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Board Talking Points: Mergers and Strategic Alliances

Today's economic conditions have presented many nonprofit organizations with rising operational costs and increased competition for funding sources.¹ Faced with such challenges, some nonprofit organizations may look to certain types of transactions, such as a merger or the formation of a strategic alliance with another nonprofit organization in an effort to preserve programs.

Below are some questions that a board of a nonprofit organization may ask as it considers whether to pursue a merger or strategic alliance with another nonprofit organization.

1. What is a "merger"?
2. What is a "strategic alliance"?
3. What are some of the motivating factors for a nonprofit organization considering a merger or strategic alliance transaction?
4. How is a nonprofit organization's "mission" relevant to a board's consideration of a transaction?
5. Why should a nonprofit organization conduct diligence before choosing a proposed merger partner?
6. What sort of diligence should a nonprofit organization conduct?
7. What are the general "mechanics" of a merger that boards should understand? What steps must be taken to approve a merger, and from whom might the organizations need consent?

Discussion Points

1. What is a "merger"?

The term "merger" is often used to describe many different business relationships and transactions. It is important to understand the differences between the transactions because the impact on your corporation will be dramatically different depending on the precise nature of the transaction. Merger is when one corporation absorbs another. The assets, staffs and programs of

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the two corporations are joined together, as are the liabilities and obligations of both corporations. The merged corporations usually operate under the name of the "surviving" corporation, i.e. the corporation that absorbed the other corporation. The board of directors of the surviving corporation manages the merged corporation, although it is not unusual for the surviving corporation to invite a few members of the "constituent" corporation (the corporation which is absorbed) to join the board. The constituent corporation ceases to do business and the merger will terminate its existence.

A "consolidation" is when the two corporations that are joining together both cease to exist and a new corporation emerges. The assets, staffs and programs of the two corporations are joined together, as are the liabilities and obligations of both corporations. In a consolidation neither corporation is dominant over the other. A newly constituted board of directors manages the consolidated corporation. The new board could be made up of members of the boards of the consolidated corporations or could be entirely new board members. The consolidated corporation could operate under the name of one of the old corporations or under a new name.

2. What is a "strategic alliance"?

A strategic alliance is effectively creating a parent-subsidary relationship between two nonprofit organizations. In New York, this can be achieved either through a sole membership or interlocking board structure. In a sole membership structure the parent corporation becomes the sole member of the subsidiary and thus has the power to elect the board of directors and approve other significant corporate actions. The sole membership structure is put in place either by amending the subsidiary corporation's bylaws or certificate of incorporation. In an interlocking board structure the parent corporation is able to nominate or appoint the majority of directors. The interlocking board structure is also put in place by amending the subsidiary corporation's bylaws or certificate of incorporation.

3. What are some of the motivating factors for a nonprofit organization considering a merger, strategic alliance or sales transaction?

A nonprofit organization may consider a merger, consolidation or strategic alliance to expand the range of services it provides or to assure its future viability in the face of changing needs for its services. However, in the current economic climate, such transactions are frequently prompted by financial challenges as a result of fewer funding sources. A merger, consolidation, or strategic alliance with another nonprofit organization providing similar or identical services may result in synergies, enabling the combined organization to provide services more efficiently. Such a transaction may also be more appealing than "venturing alone" and risking the viability of the organization as economic conditions worsen. As nonprofit organizations consider certain transactions, it is essential that they consider the impact on their clients and whether a particular transaction will improve delivery of client services.

4. How is a nonprofit organization's "mission" relevant to a board's consideration of a transaction?

A critical consideration for any board evaluating an extraordinary transaction, such as a merger, consolidation or strategic alliance, is the preservation and promotion of the nonprofit organization's mission. A board, in fulfilling its fiduciary duties, must be satisfied that the alliance will provide a continuity of mission following the completion of the transaction.

Under New York Not-for-Profit Corporation Law (“N-PCL”), the applicable test is whether the surviving corporation will engage in activities that are “substantially similar” to those of the constituent corporations. A board needs to be very mindful of whether the terms of a transaction are consistent with the nonprofit organization’s mission — whether as stated explicitly in its certificate of incorporation or expressed through its activities over time. A nonprofit organization’s mission is of such central importance that when a court reviews a plan of merger it must be sufficiently satisfied that the interests of each of the merging entities are not adversely affected by the transaction. For this reason, boards should ensure that any plan submitted to a court discusses how the specific “object and purposes” of the merging organizations will be promoted.

5. Why should a nonprofit organization conduct diligence before choosing a proposed merger partner?

Due diligence is the process of reviewing the legal and financial situation of a potential merger or strategic alliance partner. Diligence can be costly and time-consuming, but it is a critical part of the process. A merger or consolidation results in two organizations becoming one, with the surviving organization possessing all of the assets, rights, powers, and purposes of the constituent entities. But with all of the inherited assets, rights and powers, come all of the liabilities, obligations and claims of both constituent entities. Directors may be held personally liable if negative results occur from a transaction because they failed to carefully examine the merger partner. A robust diligence process can help protect directors from such challenges.

