Profit in Not-for-Profit Corporations:
The Example of Health Care

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In the course of the recent nursing home investigations, the thesis has repeatedly been advanced that a major source of the abuses uncovered is the provision of care by proprietaries (i.e., for-profit corporations). While in most human services sectors proprietary institutions account for only a small percentage of those providing services (e.g., only 13 percent of hospitals\(^1\) and an even smaller percentage of schools), about 77 percent of the nursing homes in the United States are proprietary.\(^2\) In response to the scandals, a solution more and more frequently proposed is to phase out the proprietaries and require all nursing homes to be run on a "voluntary" (not-for-profit) basis.\(^3\) Similarly, when abuses have come to light in other service areas—e.g., in proprietary correspondence schools, for-profit abortion-referral services, and the minority of

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\(^3\) This suggestion has been made by New York Assemblyman Andrew J. Stein, chairman of the New York State Temporary State Commission on Living Costs and the Economy, which investigated nursing homes; an assembly of the Golden Ring Council of Senior Citizens Clubs; and a series of expert witnesses testifying before the New York State Assembly's Health Committee. See *The New York Times*, February 27, March 19, and April 12, 1975.

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hospitals which are profit making—there has been a call to place these human services under the exclusive domain of the not-for-profit corporations.\(^4\)

A closer look at current regulation of the financial dealings of not-for-profit corporations suggests, however, that a decision to bar for-profit corporations in the human services would not suffice to eliminate profit-making abuses. The reason is that omissions, ambiguities, and loopholes in the laws and regulations governing not-for-profit corporations presently make it possible for the trustees and staff of not-for-profit corporations to engage in a variety of financial practices which bring them personal profits over and above fees, salaries, and fringe benefits due them for work performed. The practices in question are not those generally termed "fraud," i.e., kickbacks, double billing, charging for services never performed, etc., which are clearly illegal whether they are practiced in for-profit or not-for-profit corporations. Rather we refer to forms of profit making which are at odds with the underlying rationale of not-for-profit corporations, not as currently written in existing laws and regulations but as widely held and understood as legitimate expectations by members of society. Examples of these abuses of not-for-profit status constitute the body of this article.

We cannot stress sufficiently that the central thesis of this presentation is not that we have established the frequency with which abuses occur in not-for-profit corporations, a subject which would require monumental investigative efforts, but that we have identified the major types of abuses which occur, and outlined the ways to curb them. Note, though, that the cases of abuse reported below are not hypothetical and the incidents are sufficient in number to lead one to estimate that whatever the frequency of such abuses, they are not so rare or trivial that they can be safely ignored.

**Profit Making in a Not-for-Profit Corporation: A Definition**

What kinds of reforms are needed? To answer this we need first to clarify what constitutes profit making in a not-for-profit corporation and why it is considered illegitimate. The definition we propose draws on the conception of what not-for-profit corporations are expected to be by the public at large and community leaders—i.e., by the normative consensus prevalent in society. In essence, we propose a definition which, if adopted in state and federal statutes would prod not-for-profit corporations to operate according to the public-minded, responsible, and conflict-free interest standards that the society's mores ascribe to and expect of them.\(^5\)

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\(^4\) See, for example, testimony by Albert Shankar, president of the American Federation of Teachers, urging Congress to exclude profit-making day-care centers under legislation to provide new federal support to preschool programs. *The New York Times*, June 6, 1975.

\(^5\) A recent discussion of these mores was highlighted during changes in the tax laws governing foundations. The foundations relied on these mores to argue for their right to tax-exempt status and related privileges. See, for instance, Alan Piper, "Assessment of the Law and Its Effects on Foundations," *Foundations and the Tax Reform Act of 1969* (New York,
The essence of the not-for-profit organizational structure is that the pecuniary interests of the trustees and staff be decoupled from the rises and falls in the output and income of the corporation. This, in turn, allows them to concentrate on the public or client needs, without concern that this will affect their income. A conflict of interest between trustees and staff on the one hand and the public and clients on the other is basically avoided by paying the trustees and staff salaries, wages, or fees not dependent on the client's payments, and by disallowing compensation for ownership and capital investment. This is the reason these corporations have no stockholders and pay no dividends, and their trustees receive only nominal compensation or none at all.

Our central thesis is that existing laws and regulations governing not-for-profit corporations are insufficient to safeguard the underlying legitimate purpose of these corporations. For instance, the HEW guidelines for not-for-profit corporations, elaborated over sixty-five pages, define a not-for-profit corporation as one "which is not organized primarily for profit and which uses all income exceeding costs to maintain, improve, and/or expand its operations." The term "primarily" leaves open the door to profit making (if it is not "primary") and the question, how much is "not primarily"—10, 20, or 40 percent?

That this ambiguity is not a hypothetical one is illustrated in *Anateas Lineal Inc. 1948 v. U.S.* where a federal district court ruled that a commercial pathology laboratory was a not-for-profit corporation for federal tax purposes, because aside from its highly lucrative pathology services to various hospitals, it provided training to high school and medical students.

