

2001

Decision-Makers Without Duties: Defining the Duties of Parent Corporations Acting as Sole Corporate Members in Nonprofit Health Care System

Dana Brakman Reiser

Brooklyn Law School, dana.brakman@brooklaw.edu

Follow this and additional works at: <https://brooklynworks.brooklaw.edu/faculty>

 Part of the [Business Organizations Law Commons](#), [Organizations Law Commons](#), and the [Other Law Commons](#)

Recommended Citation

53 Rutgers Law Review 979 (2001)

This Article is brought to you for free and open access by BrooklynWorks. It has been accepted for inclusion in Faculty Scholarship by an authorized administrator of BrooklynWorks.

DECISION-MAKERS WITHOUT DUTIES: DEFINING THE DUTIES OF PARENT CORPORATIONS ACTING AS SOLE CORPORATE MEMBERS IN NONPROFIT HEALTH CARE SYSTEMS

*Dana Brakman Reiser**

Whereas for-profit corporations have shareholders, nonprofit corporations often have one or more "members," who vote for directors and on other major corporate decisions. Like typical shareholders, members do not owe fiduciary duties toward their corporations. When nonprofit health care corporations join together in systems, as has become increasingly common, they often do so by a transaction in which the new parent nonprofit corporation becomes the sole member of the subsidiary nonprofit corporation. After such a transaction, the parent-acting-as-sole-corporate-member ("PASCМ") holds the power to elect shareholders and make major corporate decisions as sole member, and also generally reserves additional director-type powers to itself. Because the law does not impose fiduciary duties on members, a PASCМ can make decisions for its subsidiary solely in service of the goals and interests of the parent, and without considering the impact of those decisions on the subsidiary or its beneficiaries. This Article first explores the genesis and consequences of the PASCМ structure, and then considers the possibility of regulating PASCМ-subsidary relationships through the imposition of fiduciary duties upon PASCМs. It examines several models for such a fiduciary duty, drawing on standards of fiduciary obligation applied to directors of nonprofit corporations, parents of for-profit, wholly-owned subsidiaries, and controlling shareholders in for-profit corporations with minority shareholders. Ultimately, the Article advocates the establishment of fiduciary duties for PASCМs modeled on the duties that for-profit controlling shareholders owe to minority shareholders.

Anxiety is high in the town of Localsville. Local Hospital ("Local"), a nonprofit community hospital, has been struggling financially. Community leaders are concerned that it may be closed or taken over by a for-profit concern. So, initially they are relieved when

* Assistant Professor of Law, Brooklyn Law School. I am grateful to Victor Brudney, Einer Elhauge, Marion Fremont-Smith, Ernest M. Haddad, Daniel Halperin, Joan Heminway, Daniel Meltzer, and Anne-Marie Slaughter for their helpful comments and suggestions on drafts of this Article.

Local's Board of Directors decides to affiliate with Regional Health Care System ("RHCS"), a nonprofit system including two community hospitals and Regional Hospital, a large academic medical center located in a nearby city. When Local eliminates a significant service or sells a formerly vital facility, however, the community experiences the potential problems of nonprofit affiliation. Formerly, Local's directors safeguarded the mission of the hospital and prioritized the interests of the community, as dictated by their fiduciary duties. After affiliation with RHCS, priorities and duties are less clear.

Under one common structure for affiliation, the parent nonprofit organization (Regional Hospital in the example) becomes the sole corporate member of the new subsidiary (here, Local). In this parent-acting-as-sole-corporate-member ("PASCМ") structure, the PASCМ can control these decisions without a clear, legally defined, fiduciary obligation to its subsidiary. Rather, the PASCМ and its directors may base their decisions on their desire to safeguard the PASCМ's own potentially distinct mission and to protect its particular and potentially competing interests.¹ This Article analyzes this core problem of the PASCМ structure and evaluates three potential solutions, drawing on established standards of fiduciary duty for analogous corporate actors.

Part I will introduce the nonprofit sector and describe the components of nonprofit corporations. It will explain the trend toward consolidation among nonprofit health care corporations, consider the motivations for employing the PASCМ structure, and elaborate on the concerns raised by this model of governance.

Part II will review the concept of fiduciary duty and explore the contours of fiduciary duty as applied in several contexts. These are: (1) the fiduciary duties owed by nonprofit corporate directors and officers, (2) the fiduciary duties owed by a for-profit parent corporation, its directors, or both to a wholly-owned, for-profit subsidiary, and (3) the fiduciary duties imposed upon controlling shareholders toward minority shareholders in for-profit corporations. Each of these conceptions of fiduciary duty will serve as a potential model for the fiduciary duty of a PASCМ.

Part III will analyze the merits of using each of the models outlined in Part II to define the fiduciary duties of PASCМs. First, this Part will consider the not insubstantial analytical difficulties in *ap-*

1. Elements of this story occur in communities throughout the nation as nonprofit health care organizations continue to affiliate with one another into systems. *See, e.g.*, Louis J. Salome, *Suit Aims to Dump Hospitals' Board, Freeze All Assets*, PALM BEACH POST, Sept. 13, 2000, at 3B (describing a community's suit to oppose one local hospital closing a few years after consolidation with another local hospital); John Howard, *Showdown Over A Hospital*, S.F. EXAMINER, Feb. 5, 1995, at C-1 (describing the community conflicts over a proposed hospital affiliation).

plying the fiduciary duty concepts described in Part II to nonprofit PASCMS. Then, Part III will address potential methods for enforcing these duties, if states did change their statutory, regulatory, or decisional law to charge PASCMS with them. Finally, this Part will attempt to address the consequences of applying any of these models of fiduciary duty to PASCMS. Part IV will conclude by advocating that states adopt one of the three models explored in Part II.

I. INTRODUCTION: NONPROFIT CORPORATIONS AND THE GENESIS OF THE PASCMS PROBLEM

A. *The Nonprofit Sector*

The nonprofit sector is an important and influential force in the United States economy.² Nonprofit institutions are particularly dominant in the health care industry, in which expenditures are growing rapidly.³ Almost half of the nation's hospitals are organized as nonprofits, providing fifty-six percent of all hospital beds and accounting for seventy percent of all hospital expenditures.⁴ Nonprofit entities also represent a significant portion of entities and expenditures in clinic care, home health services, and nursing home care.⁵

The term "nonprofit" can be misleading, as a nonprofit organization is not forbidden from earning profits. Rather, it is only "barred from distributing its net earnings, if any, to individuals who exercise control over it, such as members, officers, directors, or trustees."⁶ If a profit is earned, the nonprofit organization must dedicate the funds to providing the benefits or services that it was formed to offer, through reinvestment or service production.⁷ Also, the restriction on

2. See LESTER M. SALAMON, *AMERICA'S NONPROFIT SECTOR: A PRIMER* 77-81 (2d ed. 1999) ("[N]onprofit public-benefit service organizations had expenditures in 1996 of \$460 billion, or almost 6 percent of the country's gross national product and more than 30 percent of total expenditures on services."); *Developments in the Law-Nonprofit Organizations*, 105 HARV. L. REV. 1578, 1581 (1992) [hereinafter *Developments*] (offering estimates of nonprofit assets and revenues in the billions of dollars and concluding that "the nonprofit sector as a whole wields significant economic power"); NATIONAL CENTER FOR NONPROFIT BOARDS, *Ask NCNB: What is the Nonprofit Sector?*, at http://www.ncnb.org/askncnb/know1_2.htm (last visited December 2, 2001) (reporting that the American nonprofit sector includes over one million organizations, which, in turn employ one in fifteen Americans). The nonprofit sector also reportedly is growing. See THE URBAN INSTITUTE CENTER ON NONPROFITS AND PHILANTHROPY, *NUMBER OF NONPROFIT ENTITIES IN THE UNITED STATES (1998)* (finding a 59.1% increase in public charities reporting to the IRS from 1989 to 1997).

3. See SALAMON, *supra* note 2, at 95-99.

4. *Id.*

5. *Id.*

6. Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 838 (1980).

7. *Id.*

distribution of profits does not prevent a nonprofit organization from making expenditures to procure goods or services for fair value.⁸ Hence, a nonprofit may use its earnings to purchase goods and to pay employees for their services, as would a for-profit entity.

Although a nonprofit organization may take the legal form of an unincorporated association, a charitable trust, or a corporation,⁹ most nonprofit organizations opt to incorporate.¹⁰ The corporate form is even more overwhelmingly chosen by large institutional nonprofit organizations, such as nonprofit health care entities. For these nonprofit entities, the benefits of limited liability, lower fiduciary standards, and a flexible system of governance generally outweigh the costs of observing corporate formalities.¹¹ The PASCAM problem, as described in this Article, is an outgrowth of the nonprofit corporate form of organization.¹²

The basic components of a nonprofit corporation are similar to those of a for-profit corporation. For instance, one or more incorporators usually forms a nonprofit corporation. These incorporators draft the organic documents of the corporation, often with the aid of counsel, and deliver these documents to the secretary of state or other appropriate state official for filing.¹³ The submitted documents generally include the articles of incorporation, the proper filing of which begins the existence of a nonprofit corporation.¹⁴ The articles of incorporation contain a statement of the purposes for which the nonprofit corporation is formed.¹⁵ In addition, a nonprofit corporation

8. *Id.*

9. Harry G. Henn & Michael George Pfeiffer, *Nonprofit Groups: Factors Influencing Choice of Form*, 11 WAKE FOREST L. REV. 181, 181-82 (1975) (reviewing the consequences of choosing each of these three legal forms available for nonprofit entities).

10. JAMES J. FISHMAN & STEPHEN SCHWARZ, *NONPROFIT ORGANIZATIONS* 61-63 (2d ed. 2000). A nonprofit organization may incorporate under a specific nonprofit corporation statute, or, in those states that have no such specialized law, under a general corporation statute. Compare, e.g., MASS. GEN. LAWS ch. 180, § 8A (Law. Co-op. 1996) (regulating charitable corporations in particular) with, e.g., DEL. CODE ANN. tit. 8, § 141(j) (1991) (regulating nonstock corporations under the general corporation law). Unlike for-profit corporations, most nonprofit corporations incorporate in their home states. FISHMAN & SCHWARZ, *supra*, at 65.

11. FISHMAN & SCHWARZ, *supra* note 10, at 61-63; Henn & Pfeiffer, *supra* note 9, at 215-17.

12. Therefore, future references to nonprofit organizations will relate to nonprofit corporations, unless otherwise specified.

13. E.g., REVISED MODEL NONPROFIT CORPORATION ACT § 2.01 (1987) [hereinafter RMNCA]. In the interest of clarity, the balance of this Article will use terms established in the RMNCA and will point to the RMNCA's provisions as exemplary. Significant variation among state laws will be noted where relevant.

14. E.g., *id.* § 2.01-3.

15. E.g., *id.* § 2.02(b)(1); see also MARILYN PHELAN, 1 NONPROFIT ENTERPRISES. § 2:04, at 8 (1992). If the corporation will seek exemption from federal income taxation,

also has bylaws that deal with the "regulat[ion] and manag[ement] of the affairs of the corporation" in greater detail.¹⁶ The content of these bylaws, however, is constrained by the relevant state corporation statute and the corporation's articles of incorporation.¹⁷

A nonprofit corporation is managed under the direction of its board of directors.¹⁸ Nonprofit directors are universally vested with fiduciary duties, although these duties often differ slightly in their substance.¹⁹ Moreover, state nonprofit corporation statutes vary in the extent to which they define the duties of directors. Some states specifically define directors' fiduciary duties in statutes, while others define these duties only in decisional law interpreting their nonprofit and general corporation statutes.²⁰

As was explained above, nonprofit corporations are prohibited from distributing profits. Therefore, it follows that they characteristically do not have shareholders.²¹ Instead, some nonprofit corporations have one or more members. These members vote for directors and on other major corporate decisions,²² as would shareholders of a for-profit corporation. Others simply have no analogous group; in this case, directors perform virtually all governance duties and boards of directors are self-perpetuating.²³

Just as fiduciary duties are not ordinarily imposed upon shareholders of a for-profit corporation,²⁴ members of a nonprofit corporation are not bound by fiduciary obligations toward the corporation of which they are members.²⁵ In most situations, it is inappropriate to impose a fiduciary duty upon shareholders in a for-profit corporation; the shareholders simply lend their capital to the enterprise and have no responsibility for the management of the corporation.²⁶ A lack of

it must be "organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition . . . , or for the prevention of cruelty to children or animals." 26 U.S.C. § 501(c)(3).

16. *E.g.*, RMNCA § 2.06.

17. *E.g.*, *id.*

18. *E.g.*, *id.* § 8.01.

19. *See* PHELAN, *supra* note 15, §§ 4:02-09.

20. *Id.* § 1:11, at 34.

21. A few nonprofit corporation statutes do permit nonprofit corporations to issue capital stock, or have done so historically. *See, e.g.*, MASS. GEN. LAWS ch. 180, § 1.

22. *E.g.*, RMNCA §§ 8.04, 10.21(a)(2), 11.03(b)(2). Many modern nonprofit corporation laws do not require nonprofit corporations to have members at all. *E.g.*, *id.* § 6.03.

23. *E.g.*, *id.* §§ 6.03, 10.02(b), 11.03(b), 12.02(c); MASS. GEN. LAWS ch. 180, § 3. The PASCAM structure explored here arises only in nonprofit corporations with members.

24. One significant exception to this general rule, fiduciary duties imposed on controlling shareholders, will be discussed later. *See infra* Part II.C.2.

25. *See generally* FISHMAN & SCHWARZ, *supra* note 10, at 152-85.

26. *See generally* ROBERT C. CLARK, CORPORATE LAW § 3.1 (1986) [hereinafter

duty also makes sense in a so-called "mutual benefit" nonprofit corporation, like a country club or a neighborhood association.²⁷ Mutual benefit nonprofit corporations are formed to serve narrower interests than typical charitable or "public benefit" nonprofit corporations. Members in these types of nonprofits have a personal interest in the corporation, analogous to the proprietary interest that shareholders possess. Typically, shareholders in for-profit corporations and members in mutual benefit nonprofit corporations are not regularly called upon to make operational decisions on behalf of the corporation – this is the province of the directors.²⁸ Yet, when for-profit shareholders or members in mutual benefit nonprofit corporations do exercise decision-making power, provided that voting is fair, all interested parties can give their input.

Members in public benefit nonprofit corporations serve a slightly different function. They guard the mission of the corporation and represent its beneficiaries.²⁹ It would be difficult to identify this community of beneficiaries in its entirety and it would be unwieldy to rely upon them for decision-making. Instead, members are individuals who are committed to the corporation's mission selected to act as proxies for the community of beneficiaries the corporation is intended to serve. When these members make decisions by voting, the various community interests can be represented and communicated.

The PASC structure is a specialized use of this member vehicle, but it removes the concept of members as a proxy for beneficiaries or the wider community. In a PASC structure, the "parent" nonprofit corporation is the one and only member of the "subsidiary" nonprofit corporation.³⁰ This structure allows two nonprofit health care corporations to be linked or combined, and thus the PASC

CLARK, CORPORATE LAW].

27. The RMNCA divides the category of nonprofit corporations into three types: religious corporations, public benefit corporations, and mutual benefit corporations. RMNCA §§ 2.02(a)(2), 17.07. Portions of the federal tax code engage in an even further breakdown. 26 U.S.C. §§ 170, 501, 509 (1994). Hospitals and other health care providers generally fall within the public benefit corporation category; these entities also fall within the definitions of charities or public charities under state corporate and federal tax law. RMNCA § 1.40(28) (for definition of public benefit corporations); 26 U.S.C. § 170(b)(1)(A), 509(a)(1) (for description of medical and hospital organizations that will be deemed public charities rather than private foundations).

28. See CLARK, CORPORATE LAW, *supra* note 26, § 3.1.

29. See Elizabeth A. Moody, *The Who, What, and How of the Revised Model Nonprofit Corporation Act*, 16 N. KY. L. REV. 251, 270 (1988) (explaining that nonprofit corporate members tend to "relate to the organization by participation rather than by the financial interest generated by an investment").