6. What sort of diligence should a nonprofit organization conduct?

While the details of a diligence process may differ based on the particular transaction, directors may want to consider the following:

- Are there any “red flags” in the organization’s financial documents (*e.g.*, audits, I.R.S. Form 990 disclosures, budgets)?
- Are the organization’s financial processes healthy?
- What are the organization’s liabilities? Are they unrecorded, recorded, or contingent?
- Will there be any human resource overlaps upon a merger? What sorts of pay, vacation, and benefits does the organization provide its personnel?
- What are the organization’s properties? Are there any issues in the title reports or inspections?
- Does the organization have capital needs assessments or adequate reserves?
- What does the organization’s donor base look like? Does it overlap?
- Does each proposed partner have a clean vendex?
- What is each proposed partners reputation among funders? Do both organizations receiving funding from similar sources? Will funding hold steady after the alliance?
- What is the proposed partner’s potential for growth?
- What are the projections for a combined budget? Will there be any cost savings?
- Is the organization facing any pending litigation or investigations?
- Does the organization have any restricted assets or funds?

Asking questions and performing due diligence will allow directors to fully investigate a nonprofit organization's potential partner and understand the ramifications of a possible merger.

7. What are the general “mechanics” of a merger that boards should understand? What steps must be taken to approve a merger, and from whom might the organizations need consent?

Once the organizations have conducted their due diligence and elected to proceed with a merger, the next step is to consider the precise structure, as well as the impact of that structure. For example, boards should keep in mind what the identity of the surviving organization and membership of its board will look like, as well as how the management of the constituent organizations will be integrated or changed. Once such issues are resolved and a final structure determined, the parties should then prepare and negotiate the plan of merger and the proposed governing documents (*e.g.*, certificate of incorporation, by-laws) for the surviving organization. Since court approval will be required, the parties must first substantially approve a proposed plan of merger, and then prepare the documents to be submitted to the court. These documents include the: (1) plan of merger; (2) certificate of merger; (3) verified petition and affidavits for each constituent organization (with exhibits) in support of the merger; and (4) proposed court order approving the merger.

Exhibits to the affidavits typically include the: (1) current governing documents of each organization; (2) proposed new governing documents for the surviving organization; (3) board/member resolutions and minutes regarding the proposed merger; (4) list of names of all proposed directors, officer and members of the surviving organization; (5) any letters of intent or agreements entered into in connection with the proposed merger; (6) I.R.S. Form 990 for each organization for the past three years with audited financial statements; (7) I.R.S. Form 1023 for each organization; (8) detailed list of any endowments and restricted funds/assets for each organization; and (9) list of all entities whose approval is required for the merger.

These documents are then submitted to the Charities Bureau of the New York State Office of the Attorney General (the “AG”). Once the AG reviews and approves the form of these documents (the AG may request that additional information be provided and/or that certain of the documents be revised), the next step involves obtaining the required consent or approval of any New York State governmental agency that would have such consent or approval rights over both organizations pursuant to Section 404 of the N-PCL. The documents are then submitted to the board or the members of each organization to vote on the proposed merger. Two-thirds of the board or membership must approve the merger. The organization should then re-submit the documents to the AG. If the AG provides a statement to the court that it has no objection, the verified petition in support of the merger should be submitted to the Supreme Court of New York located in the county in which the surviving corporation will be located. If the court approves the petition, it will enter an order approving the merger. A certified copy of such order must then be provided to the New York State Department of State, together with a proposed certificate of merger. Once the Department of State files the certificate of merger, the merger is final.

An illustration of the typical mechanics of a merger is provided in Figure 1 below.

Figure 1

MECHANICS OF A MERGER	
STEP 1	
Complete Due Diligence Review and Determine Final Structure	<ul style="list-style-type: none"> • Review the condition, liabilities, restricted assets and other financial and legal matters of each organization • Decide final structure (<i>i.e.</i>, which organization will be the surviving organization, etc.) • Consider the potential impacts of the final structure (<i>i.e.</i>, who will serve on the board of the surviving organization, how will management be integrated or cut back, etc.)
STEP 2	
Prepare Draft Merger Documents	<ul style="list-style-type: none"> • Prepare (1) plan of merger, (2) certificate of merger, (3) verified petition and affidavits for each organization (with requisite exhibits) in support of merger, and (4) proposed court order approving merger
STEP 3	
Initial Review of Documents by NYS Attorney General (“AG”)	<ul style="list-style-type: none"> • Send documents to the Charities Bureau of the AG • Respond to the AG’s questions • AG will determine whether the interests of the corporations and the public interest will not be adversely affected by the merger
STEP 4	
Obtain Required Approvals	<ul style="list-style-type: none"> • Submit AG-approved documents to government agencies that have approval/consent rights over either of the corporations pursuant to § 404 of the N-PCL • Each corporation must submit documents for approval by two-thirds of their respective members (if any) and boards • Once all approvals obtained, have AG give final sign-off on documents
STEP 5	
Obtain Court Approval	<ul style="list-style-type: none"> • Jointly submit verified petition, affidavits and proposed order (all of which have received all required approvals) to the Supreme Court in the judicial district in which the principal office of the surviving corporation is located
STEP 6	
File Certificate of Merger	<ul style="list-style-type: none"> • Submit certified copy of court order and certificate of merger to NYS Department of State • Surviving corporation must file copy of certificate of merger in each county where the surviving corporation has offices

As every transaction is different, the circumstances and timing relating to these steps will differ. Nevertheless, boards of organizations seeking to merge should be familiar with these steps as they fulfill their duties to their respective organizations.

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This alert is meant to provide general information only, not legal advice. If you have questions as you try to determine whether to pursue a particular transaction, contact Linda S. Manley, Lawyers Alliance at (212) 219-1800 ext. 239 for assistance.