The New Mexico statute says, "'nonprofit corporation' means a corporation formed for a purpose not involving pecuniary gain to its shareholders or members, paying no dividends or other pecuniary remuneration, directly or indirectly to its shareholders or members as such, and having no capital stock." The Georgia code states "'nonprofit corporation' means a corporation no part of the income or profit of which is distributable to its members, directors or officers." As we see it, the intentions of those who formed the corporation is not a sufficient criterion, as even if their purposes were pure of any profit considerations, later they—or those who succeed them—may change their minds. However, the main difficulty is with the concept of no distribution of income. As the staff is being paid and not working as volunteers, it is necessary to determine

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6 It does not follow that in profit-making corporations, any and all increase in the amount or quality of service is viewed by owners or employees as "loss." To the extent that it increases revenues it may *increase* profit. However, at each point the owners and employees must estimate to what extent such improvement in services is in line with their interests or in conflict. This consideration, in principle, does not exist in not-for-profit corporations.


where their income is a reasonable compensation for work or services rendered, and where it exceeds this level and becomes but a veiled form of profit making. The cited codes do not cover this issue, nor does the often cited IRS code: "no part of the net earnings of which inures to the benefit of any private shareholder or individual."11 The notion of a net as definition of profit, as derived from the difference of expenditures and revenue, is borrowed from profit-making corporations. In a not-for-profit corporation, illicit gains are made by the staff and trustees, we shall see, when expenditures are smaller, equal to, or larger than revenues—i.e., even when there is no "net" at all. Our definition attempts to get at this matter by defining explicitly what distributions are allowed: a not-for-profit corporation will provide to persons associated with it (such as trustees, managers, staff, and employees) no benefits apart from reasonable and customary fees, salaries, and fringe benefits. To put it differently: while the existing definitions cited above are "exclusive" or "negative" in the sense that they characterize what may not be done, ours is "inclusive" or "positive" in the sense that it defines which allotments are proper. Of course the two definitions may be combined.

Barriers to Perception of the Problem

That the statutory language pertaining to not-for-profit corporations has for so long remained imprecise seems to stem in part from the strength of the philanthropic tradition in America and the trust long placed in the unselfish motivations of those associated with not-for-profit corporations. By and large the public and government have been content to allow a large measure of self-regulation to not-for-profit institutions, first because these institutions are typically staffed by members of respected professions who claim allegiance to a service ethic which requires placing the interest of the client above all other considerations, and second, because those who serve on the boards of trustees of not-for-profit institutions are generally among the community's leading citizens. It has been often argued in the past that pressure from professional peers, as well as the respectability assured by a board of directors should be sufficient to curb unethical practices that might develop. As one author put it:

The image of a nonprofit carries with it a halo of probity in a capitalist society; one imagines the gentle administrator of a church-owned nursing home who spends his time in good works for the benefit of his patients, rather than in calculating new ways to beat the government.12

Finally, it is probable that, until recently, when a large infusion of government funds began to rival and then surpass charitable contributions as a major source of support for not-for-profit corporations, there were fewer opportunities to exploit the law's laxities. Now that a high proportion of the income of not-

11 Section 501 (c) (3), 1954 Internal Revenue Service Code.
for-profit corporations, such as voluntary hospitals, "private" colleges, and not-for-profit nursing homes, is derived from taxpayers' funds, the question of proper use of the funds has gained in scope and significance.

In addition, the general tenor of the society seems to be one of growing ethical laxity and weakening of core values, which questions a reliance on the motivation of the staff and the reputation of the trustees, and increases the need for reliance on law, regulation, and enforcement. It is not that these regulatory mechanisms can suffice without ethical backing; but especially in periods in which the ethical base has to be shored up, the fewer temptations that are left by the regulatory mechanism, the less burden the ethical base has to carry.

The incidents or "cases" or actual occurrence of profit making in not-for-profit corporations cited below were not uncovered by us; rather we have culled them from a variety of sources including congressional and state investigatory testimony and staff reports, as well as published and unpublished accounts by others. Our contribution is to bring together the various abuses reported here and there as "cases," analyze them as being of four main types, and suggest ways to deal with them. Although the examples cited come from the health field, we suggest that the underlying issues are the same for all not-for-profit corporations, be they educational, social, charitable, or otherwise.

**Four Avenues for Profit Making in Not-for-Profit Corporations**

**Staff Income Tied to Entrepreneurship Rather than to Work**

In many voluntary hospitals several medical specialists, pathologists, and radiologists in particular receive all or part of their remuneration in the form of a share of their department's gross or net income. A 1959 survey of 2434 American hospitals found that approximately 70 percent of radiologists; 45 percent of pathologists; 49 percent of physicians specializing in EKG, BMR, and related readings; 22 percent of specialists in physical medicine; 19 percent of internists; and 14 percent of anaesthesiologists earned their income exclusively from such a "percentage of the take."

A 1969 study found that 46 percent of pathologists and 60 percent of radiologists practicing at the hospitals surveyed were paid a percentage of their department's income. A 1972 survey, based on a comparable universe of hospitals (N = 1798) found 52 percent of pathologists and 62 percent of radiologists receiving their remuneration in the form of a percentage of departmental income.

For many years, acceptance by a pathologist of a salaried position in a hospital was grounds for expulsion from the College of American Pathologists, although exemptions were allowed for government-run and university hospitals. Fol-

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ollowing a Justice Department suit charging "monopolistic practices," a consent decree was issued in 1967 whereby the College of American Pathologists agreed to delete this rule. Nevertheless, some hospital administrators contend that strong pressure is still exerted informally to maintain percent of revenue as the dominant mode of reimbursement.\(^\text{16}\) As a result, according to one observer, a heart surgeon and medical consultant, a situation has developed where pathologists of equal qualifications will work for $28,000 to $40,000 salaries in university hospitals, while those working in general hospitals under percent-of-revenue schemes can earn $200,000 and more.\(^\text{17}\)

A recent General Accounting Office study of compensation arrangements for pathology and radiology specialists at seventeen hospitals in Washington, D.C., and Missouri found that the nine pathologists with percentage-of-gross arrangements earned an average of $80,000 over annual periods ending between April and December 1972. In contrast, the four pathologists earning salaries averaged $26,000.\(^\text{18}\)

Why do we hold that these arrangements, known in the for-profit corporations as "profit sharing," are incompatible with the basic concept of not-for-profit corporations? Because as long as the income of the staff rises as more services are rendered, the motivation to provide the service may not be the needs of the client or public, but the desire of the provider to increase his or her income. Overutilization tends to result, causing both unnecessary financial burdens on the client and taxpayer, and unnecessary health risks which medical interventions entail.

