LEGAL AND TAX ASPECTS OF NONPROFIT MERGERS

W. MARSHALL SANDERS is Counsel in the Atlanta office of Alston & Bird LLP.

From the horizontal consolidation of the manufacturing sector in the late 1800s, continuing through the massive merger "wave" that swept through major industries in the 1990s, mergers and other forms of corporate restructuring have been commonplace in the for-profit sector. Although there is debate about whether and how often mergers result in more profitable companies, or even whether they are good for the economy generally, there can be little doubt they have been an important and enduring feature of the modern market economy. 1

In contrast, mergers between nonprofit corporations historically have been much less frequent. This is certainly due, in large part, to the absence of the financial incentives that encourage reorganization among business corporations. While a variety of factors may motivate a business corporation to consider a merger, the paramount consideration is usually the prospect for increasing profits and delivering additional value to shareholders. That incentive is usually absent in the case of nonprofit organizations, which by their

very nature operate for the primary objective of achieving some publicly beneficial good, rather than for the purpose of making a profit.

There is evidence, however, to suggest that merger activity in the nonprofit sector has in-creased in recent years. High-profile reorganizations include the merger of the American Bankers Association with America's Community Bankers, the combination of The Points of Light Foundation with Hands On Network, and the merger of numerous local chapters of several national voluntary health organizations into a handful of consolidated regional entities.

Observers have identified a number of reasons for the growing willingness of nonprofit organizations to merge. The recent economic downturn has resulted in decreased donations, dues, and earned revenues at a time when many nonprofit organizations are being called upon to deliver increased services to members, the public, and other constituencies. A merger may offer an opportunity to make the

¹ See, e.g., "What Are Mergers Good For?" N.Y. Times 6/5/05.

² See, e.g., "Nonprofit Mergers Gaining Velocity," Nat'l L.J., 8/25/08; "Charities Try Mergers to Improve Bottom Line," N.Y. Times, 11/11/07.

organization more efficient (through achieving economies of scale and reducing duplication and fragmentation), to enhance opportunities for earning additional revenue, and to increase the appeal of the organization to members, donors, and volunteers. In addition to financial incentives, a merger may provide a means to increase the range of program services or expand an organization's geographical reach. Also, as the non-profit sector has grown in size and sophistication, organizations are increasingly governed by board members and executives that understand the potential benefits of mergers and are willing to pursue them.

Regardless of which factors drive a nonprofit organization to consider a merger, it will almost always be one of the most important and legally complex transactions that the organization will undertake and will effect a fundamental change in its legal character. To fulfill their fiduciary duties of care and obedience to the organization, the members of the board of directors and the officers should exercise exceptional diligence when considering and executing a merger. To properly discharge this responsibility, they should acquire a basic understanding of the legal procedures, requirements, and consequences of a merger.

The discussion below focuses on general state nonprofit corporation law and federal tax law reporting requirements for mergers between charitable, nonprofit corporations. While the statutes of all states authorize mergers between nonprofit corporations, the merger provisions of those statutes are not completely uniform. Most jurisdictions generally follow (with some variation) the provisions of the 1987 Revised Model Nonprofit Corporation Act ("RMNCA' or "Act"). Others adhere to the original 1952 Model Nonprofit Corporation Act. A very small handful of states (including Delaware)

do not have separately codified nonprofit corporation laws and rely instead on the "nonstock" provisions of their general corporation codes. Nonetheless, the basic statutory merger requirements described below are common to most jurisdictions.³ The tax reporting rules related to mergers of nonprofit organizations that are exempt under Section 501(c) are the same, of course, regardless of the jurisdiction in which the corporation is organized.

First steps

The path to a merger typically will begin with discussion and analysis by the organization's board and senior staff of whether a reorganization or alliance of some sort will likely further the mission and objectives of the organization. Consideration of a merger may be provoked by the approach of a potential merger partner, or it may originate internally, perhaps as part of a strategic planning process or as a response to a financial or other crisis facing the organization.

