SHARED SERVICES
CASE STUDY

Arrowhead Economic Opportunity Agency, Inc. & Kootasca Community Action, Inc.

A study of the collaboration between two nonprofit Community Action Agencies to share administrative and programmatic services

This case study is based on CAPLAW's interviews with Paul Carlson and Harlan Tardy, the current and former Executive Directors, respectively, of Arrowhead Economic Opportunity Agency, Inc. and Kootasca Community Action, Inc., and a review of the Executive Director Services Agreement between the two organizations. This case study presents an example of a collaboration between two nonprofit Community Action Agencies to share administrative services, which has since grown to include shared program staff.

ARROWHEAD ECONOMIC OPPORTUNITY AGENCY, INC. (AEOA)

AEOA, located in Virginia, Minnesota, is a 501(c)(3) nonprofit corporation that serves a three-county CSBG service area. It operates a number of programs, including:

- CSBG
- Low-Income Home Energy Assistance Program (LIHEAP)
- Head Start and Early Head Start
- Weatherization Assistance Program (Weatherization)
- Employment training and workforce development programs for families, youth, displaced workers, ex-offenders, and public assistance recipients
- Adult Basic Education (ABE)
- Housing services, including homeownership assistance, foreclosure prevention, and homelessness and housing stability services

KOOTASCA COMMUNITY ACTION, INC. (KOOTASCA)

Kootasca, located in Grand Rapids, Minnesota, is a 501(c)(3) nonprofit corporation that serves a two-county CSBG service area. It operates a number of programs, including:

- CSBG
- LIHEAP
- Head Start and Early Head Start
- Weatherization
- Crisis services, including emergency/short-term childcare and transitional housing
- Housing services, including homeownership education, rental assistance, Minnesota Housing and Finance Agency (MHFA) Deferred Loan Program, and homelessness and housing stability services
- Community engagement projects

- Senior services, including food and nutrition, emergency assistance, tax preparation assistance, and the Retired and Senior Volunteer Program (RSVP)
- 5311 Rural Assistance Transit Program
- Asset development and savings programs
- Health insurance enrollment assistance and counseling through MNsure

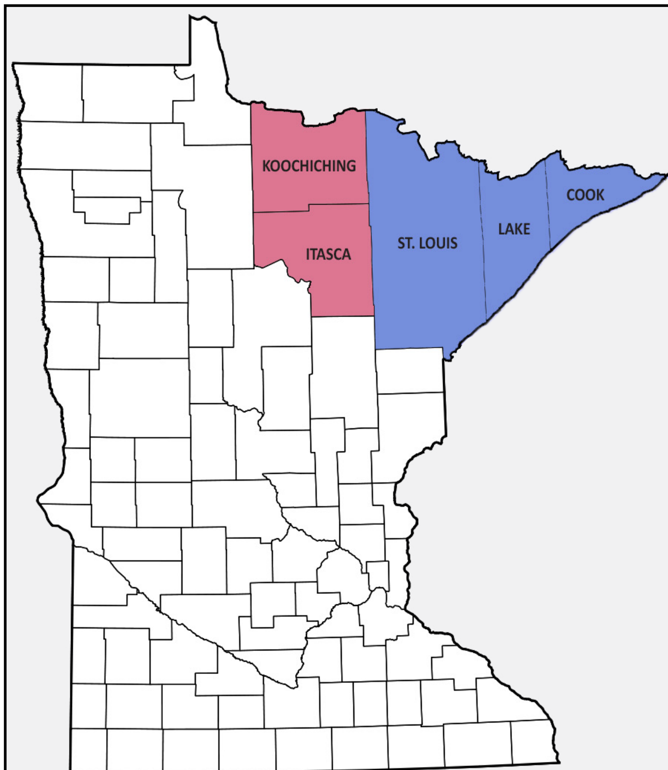
Prior to sharing services with Kootasca, AEOA had an annual budget of approximately $32 million and employed around 350 individuals. Currently, AEOA has an annual budget of approximately $38 million and employs around 385 individuals.

- Thrift store that supports youth programs
- Health insurance enrollment assistance and counseling through MNsure

Prior to sharing services with AEOA, Kootasca had an annual budget of approximately $5 million and employed around 80 individuals. Currently, Kootasca has an annual budget of approximately $10 million and employs around 90 individuals.

