Combining Forces:

A Merger Manual for Community Action Agencies

CAPLAW

About the Author

The author of this manual is **Eleanor A. Evans, Esq.** of Hemenway & Barnes LLP. Prior to joining the nonprofit practice at Hemenway & Barnes, Eleanor served as Executive Director/General Counsel of Community Action Program Legal Services, Inc. (CAPLAW) and as General Counsel of Action for Boston Community Development, Inc. (ABCD), Boston's Community Action Agency. She has many years' experience advising and training Community Action Agencies and other nonprofit and public entities on a wide range of legal, governance and compliance matters. Eleanor may be reached at eevans@hembar.com or 617.557.9711.

© 2020 Community Action Program Legal Services, Inc. and Hemenway & Barnes LLP

This publication is part of the Community Services Block Grant (CSBG) Legal Training and Technical Assistance (T/TA) Center. It was created by Community Action Program Legal Services, Inc. (CAPLAW) in the performance of the U.S. Department of Health and Human Services (HHS), Administration for Children and Families (ACF), Office of Community Services Cooperative Agreement – Grant Award Number 90ET0467-03. Any opinions, findings, conclusions, or recommendations expressed in these materials are those of the author(s) and do not necessarily reflect the views of the U.S. Department of Health and Human Services, Administration for Children and Families, or the U.S. Government. Head Start® is a registered trademark of HHS.

The contents of this publication are intended to convey general information only and do not constitute legal advice. This publication does not create an attorney-client relationship. If you need legal advice, please contact CAPLAW or another attorney directly.

Combining Forces:
A Merger Manual for Community Action Agencies

TABLE OF CONTENTS

NOTES:

INTRODUCTION

Now more than ever, Community Action Agencies (CAAs) are exploring mergers as a strategy to improve their sustainability and enhance their efficiency and effectiveness. This manual is intended to help leaders of nonprofit CAAs:

- Understand mergers and what's involved in merging;
- Assess whether their organizations are ready to merge and what they seek to achieve by merging;
- Identify and evaluate potential merger partners;
- Prepare for and approach various steps in the merger process;
- Learn from the experience of CAAs that have merged; and
- Anticipate issues that could impact and even derail a merger.

It answers common questions about mergers, explains key terms and provides worksheets, sample documents, CAA case studies and other resources to guide CAAs through the merger process. **We particularly recommend taking time to review the case studies to get a practical perspective on various CAA merger scenarios.**

This manual does not have to be read or digested in a single sitting. In fact, **we encourage CAA leaders championing a merger to work through it with their board and staff colleagues one section at a time**.

Although the manual addresses legal issues, it does not provide legal advice and is not a substitute for a lawyer. If your CAA has questions along the way or would like help in finding an attorney in your state to advise on a merger, please feel free to reach out to CAPLAW.

KEY POINTS BEFORE STARTING

What do we mean by "merger"?

Although the term "merger" technically refers to a situation where one or more organizations transfer their assets and liabilities to another organization and then dissolve, this manual uses the term in a more general sense. **By "merger," we mean any one of various methods of combining the programs, assets or entire corporate entity of another organization with a CAA.** (For more information on these various methods, see "Merger Structures" below.)

By "merger," we mean any one of various methods of combining the programs, assets or entire corporate entity of another organization with a CAA

Why consider a merger?

The ultimate goal of a merger should be to further your CAA's mission. This could mean expanding the number of people it serves, delivering new types of services or serving existing clients more effectively and efficiently. **A CAA considering merging with another organization should move forward only if the merged entity will build on the strengths of each organization and lead to a result that could not have been achieved without the two organizations joining forces.**

Some results CAAs may achieve by sharing services or merging are:

- **Improved, expanded or preserved programs and services**
- **Strengthened financial position**
- **Upgraded administrative capacity and efficiency and/or**
- **Enhanced visibility, branding and reputation**

For example, a merger may enable a CAA to expand, improve or preserve the services it provides by expanding its service area, attracting new clients or integrating services. It may enable the CAA to strengthen its financial position by achieving economies of scale, diversifying its revenue streams, increasing its assets and its ability to borrow, or expanding its base of donors. A CAA may also expand its organizational capacity by merging, if the merger enables it to add new staff with experience and expertise not previously available at the organization; improve its internal administrative functions (such finance, human resources or IT); access expanded, improved or better located facilities; improve its branding and marketing; or build new relationships in the community.

The ultimate goal of a merger should be to further your CAA's mission

Nonprofits often view mergers as a last resort, when one of the partners is already in trouble. Due to this perception, some organizations may be reluctant to explore mergers because of a concern that if, they do so, they will be labeled as failing. However, **mergers can be – and often are – used as a forward-**

looking strategy to strengthen already solid organizations, accomplish specific mission goals and increase impact. These types of mergers tend to be more successful than "rescue" mergers because both organizations are coming to them from a position of strength and have articulated clear strategic objectives they hope to achieve, rather than coming to the merger under duress and viewing it as a necessary evil.

When should we begin thinking about a merger?

It's never too soon for a CAA to start exploring the possibility of merging. In the current environment, it makes sense for CAA boards and management staff to consider whether merging might be a viable sustainability strategy for their organizations and, if so, to be constantly alert for potential merger partners.

A particularly good time for a CAA to initiate internal and external conversations about merging is when its executive director is planning to retire or otherwise depart, or when he or she has just done so. In these circumstances, the organization may be particularly open to change and there will be less tension about who will lead the merged entity than if two executive directors were vying for that role.