When the income of the staff is tied to provision of fewer services, the opposite effect—underutilization—may result; i.e., clients will receive less care than they require, which again calls for separating the income of the provider from the needs of the client. Thus, in some not-for-profit Health Maintenance Organizations (HMO's) physicians receive a bonus, above their salary, calculated as a percentage of the organizations' net surplus. The fewer services rendered, the higher the surplus, all other things being equal.\(^\text{19}\)

Writing in the *New England Journal of Medicine*, Dr. Robert W. Geist noted that HMO incentive bonuses are conceptually quite similar to fee-splitting or rebate arrangements between physicians and other providers to whom they may refer patients or from whom they may order services.\(^\text{20}\) The principal difference between such arrangements among providers—which have traditionally been

\(^{16}\) "Now they use the velvet glove approach," Richard M. Loughery, administrator, Washington Medical Center is quoted as saying in *The Washington Post*, November 1, 1972.

\(^{17}\) Dr. John Gillespie, heart surgeon, ibid.


held unethical by the profession and often illegal by government—and HMO incentive bonuses is that the former give physicians a financial reward for prescribing additional services while the latter reward them for withholding services.

The American Medical Association House of Delegates recently adopted a report by its Judicial Council stating, "compensation geared not to the quality of services but to the extent that physicians can keep the medical, surgical or hospitalization rate of a particular group of subscribers below a predetermined level is not in the best interests of the public or the medical profession." \(^\text{21}\) The council warned that this mode of payment "introduces a financial incentive that may interfere with the physician's obligation to place his patient's welfare first. In cases of doubt, deliberate or otherwise, the incentive may tip the scale against the patient's welfare..." \(^\text{22}\)

Nevertheless, the AMA has not taken the position that it considers such arrangements unethical and hence does not prohibit its members from participating in them. Government agencies are very favorable to HMO's because they are said to be more economical than other arrangements. Our point is not to ask here if cost-saving or patient services should take precedence; some balancing of health needs and costs is clearly necessary. Our point is that where the staff has a financial stake in the services rendered or not rendered, this should not be hidden under the umbrella of a not-for-profit corporation. Let the patient choose to be served by a profit-making corporation or in a not-for-profit one; but the patient looking for one free of this form of conflict of interest should not end up being subject to it. It is not a matter of informing people that profit making takes place in not-for-profit corporations, "so they know what they are getting into," an approach which would make them better informed but also leave them without a clear choice; the point is that by keeping the not-for-profit corporations clear of profit, the public's choice will be protected.

Attempts have been made to try to deal with the matter through "disclosure" rather than by regulations. An April 30, 1975, General Accounting Office report to the Congress stated:

In view of concern over high medical costs and the monopoly position of pathologists and radiologists at many hospitals, the public should be informed of methods used to determine patient charges for X-Ray and laboratory services and the extent that specialists can determine their own income. \(^\text{23}\)

The GAO recommends that consideration be given to amending the Social Security Act Amendments to require hospitals to disclose their contractual arrangements with affiliated physicians in order to be eligible for participation in publicly funded programs. \(^\text{24}\) Presently (1) such disclosure is neither required

\(^{21}\) "HMO Bonus Policy Assailed," *American Medical News*, 17, no. 13 (December 9, 1974).

\(^{22}\) Ibid.


\(^{24}\) Ibid., p. 28.
nor commonly practiced, and (2) if introduced would not provide the patients with a clear choice, because then profit making would be practiced both in for-profit and not-for-profit hospitals. It seems to us that limiting profit-sharing schemes to profit-making hospitals and other health service facilities is a more proper solution.

University of Pittsburgh Health Law Professor Nathan Hershey has suggested that perhaps getting a percentage of gross or net income arrangements are a case of "necessary evil" if we are to have the services of specialists who wish to maintain the practitioner's professional autonomy. Exploitative arrangements can, however, be prevented, he argues, by providing the hospital's attorney with a projection of the volume likely to be generated within the various hospital departments and having the attorney set a percentage of return to be not different from what the physicians would have received from a salary plus fringe benefits. If, in addition, there were greater restrictions on the tests or services classified as routine by the hospital's medical staff for all, or some categories, of patients, thereby requiring specific orders from the patient's own physician for performance of many tests and services, an increased potential for control over unnecessary tests and services, which increase specialists' income based on departmental revenue, could be achieved.

As we see it, the idea of the autonomous professional is just as readily upheld by fee-for-service compensation as by gaining a percentage of a department's income. While we agree that fee-for-service can also be abused, and hence would prefer that physicians be salaried, we suggest that its potential for profit-making abuse can be more readily controlled than that of percentage-of-income arrangements for several reasons. First, as a practical matter negotiating reasonable percentage-of-income arrangements is particularly difficult. For one thing, the volume of services a hospital specialty department has may change considerably over time, due to overall growth of the hospital, changes in the population of the area, and many other "irrelevant" reasons. Thus, gradually, a formula that originally provided a reasonable income to the specialists may become more and more lucrative, perhaps even outlandishly so. At this point, it will be quite difficult for the hospital to attempt to negotiate a lower percentage cut for the specialists. Second, it is very difficult to determine when a service is and when it is not "necessary" and hence, we hold that it is best not to generate motivation to oversupply or undersupply a service. This would curb the need to evaluate them. Nor can service initiation be limited to the patient's own physician (often an internist) and not be allowed to a specialist; nor is it reasonable to expect internists to curb their specialized, often more prestigious colleagues.

