www.hurwitassociates.com

1150 Walnut Street
Newton, Massachusetts 02461
Tel (617) 630-6900
Fax (617) 928-3441
Email info@hurwitassociates.com

# Nonprofit Law Resource Library

## Mergers, Affiliations & Reorganizations – Question & Answer

### Mergers, Affiliations & Reorganizations

1. **We are entering into discussions with a small organization to assume their operations and some of their staff. At this point we are unsure whether it would be best for them to merge with us or dissolve their organization. The discussions are on a very friendly level, and we are being perceived as an organization that can help them out before they are forced to make big cutbacks. Can you suggest a route to pursue?**

   The main distinction between merger and dissolution in this setting is: In a merger you become the legal successor to the other organization while a dissolution creates no direct legal tie between the organizations; you are more akin to a beneficiary or simply a grantee of whatever funds they may have remaining.

   Under a merger, your organization becomes owner of their funds, logo, name, assets, programs, licenses, and other property. You also own their debts, liabilities, any unasserted claims against them and other contractual obligations. The risks of becoming a legal successor necessitate that you undertake the often intensive effort of due diligence.

   In addition, since a merger is the legal combination of separate entities, the two organizations will need a merger agreement. The agreement formalizes such matters as the composition of the resulting board, programs and staff members to continue under your auspices, name of the combined entity, and other commitments you may need to make to the other organization.

   Under a dissolution, the other organization files the papers necessary to dissolve (which may involve court or state approval, depending on your state), which you would not be a party to. Once their debts are paid, assets distributed, and books closed, they are then formally dissolved by the Secretary of State. You may be the recipient of any funds they have remaining, or may strike a separate agreement to use the funds for certain purposes, continue their programs, or hire their staff.

   As you can see, merger is usually a more challenging course to pursue. If you can achieve by dissolution the same outcome as a merger with less effort and risk to your organization, then it's probably preferable. This is often the case in situations involving smaller organizations, or those without real property, dedicated endowments, or provider licensure from the state.

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On the other hand, from the perspective of the organization you are "acquiring" the merger option may be favored for the very same reasons.

In dealing with larger organizations with any of these features, you may need to merge in order to continue providing their services. You may also find that the other organization's board is opposed to dissolving (for personal or institutional reasons) and is negotiating with other competing agencies for the best merger offer.

In those situations, your question then really becomes what level of intrusion are you willing to endure to complete the deal. Are you willing to take some of their board members or staff onto yours? To pledge to continue their favored programs, even if money-losing? To pay legal and accounting fees for due diligence? To pay for additional insurance to cover their past activities? Once these factors are evaluated, you can make an informed judgment as to your bottom line and what course of action best serves your organizational needs.

2. **We are relocating our organization in another state and have been getting some conflicting advice about our legal status. Since we will no longer have any connection to our former state, should we re-incorporate in the new state?**

Re-incorporating in another state, which you might think would be a relatively simple matter, is a complex and taxing process. This is because you would be not simply shifting the current organization to a new state, but starting a completely new legal vehicle and then shifting the assets and employees to the new organization.

Of all the corporate changes an organization might make (change of name, purposes, governing mechanisms, etc.), re-incorporating is one of the most difficult. As part of the process, you would need to re-approve bylaws, get a new federal identification number, transfer employees, re-do all banking resolutions and financial agreements, and likely work with the state Attorney General to ensure proper transfer of charitable assets to a new state. Given all this, re-incorporation should be undertaken only as a last resort.

Much simpler would be to register as a "foreign" nonprofit corporation doing business in your new state. You would also need to obtain the various tax exemptions there, such as state income tax exemption and sales tax exemption. In most states, income tax exemption is pro forma for 501(c)(3) organizations. In some states, depending on your activities, sales tax exemption may be more difficult to obtain and should not be assumed to be automatic. Also, depending on the state, you might have to register and report to the Attorney General's office.

There is generally no harm in being a corporation in one state while conducting all your business in another. You will have to comply with the laws and reporting requirements of both states, but as long as you do you can remain in this arrangement indefinitely. One possible downside: a slightly increased possibility of liability on the chance your organization is sued. The plaintiff's lawyer can "forum shop" between the two states

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looking for most favorable laws. Still, in nearly all instances, the chore of re-incorporating outweighs the usually slight risk of increased liability.

