Nonprofit Mergers, Consolidations, and Asset Transfers – What's the Deal?

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Corporate mergers and their legal kin, namely asset transfers and consolidations, sound like business concepts, but they bear enormous potential significance for nonprofit organizations. Nonprofits can use these corporate transitions as powerful strategic options for combining and leveraging shared visions and resources. The following paragraphs cover the basics of nonprofit mergers, consolidations, and asset transfers to help nonprofit leaders determine when such key transitions might be a viable option.

Background

According to a recent report by Urban Institute, "the United States has 1.8 million nonprofit organizations, including 501(c)(3) public charities, private foundations, and a variety of membership and professional organizations."[1] The sheer number of U.S. nonprofits multiplied by nonprofits' varied activities may provide attractive opportunities for collaboration between nonprofits. Sometimes, the synergies lead to legal combinations of entities, resources, staff, and programs.

Nonprofits considering such collaborations should evaluate how they advance the respective nonprofits' missions and interests. For example, nonprofits facing financial challenges might also consider passing the missional baton to a larger organization. Other nonprofits leaders may be thinking in terms of succession planning, with a view to the "next chapter" or the organization's missions. Still leaders may note complementary functions and resources between nonprofits, which if combined, would yield significantly greater impact than either entity functioning alone.

When nonprofit leaders see the opportunity for collaboration, they may consider a diverse menu of options including simple contracts and memoranda of understanding, shared service agreements, licensing opportunities, partnerships, and joint ventures. The options discussed here – mergers, consolidations, and asset transfers – focus on the complete integrations of entities, their programs, and/or resources.

Keep in mind too that nonprofits are not owned but rather are controlled. Consequently, and although money may certainly be involved (and typically is, such as bank accounts), a merger or consolidation should not involve any sale between the collaborating entities. On the other hand, an asset transfer may involve either a sale of one organization's charitable assets to another, or instead it may be structured as a donation of charitable assets from one to the other nonprofit.

Nonprofit Merger

In a merger, two (or more) corporations combine to form one corporation. In each merger there will be a "surviving entity" and one or more "disappearing entities." The surviving entity enjoys the assets and legal rights of both merging organizations and takes on the responsibility of any remaining potential liabilities and legal obligations of both entities. Mergers are statutory functions; the merger must comply with each entity's applicable state statute. Mergers are also shaped through an agreed-upon plan of merger, in which the future rights and responsibilities as between the surviving entity and the disappearing entity are set forth.

Nonprofit mergers are generally collaborative transactions and are usually intended to combine the respective strengths of two or more organizations to streamline operations or to capitalize on economies of scale. In pursuing a merger, the merging entities ensure that all the assets and rights of the disappearing entity manifest in the surviving entity. This is particularly important with respect to assets that cannot be bought, such as employees and good will.

In a merger, and as may be set forth with specificity in the plan of merger, the programs, activities, operations, and other affairs of the disappearing entity may continue in and through the surviving entity. The surviving entity takes on all contracts of the disappearing entity. The plan of merger may provide that members, directors, officers, and the employees of disappearing entities will receive roles within the new organization.

Along with the assets, cash, and programs of the disappearing entity, the surviving entity assumes the disappearing entity's liabilities. The surviving entity should thus undertake a robust due diligence phase prior to taking official steps formalizing the merger. The due diligence phase should include a review of all documents pertinent to the legal and financial condition of each participant entity, including any open or threatened litigation, government fines or penalties, IRS Form 940/941s and the status of employer tax payments, IRS determination letters and/or IRS publication 78 material, government investigations, employee disputes, financial reports, current business contracts, political activities, and corporate documents. Care should be taken in the due diligence process to review contracts of the disappearing entity to ensure the surviving entity may properly act as a successor in interest to the agreements.[2] Beyond the paperwork, due diligence steps may include evaluation of internal cultural aspects, anticipated employment changes, and other potential operational shifts.

To effectuate the merger, the merging entities must each approve the plan of merger. The requisite corporate approvals for each step are determined pursuant to each organization's governing Bylaws, along with the requirements of the applicable state law nonprofit act, particularly regarding notice. Following the entities respective approvals of the merger, the merger documents, called “Articles of Merger,” are typically filed with the state’s corporate record keeper – usually the Secretary of State.

