Schaner & Lubitz, PLLC

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To Merge or Not to Merge? Considerations for 501(c)(3)s

There may come a time when your non-profit organization is presented with the possibility of a merger. Your organization may be pursuing acquisition of an entity to obtain talent, fill a market void, pursue a growth strategy or make strategic alliances.

Whether or not your organization initiates or is presented with a merger opportunity, there are considerable factors that must be evaluated. Mergers involve a lot of time and human capital. They can be costly to implement and oversee. Moreover, the end result is not always the desired result. A clash of corporate cultures, departures by top executives, a change in location or a reduction in force can occur. As such, organizations need to manage the expectations, processes and obstacles that are inherent in any merger.

This article sets forth the basic anatomy of the merger process, which may involve the merger of one organization into another or the consolidation of two organizations into a new surviving organization. Though this article is not intended to determine whether a merger is appropriate, we hope it will assist you to make the proper decision.

Establishing a Procedure

Prior to evaluating a particular merger opportunity, a formal protocol should be adopted for evaluating potential mergers, for internal use during merger discussions and subsequent negotiations with other parties. This protocol can address ways to protect confidentiality of the merger negotiations, establish lines of communication within the organization and with the potential merger partner, set forth how the principal responsible for evaluating and negotiating the merger should report to the Board, and create the parameters for how the team will advise the Board on whether merger is in the best interests of the organization.

As set forth in the protocol, a strategic team should be established. Upon identification of a potential merger opportunity, the team will explore more fully whether a merger is right for the organization. The team may be comprised of a mix of Board members, executives and relevant staff. The team may also consist of one or two of the organization's substantial funders, other organizational or industry leaders, or outside consultants. Generally, the Board President or Chairman will head the team.

Weighing the Pros and Cons

Once the protocol is established and a merger opportunity is identified, the team will need to evaluate the benefits and risks of the potential merger. Here is a checklist for the team to consider:

Possible Advantages

- **Acquiring key talent or resources**. Will a merger result in the acquisition of key personnel or assets, such as intellectual property? Will a merger increase the organization's overall capacity?
- **Revenue growth.** Will the merger bring in added revenue?
- **Avoiding financial trouble.** Will the merger assist the organization in avoiding a shut down or paying debts?
- **Reducing redundancy.** Will the merger reduce unnecessary competition that impedes accomplishments of the common mission?
- **Cost control.** Will merging help the new entity control or save costs? Will the merger result in administrative efficiencies?

- **Eliminating competition.** Will merging assist in positioning the merged organization as the industry leaders in their common mission?
- **Increasing program impact/entering a new market.** Will merging help the organization reach untapped markets? Will a merger result in new clients?
- **Strategic positioning.** Will merging advance the organization's overall long-term goals and objectives?

Even if the above questions yield one or more positive answers, the team also should determine whether there are any disqualifying factors that would make the ultimate consummation of a merger unlikely. Disqualifying factors may not be immediately apparent, but can surface during the due diligence investigation (described further below). Early identification of one or more disqualifying factors can save the staff and organization time and money. In general disqualifying factors must be identified on a case by case basis, but below are some examples:

Possible Risks

- **Dissolution.** Which entity will survive as the controlling entity? Will the organization be at a disadvantage if it is not the surviving entity after the merger and thus lose the market industry and goodwill it has worked so hard to build?
- **Clash of corporate cultures.** Are the corporate cultures compatible? Will there be issues with integration of staff, resources and overall business model?
- **Downsizing and layoffs.** Will the merger result in a reduction in force? Will there be salary adjustments for new staff?
- **Geographic concerns.** Will the merger result in a change in locale for operations?
- **Excessive merger expenses.** How much will the merger cost in administrative and legal fees?
- **Conflicts of Interest.** Is there a conflict between the interests of the two entities?
- **Client and strategic partner impact.** Will the merger have a negative impact on any current clients or strategic partners?
- **Legal formalities.** Can the organization attain requisite approval under the organizational documents? Will the merger have an impact on any current contracts or programs?
- **Material liabilities.** Are there any unfunded liabilities, such as pension plans or long term employment agreements that may make merger undesirable? Are there any pending lawsuits involving the potential merging party? Is the target having financial difficulties that have caused it to seek a merger?
- **Loss of key personnel or Board members.** Are there any potential departures or retirements of key personnel or Board members either already planned or likely triggered by a merger? This may not surface until further discussions.

Staff may informally conduct its own diligence through searches of publicly available information, such as internet searches, public filings, *etc.*

Conducting Due Diligence

If, after balancing the benefits and risks of merger, the team determines that there are no material disqualifying factors and that merger would satisfy important organization goals, the team should begin the formal due diligence process with the potential merger partner. Due diligence is the formal investigation of the potential merger partner which involves a review of corporate records, financial information, contracts and other relevant documents of the potential merger partner to determine whether merger is feasible, to verify representations made throughout the negotiation process, to assess fair market value of assets, to interview key constituents, and to form a basis for any legal opinions that may need to be rendered.