REASONS FOR THE SHARED SERVICES ARRANGEMENT

A partnership between AEOA and Kootasca made sense because the two nonprofit CAAs serve adjacent service areas in the northeastern corner of Minnesota, along the Canadian border. The two CAAs also operate a number of similar programs, including CSBG, LIHEAP, Head Start, and Weatherization. While a formal shared services arrangement was not implemented until late 2013, the seeds of collaboration had been sown a number of years earlier. In the fall of 2010, the Director of Minnesota's Office of Economic Opportunity (OEO), which administers the state's CSBG awards, approached the boards of directors of AEOA and Kootasca and proposed that the two CAAs work more closely with one another. At the time, AEOA's board was open to discussing potential ways to partner with Kootasca, including pursuing a merger of the two organizations. Kootasca's board, however, concluded that it was in the best interest of the CAA to operate independently for the time being.



The counties served by **AEOA** (Cook, Lake, and Saint Louis) and **Kootasca** (Koochiching and Itasca) are among the largest counties by square mileage in the state, yet are largely rural and experience significantly higher rates of poverty than the state of Minnesota as a whole.

Over the next few years, Kootasca experienced a number of executive and financial challenges that led it to reconsider a closer partnership with AEOA. Kootasca's long-time Executive Director retired in 2010, and the succeeding Executive Director left the organization after a brief stint. Eventually, Kootasca promoted a long-time employee to the Executive Director position, but he had already planned to retire and thus only wanted to serve on an interim basis. Around the same time, Kootasca saw its total annual funding decline from approximately $10 million to around $5 million, in part due to its executive transition issues.

In light of these challenges, two members of Kootasca's board, including the Koochiching County Commissioner (who also served on the AEOA board), approached Harlan Tardy, the then-Executive Director of AEOA, to discuss having Tardy serve as a part-time Executive Director at Kootasca. AEOA and Kootasca's boards shared two overlapping board members, and a number of other members of the Kootasca board knew Tardy because he lived in Itasca County and had served on a local school board for over 30 years. Both CAAs were open to the idea of sharing administrative staff services, and saw the partnership as a way for each organization to reduce its overhead and operational costs. The boards of AEOA and Kootasca formed a committee, which consisted of three board members as well as senior management employees from both AEOA and Kootasca, to explore possible collaboration arrangements. Based on the committee's assessment and discussions, the CAAs entered into an agreement in August 2013 to share the services of AEOA's Chief Financial Officer, Jim Glancy, and subsequently in January 2014, another agreement to share Tardy's services as Executive Director.

HOW THE EXECUTIVE DIRECTOR SERVICES AGREEMENT WORKS

Under the Executive Director Services Agreement entered into in January 2014, AEOA remained Tardy's employer and was responsible for his payroll tax withholdings and employee benefits. The agreement provided that Tardy would work as Kootasca's Executive Director for a maximum of 50% of his time, and Kootasca would reimburse AEOA for up to half of his AEOA salary and benefits, including withholdings. However, AEOA would bill Kootasca only for the hours Tardy actually worked for Kootasca. The agreement specified that Tardy would be supervised by and report to the boards of both CAAs, attend both boards' regular meetings, and attend federal, state, and regional meetings on behalf of both organizations. The agreement had an initial term of three years (to coincide with Tardy's anticipated retirement), after which it could be renewed or extended by both CAAs' written consent. Either AEOA or Kootasca could terminate the agreement for any reason by providing the other party with 60 days' written notice. Kootasca's attorney drafted the original Executive Director Services Agreement, which both sides reviewed prior to signing.

Grants

Each CAA applies for and receives its own government grants. However, AEOA and Kootasca collaborate on a number of grants, most recently for funding from MNsure, the state-run health insurance marketplace, to assist clients enrolling in the marketplace's health insurance plans. The two CAAs have leveraged their respective fiscal base and the skills and experience of their combined staffing to present a stronger application, particularly for state and local grants.

Indirect Costs

Neither AEOA nor Kootasca has a federally negotiated indirect cost rate. Rather, in accordance with the Uniform Guidance, 2 C.F.R. Part 200, each CAA directly allocates its costs as either: (1) specific program costs that can be identified with a particular project or program; or (2) joint costs, which are incurred for common purposes benefitting or supporting all agency programs or activities, and are not readily assignable to any particular project or activity. Joint costs are prorated individually as direct costs to each project or grant, utilizing a base which measures the benefits provided to each award or activity, such as payroll hours or the number of accounts payable and accounts receivable transactions. Under the shared services arrangement, the salaries of the Executive Director, CFO, and other shared staff positions are designated as joint costs and prorated to the appropriate cost center based on a predefined basis.