3. **I serve on the board of a human service organization. We have been approached by a larger social service provider to enter into a partnership. We see this as an opportunity that will provide us with some stability, but we don't want to lose control over the programs we've developed in the past 12 years. Our board has begun to show divisiveness over the issue. Some are in favor of the partnership, while another made accusations of a "hostile takeover". How can we legally merge and what can we do to prevent a "takeover"?**

   Let me answer by: 1. Suggesting an alternative solution that may help you or others in similar circumstances; 2. Listing basic legal requirements common to most state nonprofit merger statutes; 3. Pointing out crucial but often neglected practical considerations; and 4. Describing a range of legal options for you to consider.

   - **Alternative Solution.** If your organizations merge, the larger initiating organization will presumably want greater representation on the board of directors, and may want to place its staff in key management positions. As you fear, you would then be giving up at least some degree of control. A possible solution: Do by contract that which you are reluctant to do by merger.

     In other words, enter into a written agreement to jointly provide programs, share administrative functions, or do whatever is mutually beneficial to your organizations. Written in concise non-legalese, the agreement would define expectations and responsibilities, and would be time-limited.

     That way, if you find that your organizations, for whatever reasons, do not mix well (different values, personalities, or corporate cultures), you could part ways when the contract expires. The key factor in this arrangement is that both organizations would continue to maintain their separate legal identities and governing boards - allowing you, in essence, to date before marrying.

   - **Minimum Legal Requirements.** Nonprofit mergers have been long codified by statute in most states, and the legal process itself is relatively standardized and straightforward.

     At a minimum, most states require that advance written notice to be given to members (if any) and to state regulating authorities. Members, and the board of directors, must formally approve the action to combine organizations and document this in the minutes. Signed Articles of Merger must then be filed with the Secretary of State.

     Additionally, assets subject to a trust, endowment, or other restriction must remain so restricted unless changed by a court. Further, if a merging organization receives government funding or licensing, other steps may be required.

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- **Practical Considerations.** Legal compliance is a critical but small part of the total merger process. Effecting a workable merger depends primarily on carefully thinking through interpersonal considerations at all levels of the organization.

  Too often the merger process becomes legally driven. The legal outcome is emphasized at the expense of important considerations involving the resulting governing structure, programs, budget, and personnel. Who is to be the executive director? Who will comprise the board and top management? What are the key program priorities?

  For a merger to succeed these hard issues should be addressed up-front. If the issues cannot be resolved before merger, the parties can always back away. If, however, the organizations are already committed to merging, either legally or in terms of public perception, then addressing these concerns after the fact can be counter productive for both organizations. And judging from the phone calls I get, legal problems and threats of law suits and countersuits all too commonly result.

- **Range of Options.** To put these difficult issues in perspective, consider the following spectrum of affiliations. The terms used below are descriptive and not intended as technical definitions. In fact, the legal definition of the terms "merger" and "consolidation" are inconsistent from state to state and differ from popular usage.

  a. **Informal collaboration.** Under this model, there's a pooling of resources or efforts among organizations. For example, similarly positioned organizations might decide to form a trade organization for joint advocacy or to negotiate with vendors. Then, too, foundations, which today are overwhelmed with applications, are looking more favorably upon joint fund raising proposals. In response, organizations might wish to collectively develop funding strategies and combined applications.

  b. **Contractual Affiliation.** As described at the outset, separate organizations, while maintaining distinct legal identities, enter into a contractual agreement to jointly provide services or to share space, marketing, mailing, and the like. A simple win-win example under this model might be the trading of office space in return for management/administrative assistance.

  c. **Merger.** This is a true legal combination of two or more organizations. One organization, perhaps with a new name or set of purposes, results. Note that it's not necessarily a crisis that compels a merger to go forward. There may be added strength or less duplication of services in combining forces. Staff positions, therefore, would not necessarily be eliminated, although the tough issues of the executive directorship and board composition would require resolution.

  d. **Consolidation.** In contrast to merger, consolidation implies the downsizing of staff and programs, usually as a survival strategy. Most commonly, under this model, one organization comes to the rescue of a struggling

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organization. Other common scenarios: two near-failing organizations try to stay alive by combining, or a strong organization attempts to capture the programs and contracts of another weaker one.

