

# ALL ABOUT MERGERS OF NONPROFIT ORGANIZATIONS

This article first appeared in *Association Law & Policy*, a publication of the Legal Section of ASAE & The Center for Association Leadership, July 2008.

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*Despite all the barriers in their path, more and more nonprofits are heading down the road toward a merger. Here's what they can expect to see along the way.*

Mergers of nonprofit organizations are on the upswing. Such proposals are being propelled by sufficient force to overcome traditional advocates of the status quo or inertia, while the barriers to such unions are beginning to seem lower than many had thought. Members that belong simultaneously to competing organizations often say they would prefer to deal with just one, thereby consolidating their dues, volunteer leadership obligations, sources of information, networking opportunities, and meeting commitments. Volunteer and employed leaders often recognize that an industry or profession can be more effectively and efficiently represented by one large, strong advocacy organization; larger organizations simply have more influence. Sometimes two or more competing nonprofits struggle for new members, sources of revenue, and programs and activities. Combining those groups can instantly infuse them with new life and creativity. Inhibitions remain, of course. Combining two or more nonprofit organizations is in many ways more difficult than combining

two or more business corporations. When the leaders of businesses consider merging, they focus on revenue, profits, capitalization, cost cutting, and other economic factors. Equity owners' value ultimately drives such mergers and renders all other issues less important. But it is a rare nonprofit merger that is driven by perceived economic opportunities or issues. Other factors become key: What programs will survive? Who will end up in the leadership? What about employees and consultants? What will the name be? Where will the headquarters be located? What about the "culture" of the group? It's often more difficult to make a compelling case for a nonprofit merger than for a business merger because the potential benefits cannot easily be quantified. Usually the benefits—or disadvantages—seem personal to each member. Rallying membership support thus becomes more challenging. A fair percentage of nonprofit mergers that are considered ultimately do not proceed.

## **Why More Mergers?**

Why, then, are there more and more nonprofit mergers being reported? First and foremost is an evident increase in leadership professionalism throughout the nonprofit world. Those who manage nonprofits as

executives and those who govern them as volunteers are increasingly more savvy and seasoned businesspeople. When they identify overwhelming benefits from a potential merger, they are prepared to pursue those benefits aggressively. They take their jobs more seriously, often as a result of Sarbanes-Oxley and recent corporate governance scandals. They are better at making the case and addressing the naysayers. Also, mergers beget mergers. Most nonprofits have businesspeople sitting on their governing boards; those board members have usually had experience with mergers and tend to proselytize for the benefits of combining. A few nonprofits have merged more than once in the past 10 years, while others observe mergers happening in their fields or elsewhere and are inspired to consider possible mergers for their own organizations. Finally, there has been a gradual change in members' perceptions of nonprofit organizations and their relationships with those organizations. The sense of maintaining membership in a club is dissipating, especially for members of business or professional organizations. Increasingly, they see their nonprofit memberships as a means to obtain services, such as advocacy, information, networking, or credentialing. The emotional attachment that once accompanied membership may be on the wane. That allows for more businesslike and detached decision making on mergers at every level of a nonprofit organization, including the staff, board, and membership.

### **The Mechanics of Merging**

Beyond the issues of whether to merge are the issues of mechanics. They can be daunting. In some cases, the trouble and expense of a nonprofit merger has actually deterred the parties from proceeding. This is not something for do-it-yourselfers; mergers are sophisticated business transactions, likely the most sophisticated that a nonprofit will ever undertake. More than a few nonprofit mergers have failed in part because the volunteer or staff leadership thought they knew all the answers. First, a note about structure is in order here. Most combinations of non-profit organizations are not actually formal legal mergers. Instead they are, technically, formal legal consolidations. In a merger, one or more non-profit corporations merge into another, with the latter becoming the "surviving corporation" and the other(s) being automatically dissolved by virtue of the merger. By comparison, in a consolidation, two or more nonprofit corporations are dissolved and a new organization is automatically formed by virtue of the consolidation. For diplomatic reasons alone, nonprofit organizations tend to prefer the consolidation option, with none of the former corporations surviving but a new one being created. For nonprofits, use of the term "merger" in the non-technical sense to refer to both mergers and consolidations is common, and the term is used that way in this article. What's involved in a merger of nonprofits? Loosely, there are three phases or groupings of activities.

### **Inquiry and Consideration**

The first phase is a kind of courtship. It is most often undertaken at the impetus of the volunteer leadership from the organizations considering a merger, with the assistance of their senior staff. Meetings and discussions can be very informal; a nonprofit merger can have its genesis on a golf course or in a dinner conversation. As in the consideration of any business transaction, each potential partner will be assessing the pros and cons of a combination. An attitude of openness and objectivity is best. Hard questions and entrenched positions should probably be deferred during this stage lest they derail the process. This is the time for ice breakers, not deal breakers. Once it is clear that there is mutual interest in serious discussions at least, consideration should be given to a brief, non-threatening written agreement among the parties. It can fit on one page and be in the form of a letter signed on behalf of each organization. It might state that the discussions are confidential, that no commitments are being made and no risk or liability arises if the discussions are suspended or terminated, and that any costs are borne separately by the groups represented in the discussions (or that jointly incurred costs, such as for consultants, are divided equally or according to a formula). Many organizations are aided during this initial phase by consultants experienced in guiding nonprofits through merger discussions. Order and purpose may be more easily imposed by a neutral party, even as

the discussions remain informal; the inevitable sense of competition or advantage can be reduced; and conversations can be diplomatically steered in the appropriate direction, toward cataloging benefits and identifying obstacles rather than toward personalities or other peripherals. If it concludes successfully, this phase should result in some form of a deal memo, term sheet, or list of issues on which there is concurrence, as well as a catalogue of issues for which there is not yet concurrence. It should also result in participating leaders committing to sound out their governing boards about proceeding with discussions. It is usually too early to attempt formal written documents such as new bylaws, a merger agreement, or an organizational chart; such efforts risk polarization as details must be considered and resolved.