Financial Management and Executive Director Oversight

AEOA and Kootasca use the same accounting software at each of their main office locations, which permits the segregation of each CAA's financial data. Though Glancy serves as Kootasca's CFO, Kootasca retained some of its own fiscal staff, who continue to perform Kootasca's accounting work. At the beginning of each calendar year, Glancy and Kootasca's fiscal staff determine who will be accountable for each financial element of Kootasca's various grants. Each CAA has its own audit conducted by an independent auditor in accordance with Subpart F of the Uniform Guidance and files its own Form 990 with the Internal Revenue Service. Each CAA carries its own insurance.

> "The board of each CAA conducts its own performance evaluation of the Executive Director and reviews and approves his compensation on an annual basis..."

At each CAA's board meeting, Glancy and that CAA's fiscal staff submit an agency-wide financial report showing budgets, expenditures, and unspent funds. Financial information about a specific grant, such as Head Start, may also provide more detail about federal and state funding streams, expenditures, and trends. Glancy and the CAA's fiscal staff also participate in discussions with the boards of each CAA on additional topics, such as the results of the CAA's annual financial audit and pension audits, Form 990, and funding source monitoring visits.

The board of each CAA conducts its own performance evaluation of the Executive Director and reviews and approves his compensation on an annual basis, in compliance with the CSBG Organizational Standards. Any noncompliance by the Executive Director under the shared services agreement is dealt with by AEOA and subject to AEOA's own disciplinary process, but Kootasca has the right to terminate the agreement for convenience upon 60 days' written notice to AEOA.

Funding Source Approval

AEOA and Kootasca both reached out to their funding sources when they first started negotiating the shared services arrangement for a joint CFO and subsequently, for a joint Executive Director. They discussed the motivations for sharing administrative services and were proactive about explaining how the arrangement, particularly the payment and reimbursement terms, would work under the agreement. Tardy and Carlson note that funders for both CAAs responded positively and asked the CAAs to keep them informed as to how the arrangement was proceeding. All funding sources ultimately approved the shared services arrangements.

BENEFITS OF THE SHARED SERVICES ARRANGEMENT

From the outset, the Kootasca board focused on a key priority – reducing Kootasca's administrative costs to be able to spend more of its budget on mission-driven programs. The joint board committee identified some of the inefficiencies and high costs of Kootasca's fiscal department, which was large for the CAA's size, and whose operating procedures had made it very difficult for program directors to manage their own budgets. Tardy and

Glancy proposed a number of specific solutions to address these issues, including cuts to fiscal staff salaries and pushing control of program budgets to the program directors. As Tardy recounts, "I told Kootasca's board that the first thing I would change is how Kootasca's fiscal department worked. I made it very clear what the new model was going to look like. Kootasca was simply not going to be able to support salary levels [where they were], and the structure I would impose would probably not make the fiscal department very happy." While Tardy and Glancy understood that the changes might be difficult to accept, they also wanted to be honest with the Kootasca board about their assessment of Kootasca's underlying financial issues and set clear expectations about how they would address them.

Based on the needs of the CAAs, the joint committee decided to start by putting in place a fiscal director shared services agreement in August 2013, and Glancy assumed the role of CFO for both AEOA and Kootasca. Cost savings were quickly realized under this new arrangement, due in part to the efficiencies gained by sharing the costs of a CFO between two CAAs. This early success helped build trust and convince both CAA boards that they should move forward in January 2014 with sharing an Executive Director.

Sharing an Executive Director and a CFO has lowered the administrative costs for both CAAs, particularly for Kootasca, which, as the smaller of the two organizations, never needed 50% of an Executive Director's time. Over the course of the agreement, Tardy averaged 1.5 to 2 days per week at Kootasca, enabling the CAA to direct more of its funding towards direct services programs. Bringing in an experienced CFO also helped decentralize Kootasca's fiscal systems. Three fiscal staff members left before the shared CFO services agreement was finalized, and Glancy chose not to replace those positions, further streamlining the fiscal department's operations. Kootasca also benefits from Glancy's Certified Public Accountant (CPA) certification, which provides additional expertise that other members of Kootasca's fiscal department lack. The costs of hiring a CFO with a CPA are significant and the pool of qualified candidates is relatively small, particularly in rural northeastern Minnesota, so the shared CFO arrangement allows Kootasca to have access to specialized skills that it would otherwise not be able to afford on its own.