A particularly good time for a CAA to initiate internal and external conversations about merging is when its executive director is planning to retire or otherwise depart

The best time for a CAA to consider a merger is before it finds itself in crisis, when it has strengths it can bring to the table. An organization in crisis may be too busy focusing on day-to-day operations and survival to pursue long-term, strategic goals. Although mergers may be used in certain cases to "rescue" troubled CAAs, mergers are not a panacea for all challenges facing CAAs and should not be entered into lightly, simply because they are an available option. For example, merging two financially troubled CAAs is not likely to solve their problems; instead, it is likely to result in one larger, financially troubled CAA. Therefore, although it is a good idea for CAAs to be constantly open to exploring and pursuing mergers, they should not rush – or be rushed – into them.

Whether pursued to rescue an organization or as part of a long-term growth plan, **a merger will produce better results if each potential merger partner has taken the time to assess its strengths and weaknesses, clarify what it hopes to achieve by merging and determine whether a merging makes more sense than other alternatives**.

What costs are involved in a merger?

Many CAAs (and their funders) may initially be attracted to the idea of CAA merges because they think that it will resolve a current financial crisis with immediate cost savings. However, **the cost savings produced by a CAA merger are unlikely to be immediate due in part to the fact that there are often significant costs involved in merging**.

Mergers involve two types of costs – financial costs and opportunity costs. Examples of financial costs involved in merging include:

- **Staff time** spent planning and implementing the merger and integrating the two organizations
- **Professional fees** for legal, accounting, merger facilitation and communications/PR services
- **Systems integration expenses** associated with combining (and, if needed, expanding) financial, HR and IT systems
- **Human resources costs** to review and make changes to personnel policies and benefit plans and onboard new staff
- **Facilities costs** for lease changes, reconfiguring space and moving
- **Re-branding costs** (design of new logos, websites, signage, letterhead, business cards, communications)

Opportunity costs represent opportunities foregone due to the fact that the CAA's staff and resources were devoted to the merger process and not to pursuing other priorities, such as grant funding, program expansion or collaborations with other organizations. The potential for the loss of these opportunities should be considered when deciding whether to pursue a merger.

The amount a particular CAA merger will cost depends on the circumstances of the merger. Some CAA mergers have resulted in only minimal costs (less than $5,000) while for others, costs have been much more significant.

How long does the merger process usually take?

Exploring and consummating a merger may take from several months to two years. Fully integrating the organizations after the merger can take another one to three years or even more, depending on the circumstances.

Therefore, it is important to have a realistic timeline for merger. Finding an appropriate merger partner, conducting due diligence, negotiating the terms of the merger, drafting the merger documents and planning for the integration of the two organizations may prove more complicated and take more time than anticipated. Factors that will impact the length of the process will include the level of familiarity between the organizations and the challenges of integrating their organizational structures, cultures and operations.

It is the board's responsibility to oversee the merger process

What's the board's role in the merger process?

Although the day-to-day work on the merger will fall to the executive director and staff, **it is the board's responsibility to oversee the merger process**. The board analyzes pros and cons of merging and determines whether and how doing so will fulfill the organization's mission. After a potential partner has been identified, the full board votes to start formal conversations with the partner and to approve the creation of a joint merger committee with representatives from both partners, establish its scope of authority and appoint members from the CAA to it. Later in the process, the full board votes on whether to approve the merger and the merger documents. It is important to document board and committee merger discussions and votes in minutes; to include the basis for board and committee decisions; and to attach reports and other documents on which board/committee relied in making those decisions.

Board members should ensure that a full, deliberative process is conducted and that they are able to ask hard questions and get answers to enable them to make informed decisions throughout the merger process

In identifying and evaluating a merger partner, analyzing the feasibility and advisability of the merger and voting to approve it, board members must be aware of and take steps to fulfill their fiduciary duties to the CAA: the duty of care and the duty of loyalty. **Board members fulfill the "duty of care" by acting with the care an ordinarily prudent person in a like position would exercise under similar circumstances**. Board members could face possible liability if the board does not carefully vet a potential merger partner. However, **under the "business judgment rule," board members who exercise good faith judgment will usually be protected from liability to the corporation even if the decision to merge turns out to be unwise or unsuccessful.** State nonprofit corporation law generally permits board members to rely on information prepared by the organization's officers or employees, attorneys or accountants, or board committees acting within their delegated authority. Thus, board members should obtain and consider written reports and professional advice before voting on merger matters. Board members should ensure that a full, deliberative process is conducted and that they are able to ask hard questions and get answers to enable them to make informed decisions throughout the merger process. In analyzing and voting on the merger, **board members must also fulfill the "duty of loyalty" by acting in good faith and in a manner they reasonably believe to be in the best interests of the organization**. In other words, they must put the organization's interests first and avoid conflicts of interest when deliberating and voting on the merger.

What is the executive director's role in the merger process?

Although each organization's board oversees the merger process and makes the ultimate decision about whether to merge, it is the executive directors who lead the day-to-day work on the merger at their respective organizations. It is generally executive directors who start merger conversations with their counterparts at potential partner organizations (although sometimes a board chair will take the lead in doing so). Each organization's executive director will serve on the organization's merger team, as well as on the joint merger committee. Executive directors direct merger feasibility activities and the development of integration plans. They are also responsible for communicating with staff about the merger while maintaining confidentiality as necessary.

Who can help guide us through merger process?

The executive leadership and board of a CAA considering a merger will work closely together to explore merging and (if desired) to bring a merger to fruition. It may also be productive to get outside guidance from others who are familiar with and can assist with the merger process:

- **Merger Consultant:** A merger consultant can facilitate the organizational assessment process, help identify merger partners and moderate conversations and negotiations between the partners, and assist with the process of integrating the two organizations.
- **Funders:** Government grantors and private funders such as private foundations and United Ways can provide funding for merger costs and connect the CAA with technical assistance.

