INSIGHT
Center for Community Economic Development

Mergers, Consolidations, Dissolutions, and Affiliations: Legal Issues for Community-based Organizations

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Introduction

Community-based organizations (CBOs) face critical decisions as they compete for dwindling resources and as their target communities begin to struggle with the realities of government funding cutbacks. Government policies are putting at risk not only low-income people but the organizations, businesses, and institutions that serve them. CBOs are especially at risk in this volatile time of funding cutbacks and retrenchment. Many CBOs now must consider whether to merge, consolidate, dissolve or affiliate with other organizations.

The past ten years have seen an increasing concentration of very poor families in the most disinvested urban neighborhoods. In neighborhoods served by CBOs, as many as 50% of the households depend for their basic income on public benefit and related health and food stamp entitlements. As the poor become increasingly concentrated, the reduction in public benefits threatens the economic base on which many existing neighborhood businesses and institutions, including CBOs, depend.

The past twenty years have witnessed an emergence of thousands of CBOs all across the country. Some cities have dozens, and in some instances, neighborhoods are served by two or more. Today's policy and funding reality, however, points to a contraction. Smaller, less experienced CBOs may not be able to survive.

A CBO struggling to survive, or a stable CBO that is looking for ways to strengthen itself, should consider combining with another CBO or other compatible organization. By pooling their financial, technical, and community resources, CBOs might enhance their survival through a reduction in competition for scarce resources, greater efficiencies and economies of scale, and enhanced performance capacity.

Although a combination can result in increased efficiency and savings in non-personnel costs -- such as in space rental and other overhead -- personnel cost savings are usually more significant. For example, although each of two corporations might have an executive director and housing development specialist, the combined operation may need only one. However, layoffs can result in short-term cost increases due to vacation cash-out or severance pay. Differences in wage scales and benefits paid by the two corporations must be reconciled.

In assessing the advantages and disadvantages of combining two CBOs, consider the following legal structures and issues, and undertake the background investigations described below. In negotiating the terms of the transaction, consider the relative bargaining position of the other corporation, and whether other CBOs are interested in combining with it. The discussion assumes that both CBOs are charitable corporations. Additional issues are presented if one corporation is but the other is not.

Legal Structure Alternatives

Merger

In a merger, one corporation absorbs another, and the "surviving" corporation assumes the assets and liabilities of the "disappearing" corporation. Typically, the two corporations reach agreement on merger terms, such as:

- the changes, if any, to the surviving corporation's articles and bylaws;
- whether members or directors of the disappearing corporation will become members or directors of the surviving corporation;
- the effective date of the merger;
- whether and under what terms the staff of the disappearing corporation will be employed by the surviving corporation; and
- other matters concerning the operation of the surviving corporation.

The members and directors of each corporation then approve the terms of merger, and the surviving corporation files an agreement of merger with the Secretary of State. The surviving corporation also notifies other state agencies, such as the Franchise Tax Board and the Attorney General's office. The federal Internal Revenue Service (IRS) is notified through the filing of a final tax return for the disappearing corporation.

Consolidation

In a consolidation, both corporations cease to exist, and a new corporation is formed, under a new name or one of the old names. The two "constituent" corporations reach agreement as in a merger, and the process for filing and notification is similar.

Effect of Merger or Consolidation

Generally, after a merger or consolidation, the surviving or new corporation succeeds to all the rights, powers, assets, liabilities, and obligations of the original corporations. For example, a disappearing corporation need not deed its real property to the surviving corporation; the surviving corporation assumes title to the property by operation of law when the merger agreement is filed with the state. It may be advisable to record the merger agreement with the county recorder (the local agency that maintains official records of title to real property). Liens on specific property by creditors of either corporation continue as before the merger or consolidation.

However, the terms of certain grants, loans, licenses, or other assets might require their termination or forfeiture in the absence of grantor, lender, licensor, or other third-party approval of the merger or consolidation.

Merger vs. Consolidation

A consolidation might be used when the two corporations are relative equals in size and capacity, since in a merger the perception, if not always the reality, is that the surviving corporation is the larger and more capable of the two corporations. A consolidation also permits a "fresh start" -- a new corporation, with a new name that reflects the interests of both corporations. A merger is more likely to be viewed as the continuation of the surviving corporation in a larger form, even when as part of the merger the name of the surviving corporation is changed.