4. **Some agencies in my field have divided themselves into two or more nonprofit corporations. Can you tell me the reasons for these reorganizations? We have residential and home care programs and are wondering whether we should be considering such a move.**

   Here are at least five major reasons for nonprofit corporate reorganizations:

   1. **Liability concerns** - Both real and perceived (more below).

   2. **Maximizing third party reimbursement** - Let's take one common scenario. Your agency owns real property and you find that a major federal or state funder won't reimburse you for mortgage payments.

      However, the funder will include in the grant your cost for renting the property, even if you rent it from a separate entity you establish specifically to obtain reimbursement.

   3. **To channel increasing unrelated business income** – If you derive a substantial percentage of your revenue from providing services or selling products unrelated to your nonprofit purposes, it can be difficult to continue showing you are organized primarily for nonprofit purposes.

      To preserve your tax exempt status, you may wish to establish a for-profit subsidiary. Either wholly or partly controlled by your organization, this subsidiary would operate the unrelated activities and pass the profits on to you as the parent organization.

   4. **Expanding involvement in advocacy and lobbying** - Does your organization find itself, by necessity or conviction, regularly devoting more than 10 percent or 20 percent of its total effort to various legislative and political matters?

      If so, you may wish to protect your 501(c)(3) public charity status by establishing a companion 501(c)(4) social welfare organization.

   5. **The keeping-up-with-the-Jones'-syndrome** - Otherwise expressed, "Their organizational chart has more boxes with 'Inc.' on it than ours."

Although there is no inherent advantage to complexity, any number of nonprofits, under the influence of their attorneys or the prevailing trend, and without compelling legal, financial, or administrative benefit, have adopted multi-corporate structures. Let's not forget that nearly all of what you can do programmatically in separate corporations you can also do within one corporation's clearly defined internal departments.

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Notwithstanding concerns #2 through #5, the most common reason for reorganizing is #1, liability concerns and the desire to insulate your assets from risk-producing activities. In particular, protection may be needed from the possibility of damaging law suits arising out of accidental injuries to third parties or from claims of improper care.

This type of reorganization is accomplished by placing either the assets or the higher risk activities in a nonprofit corporate entity separate from the main organization.

When assets such as real estate, fund balances, endowment funds, or other valuable property are transferred out of the provider organization, the new entity is referred to as a title-holding corporation. The IRS classifies title-holding corporations as 501(c)(2) organizations.

As you may be aware, there are a number of advantages to being classified as a 501(c)(3) public charity. Prime among them is the ability to receive tax deductible donations. I mention this because it is fairly common, as part of a general restructuring effort, to shield growing endowment or capital funds in the new corporation. If that is the case, the new organization may wish to include fundraising and community outreach in the corporate purposes of the new organization, thereby likely qualifying for 501(c)(3) status.

The other approach is to place the higher risk programs in a separate 501(c)(3) and leave the assets where they are. The problem here is that it may be difficult to transfer existing licenses and contracts to the new corporation. However, if you are developing new program services, and have not yet applied for the necessary licenses, this approach may be the easier one.

The decision to reorganize should be made on the basis of a careful cost/benefit analysis. In other words, what additional legal protection do you really gain for the costs, both financial and administrative, incurred?

For your organization, a starting point might be to find out whether other similarly-positioned agencies have ever been sued and the extent of the claims and damages involved.

Often neglected in this analysis are important interpersonal considerations. Interpersonal problems derail this process as frequently as legal issues. Therefore, in terms of organizational control, it is important to be aware of the full range of legal options available to you. Legally, you have broad leeway in developing nearly identical, somewhat interlocking, or totally independent boards of directors for the various entities involved. Similarly, staff may be employed by one or more organizations. Determining the composition of the various boards and executive staff involved should be addressed along with the legal aspects at the beginning of the process.

Lastly, such restructuring is most effective in conjunction with the following:

- Proper indemnification and liability provisions in your organizational documents (bylaws, articles of incorporation);
- Insurance coverage that you understand fully and that covers your organization's specific needs;

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- An on-going risk management program to A) assess and monitor potential hazards and B) ensure full regulatory and legal compliance.

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