  > **CAPLAW RESOURCE:** CAPLAW MERGER CASE STUDY: THE MINNESOTA OFFICE OF ECONOMIC OPPORTUNITY ENCOURAGES MERGERS

- **Associations:** National and state CAA, Head Start, nonprofit and other associations can help identify merger partners and provide technical assistance.

  > **CAPLAW RESOURCE:** CAPLAW SHARED SERVICES CASE STUDY: HOW THE MISSOURI STATE CAA ASSOCIATION ENCOURAGED FOUR CAAS TO SHARE SERVICES

- **Accountant:** An accountant can assist with financial due diligence, advise on merger's impact on financial statements and systems, budgets and tax filings.
- **Attorney:** An attorney familiar with nonprofit corporation law can evaluate the organization's current legal situation; advise the board on its role and responsibilities; guide the choice of merger structure; advise on merger negotiations; conduct legal due diligence; draft legal documents and, where necessary, file them with the state.

  > **CAPLAW RESOURCE:** CAPLAW'S WORKING WITH ATTORNEYS GUIDEBOOK PROVIDES INFORMATION ON FINDING AND HIRING AN ATTORNEY

- **Interim Executive Director:** If one of the partners' executive directors has departed, the organization may hire an interim executive director to lead the organization during the merger process.
- **Other Consultants:** Depending on the circumstances, merging organizations may engage public relations, fundraising, IT or other consultants to assist with specific aspects of the merger.

Organizational Assessment and Identifying a Partner

Where do we start?

A CAA should start by conducting an organizational assessment to gather information on and analyze:

- Its mission
- Its motivations for merging
- The goals it hopes to achieve by merging
- Critical issues (a.k.a. opportunities and threats) facing the organization
- Potential obstacles and red flags to merging
- Its financial position
- Strengths and weaknesses that may affect its attractiveness as a merger partner

CAPLAW Resource: Organizational Assessment Worksheet (see Appendix)

Once a CAA has looked inward at its motivations, strengths and weaknesses, the next step is to look outward to identify possible merger partners and assess its compatibility with them.

How do we find a merger partner?

Sometimes someone within the CAA, such as a board member or the executive director, will know of an organization that might make a suitable merger partner (for example, an organization with which the CAA has previously collaborated on programmatic efforts). Often this person will have a good relationship with one of the leaders of the identified organization and will be able to initiate a confidential conversation about the possibility of merging. Should the merger effort move forward, these individuals will likely play an important role in championing the merger.

Where pre-existing relationships that could lead to merger discussions do not already exist, a CAA may decide to hire a consultant to help identify potential partners and to initiate and facilitate conversations with those organizations. In other cases, a state CAA, Head Start, nonprofit or other association or state CSBG office may be able recommend potential merger partners.

What should we look for in a merger partner?

A merger should lead to something new that could not exist without the joining of the partners' compatible strengths. Thus, each merger partner should bring assets – resources, relationships, experience or skills – to the table. **An organization with a similar mission, compatible organizational culture, contiguous service area or a menu of services or client base that complements that of the CAA often will make an attractive merger partner.** The merging organizations do not both have to be CAAs; a CAA may merge with another CAA or with another type of organization altogether.

A CAA should be guided in its search for a merger partner by the priorities it has identified in its organizational assessment

A CAA should be guided in its search for a merger partner by the priorities it has identified in the organizational assessment described above. In identifying and evaluating a potential merger partner, a CAA should consider questions such as:

- Is there a history of collaboration or shared services between the two organizations?
- Are the organizations' missions, values and organizational cultures compatible?
- What strengths would each organization bring to the merger? What weaknesses?
- Will merging with this organization help the CAA fill gaps in services currently being provided, facilitate integration of services or help CAA expand the number and types of clients it serves?
- Will the merger open up new streams of funding (including unrestricted funds), enhance the CAA's existing funding streams or improve its fundraising efforts?
- Will it improve the CAA's administrative capacity (financial, HR or IT staffing and systems, additional facilities, administrative expertise)?
- Will it enhance the CAA's outreach and connections to communities in the service area or beyond?
- Does the potential partner have a reputation as a professional, forward-looking, responsibly governed and managed organization?
- Will merging with the organization provide opportunities for the CAA to improve its branding or reputation?
- Will merging with the organization be financially feasible and beneficial?

CAPLAW RESOURCES: MERGER PARTNER IDENTIFICATION WORKSHEET AND MERGER PARTNER EVALUATION MATRIX (SEE APPENDIX)

NEXT STEPS IN THE MERGER PROCESS

Once we've identified a potential merger partner what are the next steps in the merger process?

PREPARE A LETTER OF INTENT

Once it is clear from preliminary merger conversations with a potential partner that both organizations are interested in pursuing a merger, a letter of intent to merge is drafted stating, for example, that:

- Each organization will pursue merger exploration and negotiation in good faith;
- Neither will pursue a merger with any other organization for the duration of the specified merger exploration period;
- The fact that the organizations are engaged in merger discussions and information shared during the merger exploration phase are confidential and may not be disclosed to third parties; and
- Certain individuals from each organization are authorized to engage in merger exploration discussions and, if applicable, to negotiate proposed merger terms.

The letter of intent might also specify how the two organizations will divide joint costs (such as the costs of a merger consultant or facilitator) incurred during the merger exploration phase.

DRAFT A CONFIDENTIALITY AGREEMENT

The organizations at this time may also consider entering into a separate confidentiality agreement to further protect any confidential information that may be shared or exposed during the exploratory phase and throughout the transaction.

> **CAPLAW RESOURCE:** THIS SAMPLE CONFIDENTIALITY AGREEMENT DEVELOPED BY CAPLAW IS INTENDED TO BE THOUGHTFULLY REVIEWED (PREFERABLY IN CONSULTATION WITH AN ATTORNEY LICENSED IN YOUR STATE) AND MODIFIED AS NECESSARY TO MEET THE INDIVIDUAL NEEDS OF THE ORGANIZATIONS AND COMPLY WITH APPLICABLE LAWS.