### Planning

Assuming courtship is successfully completed and the governing boards of the participating organizations agree, serious work can begin. During this phase, the new or resulting organization is designed, and a variety of legal tasks are performed. This is the detailed planning stage. It is most often led by an ad hoc committee of senior volunteers from each of the potential partners to the merger. Past chairs tend to be favored as appointees, although a better case can be made for appointing future chairs to this committee. The staffs of the organizations must also become closely involved. Subcommittees or working groups, often composed of

combinations of volunteers and staff, will consider, seek consensus, and make recommendations on a wide variety of aspects of the resulting group, such as membership, dues, governance, programs, meetings and events, name, staffing, benefits, headquarters, and so forth.

Compromise is key. Negotiators for all sides should choose a few issues most important to their organizations and try to achieve as many of those as possible by conceding the less important ones. One potentially sticky issue that must be faced is who will ascend to the senior volunteer positions in the combined entity. Most often the upcoming leaders are dovetailed with their terms spread out over a few years. Likewise, it is common to combine the boards of the merging organizations with reduction to the optimum size occurring over the next few years by attrition. While this is going on, legal endeavors must also be ramped up. The two most crucial are due diligence reviews and the development of a merger agreement.

### Due Diligence

Once it becomes clear that the governing boards of the merging organizations are interested in a formal merger proposal, due diligence reviews should be undertaken. Because these are intense and expensive efforts, it's best to defer undertaking them to the point when it seems more likely, rather than less likely, that the merger will be pursued. "Due diligence" refers to the process of systematically reviewing the legal and financial

situation of one's potential merger partner. The legal due diligence review is a kind of legal audit. A merging association seeks a comprehensive examination of the other party's or parties' legal status and risk—incorporation, contracts, claims or litigation, human resources and benefits, real estate, and so forth. In financial due diligence, which is usually less than a full financial audit, the association seeks to examine the potential partner's true financial position and risks, usually based on the other party's or parties' past audited financial reports. Legal due diligence is conducted by attorneys, and financial due diligence is conducted by accountants. Their reports to the client become a premise for the board's approval and recommendation of the merger. There's a very compelling reason for due diligence, and it should never be dismissed: Courts have held that the members of the board of directors of a corporation that recommends a merger to shareholders or members can be personally and individually responsible if untoward results occur from the merger and the board members had failed to closely examine the merger partners in advance. Due diligence is thus an insurance policy for each governing board involved in the merger. It helps avoid personal liability of directors; it also has the salubrious effect of providing an objective inside look at the merger partners. Boards are certainly permitted, without incurring personal risk for board members, to approve and recommend a merger

with a less-than-perfect merger partner, such as one with a declining membership, for example, or one that faces litigation challenges. But the board needs to have investigated and understood the ramifications of any imperfections.

### **Merger Agreement**

A formal merger agreement is also used in virtually every nonprofit organization merger. It addresses the rights and obligations of each merging entity, the understandings that underpin the merger, and what has to happen before the merger can close, such as due diligence and various approvals. The agreement usually has a variety of attachments which become part of “the deal”: the earlier informal deal memo or term sheet, the bylaws of the merged organization, the representations and warranties of the parties, possible organization charts and program descriptions, board and member approval information and filings, and so forth. Agreements for nonprofit organization mergers are usually closely negotiated and proceed through many drafts before both or all sides are satisfied that the agreement and all attachments reflect what is expected.

### **Approvals**

The final mechanical phase of a nonprofit merger is the approval phase. Dictated by state nonprofit corporation law, approval is usually in two steps, by the boards and then by the memberships. The governing board of a merging organization will

usually consider the impending merger at two or more meetings before it is comfortable considering approval of the merger. At the final approval stage, the board will review the legal and financial due diligence reports, the merger agreement, the membership approval materials, and the proposed state merger filings. Only then is the board in the proper position to approve the merger and recommend it for approval by the membership (assuming the organization has members with voting rights). Consideration at this stage often seems perfunctory, since so much volunteer, staff, and consultant work has already gone into setting up the merger for board approval. Where a merging nonprofit organization has members with voting rights, there must then be membership approval of the merger. State nonprofit corporation laws dictate the mechanics of this process. Often a membership meeting is required, and typically a fairly high-percentage vote in favor of the merger is needed, such as more than half or two thirds of all members who can vote, not just those who actually cast votes. Approval is usually via the submission of member proxies to the chairman or president, with the proxies cast for or against the merger at a “phantom” membership meeting, where all members are expected to vote by proxy rather than attend in person. Proxy fights have occurred in member voting on nonprofit mergers; proxy solicitation firms, which usually serve

business corporations seeking shareholders’ votes, are sometimes used in nonprofit mergers to help ensure membership approval.

### **Closing the Deal**

After all that has preceded it, the finalization or closing of a nonprofit organization merger often seems to be a bit lacking in glamour. On or just before the proposed effective date of the merger, filings will be made in the state where each partner organization is incorporated, following the form and content required by that state. Once the merger filings are accepted, the merger is complete from a legal point of view. Much work remains, of course. Merging programs and operations usually consumes months of volunteer and staff time following the closing. Presumably, though, it has all been worthwhile. A new, stronger, more vibrant nonprofit has been formed with a better chance of serving members’ needs for the long term.

