

## **Understanding Nonprofit Mergers and Acquisitions: A Primer** **By J. Eric Smith, Copyright 2009**

“Merger-mania” has come to be a prominent defining characteristic of the nonprofit community in the first decade of the 21st Century, and a growing level of organizational consolidation provides strong evidence that a wide-spread restructuring of the nonprofit sector is underway. A paper commissioned by the Amherst H. Wilder Foundation in 2000, and based on a review of dozens of actual mergers by management consultant David La Piana, notes that three factors drive virtually all nonprofit mergers:

- A desire to improve finances (e.g. fending off financial collapse, improving cash flow, gaining access to another organizations’ investments, etc.);
- A desire to gain access to a larger skill set (e.g. obtaining outstanding or specialized staff, expanding geographic limits, expanding programming, etc.);
- A desire to enhance the organization’s pursuit of mission (e.g. reducing service confusion and fragmentation by creating a single entity, etc.).<sup>1</sup>

Of course, many of the mergers initiated in pursuit of these three objectives end in failure. So how would a nonprofit Board determine that its organization was a viable candidate for a merger, rather than simply hastening its own demise by seeking to enter into one? A study undertaken by the Bridgespan Group evaluated over 3,300 nonprofit merger filings over an 11-year period in four states, and identified three market characteristics that are favorable to successful nonprofit merger activity:

- There are a large number of nonprofits in the market, with many small players;
- There is a high degree of competitive pressure, with variable performance factors that are measurable, and impersonal funding sources;
- There are barriers to organic growth, including asset intensive missions, saturated markets and highly regulated environments.<sup>2</sup>

In a white paper entitled “Legal Considerations for Nonprofits Considering Collaboration, Alliances, Joint Ventures and Mergers,” Community Legal Resources describes four broad ways in which organizational consolidation can be accomplished:<sup>3</sup>

- **Collaboration:** Preserving the greatest degree of autonomy by formally agreeing to work with other organizations, largely within the current scope of each organization’s bylaws and mission.

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<sup>1</sup> La Piana, David. “Nonprofit Mergers: Is Your Organization Ready for the Road?” *The Nonprofit Mergers Workbook: The Leader’s Guide to Considering, Negotiating, and Executing a Merger*, Amherst H. Wilder Foundation, 2000.

<sup>2</sup> Cortez, Alexander, William Foster and Katie Smith Milway. “Nonprofit M&A: More Than a Tool for Tough Times.” The Bridgespan Group, February 2009.

<sup>3</sup> “Legal Considerations for Nonprofits Considering Collaboration, Alliances, Joint Ventures and Mergers,” Community Legal Resources, 2006.

- **Alliances:** Preserving some autonomy by entering into a formal commitment to share or transfer decision-making power within existing governance structures, with minimal changes to mission statements and bylaws.
- **Joint Ventures:** Moving from less autonomy to more integration, a Joint Venture requires the formation of a new corporate entity to oversee a formal partnership between one or more other organizations. The new corporation would have its own independent Board of Directors, which would likely siphon off members of the constituent organization's Boards.
- **Mergers and Acquisitions:** In a merger or acquisition, only one of the two (or more) collaborating entities survives. Mergers typically result when relatively equal partners join together to form a new entity, while acquisitions result when one partner has significantly greater assets or other negotiating tools at its disposal.

Regarding mergers and acquisitions, Peter Goldberg of Families International and the Alliance for Children and Families recently wrote an article for *The Chronicle of Philanthropy* that stressed the importance of semantic accuracy in dealing with such draconian measures. "Mergers are very different than acquisitions. Nonprofit leaders are not comfortable with the term 'acquisition.' Perhaps that is because we do not know how to value or set a price for a nonprofit acquisition," Goldberg explained. "Regardless, this inability to call an acquisition an acquisition leads to false and unreasonable expectations about governance, decision making, and sometimes identity and culture in the period after an acquisition has been approved and is being put into place. It never ceases to amaze me when the chief executive of a relatively large organization confides in me about secret 'merger' talks he or she is having with an organization one-tenth the size. This mislabeling or misperception can create false or misleading expectations for the organization that is being taken over and bedevil the post-acquisition process. Fuzzifying up the difference between a merger and an acquisition in the negotiation process just to get the deal done often leads to difficulties running the combined organization after the acquisition."<sup>4</sup>

