than its formal purposes, as long as those activities are within the corporation's authorized purposes.

### **Applying the Standards**

In any proposed conversion, whether of a health care organization or any other charitable corporation, to for-profit status, the transaction should be reviewed for its substance:

(1) Are there particular purpose assets? What is proposed to be done with them?

Would a decision applying *cy pres* principles be necessary to accomplish what is intended, or may the assets be used as the donor(s) specified? Should the restrictions be released in whole or in part as permitted by NPCL Section 522?

(2) What are the existing charitable purposes or activities of the entity? What is proposed to be done with the organization--will it continue, in some form, with continuing programs, new programs? Will it spin off programs? Will it disappear? What organization(s) will carry on? What purposes/activities will they carry on? Are they "substantially similar" to the activities of the predecessor?

### **Flexible Standards**

The standards established in New York under the EPTL, the NPCL and the case law, and particularly as developed by the Court of Appeals in *Matter of MSSO*, recognize that different circumstances may call for general principles to be applied flexibly. The standards call for strict adherence to traditional treatment of charitable assets, both particular use and general purpose assets, but allow freedom to deal with different facts. Most important, the Court of Appeals recognizes that charitable corporations have full ownership of their charitable assets and

that, at least with respect to their general charitable assets, wide discretion as to how to use those assets to carry out their charitable programs. The Court of Appeals in particular recognizes the important roles of judges, and the office of the Attorney General, and of charitable governing boards, in meeting the requirements of the law.

It seems to me that the public or community interest in the preservation of charitable assets for the public good is protected by the standards articulated in the EPTL and the NPCL, and enforced and reviewed by the courts and the Attorney General's office. I also believe New York has struck the right balance in giving deference to the views of the governing board in the application of general charitable funds, as long as those views are subject to such review. The interests of the wider community regularly are heard in such proceedings, because the courts appear regularly to allow intervention by organizations claiming to have an interest in the outcome. With the roles of each player in the process — the courts, the Attorney General, and the governing board — set forth in the statutes and the case law, there can be adherence to the standards designed to protect the public interest and yet flexibility and independence in achieving the actual use of charitable assets for charitable purposes.

The public, the community and the state all have a stake in the distinct, individual “public purposes” of each charity. But the public, the community and the state also have a stake in the freedom we allow ourselves to operate as loosely as we do. American charity is a field of voluntary action in origin, history and present practice. We let people decide to create charities — we let them encumber assets with charitable purposes “forever.” The decision to convert a charitable organization to a for-profit entity should likewise be respected as long as the charitable assets are protected.

New York law provides procedures and standards of review to protect those assets and puts no restrictions on the scope or means of review to be employed by the courts or the Attorney General. To import into the law new elements intended to protect those assets, for example by giving standing to other parties to bring suit, or to define qualifications for the directors of the charitable entity resulting from the conversion, seem to me to be unnecessary. They may threaten the freedom and independence of the voluntary charitable sector and lead to the waste of charitable assets in unnecessary litigation.