Regulatory implications

Since, in our view, "profit sharing" as on the part of physicians associated with not-for-profit health facilities is in conflict with the very concept of a "not-for-profit" corporation, we suggest a revision of the law covering not-for-profit corporations to explicitly exclude any form of compensation of the staff other
than salary or fee for service. Physicians like to maintain the legal posture that they are not working for the hospital but are only "using" its facilities. We propose that, though a one time or occasional use (such as that of a consultant) may be deemed use by an outsider, persons who utilize a hospital regularly and continuously, as most physicians do, should be considered staff for the purposes of this regulation and be prohibited from contracting to provide their own (or others') services on a for-profit basis as well as from operating hospital departments as private profit-making concessions.

Self-Dealing

Self-dealing refers to business transactions in which the same persons (or their kin) appear on both sides of the transaction, once as the staff or trustee of a not-for-profit corporation, once as a profit-making provider of goods or service to the other side (the not-for-profit corporation).

In 1972 a number of practices of this sort were reported in Washington, D.C.'s largest not-for-profit hospital, the Washington Medical Center. A member of the administrative staff in charge of data processing had decided that the existing facilities at the hospital for billing, keeping track of patient records, and accounting through the hospital's computer were inadequate. His solution was to hire an outside for-profit firm to furnish these services, and he selected one he had started himself—with the help of a $50,000 deposit from the hospital. The hospital administrator received stock in the new company free of charge; five other top administrators of the hospital bought stock at $1.00 a share. Following public disclosure of these relationships, most of the administrators disposed of their stock. In 1974, however, when the General Accounting Office included the Washington Medical Center in a review of self-dealing transactions in nineteen hospitals, it found that four hospital officials and several relatives of another official owned stock in the same computer firm; a physician employed by the hospital provided consultant services to the firm; and the firm's president was a hospital consultant and a member of the hospital's action committee. The GAO also found that it was not until mid-1973 that the Washington Medical Center requested competitive bids for computer services. According to the hospital administrator the other bids were not comparable with the present firm's services for a number of reasons; thus the hospital decided to continue retaining the firm's services for twelve to eighteen months, during which time a "more specific request for bids would be developed." The GAO report concluded that the overlapping interests of the hospital officers with the firm were likely to continue to give the firm an advantage over potential competitors.

In addition, at this same hospital, the official in charge of managing the in-

26 Comptroller General, Report, pp. 7–9.
27 Ibid.
stitution's finances placed hospital funds in an interest-free account at a bank where he was vice-president. The hospital's account balance is reported to have generally hovered around $1 million, sometimes going as high as $1.8 million; a conservative estimate placed the hospital's annual loss of interest because of this account at $50,000. 28 That hospital staff gained something from these transactions is suggested by the fact that the hospital's administrator admitted this bank had lent him money at a low interest rate. 29

More recently, Medicare officials disclosed that millions of dollars in federal and private funds entrusted to Blue Cross and Blue Shield are being channeled through banks with officers who serve on the boards of trustees of these not-for-profit health organizations. Officials of the Social Security Administration identified eleven accounts out of twenty such Medicare accounts investigated as containing excess balances during the first quarter of 1975, indicating that the banks had federal money to invest beyond that needed to pay each bank for its checking account service. The excess balances ranged from $8,597 to $163,717. 30

According to a 1971 New York State Health Department working paper, "self-dealing" transactions, of the type apparently practiced at the Washington, D.C., not-for-profit hospital and by some Blue Cross and Blue Shield officials, are a growing trend. In particular, doctors, administrators, or trustees of not-for-profit health facilities are increasingly setting up their own for-profit corporations, ranging from physician provider groups, laboratory service, food service, and linen and laundry service to equipment leasing, housekeeping and maintenance, rehabilitation therapy, and health personnel service. 31 In addition, doctors frequently own pharmacies (thus giving them an incentive to overprescribe), a practice that was investigated several years ago by the Senate Monopoly and Anti-Trust Committees, and which the AMA debated but avoiding condemning. 32

The results of a recent California Auditor General's Office investigation of inexplicably high costs charged to Medicaid by a number of not-for-profit prepaid health plans can serve as a warning signal. In eight of thirteen not-for-profit prepaid health plans reviewed, officers or directors were found to have formed profit-making partnerships or associations which sold various supplies to the not-for-profit prepaid health plan, thereby enabling these individuals to make personal profits from what was ostensibly a not-for-profit operation. The report went on to note that the complex administrative structure created by these interlocking firms made it difficult for the state to determine what percentage of its payments actually went for patient services and what

29 Ibid., October 30, 1972.
32 Modern Hospital, 117 (March 1969), 86, 160.
percentage went into executive salaries and other components of administrative overhead.\textsuperscript{33}

In California, the practice of self-dealing has recently come into question in connection with the new wave of Health Maintenance Organizations. Currently most HMO's are not-for-profit corporations. There are at present, however, few legal obstacles barring not-for-profit HMO's from becoming chiefly shells for a myriad of for-profit corporations. According to California Assemblyman John T. Knox, "The notion that prepaid health plans are operated by non-profit corporations is nothing but fiction, a fiction that has worked directly contrary to the original goal of the prepaid health plan as a means of reducing the cost of health-care delivery."\textsuperscript{34} In testimony before the Senate Permanent Investigations Subcommittee, Dr. Lester Breslow, dean of the School of Public Health at the University of California at Los Angeles and former health director of the state, said that many Health Maintenance Organizations, though ostensibly not for profit, siphoned most of their state and federal funds into subsidiary profit-making corporations.\textsuperscript{35} Dr. Bruce R. Frome testified concerning California's second largest prepaid health plan, Marvin Health Services, Inc., which he had helped to found. He acknowledged that most of the state and federal money received by the not-for-profit Marvin Health Services was turned over to a profit-making subsidiary called American Health Maintenance Organization, Inc., which was owned by doctors and other health professionals associated with Marvin Health Services. Marvin Health Services, located in the Watts section of Los Angeles, had received $7 million, of which $4.2 million went to administrative costs and profits.\textsuperscript{36}