Paul C. Light of New York University observed in another recent article in *The Chronicle of Philanthropy* that the biggest question surrounding "merger-mania" is whether the shrinking of the nonprofit world will happen in a rational way, or in a Darwinian test of survival of the financially fittest. Will the best, most-needed organizations from mission and service standpoints survive the period of consolidation ahead of us? Or will the survivors be the one that are simply the best at acquiring and maintaining funding streams, without regard to their ability to actually deliver high-quality, necessary services with their spoils? Light believes that over 100,000 charities will fail in the next two years, and fears that charities with well-oiled fund-raising machines and either local or national visibility are likely to survive or even prosper, while worthy charities with little name recognition or marketing clout will go under.<sup>5</sup>

While some analysts (among them aforementioned industry leader David La Piana) suggest that merger is one of the most powerful change agents available to nonprofit organizations, others see mergers and acquisitions as fundamental threats to the core of the

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<sup>4</sup> Goldberg, Peter. "Tread Lightly in Nonprofit Mergers," *The Chronicle of Philanthropy*, 21(11), March 26, 2009.

<sup>5</sup> Gose, Ben. "Survival of the Fittest," *The Chronicle of Philanthropy*, 21(12), April 9, 2009.

nonprofit sector: small, innovative, grassroots organizations that focus on a narrowly defined target population or niche. The truth probably lies somewhere between these two poles.

Given the complexities associated with such mergers and acquisitions, prudence dictates that several high-level considerations be evaluated before such potentially draconian actions are undertaken. For purposes of discussion, these highest level considerations may be broadly grouped into three primary areas of focus and attention: operational performance, governance considerations, and financial solvency.

**Operational Performance:** Evaluating organizations' operational performance can be quite daunting for outsiders, unless those organizations are publicly, honestly, and freely forthcoming about their metrics for measuring success, and how well they achieve those metrics. Most organizations are not. It is also difficult to compare a collection of disparate nonprofits side-to-side as there are few universal or common bottom-line metrics (outside of the organizations' finances, which I will discuss later), and because it is often impossible to place a monetary value on many of the services that nonprofits offer.<sup>6</sup>

As a simple example, which of the following services has more monetary value: feeding ten homeless people for a month, preventing five children from getting pertussis, or providing mental health counseling to one family while their patriarch is dying in hospice? While an accountant could probably craft a fairly heartless life cycle and actuarial model to divine a strictly economic answer to such a question, or a government contracting officer could place a per-head price on each service, there is no practical, objective way for any organization to place meaningful comparative value on how they improve the world around us.

What *would* be important for the Board of Directors of a hypothetical community service provider interested in acquisitions to know, however, is what these other providers had planned to accomplish in each of those areas: if there were State contracts in place to feed 20 homeless (and 10 got fed), stop two pertussis infections (and five were stopped), and counsel five families in the hospice setting (and one was served), then the Board might be most interested in the pertussis prevention provider as a potential partner or acquisition, as it achieved and exceeded its contracted success rate, where the other two organizations failed to do so. Without considering such performance standards and objectives, the community service provider's Board and management might simply be drawn to organization that seemed, on the surface, to be the most-closely aligned with its own mission.

Such cross-disciplinary mergers are challenging, but viable, especially when one looks at mergers from a client perspective, where the partnerships that make the most sense are often those that serve the same clients in different ways.<sup>7</sup> If a strong mental health provider attempted to merge with another failing mental health provider that offered similar (though inferior) services to its own clients, it could create an impression that it has only added organizational redundancy and internal competition to its operations, or engender a perception that it considers clients assigned to the lesser service provider as having less importance organizationally. But if the strong mental health provider is able to offer existing clients new

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<sup>6</sup> Waide, Kyle. (2002), "Evaluating Charities: Why The Numbers Count," *Charity Navigator*, April 15, 2002.

