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Where Do We Go From Here?

A Practical Mission-Based Approach to
Assessing and Managing Nonprofit
Mergers, Reorganizations and
Dissolutions

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OVERVIEW:

This presentation will focus on 501(c)(3) charitable organizations and be geared to lay people, not lawyers

- I. Current economic climate
- II. Unique pressures on nonprofit organizations
- III. Paradox of the sector
- IV. Stormy weather ahead
- V. The importance of Mission
- VI. The basic triad for faltering nonprofits:
 1. Reorganization
 2. Merger
 3. Dissolution
- VII. Triage



- Current economic climate
- Old news; new challenges

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- Unique pressures on nonprofits:
 - Heavily reliant upon funding with funding sources in peril
 - Fee based organizations facing shortfalls as consumers continue to reign in spending
 - Funding sources (like private foundations) have less to give and very hard decisions to make with so much need
 - More regulation (like new Form 990) and accompanying scrutiny
 - Funders are more sophisticated, more informed, and more focused on strengthening the sector
 - Municipalities have budgets stressed: homeowners already under siege; is commercial real estate next?
 - What happens to charitable organizations' property tax exemptions?
 - Some municipalities have launched aggressive campaigns to restore exempt properties to tax rolls



■ Paradox of the sector: a study of extremes

1. People are forming more non-profits in New Hampshire now than ever before.
2. Meanwhile, fewer financial resources are available:
 - a. Charitable giving is down.
 - b. Funding sources are growing scarce, particularly in New Hampshire.
 - c. Private foundations will likely be paying out less in 2009 and beyond until markets and endowments rebound.
3. The need is great, and different now.

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- In a survey of the sector, the NH Center for Nonprofits (“the Center”) estimates that the nonprofit sector comprises about fourteen and one-half percent (14.5%) of New Hampshire’s economy.^[i] Contributing most heavily to the sector and to this statistic are health care organizations, like hospitals and community mental health organizations, and human service agencies that address housing, and needs of children youth and families.^[ii]
^[i] See, *Essential, A portrait of the nonprofit sector in New Hampshire*, published by the NH Center for Nonprofits, page 3.
 - ^[ii] The Center also reports that (based upon 2004 reporting data) human service organizations comprised 35% of the New Hampshire’s charitable nonprofits with health care/mental health making up another 13%. Not surprisingly, these two subsectors accounted for nearly 50% of the sector in 2004. The Center also reports that “4,799 charitable nonprofits (not including foundations) are registered as tax exempt under 501(c)(3), but only 2,451 (51%) are required to file an annual report with the IRS because they meet the filing requirement of over \$25,000 in gross receipts.” See generally, *The New Hampshire Nonprofit Sector*, published by the NH Center for Nonprofits.



- Stormy weather ahead:

- Scarce funding

- More competition for funding

- Possible dilution of the sector due to oversaturation

- Lack of support from consumers, State government and private foundations

- Now is the time for nonprofits to pick their corporate heads up, keep them up, and get back to guiding principals

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ENTER: MISSION

A charitable organization's mission is its guide and its compass in good times and in bad.

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- Charitable organizations must function in a manner that fulfills their mission
- Charitable organizations are sometimes prevented from fulfilling their purposes/mission for financial reasons. At other times, non-economic reasons like impracticability, obsolescence and the like prevent fulfillment
- Regardless of the reason, an unfulfilled mission is a crisis for a mission-driven charitable organization
- Just as mission can be used to measure success, it is also an indispensable guide to avoid failure



Those who govern nonprofit organizations are bound by fiduciary duties to act in the best interests of the organization. This is a basic concept, but what does it really mean and what does it require of a governing board?

One may answer this question by asking a few others. Whose money is it? Whose “energy” is it? Who cares?

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- There are clearly times when the nonprofit sector in general is better served, if not strengthened, by the dissolution of certain nonprofits.^[i] However, the realization of such a macro benefit must begin at the micro level. The governing body of the nonprofit must first engage in a sober assessment of the organization's chances for survival in the short term and for true viability in the long term. To do this, at least three distinct options for addressing the organization's unfulfilled mission -- reorganization, merger, or dissolution -- must be considered, with each viewed through the prism of the organization's mission.

