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ATTORNEY GENERAL OPINION NO. 89- 44

The Honorable Bob Vancrum
State Representative, Twenty-Ninth District
State Capitol, Room 112-S
Topeka, Kansas

Re: Corporations--Directors and Officers--Financial
Interest of Officer or Director in Corporate
Transaction; Application to Certain Nonprofit
Corporations

Synopsis: Not-for-profit corporations which are private
foundations are subject to the provisions of K.S.A.
17-6304 and the duty of loyalty/fairness when
making loans or charitable contributions.
Transactions between a not-for-profit corporation
and one or more of its directors are allowed if the
directors' interests are disclosed and the
directors do not unfairly benefit to the detriment
of the corporation. Cited herein: K.S.A. 17-6001;
17-6102; 17-6304; 79-4601.

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Dear Representative Vancrum:

You request our opinion regarding the applicability of K.S.A. 17-6304 and the common law duty of loyalty/fairness to Kansas not-for-profit corporations which are private foundations. Your belief that private foundations are not subject to these provisions is essentially based on two arguments: 1) These conflict of interest provisions appear to contemplate an arms-length transaction whereby the corporation receives some "benefit for the bargain" making their application to private

foundations nonsensical because these foundations frequently loan or give away corporate assets for nothing in return pursuant to K.S.A. 17-6102(9) and (14); and 2) K.S.A. 79-4601, a provision which specifically addresses self-dealing of private foundations, is inconsistent with K.S.A. 17-6304 thereby rendering the latter inapplicable to private foundations pursuant to K.S.A. 17-6001(c). Briefly, the situation with which you are concerned involves a below market rate loan made by a private foundation to a partnership which has as a limited partner a for-profit corporation with a board of directors common to the private foundation.

K.S.A. 17-6304 provides in part:

"(a) No contract or transaction between a corporation and one or more of its directors or officers, or between a corporation and any other corporation, partnership, association or other organization in which one or more of its directors or officers are directors or officers, or have a financial interest, shall be void or voidable solely for this reason, or solely because the director or officer is present at or participates in the meeting of the board or committee thereof which authorizes the contract or transaction, or solely because his or their votes are counted for such purpose, if:

"(1) The material facts as to his relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorized the contract or transaction by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum; or

"(2) The material facts as to his relationship or interest and as to the contract or transaction are disclosed or are known to the shareholders entitled to vote thereon, and the contract or

transaction is specifically approved in good faith by vote of the shareholders; or

"(3) The contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified by the board of directors, a committee thereof or the shareholders." (Emphasis added.)

Kansas has always imposed a very strict fiduciary duty on directors of a corporation to act in the best interest of the corporation, placing corporate interests above personal interests. Parsons Mobile Products, Inc. v. Remmert, 216 Kan. 256, Syl. §2 (1975). While the trend may be changing, Kansas case law currently requires a showing of fairness, if challenged, in addition to shareholder or disinterested director approval. In other words, K.S.A. 17-6304 does not preempt the common law duty of loyalty/fairness; it merely removes the "interested director cloud" and provides that the transaction will not be void or voidable if certain criteria set forth in the statute are met. Newton v. Hornblower, Inc., 224 Kan. 506, 522 (1978); Overhelman v. Barnes Investment Corp., 236 Kan. 335, 342 (1984). See also Fliegler v. Lawrence, 361 A.2d 218, 222 (Del.1976). In any event, the foundation with which you are particularly concerned has no membership and no disinterested directors making subsections (a) (1) and (2) irrelevant.

While there are no reported cases in Kansas dealing with the applicability of K.S.A. 17-6304 to not-for-profit corporations, other authority and courts in other jurisdictions have concluded that directors of such entities are encompassed by this or similar conflict of interest provisions. Lovitch, "Legal Framework Governing the Kansas Non-Profit Corporation", 48 J.K.B.A. 217, 229, 230 (Fall 1979); Stern v. Lucy Webb Hayes National Training School for Deconesses and Missionaries, 381 F.Supp. 1003, 1014, 1015 (D.C. 1974); Moody, "State Statutes Governing Directors of Charitable Corporations", 18 U.S.F.L. Rev. 749 (Summer 1984); H. Oleck, Non-Profit Corporations, Organizations and Associations 461-463, 485-487 (3d ed. 1974). Public confidence in charitable organizations and a potential for lack of self-policing in non-stock corporations are reasons cited for the necessity of imposing conflict of interest provisions on directors of not-for-profit corporations. Moody, supra; Leshner, "The Non-Profit Corporation-A Neglected Stepchild Comes of Age," 22 Bus. Law. 951, 966, 969,