However, in a consolidation, the new corporation must obtain from the IRS a determination letter of its charitable tax-exempt status (Section 501(c)(3)). The approval process can take four months or more. In a merger, the surviving corporation can rely on its existing determination letter, unless it amends the purposes clause in its articles of incorporation. In that case, in notifying the IRS about the merger, it should also seek assurance that the change in its purposes does not adversely affect its tax-exempt status.

Voluntary Dissolution

In a voluntary dissolution, a corporation notifies all known creditors that it is winding up its affairs. A creditor must come forward during the dissolution process or lose its claim. If necessary, the corporation sells assets at fair market value to satisfy creditors. It distributes the remaining assets to a Section 501(c)(3) corporation. Unless its articles of incorporation specifies otherwise, the corporation has discretion in choosing the "recipient" corporation. All staff are laid off.[1]

The members and directors of the dissolving corporation must approve the decision to wind up and dissolve, and the plan of liquidation and distribution of assets. The corporation must notify the state Attorney General's office of the planned liquidation and distribution, and request a written waiver of objections. The corporation also must obtain a certificate from the Franchise Tax Board that its taxes have been paid or adequately provided for. When all steps have been completed, the corporation files a certificate of dissolution with the Secretary of State. The corporation notifies the IRS through the filing of a final tax return.

Effect of Voluntary Dissolution

Dissolution prevents the corporation from drifting into insolvency (debts exceed assets) or wasting its remaining assets. Merely suspending or ceasing activities is not equivalent to dissolution. Even though the corporation pays its debts and settles its liabilities, if it lingers as a no-asset shell it might be fined or suspended for failure to file tax returns and reports.

A dissolution terminates the corporation's legal existence. The directors or officers are no longer responsible for annual corporate filings or otherwise maintaining the corporation.

Bankruptcy, not dissolution, might be the appropriate procedure when the corporation's liabilities exceed its assets. A nonprofit corporation is subject to the same bankruptcy laws and procedures as is a for-profit corporation.

If the corporation has an ongoing grant, it must either return the unspent grant funds or obtain funding source approval for a transfer to another corporation. Also, funding source approval might be needed to distribute certain assets, such as those acquired with government grant funds. If real property is distributed, the recipient corporation should record a grant deed evidencing the transfer of title.

Voluntary Dissolution vs. Merger or Consolidation

Creditors of the dissolving corporation must come forward and are paid in full, so the recipient corporation takes unencumbered title to assets (unless as part of the dissolution, a creditor agrees to continue as a creditor of the recipient corporation). In a merger or consolidation, the surviving or new corporation is

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responsible for the obligations of the disappearing corporation, even those obligations unknown to it at the time of merger or consolidation.

In a dissolution, the recipient corporation takes title to assets - and might receive certain records pertaining to those assets - but is not the successor to the dissolved corporation. Unlike a merger or consolidation, it does not inherit the dissolved corporation's image, history, or staff, except when an ongoing grant is transferred.

A dissolution need not benefit only the recipient corporation. A dissolving corporation with desirable assets can negotiate terms of disposition similar to merger terms. For example, a recipient corporation could agree to appoint dissolving corporation directors to its board, hire certain staff, and continue certain programs. Both corporations benefit -- the recipient corporation because it receives only those attributes of the dissolving corporation that it wants to receive, and the dissolving corporation because it is relieved of maintaining the corporation while being assured that some of its programs and activities continue.

Both corporations can also benefit from a reduction in the dissolving corporation's indebtedness. Under the threat of dissolution, a corporation can negotiate with its creditors for written forgiveness of its debts, or agreement to accept partial payment in satisfaction. This may work best when the corporation has assets that barely exceed or are less than its liabilities, and thus appears unlikely to merge or consolidate.

In a dissolution, creditors might be willing to forgive certain debts in exchange for favorable publicity, or to settle for less than the corporation could pay if it liquidated all its assets. For example, creditors might permit the corporation to retain its used office equipment and furniture, which have limited cash value, and distribute them to a Section 501(c)(3) recipient corporation upon dissolution. A creditor might not be as willing if, instead, the corporation were to merge or consolidate with another corporation capable of paying the debt in full.

On the other hand, certain desirable assets, such as a license, grant, or lease, do not survive dissolution and so cannot be distributed to another corporation without prior third party approval. Such approval might not be required if the asset were transferred by operation of law in a merger or consolidation.

Also, a dissolution might increase staff costs. In a merger or consolidation, the only staff entitled to loss-of-job benefits such as vacation cash-out, severance pay, termination and cash-out of pension plans, and unemployment compensation are those staff who will not be employed by the surviving or new corporation, although a union agreement, the personnel policies or practices of the disappearing corporation, or the merger or consolidation agreement could extend these benefits to additional staff.

