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October 15, 2013

Combinations and Alliances among Nonprofit Organizations

There is a wide array of ways in which nonprofit organizations can combine, affiliate, or otherwise come together. Some involve a complete integration of programs, activities, membership, donors, volunteer leadership, and staff, while some provide for maintaining varying degrees of separateness and autonomy. There are pros, cons, and considerations to take into account for each option. And sometimes one option can be a stepping stone to a fuller combination. Often the decisions are based on legal, tax, or economic concerns, sometimes power and politics will dominate the decision-making process, and usually it is a combination of all of these factors.

This article lays out some of the primary means by which nonprofit organizations frequently combine, affiliate, and otherwise come together in various ways. It explains what they each mean, and also highlights some of the primary considerations that come into play with each option.

I. Merger and Consolidation

A. General

Nonprofit corporations can fully and completely integrate their programs, functions, and membership by merging or consolidating. When two nonprofit entities *merge*, one entity legally becomes part of the surviving entity and dissolves. The surviving corporation takes title to all of the assets and assumes all of the liabilities, of the non-surviving entity.

Unlike a merger, a *consolidation* of nonprofit entities involves the dissolution of each of the organizations involved, and the creation of an entirely new nonprofit corporation that takes on the programs, resources, and membership of the former entities. Although the net effect of a merger and consolidation are the same – one surviving entity with all the assets and liabilities of the two previous groups – many organizations prefer consolidation over merger because it tends to lend the perception that no organization has an advantage over the other. There is a new corporation which houses the activities of the two and each is dissolved pursuant to the consolidation.

B. Benefits of Merger or Consolidation

Merger or consolidation of entities with similar exempt purposes may offer a number of benefits to the participating organizations and their members. By merging or consolidating, organizations may combine their assets, reduce costs by eliminating redundant administrative processes, and provide enhanced, broader, or improved services and resources to the industry, profession, or cause that they represent. Furthermore, for membership organizations, members who paid dues and fees to participate in the formerly separate organizations are often able to reduce their membership dues and the costs and time demands of participation by joining a single, combined organization. Finally, merger or consolidation may allow nonprofits participating within the same field or industry to offer a wider array of educational programming, publications, advocacy, and other services to a larger constituency.

C. The Divisional Approach

The fact that two organizations have become a unified legal entity does not prohibit them from continuing with some measure of autonomy within the new corporation. Councils or divisions could be established to promote and protect the unique interests of the industry subsets. Under this approach, the organization’s bylaws can cede certain distinct areas of authority to these subordinate bodies. Balancing these levels of authority, finances, and management can be challenging, but the model is frequently used.

D. Other Considerations

The law imposes stringent fiduciary responsibilities on the members of an organization’s governing body to ensure that any merger or consolidation is warranted and in the best interests of the organization. Directors and officers may be held personally and individually liable if they fail to act prudently and with due diligence. Due diligence generally requires an organization's governing body to ascertain the financial and legal condition of the organization with which the entity will be merged or consolidated. This includes examination of the other entity's books and records, governing documents, meeting minutes, pending claims, employment practices, contracts, leases, and insurance policies, and investigation into potentially significant financial obligations, such as the funding of retirement programs, binding commitments to suppliers, and the security of investment vehicles. Boards of directors often utilize accountants and attorneys to conduct due diligence reviews. The opinions of such experts may be relied upon when evaluating a plan of merger, provided that the board of directors establishes a full and accurate financial and legal profile of the other organization before approving the merger or consolidation.

In addition to conducting routine due diligence reviews, an organization's board of directors should have legal counsel review the impact of a proposed merger or consolidation on competition within the industry. Federal antitrust laws prohibit mergers or consolidations that may substantially lessen competition in any line of commerce. The U.S. Department of Justice, Federal Trade Commission, state attorneys general, and private plaintiffs may scrutinize any transaction that could lead to price fixing, bid rigging, customer allocation, boycotts, or other anticompetitive practices. That said, mergers and consolidations of nonprofit organizations typically do not pose an anticompetitive threat. If it can be shown that the joining of the two organizations will actually promote competition, there will be very little antitrust risk overall.

As described in more detail below, merger and consolidation are complex processes, which require the approval of the boards of directors and membership, if any, of each organization. As a practical matter, it can be difficult to combine and coordinate the governing bodies, staffs, and operations of two or more existing organizations. Additionally, the institutional loyalties of members, officers, and professional staffs often come into play, particularly when the organizations considering merger or consolidation are unequal in size and resources.

E. Procedural Requirements

To merge or consolidate with another organization, each organization must follow the procedures mandated under the nonprofit corporation law of its state of incorporation, as well as any specific procedures in its governing documents, provided such procedures are consistent with the nonprofit corporation statute.