970 (July 1967). We have found no authority dealing with private foundations specifically, but find no reason to treat such organizations differently than other not-for-profit corporations in this regard. We do not believe the authorizations in K.S.A. 17-6102(9) and (14) for corporate donations and loans preempt the requirements of K.S.A. 17-6304 and the duty of loyalty/fairness insofar as private foundations are concerned even though gifts or loans are made in the regular course of their operations. If an interested director is involved, the transaction is subject to strict scrutiny and the test of fairness.

You direct our attention to a Delaware case which appears to ignore conflict of interest provisions in an attempt to uphold a corporate gift to a charitable concern even though the donee was organized and controlled by the majority shareholder/director of the donor corporation. In Theodora Holding Corporation v. Henderson, 257 A.2d 398 (Del. 1969), the court appeared to apply a reasonableness test in place of the fairness test using Internal Revenue Code self-dealing standards, §4941, as a guide in determining reasonableness. However, the court also found that the charitable gift would benefit the donor corporation and its shareholders in the long run by providing significant tax breaks. 257 A.2d at 405. Thus, corporate donations and below market rate loans for charitable purposes are not necessarily considered waste and may be of benefit to the donor corporation due to tax implications and the good will generated by such transactions. See also Union Pacific Railroad Co. v. Trustees, Inc., 329 P.2d 398 (Utah 1958). We do not believe Theodora stands for the proposition that corporate donations to charity may be made in bad faith. Nor do we believe the court would uphold a loan or donation which benefits an interested director to the detriment of the corporation. It is therefore our opinion that K.S.A. 17-6304 and the common law duty of loyalty/fairness apply to not-for-profit corporations which are private foundations.

Further, we do not believe that K.S.A. 79-4601 operates as a substitute provision for K.S.A. 17-6304 where private foundations are concerned. K.S.A. 79-4601 is merely a tax statute by which a private foundation's exempt status is measured. It is not inconsistent with K.S.A. 17-6304 and should be regarded as an additional, rather than a substitute, requirement of corporations which are private foundations.

K.S.A. 17-6304 and the duty of loyalty do not necessarily prohibit corporate transactions with interested directors,

in the sense that the corporation is not being used simply to advance the interests of the directors and thereby harmed, the transaction may stand. For instance, in the situation you describe, the below market rate loan contemplated by the private foundation is to assist in funding the construction of low income housing in furtherance of its corporate purpose to "promote, inspire, foster, encourage, make possible, assist with and engage in, directly or indirectly, alone or with others, all manner and kind of lawful, educational, scientific, literary and charitable objects, including . . . homes and havens for the aged, infirm, dependent and poor." The interested directors will not benefit from the transaction in any significant way. Their for-profit corporation is only a 7% limited partner in the entity which will likely receive the loan. The for profit corporation will receive proceeds from the sale or refinancing of the property of the partnership only after principle payments, to the extent then owing, on the loan are made. (An exception to this allows the for-profit corporation, as a partner of the recipient of the loan, to receive a sufficient amount of cash before loan payments are made to enable it to pay the income tax it owes due to the sale or refinancing. The for-profit corporation will also receive tax credits for its participation in the project.) There is nothing to indicate that the private foundation is choosing this project over a similar option which would better serve the foundation's interests. The information you have provided suggests that the contemplated transaction would be considered "fair" to the private foundation. The interested directors do not appear to be benefited at the foundation's expense.

In conclusion, not-for-profit corporations which are private foundations are subject to the provisions of K.S.A. 17-6304 and the duty of loyalty/fairness when making loans or charitable contributions. Transactions between a not-for-profit corporation and one or more of its directors are allowed if the directors' interests are disclosed and the directors do not benefit to the detriment of the corporation.

Very truly yours,


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