According to Tardy, funding sources regained confidence in Kootasca due to its increased organizational capacity and strengthened management systems under the shared services arrangement. "It was a credibility kind of thing," says Tardy. "A number of funding sources that were holding back returned when they saw that Kootasca was making significant progress." Kootasca received a number of new state housing grants, as well as additional Weatherization and Head Start funding. By the time Tardy retired in April 2016 from his role as Executive Director of both AEOA and Kootasca, Kootasca's annual budget had rebounded from $5 million to approximately $10 million.

AEOA also benefitted from the shared services arrangement. In addition to the financial and cost savings of sharing Executive Director and CFO services, AEOA is able to standardize operational processes and access specialized expertise. For example, the two CAAs' Human Resources departments collaborate regularly, sharing information on employee benefits and programs and allowing each organization to develop best practices for its workforce. When AEOA lost its home ownership counselor, it engaged the services of Kootasca's counselor, who had a reputation for being one of the best counselors in the state, but was becoming too costly for Kootasca to employ given the size of its programs. By sharing the costs of a position neither could afford on its own, AEOA and Kootasca were able to access higher-quality services as well as preserve a full-time employee position at Kootasca. Tardy recalls, "It was important to both boards that both CAAs benefit from the arrangement, not just Kootasca." Paul Carlson, the current Executive Director of AEOA and Kootasca, adds that a channel of direct communication opened between the two CAAs, allowing for greater sharing of information, including staffing and programmatic needs, specialized services, and collaborations on funding opportunities.

CHALLENGES AND REVISING THE EXECUTIVE DIRECTOR SERVICES AGREEMENT

Despite the immediate financial and programmatic benefits of sharing services, clear challenges to the arrangement also emerged. The staff at both CAAs found it difficult to have a part-time Executive Director who was not on site at each CAA's offices every day. Meetings and actions that required an Executive Director's input often had to be delayed until Tardy was physically present. Both boards felt the strain of having an Executive Director running back and forth between two CAAs. Because Tardy was averaging just 10-12 hours per week working for Kootasca, its staff felt the absence of a day-to-day administrator more acutely than AEOA. From the Kootasca staff's perspective, the organizational culture of Kootasca, as the smaller and less formal of the two CAAs, seemed to shift under the shared services agreement to become more bureaucratic and rigid.

> "Both boards felt the strain of having an Executive Director running back and forth between two CAAs."

In light of these challenges, the two CAA boards formed a joint committee in the fall of 2015 to reevaluate the Executive Director Services Agreement. The organizations applied for and received funding from the Blandin Foundation, a private foundation in Minnesota that supported Kootasca's work in the community, to develop a new collaborative governance structure between the two CAAs to better fulfill their respective missions. AEOA and Kootasca used this funding to issue a request for proposals (RFP) and ultimately engaged a national nonprofit consulting and auditing firm to conduct an analysis of the two CAAs' relationship and to make a recommendation for the future of their partnership.

As this analysis was proceeding, AEOA and Kootasca also began planning for Tardy's retirement from AEOA in April 2016. AEOA's Executive Search Committee invited Kootasca's board chair to join the process to search for a new Executive Director. As a non-voting member of the committee, Kootasca's board chair sat in on interviews with applicants as well as committee discussions about potential candidates. Tardy notes that it was important to AEOA's board that Kootasca have a voice in the hiring process, even though Kootasca's board was still deciding whether to continue sharing Executive Director services after Tardy's departure. Once AEOA's board approved hiring Carlson, a long-time AEOA employee who had previously served as Deputy Director of AEOA under Tardy, Kootasca decided to renew the shared Executive Director Services Agreement and have Carlson serve as part-time Executive Director for Kootasca under the agreement for Tardy, pending the outcome of the analysis of the CAAs' partnership.

The consulting firm ultimately recommended to the boards of both CAAs that AEOA and Kootasca pursue a merger. The firm had conducted a number of focus groups involving board members, staff, funders, community partners, and customers. It recommended a merger based on the existing collaboration between the two organizations and the additional efficiencies that they could achieve by become one legal entity. Two issues, however, quickly emerged as barriers to a merger.