However, a dissolution terminates the employment of all dissolving corporation staff. Even the staff hired by the recipient corporation might be entitled to certain loss-of-job benefits.

Affiliation By Administrative Services Agreement. In an affiliation by administrative services agreement, a troubled corporation retains its separate legal existence. However, the agreement transfers to another corporation control over some or all of its activities and affairs. Legal filings or third party approvals are generally not required, and the "affiliated" corporation need not assume the prior debts of the troubled corporation.

Effect of Affiliation By Administrative Services Agreement. In the agreement, the affiliated corporation agrees to administer some or all of the troubled corporation's programs and to act as its fiscal agent for the receipt and handling of some or all of its funds. All staff might be employed in the affiliated corporation, or some staff might remain in the troubled corporation, with management supervision by the affiliated corporation. All funds could be transferred to the affiliated corporation, and new funds deposited in its account, or funds could be retained and deposited in the troubled corporation's account, with disbursement and accounting by the affiliated corporation.

The board of directors of the troubled corporation oversees the performance of the affiliated corporation. The board is responsible for government tax and corporate filings, although the affiliated corporation might prepare the forms for filing.

The affiliated corporation can do more than just carry out policies established by the troubled corporation. Depending on the terms of the agreement, the affiliated corporation might have substantial policy-making authority and discretion over what activities are carried out, not just how.

Affiliation by Amendment

In an affiliation by amendment, a troubled corporation retains its separate legal existence, but amends its bylaws (and also perhaps its articles of incorporation) to give another corporation the power to appoint some or all of its board of directors. The amended articles and bylaws must be filed with the IRS and Franchise Tax Board. An affiliation by amendment generally does not require other legal filings or third party approvals, although certain grants or loans may require grantor or lender approval of the amendments. The affiliated corporation need not assume the prior debts of the troubled corporation.

Effect of Affiliation By Amendment

When the affiliated corporation is given the power to appoint a majority of the board of directors of the troubled corporation, a parent-subsidiary (controlling) relationship is created. A non-controlling relationship is created when the affiliated corporation appoints less than a majority. In either relationship, the corporations can enter into an administrative services agreement for management and/or fiscal supervision of the troubled corporation.

Affiliation By Agreement vs. Affiliation By Amendment

An agreement usually can be terminated by either party for cause, and can have a predetermined term. Thus, an affiliation by agreement is "reversible." An affiliation by amendment can be reversed only with the approval of the affiliated corporation. Once the corporations have affiliated by amendment, the parties do not have equal bargaining power. The affiliated corporation, if it has majority board appointment power, controls the activities and assets of the troubled corporation. Also, an affiliation by amendment can be supplemented with an affiliation agreement.

Affiliation vs. Merger/Consolidation or Dissolution

Affiliation by agreement can be advantageous for a troubled corporation that has not yet decided to terminate its separate existence. Affiliation provides an opportunity to concentrate on fundraising for survival, since the corporation is not as burdened with day-to-day management. Also, during the term of the agreement, the parties have an opportunity to test the relationship and learn more about each other prior to merger or consolidation.

Sometimes, a corporation has a license, grant, lease, loan, or other asset that by its terms or by operation of law does not survive a merger, consolidation, or dissolution without third party approval. Third party approval might not be needed for an affiliation.

In an affiliation, title to real estate or other assets is not transferred to the affiliated corporation. In a merger, consolidation, or dissolution, transfer costs might be incurred, and third party approval of the transfer might be required.

Pre-affiliation liabilities of the troubled corporation remain its responsibility. In a merger or consolidation, the surviving or new corporation assumes these liabilities.

Affiliation provides separation for activities best kept separate. In a merger or consolidation, all of the activities of two or more corporations are combined into one corporation. However, for liability, management, funding source, image, or other reasons, a corporation might want to place each major project into a separate corporation, or might want to separate its non-real estate from its real estate activities.

On the other hand, in an affiliation, each corporation maintains separate legal existence and is responsible for annual government tax and corporate filings. It can be time consuming to maintain an unnecessary corporation.

Background Investigation

A corporation exploring any of the legal forms described above, either as a surviving or a disappearing corporation, should thoroughly understand the financial and programmatic affairs of the other corporation(s) involved. The investigation should concentrate on corporate and tax-exemption compliance, financial condition, corporate governance, personnel issues, project and property status, and past or potential future claims or lawsuits, and it should include not only the corporation but also its subsidiary and affiliated corporations.