^[i] Nonprofits that provide redundant services and/or that inefficiently deliver services compete for resources in the sector, notably grant funding. These scarce financial resources might be better directed to stronger organizations that provide the same (or similar) services more efficiently.



THE BASIC TRIAD FOR FALTERING NONPROFITS:

- When a charitable organization lacks the means (financial or otherwise) to fulfill its mission, the organization has essentially three options:
 - 1. It can reorganize.
 - 2. It can merge.
 - 3. It can dissolve.
- In evaluating these options, care must be taken to protect the “energy” of the organization that was created and then expended in the fulfillment of its charitable mission.



REORGANIZATION

- A faltering organization must initially consider a reorganization. A reorganization may, but need not, entail a bankruptcy filing under Chapter 11 of the Bankruptcy Code. Instead, it could simply mean an overhaul of the organization's staffing, operations, funding, fundraising and governance along with a rededication to its core purposes or mission. Many nonprofits, like many business organizations, suffer from lack of leadership, ineffective board oversight, lack of vision, insufficient funding or too much debt.^[i] In many situations, nonprofits suffer as a result of any number of these things. Whether accompanied by a bankruptcy filing or not, a reorganization must be considered in the first instance. If funding permits, an expert consultant would be a wise investment to identify organizational weaknesses and potential corrective measures at the first sign of trouble in the organization and/or in the segment of the sector that the organization serves.
- ^[i] A good example of this is real estate. Real estate is expensive to own, to properly maintain and to insure. While it may be desirable, in the long-term, for an organization to own its own quarters, care should be taken not to invest the organization's assets of real estate ownership is not integrally related to the organization's fulfillment of its mission. In some cases, a municipality's revocation (or challenge) of a charitable organization's property tax exemption can have devastating financial consequences. Leaving aside the many benefits that real property ownership confers upon property owners, a contemplative governing board should ask whether **on balance** the organization has any business owning real estate and, if so, whether it can truly afford it. Can it afford to fund reserves for maintenance? Can it afford the debt service? Is the mission advanced by property ownership? Will it qualify for exemption from local property tax as a religious, educational or charitable organization? Real estate is a great builder of wealth, but it is not appropriate for every nonprofit. By contrast, nonprofits can make attractive tenants for landlords who might be willing to trade some economic upside for a stable nonprofit and cost savings could be used to build endowment or cash reserves in furtherance of the organization's mission.



- We tried to reorganize, but we're no better off. We're not a good candidate for bankruptcy. Now what?


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MERGER

- Merger is like marriage. Merger partners need to be both compatible and committed.
- While those choosing to marry usually do so to build a life together, nonprofits opting to merge should do so to perpetuate and strengthen their ability to fulfill their mission and purposes. Selection of a partner is therefore critical.
- In the usual case, a governing board will need expert assistance to identify a suitable merger partner.


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- The ideal nonprofit merger partner is an entity with a similar mission, that has a different or better way of doing it, or that fulfills its mission from a position of strength (by way of resources, “market share”, or other unique qualities).


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- If assets alone are to merge and most staff is to be jettisoned, then “cultural” differences aren’t critical.
 - If the organization is personnel intensive, then a governing board should consider the various shades of compatibility in view of cultural differences within the organization. A failed merger won’t likely help either entity.
 - Consideration of a merger or even a loose affiliation beforehand, ***at the first sign of trouble ahead***, will do more good for the organization than any expert or lawyer will do when the storm hits and the only thing scarcer than resources is morale.

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- The challenge of a merger in our state^[i] is that challenges facing one nonprofit likely face them all. More frequently than not, funding sources are similar, the population served is similar, and the regulatory climate is likely substantially the same for all. There are, however, always community leaders and organizations that serve as the vanguard of a certain segment of the sector.

^[i] While it may be desirable, and sometimes required (see RSA 7:19-b), merger partners need not be New Hampshire based entities. They should, however, have a strong presence in New Hampshire and a commitment to fulfilling a mission within the State's borders.