While nonprofit corporation statutes differ by state, the laws governing merger and consolidation of nonprofits typically set forth certain core procedures. The board of directors of each precursor organization must develop and approve a plan of merger or consolidation according to the requirements set forth in the nonprofit corporation statute of the state, or states, where the organizations are incorporated. Typically, the details of the deal between the two organizations are set forth in a "Merger Agreement" that is not required to be filed. This document usually covers items such as integration of the staff and voluntary leadership, corporate governance changes, and programmatic consolidation. It often is quite detailed.

The plan of merger or consolidation also must be submitted to the voting members, if any, of each organization for their approval. While the conditions for member approval vary from state to state, statutes generally require a vote of two-thirds to effectuate the plan merger or consolidation – a number that can be difficult to reach for practical and political reasons. Assuming the members of *both* organizations approve the board's plan, "articles of merger" must be filed in the state where the new entity will be formally incorporated.

Where merging nonprofits are each tax-exempt under different tax classifications (e.g., a 501(c)(3) and a 501(c)(6)), the resulting merged entity will generally need to file a new application for federal tax exemption with the Internal Revenue Service ("IRS"). Likewise, a new, consolidated entity must apply to the IRS for recognition of tax-exempt status. On the other hand, where merging entities share the same tax-exempt classification, the tax-exempt status of the surviving organization is typically not affected. Instead, following the merger, all parties to the transaction must notify the IRS of the merger and provide supporting legal documentation. If the newly merged entity will carry out substantially the same activities as its predecessors, the IRS will typically grant expedited approval on a *pro forma* basis and there will be no lapse in the tax-exempt status.

II. Acquisition of a Dissolving Corporation's Assets

A. General

Another legal mechanism for "absorption" is the *dissolution and distribution of assets* of a target organization. This statutory procedure generally involves the adoption of a plan of dissolution and distribution of assets, satisfaction of outstanding liabilities, transfer of any remaining assets to another nonprofit entity, and dissolution. Where the dissolving nonprofit is exempt from federal income taxation under Internal Revenue Code Section 501(c)(3), the dissolving organization is required to distribute its assets for one or more tax-exempt purposes under Code Section 501(c)(3).

B. Benefits and Other Considerations

While the dissolving entity must adhere to specific statutory procedures, dissolution and transfer of assets is much less onerous on the entity that acquires the dissolving entity's assets (the "successor" entity) than a merger or consolidation. Because the successor entity is merely absorbing the assets of another organization, a vote of the membership and accompanying state filings are typically not required for that corporation. Furthermore, receipt of a dissolving nonprofit corporation's assets typically does not affect an organization's tax-exempt status. However, just as with merger or consolidation, a tax-exempt organization must be cautious when taking on programs or activities to ensure that they support its stated tax-exempt purposes.

Asset transfer and dissolution may be strategically preferable for combining organizations when one organization is of a much smaller size than the other. In addition, this type of transaction is particularly useful when an organization wishes to acquire the assets of another organization with significant future contingent liabilities, because the successor organization does not, by operation of law, assume the liabilities of the dissolving corporation. Further, the successor organization may seek to limit the liabilities it will assume in a written agreement, as discussed below.

While a successor organization is typically shielded from its predecessor's debts and liabilities, an asset transfer always poses some risk of *successor liability*, particularly if adequate provision has not been made for pre-existing liabilities. A court may determine that an organization that acquired the assets of a dissolved corporation impliedly agreed to assume the dissolved corporation's liabilities. Alternatively, a court may find that the successor corporation serves as a "mere continuation" of the dissolved corporation, that the asset transfer amounts to a *de facto* merger, or that the transaction was actually a fraudulent attempt to escape liability. It is also often problematic to extinguish liabilities, such as employee benefit programs, rather than assuming them.

C. Procedural Requirements

Like a merger or consolidation, an asset transfer and dissolution must follow the applicable state nonprofit corporation laws and each entity's governing documents. The procedure for dissolution and asset distribution is fairly simple for the successor entity, as it will simply be entering into a transaction – albeit a significant one – to acquire assets and absorb members, if any. Member approval for such a transaction is typically unnecessary unless the organization's bylaws require otherwise. The due diligence requirements imposed on the successor entity are also less stringent. Nevertheless, the governing body of the successor corporation should conduct a due diligence review of the dissolving corporation as a matter of course, particularly if the acquisition of the dissolving organization's assets will significantly alter the nature of the successor organization's operations.

