

**NONPROFIT SUBSIDIARIES:  
HOW AND WHEN A HOUSING AUTHORITY  
SHOULD USE THEM**

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### DEFINITIONS

A nonprofit subsidiary usually means a corporation which is organized under the general laws of a particular state dealing either with corporations generally, or nonprofit corporations in particular, and which corporation is controlled by another corporation. “[A] ‘subsidiary corporation’ is one which is controlled by another corporation . . . .” 18 Am.Jur.2d Corporations § 35, at 830.

For our purposes, another definition is to be found in R.S. 40:384(27) of the Louisiana Housing Authorities Law, which was adapted from the Housing and Development Law Institute’s Model Housing Agencies Act. That definition states as follows:

“Subsidiary” means any corporation, entity, partnership, venture, syndicate, or arrangement in which a local housing authority shall participate by holding an ownership interest or participating in its governance, in which commissioners, officers, employees, and agents of such authority constitute a majority of the governing body of such entity.

The latest version of the Model Housing Agencies Act eliminates the word “subsidiary” and instead uses the terms “controlled affiliate” and “non-controlled affiliate”. Thus, § 102.1 of the Model Act reads:

*Affiliate, Controlled Affiliate, Non-Controlled Affiliate* - “Affiliate” means any corporation, entity, partnership, venture, syndicate or arrangement in which a local housing agency shall participate by holding an ownership interest or participating in its governance, including both controlled and non-controlled affiliates as herein defined. “Controlled affiliate” means any affiliate of a local housing agency (i) in which commissioners, officers, employees and agents of such agency constitute a majority of the governing body of such entity, or (ii) in which such agency holds a majority of the ownership interests. “Non-controlled affiliate” means affiliate in which a local housing agency shall participate, that is not a controlled affiliate.

(Note: Following this approach are the definitions contained in the Nebraska Housing Agency Act, Neb. Rev. Stat. § 71-1575(1),(8) and (19).)

While the key in all of these definitions is "control", the matter may not always be as simple as one might think. This issue will be explored later.

### FORMATION

It depends upon the wording of the statutes governing formation of nonprofit corporations in each particular state, regarding who is qualified to form a nonprofit corporation. In some cases, only individuals may be the incorporators. See 18A, Am.Jur.2d Corporations §§ 189-190, at 118-20. (Note, as an example, the Nebraska Nonprofit Corporations Act, § 21-1920, permits one or more persons to act as incorporators. The term "person" includes any individual or entity, and the term "entity" includes corporations and governments. § 21-1914.)

Conceivably, there might be a question as to whether a housing authority, as a governmental body, would have the power to form a nonprofit subsidiary corporation. Normally, governmental bodies, such as municipal corporations, are subject to the rule of strict construction of their powers. See 2 McQuillin, Municipal Corporations, § 10.18a at 1048, *et seq.*

As a very conservative precaution against the possibility of strict construction, the Model Housing Agencies Act, § 201.3.10, specifically gives public housing agencies the power:

To form and operate nonprofit corporations and other affiliates of every kind and description, which may be wholly or partially owned or controlled, for carrying out the purposes of this Act and in connection with the exercise of any of the powers of a local housing agency."

See, also, R.S. 40:431 C.(10) of the Louisiana Housing Authorities Law.

### PURPOSE

The primary issue in dealing with the use of nonprofit subsidiaries is the particular objective that is desired by the public housing authority. In other words, why is the use of a subsidiary even being considered? The answer to this question is of fundamental importance.

A.

Subsidiaries Cannot Be Used To Evade Restrictions

During my many years of practice in public housing law, I have run across people who wish to use nonprofit corporations as a means of expanding the powers of the public housing authority beyond those which the legislature has specifically delegated to it. Also, there are those that assume that a nonprofit subsidiary can be used to avoid a statutory restriction or prohibition that a public housing authority would otherwise be subject to. In my opinion, those who wish to use nonprofit subsidiaries to accomplish these objectives are mistaken and are heading for trouble.

A leading case in this area is Lycoming County Nursing Home Association, Inc. v. Commonwealth of Pennsylvania, et al., 627 A.2d 238 (Pa. Cmwlth. 1993). The Commissioners of Lycoming County decided to replace its hospital for indigent patients with a new building. For this purpose, the Commissioners decided that the new facility should be owned and operated by a separate entity, and for this purpose, they created a nonprofit corporation, the Lycoming County Nursing Home Association. Originally, the County Commissioners served as the Board of Directors, but subsequently, the bylaws were amended to appoint nine private citizens as the directors of the Association. Also, the County loaned the Association proceeds of a bond issue so as to enable the Association to build the new facility.