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- While it might be desirable to look within New Hampshire's borders first, some organizations with a regional or national presence and with a desire (or a mandate) to fulfill their mission in New Hampshire should be considered. With planning and vision, an inclusive search can be conducted to the end of identifying a suitable partner with which to consummate an effective merger.

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- In the nonprofit realm, mission is, or should be, paramount. Assets, once devoted to a particular organization's charitable mission ought – to the extent thereafter possible – to continue to be devoted to the mission in perpetuity.^[i]

^[i] Fortunately, there are various means of escape from the bondage of a faltering or a failed mission. Any of these remedies can be sought to save, in a very tangible way, the charitable energy that an organization has developed over the course of its existence. This “charitable energy” is the product of the entity's fulfillment of its mission. For hospitals and similar entities, it is generally referred to as community benefit; for individuals, it may be as simple as providing scholarship funding.

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- Until released from their charitable obligations, the trustees and directors of New Hampshire nonprofits organizations are duty-bound to act as prudent stewards of the assets entrusted to their care. To that end, the selection of a merger partner that will elevate, rather than extinguish, an organization's mission is the duty of a board contemplating a merger. To do otherwise, an organization's governing board is essentially opting for a *de facto* dissolution by orchestrating a failed merger.^[i]

^[i] There are many ways for a concerned board to perpetuate its organization's mission through a merger. The most obvious way is to select a compatible partner. Less obvious, but equally effective under proper circumstances, would be to require the acquiring entity to amend its organizational documents to reflect the merger and to honor the mission of the target. In other circumstances, seeking some representation on the acquiring entity's board to preserve some "institutional memory" might be sensible.


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- There are many ways to perpetuate an organization's mission in the context of a merger. Restrictions on assets, court orders, or amendments to organizational documents are but a few tools available. In any event, the organization's mission should be honored to the full extent possible, even if it will ultimately be carried on by another organization.

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DISSOLUTION

- If the only true option is to close the doors because there are no alternatives and/or energy left, then the organization must dissolve

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- Beneath the backdrop of advancing and perpetuating an organization's charitable mission, the primary elements to consider in any dissolution are the organization's resources, both financial and human.^[i]

^[i] Debts should also be satisfied, compromised, or discharged as circumstances permit.

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- Of secondary legal importance, but surely worthy of concern as an ethical matter, is the proper management of those persons or entities who may have come to depend upon the organization's charity.



- Simply put, the board's task is to dissolve the organization in an orderly, just and permanent way.





THOUGHTS ON ORDER

- In an ideal situation, the process of dissolution would follow weeks, months or perhaps even years of deliberation and careful board discussion.
- Employee issues would have been managed by natural attrition, loose affiliations with potential merger partners would have brought the organization to the brink of a successful merger and the delivery of programs would have been reduced substantially in anticipation of the organization's end.
- Unfortunately, that's not usually how it works, particularly with small nonprofits that don't have the resources to retain competent consultants or to attract a large, talented and diversified board with sufficient expertise to manage the windup of the corporation's affairs.



- The board is responsible for the organization's actions and destiny until dissolution. Commonly, the board will have delegated its duties to an executive officer to run the organization under its direction. If that person is effective, efforts should be made to retain that individual by a retention bonus or other incentives to retain her services throughout the wind up process.^[i] Without someone competent at the helm who knows the employees and the vendors, is there to execute the board's directives, then various board members will either need to find someone else to serve in this capacity (very challenging without the means to pay such a person) or will be doing these tasks themselves. If there was ever an apt analogy to a low budget horror film, this is it. No one will hear the screams. Even if they did, they probably wouldn't help.
- ^[i] Ironically, payment of such incentives in the midst of economic turmoil is necessary to keep talented individuals engaged and motivated. The recent AIG debacle highlighted the payment of such bonuses in the private sector. Regardless of the propriety of particular payments made in the AIG case (as to amounts or recipients), the AIG case is illustrative. It is very difficult to convince employees to stay on a sinking ship without providing them with incentives to do so. Without such incentives, employees would naturally leave to find gainful employment and to secure their futures. With proper incentives, they can feel that they have some security and order in their personal lives and thus be comfortable staying on to assist with an orderly closure. The corollary to this is, of course, that the governing board needs to time its payment of these incentives to ensure that it receives full value from the employee(s) in return.