<sup>7</sup> Vogt, Jay W. (2009), "Guidance Offered to Nonprofits Considering Merging With Others," quoting Bill Walter of Innovative Solution for Non-Profits, [www.massnonprofit.org](http://www.massnonprofit.org).

services, such as an pertussis inoculation program for newborns and infants through its teen mothers' counseling center, it may allow clients to receive two services from a single, integrated provider, possibly adding a benefit that they currently require, but could only receive by engaging another nonprofit organization or government service provider.

At bottom line, organizations will be better off considering high-performing nonprofits with independent missions that can be integrated into the parent organizations' mission with some imagination and inspiration, rather than considering low-performing nonprofits with missions that are identical on a lowest common denominator basis, but do not add value to a new, joint operation. While there is a high degree of subjectivity in defining such terms as "high-performing" and "low-performing," nonprofit Boards and managers can certainly identify the types of organizational and operational behaviors that they would consider desirable in a prospective partnership. An organization entering into a merger from a well-reasoned position of confidence and strength will be a far better partner in the long run than a weak, enfeebled organization, approaching a potential investor with begging bowls in hand.

**Governance Considerations:** While one can obviously find outliers and anomalies, general contemporary research indicates that there is a positive relationship between Board effectiveness and organizational effectiveness, so it is reasonable to expect that high-performing organizations will be governed by high-performing Boards.<sup>8</sup> It is important, however, to recognize that such studies often focus on the Board as a whole, rather than as a collection of individual members with independent perspectives. While such a holistic approach is certainly appropriate when considering a Board as a legal entity, taking such an approach in viewing an organization's governance structure could be catastrophic if the acquiring organization did not have some sense of the individual board members' beliefs and perceptions, and how they influence the collective action of the board as a whole.<sup>9</sup>

As many nonprofit executives can attest, it only takes a single, strong-minded, financially-independent board member to wreak havoc on the best laid plans of management, especially in high stakes negotiations potentially involving the very dissolution of the organization altogether. Prospective partner boards must be carefully vetted individually and collectively accordingly, and an acquiring nonprofit must be prepared to offer similar information about its own Board to any prospective partners. The Minnesota Council on Nonprofits has promulgated a relatively simple assessment scheme that both organizations could undertake to provide benchmarks into their independent effectiveness, thereby giving some sense of how the governing bodies might best be integrated. Some of the factors to be considered in this evaluation include:

- Knowledge of board financial, legal and public responsibilities;
- Representation to the public by the board;
- Understanding and communicating the organization's mission;
- Effectiveness of board practice with regard to bylaws, committees, etc.;
- Relationship with the Executive Director;
- Strategic planning;

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<sup>8</sup> Herman, Robert D. and David O. Renz (2000). "Board Practices of Especially Effective and Less Effective Local Nonprofit Organizations," *American Review of Public Administration* 30(2), 146-160.

<sup>9</sup> Saidel, Judith R. (2002), *Guide to the Literature on Governance: An Annotated Bibliography*, BoardSource.

- Oversight of organizational activities and structures;
- Board succession and orientation process.<sup>10</sup>

On a more pragmatic level regarding the final bullet above, both organizations would also want to look at the Board terms and expected tenures of senior management in a prospective acquisition situation, given the formidable challenges associated with bringing two Boards and senior management teams together.<sup>11</sup> Similarly, it would be easier for organizations with defined term limits for its Board members to merge, as Board integration could be phased to take advantage of planned attrition among the consolidating organizations' governing bodies, thereby minimizing the number of Board members that may have to be involuntarily removed.