First, both CAAs had Head Start programs. Under the Head Start Program Performance Standards, the federal regulations that apply to Head Start programs, grantees that lose their "legal status" are automatically placed on the recompetition list (see 45 C.F.R. § 1304.5(a)(2)(ii)) Because mergers typically only have one surviving corporation, this meant that the CAA that did not continue to exist after the merger would have to relinquish its Head Start program. While the surviving CAA in the merger would be able to compete for the other CAA's relinquished Head Start grant, there was no guarantee that it would ultimately be successful in getting back the grant. As both CAAs ran nationally-recognized Head Start programs, neither was willing to take the risk of relinquishing its grant and losing its Head Start staff. Both boards viewed the negative impact on staff morale, including the concern that a merger would look like a takeover to Kootasca staff, as well as the uncertainty of the Head Start recompetition process, as significant barriers to merging.

The second issue was the perception that Kootasca's unique organizational culture would be swallowed up in a merger with a much larger organization. Carlson remarked:

> *The Kootasca board recognized the value that AEOA had brought to Kootasca.... However, based on an organizational culture analysis with staff from both organizations, it became clear that Kootasca was afraid its culture would turn into [one that was] larger, more bureaucratic, less community-focused. Kootasca has a much smaller staff and is closer to the community. We didn't want to lose this, it's a good thing for Community Action and we want to talk about ways to retain this [culture].*

There were also concerns that the merger would cause local funding sources that supported Kootasca's work to be less enthusiastic about continuing their grants. Ultimately, the two CAA boards were unwilling to risk losing their respective Head Start grants, and Kootasca was concerned about jeopardizing its local identity and losing the goodwill it had developed in the community over time. This led the two boards of both CAAs to decide that continuing to operate as legally separate entities while sharing administrative services would be in their respective best interests for the time being.

Once a merger was no longer considered a viable near-term option, the boards decided to closely review the shared services arrangement to address the challenges that the CAAs had experienced under Tardy's tenure. Based in part on the consulting firm's recommendations to hire additional on-site senior leadership at Kootasca, AEOA and Kootasca decided to amend the Executive Director Services Agreement to reduce the number of hours that Carlson would work as Kootasca's Executive Director. The cost savings allowed Kootasca to promote another senior Kootasca staff member to serve as Assistant Executive Director, who would work at Kootasca's offices each day to answer questions and sign documents.

In April 2017, Maureen Rosato, who had been and continues to serve as Kootasca's Education Director, assumed the role of Kootasca's Assistant Executive Director, providing consistent, day-to-day leadership at Kootasca. This arrangement has reduced the pressure on Carlson's responsibilities and saved him many hours of commuting between AEOA and Kootasca's offices. Carlson notes that he and Rosato are in regular communication, and that the arrangement filled the leadership vacuum that Kootasca staff perceived under the prior Executive Director Services Agreement. The revised agreement is effective for one year, rather than the original three-year term, to allow both CAA boards to reevaluate the arrangement on a more regular basis.

DEVELOPING PROGRAMMATIC SHARED SERVICES

Based on the successful outcomes of the shared administrative services arrangements, the joint board committee began to look beyond sharing back-office services to discuss other avenues of collaboration. Because the two CAAs share an Executive Director and CFO, there is a natural flow of information about each organization's operational and programmatic needs. For example, the CAAs learned that AEOA's weatherization crews had the capacity to take on additional weatherization work, while Kootasca, which traditionally looked to contractors to fulfill its weatherization projects, was having difficulties finding contractors who were either willing to prioritize Weatherization work or who could meet the state's rigid Weatherization work specifications. In light of these issues, the two CAAs entered into a services agreement to share AEOA's weatherization crew. Similarly, when AEOA lost its home ownership counselor due to funding cuts, AEOA entered into an agreement to share Kootasca's counselor, who had a reputation for being one of the best in the state, thus allowing her to work a full-time position.

AEOA and Kootasca also partner on their CSBG Community Needs Assessments. After realizing that their respective assessment methodology consistently lacked low-income participation in their focus groups, interviews, and surveys, the two CAAs joined forces to develop better assessment tools to provide a more accurate representation of low-income needs. These tools require considerable staff time, resources, and outreach, and collaboration was vital for both CAAs to be able to make them work. Tardy recounts, "As trust [between the organizations] grew, it became much easier to share programs… It didn't matter who the staff person was, whether the person was employed at AEOA or Kootasca. If we can get access to the expertise, we will try to collaborate."