The following is a list of documents to review, what to look for, and possible actions to take. It is not intended as a complete list, but as a starting point for the investigation.

Each corporation should be represented by legal counsel to determine whether the other corporation can fulfill its commitments, to identify potential liability and to preserve title to assets and other corporate rights. An accountant can advise on risks and liabilities following an examination of the other corporation's financial records. An insurance broker can advise on whether the surviving corporation's insurance coverage will be adequate, or whether some coverage will be duplicated, some gaps in coverage will exist, or additional insurance will be needed to cover liabilities inherited from the other corporation.

Corporate and Tax-Exemption Compliance

Articles of Incorporation

Review the original and all amendments, with particular attention to the purposes clause and any limitations on activities, provisions for members and member rights, approvals required for amendment or other actions, and disposition of assets on dissolution. Note the corporate number assigned by the state, since it might have to be included on correspondence about the corporation. Request a written certification by the corporate secretary that the documents are complete and have not been further amended, or obtain certified copies from the Secretary of State.

Bylaws

Review the original and all amendments, with particular attention to the process for approving amendments or taking other corporate action. Note the corporation's fiscal year for filing tax returns. Request a written certification by the corporate secretary that the documents are complete and have not been further amended.

Federal and State Tax Exemption Applications

Review in particular the description of proposed activities. Note the corporation's employer identification number and fiscal year.

Federal and State Tax Exemption Determination Letters

Verify the corporation's Section 501(c)(3) and corresponding state tax exemption, and whether it is subject to any special requirements or limitations. Note the corporation's public charity classification, and whether it received an advance or a final ruling.

Government, Corporate and Tax Filings For Past Three Years

The corporation may have to file annually with the Secretary of State, state Attorney General's office, and Franchise Tax Board. If the corporation's gross income averaged at least $25,000, it had to file annually with the IRS (Form 990 or 990 EZ). Review whether required filings were made, and review the filings for information about the corporation's finances and activities.

Request a certificate of good standing or similar document from the state that the corporation is a nonprofit corporation, duly organized, validly existing and in good standing, and that all required forms have been filed, that the corporation has not been suspended and does not have a tax or filing fee liability.

Review IRS Publication 78 or request a letter from the IRS that the corporation's tax exemption has not been revoked or its public charity status modified. Request a letter from the Franchise Tax Board that the corporation's state tax exemption has not been revoked or modified.

Alternatively, request an opinion of the corporation's counsel concerning its good standing with the state and IRS, that it has not engaged in any transaction or activity that could cause its tax exemption to be revoked, and that it has complied with all statutory requirements necessary to retain its tax exempt status, including the filing of all returns and reports.

Financial Condition

Financial Audits for Past Three Years, Current Financial Statement

Review the assets and liabilities, management letters from the auditors, and any other statements about the corporation's financial practices. Request copies of current bank account statements. Request a written certification by the corporate treasurer that the financial statement fairly presents the current financial condition of the corporation, and that since its date there has been no material adverse change in the corporation's financial condition, operations, properties or prospects. Alternatively, request a current year audit.

Also, request a written certification by the corporate treasurer that the corporation does not have outstanding any indebtedness for borrowed money or other liabilities except as set forth in the financial statement, or except as disclosed by the corporation in writing. Obtain copies of relevant documents pertaining to all indebtedness, such as loan agreements, promissory notes, and deeds of trust.

Liability Insurance Policies

Review all liability insurance policies, including general liability, director and officer liability, property ownership liability (fire, etc.), automobile, and bonding of those handling corporate funds. Request a claims history.

Corporate Governance

Board and Committee Meeting Minutes For Past Three Years. Review whether meetings were held with proper notice and with a quorum present, and whether significant projects and transactions were approved by the board. Note any discussions concerning potential liability, lawsuits threatened against the corporation, an impending government audit, or other unusual activity.

Operating Policies and Procedures

Review corporate management practices and whether adopted policies and procedures are followed.

Approval of Combination

Verify that the merger, consolidation, or other transaction has been duly authorized by all requisite corporate action.

List of Officers and Directors

Determine whether a conflict of interest or other pre-existing relationship exists between a corporation and the officers and directors of the other.

Personnel Issues

Personnel Policies and Records

Review the personnel policies for employee rights and benefits. Review employment records to determine staff turnover and staff disciplinary problems, job descriptions and duties, current rate of compensation, and compliance with immigration and tax laws (completion of Forms I-9, W-4, etc.).