Whatever prompts the organization to con-sider a merger, it is usually prudent to consult legal counsel relatively early in the process. There are a variety of legal issues that can bear on the question of whether a reorganization is practical or even possible. Would the reorganization require the approval of regulatory or funding authorities or jeopardize the organization's accreditation, if it has one? Does the organization have legal liabilities that would make it an unattractive merger partner?

³ The provisions of the RMNCA are cited herein because the majority of states base their statutes on that Act. A second, major revision of the model act, the Model Nonprofit Corporation Act Third Edition, was promulgated by the American Bar Association in 2008, but its influence has not yet been felt on state nonprofit corporation codes.

Does the organization have debt or contractual obligations that could complicate a merger? Will the surviving organization's nonprofit, tax-exempt status be jeopardized by the transaction? Does the charity have substantial assets subject to donor-imposed restrictions that would have to be modified or released in connection with the merger, or that would require legal filings and the payment of fees if their ownership changes as a result of the merger?

A lawyer's input is also essential in addressing the more general question of whether a merger is the right legal form of reorganization for the corporation. The term "merger" has a specific legal meaning. It refers to the amalgamation of two (or more) corporations through a statutorily prescribed process in which all but one of the corporations ceases to exist and the "surviving corporation" inherits all of the assets and liabilities of the non-surviving corporations.⁴ All state statutes expressly authorize mergers by nonprofit corporations. RMNCA § 11.01 expressly authorizes one or more non-profit corporations to merge into a domestic nonprofit corporation. RMNCA § 11.06 permits the merger of a domestic nonprofit corporation with one or more foreign nonprofit corporations, provided that the law of the state of incorporation of the foreign corporation permits the merger.

There are other forms of reorganization that may accomplish the organization's goals, how-ever. For example, a "consolidation" is related to, but legally distinct, from a "merger:' In a consolidation, all of the combining organizations lose their legal identities and a new corporation is created.⁵ (There is no "surviving"

corporation after a consolidation.) Another alternative to a merger is a transfer of assets by one nonprofit to another, followed by the legal dissolution under state law of the transferor organization. There also are other options—joint ventures, contractual arrangements, informal alliances, etc.—that do not involve a legal restructuring but that may achieve many of the same objectives as a merger. (For example, two organizations that are seeking to increase the efficiency of their operations or reduce duplication of services may be better served by an agreement to share office space or administrative functions, or jointly deliver programs, than by a merger.)

From a legal standpoint, it is important to remember that very different consequences can attend different types of restructuring. For example, the surviving corporation in a merger or the new corporation in a consolidation assumes the assets and liabilities of the other par-ties to the transaction by operation of law. ⁶ Title to all real estate and other property owned by the non-surviving corporations becomes vested in the surviving corporation. The surviving corporation takes on all of the liabilities and obligations of the other parties to the merger. The surviving corporation is automatically substituted for the disappearing corporation(s) in any lawsuit or other legal proceeding. In contrast, in the case of a sale or contribution of assets by a dissolving nonprofit corporation, the transferee nonprofit organization may or may not choose to assume the liabilities or accept all of the assets of the transferor.

Similarly, a merger—at least in cases in which all the constituent corporations are organized and operate for charitable or public benefit purposes—will not usually

⁴ Fletcher Cyclopedia of the Law of Corporations, § 7041 (Thomson/West, 2009-10).

⁵ Id.

⁶ RMNCA § 11.05.

require involvement of the attorney general. A dissolution, on the other hand, typically requires no-tice to the attorney general. A consolidation of charitable organizations may be preferable to a merger for "political" reasons if one or more of the merging entities may be threatened by not being the surviving corporation. The merits of a consolidation, however, would have to be weighed against the fact that the new corporation will have to apply for a determination letter from the IRS if it wishes to be classified as an organization exempt under Section 501(c)(3). (In the case of a merger, the surviving corporation usually would not have to obtain a new determination letter.)

In sum, legal counsel is essential in helping the organization think through the pros and cons of the various options that may be available.