30. This role for members is not yet universally appreciated. See, e.g., PHELAN, *supra* note 15 § 4:01, at 1-2 & n.1 (noting that controlling shareholders of for-profit corporations are subject to fiduciary duties, but stating that "nonprofit corporations would not normally have a separate class of 'controlling' members").

structure frequently has been used in response to the trend toward affiliation in nonprofit health care.

B. *The Affiliation Trend*

The story of hospital affiliations and mergers is a common one in localities across the country, as the health care field has undergone tremendous consolidation in the past decade.³¹ Although more ink has been spilled on the issue of for-profit mergers and acquisitions of nonprofit health care institutions by for-profit entities, nonprofits also have affiliated in large numbers.³² The trend toward affiliation among nonprofit health care corporations can be explained in part by the typical economic motivations for consolidation in any industry: the desire to capture economies of scale by eliminating duplicative services and consolidating overhead costs.³³ Affiliations also can bring benefits to the patients and communities served by nonprofit hospitals, by increasing the quality of care and by improving access.³⁴

Special circumstances in the health care field have pushed the affiliation trend further than these ordinary economic factors alone might dictate. As is true in the health care sector generally, the behavior of the federal government, the nation's largest health services payor, has greatly influenced this trend. During the late 1980s, changes to the reimbursement methods under Medicare, Medicaid and other public health care programs drastically decreased payments to hospitals, particularly teaching hospitals.³⁵ This reduction

31. Simon Francis & Ernest Plock, *Health and Medical Services, in U.S. INDUSTRY & TRADE OUTLOOK* 2000 43-1, 43-2 (2000); BARRY FURROW, ET AL., *HEALTH LAW* § 5-48 (2d ed. 2000) (explaining various types of alliances between health-related organizations).

32. 1 HEALTH CARE CORPORATE LAW: FACILITIES AND TRANSACTIONS §§ 4.6.3, 5.1 (Mark A. Hall & William S. Brewbaker III eds., 1999) [hereinafter HALL & BREWBAKER, FACILITIES & TRANSACTIONS] (reporting that of all hospitals participating in multi-hospital systems in 1992, almost 50 percent were nonprofit organizations).

There are some indications that we may be at the end of, or at least at a break in, the rush to affiliation. For example, some of the most well-known affiliations of the 1990s recently have broken down. See, e.g., J. Duncan Moore Jr., *System Divorces on Rise: Unscrambling Deals Is Messy and Contentious*, MOD. HEALTHCARE, May 29, 2000, at 24 [hereinafter Moore, *Unscrambling Deals*] (describing the breakup of UCSF-Stanford Health System, Penn State Geisinger Health System, and others).

33. HALL & BREWBAKER, FACILITIES & TRANSACTIONS, *supra* note 32, § 4.5; Stuart M. Lockman & Tracy E. Silverman, *Formation of Hybrid-Type Organizations: Virtual Mergers of Health Care Systems*, 72 FLA. BAR J. 14, 14 (1998).

34. HALL & BREWBAKER, FACILITIES & TRANSACTIONS, *supra* note 32, § 4.6.3; Lockman & Silverman, *supra* note 33, at 14.

35. HALL & BREWBAKER, FACILITIES & TRANSACTIONS, *supra* note 32, § 4.2.1; Arnold S. Relman, *The Crisis of Medical Training in America: Why Johnny Can't Operate*, THE NEW REPUBLIC, Oct. 2, 2000, at 37 (describing these cutbacks in payments and the resulting reduction in clinical education programs at teaching hospitals).

in payments substantially weakened the financial position of many nonprofit health care providers, making the potential economic gains of affiliation more attractive, if not a necessity.

The advent of managed care health insurance, and its virtual replacement of indemnity health insurance, also has spurred the growth of hospital affiliations.³⁶ Indemnity health insurance was the norm before the rise of managed care.³⁷ In indemnity health insurance, patients allocate health care payment dollars by choosing their providers based on perceptions of quality; the insurers then make payments to these patient-selected providers.³⁸ In managed care health insurance, the managed care organization ("MCO") contracts with providers to provide care at negotiated rates to subscribers.³⁹ The MCO controls providers' access to subscribers by negotiating coverage contracts with the subscribers' employers. The MCO also controls providers by allocating health care payment dollars among them.⁴⁰ Further, employers rather than patients are the consumers to whom MCOs market their health care plans; employers see cost distinctions much more clearly than distinctions in the quality of care.⁴¹ Today, a majority of the nation's health insurance is some form of managed care.⁴² In this context, it is vital for health care providers to obtain contracts with managed care organizations, and for these contracts to designate favorable payment rates.

In contract negotiations with MCOs, affiliation offers the advan-

36. 4 HEALTH CARE CORPORATE LAW: MANAGED CARE § 5.2 (Mark A. Hall & William S. Brewbaker III eds., 1999) [hereinafter HALL & BREWBAKER, MANAGED CARE]; Mark A. Hall, *Managed Competition and Integrated Health Care Delivery Systems*, 29 WAKE FOREST L. REV. 1, 4-5 (1994) [hereinafter Hall, *Managed Competition*].

37. See John R. Gabel et al., *Withering on the Vine: The Decline of Indemnity Health Insurance*, 19 HEALTH AFFAIRS 152, 152 (2000) (reporting that indemnity insurance coverage in the United States declined from 95% of health insurance in 1978 to 71% in 1988, and then further declined to 14% of health insurance in 1998).

38. HALL & BREWBAKER, MANAGED CARE, *supra* note 36, § 5.2.

39. *Id.*

40. *Id.*

41. *Id.*

42. Various sources peg the numbers differently, but all agree that the number of individuals with health insurance including some managed care component has swelled to over fifty percent of all insureds. *E.g.*, KAISER FAM. FOUND. & HEALTH RES. & EDUC. TRUST, *Employer Health Benefits 2000 Annual Survey*, (2000), at <http://www.kff.org/content/2000/20000907a/EHBreport.pdf> (last visited November 2, 2001) (reporting that only 8% of employer-sponsored health plans were conventional, 29% were health maintenance organizations, 41% were preferred provider organizations, 22% were point-of-service plans); Dan Froomkin, *Backlash Builds Over Managed Care*, WASH. POST, at <http://www.washingtonpost.com/wp-srv/health/policy/managedcare/overview.htm> (last updated Feb. 23, 1999) (providing that in 1996 "about 60 percent of Americans were enrolled in some sort of managed care health plan").

tage of size.⁴³ Large systems of nonprofit provider entities can leverage their market position to obtain better rates and other advantageous contract terms than an individual hospital would be able to negotiate alone.⁴⁴ Hoping to further increase this competitive advantage, many hospitals have joined together not only with other hospitals of various types but also with physician groups.⁴⁵ The final step toward capturing the gains of managed care is realized if an insurer entity is included within the health care system.⁴⁶ By employing some or all of these affiliating mechanisms, nonprofit hospitals enhance their ability to compete in today's managed health care industry.

The final impetus to nonprofit affiliation is the backlash against the recent spate of for-profit conversions. Communities faced with the possible acquisition of a nonprofit health care institution by a for-profit company may look to nonprofit affiliations to save their institutions from a perceived for-profit menace.⁴⁷ Whether the fear of for-profit conversion is warranted is a topic upon which there is great debate.⁴⁸ Regardless of whether this fear is appropriate, there is a

43. HALL & BREWBAKER, FACILITIES & TRANSACTIONS, *supra* note 32 § 4.5, at 4-57 to 4-58; Hall, *Managed Competition*, *supra* note 36, at 4-5; Lockman & Silverman, *supra* note 33, at 14; U.S. GEN. ACCT. OFF., ISS. NO. GAO-HEHS-98-24, NOT-FOR-PROFIT HOSPITALS: CONVERSION ISSUES PROMPT INCREASED STATE OVERSIGHT (Jan. 5, 1997), available at <http://www.gao.gov> (noting that not-for-profit hospitals must "build networks" to be competitive).

44. Hall, *Managed Competition*, *supra* note 36, at 4-5.

45. See *id.* at 4-7 (writing at the height of this trend that, "[a]ccording to one survey, over one-third of surveyed hospitals have purchased physician practices recently, and an additional forty percent plan to do so"). The acquisition of physician groups can improve the market position of a health care system by encouraging the acquired physicians to send their patients to the affiliated hospital(s), potentially increasing hospital occupancy. *Id.*

The trend towards physician practice acquisition, however, has slowed in recent years, suggesting countervailing disadvantages of, at least, unfettered practice acquisition. See Gail P. Heagen, *Reassessing Integrated Delivery Systems*, in HEALTH CARE M&A: HOW TO STRUCTURE THE TRANSACTION 381, 381-398 (P.L.I. Corp. L. & Prac. Course Handbook Ser. 1998) (noting that many integrated providers have abandoned the physician line of business due to "spectacular losses").

46. FURROW ET AL., *supra* note 31, § 5-49, at 250-51; Hall, *Managed Competition*, *supra* note 36, at 5-6.

47. See, e.g., Brian C. Jones, *Three Rhode Island Hospitals Agree to Join Massachusetts Network*, PROVIDENCE J.-BULL., July 18, 1997, at A01.

48. See David A. Hyman, *Hospital Conversions: Fact, Fantasy and Regulatory Follies*, 23 J. CORP. L. 741, 744-48 (1998) (discussing the hospital conversion debate and describing four concerns underlying the "philosophical bias" against for-profit hospitals); Lawrence E. Singer, *The Conversion Conundrum: The State and Federal Response to Hospitals' Changes in Charitable Status*, 23 AM. J.L. & MED. 221, 221-24 (1997) (detailing states' regulatory responses to increasing conversion and characterizing many states' attitudes toward conversions as "suspicious"); Vincenzo Stampone, *Turning Patients Into Profit: Nonprofit Hospital Conversions Spur Legislation*, 22 SETON HALL LEGIS. J. 627, 631-36 (1998) (noting the strong debates regarding conver-

perception in many communities that conversion of health care providers to for-profit status will decrease access to care, raise costs to patients, and reduce the quality of care.⁴⁹ In this climate, a nonprofit health care system in the same or a nearby community can acquire or affiliate with an ailing or targeted nonprofit provider and the community and target may perceive the system as a savior. Communities and politicians facing for-profit conversion of local health care providers may even approach potential nonprofit acquirers and plead with them to affiliate with their nonprofit provider.

C. *The PASC M Structure*

Nonprofit hospitals responding to the trend toward affiliation have many options for structuring such an arrangement. General categories include mergers, asset purchases, and consolidations, in addition to PASC M structures.⁵⁰ If the hospitals wish to use a technique in which one entity overtakes the other, and only one survives, they most likely will select a merger process.⁵¹ Alternatively, the surviving corporation can purchase or be granted all the assets of the other corporation, and the latter then can be dissolved.⁵² If the affiliating corporations are willing to form a new, combined corporation, thereby disbanding both existing corporations, they may utilize a consolidation transaction.⁵³ Each of these actions may require involvement of state regulators, the attorney general, and perhaps even the state courts.⁵⁴ In contrast, replacement of the membership

sions and "clarify[ing] misconceptions about the effects of hospital conversions to for-profit status").

49. Jack Needleman, *Nonprofit to For-Profit Conversions by Hospitals and Health Plans: A Review 12* (Pioneer Institute for Public Policy Research White Paper No. 5, February 1999); Singer, *supra* note 48, at 221-24; *see also* Brian C. Jones, *Debate Over Hospitals to Heat Up in 1997: Takeovers by For-Profit Companies Could Transform Rhode Island's Medical Care Landscape*, PROVIDENCE J.-BULL., Dec. 29, 1996, at A01 (reporting on one community's experience).

50. HALL & BREWBAKER, FACILITIES & TRANSACTIONS, *supra* note 32, § 4.1, at 4-5 to 4-6; FURROW ET AL., *supra* note 31, § 5-47, at 249. The PASC M structure is not available solely in the acquisition context; entities also may elect to implement this structure when initially creating a nonprofit health care system or during reorganization.

51. HALL & BREWBAKER, FACILITIES & TRANSACTIONS, *supra* note 32, § 5.3.1, at 5-8.

52. *Id.* § 5.5, at 5-14 to 5-17.

53. *Id.* § 5.4.1, at 5-11 to 5-12.

54. *See, e.g.*, ALA. CODE §§ 10-3A-103 and 10-3A-104 (requiring that the secretary of state find articles of merger and consolidation "conform to law" before certifying them, which certification will make the merger or consolidation effective); MASS. GEN. LAWS ANN. ch. 180, § 8A(c) (requiring notice to the attorney general prior to certain transfers of assets); NEW YORK NOT-FOR-PROFIT CORP. LAW § 1002(d) (McKinney 1997) (requiring court approval for some dissolutions of nonprofit corporations). Regulatory and legal obstacles are likely to be significant to the extent the corporation to be

of a subsidiary-to-be with a PASCМ often requires less involvement by state authorities than an acquisition by statutory merger, consolidation, or dissolution accompanied by a transfer of assets.⁵⁵ In addition, licensure or bond financing agreements may require regulators or lenders to approve mergers, consolidations, or major sales or transfers of assets, but often do not demand such approval for changes in membership.⁵⁶

Even if the requirements for dissolution, merger, or consolidation under the relevant state law and existing licensing and financing agreements are not onerous, a host of practical reasons often favors the use of a transaction in which both entities survive, such as the PASCМ structure.⁵⁷ Even in a situation in which one nonprofit hospital essentially desires to acquire another, a PASCМ structure may be preferred in order to retain favorable reimbursement rates that one hospital already has in place with payors, especially with Medicare or Medicaid. These rates can be one of the few remaining assets of a struggling hospital; without them other entities might not consider affiliation at all. If a hospital with favorable rates ceases to exist due to a merger, consolidation, or dissolution, the rates can be lost. The PASCМ structure can permit control of the target hospital without the costly loss of favorable rates.⁵⁸

Additional pressures favor the use of a PASCМ as an umbrella

dissolved holds charitable funds. *See infra* note 67.

55. HALL & BREWBAKER, FACILITIES & TRANSACTIONS, *supra* note 32, § 5.5.3, at 5-16. *But see, e.g.*, CAL. CORP. CODE § 5914(a)(2)(b) (West Supp. 2001) (requiring Attorney General approval for change of membership transactions as well).

56. Lockman & Silverman, *supra* note 33, at 15. The PASCМ structure, however, will not always obviate the need for approvals. For instance, some licensure schemes and lending documents will require consent for any "change in control," rather than specifying mergers, consolidations, or sales as triggering transactions. *Id.*

57. *See* HALL & BREWBAKER, FACILITIES & TRANSACTIONS, *supra* note 32, § 5.5.3, at 5-16; Lockman & Silverman, *supra* note 33, at 14. This discussion is not intended to provide an exhaustive catalogue of the possible transactions by which hospitals may affiliate; nor is it intended to provide a comprehensive list of the factors that may lead to the adoption of a PASCМ structure. Rather, the intent of this discussion is to offer an introduction to the range of motivations for using the PASCМ structure.

Moreover, the PASCМ structure is by no means the most complex of the possible transactions available to affiliating nonprofit hospitals. However, it is a common structure and an element found in many other structures. For an overview of other types of available transactions, including transactions using multiple tiers of nonprofit corporations, and using nonprofit and for-profit corporations in the same system, see Robert B. Craig, *Multi-Hospital Systems: Developing Non-Profit Systems*, in NEW HEALTH CARE ECONOMY: LEGAL RESPONSE TO NEW ECONOMIC FORCES, at 346, 346-52 (PLI Com. L. & Prac. Course, Handbook Series No. A4-4103 1984).

58. HALL & BREWBAKER, FACILITIES & TRANSACTIONS, *supra* note 32, § 5.5.3, at 5-16. A holding company PASCМ, as described *infra* text accompanying note 59, also can be used to achieve this goal. *Id.*

holding company, with both affiliating hospitals as subsidiaries.⁵⁹ For example, the lack of geographic proximity among the entities to be affiliated may raise fears regarding the difficulty of managing the resulting "single" entity after a merger, consolidation, or transfer of assets. In a holding company PASC structure, each hospital subsidiary can retain some operational authority at the local level. In some instances, local or internal politics also may make a holding company PASC structure attractive because any acquisition-type model, in which the acquired hospital disappears or appears to have been swallowed by the other, is politically impossible.⁶⁰ This type of PASC structure also may be helpful in dealing with special concerns of local autonomy involved when one of the hospitals to be affiliated is a religious entity⁶¹ or when physicians prove an obstacle.⁶² Finally, the holding company PASC structure may ease future expansion, as the holding company can similarly become the sole corporate member of further acquisitions.⁶³

The success of the holding company PASC structure in resolv-

59. See Lockman & Silverman, *supra* note 33, at 15 (describing many of these motivations). In addition, the holding company PASC structure may be repeated through tiers of holding companies. See HALL & BREWBAKER, FACILITIES & TRANSACTIONS, *supra* note 32, § 4.6.1 at 4-60; Craig, *supra* note 57, at 349.

60. See HALL & BREWBAKER, FACILITIES & TRANSACTIONS, *supra* note 32, § 4.6.1, at 4-60. Even a consolidation in which both hospitals change names and begin a new life as a joint entity may be politically difficult and could result in a costly loss of goodwill. Local politicians and other leaders can chafe against the idea of losing "their" hospital. Naming also can be quite an important issue. If the name of a consolidated entity is different from the original corporation's, identity and market recognition is put at risk. See *id.* § 5.4.2, at 5-13. A holding company PASC structure allows some elements of the founding hospitals to remain, including their names, but still will not always overcome political pressure.

61. Variations on the holding company PASC structure may be used to protect the religious principles of religious institutions. See Craig, *supra* note 57, at 350 (describing a transaction in which a religious order becomes an additional class of member with control over certain operational matters, but noting the potential impact of this variation on operational control by the PASC).

62. Doctors from institutions with differing cultures, histories, and levels of prominence may balk at true integration of medical staffs under a single resulting entity. Cf. Moore, *Unscrambling Deals*, *supra* note 32, at 26 ("In hospital system mergers, usually it's the doctors who refuse to get along."). Moore describes how the physician faculty of Stanford Medical Center ultimately was unwilling to accept a joint risk sharing agreement with faculty from UCSF, even though such an arrangement was contemplated under the original Stanford/UCSF merger agreement. *Id.* He relates similar difficulties at Penn State Geisinger Health System. *Id.* There are exceptions, however, to the rule that it is difficult to obtain medical staff integration. For instance, Moore also reports that physicians at Elliot Hospital and Catholic Medical Center, both of the divorcing Optima Health system, actually voted to remain one medical staff to serve the two separating hospitals. *Id.*

63. HALL & BREWBAKER, FACILITIES & TRANSACTIONS, *supra* note 32, § 4.6.1, at 4-61.

ing these issues once implemented depends on the allocation of power between the holding company parent and its subsidiaries. This power allocation must be made with an eye to the tradeoff between the efficiency of control at the parent level and the political and efficacy gains from autonomy at the subsidiary level.⁶⁴

While the PASC structure can facilitate the difficult but beneficial process of affiliation, it also suffers from definite shortcomings. Although it is the sole member of a public benefit nonprofit corporation, the PASC does not claim the type of separable interest in the corporation asserted by a member in a mutual benefit nonprofit corporation. Also, the PASC is ill-suited to act as a proxy for the public or to play the role of community stakeholder or guardian of the corporate mission. Instead, sole corporate membership is simply a means of corporate control.

A nonprofit PASC has substantial access to decision-making power through statutorily-prescribed member authorization requirements⁶⁵ as well as through its "reserved powers."⁶⁶ Reserved powers are powers that, if not for reservation by the PASC, would be held by the subsidiary's Board of Directors. These reserved powers often include power over major operational decisions and approval of budgets. This structure and circumstance allows the PASC to take many actions that otherwise would be taken by directors or by a variegated group of members. Without clear legal guidance on the limitations of its authority, the subsidiary's member, who is also the parent, may make decisions for the subsidiary in furtherance of the goals and interests of the parent – even if those decisions are adverse to the more particular interests of the subsidiary.

Unless some external control is placed on its actions, the PASC structure permits a PASC to make decisions that compromise or sacrifice a subsidiary. For example, a PASC can cut off local services offered by the subsidiary if it finds that they are duplicative or financially unjustifiable. Also, a PASC can change the historical focus of a subsidiary in order to achieve integration and blend it with the variety of offerings within the system as a whole. In affiliations, the corporation that becomes a PASC's subsidiary was formerly a freestanding entity, which likely was created and granted nonprofit status to serve a more narrowly circumscribed or altogether different

64. *Id.* at 4-60 to 4-62.

65. *E.g.*, RMNCA § 10.03(a)(2) (requiring member approval for article and bylaw amendments); *id.* § 11.03(a)(2) (requiring member approval for mergers); *id.* §12.02(b)(2) (requiring member approval for sales of corporate assets other than in the regular course of activities).

66. *See* James Bandler, *CareGroup Plans Overhaul of Its Board*, WALL ST. J., January 5, 2000, at NE1 (describing a PASC's plans to reserve final approval of subsidiary hospital budgets).

public than the PASCМ. Consequently, beneficiaries of the subsidiary may not benefit from its integration into the PASCМ's system. For instance, they may be forced to travel farther for services they previously obtained locally or they may see the diminution of a local focus of care they once enjoyed.

Moreover, in a freestanding nonprofit corporation, the directors are accountable to the public the corporation serves. The directors are accountable for the decisions they make through the vehicles of the corporation's mission and the group of members who elect directors. In contrast, under a PASCМ structure, the PASCМ elects subsidiary directors and makes decisions for the subsidiary through its reserved powers. Hence, in a PASCМ structure, accountability and commitment to the public becomes more difficult to trace and enforce.⁶⁷

Further expansion of the example described at the outset⁶⁸ – the affiliation between Local and RHCS – highlights the problems potentially created by a PASCМ structure. Assume that following the af-

67. There is an important qualification to this statement. While a PASCМ without a fiduciary duty or other control to limit its actions may make many decisions in its own service and adverse to those of a subsidiary or its beneficiaries, legal mechanisms often will protect the donated assets of the subsidiary from outright looting by the parent. See Evelyn Brody, *The Limits of Charity Fiduciary Law*, 57 MD. L. REV. 1400, 1465-67 (1998) [hereinafter Brody, *Charity Fiduciary Law*]. When donations are made to a charitable organization for a particular purpose, those assets are impressed with a charitable trust. *Id.* The funds may not be spent other than in the service of the purposes for which they were donated. *Id.* This obligation follows the funds, and thus would bind the PASCМ as well as the subsidiary. *Id.*

In some jurisdictions, this concept carries through to unrestricted donations, at least in part. See, e.g., *Attorney Gen. v. Hahnemann Hosp.*, 494 N.E. 2d 1011, 1021 n.18 (Mass. 1986). The *Hahnemann Hospital* court rejected the argument by a charitable corporation that unrestricted funds could be used for any purposes the corporation's charter was amended to include. *Id.* The court explained that if this were the law,

By simply amending its charter purposes, a charitable corporation would itself be able to exercise the power to devote funds to new charitable purposes whenever the trustees decided to do so, without any requirement that the new purposes be similar and not contradictory. The public could not be assured that funds donated would be used for similar public charitable purposes.

Id. at 1021. Instead, the court suggested that unrestricted donated funds must be used for the purposes of the corporation as stated in its articles at the time of the donation, *id.*, and noted the Attorney General's vivid example that "those who give to a home for abandoned animals do not anticipate a future board amending the charity's purpose to become vivisectionists." *Id.* at 1021 n.18.

Thus, even without a clear application of fiduciary duty to PASCМs, in some important ways, such as the outlay of funds, the PASCМ is not unfettered. Still, when direct misuse of funds is not involved, such as when a PASCМ shifts organizational priorities or makes operational decisions, rather than straight financial decisions, even a stricter *Hahnemann*-type rule would not limit its actions.

68. See *supra* p. 1.

filiation, RHCS is a system of nonprofit health care corporations composed of the Regional Hospital downtown academic medical center and three community hospitals, Local, Northside Hospital, and Southside Hospital. Regional Hospital, the downtown academic medical center and the strongest individual entity within the system, is the PASCМ.⁶⁹ Assume that Local and Southside Hospital both offer elective radiology services, and that each service produces marginal revenue for its hospital. The PASCМ sees the opportunity to improve its research capabilities and to cut costs across the system by aggregating these services at Southside Hospital. Using its control over the subsidiary boards and its reserved powers, the PASCМ closes the elective radiology service at Local and expands the unit at Southside Hospital. RHCS will provide the same total number of visits, but all at one site. The current lack of limitation on PASCМ action permits the PASCМ to shift the radiology services in this manner without consideration of the implications of this decision for access to elective radiology services for the communities of Localsville and Northside. Under current law, PASCМ decision-makers need not consider or address the needs of these communities. In addition, they need not consider the impact of the decision on Southside Hospital or its community.

In order to respond to the problems raised by the PASCМ's control over its subsidiary's actions and to regulate PASCМ behavior appropriately, the law must balance the risks of this organizational structure with the benefits it offers. As described above, allowing the parent to control subsidiary governance, budget, and direction creates numerous potential and real dangers. Further, it is important to recognize that state nonprofit corporation laws tightly control the dissolution or conversion of nonprofit corporations. Therefore, under current law, if a would-be subsidiary actually went out of existence, it would be subject to greater restrictions to protect the interests of its beneficiaries than if its membership were replaced with a PASCМ entity.⁷⁰ In fact, as described above, statutory and regulatory controls on dissolution may be an important factor in the selection of a

69. Similar issues would likely arise if RHCS was the parent holding company of all four hospitals. Due to its financial sophistication, name brand recognition, research dollars and other assets, the concerns of the academic medical center in a hospital system can dominate those of the disparate former community hospitals.

70. See, e.g., RMNCA § 14.03 (requiring Attorney General notice for some dissolutions, but providing no similar requirement for changes of membership); MASS. GEN. LAWS ch. 180, § 8A(c) (1998) (requiring notice to the attorney general prior to certain transfers of assets, but not for changes of membership); NEW YORK NOT-FOR-PROFIT CORP. LAW § 1002(d) (McKinney 1997) (requiring court approval for some dissolutions of nonprofit corporations, but not addressing changes of membership specifically). *But see* CAL. CORP. CODE § 5914(a)(2)(b) (requiring Attorney General approval for change of membership transactions as well).

PASCM transactional structure in the first place.⁷¹

Simultaneously, however, the PASCMS can play a positive role for struggling, small, or local nonprofit hospitals or nonprofit hospitals targeted for conversion to for-profit status. And, without some freedom to integrate new subsidiaries into existing systems, would-be PASCMS nonprofits have little incentive to affiliate with these would-be subsidiaries. Instead, many potential subsidiaries would be converted into for-profit entities or would fold altogether. Thus, removing all control available to parents in the PASCMS role would hamstring parents and could chill affiliations generally, with potentially deleterious effects on the nonprofit health care industry as a whole.

The challenge for courts and nonprofit regulators is to regulate PASCMS relationships to avoid the unbridled use of a subsidiary to serve the purposes of the PASCMS, without placing so many burdens on would-be PASCMSs that affiliation among nonprofit hospitals will be utterly asphyxiated. At present, state statutory and case law provides little comfort or direction for courts and regulators attempting this task. The remainder of this Article argues that courts should draw on existing statutory and case law, and the models contained therein, to assign and define fiduciary duties to discipline PASCMSs when they make decisions for their subsidiaries.

II. THREE MODELS OF FIDUCIARY DUTY FOR PASCMS

Courts, regulators, and legislators might take many routes to create enforceable restrictions on the actions of PASCMSs. However, if the goal is to hold a PASCMS to some standard of behavior in carrying out its responsibilities to a third party that is ill-equipped to monitor or enforce these standards, fiduciary duties are an apt place to begin. Fiduciary duties occur throughout the law to deal with the problem of enforcing standards on actors in contexts in which the beneficiaries of those standards lack power, voice, and/or resources.⁷² A third-party decision-maker without a fiduciary duty is anomalous in the world of corporate law and in law generally. Directors and officers operate under fiduciary duties to their corporations in the for-profit and nonprofit contexts; agents owe fiduciary duties to their principals; employees owe them to their employers; trustees owe them to the beneficiaries of the trust. In contrast, the PASCMS is an entity charged with making decisions for the benefit of others, but current law does not recognize a fiduciary duty for a PASCMS when it makes

71. See *supra* text accompanying notes 50-55.

72. See generally Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879, 880-892 (1988) [hereinafter DeMott, *Fiduciary Obligation*] (reviewing the historical background and general principles of fiduciary obligations); Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795, 795-96 (1983) (describing different types of fiduciaries).

these decisions. Further, even if it is accepted that a PASCМ does owe fiduciary duties when acting on behalf of its subsidiary, it is unclear to whom this duty would be owed and what its substance would be. Thus, to constrain the powers of PASCМs and protect the interests of subsidiaries' beneficiaries, it is appropriate to apply a fiduciary standard to PASCМs.

To narrow the field of models for a PASCМ's fiduciary duty, one may follow the lead of the courts and look to conceptions of fiduciary duty applied in contexts that are factually similar to the situation in which PASCМs operate.⁷³ This Part will explore the contours of fiduciary duties as applied in three such contexts: nonprofit directors, parents of wholly-owned, for-profit subsidiaries, and controlling shareholders in for-profit corporations with minority shareholders. These conceptions of fiduciary duty then will be refined for use as models for possible standards of fiduciary duty to apply to PASCМs.

A. *Rationale for Fiduciary Duties*

The concept of a fiduciary duty is a common one throughout corporate law, and the law more generally. The substance of these duties, all deemed "fiduciary," resides on a continuum with differing content for trustees, corporate directors and simple agents.⁷⁴ However, fiduciaries across the continuum share some common characteristics: the fiduciary performs some service for the individual or entity to whom he owes a fiduciary obligation (the "entrustor"⁷⁵); the fiduciary must act in the best interests of the entrustor; and the fiduciary must avoid conflicts between his own interests and those of the en-

73. Tamar Frankel has objected that courts' analogical development of new areas in which to apply fiduciary obligations is haphazard. Frankel, *supra* note 72, at 797. Instead, she argues for a unitary base of fiduciary law, as it becomes a larger and more important part of the legal landscape. *Id.* at 797, 832-36.

Deborah DeMott also argues against courts' practice of giving substance to corporate fiduciary obligations by analogy. DeMott, *Fiduciary Obligation*, *supra* note 72, at 879. Her objection, however, is to the distinct practice of grounding the substance of fiduciary obligation on the "hypothetical bargain" made by the fiduciary and the entrustor, drawing on concepts from contract law. *Id.* at 885-92; *see also* Robert C. Clark, *Agency Costs Versus Fiduciary Duties*, in *PRINCIPLES AND AGENTS: THE STRUCTURE OF BUSINESS* 55-79 (John W. Pratt and Richard J. Zeckhauser eds., 1985) [hereinafter Clark, *Agency Costs*] (noting the limitations of this hypothetical contract analogy).

74. DeMott, *Fiduciary Obligation*, *supra* note 72, at 879; Frankel, *supra* note 72, at 795. As such, the field of fiduciary law is far from unitary; indeed, few would suggest that there is such a unified field of law. *See* DeMott, *Fiduciary Obligation*, *supra* note 72, at 908-16 (describing and critiquing scholarly attempts to create a "general legal theory" of fiduciary obligation). *But see* Frankel, *supra* note 72, at 797 (offering one such unified theory).

75. Frankel coined this term to denote any party to whom the obligations of a fiduciary may run. Frankel, *supra* note 72, at 800 n.17.

trustor.⁷⁶ And, in at least a rough sense, all fiduciary obligations are imposed to protect the entrustor from potential abuse at the hands of the fiduciary.⁷⁷

Despite these common attributes, it is important to craft fiduciary obligations to fit the issues at hand. "Determining whether fiduciary obligation applies in a particular context and what requirements inhere in the imposition of fiduciary obligation demands recognition of [] situation-specificity."⁷⁸ As described above, the potential for abuse certainly exists in the PASCМ situation.⁷⁹ Through its statutory rights as member, and through its reserved powers, the PASCМ may make decisions for the subsidiary corporation that are detrimental to the subsidiary, its beneficiaries, and its community. Thus, to gain particular insight into the appropriate fiduciary duties for PASCМs, it will be fruitful to explore in more detail the components of fiduciary duties in analogous situations.

B. *Fiduciary Duties of Nonprofit Corporate Directors*

Through its singular ability to elect and reelect subsidiary directors, a PASCМ possesses influence over the actions of those directors. Through its reserved powers, a PASCМ makes decisions that otherwise would be controlled by directors. Therefore, it is sensible to consider whether the standards of fiduciary duty imposed on nonprofit directors, whose actions the PASCМ may influence or overtake, would impose appropriate constraints upon PASCМ actions.

The fiduciary duties imposed on nonprofit directors are the classic duties of care and loyalty.⁸⁰ Directors must abide by the duty of care, which may be accompanied by the business judgment rule or a similar construct. Directors of nonprofits also are charged with the duty of loyalty; they may not place their own interests ahead of those of the corporation that they serve. These duties are described in greater detail below.⁸¹

Of course, nonprofit corporate law is state law, and state law

76. BLACK'S LAW DICTIONARY 625 (6th ed. 1990) (defining fiduciary); DeMott, *Fiduciary Obligation*, *supra* note 72, at 882; Frankel, *supra* note 72, at 800-01.

77. Clark, *Agency Costs*, *supra* note 73, at 77; Frankel, *supra* note 72, at 809-10.

78. DeMott, *Fiduciary Obligation*, *supra* note 72, at 923. No less an authority than Justice Frankfurter recognized the question-begging aspect of the fiduciary label. SEC v. Chenery Corp., 318 U.S. 80, 85-86 (1943) ("[T]o say that a man is a fiduciary only begins an analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary?").

79. See *supra* text accompanying notes 65-71.

80. References to directors' duties and obligations under current nonprofit and for-profit corporate law are not intended to discount the duties imposed upon officers, but rather serve to focus the discussion.

81. See discussion *infra* Parts II.B.1, II.B.2.

varies in the manner in which it imposes duties of care and loyalty on nonprofit directors. Some states impose the duty in their nonprofit corporation statutes, others in general business corporation statutes that also apply to nonprofit corporations, still others only in case law.⁸² Despite these differences in the manner in which states specify the application of the duties of care and loyalty, and some differentiation in the substance of these duties across states, there is no serious debate over whether fiduciary duties apply to nonprofit directors in general.⁸³

1. The Duty of Care

The contours of a nonprofit director's duty of care are fairly, although not entirely, consistent across states and across the for-profit and nonprofit contexts.⁸⁴ The classic statement of the duty of care in

82. See *infra* notes 87-89, 114-19 and accompanying text.

83. The following description of the contours of the fiduciary duties imposed upon nonprofit actors is intended only as an introduction sufficient to summarize the generalities of the fiduciary concepts applied in the nonprofit context. If one desires a comprehensive treatment of the fiduciary duties of nonprofit directors, several sources can be consulted. See, e.g., Marion Fremont-Smith & Michael S. Arlein, *The Fiduciary Duties of Directors of Nonprofit Corporations: A Fifty State Survey*, (work in progress) (unpublished manuscript on file with author); Brody, *Charity Fiduciary Law*, *supra* note 67, at 1425-28; Harvey J. Goldschmid, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms*, 23 J. CORP. L. 631, 638-49 (1998).

84. Although there is some support for applying trustee fiduciary standards to nonprofit directors, most sources agree instead that corporate fiduciary duties should apply. See *Stern v. Lucy Webb Hayes Nat'l Train. Sch. for Deaconesses & Missionaries*, 381 F. Supp. 1003, 1013-14 (D.D.C. 1974); PHELAN, *supra* note 15, § 4:05; Brody, *Charity Fiduciary Law*, *supra* note 67, at 1426-27.

Critics of the wisdom of the corporate approach point out the genesis of nonprofit corporations in charitable trust law and the potential advantages of applying the stricter set of fiduciary obligations for trustees to the directors of nonprofit corporations. See, e.g., Thomas H. Boyd, Note, *A Call to Reform the Duties of Directors Under State Not-For-Profit Corporation Statutes*, 72 IOWA L. REV. 725, 736 n.98 (1987) (proposing that trustee standards should apply to public benefit nonprofits, while corporate standards should apply to mutual benefit nonprofits); Deborah A. DeMott, *Self-Dealing Transactions in Nonprofit Corporations*, 59 BROOK. L. REV. 131, 135-36 (1993) [hereinafter DeMott, *Self-Dealing Transactions*] (noting the charitable trust model as a potential alternative to the corporate model adopted in the RMNCA); Henry B. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PENN. L. REV. 497, 569-73 (1981) [hereinafter Hansmann, *Reforming Nonprofit Corp. Law*] (arguing that a strict prohibition on director self-dealing in nonprofit corporations would have "an enormously salutary effect"); see also Michael W. Peregrine, *Charitable Trust Laws and the Evolving Nature of the Nonprofit Hospital Corporation*, 30 J. HEALTH & HOSP. L. 1, 3-10 (1997) (describing the application of charitable trust standards to nonprofit corporations in some hospital dissolution and conversion cases).

Despite the interest of this debate, for current purposes, it is sufficient to accept the descriptive point that most states follow a corporate fiduciary standard for nonprofit directors. The arguments for and against stricter trust standards for PASCMS must

the for-profit director context requires directors to act with "that degree of skill, diligence, and care that a reasonably prudent person would exercise in similar circumstances."⁸⁵ The language describing the requisite level of care for nonprofit directors under the Revised Model Nonprofit Corporation Act ("RMNCA") is remarkably similar. A director must act "in good faith . . . with the care that an ordinarily prudent person in a like position would exercise under similar circumstances [and] in the manner the director reasonably believes to be in the best interests of the corporation."⁸⁶ Most jurisdictions adopt similar language either in their nonprofit corporation statutes,⁸⁷ general corporation statutes,⁸⁸ or in case law addressing nonprofit directors' duty of care.⁸⁹

Discussion of the duty of care in for-profit corporations often is tied to the concept of the business judgment rule.⁹⁰ This rule can take several linguistic forms. Generally, however, the rule is understood to hold that if a director makes a business decision on an informed basis, and the decision is not tainted by bad faith, fraud, conflict of interest, or illegality, a court will not challenge the substance of the decision under the duty of care.⁹¹ A number of courts have applied the business judgment rule to shield the informed, good faith, non-conflicted decisions of nonprofit directors.⁹² The RMNCA reporters

await future analysis.

85. CLARK, CORPORATE LAW, *supra* note 26, § 3.4, at 123 (1986) (citing the Model Business Corporation Act § 8.30(a), and analogous requirements of California, New York and Delaware law).

86. RMNCA § 8.30(a)(1)-(3). In prescribing the fiduciary duties imposed on directors, the RMNCA's drafters used existing specifications of the elements of the duties of for-profit directors as a model. *See* Moody, *supra* note 29, at 275.

87. *See, e.g.*, FLA. STAT. ANN. § 617.0830(1)(a)-(c) (West 1992); MONT. CODE ANN. § 35-2-416(1)(a)-(c) (1999); TENN. CODE ANN. § 48-58-301(a)(1)-(3) (1995).

88. *See, e.g.*, HAW. REV. STAT. ANN. § 415-35(b) (Michie 1997), N.H. REV. STAT. ANN. § 293A:8.30(a)(1)-(3) (1999).

89. *See, e.g.*, Stern, 381 F. Supp. at 1013-14; *United States v. Mt. Vernon Mort. Corp.*, 128 F. Supp. 629, 636 (D.D.C. 1954).

90. *See* CLARK, CORPORATE LAW, *supra* note 26, at § 3.4.

91. *Id.* § 3.4, at 124; *see also* FISHMAN & SCHWARZ, *supra* note 10, at 179-80 (providing a similar statement of the business judgment rule as applied in the nonprofit context); Goldschmid, *supra* note 83, at 643-44 (similar).

92. *E.g.*, *Beard v. Achenbach Mem'l Hosp.*, 170 F.2d 859 (10th Cir. 1948); *Oberly v. Kirby*, 592 A.2d 445, 462 (Del. 1991) ("A court cannot second-guess the wisdom of facially valid decisions made by charitable fiduciaries, any more than it can question the business judgment of the directors of a for-profit corporation."); *John v. John*, 450 N.W.2d 795 (Wis. Ct. App. 1989); *see also* *Scheuer Fam. Found., Inc. v. 61 Assocs.*, 179 A.D.2d 65 (N.Y. App. Div. 1992) (finding the nonprofit directors at issue had operated under a conflict of interest and therefore were not eligible for the protection of the business judgment rule); Michael W. Peregrine & James R. Schwartz, *The Business Judgment Rule and Other Protections for the Conduct of Not-for-Profit Directors*, J. HEALTH LAW 455, 459-71 (2000) (providing a general exposition of current business

state that “[a]lthough it may seem anomalous to apply the business judgment rule to nonprofit corporations,” to do so is not inconsistent with the RMNCA’s statement of the duty of care.⁹³ Several rationales for the rule, including “that it encourages rational risk taking and innovation, limits litigation and unfair exposure, encourages service by quality directors, and limits judicial intrusiveness . . . [recommend its] appl[ication] as much to nonprofit directors and officers as to their for-profit peers.”⁹⁴

The duty of care also can be understood to contain at least two constituent duties: the duty of attention and the duty of obedience. As its name suggests, under the duty of attention, directors are required to be attentive to their responsibilities as board members.⁹⁵ Specifically, the law does not tolerate “dummy” directors, even when they serve voluntarily, as do many directors of nonprofit corporations.⁹⁶ Directors must attend meetings and must inform themselves of the facts needed to reach reasonable judgments.⁹⁷ Of course, like for-profit directors, in order to obtain this necessary information, nonprofit directors may reasonably rely upon other directors and corporate officers, as well as upon experts retained for their opinions.⁹⁸

The directors of a nonprofit corporation also are charged with obedience — a duty of greater consequence in nonprofit corporate law than in for-profit corporate law.⁹⁹ The duty of obedience requires non-

judgment rule doctrine in the nonprofit context).

93. RMNCA § 8.30, cmt. 3. Although the Reporters stop short of advocating application of the business judgment rule to nonprofit corporate directors, they do report that several courts have applied the rule to nonprofit actors. *Id.* Some commentators suggest, however, that the moniker “best judgment rule” would be more apt in the nonprofit context. FISHMAN & SCHWARZ, *supra* note 10, at 186.

94. Goldschmid, *supra* note 83, at 644.

95. *Stern*, 381 F. Supp. at 1013-14 (explaining that “total abdication of the supervisory role” would violate a nonprofit director’s duty of care to his corporation).

96. *E.g.*, *Ray v. Homewood Hosp.*, 27 N.W.2d 409, 411 (Minn. 1947).

97. *Stern*, 381 F. Supp. at 1014 (maintaining that a director violates his fiduciary duty to the corporation when he fails to acquire necessary information to oversee investment policy or fails to attend meetings where these policies are considered); Naomi Ono, *Boards of Directors Under Fire: An Examination of Nonprofit Board Duties in the Health Care Environment*, 7 ANNALS HEALTH L. 107, 111 (1998) (noting that the duty of care requires nonprofit directors “to inform themselves of all material facts necessary to reach reasoned decisions”).

98. *Stern*, 381 F. Supp. at 1014; RMNCA § 8.30(b) (providing a list of sources “a director is entitled to rely on [for] information, opinions, reports, or statements”).

99. There is some dispute over whether the duty of obedience is a separate third duty or a subsidiary duty within the duty of care. Daniel Kurtz argues that the duty of obedience to corporate purposes is not a part of the duty of care at all, but rather a separate and additional duty of nonprofit corporate directors. DANIEL KURTZ, BOARD LIABILITY: GUIDE FOR NONPROFIT DIRECTORS 21 (1988). See also Rob Atkinson, *Unsettled Standing: Who (Else) Should Enforce the Duties of Charitable Fiduciaries?*, 23 J. CORP. L. 655, 661 (1998) (referencing the duty of obedience as separate duty of non-

nonprofit directors to obey the law and to obey the purposes of the corporation as expressed in its articles and bylaws.¹⁰⁰ Obedience of the law is largely self-explanatory. Nevertheless, there are areas of the law of special concern to nonprofit directors and that are unfamiliar in the for-profit context, such as tax exemption and charitable solicitation regulations. In addition, the duty of obedience may include the duty to establish and oversee appropriate corporate compliance programs.¹⁰¹ Obedience to the mission and purposes of the corporation, however, is unique to the nonprofit corporate context.¹⁰² This part of the duty of obedience protects donors to nonprofit corporations, who rely on corporate statements of mission and purpose in making their contribution decisions.¹⁰³

2. The Duty of Loyalty

The core idea of the duty of loyalty for a nonprofit director is relatively constant: devotion to the interests of the corporation over one's own interests.¹⁰⁴ Courts use the duty of loyalty rubric to regulate director self-dealing, in which a director has interests on two or more sides of a corporate decision, in his personal and his directorial capacities. Many states' nonprofit corporation statutes specifically address certain types of self-dealing transactions, such as loans to directors, unlawful distributions by directors, and conflict of interest transactions.¹⁰⁵ Of these, conflict of interest provisions are the most significant.¹⁰⁶ A director is operating under a conflict of interest when

profit directors); Daniel Kurtz & Paula Green, *Liabilities and Duties of Nonprofit Directors and Officers*, 11-1, 11-15 to 11-16, in NEW YORK UNIVERSITY SIXTEENTH CONFERENCE ON TAX PLANNING FOR THE CHARITABLE SECTOR (1988) (detailing how the duty of obedience operates for nonprofit directors). For present purposes, the details of this categorization are not dispositive. Therefore, I will treat obedience as a component of the duty of care, as is most common.

100. Goldschmid, *supra* note 83, at 641.

101. *Cf. In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996) (explaining that for-profit directors' fiduciary obligations include responsibility for ensuring the existence and adequacy of corporate reporting and information systems).

102. Goldschmid, *supra* note 83, at 641.

103. *See, e.g., Collins v. Beinecke*, 495 N.E. 2d 335 (N.Y. 1986) (stating the rule as directors "may not act in a manner inimical to the charitable purposes of the foundation"); *Commonwealth v. Barnes Found.*, 159 A.2d 500, 505 (Pa. 1960) (holding that directors could not go against the wishes of the donor of the foundation's assets that the assets, paintings, be open for public view).

104. Kurtz & Green, *supra* note 99, § 11.02[2], at 11-12.

105. *E.g.,* COLO. REV. STAT. § 7-24-111 (1986) (prohibiting loans to nonprofit directors); IND. CODE § 23-17-13-4 (1994) (holding nonprofit directors personally liable to the corporation for unlawful distribution of corporate assets); OHIO REV. CODE ANN. § 1702.301 (Anderson 1994) (regulating conflict of interest transactions).

106. Daniel L. Kurtz, *Safeguarding the Mission: The Duties and Liabilities of Officers and Directors of Nonprofit Organizations*, in ALI-ABA COURSE OF STUDY, NOT-

he or she has a direct or indirect interest in a transaction under consideration by the nonprofit corporation for which he or she serves. The duty of loyalty prohibits such a director from using his or her position on a board to further his or her personal financial interests or the interests of other entities doing business with the corporation. At one time, director conflicts of interest were thought to render the resulting transaction voidable at the option of the conflicted director's corporation.¹⁰⁷ Moving markedly away from this sort of flat prohibition, the current trend in the law is to use procedural solutions for conflicts of interest.¹⁰⁸

The RMNCA provision on conflicted transactions is instructive as a point of departure, although states have not adopted it widely in its entirety.¹⁰⁹ The provision states that a conflict of interest transaction is not voidable if it was fair at the time it was entered or if it has been:

approved [] in advance by the vote of the board of directors or a committee of the board if [] the material facts of the transaction and the director's interest are disclosed or known to the board or committee of the board; and the directors approving the transaction in good faith reasonably believe the transaction is fair to the corporation.¹¹⁰

Thus, the RMNCA creates a process whereby (1) if a majority of the disinterested directors in the relevant body (the full board or a board committee), (2) approve a self-dealing transaction after full disclosure, and (3) in good faith reasonably believe that the transaction is fair to the corporation, then the transaction is not voidable by the corporation.¹¹¹ Further, the individual interested director is

FOR-PROFIT ORGANIZATIONS: THE CHALLENGE OF GOVERNANCE IN AN ERA OF RETRENCHMENT 15, 34 (April 9, 1992).

107. CLARK, CORPORATE LAW, *supra* note 26, § 5.1, at 160-61.

108. *Id.*; see also Fremont-Smith & Arlein, *supra* note 83, at 51 (explaining the typical procedures for "validating conflict-of-interest transactions").

109. Fremont-Smith & Arlein, *supra* note 83, at 51 n.183 (noting that only Montana, Nebraska, South Carolina and Vermont have, as of yet, adopted the precise RMNCA standard).

110. RMNCA § 8.31(b)(1)(i)-(ii). The RMNCA specifies that "a conflict of interest transaction is authorized, approved, or ratified, if it receives the affirmative vote of a majority of the directors on the board or on the committee, who have no direct or indirect interest in the transaction . . ." *Id.* § 8.31 (e).

111. *Id.* § 8.31(a)-(b). Commentators have criticized this RMNCA standard. See DeMott, *Self-Dealing Transactions*, *supra* note 84, at 138-47; Goldschmid, *supra* note 83, at 648-49. DeMott interprets the RMNCA provisions, in conjunction with the standard presumption that directors act in good faith and in the best interest of the corporation, to mean that a plaintiff bears the burden of proof when challenging a conflict-of-interest transaction under the RMNCA. DeMott, *Self-Dealing Transactions*, *supra* note 84, at 138. She finds this burden too low and argues for self-dealing transactions to be voidable at the corporation's option, unless they are affirmatively estab-

shielded from liability arising from the transaction.¹¹² The RMNCA also states that an interested director transaction is not voidable by a nonprofit corporation if a court or the state attorney general approves the transaction.¹¹³

Most states have codified similar, process-oriented solutions to nonprofit director conflicts of interest. Thirty-three jurisdictions have enacted process-based conflict of interest provisions as part of their nonprofit corporation statutes.¹¹⁴ Fifteen of the remaining states, which either do not directly address the duty of loyalty in their nonprofit corporation statutes or have no nonprofit corporation act at all, have adopted similar provisions in their for-profit corporation acts.¹¹⁵ In the absence of an instructive nonprofit statutory provision, courts would look to these for-profit statutory counterparts. All forty-eight of these interested transaction statutes provide that when the interested director makes full disclosure and the transaction is approved

lished as fair to a corporation at the time of the transaction. *Id.* at 143. Further, DeMott argues that this determination ought to be made in court. *Id.* at 147.

Harvey Goldschmid agrees that overly deferential judicial review of conflict of interest transactions in nonprofit corporations is unwise, particularly in light of the complaisant culture that can characterize board interactions and the lack of extensive external disclosure requirements, enforcement mechanisms, and other protections that are available in the for-profit sector. Goldschmid, *supra* note 83, at 648-49. He believes, however, that an intermediate standard – more rigorous than a presumption of compliance with the duty of loyalty but less stringent than DeMott's approach – would provide nonprofit corporations with sufficient protection. *Id.*

Goldschmid cites the Supreme Court of Delaware's formulation in *Oberly v. Kirby* as an example of one such intermediate test. *Id.* at 649 (citing *Oberly*, 592 A.2d at 468 n.17). The *Oberly* court explained that "[b]ecause of the special duty of the fiduciaries of a charitable corporation to protect and advance its charitable purpose . . . review of an independent committee's approval [of an interested transaction] would be more searching for a charitable corporation than for a for-profit corporation." *Oberly*, 592 A.2d at 468 n.17. While the *Oberly* court stated that it had not been presented with the question of the appropriate level of review for this type of transaction, it suggested that fairness would be the appropriate standard. *Id.* The court further explained that the Attorney General would have "leeway" to challenge some conflict of interest transactions even if they had been approved by disinterested directors, but that in such instances the Attorney General would bear the burden of proof. *Id.*

112. RMNCA § 8.31(a). Nonprofit directors also may be protected by the statutory liability limitations that have recently been enacted to shield nonprofit directors. Peregrine & Schwartz, *supra* note 92, at 471-75. These statutes either directly limit the liability of nonprofit directors for their duty of care violations or permit individual nonprofit corporations to adopt such limitations for their directors. *Id.*; see also Brody, *Charity Fiduciary Law*, *supra* note 67, at 1458 (arguing for the imposition of liability caps for nonprofit directors).

113. RMNCA § 8.31(b)(2).

114. Fremont-Smith & Arlein, *supra* note 83, at 51 n.179; see also, e.g., OHIO REV. CODE ANN. § 1702.301 (Anderson 1994); WYO. STAT. ANN. § 17-19-831 (Michie 1999).

115. Fremont-Smith & Arlein, *supra* note 83, at 51 n.180; see also, e.g., DEL. CODE ANN. tit. 8, § 144 (1991); N.M. STAT. ANN. § 53-11-40.1 (Michie Supp. 1993).

by a "majority" or a "sufficient" (somewhat less than a majority) vote of disinterested board members in advance,¹¹⁶ the transaction is not voidable by the corporation by reason of the conflict.¹¹⁷ Almost all of these statutes also permit a court to validate, after the fact, an interested transaction using a fairness standard,¹¹⁸ and a significant group of states permits pre-approval by the state attorney general, a court, or both.¹¹⁹

While not entirely uniform, enactments and decisional law demonstrate substantial agreement on the substance of the duties of care and loyalty for nonprofit directors. As such, the corporate standard of care and the RMNCA's interested transaction provisions can serve as a potential model for the fiduciary duty of PASCMS. Such a stylized Director Model would define a fiduciary duty for PASCMS as if the PASCMS entity were a director, and would subject the PASCMS to the typical duties imposed on such directors. Under this Model, courts would evaluate actions taken by a PASCMS with respect to a subsidiary for violations of the duties of care and loyalty. As in the director context, duty of loyalty challenges would be the most prominent enforcement vehicle.¹²⁰ If a PASCMS makes a decision for its subsidiary, in which the PASCMS also has an interest, it would be deemed to be operating under a conflict. The decision could be approved or validated through procedures analogous to those applied in interested transaction statutes.¹²¹

116. Fremont-Smith & Arlein, *supra* note 83, at 52. Some state statutes require that the interested director not be counted towards a quorum at the meeting at which the action is taken; however, most states waive the quorum requirement. *Compare, e.g.,* N.D. CENT. CODE. § 10-33-46 (Supp. 1997) (requiring a quorum to approve interested director transactions and an interested director does not count toward the quorum) *with, e.g.,* MO. REV. STAT. § 355.416 (West Supp. 2000) (waiving the quorum requirement).

117. Fremont-Smith & Arlein, *supra* note 83, at 52. *See id.* at 52-58, for a comprehensive review of the requirements for disclosure and voting.

118. *Id.* at 58 n.212; *see also, e.g.,* 805 ILL. COMP. STAT. ANN. § 105/108.60 (West 1993); VA. CODE ANN. § 13.1-871 (Michie 1999).

119. Fremont-Smith & Arlein, *supra* note 83, at 52; *see also, e.g.,* CAL. CORP. CODE § 5233(d)(1) (West 1990) (permitting approval by the attorney general); GA. CODE ANN. § 22-2861 (Harrison Supp. 1993) (permitting approval by a court); S.C. CODE ANN. § 33-31-831 (Law. Co-op Supp. 2000) (permitting approval by the attorney general or a court).

120. Brody, *Charity Fiduciary Law*, *supra* note 67, at 1406.

121. Most states have rejected the notion of reviewing actions by non-director entities under their conflict of interest statutes, even under the rubric that individuals holding common directorships operate under a conflict. MICHAEL P. DOOLEY, *FUNDAMENTALS OF CORPORATION LAW* 610 (1995); Mary Siegel, *The Erosion of the Law of Controlling Shareholders*, 24 DEL. J. CORP. L. 27, 39-42 (1999). However, statutes in Connecticut and Maine do permit director validation of transactions between nonprofit corporations and their parents or subsidiaries. CONN. GEN. STAT. § 33-1127(2) (1997); ME. REV. STAT. ANN. tit. 13-B, § 713(3) (West 1981).

In the Localsville example, the PASCМ has both a mission-related interest and a financial interest in the decision to close Local's elective radiology services, and thus operates under a conflict. To protect its decision from challenge, the PASCМ could seek approval by the directors of Local, provided that these directors are disinterested and full disclosure is made. If such approval could not be obtained, the PASCМ's action could be validated in court, if the closure is held to be fair.

C. *Fiduciary Duties of For-Profit Controlling Shareholders*

Part II.B explored the duties of nonprofit directors, in order to develop one potential analogue for PASCМs' fiduciary duties. The advantages of the Director Model include its sensitivity to the unique issues at play in the nonprofit sector and the factual similarities between the PASCМ actions at issue and those often taken by nonprofit directors. Another potentially useful analogy may be made to the fiduciary duties imposed on parents and other controlling shareholders in for-profit corporations. Despite the obvious and subtle differences between the for-profit and nonprofit contexts, these actors play roles quite similar to PASCМs in systems of nonprofit health care corporations. Controlling shareholders, like PASCМs, control the actions of their controlled corporations through their power to elect and influence directors and to vote on corporate actions.

The law of fiduciary duties for controlling shareholders defies simple description. There are many different types of controlling shareholders, and the courts often distinguish between these types in their treatment of these actors. For example, distinctions are drawn between majority and minority controlling shareholders, between close and publicly traded corporations, and between external shareholders operating controlling blocks of stock and related corporate parents. For present purposes, the model of the small and close corporation may be set aside as factually dissimilar to the large, sophisticated nonprofit corporations that typically become PASCМs. Still, there are important factual and legal differences between the responsibilities of a parent corporation of a wholly-owned subsidiary and those of a parent or other controlling shareholder exercising control in a corporation that also has minority shareholders.¹²² This subpart

122. Debate over the substance of a controlling shareholder's fiduciary duty, particularly in the context of sales of control and parent-subsidary mergers, has been fierce at times. Compare, e.g., Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698 (1982) with, e.g., Victor Brudney & Marvin A. Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297 (1974). The present discussion is not intended to enter into or to take sides in this for-profit debate, but rather to explore whether some of its contributions may be useful in specifying a fiduciary duty for PASCМs.

will attempt to summarize the various strands of this law and the commentary on it, in order to distill two more potentially useful models by which to analyze PASCМ fiduciary duties.¹²³

1. Wholly-Owned Subsidiary

The resemblance of a PASCМ's subsidiary to a wholly-owned, for-profit subsidiary is apparent. The PASCМ, like the parent of a wholly-owned, for-profit subsidiary, has the right to elect all of the subsidiary's directors and to vote on major organic events in the life of the subsidiary.¹²⁴ The PASCМ holds these rights by virtue of its membership interest, rather than the ownership interest possessed by the parent of a wholly-owned, for-profit subsidiary. This distinction notwithstanding, the similarities of these two control positions make it more than reasonable to look to the law governing parents of for-profit, wholly-owned subsidiaries to detect potential regimes for regulating PASCМs.

Relatively few cases limn the duties of parents in the context of for-profit, wholly-owned subsidiaries. This fact is unsurprising given that the enforcement mechanisms for claims by a mistreated for-profit subsidiary are legal actions instituted by the subsidiary's directors or shareholders. There are no individual disappointed shareholders to challenge the parent in this context; the parent is the sole shareholder. This places the burden of enforcement entirely on the wholly-owned subsidiary's directors. However, these directors are unlikely to prosecute the parent corporation for breach of fiduciary duty because they commonly are dominated, or at least influenced, by the parent who elects them.

However, a rule has begun to emerge from cases arising in unusual postures. In *Anadarko Petroleum Corp. v. Panhandle Eastern Corp.*,¹²⁵ the parent company of a wholly-owned, for-profit subsidiary planned to spin off the subsidiary and declared a stock dividend to this effect.¹²⁶ Before the effective date of the stock dividend, the parent restructured contracts between itself and its subsidiary, making the contracts less favorable to the subsidiary. The parent obtained approval for the restructured contracts from the subsidiary's board.¹²⁷

123. In reviewing for-profit analogies, reliance primarily will be placed upon Delaware law and the pronouncements of the Delaware courts.

124. *E.g.*, RMNCA § 8.04(1) (providing for the election of directors by the members of a nonprofit corporation with members); *id.* §§ 6.01, 10.03, 11.03(a), 12.02(b) (describing members' pivotal role in article amendment, mergers, sales of assets, and dissolutions).

125. 545 A.2d 1171 (Del. 1988).

126. *Id.* at 1173.

127. *Id.* Four of the five members of the subsidiary's board who participated in the relevant meeting, including three of the directors who approved the contracts, also

Following the spin-off, and after the appointment of a new independent board, the former subsidiary attempted to rescind the contracts.¹²⁸ It sued the former directors and the parent corporation.¹²⁹

In affirming summary judgment against the subsidiary, the Delaware Supreme Court made two statements important to the present inquiry: (1) "in a parent and wholly-owned subsidiary context, the directors of the subsidiary are obligated only to manage the affairs of the subsidiary in the best interests of the parent and its shareholders," and (2) "a parent does not owe a fiduciary duty to its wholly-owned subsidiary."¹³⁰

Although at least one court has limited its interpretation of these statements to the unusual facts of *Anadarko*,¹³¹ other courts and commentators have accepted these statements as general propositions of law in the for-profit, wholly-owned subsidiary context.¹³² *Anadarko* has been used successfully as a defense to liability by a parent accused of breaching fiduciary duties toward its wholly-owned, for-profit subsidiary.¹³³ *Anadarko* also has been used offensively. In these cases, courts have permitted shareholders of parents to assert liability for breach of fiduciary duty against directors of the parents' wholly-owned subsidiaries.¹³⁴

The rule absolving for-profit, wholly-owned subsidiary *directors* of fiduciary obligations to the subsidiary itself is understandable as a practical matter. If the parent elects all of the subsidiary's directors,

were affiliated with the parent or one of its other subsidiaries. *Id.*

128. *Id.*

129. *Id.* at 1172.

130. *Id.* at 1174.

131. *First Amer. Corp. v. Al-Nahyan*, 17 F.Supp.2d 10, 26 (D.D.C. 1998) (holding that Virginia law would interpret *Anadarko* to apply only in the spin-off context and that otherwise "the directors of a wholly-owned subsidiary owe the [subsidiary] corporation fiduciary duties, just as they would any other corporation"). Note, however, that the District Court left the "far more perplexing" issue of the scope of the duties owed to such a wholly-owned subsidiary to "future cases and further commentary." *Id.*

132. *Shaev v. Wyly*, 1998 WL 13858 *1, *2 (Del. Ch. 1998) (describing the *Anadarko* court's twin pronouncements as statements of "settled rules of law"); 3 BETH A. BUDAY & GAIL A. O'GRADNEY, *FLETCHER CYCLOPEDIA OF CORPORATIONS* § 844.30 (1994) (citing *Anadarko* as authoritative).

133. *Resolution Trust Co. v. Bonner*, 1993 WL 414679 *1, *3 (S.D. Tex. 1993) (granting a motion to dismiss such a claim for breach of fiduciary duty against the parent of a wholly-owned subsidiary).

134. *Richardson v. Reliance Nat'l Indemn. Co.*, 2000 WL 284211 *1, *12 (N.D. Cal. March 9, 2000) (slip opinion) (rejecting a motion to dismiss breach of fiduciary duty claims against subsidiary directors, which motion had plead that the wholly-owned subsidiary directors owed no fiduciary duty to the plaintiff, a shareholder of the parent); *Shaev*, 1998 WL 13858 at *3 (Del. Ch. 1998) (finding a shareholder of the parent of a wholly-owned subsidiary would have standing to bring a derivative action against the subsidiary's directors).

the rule that the subsidiary's directors' only duty runs to the parent and its shareholders simply may recognize that a duty to the parent is the only duty that these directors practically could be depended upon to fulfill. If the law of fiduciary obligation bade these directors to serve the interests of the subsidiary as well, in any cases in which the two interests diverged, the subsidiary's directors would suffer from a potentially disabling "horizontal conflict."¹³⁵

When the interests of two groups to which duties are owed are in such a conflict, one practical resolution for the fiduciary is to comply with the duty for which the most effective enforcement mechanisms exist.¹³⁶ In the for-profit context, all of the effective enforcement mechanisms belong to the corporate parent/sole shareholder.¹³⁷ Thus, to state that wholly-owned subsidiary directors owe, or should pursue, duties to constituencies other than the parent corporation and its shareholders could be to engage in fiction.¹³⁸ One also may posit a theoretical reason for the *Anadarko* rule in a for-profit, wholly-owned subsidiary. In the for-profit situation, in which a parent owns all of the subsidiary's stock, the argument can be made that the interests of the single shareholder parent and the wholly-owned subsidiary are simply identical.¹³⁹

The rationale for *Anadarko's* declaration that the *parent* owes no

135. Eric J. Gouvin, *Resolving the Subsidiary Director's Dilemma*, 47 HASTINGS L.J. 287, 302-03 n.62 [hereinafter Gouvin, *Subsidiary Dilemma*] (explaining that for-profit subsidiary directors are placed in a "horizontal conflict" when they "owe duties to more than one constituency and are charged with making sure that all the constituencies get their due . . .").

136. See *id.* at 302-03 n. 62. Analogously, Lawrence Mitchell argues that in the for-profit sector, the interests of non-shareholder constituencies, nominally protected by statute, will be under-enforced unless they coincide with shareholder interests. Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 TEX. L. REV. 579, 603-07 (1992) (concluding that because of the differential availability of enforcement tools, directors will resolve "horizontal conflicts" by opting for the action that serves shareholders, rather than other constituencies).

137. Gouvin, *Subsidiary Dilemma*, *supra* note 135, at 302-03.

138. *Id.* at 304-05. But see Deborah A. DeMott, *The Mechanisms of Control*, 13 CONN. J. INT'L L. 233, 251 (1999) [hereinafter DeMott, *Mechanisms of Control*] (noting that a parent pursuing strategies of removal and replacement of subsidiary directors in the for-profit context may incur some costs). Such strategies do "require a public and visible assertion of the majority shareholder's power, a prospect that invites adverse publicity, intensified regulatory scrutiny, and perhaps the close attention of entrepreneurial shareholders' lawyers." *Id.* Removal or replacement of subsidiary directors in the nonprofit context likewise may invite poor publicity, regulatory scrutiny and close attention by the attorney general. *Id.*

139. Gouvin, *Subsidiary Dilemma*, *supra* note 135, at 296-97 (noting that in ordinary situations, the interests of a corporation and its shareholders will coincide). But see *id.* at 307-312 (exploring the duties that a corporation owes to non-shareholders, which may conflict with duties owed to shareholders).

fiduciary obligation to a wholly-owned, for-profit subsidiary is less compelling. One critic argues that it is misguided entirely to dismiss the parent's potential duty to its wholly-owned subsidiary.¹⁴⁰ Rather, he advocates the recognition of the subsidiary directors as the agents of the parent corporation. Therefore, the duties that subsidiary directors cannot be counted on to fulfill could be imposed upon the parent corporation itself.¹⁴¹

Another critic of *Anadarko* similarly disapproves of the wholesale removal of fiduciary obligations running to wholly-owned, for-profit subsidiaries, but would be comfortable imposing these duties on the subsidiary's directors.¹⁴² She asserts that

[I]t can be both feasible and worthwhile to treat subsidiary directors, not as the parent's agents, but as the governing body of a separate corporation. Even when the subsidiary has no minority equity investors, third party relationships with the subsidiary give

140. *Id.* at 332-38.

141. *Id.* at 332-37; Eric J. Gouvin, *Of Hungry Wolves and Horizontal Conflicts: Rethinking the Justifications for Bank Holding Company Liability*, 1999 U. ILL. L. REV. 949, 986-1004 (1999) [hereinafter Gouvin, *Bank Holding Company Liability*] (describing this approach in more detail in the context of bank holding companies).

Eric Gouvin also notes the potential applicability in the wholly-owned subsidiary context of Mitchell's approach to enforcing the interests of non-shareholder constituencies in "horizontal conflict" with shareholder interests. Gouvin, *Subsidiary Dilemma*, *supra* note 135, at 330-32. Mitchell's approach was designed to help enforce so-called "other constituency statutes." These statutes have been enacted in many states in order to permit for-profit directors to take into account the interests of non-shareholders in making business decisions, without losing the protection of the business judgment rule. Mitchell, *supra* note 136, at 579-81. Mitchell adapts a test sometimes used to measure close corporations' shareholders' compliance with their fiduciary duties to test the fiduciary responsibility of directors faced with horizontal conflicts. *Id.* at 635-39. The test proceeds in steps.

First, plaintiffs, including non-shareholder groups granted standing by other-constituency statutes, must prove that actions taken by a corporation's board were injurious to their legitimate interests. *Id.* at 635-36. Once this burden is discharged, the burden shifts to the board of directors to prove that its actions were taken in the pursuit of a legitimate corporate purpose. *Id.* at 636. If they succeed, the plaintiffs are permitted to show that the demonstrated purpose could have been achieved in a manner "less injurious to their interests." *Id.* If plaintiffs make this showing, Mitchell argues that courts should enjoin or endeavor to undo the conflicted transaction. *Id.*

Gouvin explains that because a wholly-owned subsidiary director's position often places the director in similar horizontal conflicts, Mitchell's burden-shifting rule could be used to protect the interests of wholly-owned subsidiary corporations against those of their parents/sole shareholders. Gouvin, *Subsidiary Dilemma*, *supra* note 135, at 330-32. Ultimately, however, Gouvin finds this solution unworkable because it lacks a sufficient understanding of the demands of the parent on the subsidiary's directors, and because it creates a rule that is too complex, inefficient and unpredictable. *Id.* at 331.

142. DeMott, *Mechanisms of Control*, *supra* note 138, at 254-55 & n.101.

it interests that are not identical with those of the parent¹⁴³

Both critiques offer arguments for the imposition of a fiduciary duty running to wholly-owned subsidiaries and against prevailing law, even in the for-profit setting.

However, assuming that courts do not modify the *Anadarko* rule to meet these critiques, the current rule serves as a workable alternative model for PASCМ fiduciary duties. A Wholly-Owned Subsidiary Model would treat a PASCМ as if it were the parent of a for-profit, wholly-owned subsidiary or one of the subsidiary's directors, whose only fiduciary obligations run to the parent and the shareholders of the parent.¹⁴⁴ The PASCМ would owe no fiduciary obligation to the subsidiary and would be duty-bound to serve only the interests of the parent and its members. Therefore, a PASCМ action on behalf of its subsidiary could be reviewed only to ensure that it extended the appropriate care and loyalty to the parent and the parent's members, if any. The current lack of state law recognizing fiduciary duties for PASCМs might be interpreted to adopt this Model.

Consider again the Localsville example. A court adopting the Wholly-Owned Subsidiary Model simply would not inquire into the interests of Local or its community in evaluating the PASCМ's decision to aggregate the elective radiology services of Local and Southside Hospital. It would evaluate only whether the PASCМ's directors have met their fiduciary duties of care and loyalty toward the PASCМ and its members, and would dismiss any action purportedly brought to enforce a fiduciary duty of the PASCМ or its directors toward Local.

2. Controlling Shareholder with Minority Shareholders

At first blush, the Wholly-Owned Subsidiary Model may seem most factually aligned with the PASCМ situation, in that the PASCМ, by definition, is a *sole* member. It wholly controls the subsidiary, although it does not own it. However, the for-profit corporation with both a controlling shareholder and minority shareholders should not be dismissed out of hand as a relevant model. In significant respects, the beneficiaries of the PASCМ's subsidiary, namely its patients and community, stand in a position similar to the minority shareholders in a non-wholly-owned, for-profit subsidiary. These beneficiaries are legitimate stakeholders, but they, like the for-profit subsidiary's minority shareholders, are vulnerable to the power of the controlling entity. They have a legitimate and potentially conflicting claim to call on those directing the corporation to act in the interests that they represent. And, they have a potential enforcement

143. *Id.* at 254-255 n.101.

144. *Anadarko*, 545 A.2d at 1178.

mechanism in the Attorney General's enforcement powers. Of course, this mechanism may well be less effective than a minority shareholders' derivative suit in the for-profit context.

As early as 1919, the United States Supreme Court stated that when a majority shareholder exercises control, "it occupies a fiduciary relation toward the minority, as much so as the corporation itself or its officers or directors."¹⁴⁵ The fact of this obligation is widely accepted.¹⁴⁶ However, the substance of this obligation and its application by the courts has not always been clear.¹⁴⁷ The meaning of the controlling shareholder's duty remains the subject of debate in the corporate legal practice and academic communities.¹⁴⁸ Still, in considering the application of the majority shareholder's fiduciary duties to the PASCAM situation, it is instructive to look at the rules applied in cases addressing operational decisions by controlling shareholders.

In *Sinclair Oil Corp. v. Levien*,¹⁴⁹ the Delaware Supreme Court explained its views of the fiduciary obligations of a for-profit parent corporation toward its non-wholly-owned subsidiary in the context of three operational decisions: the declaration of a dividend, the alleged misappropriation of a corporate opportunity, and a breach of contract.¹⁵⁰ The court stated:

A parent does indeed owe a fiduciary duty to its subsidiary when there are parent-subsidiary dealings. However, this alone will not evoke the intrinsic fairness standard. This standard will be applied only when the fiduciary duty is accompanied by self-dealing – the situation when a parent is on both sides of a transaction with its subsidiary. Self-dealing occurs when the parent, by virtue of its domination of the subsidiary, causes the subsidiary to act in such a way that the parent receives something from the subsidiary *to the exclusion of, and detriment to, the minority stockholders of the subsidiary*.¹⁵¹

In the absence of self-dealing, so defined, the *Sinclair* rule evaluates compliance with fiduciary duty by the parent corporation using the business judgment rule.¹⁵² If no such advantage is taken by the parent, the parent is protected unless the objecting minority shareholders can demonstrate that the parent failed to make a ra-

145. *S. Pac. Co. v. Bogert*, 250 U.S. 483, 487-88 (1919).

146. John C. Carter, *The Fiduciary Rights of Shareholders*, 29 WM. & MARY L. REV. 823, 831 (1988); J.A.C. Hetherington, *Defining the Scope of Controlling Shareholders' Fiduciary Responsibilities*, 22 WAKE FOREST L. REV. 9, 12 (1987).

147. Siegel, *supra* note 121, at 31.

148. *See supra* note 122.

149. 280 A.2d 717 (Del. 1971).

150. *Id.*

151. *Id.* at 719-720 (emphasis added).

152. *Id.* at 720.

tional, informed decision.¹⁵³ In contrast, if an advantage is taken by the parent to the exclusion of and detriment to the subsidiary's minority shareholders, the burden of proof falls to the parent to show the intrinsic fairness of the disputed action.¹⁵⁴ Earlier in its opinion, the court explained that to show such "intrinsic fairness," the parent corporation would have the burden to prove that the transactions in question were "objectively fair."¹⁵⁵ Not surprisingly, in *Sinclair*, for each of the transactions in which the threshold test required business judgment rule scrutiny, the court held in favor of the parent.¹⁵⁶ When the threshold test pointed to intrinsic fairness review, the court held in favor of the objecting minority shareholders of the subsidiary.¹⁵⁷

A similar principle was relied upon in *Case v. New York Central Railroad Co.*¹⁵⁸ In that action, minority shareholders objected to a contract between the parent and its controlled subsidiaries, which allocated tax savings among them on a consolidated tax return.¹⁵⁹ The agreement allowed the parent to be credited with virtually all of the tax savings of the relevant subsidiary.¹⁶⁰ On these facts, the New

153. *Id.*

154. *Id.*

155. *Id.* at 719-20.

156. *Id.* at 722.

157. *Id.* at 722-23. At least one commentator, Mary Siegel, reports that the *Sinclair* regime has eroded over time; some cases do not apply it at all and others misapply it in various ways. See Siegel, *supra* note 121, at 51-70. In challenges to actions by controlling shareholders that are in the ordinary course of business, Siegel reports that the *Sinclair* advantage/disadvantage test has been applied only inconsistently. See *id.* at 59-70. And, she finds that when Delaware courts review controlling shareholder transactions involving ultimate ownership of the controlled corporation, most often they neglect the threshold test and move immediately to an intrinsic fairness review. See *id.* Despite this checkered history, the *Sinclair* test has not explicitly been overruled, has been applied and cited over time, and still provides a workable alternative test for evaluating the conduct of PASCMS. See, e.g., *Solomon v. Armstrong*, 747 A.2d 1098, 1112-13 nn.35-36 (Del. Ch. 1999); see also *Getty Oil Co. v. Skelly Oil Co.*, 267 A.2d 883, 887 (Del. 1970) (applying a *Sinclair*-type test to a parent-subsidiary transaction case predating *Sinclair*).

Despite her finding that the *Sinclair* test has eroded, Siegel supports revitalization of the test in cases involving "enterprise" decisions by controlling shareholders. See Siegel, *supra* note 121, at 43-44, 80-81 (using Bayless Manning's terms to distinguish two categories of controlling shareholder decision-making, those involving "enterprise" versus "ownership-claim" decisions) (citing Bayless Manning, *Reflections and Practical Tips on Life in the Boardroom after Van Gorkom*, 41 BUS. LAW. 5-7 (1985)). She argues that in these situations, the courts should apply a meaningful *Sinclair* advantage/disadvantage test before requiring the controlling shareholder to prove entire fairness. See *id.* at 80-81.

158. 204 N.E.2d 643 (1965).

159. *Id.* at 644-45.

160. *Id.* at 647.

York Court of Appeals held that although the controlling shareholder parent had gained much more from the arrangement than had the minority shareholders, "the pattern of managerial disloyalty to a corporation by which the stronger side takes what the weaker side loses is entirely absent from this record."¹⁶¹ Since the controlling shareholder's advantage did not come at the disadvantage of the subsidiary — the subsidiary was not in a worse position than it would have been if no such arrangement had been made — the court declined to "interfere[] with the challenged corporate decision."¹⁶²

The controlling shareholder situation is not a simple one in which the fiduciary is charged solely with serving the interests of the entrustor. The interests of both minority shareholders and the controlling shareholder are legitimate. The controlling shareholder purchases a controlling stake. It understandably wants to use that control to influence the corporation's decisions to further its own interests, without necessarily considering the interests of the minority shareholders. The minority shareholders, however, also lend their capital to the enterprise with the expectation that they will share in its control and its fortunes.¹⁶³

The *Sinclair/Case* principle attempts to balance these legitimate but conflicting interests. In both cases, the courts separate out those transactions in which a controlling shareholder's influence poses the greatest threat to the interests of the minority shareholders. Less offending exercises of control are spared intrusive fairness review. Reasonable minds can differ as to whether the *Sinclair* and *Case* rules strike the right balance. However, this sort of functional rule serves the important purpose of decreasing the threat of litigation in every controlling shareholder decision.¹⁶⁴ Such a test is also a useful alternative for regulating the PASCМ.

In a model based on controlling shareholder standards of fiduciary duty, the PASCМ would be treated like a controlling shareholder in a for-profit corporation with minority shareholders. A court reviewing a challenged PASCМ action under this Controlling Shareholder Model first would ask the threshold question whether the action afforded an advantage to the PASCМ to the exclusion of, and detriment to, the subsidiary's minority shareholders. If the PASCМ took no such advantage, its action would be subject to scrutiny only under the duty of care/business judgment rule rubric. If the PASCМ

161. *Id.*

162. *Id.*

163. On the other hand, one could say that when purchasing shares of a controlled corporation, informed investors should be aware of and assume the risks of controlling shareholder abuse.

164. Siegel, *supra* note 121, at 72-80 (describing the utility of a mechanism to ward off fairness review of some for-profit controlling shareholder actions).

undertook a reasonable process, considering all of the relevant interests, its action most likely would go undisturbed. In contrast, if application of the threshold question revealed that the PASCМ had taken an advantage to the exclusion of and detriment to the subsidiary's minority shareholders, the action would be deemed a breach of fiduciary duty unless the PASCМ could show its action to be objectively fair.

In the Localsville example, the PASCМ does take such an advantage. It closes elective radiology services, a revenue producer for Local and a benefit to the patients of Localsville. It relocates these services in order to gain mission-related and financial advantages for itself – improved research capabilities and greater revenue from the combined elective radiology unit at Southside. In order to avoid liability for breach of the duty of loyalty under the Controlling Shareholder Model, the PASCМ would be required to prove the objective fairness of the decision to consolidate these services.

III. EVALUATION OF MODELS

The foregoing review of the fiduciary obligations imposed upon directors of nonprofit corporations, parents of wholly-owned, for-profit subsidiaries, and controlling shareholders in for-profit corporations with minority shareholders, has yielded three potential models for the substance of fiduciary obligations to be imposed upon PASCМs. These are: the Director Model, the Wholly-Owned Subsidiary Model, and the Controlling Shareholder Model. This Part evaluates each of these models on three aspects, in order to determine which best addresses the PASCМ situation and the problems it raises.

Part III.A will consider issues of application and will determine how each model translates from the area of the law from which it was drawn to the context of the PASCМ. Here, the main issues involve whether standards drawn from law created to regulate individual behavior and/or for-profit behavior can be applied successfully to institutions in the nonprofit sector. This Part also will deal with the complications that arise in defining the relevant interests under the various models.

Part III.B will explore questions of enforcement. It will evaluate whether each model, regardless of its ease of application in theory, can be enforced effectively to control PASCМ behavior. This discussion will touch upon the effectiveness of traditional modes of enforcement in the nonprofit sector, as well as the potential for new avenues for enforcement suggested by the models.

Finally, Part III.C will consider the consequences of applying and enforcing each model. Each model has the potential to affect various constituencies, including the PASCМs themselves, the health

care systems they seek to create, the public they are intended to benefit, and the health care and nonprofit sectors in general. It is, of course, impossible to catalogue or predict every consequence of applying the models to all of these groups. However, Part III.C strives to give an overview of the types of consequences that regulators, legislators and courts should reflect upon when considering whether to treat PASCMS under one of the three models raised here.

A. *Issues of Application*

1. The Director Model

As will be recalled, in the Director Model, the PASCMS is treated, and may be regulated, as an individual nonprofit director would be, by the following rules. Actions taken by the PASCMS as the sole member of the subsidiary are subject to the requirements of the duty of care. The PASCMS must take these actions in good faith, with necessary information, reasonable care, and appropriate concern for the organization's mission. To the extent that a state's law applies the business judgment rule to protect actions taken by nonprofit directors with proper indicia of reasonableness, the PASCMS also may avail itself of that rule's protection. Further, the PASCMS is subject to the duty of loyalty. If it takes action while laboring under a conflict of interest, the action either may be protected in advance by a vote of disinterested subsidiary directors after full disclosure, or it may be validated post hoc by a court on a finding of fairness.

Not surprisingly, a model drawn from law that ordinarily applies only to individuals raises several problems of application when applied to entities. In applying the duty of care to a PASCMS's actions, it is fairly simple to require the PASCMS entity's actions to be informed and reasonable. However, serious translation problems arise in applying the duty of loyalty obligations of individual nonprofit directors to a PASCMS entity. The first challenge is to determine the circumstances in which a PASCMS would be operating under a conflict of interest. The RMNCA defines a conflict of interest transaction as "a transaction with the corporation in which a director of the corporation has a direct or indirect interest."¹⁶⁵ In the context of individual directors, such conflicts generally result from a personal financial interest in the matter at hand. Common directorships, in which an individual director serves as a director for more than one party to a transaction, also can create conflicts of interest.¹⁶⁶

165. RMNCA § 8.31(a).

166. See *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983) (noting the conflict of interest faced by individuals holding dual or multiple directorships); Andrew G.T. Moore, *The "Interested" Director or Officer Transaction*, 4 DEL. J. CORP. L. 674, 674-75 (1979) [hereinafter Moore, *The "Interested" Transaction*].

The PASCМ has "a direct or indirect" financial interest in almost any decision the PASCМ makes for the subsidiary, if the idea of interest is read broadly enough. Further, common directors are likely. Some subsidiary directors are virtually certain to serve in other capacities within the PASCМ system. Therefore, under an expansive reading of "direct or indirect interest," every action taken by a PASCМ would be deemed tainted by a conflict of interest. However, if a narrower or more fact-specific construction of "direct or indirect interest" is employed, it is quite difficult to articulate standards for whether an individual PASCМ action would be so tainted.

The validation procedures in the Director Model also fail to track precisely to the PASCМ situation. The first procedure, validation by a vote of disinterested directors after full disclosure, raises the difficult question of whether the directors of the subsidiary ever could be disinterested in a decision involving the PASCМ and the subsidiary. As suggested above, some of the subsidiary's directors also may serve in other capacities for the PASCМ; they may serve as PASCМ directors or employees, or as directors or employees of other corporations of which the PASCМ is also the sole corporate member. These directors should be ruled out as potentially disinterested. Even more fundamentally, since the members elect directors in nonprofit corporations with members, the PASCМ elects all of the subsidiary directors. If every director subject to this influence of the PASCМ is treated as interested in a transaction or other decision in which the PASCМ is conflicted, disinterested director validation would never be viable.

It is possible that, although the PASCМ elects the directors of its subsidiary, these directors, once in office, could be trusted to make disinterested evaluations of a PASCМ's decisions. There may be directors on the board who are traceable to the subsidiary as an independent entity. The disinterestedness of these directors might be provable as a matter of fact in each case.¹⁶⁷ One way to deal with the question of disinterestedness is to assign to the PASCМ the burden to prove that a sufficient number of directors approved the action and were disinterested. If the PASCМ could not show a disinterested director vote to stave off a challenge to its actions, a court's inquiry could proceed to whether the PASCМ's action was fair.¹⁶⁸

167. Cf. DeMott, *Mechanisms of Control*, *supra* note 138, at 246-52 (describing the means for determining whether a controlling shareholder dominates corporate directors).

168. If the Director Model is adopted and implemented in this fashion, PASCМs appointing directors could consider electing a group of truly disinterested directors, in order to validate PASCМ actions and protect them from significant judicial scrutiny. However, such a strategy also would entail the risk that directors whose disinterestedness would not be questioned could refuse to validate some actions to which no objection ever would have been raised or that the courts ultimately would have deemed fair.

The second procedure for validating conflicted transactions, approval by a court on a fairness standard, raises an additional application issue – how to define fairness in the PASCМ context. It is easier to answer this question when evaluating whether an individual director meets his or her fiduciary duty in a freestanding nonprofit corporation than when considering a PASCМ action. In the former case, for the director to meet the fairness standard, the transaction must be concluded using fair procedures and it must be fair in its ultimate treatment of the corporation for which the director serves.¹⁶⁹ To make this determination of fairness in reviewing a typical nonprofit director's conflicted transaction, involving a personal financial conflict of interest, courts can evaluate the procedures used in negotiating the transaction and its financial terms. However, the transactions in which a PASCМ could be conflicted include not only cash or goods transactions reviewable on the basis of financial terms, but also operational decisions. These types of decisions are difficult to evaluate quantitatively.

In a related issue, if a court is asked to assess whether the action of a PASCМ is fair, it must answer the question "fair to whom?" For example, in the Localsville hypothetical, the interests of Local and Localsville, Regional Hospital, and RHCS are all legitimate, yet they potentially compete. If fairness requires a PASCМ to act solely in the interests of the subsidiary, as if the subsidiary was still freestanding, courts may stray too far from the realities of the situation. For instance, once Local is integrated into RHCS, it may be impossible for a court to evaluate Regional Hospital's actions towards Local in isolation from its actions throughout RHCS. Further, if courts completely ignore the subsidiary's position as part of a system in evaluating the fairness of a PASCМ's actions, liability concerns would force PASCМs to take actions out of line with their economic reasons for affiliation. This could chill affiliations to a degree not warranted by the potential dangers of PASCМ action.

To define fairness as solely serving the interests of the parent itself is also an unsatisfactory solution. Evaluating the fairness of a PASCМ's decision solely in terms of its impact on the PASCМ itself would emasculate the Director Model. This definition of fairness would render nonexistent the fiduciary duties to the subsidiary that the Director Model purports to enforce.

The best application of the fairness concept to the PASCМ context takes its cues from the realities of that context. Thus, fairness in

169. Fairness also can be easier to evaluate in the for-profit director context because a court or regulator can use the expedient of evaluating the financial impact of the transaction. *But cf.* Mitchell, *supra* note 136, at 579-83 (raising concerns regarding the enforcement of a corporation's duty to serve non-shareholder interests even in for-profit context).

the actions of PASCMS should be defined with reference to the system of which both entities have chosen to become a part. In the Localsville example, in order to evaluate Regional Hospital's decision to close Local's elective radiology service, a court would consider the costs and benefits of the decision, in financial terms and in terms of access to and quality of care, to all of the communities and beneficiaries served by RHCS.

Courts should require that the subsidiary's purposes include system-wide service in order for a PASCMS to seek shelter in this enhanced definition of fairness. To meet this requirement, corporate articles and bylaws should be amended to include service of system-wide interests as a corporate purpose before or during the affiliation transaction. This requirement would highlight for the potential subsidiary and other interested parties (the community, beneficiaries of the subsidiary, etc.) the power shift inherent in a PASCMS transaction. Moreover, it would do so before the potential subsidiary becomes subject to the control of a PASCMS and duties become muddled.¹⁷⁰ To the extent that such a change of purposes raises duty of obedience questions regarding the potential misuse of donated funds, this requirement would encourage resolution of these issues prior to the entanglement of directors' fiduciary duties by the affiliating transaction.

If a change of purposes is required for use of a system-wide definition of fairness, it does potentially set a trap for unwary entities that create a PASCMS structure without proper amendments to corporate documents. However, PASCMS usually are quite sophisticated entities and PASCMS structures generally are created in major transactions. Skilled practitioners can be counted upon to provide advice on the relevant issues and to craft revised documents, tempering this problem greatly. The benefits of this solution, in requiring forethought and honesty about the changing nature of the duties owed once a PASCMS structure is established, should outweigh this potential cost.

2. The Wholly-Owned Subsidiary Model

Of all of the models, the Wholly-Owned Subsidiary Model is the easiest to apply to the PASCMS context. In the Wholly-Owned Subsidiary Model, the PASCMS has no duty to its subsidiary, just as a parent of a for-profit, wholly-owned subsidiary has been held to have no duty toward its subsidiary. Here, translation is simple. The PASCMS may make any decisions acting as PASCMS that it desires in

170. Such a requirement also would add to the fiduciary obligation a contractual argument that the PASCMS must consider the system-wide impact of actions it takes on behalf of its subsidiaries.

order to serve its own interests. A court evaluating a challenge to a PASCAM action under this Model would need to assess only whether the PASCAM's directors have met their fiduciary duties of care and loyalty toward the parent's interest. Moreover, it would dismiss any action ostensibly brought to enforce fiduciary duties running to the subsidiary.

3. The Controlling Shareholder Model

The Controlling Shareholder Model, as conceived here, requires courts to evaluate the actions of a PASCAM as if it were a controlling shareholder in a for-profit corporation with minority shareholders. As such, a court first would apply the threshold test of whether the challenged action advances the PASCAM's position to the exclusion of and detriment to the subsidiary's minority shareholders. If no such advantage is taken, a court would evaluate the PASCAM's action only under the business judgment rule. If such an advantage is appropriated by the PASCAM, a court would determine whether the PASCAM's action was fair. The challenges in applying the Controlling Shareholder Model to the PASCAM context are defining the "minority shareholders" of a PASCAM subsidiary in the threshold test and evaluating fairness in the ultimate test.

The first challenge arises because a PASCAM subsidiary has no actual shareholders, minority or otherwise. Therefore, a court applying this Model must select an appropriately analogous entity and consider the impact of the PASCAM's action on that entity. A court could designate the subsidiary corporation itself as the relevant entity, and then consider whether the PASCAM action advantages or disadvantages the subsidiary from an operational and/or financial perspective. However, after a PASCAM structure has been established, accepting this understanding of the subsidiary's "minority shareholders" requires a court to define a fictional set of interests for an entity that no longer exists.

Further, analogizing the interests of minority shareholders to the interests of the subsidiary as if it remained freestanding could permit manipulation by PASCAMs. The PASCAM could strategically share with the subsidiary corporation some portion of the advantage it obtains by its action in order to meet the threshold test, and avoid intrusive fairness review. The absence of an element of relative exclusion or relative detriment in the threshold test heightens this potential for manipulation. A significant detriment is insufficient to trigger fairness review if even a small portion of financial advantage gained by the parent is shared with the subsidiary. This is acceptable in the for-profit controlling shareholder context because the interest of minority shareholders is in sharing the financial success of the corporation with the controlling shareholder. Thus, sharing even a

small portion of the financial advantage of the controlling shareholder's decision offers minority shareholders significant protection. However, in the nonprofit context, sharing a small financial advantage with the subsidiary may not provide any protection for the interests of the subsidiary's beneficiaries or the wider public.

In order to offer some protection for these stakeholders, courts adopting the Controlling Shareholder Model should treat the particular beneficiaries of the subsidiary – here, its patients and broader community – as the subsidiary's "minority shareholders." These beneficiaries are the unwitting potential losers in the PASCМ structure. Like the interests of a for-profit subsidiary's minority shareholders, the interests of these beneficiaries are unrepresented and vulnerable. Further, by defining the interests that are protected in this fashion, the threshold test would filter out less threatening PASCМ actions from court review.¹⁷¹ It would, of course, be more difficult to quantify the interests of the subsidiary's beneficiaries than for a court to assess the financial losses of excluded minority shareholders. Consequently, the courts would have to translate the advantage/disadvantage test to the more qualitative terms relevant in the nonprofit context, such as access to and quality of care.

Once this definitional issue is resolved, courts would apply the advantage/disadvantage test and would evaluate the subset of PASCМ actions with significant potential for abuse on the standard of fairness. At this step, fairness again should be understood in system-wide terms. As in the Director Model, if the standard of fairness were to require PASCМs to act as if the subsidiary were freestanding, it would ignore the realities of the situation. Further, many of the economic reasons for both parties to affiliate would be lost. In their ultimate decisions, courts do not want to stifle affiliation completely, but rather to protect the interests of those who benefit from both nonprofit corporations.

4. A Final Note on Application

Application of either the Director Model or the Controlling Shareholder Model would result in some clouding of the duties of PASCМ directors. PASCМs, as entities rather than individuals, must work through agents. In this case, the relevant agents will be PASCМ directors. PASCМ directors have fiduciary obligations to the PASCМ. If they also are bound to act in compliance with the PASCМ's fiduciary duties toward its subsidiaries, they may find themselves faced with simultaneous and conflicting duties in indi-

171. Cf. Siegel, *supra* note 121, at 75-81 (arguing for an invigorated threshold test for for-profit controlling shareholders on similar grounds).

vidual transactions.¹⁷²

Traditionally, when an individual decision-maker is faced with fiduciary duties to two entities, the law instructs that he should act in the best interests of both entrustors.¹⁷³ This guidance can be quite difficult to follow in practice.¹⁷⁴ However, the ultimate standard of system-wide fairness applied in both the Director and Controlling Shareholder Models offers a compromise standard for directors to follow and for courts to enforce.

B. Problems of Enforcement

1. The Director Model

Application of the Director Model of fiduciary duty to PASCMS permits various mechanisms for enforcement. As is always true in the nonprofit sector, state attorneys general are the first line of defense. Attorneys general are authorized to enforce fiduciary duties running to nonprofit corporations.¹⁷⁵ Under the Director Model, therefore, attorneys general could seek injunctions against proposed PASCMS actions or damages or equitable remedies for completed PASCMS actions, on grounds the actions were taken in violation of a PASCMS's fiduciary duties. Unfortunately, this line of defense is not without its weaknesses. The offices of state attorneys general already are overburdened, and funds and manpower to devote to the policing of nonprofits historically have been and remain difficult to obtain.¹⁷⁶ However, political necessity may drive attorneys general to refocus on the nonprofit sector. At the moment, nonprofits in general, and health care nonprofits in particular, are coming increasingly under scrutiny by the public¹⁷⁷ and various government entities.¹⁷⁸ State at-

172. See L. Edward Bryant, Jr., *Responsibilities of Directors of Not-for-Profit Corporations Faced with Sharing Control with Other Nonprofit Organizations in Health Industry Affiliations: A Commentary on Legal and Practical Realities*, 7 ANNALS HEALTH L. 139, 152-53 (1998).

173. See *id.*; Moore, *The "Interested" Transaction*, *supra* note 166, at 674-75.

174. See Bryant, *supra* note 172, at 152-58 (discussing the difficulty of compliance when a fiduciary is subject to competing obligations to two or more nonprofit organizations).

175. See Hansmann, *Reforming Nonprofit Corp. Law*, *supra* note 84, at 600. Of course, statutory caps on liability and corporate indemnification agreements may limit the quantity of damages assessed against and paid by directors. See *supra* note 112.

176. See *Developments*, *supra* note 2, at 1595-96 (describing the lack of resources available to attorneys general in order to police nonprofit actors); Hansmann, *Reforming Nonprofit Corp. Law*, *supra* note 84, at 601 (describing the common lack of staff available to address nonprofit issues in the offices of state attorneys general); Kenneth L. Karst, *The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility*, 73 HARV. L. REV. 433, 437 (1960) (discussing the infrequent and irregular supervision of attorneys general over charitable fiduciaries).

177. Evelyn Brody, *Institutional Dissonance in the Nonprofit Sector*, 41 VILL. L.

torneys general may find enforcement of PASCAM fiduciary duties to be a useful tool in policing these entities. It will be especially useful in targeting those nonprofits that most closely resemble for-profit entities – against whom public skepticism seems to run most high.

Some states limit standing to challenge nonprofit actors for breach of fiduciary duties exclusively to the Attorney General.¹⁷⁹ Directors of a nonprofit corporation sometimes also are permitted to bring suit on behalf of the corporation, in their directorial role.¹⁸⁰ Otherwise, the grant of standing in such actions is quite limited.¹⁸¹ Thus, if a fiduciary duty based on the Director Model is applied to PASCAMs, a subsidiary director could sue to enforce this duty, on the theory that a director of a nonprofit corporation would have standing to bring an action to enforce the duties of other directors. As recognized above, however, there are substantial reasons to doubt the efficacy of subsidiary directors as a check on PASCAM actions in violation of fiduciary duty. The discussion of disinterested director validation concluded that subsidiary directors dependent on the PASCAM for their offices would be unlikely to refuse to validate PASCAM action. It seems even less likely that such directors would sue the PASCAM to prevent or undo such an action.

The imposition of the Director Model also could fuel private enforcement. The Director Model's procedural answer to fiduciary duty enforcement, allowing the PASCAM to obtain validation through a vote of disinterested subsidiary directors following full disclosure, could encourage self-regulation by PASCAMs.¹⁸² If PASCAMs are aware of the potential to remove the taint of fiduciary violation from their

REV. 433, 454-56 (1996) (describing the United Way scandal); Goldschmid, *supra* note 83, at 633-37 (cataloging recent nonprofit scandals at the United Way and Adelphi University and citing press reports).

178. Ono, *supra* note 97, at 107 & 133-35 (citing the rise in investigations into decision-making by fiduciaries in nonprofit health care organizations, including cases in Michigan, California, and Ohio); Lorraine McCarthy, *Governor Seeks State Oversight of Nonprofit Acquisitions of Other Nonprofit Hospitals*, 9 BNA HEALTH L. REP. 1489-90 (Sept. 28, 2000).

179. See Hansmann, *Reforming Nonprofit Corp. Law*, *supra* note 84, at 606-07 (explaining that although few state nonprofit statutes address standing, most states follow the rule of charitable trusts that only the attorney general has standing to sue).

180. See, e.g., RMNCA § 3.04; *Holt v. Coll. of Osteopathic Physicians & Surgeons*, 394 P.2d 932, 937 (Cal. 1964).

181. See Atkinson, *supra* note 99, at 657; Hansmann, *Reforming Nonprofit Corp. Law*, *supra* note 84, at 606-08; Kurtz & Green, *supra* note 99, § 11.01[1], at 11-2 to 11-3. Some states also grant standing to members. See, e.g., CAL. CORP. CODE § 7710 (West 1990) (providing the circumstances under which members may bring derivative actions); RMNCA § 6.30 (providing for derivative actions by members). However, suits by members are not a useful means of enforcement in the PASCAM context.

182. Of course, the potential for such self-regulation will be lost if it is impossible for subsidiary directors to be disinterested.

actions by obtaining subsidiary director validation, they might obtain validation as a matter of procedure, perhaps even enjoining such a procedure in their bylaws. This mode of self-regulation may be a useful adjunct in light of the limited resources available for government enforcement of fiduciary duties owed by nonprofit actors.¹⁸³

2. The Wholly-Owned Subsidiary Model

The Wholly-Owned Subsidiary Model, because it includes no duties for PASCMS, is easily enforced. The current machinery for enforcement of fiduciary duties can continue to operate without any additional need to police duties owed to subsidiaries by PASCMS. Under the Wholly-Owned Subsidiary Model, there are no such duties. Any claims that PASCMS or directors of their subsidiaries have failed to uphold their fiduciary duties to the subsidiary would be rejected quickly, so long as the subsidiary directors faithfully have pursued the interests of the PASCMS and its members.

3. The Controlling Shareholder Model

As in the Director Model, the primary enforcement mechanism for the Controlling Shareholder Model is litigation by state attorneys general and subsidiary directors. As such, the same advantages and disadvantages apply. Attorneys general have an interest in enforcing PASCMS duties and may have the motivation to do so, but usually lack sufficient resources. The subsidiary's directors and member may have standing to sue, but likely lack motivation. The subsidiary's beneficiaries and members of its community may possess the motivation to enforce PASCMS duties, but generally lack standing.

However, the Controlling Shareholder Model could encourage courts to expand the currently restricted grant of standing to enforce

183. Unlike in other situations involving fiduciary duties owed to nonprofit organizations, Internal Revenue Service enforcement of the so-called "intermediate sanctions" is unlikely to supplement state law enforcement of fiduciary duties in the PASCMS context.

A recent amendment to the federal tax imposes excise taxes on self-dealers in nonprofit, tax-exempt organizations under certain circumstances. 29 U.S.C. § 4958 (1998). Temporary regulations further define the application of these intermediate sanctions. 66 Fed. Reg. 2144 (2001) (to be codified at 26 C.F.R. pts. 53, 301 & 302). Although these intermediate sanctions are an important addition to the IRS' arsenal, they will not be available to regulate the actions of PASCMS because the sanctions do not apply to self-dealing by other exempt entities. See 26 C.F.R. § 53.4958-3T(b)(2)(iii)(d)(1). Even if an exception were to be made to allow the application of the intermediate sanctions to exempt PASCMS entities, these sanctions would not be a complete response to the PASCMS problem. The imposition and scope of sanctions are keyed to the financial impact of an improper transaction on an exempt entity. See § 4958(c). However, cash and good transactions are not the only types of PASCMS actions that raise concerns. Operational decisions, like those involved in the Localsville example, are also troubling and would not be addressed adequately by the current intermediate sanctions regime.

fiduciary duties owed to nonprofit corporations, to permit enforcement actions by the subsidiary's beneficiaries and community members. Because the Controlling Shareholder Model explicitly looks to the interests of these groups in its threshold test, courts could relax standing rules to entertain suits brought by them.¹⁸⁴ This Model, then, offers a third potential source of enforcement for PASCAM fiduciary obligations.

C. *The Question of Consequences*

It is not sufficient for the standards of these models to be applicable or translatable to the PASCAM context and for there to be mechanisms to enforce them. In order for any one of the proposed models for the fiduciary duties of PASCAMs to merit adoption, it also must detect and deter the types of PASCAM actions that potentially harm the public, while not preventing beneficial nonprofit affiliations. This is the question of consequences.

1. The Director Model

The Director Model has the advantage of drawing on a relatively well-developed body of case law created with sensitivity to nonprofit issues, and with which nonprofit directors will be familiar. Its primary advantage, however, is that it targets those situations in which the PASCAM problem arises. By regulating conflicts of interest under the duty of loyalty, the Director Model submits to review those decisions in which the PASCAM has the opportunity to serve its own purposes, rather than those of the subsidiary. As outlined above, this reviewing function may be performed by disinterested subsidiary directors or by the courts in a challenge to PASCAM action.

Unfortunately, however, the Director Model is overinclusive. The difficulty of translating to PASCAM actions a set of conflict of interest standards created to police financial interests of individual directors could submit virtually every PASCAM decision to review. As noted above, in an interconnected health system, PASCAMs are likely to have a direct or indirect interest in most decisions that would require member action, either statutorily or through reserved powers. The need to obtain disinterested director approval to validate the lion's share of PASCAM actions would add bureaucracy to the decision-making process and obviate many of the intended benefits of reservation of powers.

184. Scholars have debated at length the advisability and effectiveness of expanded standing to sue to enforce the duties of nonprofit fiduciaries. See, e.g., Atkinson, *supra* note 99, *passim*; Hansmann, *Reforming Nonprofit Corp. Law*, *supra* note 84, at 606-14. Traditionally, the main argument advanced against broadened standing is that it would increase harassing litigation. Hansmann, *Reforming Nonprofit Corp. Law*, *supra* note 84, at 607.

Moreover, even if PASCMS were willing to add approval by disinterested subsidiary directors to their decision-making processes, in many cases, disinterested director approval would not be viable. As described in Part III.A.1, it would be extremely difficult as a practical matter for subsidiary directors to remain disinterested when they depend exclusively upon the PASCMS for their offices. If disinterested director approval is not an available option, the Director Model leaves open to court challenge every PASCMS decision taken subject to a conflict of interest. Even with a system-wide conception of fairness, as advocated above, the fairness standard is factual and situation-specific. The difficulty of predicting the outcomes of such court challenges may render PASCMS decision-making uncertain and make PASCMS structures, and affiliation generally, less attractive.¹⁸⁵

Thus, the consequences of adopting the Director Model are decidedly mixed. The Director Model offers nonprofit-specific case law and the potential to review PASCMS actions for the type of overreaching that can be most troubling to local communities. However, the problems of defining conflicted transactions and of obtaining disinterested director validation increase the likelihood of litigation. This, coupled with the unpredictable fairness standard, may chill beneficial PASCMS actions and consolidation generally.

2. The Wholly-Owned Subsidiary Model

The Wholly-Owned Subsidiary Model suffers its major shortcomings in the area of consequences. This Model is drawn from an area of law without sensitivity to the special concerns present in nonprofit corporations, and of which nonprofit actors may be quite unaware. More importantly, however, this Model will not subject enough PASCMS actions to review. In fact, the Wholly-Owned Subsidiary Model does not call for review of any PASCMS actions. It simply deems the PASCMS problem incapable or unworthy of resolution and leaves it unchecked.

Therefore, the consequences of this Model are straightforward, if one-sided. If a jurisdiction is unconcerned with the potential abuses of a PASCMS's position, the Wholly-Owned Subsidiary Model is an appropriate response. However, if it is concerned that the PASCMS structure permits a subsidiary to maintain nonprofit status and the amenities of that status, although it may be used solely to serve the interests of another nonprofit corporation, the Wholly-Owned Subsidiary Model is not a satisfactory solution.

Additionally, if the jurisdiction seeks to protect the interests of

185. Cf. Goldschmid, *supra* note 83, at 637-38 (explaining that overburdensome regulation of nonprofit directors can be counterproductive by discouraging talented individuals from serving as directors).

the subsidiary's beneficiaries, the Wholly-Owned Subsidiary Model is inadequate. The *Anadarko* rule has been strongly criticized even in the for-profit sector, for failing satisfactorily to account for the separate interests of wholly-owned subsidiaries.¹⁸⁶ In the context of public benefit nonprofit subsidiaries, which are specifically created and granted nonprofit status due to their public-oriented interests, this Model is even less likely to be acceptable.

3. The Controlling Shareholder Model

Although the Controlling Shareholder Model draws on an area of for-profit law without a special awareness of nonprofit issues and that may be unfamiliar to nonprofit directors, it offers many benefits. Like the Director Model, it targets situations with the potential for PASCAM abuses of power. The Controlling Shareholder Model recognizes that a PASCAM owes a fiduciary duty to its subsidiary when it exercises its control over that subsidiary, and provides a mechanism to enforce this duty.¹⁸⁷

Also like the Director Model, the Controlling Shareholder Model provides a screen to protect some PASCAM actions from intrusive fairness review by the courts. This reduces the potential chill on affiliation threatened by over-burdensome regulation of PASCAM actions. In the Director Model, this screening function is served by disinterested director validation. However, the effectiveness of this screen is significantly reduced by the low likelihood that truly disinterested subsidiary directors would be available in the PASCAM context. If these disinterested subsidiary directors do not exist, whether a PASCAM action breaches its fiduciary duty could be determined conclusively only by court application of case-by-case fairness review.

The screen provided by the Controlling Shareholder Model is more practical and more sensitive. In the Controlling Shareholder Model, the courts and their precedents perform the screening function in the form of the threshold advantage/disadvantage test.¹⁸⁸ PASCAMs can evaluate their actions on the basis of this test and can determine that some of their actions will be reviewed, if at all, only under the business judgment rule. The laxity of this standard should provide considerable comfort to a PASCAM considering a decision on behalf of its subsidiary. The potentially swift conclusion of a case after failure to pass the threshold test also should moderate attorneys general and other potential litigants considering a challenge to a

186. See *supra* text accompanying notes 140-43.

187. At least one influential court already has compared the position of a sole or dominating individual member of a nonprofit corporation to that of a controlling shareholder in the for-profit context, and imposed upon this individual the fiduciary duties of a controlling shareholder. See *Oberly*, 592 A.2d at 461-62.

188. Cf. Siegel, *supra* note 121, at 72-81.

PASCM action on the basis of breach of fiduciary duty.

Therefore, the Controlling Shareholder Model offers the most important benefit of the Director Model, namely protecting the subsidiary and its beneficiaries from abuse by PASCMS, but its screening method is more effective. It places limitations on PASCMS' actions and subjects them to review. However, it blocks or renders uncertain fewer PASCMS actions, and protects from intrusive review actions that are the unobjectionable outgrowth of beneficial consolidation. Finally, it offers the potential for additional enforcement through self-regulation by PASCMS and may encourage courts to permit enforcement of nonprofit fiduciary duties by new groups of affected individuals.

IV. CONCLUSION

Due to the trend of affiliation in the nonprofit health care industry and the transactional and political advantages of the PASCMS affiliation structure, PASCMS entities have become commonplace. However, current law provides little guidance to courts, regulators, and PASCMS themselves on the manner in which a PASCMS should exercise the decision-making power it possesses over its subsidiaries. Under current law, PASCMS are decision-makers without duties. This gap creates the potential for abuse, at a loss to the beneficiaries of PASCMS subsidiaries.

The PASCMS problem can be ameliorated if courts and regulators recognize that a PASCMS, like other third-party decision-makers, owes fiduciary obligations when it acts on its entrustor's behalf. The details of this duty may most profitably be drawn by analogy to the standards of fiduciary duty imposed upon a for-profit controlling shareholder toward minority shareholders. Adopting the Controlling Shareholder Model to define PASCMS fiduciary duties will best allow nonprofit health care corporations to achieve the economic and qualitative gains of affiliation, while upholding their missions and protecting the interests of their beneficiaries.