LESSONS LEARNED

Be clear about your CAA's goals and reasons for entering into a shared services arrangement. From the outset, an organization must be able to identify how it will benefit from the shared services arrangement and then structure the agreement to achieve those goals. "It always sounded like the right thing to do, but I'm not sure much thought went into the right way to do it," admits Carlson. AEOA and Kootasca learned a lot from the first Executive Director shared services agreement and subsequently amended it to address issues the organizations encountered. For example, the lengthy three-year term of the initial agreement was intended to coincide with Tardy's retirement, but it also meant the boards did not have the incentive to formally review the agreement each year to ensure that it was working well. Further, though Kootasca was the smaller of the two CAAs, the initial agreement set the expectation that it would need half of AEOA's Executive Director's time, when in fact Kootasca may have benefitted from having an onsite Assistant Executive Director and fewer total Executive Director hours.

LESSONS LEARNED (CONTINUED)

Be sensitive to employee morale. The Kootasca board thought it was extremely important to engage staff and keep them informed during the initial discussions with AEOA about sharing Executive Director and CFO services. Kootasca's board chair held a series of all-Kootasca staff trainings to keep employees in the loop, and was upfront about considering a merger between the two CAAs as an option. Even though the boards ultimately ruled out merger as a near-term option, both CAAs underestimated how staff might still perceive a shared services arrangement as an interim step to a merger. "We tried to communicate the reasons and goals for sharing services to staff, but not everyone bought into it," Carlson said. "Dealing with this is such a challenge, because people can be very sensitive and misread or misconstrue your actions. You just have to be careful and proactive in these discussions, to explain the purpose of the arrangement and cast a vision that is different from one where staff lose their jobs and the organizational culture changes."

Ensure board members stay engaged. Both Tardy and Carlson said that it was important for board members to lead the process and to stay involved. Despite employee concerns, the Kootasca board has always been an advocate for partnering with AEOA, and its support has been critical to the arrangement's success. Kootasca's board also has to ensure that it can exercise effective oversight of the Executive Director and CFO, as they are not directly employed by Kootasca. Both CAA boards must be able to directly monitor the financial transactions between AEOA and Kootasca for conflict of interest issues and ensure that their respective organizations are meeting the requirements of their government grants and contracts.

Reach out to your CAA's funding sources and get their support. AEOA and Kootasca contacted their state CSBG office early in the process to let them know about the shared services discussions and found the state to be very receptive to the idea. Tardy notes that funding sources are always looking for ways to streamline nonprofit administrative and back-office services, and if an organization is proactive about doing so, it can bolster the funder's opinion of the organization's reputation and capacity to run programs. Not only did the state CSBG office provide some CSBG funding to cover part of the costs of finalizing the shared services agreements, the state's confidence in the CAAs deepened after the arrangement and both organizations saw an increase in other grant awards administered by the state. Similarly, the Blandin Foundation, which fund a number of Kootasca's programs, was supportive of the shared service arrangements. Its willingness to pay for an outside third party to conduct an evaluation of the partnership provided invaluable information for the CAAs' boards to be able to decide how to move forward in their collaboration.

Identify champions of the collaboration. Big organizational changes require cheerleaders and champions at all levels of the organization—board, senior management, and staff. AEOA's and Kootasca's experience highlights the importance of finding supporters of sharing services who understand and can help convince others of the benefits of collaborating. Carlson notes, "There will be tension and there will be angst. One or more detractors can do a lot of damage. Detractor concerns must be addressed, not ignored." Having a champion of the cause can go a long way towards getting buy-in from all stakeholders or, at the very least, facilitating trust in the board's goals and decisions.

LESSONS LEARNED (CONTINUED)

Keep your eye on the prize. It's important to remember the long-term goals of partnering with another organization. Ultimately, Tardy emphasized, a CAA exists to serve people and wants to put as much money as possible into fulfilling its mission. "Don't be afraid to consider sharing services or collaborating, whether you're a large agency or small agency," Tardy says, "99 times out of 100, you create more jobs than you lose."

When considering a shared services arrangement, consulting with an attorney and an accountant can help a CAA understand the issues and options involved and plan a course of action that will enable it to meet its objectives and fulfill its mission.

This case study is provided for informational purposes only and does not constitute legal advice. Please consult an attorney for advice regarding your organization's individual situation.