The most comprehensive study of "self-dealing" in not-for-profit health facilities to date is a General Accounting Office survey of "overlapping business interests" of key hospital employees and members of hospital governing and advisory boards. Nineteen hospitals were studied: five not-for-profit and one profit-making hospital in the Washington, D.C., metropolitan area and thirteen not-for-profit hospitals in the cities or metropolitan areas of Kansas City, St. Louis, and Springfield, Mo. At the Missouri hospitals, only overlapping interests involving governing or advisory board members, not those involving employees, were investigated. At seventeen of the nineteen hospitals "overlapping interests" were found.\textsuperscript{37} Of these,

\textsuperscript{33} Testimony from California Auditor General's office represented by Gerald Hawes and Robert Christophel before the United States Senate Special Committee on Aging concerning "Medicaid—Home Health Care Regulations" (Washington, D.C., October 29, 1975), pp. 9–10.
\textsuperscript{34} Medical Care Review, 32, no. 4 (April 1975), 373–374.
\textsuperscript{35} Ibid.
\textsuperscript{36} Ibid.
\textsuperscript{37} Comptroller General, Report, p. 3.
firm serving the hospital. Board members at 3 hospitals had associations with insurance companies; 14 hospitals had board members associated with various other firms doing business with the hospital.\textsuperscript{38}

At one St. Louis not-for-profit hospital, ten of the fifteen board members had overlapping interests with twelve different companies, primarily banks in which the hospital had accounts or which managed its pension funds or investments. In addition, however, the hospital did \$934,000 worth of business in 1972 with utilities, conglomerates, or manufacturing firms with which its trustees were associated.\textsuperscript{39} Again, noting the unfair competitive advantage that could result from "overlapping interests" between board members or staff and firms doing business with a hospital, the GAO recommended public disclosure of all such relationships.

\textit{Regulatory implications}

In total, it seems that to avoid conflict of interest between the staff and trustees on the one hand and the client and public on the other hand, it is necessary to deal not only with transactions within the not-for-profit corporation but also with dealings between it and other corporations. Thus we suggest that business transactions between an institution where an individual is a staff member or official and a company in which he or she has a financial interest should be disallowed.

At present, most statutes regarding not-for-profit corporations either contain no provisions regulating self-dealing or rather permissive ones. For example, section 715 of the New York Not-for-Profit Corporation Law is nearly identical to New York business corporation law in providing that:

No contract or other transaction between a corporation and one or more of its directors or officers, or between a corporation and any other corporation, firm, association, or other entity in which one or more of its directors or officers are directors or officers, or have a substantial financial interest, shall be either void or voidable for this reason alone or by reason alone that such director or directors or officer or officers are present at the meeting of the board, or of a committee thereof, which authorizes such contract or transaction, or that his or their votes are counted for such purpose.

The director or officer is, however, expected to disclose his interest in good faith to the full board which then takes a vote (not including the interested director) to decide whether or not to authorize the transaction. If there was no such disclosure or the vote of the interested party was necessary to authorize the transaction when the vote was taken, then

the corporation may avoid the contract or transaction unless the party or parties thereto shall establish affirmatively that the contract or transaction was fair and

\textsuperscript{38} Ibid., p. 7.

\textsuperscript{39} Ibid., pp. 13–14.
reasonable as to the corporation at the time it was authorized by the board, a committee, or the members.

A notable exception is Section 4941(d) of the 1954 Internal Revenue Code which sets forth a set of limits and levies a special tax on self-dealers in the context of foundations. Prohibited acts of self-dealing are defined as follows:

(1) In General.—For purposes of this section, the term “self-dealing” means any direct or indirect (A) sale or exchange, or leasing, of property between a private foundation and a disqualified person; (B) lending of money or the extension of credit between a private foundation and a disqualified person; (C) furnishing of goods, services, or facilities between a private foundation and a disqualified person; (D) payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person; (E) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation; . . .

We hold that the same prohibitions should be applied to all not-for-profit corporations. It might be asked if a trustee who owns a few shares of Johnson and Johnson, Ford Motor, and Procter and Gamble would be disqualified from serving on a hospital board if the hospital buys paper towels, a car, and soap from the respective companies. One may say that such purchases by the hospital are so small compared to the total volume of transactions of the said corporations that trustees could not expect any benefits to accrue to them because the hospital buys from “their” corporations rather than other ones and hence view that such ownership is not a violation. However, the courts may have been too lax when they allowed self-dealing when the director had up to 10 percent (or even more) interest in the other corporation.40

The argument that unless one allows trustees not to divest themselves of ownership and management roles in related business there will be an insufficient number of trustees outweighing the danger of some self-dealing, is doubly mistaken. First, it overestimates that role of the trustees. They no longer are a main source of “raising funds” for private hospitals, colleges, etc., which rely heavily on public funds (Medicare, Medicaid) and insurance (Blue Cross). Second, the trustees need not be businessmen and can be community leaders, union representatives, and others with little business investment.41

Another legal means for curbing self-dealing transactions in not-for-profit institutions is by holding trustees accountable on the basis of their fiduciary obligation to the institution. Directors and officers of not-for-profit corporations are considered as having duties vis-à-vis the corporation encompassing good faith, loyalty, and the exercise of sound business judgment, as well as the responsibility to use corporate assets in a manner consistent with the purposes set forth in the corporation charter. A recent court decision suggests that these fiduciary duties can serve to provide a legal foundation for penalizing, or at

41 Ibid. at 36.
least censuring, trustees who engage in or allow self-dealing transactions. In July 1974, U. S. District Judge Gerhard A. Gesell ruled that five trustees of Sibley Hospital had failed to supervise properly the not-for-profit hospital’s funds and investments over several years. While Judge Gesell did not characterize the acts of the trustees as conspiracy or illegal use of the funds for their own benefit, he did rule that they had breached their fiduciary duty to exercise proper supervision. Although not taking any action against the trustees (who were also members of the boards of the banking and financial institutions handling the hospital’s funds), Judge Gesell outlined specific steps to be taken in the future by the hospital and its trustees on a regular basis, including full listing to the boards of directors of the hospital’s dealings with any institution. In addition Judge Gesell recommended that the hospital restrict board membership to representatives of financial institutions that have no substantial business relationship with the hospital.

