

The Potential Competitive Advantage of Innovative For-Profit/Non-Profit Partnerships in Higher Education

An A-HEC Leadership Interview with Mike Goldstein of Dow, Lohnes and Albertson Published August 18, 2004

Introduction

At the recent “Competing in Higher Education” conference hosting by Eduventures, one of the panel sessions stressed the importance of partnerships in an increasingly competitive higher education industry. In this Leadership interview we consider the impact that innovative partnerships between non-profit and for profit entities may have on the future of higher education.

The leading for-profit, career-oriented colleges and universities have been creating great wealth for shareholders in the last few years due to soaring demand, while serving an important role in developing the workforce. Meanwhile, most non-profit/traditional post-secondary institutions, while having significant overlap in serving career education and workforce development needs, either have little incentive to grow capacity at the rate required to meet these needs or are just not set up to do so.



Our interviewee has been helping institutions consider innovative approaches that could help provide the incentives and capabilities needed to meet the important societal need of high quality, career relevant education.

Mike Goldstein, a member of the Washington, DC law firm Dow, Lohnes and Albertson, created and for 26 years has lead the firm’s higher education practice. Before he joined DLA, Mike was an Associate Vice Chancellor at the University of Illinois in Chicago. He is responsible for ground-breaking work and he and his colleagues are true experts in a number of key areas of higher education, including accreditation and licensure, federal regulation, non-profit taxation, online learning and the general use of technology in delivering education, intellectual property, financing, mergers and acquisitions, spin-offs and joint ventures.

Mike’s full resume can found on the Dow, Lohnes website: <http://www.dowlohn.com>.

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Mike was kind enough to answer some challenging questions proposed by A-HEC on behalf of a presumed to be a cautious majority of higher education leaders.

A-HEC: For several years you have been helping higher education institutions consider new approaches, such as for-profit spinouts of non-profit and public institutions. Is interest in these types of partnerships increasing and what is driving this trend?

MG: There seems to be increasing interest in new approaches by both non-profit and public institutions, investors and strategic partners to strategies that allow each to benefit from the resources and capabilities of the others. The drivers are straightforward: institutions need to find ways to generate new financial resources – particularly capital – to achieve their goals; investors see postsecondary education as a long-term growth market; and strategic partners are looking for opportunities to leverage assets more effectively (efficient ways to integrate with their clients.) Key to these partnerships -- and I use this term in its loosest rather than narrow legal meaning -- is the emerging understanding that the functions of a “traditional” college can be unbundled, distinguishing between those activities that must be retained within the academic enterprise and those that can properly be carried out by another entity.

A-HEC: How would you characterize the type(s) of institution(s) that should be seriously considering partnerships of this nature?

MG: This is probably the question I am asked most frequently. But it should be turned on its head. The issue is not what type of institution but rather what is the reason for the partnership. The key to a viable partnership is determining that the outcome will be mutually beneficial to the partners: doing it for the sheer joy of being “cutting edge” is certainly wasteful and probably affirmatively dangerous. Obviously, an institution needs to either be entrepreneurial in order to successfully enter into one of these arrangements, and it has to have the legal capacity to do so. Beyond that, everyone can play.

A-HEC: What are the most significant benefits to considering formation of a for-profit entity in which a non-profit institution holds an ownership stake?

MG: The first is access to the capital marketplace. Traditionally, colleges have raised capital by begging, borrowing or working for it (that is, contributions, debt and tuition). The traditional capital market approach of selling equity has simply not been there, since no one can “own” a piece of a non-profit and of course that is equally true for a public institution. Unbundling the institution provides one way to resolve this problem by creating a “capitalizable” entity.

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The second is the possibility of capital appreciation, particularly if the institution's investment is intellectual property, know-how or sweat (that is, the skills and services it brings to the partnership). As a part owner in a venture the institution has the opportunity to not only benefit from the revenue it generates but also of its potential for appreciated value. It is particularly appropriate to note here that this June the Internal Revenue Service issued a Revenue Ruling making joint ventures between non-profit institutions and for-profit companies much easier, less risky and more profitable for the non-profit.

The third is flexibility. While a for-profit venture is not necessary, the creation of an entity that is separate from the restrictions of the non-profit or public institution can be a real benefit. Academic policies are by their nature conservative and restrictive, for many good reasons. Because of that they are not very well suited to entrepreneurship. A separate venture can allow the institution to participate in activities that would be difficult or impossible if operated within the structure of the college.