The issue in these proceedings was whether the Association was subject to the State of Pennsylvania's minimum wage law. The respondent in these proceedings was the agency responsible for the administration of the law, namely, the Prevailing Wage Appeal Board of the Commonwealth. The Association argued that it was not subject to the minimum wage law since it was a private nonprofit corporation. The respondent, Wage Appeal Board, argued that the Association was, for purposes of this issue, the alter-ego of the County, and, the County, as a public body, was subject to the minimum wage law. The court agreed with the respondent, Wage Appeal Board, that the corporate veil, in this instance, should be pierced. The court stated:

The Board concluded that the presumption that the corporate entity should be maintained was rebutted by the evidence in this case. We agree. The Commissioners, and therefore the County, controlled the project from its

inception. The attempts to disassociate the County from the Association did not overcome the fact that the Association was the instrumentality of the County.

We clearly do not wish to convey the idea that the Commissioners' acts were fraudulent. However, "the corporate existence can be disregarded without a specific showing of fraud," *Camelback*, 371 Pa. Superior Ct. at 462, 538 A.2d at 533, whenever it is necessary to avoid injustice or when public policy requires. *Id.*

We conclude that the public policy advanced by the Act would be defeated if we allow the County to rely on the independence of the Association. Moreover, by empowering the County to use the Association to build a project, such as the nursing home at issue here, we would condone the circumvention of the Act and its purpose.

Having determined that the Association is a "public body" doing "public work" and that the Association is the alter-ego of the County, allowing the piercing of the corporate veil, we conclude that the County must assume the responsibility of complying with the Act.

627 A.2d at 244.

The Lycoming case was favorably cited by the Supreme Court of New Mexico in Memorial Medical Center, Inc. v. Tatsch Construction, Inc., et al., 12 P.3d 431 (2000). In this case, various public bodies, the city and the county, and the state university, leased a hospital to the Memorial Medical Center, Inc., a private corporation. The issue before the court was whether the state Minimum Wage Act and the state's procurement code regulating public contracting by governmental agencies would apply. The Attorney General of New Mexico had issued an opinion that the nonprofit corporation was not subject to these state laws because it was not a public body. However, the trial court found that the nonprofit corporation was subject to these state laws because there was "substantial government involvement" with the private entity.

While the Supreme Court of New Mexico rejected the trial court's standard as being too broad, nevertheless, it recognized that circumstances could exist where the corporate veil should be stripped away. It adopted the following standard:

It is therefore our view that under current New Mexico law there are circumstances in which a private corporation must be deemed a political subdivision or a local public body because the private entity has so many public attributes, is so controlled and conducted, or otherwise is so affiliated with a public entity that as a matter of fairness it must be considered the same entity.

12 P.3d at 440-41. The New Mexico Supreme Court felt that this was, in essence, the holding of the Lycoming County case as well. The Court then remanded the case for the trial court to apply the facts to this standard.

The foregoing judicial opinions make it clear that public bodies cannot evade important legislation applicable to them by the use of allegedly private subsidiaries.

B.

#### Useful Purposes For Subsidiaries

Even though a subsidiary of a public housing authority may be subject to the same public laws as the housing authority itself, that fact, by itself, does not mean that there would not be many legitimate reasons for forming a subsidiary. Administrative convenience may be one reason. For example, in the Lycoming County case and the Memorial Medical Center case, hospitals were involved. Hospitals are usually large scale enterprises. In all probability, such enterprises would be easier to manage if they were separate entities from their governmental sponsors.

Undoubtedly, another significant reason for forming a subsidiary corporation would be to shield the assets of the public housing authority from exposure to liability, whether in contract or in tort, if the housing authority is about to embark on a special project. For example, such a project might be with a private developer with public and private ownership, or such a project might involve mixed financing involving public and private lending. Assuming that proper corporate formalities are observed, usually, a parent corporation is not liable for the contracts of its subsidiary, nor for its torts. See the annotations: Liability of Corporations for Contracts of Subsidiary, 38 ALR3d 1102, and Liability of Corporations for Torts of Subsidiary, 7 ALR3d 1343.