This suggests that (1) the concept of good faith does imply proper curbs on the trustees, but (2) it is too vague to provide a sufficient guideline to either trustees or courts, and hence (3) additional, more specific curbs are necessary—ones which explicitly rule out self-dealing.

In addition, we hold that while public competitive biddings are not a cure-all, because such biddings have been known to be rigged and there are occasions when they are not practical, this procedure does offer fewer opportunities for abuse than do sole service contracts. It would seem that in exchange for the privileges which their special tax status bestows on the not-for-profit corporations, they should be required to make their purchases through competitive bidders except when this is not practical (e.g., when there is only one supplier within an extensive geographical radius).

Such a “rule” has been on the books of New York City since 1909. Rule 9 of the Terms and Conditions Governing Payments to Charitable Institutions states that no member of a hospital board can be a member of a company that is paid for providing services or merchandise to these institutions. The rule, though, is not on the books elsewhere and the mechanisms for its implementation are not clear. Thus when the New York City comptroller asked the trustees of New York City hospitals to disclose any such affiliations, most failed to respond, leaving on him the onus of making the case. We would add, then, the requirement that persons accepting a public office, such as that of trustees or director of a not-for-profit corporation, should be required to disclose all such affiliations and how they dispose of them.

In addition, the lack of enforcement of Rule 9 was attributed to the fact that the city felt that it could not cut off the funds to the hospitals because some trustees violated a rule. We suggest that the penalty for violation of such rules

43 Ibid.
45 Ibid.
should be exacted from the individual trustee, not from the not-for-profit corporation; also, that the penalties will have to be sufficiently large to more than outweigh the benefits which accrue to violators. The antitrust law notion of triple damages may apply here.

In sum, we recommend that (1) persons having potential “conflicts of interest” be required to sever the relationship in question before being permitted to serve on the board or as an official or staff member of a not-for-profit entity; (2) penalties be exacted from any member or trustee of a not-for-profit institution engaged in any such conflict of interest transactions; (3) in order to prevent exploitation of the authority to award contracts on the part of the not-for-profit entity’s officials—in particular, favoritism toward friends and relatives—the law should require competitive bidding for all business transactions over a given size, unless special circumstances can be demonstrated to the regulatory agencies before the transaction.

Real Estate Transactions

The sale or lease of land or facilities to a not-for-profit corporation by an officer or staff member offers a number of profit-making opportunities, which differ from the self-dealing reported above chiefly in the magnitude of the abuse and in the form of the transaction. Since some areas, especially nursing homes, are believed to account for a major proportion of all the damage done, they deserve separate attention and treatment. Instead of profiting from purchases of goods or services from a corporation in which the officer has an interest, here real estate manipulations make it possible to reap profits from the property the officer owns (or once owned) and which is now used by the not-for-profit corporation. One way is for the owner of a property (land, building, nursing home, or hospital) to set up a not-for-profit corporation of which relatives, friends, or long-standing business associates—and often the owner himself—become the trustees. The not-for-profit corporation then buys or leases the properties from the owner at highly inflated prices much above the market terms of purchase.

A 1970 Senate Finance Committee report pointed to the profit-motivated conversion from proprietary to “not-for-profit” ownership as a growing problem. One instance among several that the report cited involved a 160 bed hospital that had been operating for eighteen months. It had been set up as a proprietary hospital for investment purposes by the hospital administrator and a group of businessmen who then converted it to a not-for-profit institution. Purportedly, the not-for-profit organization taking over the hospital was set up by three disinterested citizens concerned with the welfare of the community. The owners furnished the not-for-profit group with an appraisal of the hospital’s worth to be $5 million (although the Internal Revenue Service later contended in litigation that the hospital had a fair market value of $2.9 million), and this was the price paid. The sales agreement provided for the continued employment of the pro-
proprietary hospital administrator, and since his share of the purchase price as a former stockholder was to be paid out of future hospital earnings, he was also accorded a great deal of autonomy in controlling operations. After the sale was consummated two other former stockholders became members of the board of directors.

Mary Adelaide Mendelson has described the conversion from "for-profit" to "not-for-profit" status of a Cleveland nursing home. In 1971 the owner of this nursing home sold it to a not-for-profit organization, a Baptist church, which was to expand it to encompass a family training, day care, and health services center. The church became responsible for the former owner's debts, plus its own mortgage with a bank and a second mortgage with the former owner. Thus,

The nursing home, which had been built with little or no down payment, and was purchased with no down payment at all, now served as collateral for debts totalling $2,695,000. The mortgage obligations had doubled, and the home now enjoyed the advantages of nonprofit status. As for [the owner] he had turned a debt of $1.1 million owed by him into a debt of $1 million owed to him.

Mendelson went on to note that because the home's mortgage would require, for the next twenty years, monthly payments of $22,000 while the Medicaid reimbursement rates for most of the patients' care was fixed, the only way that the payments could be met was to cut the cost of care. The result, state inspectors' reports indicate, was poor quality care. Staff was cut and the following year the State Medical Review Team noted the effects of the staffing shortage: poorly groomed patients, dehydrated patients, and a pervasive odor of urine. Subsequently, state personnel had to be sent in to investigate why fifteen patients, an abnormally high number, had died in the home in a single month.