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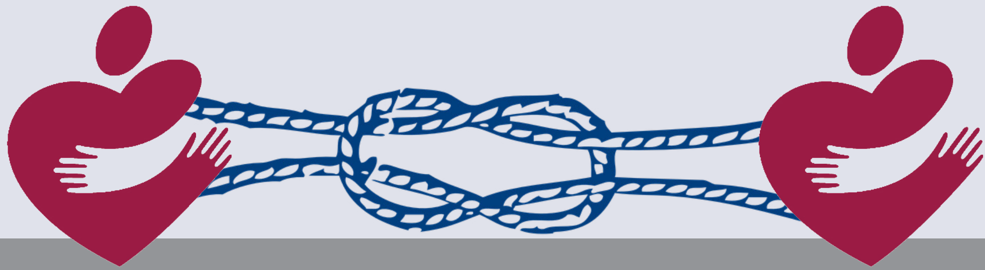

Sharing Services vs. Merging: The Trade-Offs

Many CAAs seeking efficiencies and better service delivery through formal collaborations find themselves asking at some point which would be a better option—a shared services arrangement or a merger. CAAs should consider the benefits and trade-offs of choosing one strategy rather than the other.

BENEFITS OF MERGING:

- **Achieves greater efficiencies than a shared services arrangement.** Depending on the structure of the merger, the organizations may be able to achieve greater efficiencies and economies of scale than under a shared services arrangement due to the complete overlap and integration of the two organizations.
- **Stronger board of directors.** A merger offers opportunities to combine the strengths of the organizations' boards of directors, extending an organization's fundraising capabilities and community connections. A board that has trouble recruiting directors or filling vacancies may benefit from joining forces with a well-functioning board with strong leadership, experience, and expertise.
- **Automatic combination of entities.** A statutory merger effected under one of the merging organization's state nonprofit corporation law automatically transfers all assets and liabilities of the non-surviving entity to the surviving entity in a single transaction. This automatic combination "by operation of law" means that legally, the merger is recognized by the state's Secretary of State, and the non-surviving organization does not have to amend each contract to update its name. However, the organizations should notify funding sources, vendors, and other parties with which they contract about the merger. Note that there are other options for structuring mergers, including asset transfers, program transfers, and certain change-of-control transactions such as forming a parent-subsidiary arrangement with another organization.
- **Ease of administration.** A statutory merger results in a single organization and one board of directors. The organizations only need to file one Form 990 and make state filings on behalf of one organization, keep one set of financial books, conduct one annual audit, keep track of an employee benefits plan for one organization, etc.
- **Offers a solution for financially-distressed organizations.** Sometimes, a merger with a fiscally strong organization is the only alternative to dissolution for an organization in financial distress. An organization that cannot survive on its own may not save enough administrative or operational costs through a shared services arrangement to keep its doors open and preserve its programs. An organization with significant outstanding debts, however, may have a difficult time finding a merger partner willing to take on its liabilities. In these cases, structuring the merger as an asset or program transfer may be a more realistic solution.

DRAWBACKS OF MERGING:

- **May require recompetition of Head Start grant.** Because a merger is deemed to result in the non-surviving entity losing its "legal status," the Office of Head Start takes the position that the transaction will automatically trigger recompetition of the non-surviving entity's Head Start grant.[1] Thus, if both organizations in a merger have Head Start funding, one organization will be required to relinquish its Head Start grant. The surviving entity can compete for this grant, but there is no guarantee that it will get the award back.

- **Transfers all assets and liabilities.** In a statutory merger, the surviving entity inherits all of the assets and liabilities of the non-surviving entity. An organization with significant liabilities (e.g., an outstanding debt or judgment) may have a hard time finding a merger partner willing to take on these liabilities.

- **Requires more thorough due diligence.** Because mergers combine all of the assets and liabilities of two separate organizations, it is crucial for all parties to conduct careful due diligence to determine what assets and liabilities (actual and potential) may be transferred as part of the transaction. A merger can saddle the surviving entity with significant costs and risk exposure if liabilities are not sufficiently disclosed and investigated during the due diligence process.

- **Requires greater attention to staff culture and integration.** Mergers bring together all staff under the same organizational roof, which means that the boards and senior management of both entities must consider differences in organizational culture and barriers to getting staff buy-in. Leaders must be proactive about creating a vision for the culture of the new organization post-merger, which might look different from the current ones, and develop a strategy for moving from one to the other.

- **Loss of the non-surviving entity's individual identity.** In a merger, the non-surviving organization ceases to exist as a legal entity and loses its name and individual identity. The loss of a nonprofit organization's unique brand identity can be an obstacle to a merger, especially if that organization has existed for a long time and has a well-known reputation in its community. Note, however, that the non-surviving entity can still operate under its former name by registering for a "doing business as" (d/b/a) business name with its state Secretary of State's office. Other merger structures such as a change-of-control transaction or parent-subsidiary merger may also retain the separate legal identities of the two organizations.