GET BOARD APPROVAL OF LETTER OF INTENT AND JOINT MERGER COMMITTEE

The boards of both organizations will then meet separately to approve the signing of the letter of intent and confidentiality agreement (if applicable), and to appoint members to a joint merger committee.

The joint merger committee is usually made up of the board chairs, executive directors and two or three other board members and/or other leadership team members from each organization. It will:

- Oversee negotiation and due diligence;
- Act as a liaison between the two organizations;
- Resolve details on issues such as governance, staffing, policies, salary scales and employee benefits; and
- Ultimately, make a recommendation on whether or not to merge.

Members of the joint merger committee will regularly report back to their respective boards on the progress and the substance of their work

In some cases, the committee members from both organizations will work together (for example, to develop a joint external communications plan or to negotiate the governance structure for the merged entity) and in other cases, they will work separately (for example, to conduct due diligence on the other organization). Members of the joint merger committee will regularly report back to their respective boards on the progress and the substance of their work.

Initially, the joint merger committee will make recommendations on how merger costs will be funded, what the timeline for the merger will be and how the success of the merger will be determined.

Articulate a Shared Vision

After the letter of intent is signed, a simultaneous process of conducting due diligence, negotiating the details of the merger, drafting legal documents for the merger and planning the integration of the two organizations begins. At the beginning of this phase, the merger committee will articulate a shared vision for the merger, establish a time frame for the remaining steps in the merger process and a target date for completion of that process, and outline a plan for internal and external communications about the merger.

Conduct Due Diligence

During this phase, each organization conducts a thorough investigation of the other organization's operations, assets and liabilities (actual and potential). The purpose of due diligence is to identify issues that could derail the merger or that at least must be negotiated and to inform how the merger will be structured. (For example, if one of the merging organizations is burdened with substantial liabilities, it will generally make sense to structure the merger as an asset transfer so that those liabilities will not be transferred to the merged entity.) Conducting thorough due diligence satisfies the board members' fiduciary duties to their respective organizations.

Due diligence will usually include evaluating the other organization's financial statements, audit reports, grants and contracts, personnel policies, employee benefit plans, union contracts (if any), insurance policies, articles of incorporation, bylaws and other records. Due diligence can also include contacting community partners and funding sources, and meeting with key employees from the other organization to verify information and ensure that future plans are realistic.

It is often helpful to appoint a staff person as the day-to-day liaison with the merger partner to obtain the needed information. It is also important to involve an attorney and accountant in the due diligence process.

CAPLAW RESOURCE: SAMPLE DUE DILIGENCE CHECKLIST FOR CAAS TO USE AS A STARTING POINT AND MODIFY AS NECESSARY

CHOOSE A MERGER STRUCTURE

Based on the shared vision and due diligence results, the organizations choose a legal structure for the merger.

ENGAGE IN NEGOTIATIONS AND DEVELOP RECOMMENDATIONS

The merger committee will meet regularly to negotiate and develop recommendations on key issues, including:

- **Corporate Structure:** How will the merger be structured from a legal perspective? Will only one of the organizations survive? If so, which one?
- **Governance:** How will the board of the merged entity be structured? Will new seats need to be added to include representation from the non-surviving entity board or from its service area? What provisions will the bylaws of the merged entity include?
- **Executive Leadership:** Who will fill the role of executive director of the merged entity? What will happen to the other executive director? Who will fill the other key leadership positions?
- **Other Staff:** Will staff of the non-surviving entity be guaranteed positions with the merged entity or must they apply for positions with the merged entity and possibly not be hired?
- **Programs:** Which programs will be retained? Which employees will staff the merged or remaining programs?
- **Organizational Name and Branding:** What will be the name of the merged entity? What will the branding strategy be for the merged organization?
- **Location:** Where will the headquarters for the merged entity be located? Should any current locations be closed?
- **Employee Benefits:** What salary scales and employee benefits will be offered to the staff of the merged entity?

Plan and Manage Communications

During this phase, internal and external communications should be planned and effectively managed. Working out HR issues – including changes in staffing, job functions, policies and benefits – can be one of the trickiest parts of a merger. Regular internal communications with staff at all levels will be needed to keep them informed of merger developments, answer their questions, clarify roles and reduce their anxiety about how the merger will affect them. Developing and implementing an external communications plan is also key – doing so will keep funding sources and other key stakeholders apprised of the merger process and allow the merging organizations to control merger messaging and prevent the spread of rumors about the merger.

Work with Funding Sources, Licensors and Accreditors

The organizations should keep their funding sources apprised of the merger. They should work closely with funding sources, licensors and accrediting bodies to determine whether grants, contracts, licenses and accreditations may be transferred to the merged entity. If so, they should take the necessary steps to effectuate those transfers. If one partner will not survive or will be transferring its assets in the merger, the parties should review that organization's contracts and leases to determine whether consent of vendors, landlords or other third parties must obtained in order to transfer the contracts and leases. If so, they should follow the specified procedures for obtaining those consents.

Depending on the circumstances, certain aspects of the integration process may begin before the merger formally occurs

Plan for and Start Working on Integration

The joint merger committee – in some cases with the assistance of additional staff from each organization – will prepare plans for the integration of the governance, administration, financial management, human resources, information technology, facilities, fundraising and programs of the two organizations. **Depending on the circumstances, certain aspects of the integration process may begin before the merger formally occurs.** For example, the organization that will not survive in the merger may transfer its financial information into the surviving organization's financial software.