Leasing arrangements can be another source of profit. Recently, a well-known dealer in nursing home construction attempted to have a small liberal arts college, of which he was chairman, buy from him four nursing homes which he owned, and then lease them back to him. The motive seemed to be a desire to boost artificially the value of the real estate in order to increase the reimbursement for rent that he would be entitled to receive under Medicaid.

Another example entails a husband and wife team in White Plains, N.Y., who constructed a sixty-six bed nursing home under the ownership of a real estate company of which they were the sole stockholders. The home's construction cost was approximately $779,800 of which $700,000 had been financed by an FHA guaranteed mortgage. Shortly before the home opened, the owner entered into a lease agreement with his real estate company—that is, with himself—to

47 Mendelson, Tender Loving Greed, p. 200. For an example of circumventing a law which limits kidney dialysis centers to not-for-profit corporations in New York City, see Barron's, October 20, 1975.
48 Mendelson, Tender Loving Greed, p. 201.
lease the facility and run it as a proprietary home. A few years later, he converted the home into a not-for-profit corporation. He then applied to the state for permission to sell his leasehold to the newly organized not-for-profit corporation of which he and his wife were members of the board of directors. Although at first state officials were apparently reluctant to approve the transaction, they eventually granted the home not-for-profit status. Next, the owners arranged for the not-for-profit corporation to lease five-year-old equipment, estimated to be worth $198,000, at an annual cost of $24,000 over a fifteen year period—$360,000 all told. Thus at the end of the lease term, the real estate company was expected to have realized a profit of $195,000 and still own the property free and clear. The not-for-profit corporation would then be permitted to exercise an option to buy the property, which had originally cost $780,000, for $900,000.

The total profit to the [owners] would then be $1,095,000—not bad at all, considering that the most the [owners] themselves would have put up, with the FHA-insured mortgage, is $80,000. Payments on the mortgage for $700,000 which provided the balance of the original cost, would have been covered by the payments under the lease. That, of course, is in addition to their profit on the equipment. The term "non-profit" clearly does not include the [owners'] share of the deal.\(^{50}\)

An analysis by a state health department official showed that the money needed to meet these lease payments was slated to come out of patient care; specifically, the home's projected operating budget indicated a major portion would be provided by skimping on patients' meals. Indeed, a 1970 state audit later revealed that 24 percent of this not-for-profit home's expenditures went into the pockets of its owner-operator-trustees.\(^{51}\)

**Regulatory implications**

Here the correctives are basically the same as those suggested above for self-dealing: no transactions should be allowed between owners and their relatives and the officers of a not-for-profit corporation when these persons are one and the same or related.

Legal provisions should be adopted similar to those regulating the relationship between persons donating funds to establish a foundation and the foundation which results. Thus, former owners and their relatives should not be permitted to serve on the board of trustees of the newly created not-for-profit institution.

In the case of providers of health services such as nursing homes and hospitals, it is also necessary to rewrite substantially the regulations covering reimbursement rates for Medicaid in those states where provisions for reimbursement increases presently in effect encourage frequent sales and changes in

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\(^{50}\) Mendelson, *Tender Loving Greed*, p. 205.

\(^{51}\) Ibid.
leasing arrangements as well as concealment of personal relationships among the parties involved in these transactions. The New York Temporary State Commission on Living Costs and the Economy recommended, and the New York State Legislature enacted into law, a bill specifying that the Medicaid reimbursement formula no longer be tied to changes in ownership or lease. Though this change was made primarily to combat real estate manipulations of for-profit homes, the reform is also likely to discourage the profit-motivated conversion of nursing homes from "for-profit" to "not-for-profit."

Finally, we note that some state statutes (e.g., California, Georgia) permit under certain circumstances what amounts to the conversion of not-for-profit properties to for-profit status. This is accomplished by allowing individuals associated with a not-for-profit corporation to pocket a share of its assets upon the corporation's dissolution. Thus, the California statute reads:

A nonprofit corporation may be formed by three or more persons for any lawful purposes which do not contemplate the distribution of gains, profits or dividends to the members thereof. ... Carrying on a business at a profit as an incident to the main purposes of the corporation and the distribution of assets to members on dissolution are not forbidden to nonprofit corporations but no corporation formed or existing under this part shall distribute to any of its members except upon dissolution or winding up.

To prevent the possibility of persons creating not-for-profit corporations in order to claim their assets upon dissolution, such statutes should be altered to require (as some federal and state statutes already do) that the assets of a dissolved not-for-profit corporation be donated to another not-for-profit institution or organization, and not distributed to the members.

Unreasonable and Uncustomary Fees, Salaries, and Fringe Benefits

The easiest way to violate the essence of a corporation's not-for-profit status is to provide its staff or officers with unreasonable and uncustomarily high fees, salaries, or fringe benefits. In principle, income is not a violation of the not-for-profit concept, and as it is rather difficult to establish what is proper and what is exaggerated compensation, this area is rather difficult to regulate. Thus, attention must focus on those situations in which the income provided is manifest.

One such example is a hospital paying for the poetry and drama lessons of the physicians' children. No reasonable person would define such fringe benefits as typical, common, or legitimate. That a not-for-profit hospital can provide

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such benefits is ironic: this case involves New York City voluntary hospitals that have contracted with the city's municipal hospitals to be paid for providing the municipalities with such services as physician and nursing assistance and laboratory work. These affiliation contracts were entered into by the city because it could not attract the needed qualified personnel for its own hospitals. By paying the voluntaries, however, they are perpetuating the problem, since the voluntaries use the contract money to pay for the education of doctors' children and for poetry and drama lessons, terming these fringe benefits. Thus, the city is paying the voluntaries because it cannot attract good personnel, and the voluntaries use this money to attract the personnel via benefits the city cannot match.