Nonprofit Consolidation

A consolidation is a close corporate cousin of mergers. The Illinois General Not-for-Profit Corporation Act provides that “Any two or more corporations may merge into one such corporation or consolidate into a new corporation.”1 Consolidations effectively allow for two or more disappearing entities to create a new third entity. Consolidations are preferred when the participant entities want a proverbial fresh start – sometimes due to branding considerations, relational aspects, or political factors between the organizations. For example, two organizations may prefer the organizational narrative in which two equal entities pooled their resources to create something new, instead of indicating the subordination of one entity (the disappearing entity) to the other entity (the surviving entity), as in a merger.

The legal effect, however, of a consolidation is very similar to that of a merger. As in a merger, where the surviving entity takes on the assets and liabilities or the disappearing entities, in a consolidation, pursuant to an approved plan of consolidation, the assets and liabilities of all disappearing entities vest in the newly created third entity. The contracts of all entities also generally vest in the consolidated entity too, by operation of law.

Like merging entities, consolidating entities are also well advised to undertake significant due diligence processes before effectuating a consolidation to identify the specific assets and potential liabilities as well as the applicability of agreements by both entities on the consolidated entity. To complete the consolidation, each disappearing entity must approve the plan of consolidation according to each entity’s Bylaws. Following the entities respective approvals of the consolidation, the merger will be filed with state’s the Secretary of State or specific state corollary through the filing of Articles of Consolidation (which, per state, may overlap with Articles of Merger).

Nonprofit Asset Transfers

As an alternative to merger or consolidation, nonprofits seeking to continue their mission through another entity will sometimes consider an asset transfer agreement, followed shortly thereafter by a corporate dissolution of the entity that transfer its assets to the acquiring entity.

Through the asset transfer and dissolution option, the acquiring nonprofit obtains all or nearly all of another corporation’s assets – including its tangible and intellectual property. An asset transfer agreement should be developed reflecting any transfer of cash or other liquid assets, property transfer, enumerated rights of directors, officers, and other stakeholders, employment transitional matters, contractual matters, intellectual property aspects, timing, and related representations and other promises made between the parties. These detailed arrangements are typically negotiated over a period of time, then culminate in a written asset transfer agreement for optimal clarity and mutual understanding. Subject to the agreement's terms, the transferring entity will likely dispose of any remaining assets pursuant to requirements for dissolution under Internal Revenue Code, section 501(c)(3) or other relevant section under 501(a) and then proceed to dissolve the corporation.

One advantage to the transferee (i.e., the receiving entity, or sometime a buyer) in an asset transfer is that such nonprofit avoids taking on the transferor nonprofit's liabilities. This aspect may be of enormous significance, particularly if the transferor entity has engaged in high-risk activities (e.g., childcare, summer camp, or other programs involving potential personal injury claims) - and especially for which a statute of limitations may still be running on possible adverse claims.

Additionally in an asset transfer arrangement, the transferee may selectively choose which assets to purchase. This aspect is similarly attractive for the transferee, so that the transferor's liabilities are not assumed. From the transferor's perspective, however, such arrangement may not be ideal if it has substantial liabilities, since all liabilities must be resolved (e.g., via full payment or settlement) in order to proceed with a corporate dissolution.

Note too that significant transactional costs may accompany an asset transfer arrangement that are absent from a merger or consolidation, especially where the asset transfers involve real property. For example, as noted above, an asset transfer agreement will need to be carefully developed, with particular attention to identifying assets, contracts, and other operational matters for transfer – and what is to be omitted. Additionally, any conveyance of real estate will require a deed and other instruments of transfer, along with a new property tax exemption application for any tax-exempt property. Similarly, a bill of sale will be needed for any vehicle transfer, and contract assignments will be required to effectuate those transitions.

Plan Wisely

Mergers, consolidations, and asset purchases each provide unique opportunities for nonprofits to continue their missions and collaborate with other like-minded nonprofits. No one-size-fits-all solution thus applies within the nonprofit context. Leaders considering one of these options should discern which transaction structure, both in short-term and long-term impact on the disappearing and surviving entities, best advances its charitable mission. Additionally, they should thoroughly understand the above distinctions, be mindful of their due diligence responsibilities throughout, and consider strengths and weaknesses of each approach to choose the best path forward.

[1] See Urban Institute, Nonprofit Trends and Impacts 2021.

[2] For more information about merger due diligence considerations, see our law firm's blog article, Nonprofit Merger Essentials.

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