Prepare Legal Documents

During this time, an attorney should prepare legal documents to facilitate the merger and effectuate any necessary corporate changes. Depending on the structure and circumstances of the merger, these documents may include: amended articles of incorporation; bylaws amendments; a merger or asset transfer agreement; and corporate votes.

GET BOARD APPROVAL OF MERGER

Once due diligence has been completed and all outstanding issues are resolved by the merger committee, the committee votes on whether to recommend the merger and committee members from each organization present the recommendation to their respective boards. Each organization's board then votes on whether to approve the merger.

If its name, address or corporate status changes due to the merger, the CAA must notify the IRS on its annual Form 990

SIGN AND FILE LEGAL DOCUMENTS

After both organizations' boards vote to approve the merger, the legal documents necessary for the merger are signed and, as necessary, filed with the state. In some cases, notification or approval of the state attorney general is required. If its name, address or corporate status changes due to the merger, the CAA must notify the IRS on its annual Form 990. If its name changes and it needs documentation of its 501(c)(3) status under the new name before it files the Form 990, it may report the name change and request an affirmation letter from the IRS listing the new name and confirming its organization's 501(c)(3) status.

INTEGRATE THE ORGANIZATIONS

After the legal documents have been executed comes the difficult work of combining the organizations. Depending on the merger, integration may encompass joining boards, management, staff, administrative departments and programs, all while being mindful of differing corporate cultures. **This can be the most difficult and lengthy of the steps as it can take several years to fully integrate organizational culture and realize the vision behind the new organization.** It is here where the planning conducted during the merger exploration phase will be put to the test, as well as the flexibility of leaders and staff in the newly merged organization.

FYI:

The steps outlined here are those typically followed in the case of a "statutory merger" (discussed on the next page). For other types of mergers, some of the steps may not be necessary or as in-depth as those described. For example, in an asset transfer where no liabilities are being transferred, the due diligence process will be simpler than where the acquirer is assuming liabilities too. Similarly, where a single program is being transferred, the parties will generally not need to address corporate structure, governance and executive leadership issues.

MERGER STRUCTURES AND ALTERNATIVES

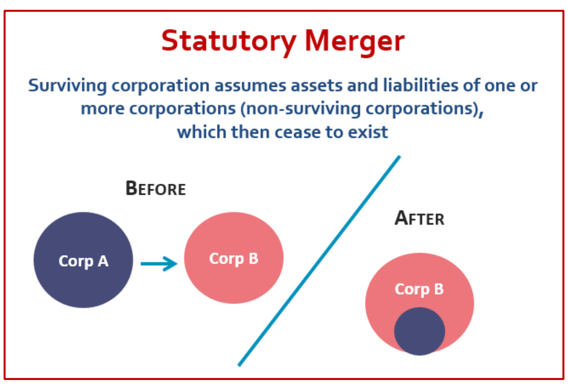
What options do we have for structuring the merger?

Following is a brief description of common ways to structure mergers. **When structuring a merger, keep in mind that form (choice of structure) should follow function (the vision for the merger).** Merger transactions are governed by state nonprofit corporation law and/or contract law. Therefore, **it is important to work with an attorney in your state familiar with the state's nonprofit corporation law** to plan and implement the merger transaction.

STATUTORY MERGER

In a true merger (known as a "statutory merger"), the surviving corporation (Corp B in the diagram below) assumes the assets and liabilities of one or more other corporations (Corp A). The non-surviving organization(s) are then dissolved by operation of law; no additional dissolution filing is needed.

Because the surviving entity inherits not only the assets of the non-surviving organization, but also all of its liabilities (including known and unknown debts and other legal claims), the surviving entity should perform careful due diligence in order to identify and quantify those liabilities.

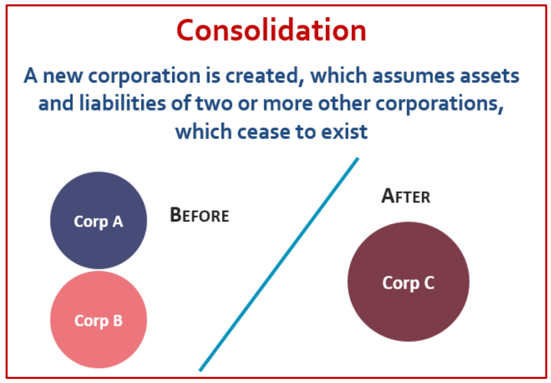


In this scenario, the surviving entity may be required to modify its board size and composition (for example, to comply with CSBG and/or Head Start rules) and may choose to include some board members from the non-surviving entity's board. The surviving entity may also change its name to reflect the absorption of the non-surviving entity. Approval from funding sources and licensing and accrediting bodies is usually required in order to transfer the non-surviving entity's government grants, licenses and accreditations.

CAPLAW RESOURCE: CAPLAW MERGER CASE STUDY: MERGER OF PEOPLES' REGIONAL OPPORTUNITY PROGRAM, INC. WITH YOUTH ALTERNATIVES INGRAHAM TO FORM THE OPPORTUNITY ALLIANCE

CAPLAW Resource:
[CAPLAW Merger Case Study: Merger between Economic Opportunity of Suffolk, Inc. and Suffolk Network on Adolescent Pregnancy, Inc.]