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- Because no individual “owns” the organization’s assets, the only thing connecting the directors to the organization’s assets is their good will, fiduciary duty, and/or or fear. Unlike situations where one is protecting his or her property (and might be likely to be more aggressive to fight for what is his), there *appears* to be no chance for personal loss, unless the Attorney General’s Office becomes involved and decides to bring action.^[i]
 - ^[i] This would be a dangerous view to hold. Violations of RSA 7:19-32-a, inclusive, are unlawful and carry civil penalties of up to \$10,000.00 for each violation. See RSA 7:28-f, II (d)(2003). Worse yet, no indemnification of the officers, employees or directors of a charitable trust (which includes charitable corporations) may be indemnified by the charitable corporation (or its insurer(s)) unless a court determines that the individual acted in good faith and for the benefit of the organization. See RSA 7:28-f(II)(f). In other words, inaction will not suffice and ignorance will not prove an effective insulator from enforcement action by the Director of Charitable Trusts.

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- If the organization lacks financial resources to retain an executive officer, or to hire a short term replacement to wind up the organization's affairs, the task will legally fall to the board.^[i] If more boards truly thought this through and appreciated the scope and duration of their duties, many nonprofits would likely merge, reorganize or dissolve long before they usually do.

^[i] Resignation, while an option, is not the answer. In this speaker's view, a director's resignation in times of turmoil that harms the organization is a clear breach of duty. One would be wiser not to join a suspect board, or to resign at the first sign of trouble, than to jump ship at the last moment. Prospective board members should thoroughly examine an organization (its most recent Form 990 is a good place to begin) before agreeing to serve.



- The above makes the point that stewards of a nonprofit need to understand the organization's mission and insist that it be capable of fulfillment from the moment one agrees to serve on a board. Failing such vigilance, the organization may quickly find itself in a dizzying downward spiral from which no escape seems likely.



TRIAGE

First, call for help!

- Some practical tips for nonprofits in distress:
- Immediately contact creditors and explain the organization's situation; ideally, strive for forbearance agreements, unless bankruptcy is the decided option.
- Control and understand expenses.
- Manage personnel costs and potential labor claims. If possible and appropriate, consider severance packages for employees, conditioned upon a term of service to the organization through a date certain and in exchange for releases from claims. If that is not possible, then employees should be released and treated as well as prudently possible. [i]



TRIAGE (CONTINUED)

Prevent waste of the organization's assets. Resist the urge to mortgage the organization's real estate^[ii] or to borrow from its endowment unless absolutely necessary and entirely defensible.

- Assemble committees (from within the board or from the community at large) to manage the various tasks and draw from strengths to manage various tasks, particularly if resources are scarce.
- Expect and encourage transparency, keep careful notes and minutes, and ensure that everyone executes on assigned tasks.



TRIAGE (CONTINUED)

- Develop a timeline and an action plan.
- Remain aware of applicable annual filing deadlines for property tax exemption, if applicable, and endeavor to keep the organization eligible for such exemptions, particularly if a merger or reorganization is contemplated.
- Contact regulators.] Bear in mind that, if inclined, regulators **will** uncover the true state of the organization and how it got there. If the organization is in trouble, deal with the problem openly and honestly lest you make matters worse by obfuscation.
- The above is not an exhaustive list by any means, but threshold issues that should be considered.
- [i] Beyond the public at large, there are usually two distinct classes victimized by the closure of an effective and productive nonprofit: its employees and the beneficiaries of its mission. In the usual case, neither class will have had much (if anything) to do with the nonprofit's collapse, but the interests of both should be managed appropriately for at least two reasons. First, because the governing board has an obligation to these two classes on account of the organization's mission. Second, because failure to properly manage these classes will likely expose the organization to potential legal claims, particularly from its employees. Employees who are not treated well are more inclined to sue and/or retaliate, particularly if they have no options or if they perceive that they have no options. This again makes the point that foresight is critical and that boards need to act at the first sign of trouble. It is very difficult to manage either class without sufficient financial resources, particularly in the midst of chaos.
- [ii] In the current economic climate, lenders are unlikely to lend to an insolvent organization or one with less than bright prospects, without some additional guaranties. It is not beyond the realm of possibility for a lender to ask the board for joint and several personal guaranties before extending credit, a situation that would need to be avoided for many reasons, particularly for 501(c)(3) tax exempt organizations.
- [iii] While there may be varying views on an open approach with regulators, this speaker's experience with New Hampshire regulators has been overwhelmingly positive. In few, if any, instances will counsel-however skilled-be able to resist the inquiries of regulators determined to ferret out the cause of a nonprofit's demise and to shine the bright light of inquiry on the actions of the board. Clever legal maneuvers to delay or obscure should be carefully considered and, ideally, avoided.