The process is more complicated, however, for the dissolving entity. In most instances, the nonprofit corporation statute of the dissolving entity's state of incorporation imposes the following requirements to effectuate a transfer and dissolution:

- The governing body of the dissolving corporation is obligated to exercise the same level of due diligence as in a proposed merger or consolidation, as discussed above.
- After the governing body of the dissolving corporation has determined that dissolution and transfer of its assets are in the best interests of the organization, it must develop and approve a "plan of dissolution" (or "plan of distribution" according to some states). The number of directors that must vote to accept the plan varies by state.
- If the dissolving corporation has members, it must obtain member approval of the dissolution plan. Again, the requisite margin of member approval varies from state to state; most states require a two-thirds majority.
- The dissolving corporation must file "articles of dissolution" with the state in which it is incorporated. States typically accept articles of dissolution only after all remaining debts and liabilities of the dissolving entity are satisfied or provisions for satisfying such debts have been made.
- As part of the plan of dissolution, the dissolving corporation will transfer all of its remaining assets to a designated corporation.

- Once the plan of dissolution is executed, the dissolving entity is generally prohibited from carrying on any further business activity, except as is necessary to wind up its affairs or respond to civil, criminal, or administrative investigation.

As part of the asset distribution process, the parties typically execute a written agreement detailing their understanding of the transfer of the dissolving corporation's assets. The parties may utilize such an agreement where they wish to obtain warranties regarding the absence of liabilities to be assumed by the successor corporation; account for any outstanding contractual obligations of the dissolving entity; provide for third-party consents where necessary to transfer any contractual obligations to the successor organization; or detail terms for the integration of the dissolving entity's members. Note that in the event of any breach of warranties by the dissolving corporation, it generally will not be possible for the successor corporation to obtain redress unless the agreement specifically obligates some third party to indemnify the successor corporation, as the dissolving corporation will no longer exist.

III. Federation

A. General

A federation is generally an association of nonprofit associations. Federations are most often structured along regional lines (*e.g.*, a national nonprofit association whose members are state or local nonprofit associations). In some cases, a federation consists of special interest groups that represent discrete segments of the industry represented by the" umbrella" association. The national or umbrella association's relationship with its affiliated associations is governed by formal affiliation agreements.

An affiliation agreement is a binding contract that sets forth the nature of the relationship between the parties. Most affiliation agreements include provisions that address the following: term and termination of the relationship; use of the organization's intellectual property; the provision of management services; treatment of confidential information; coordinated activities; and tax and/or financial issues, among other provisions. Where an affiliated association fails to adhere to the terms of its affiliation agreement with the national association, the affiliate could lose privileges (*e.g.*, loss of ability to use the association's intellectual property), become disaffiliated, or suffer some other penalty. Similarly, where a national association violates the terms of an affiliation agreement with its affiliate, it may be liable for such breach.

B. Benefits and Other Considerations

In the federation context, the national association is, for tax and liability purposes, a separate legal entity from its affiliated associations. There are instances, however, in which the separateness between two entities (even though each entity may have separate corporate and tax statuses) will be disregarded by a court or the IRS, thus creating exposure to potential legal and tax liability to both entities. Specifically, the separateness can be disregarded where the national association so controls the affairs of its affiliates, rendering it a "merely an instrumentality" of the national association.

There are two primary areas of concern for national associations that are governed by a federated structure. First and foremost, because the national association is primarily (if not completely) comprised of other associations, the income and membership of the national is generally controlled by its affiliates. Without control over these two vital areas, the national association could be susceptible to secession by an affiliate (resulting in attendant loss of income), or have its power and authority undermined by an affiliate. Second, the federated structure could cause legal or policy problems if factionalism among affiliated associations arose. Additionally, the federated structure lends itself to diluted membership loyalty toward the national association.

C. Procedural Requirements

Preliminarily, all steps must be taken to form the national association in accordance with applicable state nonprofit corporation laws. Generally, this requires a minimum of filing articles of incorporation, selecting an initial board of directors, and developing bylaws for the association. Once the association is formed, it must apply to the IRS for recognition of tax-exempt status.

After formation, the national organization must execute detailed affiliation agreements with each of its affiliated organizations. There are generally no statutory requirements mandating the exercise of due diligence by any entity that chooses to enter into an affiliation agreement. Rather, the relationship is generally governed by the terms of the affiliation agreement and the general principles of contract law.

IV. Management Company Model

Nonprofit organizations with similar interests can affiliate through a common management structure, whereby the groups would realize the efficiencies of coordinated "back office" operations such as accounting, meeting management, IT, human resources, and other supportive functions, possibly through the ownership of the nonprofits by a for-profit umbrella organization. Although there are mechanisms that could be used to effect the coordinated operations that many organizations seek, the idea of for-profit corporate "ownership" is problematic for several reasons, most notably tax law inhibitions on private inurement from a tax-exempt entity and state corporate law restrictions.