Finally, there is protection. A separate entity, properly organized, can provide a "fire wall" between an activity and the core institution. Risk is limited to the amount of the investment, and liability generally cannot reach back to the resources of the institution itself. Since colleges are notoriously risk-adverse, this approach can allow a school to take somewhat more risk without putting the "family farm" on the block.

A-HEC: What are the major hurdles that higher education leaders experience in moving forward with forming for-profit entities?

MG: The first, surprisingly, is the lack of understanding on the for-profit side as to how colleges and universities are organized and function. Ironically, I've found institutional leaders to be far more knowledgeable of the commercial and financial sectors than the other way around. It is incomprehensible to an executive of a corporation or the managing partner of a venture fund that the president of a university is not, in reality, the CEO. To the contrary, the president's authority is sharply curtailed by a very delicately balanced power sharing arrangement with the faculty and the academic leadership, as well as the institution's trustees who are nothing like a company's board of directors. President's who "govern" best do so through persuasion, not authority. Knowing the culture, politics and the language (for example, the term "shared governance" has very real meaning in academia) as well as the nuances of the decision-making process is essential to successful negotiations.

The second is a lack of knowledge on the part of an institution's leadership as to what the involvement of the institution is worth; that is, what kind of value does a university bring to the negotiating table. The for-profit partner wants to play for a reason: making money. The value of what the institution contributes to that

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process needs to be clearly understood by the institution's own leaders so that it can be translated into an appropriate interest in the venture

Third is the flip side of the first: convincing institutional stakeholders, notably the faculty and the trustees, that partnering with a for-profit entity is not a crime against nature. The institutional leadership has to bring its faculty and trustees into the process; if they are neglected, the project will likely stall, and may well die. I have spent many happy hours explaining to faculty senates why a particular kind of venture is, in the end, in their best interests as well as those of the institution.

The fourth is knowing how to deal with the several external constituencies who exercise control over institutions: these include the state which licenses them (or, in the case of public institutions, controls them), the accrediting bodies which validate their legitimacy, and the U.S. Department of Education, which makes available quite a few billions of dollars in student financial aid.

A-HEC: There is some sentiment among higher education "traditionalists" that high profile for-profit ventures, such as those launched and shutdown by Columbia and NYU, prove that it is folly to go down this road. Do you have any thoughts on how such failures compare with the latest ideas on what has a better chance at success? What is different?

MG: Columbia's Fathom and NYU Online did not fold because they were for-profit. There were many reasons why both were ultimately rolled up, but being for-profit was not one of them. In some respects organizational structure has undermined some of these projects, but that arose from a failure to garner necessary support from the institution at the operating level, not because they happened to be for-profit. And certainly some – Fathom, for example – simply did not in the end have a viable business plan. Keep in mind the high rate of failure for new business start-ups generally. Here is a real difference between for- and non-profit structures. In the for-profit world, there is a bottom line and accountability to the shareholders. If an enterprise isn't working, pull the plug. In comparison, many unsuccessful non-profit services continue to exist out of sheer inertia, long after it is clear that they cannot achieve their goals, financial or otherwise.

An advantage of a for-profit activity is that the investors will (at least after the bursting of the dot-com bubble) demand a sound business plan, with oversight, benchmarks and accountability. Second, if the new venture is dependent on other parts of the institution for faculty or other services, that arrangement needs to be firmly in place, preferably with a strong contractual commitment. Lastly, institutions can't succeed if they compete against themselves: too often, traditional academic units have continued to offer programs and services similar to those of the for-profit spinout.

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Institutions, strategic partners and investors have to understand that a for-profit venture is a financial and structural tool, not an end itself. While the collapse of Fathom was greeted with loud “told you so’s,” the number of internal institutional initiatives that have vanished is legion. A flawed plan will fail, regardless of the form. The converse is not, however, necessarily true, and here is where the hybrid model can breathe life – in the form of capital – to a good idea that only wants for financial legs.

A-HEC: Some institutions have generated growth by allowing individual schools and units to operate as largely stand-alone units, encouraging them to think and act in a more entrepreneurial fashion. Is that an alternative strategy for institutions that prefer not to set-up a for-profit entity?

MG: Certainly. “Each ship on its own bottom” is a time honored premise at many large institutions (indeed, it is something of a mantra at Harvard), and anything that encourages innovation and entrepreneurship and provides intellectual space for the entrepreneurs to flourish is a good thing. But there are some things that can be done with a for-profit model, most notably raising capital, which simply cannot happen by reorganizing.