THOUGHTS ON JUSTICE


- A thoughtful board will consider elements of justice in dissolution, as should its counsel. The theme of justice will echo during the board's attempt to find order and achieve completeness. Indeed, thoughts of "doing right" by the employees, the organization, the organization's stakeholders and the community at large should be considered. While the dissolution of a for-profit, privately held company is essentially a private matter, the dissolution of a nonprofit is "public" and implicates many different concerns. There is a need, perhaps even a moral imperative, to do "right" to the full extent possible. How to do right in the context of mission is highly fact specific and judgment intensive and there is no substitute for experience in this area.




THOUGHTS ON PERMANENCE AND COMPLETENESS


- The solution, once chosen, should be permanent and complete.
- As to completeness, measures should be taken to ensure that there are no lingering issues after the closure occurs. To that end, all liabilities *should* be managed and dealt with in the closure, whether by payment in full, compromise, discharge in bankruptcy or assumption by the successor/acquirer. Of course, with scarce assets and limited liability for the board (if any), the board may need to make hard choices to prioritize payments of liabilities given potential issues of managing payroll and retiring both secured and unsecured debt. In the case of a voluntary dissolution, a charitable corporation must present a plan for the distribution of its assets *and* satisfaction of its obligations.^[i]
^[i] See RSA 292:10-a, I.

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- As a matter of completeness, permanence and simple good housekeeping, articles of dissolution should be filed. With an intact board, the endeavor is relatively simple. With a board in shambles, or in the case of an absent board with the assets of the organization being managed by a court appointed receiver, or the like, the process for filing articles of dissolution becomes more difficult because of the inability to convene a meeting to obtain authority to file them.

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- Formal dissolution puts the public and regulators on notice that the organization no longer exists. This is particularly important in the case of organizations that have been qualified as tax exempt so that would-be donors don't inadvertently contribute to a non-existent entity with the expectation of receiving a tax deduction for their charity.


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- As to taxes, the organization should final a “final” return with the Internal Revenue Service thereby indicating to the IRS that its corporate existence has ended. In the unlikely event that the organization was not exempt from paying various taxes to the State of New Hampshire, it should also notify the New Hampshire Department of Revenue Administration that its existence has ended as a matter of completeness. Finally, it would be good practice to file final paperwork with the Director of Charitable Trusts (notably, copies of the documents and forms filed with the New Hampshire Secretary of State and its plan of dissolution) so that the record is clear and so that the Charitable Trusts Unit can properly list the organization’s status as closed.

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- Various regulated organizations like hospitals, nursing homes and some schools may also need to provide notice of their closure to agencies with jurisdiction over them. In some cases, organizations granted licenses by licensing authorities will need to physically surrender their licenses. The full extent of such reporting is beyond the scope of this article, but counsel should be mindful of this issue while counseling organizations to conclude their affairs.