Consolidation

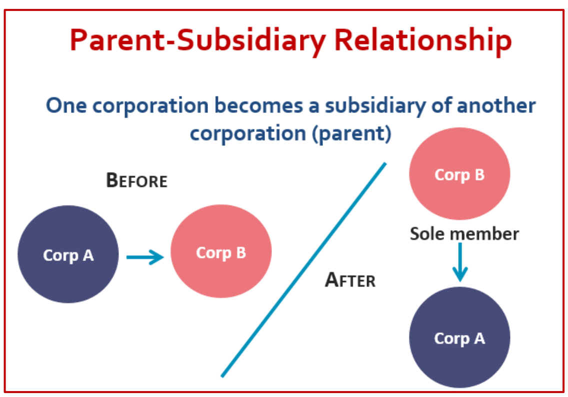


In a consolidation, a new corporation (Corp C, in the diagram opposite) is created, which assumes assets and liabilities of two or more other corporations (Corps A and B), which then dissolve. Consolidations are generally not attractive for CAA mergers because the new entity must apply to the IRS to obtain 501(c)(3) status. Also, the non-surviving entities will need to arrange the transfer of their grants to the new entity, which may require competition or simply not be possible.

Parent-Subsidiary Relationship

In this scenario, rather than merging to become a single corporation, one corporation (Corp B in the diagram below) amends its articles of incorporation and bylaws to make another corporation (Corp A) its sole corporate member, thereby creating a parent (Corp A) / subsidiary (Corp B) relationship between the two entities.

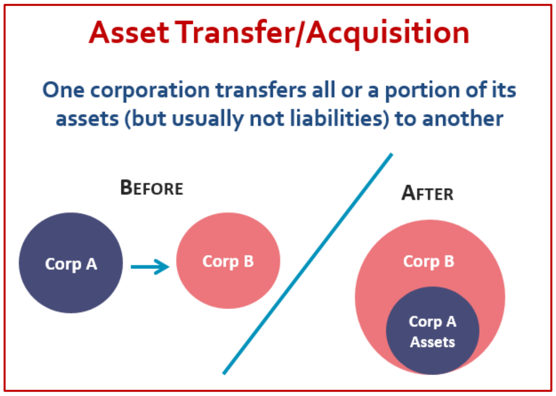
With this structure, a CAA may preserve its tripartite board structure and should not have to transfer its grants, contracts, licenses and accreditations to the other organization. It may also enable a Head Start grantee to keep its legal status and not have to re-compete its Head Start program (see "How will merging impact our Head Start funding" below). However, because there are two organizations post-merger (and thus two separate boards, two sets of books/audits, separate Forms 990, etc.), a parent-subsidiary relationship will likely be less cost-effective than a statutory merger.



CAPLAW Resource: [CAPLAW Merger Case Study: Merger between MesaCAN and A New Leaf, Inc.]

Asset Transfer/Acquisition

In an asset transfer, one corporation (Corp A) transfers assets – but usually not liabilities – to another corporation (Corp B). The acquiring entity is able to choose which assets it will acquire and whether it will take on any of the transferring entity's liabilities.



Where a nonprofit corporation is transferring all (or substantially all) of its assets to another entity, it will need to follow the procedures specified in state nonprofit corporation law to effectuate the transfer and may need to obtain approval from the state charity regulator (often the attorney general).

The transferring entity will need to obtain approval (which may not always be forthcoming) from its funding sources and licensing and accrediting bodies to transfer its government grants, licenses and accreditations. Additional steps may need to be taken in order to complete the transaction – including assigning the transferring entity's contracts/agreements and leases, which may require getting consents from the other parties. The transferring entity will remain in existence after the transfer; additional steps are required if it seeks to dissolve.

CAPLAW Resource: CAPLAW Merger Case Study: Merger between Mahube Community Council and Otter Tail-Wadena Community Action Council

Program Transfer

In a program transfer, one organization voluntarily or involuntarily gives up a single program or multiple programs, each of which the funding source then transfers to another organization.

CAPLAW Resource: CAPLAW Merger Case Study: Merger between Three Rivers Community Action and Olmstead County Community Action

What alternatives are there to merging?

Possible alternatives to merging include:

- **Maintaining the Status Quo:** A CAA may simply go back to business as usual without changing its programs or operations.
- **Conducting Joint Program Activities:** A CAA may work with one or more other organizations on programs formally (such as through a subgrant relationship) or informally (for example, by participating in a coalition).

- **Sharing Administrative Functions or Facilities:** A CAA may contract with another nonprofit to provide or obtain program staffing programs (such as a shared Weatherization director) or administrative staffing (such as shared fiscal or IT staff – or it may purchase these services from a for-profit). It may occupy facilities with another nonprofit with a similar mission. Or it may engage in joint purchasing arrangements with other organizations.

  > **CAPLAW RESOURCE:** CAPLAW SHARED SERVICES CASE STUDY: ARROWHEAD ECONOMIC OPPORTUNITY AGENCY, INC. & KOOTASCA COMMUNITY ACTION, INC.")

- **Giving Up Program(s):** A CAA may give up one or more of its programs voluntarily or involuntarily.
- **Shutting Down:** A CAA in dire financial or other straits may be forced to close its doors.

REGULATORY ISSUES

How will merging impact our Community Service Block Grant (CSBG) funding?

CSBG DESIGNATION

The federal CSBG Act provides that if a geographic area ceases to be served by CAA, the state may solicit applications from nonprofit organizations located in the unserved area or in an area contiguous to the unserved area and designate from among them a new entity to serve the area. See 42 United States Code (U.S.C.) § 9909(a)(1). U.S. Department of Health and Human Services (HHS) regulations defer to each state's interpretation of the federal CSBG Act unless the interpretation is clearly erroneous. See 45 Code of Federal Regulations (C.F.R.) § 96.50(e). A state thus has discretion to determine whether a geographic area is no longer being served and whether to use a competitive application process to designate a new entity to serve that area.

To maintain eligibility for CSBG funding, the surviving entity in a merger must comply with the CSBG Act's tripartite board requirements

In the case of a merger between two CAAs, where one will dissolve and the other will take over its CSBG service area, the CAAs should discuss with the state CSBG office what process must be followed to obtain the state's approval of the merger and of the expansion of the surviving CAA's CSBG service area.