Ordinarily, a corporation which chooses to facilitate the operation of its business by the employment of another corporation as a subsidiary will not

be penalized by a judicial determination of liability for the legal obligations of the subsidiary.

7 ALR3d at 1349.

I believe that an entrepreneurial housing authority that wishes to develop a project with the involvement of private entities would be well advised to seriously consider forming a subsidiary corporation. By using a subsidiary corporation for the particular project involved, the housing authority would protect the rest of its assets from liability should this new project for some reason fail or otherwise be exposed to significant liability.

There could be other reasons for forming nonprofit subsidiaries. For example, a public housing authority may wish to establish its own "foundation". This would be a nonprofit corporation that would be qualified to accept charitable contributions under § 501(c)(3) of the IRS Code. One might argue that this should be unnecessary since individuals can also get a deduction by contributing directly to governmental entities. See § 170(c)(1) of the IRS Code. However, it has been my experience that many donors, even highly sophisticated ones, frequently are unfamiliar with those provisions of the Tax Code dealing with charitable donations to governmental entities, and, therefore, are more comfortable dealing with nonprofit corporations that have 501(c)(3) status.

#### TAXATION ISSUES

Before using a nonprofit subsidiary, the tax consequences of this device should be thoroughly examined. It should not be assumed that merely because the subsidiary is "nonprofit", such status confers, ipso facto, exemption from taxation. For example, in Evangelical Lutheran Good Samaritan Society v. Buffalo County Board of Equalization, 230 Neb. 135, 430 N.W.2d 502 (1988), property owned by a nonprofit corporation and used for low income housing was denied tax exemption!

While real estate owned by public housing authorities is usually tax exempt, because public housing authorities are governmental bodies, property owned by other entities may not be so exempt even if their purpose is in aid of low income housing. Thus, in Nebraska, entities other than public housing authorities may not claim tax exemption for low income housing because the particular tax statutes involved do not create such an exemption, and it does not matter whether the entity claiming property tax exemption is not-for-profit or otherwise. Since the tax status of property to be used in any project is

usually a very significant matter, the tax laws for the state which the project is situated need to be examined with great care. It is the constitution and the particular laws of each state that determine property tax exemption status. No assumptions should be made simply because the owner involved is nonprofit.

In addition, the tax status of a nonprofit in regard to its income also needs to be considered. This is particularly true if the nonprofit entity is to be used in some type of public-private partnership arrangement. Assuming that a nonprofit corporation qualifies as a 501(c)(3) corporation, nevertheless, before it creates some sort of special arrangements with for profit entities, tax matters such as Revenue Ruling 98-15 of the IRS should be examined. This ruling gives examples of situations in which nonprofit entities might combine with profit entities to form new structures. Depending on the circumstances, the arrangement may or may not preserve income tax exemption for the nonprofit corporation. The matter needs to be studied with care.

While these taxation issues can be very complex, the point here is only that one should not make naïve assumptions that the use of a nonprofit corporation will automatically achieve tax exempt status either for the property or income of the nonprofit.

#### OTHER ISSUES

If a nonprofit subsidiary is formed for legitimate purposes, as a subsidiary of a public body, it would be subject to all of the laws applicable to the parent public body. Thus, for example, if a state open meeting law is applicable to public housing authorities, it should also be applicable to their subsidiaries.

In 1995, the Housing Authority of the County of Santa Cruz, California, received an opinion from the County Counsel that its private nonprofit corporation that was formed for the purpose of facilitating the financing of a particular housing project was held subject to California's Ralph M. Brown Act (Government Code Section 54950, et seq.), dealing with meetings of public bodies, open access, notices and the like. The opinion stated that the California Act:

[A]ppplies to entities which receive funds from a local agency where the legislative body for the local agency appoints one or more of its members to the governing body of the entity.

Since the housing authority commissioners formed the board of directors of the nonprofit, and since the housing authority donated funds to the nonprofit, the nonprofit was considered subject to the Ralph M. Brown Act.

According to the California law, it would take only one public housing commissioner serving on the board of a nonprofit to make that nonprofit subject to California's open meeting law if public funds were also involved. Under the statutory definitions found in the California law, an established nonprofit corporation might hesitate to appoint a public housing commissioner to its board, because, if it also accepted any funds from the public housing authority, that might subject the corporation to the open meeting law and perhaps other laws as well. This might be true even if nonprofit was thoroughly independent of the public housing authority and would otherwise not be considered a subsidiary.

