

Four Steps to a Merger

Is a merger right for your organization? Consider these four steps to decide if it's time to move forward.

By Christopher R. Vaccaro

Mergers offer an excellent way to expand your services, lower administrative expenses, and obtain access to new funding sources. However, pursuing these transactions without heeding potential difficulties can weaken, rather than improve, your ability to serve your stakeholders. Success requires keeping the big picture in mind while paying attention to details.

Mergers entail a four-step process:

STEP ONE: CONSIDERATION

Before undertaking a merger, answer a basic question: Why should we do this? The answer requires deep inquiry about how the transaction will further your mission and serve the needs and expectations of your stakeholders.

A merger can be beneficial if it lets you reduce administrative expenses and redirect resources to your services. For example, it's less expensive to pay an accounting firm to audit a single organization than for two separate nonprofits to perform two separate audits. Also, the merged organization can offer new areas of expertise, expanded services, talented employees, and access to new funding sources. A merger can also eliminate a competitor.

Before proceeding, consider other options to achieving your goals. For instance, if you can develop new areas of expertise or funding sources in-house, or hire the right team of new employees, a merger may be unnecessary.

If you decide that a merger is in your organization's best interests, you need to identify an appropriate merger partner. Look for candidates that offer a synergy with your organization and provide services similar to yours. The organizations' cultures should be compatible. Most important, your candidate must be amenable to merging.

In evaluating a potential candidate, look for obvious red flags that weigh against the merger, such as debt problems, litigation, hostility from major stakeholders or funding sources, deferred capital investments, conflicts of interest involving officers or directors, regulatory problems, and cultural differences. The importance of compatible cultural values cannot be overstated, and failure to consider this intangible can destroy trust and invite disaster. Examining a nonprofit's culture is highly subjective, but it becomes easier if the leadership teams of the two organizations already have some familiarity with each other.

Before you can seriously consider a merger, you must look inward and examine your charter, mission, and strategic plan. Your charter is the document originally filed with the secretary of state. It should state your charitable purpose. If the other organization's purposes are inconsistent with or outside the scope of your purpose, don't pursue the merger further.

Similarly, review your mission (stated goals) and strategic plan (the roadmap to pursuing those goals). If the proposed merger doesn't support these documents, it's best not to go forward.

To make sure that the merger is structured to avoid legal and financial problems, answer these questions:

- **Will the transaction jeopardize** your tax-exempt status?
- **What governmental agencies**, such as the attorney general's office, must approve the merger?
- **If your organization was created** under a charitable trust or holds property by gift or bequest, are there any restrictions tied into the trust, gift, or will that may impede the merger?
- **Is your organization bound by contractual obligations** to officers or directors that may present a conflict of interest?

STEP TWO: NEGOTIATION

After you identify a desirable partner for a merger, you must negotiate terms with the other organization. Outline the acceptable terms in a letter of intent or memorandum of understanding. This document won't necessarily be a binding contract, but it's an important memorialization of how both nonprofits are expected to proceed.

The letter of intent lays out the structure of the transaction and determines if it will be a merger, consolidation, or asset purchase. It establishes a time frame for the completion of the necessary tasks. The letter of intent will allow you to review the other nonprofit's operations and finances so that you can find out whether there are any financial, regulatory, or other problems that make the transaction undesirable. The amount of time for this review will vary from transaction to transaction. For large nonprofits several months will be appropriate. If the review reveals insurmountable problems, be ready to terminate the transaction.

The letter of intent should do the following:

- **List any conditions** that need to be satisfied before the merger can proceed to closing, such as obtaining approvals from the nonprofits' members or board of directors, regulatory agencies, and lenders.
- **Note whether the transaction is conditioned** upon the extension or renewal of any contracts (including employment contracts with key employees), leases, or grants.
- **Include exclusivity and confidentiality** clauses. The former protects you from spending time and resources on due diligence while the target nonprofit quietly entertains other suitors. The latter reduces the risk of adverse publicity and gossip that can harm both organizations.

STEP THREE: INVESTIGATION

The investigation phase is critical to a successful transaction. First, assemble a team of professionals to perform the investigations, and assign responsibilities to them. The team will usually include at least one attorney and an accountant. These professionals should be familiar with the regulatory and financial environments in which

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both nonprofits operate. Consult with your board of directors, bank officer, and major funding sources early in the process, so those individuals are aware of the undertaking.

There are several areas of inquiry for the due diligence team:


- **Confirm that the nonprofit being acquired** has necessary licenses and permits, and that the licenses and permits will remain in effect after the transaction is completed.
- **Obtain approval** by the required governmental agencies.
- **Examine both nonprofits’** bank loan agreements. If these loan agreements prohibit a merger (as is often the case), secure the lenders’ consent before proceeding.
- **Make sure that the transaction** won’t adversely affect any financial covenants imposed by your organization’s lenders.
- **Review the target nonprofit’s** charter and bylaws, and confirm that the target nonprofit has maintained its tax-exempt status.
- **Find out if the other nonprofit is involved** in any significant litigation.
- **Examine and summarize** financial statements, tax returns (IRS Form 990s), audit reports, and major contracts and leases.
- **Scrutinize the terms and conditions** of all major gifts and requests to make sure that these resources will continue to be available after the transaction closes.
- **Identify key employees** of the other nonprofit, and confirm that their services will be retained after the merger.
- **Arrange for an inspection** of the other nonprofit’s buildings, improvements, and equipment.

STEP FOUR: IMPLEMENTATION

Implementing the transaction requires proper documentation. You’ll need to enter into a merger agreement and file articles of merger with the secretary of state. The transaction may also require consents from other government agencies, such as the state attorney general’s office. For an acquisition, there will be an asset purchase agreement between the nonprofits. You will need bills of sale to obtain ownership of personal property and deeds to the

real property being acquired. Again, approval from governmental agencies will likely be needed.

The merger will require appropriate votes of the nonprofits’ members and boards of directors. You should obtain a legal opinion from an attorney, confirming that the transaction is properly authorized and doesn’t violate any applicable laws or contracts. Be sure you have employment contracts in place with key employees, whose expertise will be necessary to implement a successful merger.

The paperwork described above is time-consuming and challenging, but it’s only the beginning. The hardest work lies ahead. While the transaction may be closed on paper, with legal documents signed and exchanged, and government and lender approvals secured, you still must assimilate the other nonprofit’s managers, employees, and stakeholders. The success of this most important phase of the transaction requires wise leadership, competent and dedicated employees, and a skilled human resources department. The task becomes more manageable if you keep in mind the guiding principles of your mission and strategic plan. 

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The Four Steps: A Quick Review

1. **Consider:** Decide whether a merger is in your organization’s best interests, and identify a desirable partner.
2. **Negotiate:** Determine the terms and conditions of the transaction.
3. **Investigate:** Scrutinize financial and legal matters to assure that the merger strengthens both organizations.
4. **Implement:** Complete the merger, a process that can take years to finalize.