In the case of a merger between a CAA and a non-CAA, one can avoid these issues by structuring the merger so the CAA's corporate status and tripartite board remain intact (even if its name may change).

TRIPARTITE BOARD SIZE AND COMPOSITION

In order to receive CSBG funds, a CAA must comply with the tripartite board requirements of the federal CSBG Act. See 42 U.S.C. section 9910. **To maintain eligibility for CSBG funding, the surviving entity in a merger must comply with the CSBG Act's tripartite board requirements.** In the case of a merger of two CAAs, where one CAA will dissolve and the surviving CAA will take over its CSBG service area, the surviving CAA's board will need to be expanded to include representation from the service area of the dissolving CAA. In many cases, this will require an increase in the size of the surviving CAA's board – typically, by three seats, one for each of the three sectors. In some circumstances, if existing board members resign, the size of the board may not need to be increased. Whether or not the surviving CAA's board size will increase, its bylaws will most likely need to be amended to describe the representation from the new service area. When a CAA merges with a non-CAA, it must ensure that the board of the surviving entity will comply with the tripartite board requirements.

CSBG Funding Level

When two CAAs propose to merge, they should work with their state CSBG office to determine the amount of CSBG funding that the surviving CAA will receive. Although CSBG funding is often tied to the size of the low-income population in a CAA's service area, many states set a base level of funding that every CAA can expect to receive. Depending on the circumstances, it is possible that the level of funding that will be allocated to the surviving CAA in a merger of two CAAs will fall short of the level of funding that both CAAs had received as separate entities.

If a merger of two CAAs is likely to result in a decrease in CSBG funding to the surviving entity below the combined about of CSBG funding received by each CAA before the merger, the merging CAAs should work with the state CSBG office to mitigate the decrease. This could be done, for example, by the state granting CSBG discretionary funding to the merged entity to make up the difference in foregone funding or by the state adopting a statute or regulation specifying that a merger of two CAAs will not trigger a decrease in CSBG funding.

FYI:

The Minnesota legislature amended its Community Action statute in 2014 to specify that when two CAAs merge, the merged entity will receive a base funding amount equal to the sum of the base funding amounts each of the merging CAAs had received before the merger. Minnesota's Community Action regulations implement this law. Minnesota Statutes section 256E.30 and Minnesota Administrative Code section 9571.0040. View the MN statute and regulations

Amendment to CSBG State Plan

If a merger between two CAAs, in which one CAA will dissolve, takes place during the CSBG program year, the state CSBG office will need to amend the state CSBG plan and its contract with the surviving CAA to reflect the fact that the surviving CAA is taking over the dissolving CAA's service area and funding. The state will also need to terminate its CSBG contract with the dissolving CAA.

CSBG Reporting

The surviving entity will need to work with the state CSBG office to determine what additional information it will need to report to the state as a result of the merger and how to report that information.

How will merging impact our Head Start funding?

A significant obstacle to a merger of two Head Start grantees is the potential for competition of the non-surviving CAA's Head Start program. The Administration for Children and Families (ACF, the agency within HHS that administers the Head Start program) takes the position that mergers of Head Start grantees usually require it to offer an open competition for the service area of the grantee being absorbed. This is because under the Head Start regulations, a grantee must have legal status – i.e., existence as a private nonprofit agency or organization as a legal entity recognized under the law of the state in which it is located; a grantee's failure to maintain legal status is grounds for termination of its Head Start grant. See 45 Code of Federal Regulations (C.F.R.) § 1304.5(a)(2)(ii).

ACF considers a grantee that dissolves to have lost its legal status and voluntarily relinquished its grant. A Head Start grantee's voluntary relinquishment of its grant constitutes a termination of the grant. See 45 C.F.R. § 1305.2. Where a Head Start grant has been terminated (including through voluntary relinquishment) a replacement grantee is selected through a competitive process. 45 C.F.R. § 1304.20.

A possible solution to this problem may be for one of the merging grantees to become a subsidiary of the other; the subsidiary corporation would thus retain its corporate existence and should be able to continue operating its Head Start program. CAAs facing this situation should discuss with ACF whether such a parent-subsidiary relationship would avoid the need for competition and, if so, work with an attorney to structure the merger accordingly.

Recompetition is not required if the Head Start grantee survives the merger. In the case of a merger between a Head Start grantee and another organization without Head Start, be sure to structure the merger so the Head Start grantee's corporate status remains intact (even if its name may change).

A Head Start grantee that is not planning to dissolve but will simply change its name in a merger does not need to obtain prior ACF approval but must give ACF advance notice of the name change. A name change will not affect the grantee's continued eligibility for its Head Start grant. See HHS Grants Policy Statement pp. II-51 and II-79. If the merger will result in changes in the Head Start director position or any other position – such as executive director – held by someone listed as a "key person" in the grant application or notice of award, the grantee must obtain prior ACF approval of those changes. See 45 C.F.R. § 75.308(c)(ii).

How will merging impact our other government grants and our licenses or accreditations?

A CAA that is planning to merge with another organization but not be the surviving entity in the merger should work with its other funding sources and any entities from which it has obtained licenses or accreditation to facilitate the transfer of its other grants, licenses or accreditations to the surviving organization.

Can the cost of merging be charged to federal grant(s)?

Under the federal cost principles, merger costs cannot be charged to a federal award without prior approval. See 2 C.F.R § 200.455 (Office of Management and Budget Uniform Guidance) and 45 C.F.R. §75.455 (Uniform Guidance applicable to HHS grants). However, in some cases a government funding source, such as a state CSBG office, may be willing to authorize the use of federal grant funds to pay for merger costs. Therefore, **a CAA contemplating merging should contact its state CSBG office to obtain prior approval to use CSBG funds to pay merger costs**.