Some for-profit entities – association management companies ("AMCs") – manage the day-to-day business of numerous nonprofit organizations. The models vary depending on the resources and needs of the nonprofits, but in almost all settings the AMCs provide the finance and accounting, meeting planning, correspondence, communications, staffing, and office requirements. In some cases, the nonprofit will have a separate office identity, including signage and limited access, while in others there will be common nonprofit offices with shared employees. Employees are formally employed by the AMC, but, at least in part, report to the boards of the nonprofit organizations.

One critical aspect of this organizational model is that the AMC does not have an ownership interest in the nonprofit organizations. AMCs operate under management agreements that typically can be terminated with relatively short notice or at the conclusion of a stated term. The contractual arrangements are based on arm's-length compensation, depending on the services provided.

The advantage of this model is the professionalism that an AMC can provide, particularly to nonprofit that have limited means. On the other hand, there is a lack of permanency. A nonprofit generally can fairly easily terminate its management company agreement and move on to a different AMC or hire its own employee(s) directly. In contrast, a merged or consolidated group has the solemnity of a corporate transformation which cannot be easily unraveled.

V. Other Types of Strategic Alliances

Merger, consolidation, acquisitions, and the creation of a federation involve a substantial level of commitment – but organizations need not go so far in order to engage in alliances with one another. Nonprofit organizations may enter into other strategic alliances that are temporary or permanent, and allow both entities to “test the waters” before binding themselves to a more involved or permanent arrangement.

A. Partial Asset Purchase or Transfer

A lesser alternative to dissolution and transfer of all of a nonprofit’s assets is a limited asset purchase or transfer from one entity to another. In general, an asset purchase may be advantageous where one nonprofit entity wishes to acquire a discrete property, activity, program, or business unit of another. The directors of both organizations owe their members a significant level of due diligence prior to finalizing the deal, but, unless required under the organization’s governing documents, partial asset transfers typically do not require the approval of an organization’s membership. The transfer is executed pursuant to a written asset purchase agreement between the parties.

This approach has an obvious negative for the ceding organization in terms of prestige and justification for the hand-off.

B. Joint Venture

In a joint venture, two or more nonprofit organizations lend their efforts, assets, and expertise in order to carry out a common purpose. The organizations involved may develop a new entity (such as a limited liability company or a partnership) to carry out the endeavor. Such new entity may receive tax-exempt status if it is organized and operated for exempt purposes. Generally, however, organizations commit certain resources to a joint venture without forming a new entity. A well-structured joint venture is codified in a written agreement that details the precise obligations and allocation of risk between the organizations involved. Joint ventures can be permanent, set to expire on a given date or after the accomplishment of a certain goal, or structured with an increasingly overlapping set of commitments and an eye towards an eventual merger. Although the bylaws of an organization might specify otherwise, joint ventures do not usually require the approval of the general membership.

In a *whole joint venture*, one or more of the partnering entities contribute all of their assets to the enterprise. Nonprofits commonly engage in *ancillary joint ventures* with other organizations. Ancillary joint ventures are essentially small-scale joint ventures – enterprises that do not become the primary purpose of the organizations involved which are often for a limited duration. Tax-exempt organizations seeking additional sources of revenue may also enter into ancillary joint ventures with for-profit corporations, provided that the joint venture furthers the tax-exempt organization’s purposes, and the tax-exempt organization retains ultimate control over, at a minimum, the exempt purposes of the joint undertaking.

C. Joint Membership Programs

Joint membership programs generally allow individuals to join two organizations for a reduced fee. These initiatives allow the members of one organization to become more familiar with another, and are typically conducted in the context of other jointly run programs and activities. Programs in this vein are designed to bring organizations closer together, often as a precursor to a more formal alliance, but allow the entities to modify the arrangement or disengage altogether if circumstances or expectations change.

VI. General Tax Issues

Tax-exempt organizations that choose to become affiliated with other taxable or tax-exempt entities must be mindful of certain legal requirements in order to ensure that the affiliation does not jeopardize the organization's tax-exempt status. This section discusses three key tax-related concepts that organizations must consider prior to affiliating with another entity: unrelated business income tax, control by the tax-exempt organization, and private inurement.

A. Unrelated Business Income Tax

In general, tax-exempt organizations are exempt from federal taxes on income derived from activities that are substantially related to their exempt purposes. Nevertheless, a tax-exempt organization may still be subject to unrelated business income tax ("UBIT") on income received from the conduct of a trade or business that is regularly carried on, but is not substantially related to the organization's exempt purposes.