A-HEC: A key element of your work on partnerships is that there are a core set of academic functions that an institution should focus on and control, and another set that are non-core. What does this really mean and why is it important in the context of enabling institutions to be more entrepreneurial?

MG: I think the first question to answer is what are those core academic functions that cannot be relinquished. Visualize an egg. Most of us see institutions in that form: a singular entity. However, crack the egg and there is a very distinct yolk in the center, surrounded by the white. The yolk constitutes the “core academic functions” which regulators, accreditors and academic tradition demand be kept under the control of the institution. Interestingly, these core functions are relatively narrow:

Appointment of the faculty and overall supervision of its performance.

Establishing and adopting the curriculum through the appropriate faculty consultative process.

Adopting specific courses through the same consultative process.

Setting admission standards and ultimate say in the admission of students.

Establishing of student academic performance standards and supervising the process of measuring such performance.

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Setting the criteria for the award of academic credentials, determining that students have met those criteria, and awarding the credentials.

This is a litmus test. Indeed, in the Revenue Ruling I mentioned before a key reason the IRS blessed the activity was precisely because the college kept control over the key academic functions.

What is left is a significant part of what we customarily see as “the institution,” and it is precisely these areas where the commercial world not only has capital but also skills that very often exceed those of the institutions. In essence, a for-profit provider (which might be the venture established by the institution and its financial or strategic partner) can:

Recruit prospective faculty and, subject to their meeting the criteria of the institution, employ them on behalf of the institution.

Develop a curriculum (and the necessary course materials and, as appropriate online content) and, again subject to adoption by the institution, provide for its delivery.

Market the program, recruit students and process applications for admission.

Provide for the evaluation of student performance in accordance with institutional standards.

Perform all the "back office" tasks, from providing facilities and services to managing finances and student aid.

The recent acquisition of control of Grand Canyon University and the wrapping around it of a for-profit “services” corporation is one example of this division of labor; another much more venerable one is National Technological University, now owned by Laureate. NTU created a for-profit subsidiary and contracted with that entity to provide all of its non-core functions; then it sold a portion of the subsidiary to an investment group for about \$30-million, which in turn provided the capital necessary to grow and promote the program.

A-HEC: What type of reactions do Boards of Trustees typically have to innovative partnership ideas?

MG: There is an old saying in higher education that men and women who are titans of industry and commerce check their business sense at the door when they sit down as university trustees. I think that era is over: trustees are interested in seeing their institutions find ways to leverage their value. While there is still a

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very firm commitment to both institution integrity and the maintenance of quality, I am seeing a lot more willingness on the part of trustees to consider new approaches.

The bottom line, however, is education. Explaining the hybrid concept to trustees is not easy. There remain a lot of misconceptions, such as the loss of a colleges' tax exempt status, if it goes near a for-profit venture. As the recent Revenue Ruling points out, that risk is obviated by a properly structured and managed venture.

A-HEC: What steps should higher education leaders take if they desire to evaluate a nonprofit/ for-profit hybrid? How long does it take to put a new legal entity together? What are the key legal issues?

MG: The first step has to be to determine what such a venture can do *for* the institution. A for-profit venture adds nothing in and of itself: it is a means to an end, and the institution has to have a clear understanding of the desired end. That often requires getting expert guidance, not just for putting a deal together but for helping the institution evaluate the opportunity and then, if the prospect is attractive, helping put it in the best bargaining position and while avoiding the land mines that still dot the road.

As for how long, the legal work is the easy part. A for-profit limited liability company or partnership can be put together in a matter of days. It is the negotiating an agreement that can take much longer. It is not uncommon in the commercial world for many weeks to go into negotiating joint venture agreements. Add to that the very different decision process in a university makes for a really indeterminate timeline, from a few weeks to "as long as it takes." In the end, getting it right is far more important than getting it fast.

Finally, the legal issues fall into a few basic categories: what kinds of legal structures are allowable in the particular jurisdiction, what are the tax consequences, how can the structure be shaped to both protect the institution and facilitate its attaining its goals, how will the enterprise be governed, how is capital contributed and how are revenues and appreciated value shared, and how can this all be done within the rigors of good academic practice and the regulatory requirements of the states, the accreditors and the federal government. A lot of moving parts, but for the right institutions under the right circumstances and with the right leadership, the opportunities to bring leverage to a traditionally leverage-deprived community are very real.

At the end of the day, there are two questions that must be asked and answered: is the venture in the best economic interest of the institution and is it consistent with and supportive of the institution's academic mission. Success is dependent on an affirmative answer to both.