Under the federal cost principles, merger costs cannot be charged to a federal award without prior approval

Will our CAA's unionized workforce impact a merger?

A unionized workforce may make a merger more complicated. **A CAA with a unionized workforce should consult with a labor attorney to determine how its collective bargaining agreement might impact its plans to merge.**

Potential Obstacles and Lessons Learned

What obstacles could we face as we pursue a merger?

Common obstacles that can derail an otherwise beneficial merger are:

- **Loss of Identity:** Worries about loss of organizational identity and goodwill and about reduction in services to the community
- **Cost and Time:** Concern about how much money, time and effort will be required to merge
- **Funding Source Rules:** For example, the possible need to re-compete for the non-surviving entity's Head Start program
- **Lack of Buy-In:** Lack of buy-in from boards and/or staff –for example, due to staff concerns about employment prospects and organizational culture post-merger
- **Short-Term Focus:** A short-term focus on day-to-day operations and survival that prevents the pursuit of a merger's long-term, strategic goals
- **Organizational Culture:** Failure to identify and address differences in organizational culture

FYI:

If the board of your CAA ("XYZ County CAA") is concerned that a potential merger with a neighboring CAA will result in the loss of your CAA's identity and of services to residents in XYZ county, you could explain that, even if your CAA does not survive as a separate entity after the merger, services in XYZ county will continue to be provided by the merged entity, and could even be provided in XYZ County by the merged entity "doing business as" "XYZ County CAA" so that clients won't even be aware that a merger has taken place.

Anticipating and proactively addressing these and other obstacles can mean the difference between success and failure.

What lessons have other CAAs learned from merging or attempting to merge?

CAAs interviewed by CAPLAW for the various case studies referenced in this manual identified the following lessons learned:

Mission

Ensure that the merger furthers each partner's mission. The merger partners' reasons for merging should be mission-driven in order for the merger to succeed. From the outset, each organization must be able to identify how the merger will help it reach its strategic, mission-related goals. Both partners should examine the decision to merge from the perspective of the individuals, families and communities they currently serve and hope to serve in the future.

Shared Vision

Articulate a shared vision for the merger. A successful merger requires a shared vision of the results to be achieved by merging and the impact that merging will have on the community. This shared vision will enable merger advocates to make the case for merging to the boards and staff of the merging organizations, as well as to funding sources. It will also help keep board members, executive directors and staff motivated to overcome the hurdles that will inevitably arise while negotiating and planning the merger.

Board Buy-In

Get early board buy-in. Though the initial conversations about a possible merger often originate at executive director level, the boards of each organization will ultimately lead the process. Lining a few prominent board members from each organization up as merger advocates early on is key to helping each board understand the transaction and its benefits and fulfill its oversight role.

Both partners should examine the decision to merge from the perspective of the individuals, families and communities they currently serve and hope to serve in the future

Merger Champion

Identify one or more visionary advocates for the merger who are passionate about and can help convince others of the benefits of merging. Merger champions can help drive the process forward in the face of logistical hurdles and naysayers. One CAA executive director 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 someone to champion 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.

Trust

Make the time and effort to identify and build trust with a compatible merger partner. Trust between the merging organizations will play a critical role in helping overcome the challenges and obstacles that will inevitably arise during the merger process. Establishing a strong relationship before merging is therefore essential. To determine compatibility, start by reaching out to organizations with which your CAA, its executive director or board members have a prior relationship. These pre-existing relationships are likely to foster trust and confidence in the other organization's leadership and help the partners develop a good rapport early on in the integration process.

After the partners have agreed to explore merging, it is important for their respective boards and executive directors to build relationships with each other. As the merger process proceeds, it is a good idea to involve middle management and other staff as appropriate in integration planning.

DUE DILIGENCE

Conduct thorough due diligence. Identify and be honest about each organization's assets, liabilities, strengths and weaknesses. Hire experienced professionals to assist with due diligence to make sure your CAA covers all of its bases and identifies any problems as early in the merger process as possible. Due diligence – especially financial due diligence – should be conducted before beginning to integrate the two organizations. It is important to get a complete and accurate picture of a merger partner's financial position, especially whether it has any hidden liabilities such as unpaid payroll taxes or outstanding legal claims, before getting "past the point of no return." Before merging, have an attorney check that both organizations are up-to-date on all of their corporate, tax and other legal filings and that those filings have been done correctly.

Identify and be honest about each organization's assets, liabilities, strengths and weaknesses

Communication with Funders

Communicate with both organizations' funders early and often to get support for the merger and to determine the steps necessary to ensure continued funding after the merger. Funders are often supportive of mergers as a means of maximizing limited resources and meeting increased expectations for effectiveness, efficiency and oversight. Taking proactive steps to pursue a merger can bolster a funder's opinion of the organization's administrative and programmatic competence and capacity.

Community Outreach

Strategize about the post-merger outreach to the community. For example, if the merged entity will serve an expanded geographic area, consider placing offices for the new organization in the heart of the expanded service area to gain exposure to clients and to form relationships within the community. The transition to a new face for the delivery of programs can be a unique opportunity to build positive, new relationships in the community.

Training & Technical Assistance

Take advantage of training and technical assistance offered by funders and national and state Community Action and other associations.

__Assess the cultures of both organizations and identify areas where culture could get in the way of effective integration__

Organizational Culture

Keep organizational culture front and center from day one.

Assess the cultures of both organizations and identify areas where culture could get in the way of effective integration. Take proactive steps to address those issues and to build a new organizational culture in the merged organization.

Appendix:

Organizational Assessment Worksheet

Merger Partner Identification Worksheet

Merger Partner Evaluation Matrix