- Given the Director's broad regulatory authority over charitable trusts, it is good practice to involve the Director in matters involving charitable trusts. As the voice of the public (the intended beneficiary) of charitable trusts, the Director has broad authority to regulate the operation of such trusts. [\[i\]](#)
- The Director has, pursuant to RSA 7:19, broad regulatory authority over charitable trusts. Beyond the specific regulatory authority granted by RSA 7:19, the Director also has certain common law powers pursuant to which the Director has the authority file petitions to remove governing boards, to suspend the authority of governing boards, and/or to see the appointment of a receiver to act in the board's stead once removed or suspended, or if it is not functioning. The Director has similar authority in the case of charitable trusts to seek the appointment of a special trustee if circumstances so warrant. [\[ii\]](#) Trustee, board members, and their counsel should be aware of the Director's broad authority, particularly when contemplating a merger or dissolution. In the usual case, the Director will learn of mishaps with charitable trusts upon (i) a public complaint; (ii) review of annual filings, or; (iii) from whistleblowers or press inquiries and will always be in a position to conduct a complete investigation. Hence, there is little to be gained by not contacting the Director's office at the first sign of trouble. One way or another, the Director will become involved if trouble comes. Moreover, beyond its regulatory role, the Charitable Trusts Units can be a very good source of information and assistance for a faltering charitable organization.

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- Health Care Charitable Trusts are a subset of charitable trusts that operate under different pressures and serve unique needs.^[i] Given the broad community needs met by health care charitable trusts, acquisition transactions^[ii] involving such trusts are subject to a different statutory scheme set forth in RSA 7:19-b. That statute establishes certain minimum standards applicable to the governing board. In broad terms, the statute requires, as a prerequisite to entering into an “acquisition transaction”, that a health care charitable trust’s governing body: (i) act in good faith; (ii) in a manner consistent with its fiduciary duties to the health care charitable trust, and (iii) while meeting seven enumerated minimum standards. Items (i) and (ii) impose a statutory obligation on such an entity’s governing board to act in accordance with established common law principles.^[iii] These trusts include nonprofit hospitals, community health centers, visiting nurses organizations and other entities that provide direct healthcare services to patients.^[ii] See generally, Fahey, Todd C., Transforming a Nonprofit Healthcare Entity: New Hampshire’s Cy Pres Doctrine and RSA 7:19-b, New Hampshire Bar Journal, March, 2003.
 - ^[iii] An “acquisition transaction” is defined in part as a “transfer of control, direct or indirect, of a health care charitable trust, or of 25 percent or more of the assets thereof, including, but not limited to, purchases, mergers, leases, gifts, consolidations, exchanges, joint ventures, or other transactions involving transfer of control or of 25 percent or more of assets.” RSA 7:19-b, 1(a).
 - ^[iii] For instance, in accordance with its fiduciary duties and consistent with the charitable trust’s organizational documents, etc.




LET MISSION BE YOUR GUIDE

TAKE ADVANTAGE OF THESE TIMES

**KEEP YOUR ORGANIZATION FOCUSED
AND AWARE**

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- [1] Attorney Fahey is a director and shareholder at Orr & Reno, P.A. in Concord, New Hampshire where he focuses on the representation of nonprofit and tax exempt entities. He has a particular interest, and unique experience, counseling New Hampshire nonprofits in distress and in transition.
 - This presentation is a condensed version of a more in-depth article on the same subject available at www.orr-reno.com or from Attorney Fahey at tfahey@orr-reno.com, direct dial (603) 223-9144.

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Mark your Calendars!

- **Tuesday, December 15** **Dealing with a Financially Distressed Client**
Learn about the basic issues and risks related to doing business with an insolvent or bankrupt client. Presented by Attorneys Justin M. Boothby and Todd C. Fahey
- **Tuesday, January 26** **Employment Issues**
Get updated on employment law hot topics and employment-related immigration issues. Presented by Attorney Steven L. Winer
- **Tuesday, March 16** **Zoning & Planning: Concord NH Style**
Concord has one of the most complex zoning ordinances in New Hampshire. Coupled with regulations, on-site plans and subdivisions, planning a project in this area can appear to be formidable. Tips on development projects in Concord will be the focus of this presentation. Presented by Attorney Richard Y. Uchida
- **Tuesday, April 20** **Basic Estate Planning**
This workshop will cover avoiding probate with trusts and the importance of medical powers of attorney. Presented by Attorney Vera B. Buck
- **Tuesday, May 18** **The Basics of Business Succession Planning**
Learn about moving assets from the senior generation to the next generation in a tax efficient manner, while preserving family relationships and the business. Presented by Attorneys Peter F. Burger and Vera B. Buck