Memorandum of understanding

If preliminary discussions between representatives of the potential merger partners indicate that it is in the interests of each of their organizations to pursue a merger, the parties will typically enter into some type of formal written agreement that defines the responsibilities and expectations of the parties, identifies steps to be completed prior to consummation of the merger, and memorializes the general commitment of the parties to work collaboratively towards a common goal. This "memorandum of understanding" (or "term sheet" or "letter of intent") is often the first legal step towards the adoption of a final "merger agreement" or "plan of merger:' It does not legally bind the organizations to complete the merger. In fact, with some exceptions (e.g., a provision obligating the parties to keep certain information exchanged by the parties during the due diligence process confidential), few of the provisions may be binding on the

parties. Generally, the parties will agree to cooperate and work in good faith to complete due diligence. The agreement may include a timetable for completion of various pre-merger tasks; detail how legal, accounting, and other costs incurred in connection with the proposed merger will be allocated; identify which party will be the surviving corporation; and set forth the general governance structure (and perhaps the name) of the surviving entity. The governing body of each organization should formally approve this document and authorize an officer to execute it on behalf of the corporation.

Due diligence

The execution of a memorandum of understanding or similar document is usually followed by a period of "due diligence.' Generally speaking, this concept refers to the act of making a reasonable investigation into and evaluation of the history, finances, and operations of the other parties to the merger. In the case of the surviving corporation, thorough due diligence is essential in a merger because the surviving corporation will assume all of the debts, legal claims, contract obligations, and other liabilities of the non-surviving corporation(s). Records and information that will typically be important to parties to the transaction will include charters and bylaws; board, committee, and membership meeting minutes: IRS determination letters, annual information returns and other federal tax documents; records relating to exemption from property, sales, and other state or local taxes; contracts and other legal agreements; deeds and other real estate records; pending or threatened lawsuits or other claims: licenses and accreditations; accounting statements, reports of internal or external auditors, and other financial documents; internal policies (for, e.g., personnel, conflicts of interest, records retention, etc.);

employee benefit plans; etc. While the surviving organization obviously has a strong interest in making sure that the due diligence process is thorough, the nonsurviving corporations should take this obligation seriously as well. The governing boards of the non-surviving parties to the merger have a fiduciary obligation to obtain reasonable assurances that the surviving corporation will have the capacity and commitment to properly steward the assets of the non-surviving corporations after the merger is complete.

It should be noted that although a merger is a legally driven process, much of the attention of the organizations will be focused during the pre-merger period on non-legal aspects of the merger. For example, while the merger partners may have similar missions, the "corporate cultures" of the two organizations may be quite different. Careful thought will need to be given to how these cultural differences will be bridged. Mergers also invariably raise unsettling issues that range from the loss of organizational independence and job security to the impact on donor or member relations. Preparing donors, members, staff, and other stake-holders is essential to success. Besides these very human concerns, staff will need to address logistical and practical issues related to the integration of such things as programs, facilities, technology, etc.

Plan of merger

Once all the parties are satisfied with the results of the due diligence process, a logical next step will be to draft and negotiate a plan of merger (sometimes referred to as a "merger agreement"). The plan must state the names of the merging corporations, identify which corporation will be the survivor, and set out the terms and

conditions of the merger. If memberships in the disappearing corporations are to be converted into memberships in the surviving corporation, the plan also must state the manner and basis of that conversion.

In short, the statutory requirements for the terms of a plan of merger are minimal, and the parties have great latitude in determining what other information to include in the plan. Depending on the size and complexity of the organizations involved, the plan may include many other provisions. The plan may include copies of a restated charter and bylaws for the surviving corporation; provisions addressing the integration of programs, services, and systems; the identification of initial directors, officers, and senior managers; etc.

The statute does set forth very specific procedures for the adoption of the plan. In the case of a corporation with a self-perpetuating board of directors, the Act requires (unless otherwise required by a corporation's articles of in-corporation or bylaws) that the plan of merger be adopted by a majority of directors in office at the time of the approval. If the merger is to be considered at a directors' meeting, the corporation must provide timely notice to the directors of the meeting, and the notice must expressly state that one of the purposes of the meeting is to consider a merger.

In the case of membership corporations, the board, after adopting the plan of merger, must submit it to the members for approval. Unless otherwise provided in the governing documents, the members must approve the merger by two-thirds of the votes cast or a majority of the voting power,

⁷ RMNCA § 11.01(b).

