

SALE OF SIGNIFICANT ASSETS OF A NONPROFIT CORPORATION

House Bill 4580 (Substitute H-8) First Analysis (11-6-97)

**Sponsor: Rep. Kirk Profit
Committee: Commerce**

THE APPARENT PROBLEM:

Increasingly it is the case that successful nonprofit charitable organizations whose purpose is research and development (R & D) are converting their corporate status to for-profit. In these role reversals, the nonprofit organizations offer a variety of rationales: The profits they expect from product sales surpass the value of their tax exemptions; their sources of funding (primarily government and foundation grants) are inadequate, uncertain, short-term, or narrowly targeted; or, there is a certain entrepreneurial cachet with for-profit status, and this serves as a decided advantage in financial markets during an era of heightened focus on new product development, a focus that is sharpened by global electronic communication.

During a conversion to for-profit status, critics and some advocates of the conversions (sometimes current and former employees) are troubled by conflicts of interest, and in particular the vague and uncertain understanding of directors' responsibilities to the public. As the directors' responsibility to the public gives way to their new focus--that is, their responsibility to the public shifts to a responsibility to investors (and, indeed, sometimes to their own investments and personal compensation)--conflicted understandings of roles and responsibilities abound.

Some matters of conflict are financial, some legal, and others ethical. Such conflicts are especially prevalent since the boards of directors of a new for-profit organization generally overlap (either in whole or in part) its predecessor nonprofit's board. As directors' business and professional interests collide, their loyalties are confounded.

The public (that is to say, the taxpayer) subsidizes charitable nonprofit organizations by exempting them from payment of many taxes. Exemptions are earned by any organization that demonstrates its primary purpose to be the promotion of education, research, or science. A key question during nonprofit conversions is this: What value did the nonprofit accrue during its tax exempt years? If such value accrued and conversion

or sale is imminent, then an argument follows that the public is

entitled to repayment, in lieu of forgone taxes, for all or a portion of that value.

Research institutes, usually funded by grants and enjoying tax-exempt status, often are located at research universities. Some institutes, generally those whose R & D investments result in products that yield revenue, have transferred their assets during conversion.

At present Michigan law does not allow for a review of transactions in which publicly funded assets are transferred to profit-making corporations. Further, the valuation of such assets by neutral parties outside the transaction is not required under law.

THE CONTENT OF THE BILL:

House Bill 4580 would amend the Nonprofit Corporation Act (MCL 450.2271 et al.) to impose requirements that a nonprofit corporation would have to comply with in selling, conveying, or distributing a significant corporate asset. The term "significant corporate asset" would be defined in the bill so as to refer to any asset with a fair market value that is both greater than \$100,000 and is more than 25 percent of the aggregate fair market value of that corporation. The term would include, but not be limited to, real property, tangible personal property, intangible personal property, and intellectual property.

Under the bill, a "nonprofit research institute" would mean a corporation that is described in and qualified under Section 501(c)(3) of the Internal Revenue Code of 1986 and is organized and operated for the principal purpose of engaging in scientific research. Nonprofit research institute would not include any of the following: a corporation that is a hospital, school, college, or university; or a corporation that provides health service directly or through a subsidiary corporation or affiliate.

Review by Attorney General. Sixty days before a significant corporate transfer, a nonprofit research institute would be required to provide written notice of the transfer to the attorney general. Within 30 days, the

attorney general could request further information from the nonprofit (and the organization would be required to provide it.) The notice to the attorney general and documents submitted for review would be public records subject to disclosure under the Freedom of Information Act. The bill would require that in the course of the review, the attorney general would convene a public hearing in the county where the nonprofit research institute does business. The attorney general's review and hearing would be to determine if steps had been taken to safeguard the value of the institute's assets and to ensure that any net proceeds were be used to further the research institute's corporate purpose. Specifically, there would be consideration as to whether:

--the transfer would violate any laws;

--the officers had exercised due care in deciding to enter into transfer, selecting a buyer, and negotiating the transfer terms;

--the institute's procedures had been followed, and if appropriate, expert assistance was used;

--conflicts of interest had been avoided or appropriately addressed;

--the institute would receive fair market value for any assets transferred;

--the research institute's assets would be placed at risk;

--net proceeds would be used in a manner consistent with the corporate purposes and whether any net proceeds would be controlled as charitable assets; and,

--the charitable interest and its governing structure would be representative of the community served by the nonprofit.

Attorney General Expert Evaluation. The bill would allow the attorney general to employ experts at the reasonable expense of the nonprofit research institute, in order to conduct the review.

Safeguarding Value. If after application of the review standards the attorney general determined that appropriate steps to safeguard the value of the nonprofit research institute's assets were not taken, he or she could institute a legal action, and could do so in the right of the institute against its directors, officers, or other persons holding or receiving assets. Except for costs or expenses to the attorney general, any damages awarded or property recovered would be the property of the nonprofit research institute.

FISCAL IMPLICATIONS:

Fiscal information is not available.

ARGUMENTS:

For:

The bill would enable public review of asset transfers when charitable nonprofit corporations convert to for-profit status. This review is necessary, as absent a public review the taxpayers (who subsidize nonprofits by extending to them tax exemptions) cannot know the fair market value of the assets. Public disclosure could help to prevent financial aggrandizement, to expose inappropriate self-enrichment, and to protect public R & D assets and to retain them in public trust. A case on point is that concerning the recently converted Environmental Research Institute of Michigan, International, which was formerly a research institute at the University of Michigan in Ann Arbor. At the nonprofit research institute, faculty and their nonacademic co-workers conducted surveillance satellite research for two decades. During the institute's recent conversion to for-profit status, there were conflicting reports about the value of corporate assets.

Against:

The bill would require the Office of the Attorney General to perform regulatory and oversight functions that require particular and technical expertise in corporate valuation. At present, no agency of state government can provide that expertise. What's more, no agency of state government now knows precisely how many charitable nonprofit research institutes exist. (A database search for scientific and research corporations among the charitable nonprofits was incomplete at the time this bill was reported from committee.) It is therefore unknown how many charitable conversions might require a review. This legislation could, then, be costly to implement.

POSITIONS:

The Office of the Attorney General supports the concept of the bill. (11-5-97)

The Michigan Nonprofit Association is neutral on the bill. (11-5-97)

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■ This analysis was prepared by nonpartisan House staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent.