

**SALES OF CHARITABLE ASSETS TO
FOR-PROFIT ENTITIES - REVIEW PROTOCOL**

Pursuant to the provisions of the Non-Profit Public Benefit Corporation Law (Corporations Code section 5000 et seq.), the approval of the Attorney General is not required as a condition of the sale of charitable assets. Rather, this decision is left to the discretion of the charitable corporations's Board of Directors (Corporations Code section 5911). The sole procedural requirement under the law in this respect is that the Attorney General be provided with 20-days' notice of the transaction if it involves all or substantially all of the charity's assets. (Corporations Code section 5913).

Notwithstanding these limitations, the Attorney General has authority to fully review the transaction, to obtain all relevant information and data, and to take appropriate action to remedy a breach of trust, should such occur. (Corporations Code sections 5142; 5250). In this regard, the role of the Attorney General is not to make public policy, but rather to enforce the provisions of the Non-Profit Public Benefit Corporation Law and California trust law so as to fully protect the charitable assets for the benefit of the public, who are the beneficiaries of all charitable trusts.

This protocol is for use by the attorneys and auditors within the Charitable Trust Section. It is not intended to be a complete or exclusive list of items to be reviewed and/or investigated, as these will vary on a case-by-case basis. Instead, it is intended to provide broad, general guidelines with respect to issues which are commonly found in such transactions.

I. INFORMATION GATHERING

Prior to the substantive review, care should be taken to obtain all necessary information and data relevant to the transaction. These generally include:

- A. All sale documents, including all collateral or ancillary agreements that may involve officers, directors, or employees, e.g., employment contracts, stock option agreements in the acquiring for-profit entity, etc. Where there are related business entities (partially or wholly-owned subsidiaries, related corporations, partnerships, etc), whether non-profit or for-profit, all necessary documents to determine the effect on these entities must also be obtained.

- B. Financial documents, including audited financial statements, ownership records, business projection data, current capital asset valuation data (marked to market), and any other records upon which future earnings, existing asset values and fair market value analysis can be based. Again, where there are related entities (non-profit or for-profit), similar data should be obtained for them.

- C. Relevant major contracts (assets and liabilities) which may affect value. These should include not only business contracts, but also employee contracts including buy-out provisions, profit-sharing agreements, etc.

- D. With respect to the acquiring entity, all ownership information necessary to determine whether there is a wholly independent third party involved in an arms-length acquisition or whether statutory self-dealing provisions apply. (Corporations Code section 5233). Particular attention should be paid where the acquiring entity is also acquiring additional interests in related companies or partnerships in which officers, directors or employees may have an ownership interest.
- E. In sales which are not "all cash to seller", all documents relating to the non-cash elements (stock, notes, etc.) should be obtained, including all necessary valuations of security for loans, stock restrictions, etc.
- F. All information, including Articles of Incorporation, bylaws, endowment fund documentation, trust restrictions, expenditure history, and other information necessary to define the trust upon which the selling charity's assets are held. In addition, all documentation regarding the process by which Board approval of the transaction was obtained should be reviewed.
- G. Tax-sensitive information, including the existence of tax-free debt which must be redeemed, disqualified person transactions yielding tax liability, etc.

- H. With respect to the remaining or successor charity, similar information to that contained in Paragraph F. In addition, all information with respect to officers, directors, and employees (both current and post-sale) in order to determine independence, Board make-up, charitable purposes, and to review any financial arrangements with officers, directors, or employees which may be affected by the transaction. Particular attention should be paid to financial arrangements which might affect an individual's objectivity in supporting or approving the transaction.
- I. Information from the beneficiary class and/or representatives thereof to insure that the sale proceeds are utilized for purposes consistent with the charitable trust for which they are held and that the beneficiary class remains constant. While the Non-Profit Public Benefit Corporations Law provides no statutory or regulatory authority to hold hearings in this regard, informal public input is usually readily available and should be obtained.

II. SUBSTANTIVE REVIEWS

A. Fiduciary Standards

1. Self-Dealing Transactions -

Initially a review should be conducted to determine if the transaction involves self-dealing. If so, strict compliance with the provisions of Corporations Code section 5233 is required.

Normally, the insider-purchasers and the charity should have separate counsel, separate valuation consultants, etc. Special concern should exist in those cases where no attempt has been made to expose the transaction to potential outside purchasers through employment of investment bankers, etc.

In all cases, independent directors (and this office) should be provided with independent valuation information and should exercise diligence to insure that the proposed transaction is the most advantageous available. (Corporations Code section 5233(d)(2)(D)).

2. Arms-Length Transactions -

Where the sale is to an independent third party in an arms-length transaction, the directors' decision is guided by the fiduciary standards set forth in Corporations Code section 5231. (See also Corporation Code section 5911).

- a. Initial review should concentrate on the duty of reasonable inquiry. Key elements should include whether appropriate and adequate consultants were retained to evaluate the benefit to the charity, valuation, tax consequences, etc.
- b. Special attention should be paid where there has been no legitimate effort to market the charitable asset widely to insure maximum return.

B. Specific Transactional Issues

1. Terms and Conditions of Sale

All terms and conditions of the sale should be carefully scrutinized.

Particular emphasis should be placed on the following:

- a. Contingencies which affect the purchase price.
- b. Indemnification provisions.
- c. Where stock (in lieu of cash) represents a significant portion of the sales price, issues of control, restrictions on sale, possible adverse tax consequences (redemption of tax-free bonds, minimum pay-out requirements, transactions involving disqualified persons, etc.), possible future dilution of interest (through stock options, retention of treasury stock, etc.), lack of liquidity, imprudent concentration of assets in a single holding, discount for minority interest, voting versus non-voting stock and related tax issues, etc., need to be considered.
- d. Where notes (in lieu of cash) are involved in the sale proceeds, security, discount to present value, marketability of note, tax consequences, etc., need be considered.
- e. Where related entities exist (e.g. co-owned partnerships, or corporations, wholly or partially-owned subsidiaries, etc.), special attention should be paid to the terms and conditions of sale so as to insure that arbitrary and/or unfavorable allocations

of assets, liabilities, costs, or proceeds are not used to reduce the charity's share of the total purchase price.

- f. Where the final purchase price is related to future earnings, special protections are often necessary to prevent unfavorable allocations of costs or corporate expenditures to depress earnings over the short-term.

2. Fair Market Value -

This is the key issue in most cases. A useful definition is found at Code of Civil Procedure section 1263.320. Simply put, the charitable beneficiaries are entitled to receive maximum value for their assets. Since we are normally dealing with valuation of a "going business concern", key items include:

- a. Make sure all assets are "marked to market" and not carried at book value (this is particularly important regarding land and securities).

- b. Future earnings are a key element of value -- as such, projected earnings, business plans, anticipated contracts, and sale timing are crucial.

- c. Whether the asset has been aggressively marketed by investment bankers, etc., in an attempt to generate multiple bidders and maximum value.

- d. Whether there are competing offers.

- e. Whether business valuation appraisals have been obtained and whether they include stock offerings, IPO values, and comparable sales, including control premiums, etc.

- f. Normally inadequate professional assistance, e.g., investment bankers, accountants, valuation analysts is indicative of lack of reasonable inquiry and due diligence.

- g. Values are normally estimated within ranges. If at the lower end of the range, look for overly lucrative officer, director, employee contracts, overly lucrative buy-outs of related, non-

wholly-owned subsidiaries or entities, etc., at the expense of the charitable interest.

- h. Non-cash transactions need to be scrutinized with special care to obtain an equivalent cash value. (See B. 1. c. and d. herein.)
- i. Be alert to specific items peculiar to non-profits that can depress earnings and which may cease immediately upon sale. These items should be factored out if not mandated to continue by the purchase agreement so as to avoid understating value.

3. Inurement -

All transactions should be investigated to insure that no officer, director, employee, spouse or family member, or private party receives inurement from the transaction. Key areas of inquiry normally include:

- a. Stock options;
- b. Pension plans and perquisites;
- c. Performance bonuses;

- d. Corporate loans;
- e. Golden parachute provisions;
- f. Excessive salaries;
- g. Side deals for officer, director, employee private ventures;
- h. Over-market compensation for employee-owned related entities. (See B.1.a.; B.2.a.).
- i. A related issue is whether post-sale employment terms at the remaining (or successor) charity affected objectivity in approving the transaction.

III. **CHARITABLE TRUST ISSUES**

A. Charitable Purposes

- 1. Attendant to the sale of charitable trust assets, it is important to insure that the sale proceeds are used for their proper purposes. In this regard, all restricted funds must remain segregated and used for their

restricted purposes. With respect to general corporate funds, the remaining (or successor) charity must utilize the assets for a like charitable purpose benefitting the same class of beneficiaries, e.g., health care, education, low-cost housing, etc. Obviously any newly created charity must have the same purposes and same dedication clause as its predecessor.

2. In those instances where a sale of assets results in the reallocation of funds from an operational use to a grant-making use, it is particularly important to insure that a constancy of purpose is maintained. Where specific charitable purposes are likely to be lost or significantly diminished by the sale of assets, restrictions should be placed on the sale proceeds to mitigate those losses and to insure that those charitable purposes continue.

B. Prevention of Conflicts

1. Charity-Acquiring Entity Contracts

Where sale proceeds are tied to the provision of services by the acquiring for-profit entity, they should be carefully scrutinized for

necessity, valuation, and verifiability. These provisions are always suspect.

2. Non-Independent Charities

Acquiring for-profits should not be permitted to maintain control of the payment proceeds through the creation of a new controlled foundation or through appointments to the existing charity's Board. It is hardly an arms-length sale if the buyer controls the proceeds after sale.

3. Individual Conflicts

Inquiry should be made to attempt to insure that conflicts of interest do not exist between officers, directors, or employees of the charity and the acquiring entity.

C. Continuing Oversight

Since such sales often create new and extremely large charitable foundations, often with significant restricted funds, continuing oversight under normal charitable trust standards should be maintained to insure compliance with applicable laws.

IV. CONCLUSION

While Corporations Code section 5911 expressly authorizes the sale of charitable assets at the discretion of the corporation's Board of Directors, such authorization is subject to review by this office for compliance with the substantive provisions of the Non-Profit Public Benefit Corporations law. The fiduciary standards required of Directors should be firmly enforced. In doing so, we are most able to protect the public beneficiaries of charitable trusts.