- **Harder to unwind.** Statutory mergers are more difficult to reverse than a shared services arrangement, which is based on a contract that can be terminated in accordance with the terms of the agreement. Thus, if the relationship ultimately sours, it may not be easy to separate the two organizations.

BENEFITS OF SHARING SERVICES:

- **Achieves some operational efficiencies.** Sharing services, whether administrative or programmatic, can result in cost savings for all organizations involved by reducing duplication of functions and infrastructure. Organizations can also access specialized services that they may not be able to afford or obtain on their own.

- **Preserves individual organizational identity.** Organizations for whom identity and autonomy are important may find that sharing services allows them to enjoy the benefits of partnering with another organization while retaining their own unique character. Since the organizations sharing services continue to exist as independent legal entities, they can preserve their local identities and retain the reputation and associated goodwill developed in their communities.

- **Allows for incremental building of trust.** For organizations that may not know each other well or have an established relationship, sharing services can be a way to "test the waters" for a longer-term collaboration through working together in a clearly delineated manner. The scope of the shared services arrangements can gradually expand over time, depending on organizational compatibility and needs.

- **Easier to amend or reverse than a merger.** Unlike a merger, shared services arrangements are governed by contract (the shared services agreement) and thus can be terminated or renewed according to the terms of a contract. This makes sharing services much easier to unwind than a merger if the collaboration is not working out as the organizations had intended. Organizations can also adjust the terms of the arrangement to fit organizational needs (e.g., the scope of the arrangement and the services that are shared, supervision and oversight, reimbursement terms, etc.) by amending the shared services agreement.

DRAWBACKS OF SHARING SERVICES:

- **Administratively more complex than a merger.** Regardless of the scope of the shared services arrangement, organizational leaders must ensure that the entities operate separately. The boards of each organization must continue to exercise their fiduciary duties to, and act in the best interests of, their respective organizations. The organizations must maintain separate financial accounts, have separate audits, and make their own Form 990 and state filings.

- **Potential conflicts of interest.** Since the organizations sharing services remain separate legal entities, the boards and staff must be aware of potential conflicts of interest that arise as a result of the close relationship between the organizations. For example, if both organizations apply for the same grant, any shared staff or overlapping board members should be sure to follow their organizations' conflict of interest policies. This should include, at a minimum, keeping confidential any information learned while performing services for one organization, as well as recusing themselves from the discussion and vote on any decisions involving the other organization.

- **Federal procurement rules apply.** If a CAA provides administrative services to another CAA or federally-funded entity, the entity receiving the services must follow its procurement policy and ensure that it is in compliance with the procurement standards of the Uniform Guidance, 2 C.F.R. §§ 200.318-200.326. Depending on the aggregate dollar amount of the shared services agreement, the entity receiving the services should use the appropriate method of procurement listed in the Uniform Guidance, 2 C.F.R. § 200.320. All procurement transactions must be conducted in a manner involving full and open competition, and the circumstances under which entities can use sole source procurement (i.e., procuring services without competition) may be limited.[2]

- **Unrelated business income tax issues.** The income generated by a 501(c)(3) tax-exempt organization providing administrative services to another tax-exempt organization in a shared services arrangement is likely to be deemed "unrelated business taxable income" (UBTI) under IRS rules.[3] The IRS does not consider the provision of administrative services to be an exempt function, even if the two nonprofit organizations share similar missions. A number of factors are relevant to the IRS's determination, but unless a specific exception applies (namely, providing services to a legally related, exempt organization; or being reimbursed for an amount that is substantially below the organization's cost of providing the services), a tax-exempt organization will likely need to report the amounts it receives for providing the services as UBTI on Form 990-T, if it generates $1,000 or more in such income in a year. If the organization provides the services at cost, it will be entitled to deduct its ordinary business expenses on Form 990-T and may not ultimately owe any taxes; however, because Form 990-T requires reporting all gross income, the organization is still required to file Form 990-T.

ENDNOTES

[1] 45 C.F.R. § 1304.5(a)(2)(ii).

[2] 2 C.F.R. § 200.320(f).

[3] See Rev. Rul. 72-369, 1972-2 C.B. 245 (holding that a 501(c)(3) organization that regularly provides managerial and consulting services to another 501(c)(3) organization for a fee equal to cost is carrying on an unrelated business, as providing the services at cost does not contain the donative element necessary to constitute a charitable activity); IRS Tech. Adv. Mem. 9811001.

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