Also, review personnel-related tax filings for the past three years to verify corporate compliance, including federal and state income tax withholding and transmittal, social security (FICA) withholding and transmittal of both the employer and employee portion, proper treatment of employees as employees and not independent contractors, proper distribution of Forms W-2 and 1099, and proper accounting for other payroll deductions (such as state-required employee-pay disability insurance).

Benefit Policies

Review the corporation's unemployment rate and workers compensation rates and policies, and verify that payments are current. Review employee benefit programs such as health, life, retirement, and disability, including cost and amount paid by the employer and employee.

Project and Property Status

Annual Reports For Past Three Years. Review the description of the corporation's major activities and accomplishments, its funding sources, and its future plans, and compare with the other information gathered about the corporation.

Business License and Other Government Permits and Licenses

Review that all required licenses, approvals, accreditations, and authorizations from all appropriate government agencies have been obtained and are current. Request an opinion of the corporation's counsel that it is in compliance with all government laws, rules, and regulations. Review the status of corporate copyrights, trademarks, or other intellectual property rights. If needed, confirm the transferability of all licenses, approvals, etc., or become licensed prior to the effective date of the transaction.

Grant Agreements, Loans, and Reports To Funders or Lenders

Review all current grants and loans for limitations or restrictions on future activities or actions that require third party approval. Review reports to determine whether the corporation is meeting the requirements of the grant or loan. Request a statement from each funder or lender that the corporation is in compliance with all terms of its grant or loan.

Alternatively, request an opinion of the corporation's counsel that it is in compliance with the terms of all agreements by which it is bound or to which any of its property is subject, and that the contemplated transaction will not result in a breach or violation of or conflict with any of the terms or provisions of any agreement of any kind to which the corporation is a party or by which it is bound.

Contracts and Other Agreements

Review accounting services and other agreements to determine the duration and terms of the corporation's obligations. Request a statement that all payments due from the corporation have been made.

Property Records

Review all leases in which the corporation is a lessor or lessee. For each property in which the corporation is a lessor, contact each tenant and verify the most recent date of payment, the amount held on deposit by the corporation, and the date of the most recent lease amendment. For each property in which the corporation is a lessee, contact the landlord and verify that the corporation is not in default, the amount of the corporation's deposit, and the date of the most recent lease amendment.

Obtain a report on each property owned by the corporation, including outstanding indebtedness secured by the property, the nature of any easements or zoning or other restrictions on the use of the property, and potential environmental or other hazards on or near the property.

Determine whether the corporation has filed for and is in compliance with all requirements of a property tax exemption on each property it owns, or that it has timely filed and paid real and personal property taxes.

Determine whether third parties have an option to acquire any corporate property, or whether the corporation has an option to acquire property.

Partnership Agreements

Review the corporation's rights and responsibilities under any partnership, joint venture, or similar agreement.

Past or Potential Future Claims or Lawsuits

In addition to the officer certificates, written statements from third parties such as lenders and tenants, and legal opinions described above, obtain satisfactory verification that

Lawsuits

No action, suit, proceeding, or claim of any kind is pending or threatened before any court, arbitration panel, or governmental or administrative body or agency, by or against the corporation, except as disclosed by the corporation in writing.

Defaults

The corporation is not in default with respect to any judgment, writ, injunction, or decree of any court, arbitration panel, or any governmental or administrative body or agency.

Taxes

No assessment of tax, interest, or penalties are proposed against the corporation, and no tax returns of the corporation are currently being audited, and the corporation has not received any notice of any such audit.

Effect of Combination

The contemplated combination will not violate any statute or regulation, or order of any court, arbitration panel, or governmental or administrative body or agency; and no consent, approval, or authorization by, or notice to or filing with, any governmental or administrative body or agency is required, except as disclosed by the corporation in writing.

Conclusion

Consider carefully a decision to merge, affiliate, or otherwise combine with another organization. Evaluate the compatibility of mission and managerial styles. Look for problems that could outweigh the benefits of the combination, such as loss of funder support, or community hostility or controversy. Create a written record to document that all appropriate issues have been considered. Determine how and when the public should be told, and what and when to tell staff, especially when layoffs or reorganizations are involved.

As difficult and time consuming as this process may seem, community-based organizations may have little choice but to consider a merger, consolidation or affiliation with other organizations. An attorney is essential to spotting conflicts of interest and other potential troubles, protecting the corporation's interests during the process, preserving the corporation's title to property, and paving the way for a smooth transition.