For the purposes of determining UBIT, an activity is considered a "trade or business" if it is carried on for the production of income from the sale of goods or performance of services. Income from a passive activity – *e.g.*, an activity in which the exempt organization allows another entity to use its assets, for which the organization receives some payment – is not considered a business. The Code specifically excludes certain types of passive income – dividends, interest, annuities, royalties, certain capital gains, and rents from non-debt financed real property. UBIT also does not include income generated from volunteer labor, qualified corporate sponsorship payments, or qualified convention or trade show income.

An activity that is substantially related to an organization's tax-exempt purposes will not be subject to UBIT. A "substantially related" activity contributes directly to the accomplishment of one or more exempt purposes. Alone, the need to generate income so that the organization can accomplish other goals is not a legitimate tax-exempt purpose.

In the context of trade and professional organizations, an activity is "substantially related" if it is directed toward the improvement of its members' overall business conditions. The receipt of income from particular services performed to benefit individual members, although often helpful to their individual businesses, usually results in UBIT to the organization where those services do not improve the business conditions of the industry overall.

An organization jeopardizes its tax-exempt status if the gross revenue, net income, and/or staff time devoted to unrelated business activities is "substantial" in relation to the organization's tax-exempt purposes. Although the "substantial" criterion has not been defined by statute or by the IRS, commentators generally agree that a level of 25-30% gives rise to concern. In an effort to prevent loss of exempt status, many tax-exempt organizations choose to create one or more taxable subsidiaries in which they house unrelated business activities. Taxable subsidiaries are separate but affiliated organizations. Generally, a taxable subsidiary can enter into partnerships and involve itself in for-profit activities without risking the tax-exempt status of its parent. Moreover, the taxable subsidiary can remit the after-tax profits to its parent as tax-free dividends. It is also beneficial in some situations to immunize the organization from potential liability, by putting certain commercial activities in a separate subsidiary corporation.

B. Control

Where a nonprofit organization partners with another entity, it will continue to qualify for tax exemption only to the extent that (1) its participation furthers its exempt purposes, and (2) the arrangement permits the organization to act exclusively in furtherance of its exempt purposes. If a tax-exempt entity cedes "control" of partnership activities to a for-profit entity, the IRS will consider the partnership to serve private aims, not public interests.

In any arrangement with a for-profit entity that involves *all or substantially all* of a tax-exempt organization's assets, the IRS requires the tax-exempt organization to retain majority control over the entire undertaking – *e.g.*, majority voting control. However, where the arrangement involves only an insubstantial portion of the tax-exempt organization's assets, the IRS has approved a structure in which the for-profit and tax-exempt organizations shared management responsibilities, but left the exempt organization in control of the exempt aspects of the arrangement.

Nonprofit organizations frequently enter into short-term partnerships with for-profit corporations in order to conduct a particular activity. These ventures should not jeopardize a nonprofit's tax-exempt status in most cases – even if the nonprofit does not maintain operational control over the ventures – as such activities generally are not substantial activities of the organization.

C. Private Inurement and Private Benefit

In general, organizations recognized as tax-exempt under Code Sections 501(c)(3) and 501(c)(6) are prohibited from entering into any transaction that results in "private inurement." Private inurement occurs where a transaction between a tax-exempt organization and an "insider" – *i.e.*, someone with a close relationship with or an ability to exert substantial influence over the tax-exempt organization – results in a benefit to the insider that is greater than fair market value. A nonprofit organization's affiliate or partner may be considered an insider. The IRS closely scrutinizes arrangements between tax-exempt organizations and taxable entities to determine whether the activities contravene the prohibition on private inurement. Thus, an arrangement with a for-profit entity, such as a management company, must be entered at arm's-length and carefully reviewed to ensure that any benefits to insiders are at or below fair market value.

Code Section 501(c)(3) and 501(c)(4) organizations also are not permitted to confer impermissible private benefit on one or more individuals, entities, industries, or the like; doing so can jeopardize the organization's tax-exempt status. While a fuller discussion of the private benefit doctrine is outside of the scope of this article, it is an important consideration that needs to be taken into consideration in these kinds of transactions and arrangements.

VII. Conclusion

There is an array of possible mechanisms for combinations and alliances that nonprofits can enter into with other organizations, both nonprofit and for-profit. The selection of an appropriate structure is heavily dependent on fully identifying the goals of the transaction and the potential ramifications for both groups. While the underlying legal and tax issues are complex and nuanced, a good understanding of them is critical in order to be able to effectively weigh the pros and cons of various alternatives in this area.