⁸ Id.

⁹ RMNCA § 11.03(b).

¹⁰ RMNCA § 11.03(a)(2).

whichever is less. If the merger is to be considered by the membership at a meeting, notice of the meeting must be timely and expressly state that consideration of the merger is a purpose of the meeting. Regardless of whether approval is sought at a meeting or by written consent, the members must be provided with a copy of the plan of merger. Members of the disappearing corporation(s) must also be provided with a copy or summary of the articles and bylaws of the surviving corporation that will be in effect after the merger. The plan provided to the members of the surviving corporation must include any provision that, if contained in a proposed amendment to the corporation's governing documents, would require a vote of the members. If the corporation has classes of members, and the plan contains a provision that, if contained in an amendment to the articles or bylaws, would entitle the class to vote on the proposed amendment, approval of the merger by the class is required. Approval by two-thirds of the votes cast by the class or a majority of the voting power of the class, whichever is less, is required, again unless otherwise provided by the applicable governing documents.

Finally, if the articles of incorporation of the corporation require approval by a third party of an amendment to the articles or bylaws, such person must approve the merger in writing.¹¹

Articles of merger

The final legal step in a merger is the creation of a public record of the merger by the filing of official documentation, known as articles of merger (or a "certificate of merger" in some cases), with the states in which each of the parties to the merger is organized. After the plan of merger has been

approved by all of the merging corporations, the articles must be delivered to the secretaries of state (or equivalent state office) in the states where the parties to the merger are incorporated. ¹² In some states, the articles must be executed by a duly authorized officer of the surviving corporation. In other jurisdictions, they must be signed by an officer of each of the parties to the merger. The merger becomes effective on the date of the filing of the articles of merger unless the articles provide for a delayed effective date. ¹³

The articles will identify the parties to the merger, the parties' states of incorporation, and the surviving corporation. They must set forth or include a copy of the plan of merger and a representation that the merger was properly approved. For corporations without members entitled to vote on the merger, the articles must include a statement that no membership approval was required and that the merger was adopted by a sufficient vote of the board of directors.

If membership approval is required, the articles must state the designation, the number of memberships outstanding, the number of votes entitled to be cast by each class entitled to vote separately on the plan of merger, and the number of votes of each class voting on the plan. The articles must also include either (1) the total number of votes cast for and against the plan by each class or (2) the total number of votes cast for the plan by each class and a statement that the number of votes cast by each class was sufficient for approval by that class. ¹⁶ If the

¹¹ RMNCA § 11.03(a)(3).

¹² RMNCA § 11.04.

¹³ RMNCA § 11.04 (cmt).

¹⁴ RMNCA § 11.04.

¹⁵ RMNCA § 11.04(2).

¹⁶ RMNCA § 11.04(3).

merger required approval by a party other than the board of directors or the members, the articles must include a statement that such approval was obtained.¹⁷

Depending on the jurisdiction, other information may be required in the articles. This information may include (1) a statement that a copy of the plan of merger will be made available to anyone who requests it, (2) a statement that the laws of all of the states in which any parties to the merger are organized permit the merger, (3) copies of the amended articles of incorporation or bylaws of the surviving corporation, and (4) appointment of an agent in the state for service of process in a lawsuit or other proceeding to which a non-surviving party to the merger would have been subject.

Oversight of nonprofit mergers

The merger of some types of non-profit organizations—for example, a merger involving mutual benefit organizations or a merger involving nonprofit and for-profit entities—may require the approval of a court and/or the attorney general. This provision is designed, of course, to prevent the diversion of assets for other than proper nonprofit purposes. In most cases, however, a merger that involves only charitable or public-benefit nonprofit organizations does not require notice to or approval from the attorney general or from a court. 19 However, practitioners should carefully review the requirements in the relevant states. Some jurisdictions do mandate some degree of attorney general oversight. California, for example, requires 20 days notice to the attorney general before a public benefit

corporation engages in a merger with any other nonprofit organization, even another public benefit corporation. ²⁰

Restricted and post-merger gifts

Absent some provision in the gift instrument to the contrary, both restricted and unrestricted gift assets owned by nonsurviving parties at the time of the merger become the assets of the surviving corporation as a result of the merger. If gifts made to a constituent corporation in a merger are subject to a purpose restriction or similar limitation, those gifts remain subject to that restriction notwithstanding the merger. Such gifts are impressed with a charitable trust and the surviving corporation must abide by the restrictions imposed on the gift. If the surviving corporation cannot hold the gift assets subject to the restrictions—because, for example, its charitable purposes are substantially different than those of the disappearing corporation—it must seek either re- lease/modification of those restrictions from the original donor or judicial relief under the cv pres. administrative deviation, The Uniform Prudent Management of Institutional Funds Act, or similar state law doctrines or statutes.²¹

It is not unusual for gifts and grants to be made to charitable organizations that have dis-appeared by virtue of a merger with another charitable organization. This is particularly true of bequests or devises made to a charity under wills or other testamentary instruments drafted prior to the merger that were never changed to account for the subsequent disappearance of the charity. Fortunately, many state statutes have

¹⁷ RMNCA § 11.04(4).

¹⁸ See, e.g., N.Y. Not-for-Profit Corp. § 907.

¹⁹ RMNCA § 11.02.

²⁰ Cal. Corp. Code § 6010.

²¹ RMNCA § 11.07 (cmt).

adopted the provisions of RMNCA 4 11.07, which affords relief in this situation. This section provides that " [a]ny bequest, devise, gift, grant, or promise contained in a will or other instrument of donation, subscription, or conveyance, that is made to a constituent corporation and that takes effect or remains payable after a merger, inures to the surviving corporation unless the will or other instrument otherwise specifically provides.²²

Will the surviving organization's nonprofit, tax-exempt status be jeopardized by the transaction? Reporting mergers to the IRS

In mergers between business corporations, the income tax implications are usually critical and will often significantly influence the legal structure of the transaction. Matters are vastly simpler in the case of a merger between two or more nonprofit charitable organizations. In most cases, the entire transaction should be without income tax consequence to any of the parties.

Nonetheless, if a merger or other 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 does require the exempt organization to report the transaction. In a recent publication, the IRS identified the notice requirements that must be satisfied by merging Section 501(c)(3) organizations that are required to file an annual tax information return.²³

Reporting requirements for merging public charities. For exempt

organizations not classified as private foundations, a non-surviving organization will typically notify the IRS of its decision to merge by filing of a final Form 990, 990-EZ, or 990-N (as the case may be). The organization should mark the return "final" and file it no later than four and a half months after the effective date of the merger. For those exempt organizations filing Form 990, the organization should check the "termination" box at the top of page one, and answer "yes" to the question at line 31 of Part IV regarding whether the organization liquidated, terminated, or dissolved. Organizations that file Form 990-EZ also should check the termination box on the heading of the return and answer affirmatively the question regarding terminations at line 36 of Part V. Small organizations that are required to file Form 990-N (the "e-Postcard") should respond affirmatively to the question as to whether they have terminated or gone out of business.

The revised Forms 990 and 990-EZ include a new schedule—"Schedule N: Liquidation, Termination, Dissolution, or Significant Dis-position of Assets"—which requires the filing organization to disclose a wealth of specific in-formation about a merger. This information includes a description of any transferred assets, transaction fees, the dates of distributions, the fair market value of the assets, and any information about the recipients of the assets.

Finally, the filing organization should include a certified copy of the articles of merger, resolutions, and the plan of merger with its re-turn. Any other information that may relevant to the merger should also be attached (e.g., a copy of the ruling letter if the organization obtained an IRS ruling approving the proposed merger).

²² RMNCA § 11.07.

²³ IRS Publication 4779, "Facts about Terminating or Merging Your Exempt Organization" (May 2009).

Merging private foundations. The rules are considerably more complex for private foundations. Like a public charity, a private foundation that will cease to exist as a consequence of a merger must file a final tax information return. It should check the "final return" box on page one of Form 990-PF and answer "yes" to the question at line 5 of Part VII-A as to whether it underwent a liquidation, termination, or dissolution during the tax year. It also must provide the information required by General Instruction T of Form 990-PF. The required information includes an attached statement explaining the nature of the termination, a certified copy of the plan of merger and resolutions, a list of the names and addresses of the recipients of the assets, and an explanation of the nature and fair market value of the assets transferred as a result of the merger. The final Form 990-PF is due four and a half months after the effective date of the merger.

Additionally, private foundations that are terminating under state law by way of a merger will need to consider the termination of their private foundation status under Section 507. The 1969 Tax Reform Act imposed a variety of restrictions on the investments and activities of private foundations.²⁴ Because Congress was concerned that a private foundation might be able to avoid these restrictions by surrendering its tax-exempt charitable status (after having enjoyed substantial tax benefits in the form of tax exemption and the ability to attract deductible contributions), it added Section 507 to the Code. This section limits a foundation's ability to surrender its private foundation status without incurring a confiscatory penalty tax (i.e., a tax roughly equal to the amount of the aggregate tax

²⁴ Sections 4940-4945.

benefits enjoyed by the foundation and its substantial contributors prior to termination).

Section 507 has generated much confusion over the years and, absent egregious violations of the Chapter 42 rules, private foundations are rarely liable for the tax. The IRS has issued published guidance on this issue, and the basic rules are now relatively clear. 25 There are several ways to terminate an organization's private foundation status, but only two of them may subject the organization to the termination tax. The organization will be subject to the tax if there is an involuntary termination of the organization's status by the IRS for willful and repeated violations of the private foundation excise tax provisions of Chapter 42, or if it notifies the IRS of its intent to voluntarily terminate without following one of the termination procedures described below.

A private foundation may avoid payment of the termination tax by transfer of its assets to one or more public charities that have been in existence for at least five years prior to the distribution. Thus, a private foundation that merges with a public charity that has been in existence for at least five years will not be subject to the tax. ²⁶ In fact, mergers between private foundations and public charities are relatively rare. For a

²⁵ Rev. Rul. 2002-28, 2002-1 CB 941; Rev. Rul. 2003-13, 2003-1 CB 305.

²⁶ Rev. Rul. 2003-13, supra note 25. Although not relevant in the case of a merger, a private foundation also may avoid the tax by operating as a publicly supported charity or a supporting organization for a continuous five-year period, provided that it notifies the IRS before the beginning of the period that it is terminating its private foundation status. At the end of the five-year period, the organization must establish to the satisfaction of the IRS that it has, indeed, met the requirements of Section 509(a)(1), (2), or (3). See Section 507(b).

variety of reasons, the foundation's objectives usually are more easily accomplished' by a transfer of its assets to a public charity followed by dissolution of the foundation.

Mergers between private foundations are more common. In a published ruling, the IRS has made it clear that it is possible for a private foundation to transfer its assets to another private foundation and avoid payment of the termination tax.²⁷ The organization may voluntarily terminate and, if it does not give notice of termination to the IRS, or if it does give notice but it has already transferred its assets as a result of the merger, it will pay no termination tax (because it has no assets). In this case, the surviving foundation will acquire all of the aggregate tax attributes of the transferor foundation that are associated with those assets.

A private foundation that will not survive after a merger is required to respond to questions on Form 990-PF regarding the termination of its private foundation status. As has been noted, the merger should not subject the private foundation to a termination tax if it is done properly. Counsel should be sought to ensure that the proper procedures are followed in advance of the completion of the merger and that the final return is properly completed.

Conclusion

A merger is a potentially valuable strategy for a charity and can help it achieve a variety of goals. The attention of the organization's board and managers will understandably and appropriately focus mainly on financial, "cultural; and other non-legal aspects 'of integrating the organizations. A merger, however, is a complicated, sophisticated transaction that

does require compliance with specific legal requirements of state nonprofit corporation law and federal tax law. Ensuring a basic understanding by the merging organizations' leadership of the legal requirements and consequences of a merger—and particularly an appreciation of the importance of involving legal counsel early in the process—can go far in helping the merger proceed smoothly to a successful conclusion.

²⁷ Rev. Rul. 2002-28, supra note 25.