To determine what laws dealing with public agencies might be applicable to subsidiary nonprofit corporations and what might not be, may not be a simple task. Thus, in California, for purposes of its open meeting law, the wording of the statute determines to what bodies the law would apply, regardless of whether the nonprofit corporation is a true subsidiary of the public body or not. It is conceivable that there might be nonprofit corporations in California that, in fact, are not controlled by public bodies, and yet, the Ralph M. Brown Act might apply, as stated above.

If one examines the statutory definitions of a subsidiary under the Louisiana public housing law, or a controlled affiliate under the Nebraska public housing law or the Model Housing Agencies Act (see "Definitions", supra), the matter of control is to be determined by who holds the majority seats on the board of directors of the nonprofit corporation in question. If the public housing authority holds less than a majority of the seats on the board of directors of the nonprofit, then the nonprofit would not be considered a subsidiary of a public housing authority under Louisiana law, or a controlled affiliate under Nebraska law and the Model Housing Agencies Act.

Most states, however, have not adopted the Model Housing Agencies Act and, so, most likely, common law principles would be applied to determine whether or not a subsidiary is controlled by the public body. Using these principles, it is possible that the concept of control might have a much broader application than merely determining how many seats on the nonprofit's board of directors are filled with representatives of the public

body. As the Supreme Court of New Mexico observed in the Memorial Medical Center case, control is a matter of substance and not of form.

Regardless of how much authority a lease potentially gives a government entity to control a private entity, if the government entity does not exercise the authority so as to make the private entity a conduit through which the government acts, then the existing statutes governing public entities ought not apply. On the other hand, if the contract that creates the relationship provides for no control, but in fact the government exercises control, then the existing statutes governing public entities might apply. Under the standard we identify, form does not control over substance; substance must control over form. *Cf. Lycoming*, 627 A.2d at 244 (holding a private entity was an alter ego of a county and subject to Pennsylvania's Prevailing Wage Act because the county "controlled the project from its inception" and "attempts to disassociate the County from the Association did not overcome the fact that the Association was the instrumentality of the County.")

12 P.3d at 441.

The foregoing indicates that it is possible for the public body to control a nonprofit by use of leases or contracts or some other method of control, all of which would have to be examined in each particular circumstance. In the Lycoming case, supra, the fact that the county commissioners reduced their representation on the board of the nonprofit association, so that the county commissioners did not constitute a majority of the board, did not persuade the court that the nonprofit was truly a private corporation.

Thus, outside of Louisiana, Nebraska, and any other state adopting language similar to the Model Housing Agencies Act, in any given situation, determination of whether nonprofit is under the control of a public housing authority is not subject to any mechanical rule. If the majority of the board of directors are representatives from the public body, undoubtedly, that would persuade the court that the nonprofit is a subsidiary of the governmental agency. But, on the other hand, even if the percentage of seats on the nonprofit board that are occupied by public housing officials is in the minority, that would not, necessarily, dispose of the issue of control.

If there is any doubt in legal counsel's mind as to whether a nonprofit is or is not a subsidiary, that is, controlled by a public housing authority, then the conservative legal approach would be to conduct the nonprofit corporation's business as if it were, in fact, subject to all of the public laws that the housing authority is subject to. These laws might include open meeting laws, procurement codes, matters dealing with due process of law, labor laws as they apply to public entities, and probably a whole host of other laws. The consequences of a mistake here could be quite costly. For example:

In some states, the court has the discretionary power to invalidate an action taken by a municipal board or agency in violation of an open meeting law.

4 McQuillin Municipal Corporations § 13.07.10, at 775.

There also might be criminal sanctions to contracts entered into without public bidding or the like. Thus, again, the prudent course is to deal with the nonprofit's affairs as if they were subject to all the public laws and procedures that a public housing authority is subjected to, or consider some form of judicial interpretation such as a declaratory judgment prior to acting. In the Memorial Medical Center case, an Attorney General's Opinion was no safe harbor.

### CONCLUSION

There may be many excellent reasons for using nonprofit corporations by public housing authorities. But if those nonprofit corporations are subsidiaries of public housing authorities, then they should be operated according to the same laws and rules that public housing authorities are governed by.