Prior to commencing the formal due diligence process, the parties should enter into a non-disclosure agreement to protect the confidentiality of the materials to be exchanged during the process.

While the contents of the due diligence list should be tailored to fit the potential merger partner being investigated, below is a list of information that should be obtained from any target during due diligence:

1. **Organizational Documents.** This includes the organization's founding documents, such as articles of organization, bylaws, operating agreement, *etc.* These documents are necessary to review whether the potential merger partner is a stock or membership entity where members would have a right to vote on the potential merger.
2. **Minutes from recent years.** Minutes from the last 3 years or more of Board, committee and membership meetings.
3. **Copy of the IRS ruling**. If the target is tax exempt, a copy of the IRS ruling should be obtained.
4. **Recent independent audits and audit opinions.** These should be obtained from the last 3 years or more.
5. **Recent tax returns.** These items should be obtained from the last 3 years or more.
6. **Financial statements.** Financials for the last 3 years or more should be reviewed, especially if the audits for the recent years have not yet been completed. Financials for the last partial year should be obtained up to the time of the investigation and updated thereafter, including data on how such results compare with the current budget.
7. **A list and resumes of all employees**. This information should include all employees' positions with the potential merger partner, present compensation, including likely bonus, time periods employed, and any retirement plans that have been disclosed to the target. Early due diligence efforts may focus on key employees first.
8. **A list and resumes of all Board members**. This information should include the period that members have served on the Board of the potential merger partner.
9. **All written employment agreements.** Termination provisions need to be reviewed, especially for top personnel.
10. **All material current contracts with third parties**. These should include any lease agreement(s), IT agreements, long-term contracts, *etc.*
11. **Real property.** Identification of any owned or leased real property and the associated deed and any mortgage.
12. **Insurance.** Review of current and historic insurance coverage.
13. **Litigation.** A list and description of any pending or potential litigation in which the potential merger partner is or could be a party.
14. **Contingent Liabilities.** A list and description of any threatened claim or contingent liability of which the potential merger partner is aware.
15. **Intellectual Property**. A list and description of any intellectual property owned or licensed by the potential merger partner. These would include any patents, registered trademarks, or software owned or licensed by the potential merger partner.
16. **Grants.** A list of grants (government, etc.) and major funders.
17. **Business Plan**. A copy of the potential merger partner's strategic or business plan.
18. **Corporate Culture.** An investigation of the culture of the potential merger partner to determine how difficult integration would be after merger. This is a subjective determination that must be gleaned from discussions with the target staff, Board members, and key constituents, but is vital in determining whether a merger can be successful. Difficulties determined during the due diligence period may not be able to be overcome.

Considering Alternatives

When contemplating a merger, the team should also consider whether there may be alternatives. Perhaps the organization would prefer to enter into a strategic alliance with a third-party entity in lieu of merger. Strategic alliances may include contracts for the provision of services from one party to the other or an agreement to mutually pursue revenue-generating opportunities. A strategic alliance may allow the organization to gain the advantages identified above without the costs and risks of a merger. The team should include in its recommendation to the Board the fact that it has considered a strategic alliance in lieu of a merger, and if it preliminarily recommends that a merger be further investigated, its rationale for reaching this conclusion.

Merger Formalities

Charitable assets must be dedicated for charitable purposes and, upon dissolution, must be transferred only to another charitable organization with a similar tax exempt purpose. A merger of two non-profit organizations generally does not require court or attorney general approval so long as the assets remain for charitable purposes post-merger. However, if there is a merger between a non-profit organization and a for-profit entity, there can be federal income tax implications. Federal income tax rules generally prevent a tax exempt organization from merging into or converting to a for-profit corporation (but the assets of a non-profit organization may be transferred to a for-profit corporation so long as the recipient corporation pays fair market value for the assets). Conversely, a for-profit corporation can convert to a non-profit by amending its articles of incorporation but the conversion may be treated as a taxable liquidation for federal income tax purposes.

After due diligence has been conducted and no impediments to merger are discovered, the organization can then undergo the merger process. This involves devising a timeline for the merger process and a cost estimate, including determining financial responsibility for each entity. In this process, the parties will decide what the new entity will be, choose the Board of Directors and executive leadership, determine what programs will remain, and devise the new corporate structure, rearrangement of debt, transfer of contracts, *etc*. These details initially will be contained in the merger term sheet and then later addressed in the formal merger agreement. Legal counsel for the organization will be heavily involved in drafting and negotiating the term sheet and merger agreement. Once a formal merger agreement is finalized, the Board of Directors of the organization will pass a resolution to approve it. If constituent or membership approval is also required, the requisite vote of the membership must be attained. A special meeting of the membership may need to be called to approve the merger. The organizational documents will need to be reviewed to determine the requisite quorum and voting thresholds required for approval.