The ambiguities of the law and regulations concerning not-for-profit status of a corporation are illustrated by the trial and appellate decisions in *American Automobile Association v. Bureau of Revenue*.[56] The AAA claimed tax-exempt status as a not-for-profit corporation despite many discounts and other benefits it distributes to its members. The court held that "Profit does not necessarily mean a direct return by way of dividend, interest, capital allocation or salaries. A saving of expense which would otherwise necessarily be incurred is also a profit to the person benefited."[57] However, the New Mexico Court of Appeals rejected this analysis because there were no income or dividends, the corporation was chartered without capital stock, and the corporation's purpose was not profit so that any benefit conferred upon its members was "wholly irrelevant." As we see it, a third position seems worthy of consideration: some benefits to members are not, prima facie, evidence of profit, as of course salary is not. However, unreasonable and uncustomary benefits are, because they are but a different form of what in effect amounts to sharing of profit.

An example of out-of-line salary seems to be provided by a prepaid health plan contractor who employed a physician as plan administrator at an annual salary of $120,000 plus expenses. The contract with the physician read:

Employer recognizes employee is involved in other medically related ventures such as inhalation therapy contracts and other non-medically related business ventures. These ventures shall at all times remain under the strict control and ownership of the employee.[58]

That one can establish what reasonable and customary salaries are is illustrated by court cases which have on a number of occasions disallowed salaries and fringe benefits in part because they failed to satisfy criteria of reasonableness. While the only cases we have come across deal with profit-making corporations, we see no reason why the same procedures may not be applied to not-for-profit ventures. In the case of *Miller Box, Inc. v. U.S.*, a taxpayer (a

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55 Ibid.
57 525 P. at 932.
58 Testimony, Gerald Hawes and Robert Christophel, "Medicaid—Home Health."
59 488 F. 2d 695 (5th Cir. 1974).
corporation owner) sued the Internal Revenue Service to recover an alleged over-collection of taxes. The IRS had disallowed the taxpayer's claim under the section 162 deduction for "a reasonable allowance for salaries or other compensation for personal services actually rendered. . . ."60 The plaintiff had paid his brother more than $1 million plus $24,000 for two years' work as manager of two corporations. As grounds for rejecting this payment as unreasonable the court noted (1) that the brother's immediate prior salary as a farm worker was $200 per week, (2) the corporate work was not complicated, and (3) comparable positions generally paid $50,000 and at most $100,000. The court further stated:

It is the duty of the directors of the corporation . . . to bargain with an employee for "fair and advantageous terms" to obtain the service of such individuals.61

Thus, a standard for reasonable salaries and fringe benefits keyed in part to the nature of the duties involved, in part to salaries in comparable positions, and in part to employee qualifications is not unenforceable.

Regulatory implications

Whenever fees, salaries, and fringe benefits in not-for-profit corporations significantly exceed those in comparable institutions, the not-for-profit status of the corporation is being circumvented. How this practice can be effectively prevented is less clear. However, in those cases where such institutions draw on public funds, the government regulatory apparatus should examine fees, salaries, and fringe benefits as compared to similar institutions, and refuse to certify or recertify for participation in government programs those institutions providing income grossly above the norm.

Guidelines would need to be established for determining when fees, salary levels, and fringe benefits have begun to exceed the reasonable and customary. Flexibility within the limits of reasonableness could be permitted in establishing a range within which differences in qualifications among individuals could be accommodated.

As the experience of private insurers as well as Medicare and Medicaid suggest, determining reasonable and customary charges solely by reference to the particular professional or occupational group in question tends to place the setting of allowable fee or salary levels at the mercy of collective action by a significant segment of the group (which will benefit by high charges). Thus, it would be advisable to compare what members of a profession claim are their reasonable and customary fees or salaries with what is paid to persons of other professions doing work involving similar skills and level of training. Thus, a nursing home administrator with no professional degree or education beyond a high school

60 26 USCA § 162.
61 488 F. 2d at 707.
diploma should not be able to justify earning more than the average hospital administrator by referring to other nursing home administrators. Nor would chiropractors be permitted to charge fees exceeding those received by surgeons.

SHORING UP THE INTEGRITY OF THE NOT-FOR-PROFIT SECTOR

This article points to four types of abuses which violate the underlying concept of the not-for-profit corporation, the source of its legitimacy, and suggested ways these abuses may be curbed. This is not to imply that we are "down on not-for-profits" or that they are "no different" from profit-making proprietaries. On the contrary, we consider them an essential, important part of the three sectors of America: the government, the private sector, and the not-for-profit sector.

Actually, some have argued that the not-for-profit sector, or—as it is often referred to—the voluntary one, is the "best" sector of the three, while others hold that the private sector is more efficient and the government sector more egalitarian.\(^{62}\) This is hardly the place to settle this age-old argument of which sector is "the best," nor is it necessary. Hardly any one questions the fact that America is a pluralistic society, one in which a range of choices is offered precisely by there being services provided by different sectors. At least, since Tocqueville it has been widely recognized that in this pluralistic spectrum, the voluntary, not-for-profit sector is a main source of protection of individual freedom and initiative, of public interest service, of concern for quality of service and quality of life. Undermine the voluntary sector and America's choices are reduced to reliance on the government and the profit makers. There can thus be no question about preserving the integrity, and thus the legitimacy, of the voluntary, not-for-profit sector.\(^*\)

\(^{62}\) For additional discussion see Amitai Etzioni, Social Problems (New York, 1976), chap. 5. For some relevant studies see Richard K. Earner, "Nonprofit vs. profit: What data do you see?: corporate executive" and Richard L. Johnson, "Data show for-profit hospitals don't provide comparable service: consultant," Modern Hospital, 122 (April 1974), 116–118; Sharon Winn, "Analysis of Selected Characteristics of a Matched Sample of Nonprofit and Proprietary Nursing Homes in the State of Washington," Medical Care, 12, no. 3 (March 1974), 221–228; and Fornia, Blue Cross Reports Research Series No. 9 (Chicago, March 1973).

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