Upon the approval of the merger, the organization's legal counsel will prepare the necessary state and government filings to merge the entities, dissolve pre-merger corporate remnants, and file the appropriate legal documents necessary to effectuate the merger. In order to comply with state law, a formal "plan of merger" will be drafted which will set out the terms and conditions for the merger, and identify what the surviving organization will be. If the merger is approved, a certificate of merger will be filed with the appropriate state bodies.

If a merger or other similar transaction will result in a fundamental change in the legal character of an exempt organization, or in a significant disposition of its assets, the IRS requires the exempt organization to report the transaction. The type of information that needs to be reported to the IRS depends on whether the charities involved are public charities or private foundations.

Confidentiality

The merger process is generally lengthy. During the process, the organizations will attempt to maintain confidentiality within the respective merger teams. However, at some point during the process, news of the possible merger may leak. In order to prevent a serious loss of productivity and alleviate employee concerns, each organization involved with the merger may wish to share the outcome of the merger with a broader group as its prospect becomes more likely. Agreement on a message to employees may be the first step in an overall communications plan regarding the merger.

Integration

Once the legal formalities are handled, the integration process of the two entities will begin. Integration involves transferring or redistributing assets as provided for in the merger agreement. There may be a post-closing audit conducted of the old corporate entity.

Key areas to address in the integration process are determining the new leadership and establishing the corporate culture of the new organization. A "top down" leadership approach is vital for ensuring a smooth transition from the former corporate culture into the new organization. It is critical for the senior

leadership to always keep in mind the original goals of the merger when effectuating the transition.

Upon launch of the new organization, there will be new marketing materials created, logos, letterhead, website re-design, *etc*. There will likely be a publicity push to inform constituents and the public of the merger. Existing contracts will be bought out, renegotiated, or assigned to the new entity and existing liabilities transferred or restructured. There may be a change in network and IT systems. There will likely be staff orientation or training. In some instances, a consultant may be hired by the new entity to assist throughout the transition process.

Conclusion

A successful merger process involves strategic forethought, observance of legal formalities and committed leadership from both of the involved entities. With careful planning, probing due diligence and sustained attention to operational integration (which can take months or even years), an appropriately tailored merger can create a new whole that is greater than its parts.

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About the Firm (for more information, please see www.schanerlaw.com.):

Ken Schaner and David Lubitz had a desire to apply their many years of experience primarily to the representation of tax exempt organizations, but could not do so in their then positions as partners in a large law firm, where the fee structure is not generally compatible with representation of non-profit entities. Accordingly, they formed Schaner & Lubitz in 2008. Today, their clients include the Cystic Fibrosis Foundation, JDRF International, Michael J. Fox Foundation for Parkinson's Research, Foundation for Fighting Blindness, Multiple Myeloma Research Foundation, Crohn's & Colitis Foundation of America, Leukemia & Lyphoma Society, and a number of other disease related entities and other section 501(c)(3) organizations, including several large private foundations. The firm has worked on over 300 venture philanthropy transactions and other diverse, sophisticated matters. Leslie Brown, former counsel at Rees Broome PC, who brings a depth of corporate and association experience, joined the firm as counsel in 2014.

About the authors:

Ken Schaner has practiced law for more than 40 years. He began his legal career at the Internal Revenue Service, where he was part of the team that drafted the 1969 amendments to the tax code pertaining to exempt organizations. He was a founding partner of Swidler Berlin, LLP, where he also served as managing partner and head of the corporate practice, and then a partner at Bingham McCutchen, LLP before co-founding Schaner & Lubitz, PLLC.

David Lubitz has practiced law for more than 20 years. He has worked for or represented non-profit organizations throughout his legal career. David has worked as a law clerk to a United States District Judge, he has worked for the Legal Aid Society, overseas on U.S. government funded rule of law projects, and as an associate at Morgan, Lewis & Bockius in Washington, D.C. He was a partner at Swidler Berlin, LLP and Bingham McCutchen, LLP before co-founding Schaner & Lubitz, PLLC.

Leslie Brown has practiced law for nearly 15 years. Leslie began her legal career as an associate at the Washington, D.C. law firm, Shaw Pittman, LLP. Leslie then clerked for the Honorable Lynn J. Bush of the U.S. Court of Federal Claims, before serving as Counsel for nine years at Rees Broome, PC, where she served as the outside general counsel to numerous community associations across the D.C.-area. Leslie joined Schaner & Lubitz, PLLC as Counsel in June 2014.