Human resources considerations also will be crucial as merging organizations attempt to bridge and consolidate their respective cultures under a merger scenario. Ruth M. Branson of the American Society for Training and Development has proposed the following guiding principles for HR professionals in dealing with employees of both companies during merger or acquisition scenarios:

- Taking definitive action and making decisions quickly, thereby encouraging the best people to remain with the merged organization;
- Being candid with employees, and treating them with respect;
- Clearly communicating to employees that the combined entity will be a more valuable organization;
- Being honest about the staffing decisions that must be made;
- Treating those who leave with the same respect and attention as those who are staying with the merged organization.<sup>12</sup>

**Financial Solvency:** The final, and probably most obvious, consideration in evaluating nonprofits for potential mergers revolves around these organizations' financial solvency, stability and security. As noted earlier, in the absence of standardized metrics for comparing disparate nonprofits based on their operational performance, financial data have become the most common tools for evaluating and comparing nonprofits. Board members and managers have ready access to filing organizations' IRS Form 990's and other key governance documents through Guidestar, Charity Navigator and similar online resources. Some might argue that wading through this plethora of information could actually be misleading, as the act of judging nonprofits strictly on their fundraising and executive compensation expenses, or how large their endowments are, does not capture their unique characters and the human elements that make their work distinct.<sup>13</sup>

Boards must take such unique characters and human elements into consideration before leaping straight into a deal with the strongest financial contenders based on simple ratio

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<sup>10</sup> Stoesz, Edgar and Chester Raber (1994). *Doing Good Better!*, Good Books, Inc., cited by Minnesota Council on Nonprofits at [www.idealists.org](http://www.idealists.org).

<sup>11</sup> Vogt (2009)

<sup>12</sup> Branson, Ruth M. "HR's Role in Mergers and Acquisition," American Society for Training and Development, The Gale Group, 2000/2001.

<sup>13</sup> Waide (2002)

analyses. Care must also be taken to avoid putting too much emphasis on ratio analysis and the commonly-cited “punitive” ratios used to assess charitable giving, (e.g. percentages of revenue spent on program, executive compensation, overhead and fundraising), especially when comparing organizations with different missions.<sup>14</sup> Given the choice between an art gallery that spends 80% on its programs and a food pantry that spends 90% on its programs, for instance, one might conclude that the pantry is the more efficient and effective deliverer of services. But when one considers that the median program level for museums is 71%, and the median program level for food pantries is 94%, it becomes clear that the museum is actually a leader in its cohort, and the food pantry a laggard.<sup>15</sup>

Ratios are of most use when comparing organizations of similar age and size, with similar missions, and operating within similar catchment areas, or when tracking individual organizations over time.<sup>16</sup> Nonprofit Boards and management would certainly want to track several years’ worth of 990s for any candidate organization to develop a sense of how their finances have fared through varying economic times and different program periods, and closely consider current liquidity, debt, savings, accounts payable and receivable, revenue streams (from fundraising, grants, government and other sources), and fixed and variable costs associated with each organizations’ operating model.<sup>17</sup>

It will also be important for nonprofits to identify partners with donor bases that do not significantly overlap with the acquiring organization’s own pool of supporters. In tough economic times, many nonprofits are wrestling with donor fatigue, and if a merger results in the same donors now being expected to provide support for a larger, joined body, then the consolidated organization is not likely to reap any development benefit from such a merger. Nonprofits will need to coordinate closely with their State and Federal customers as well, to guarantee that they do not put current contracts at risk by assuming another organization’s contractual obligations through the merger process. In the same way that a merger will likely result in the shedding of board members who are donors, Boards must assume that it may similarly lead to the elimination or reduction of revenue streams that won’t necessarily follow clients into a new organization.

Once the Boards of one or more organizations resolve that some form of organizational consolidation is in order, they must move into a formal due diligence process. Typically, such processes are guided by a joint committee of members from each organization, often supported by outside counsel or consulting firms. People often use the term “due diligence” in a casual, euphemistic sense, but in its legal definition, especially in regard to mergers, it is an onerous, time-consuming and strenuous process that places significant organizational strain on both entities in a prospective merger, as the effort required to clearly answer all of the necessary questions, and clearly identify and evaluate all the necessary documents, is massive.

Attorney Emily Chan notes on Gene Takagi’s Nonprofit Law Blog that the exercise of due diligence may be the most important task in the planning phases for a merger. She notes,

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<sup>14</sup> Holtzman, Andrew C. et.al. (2005) “The Analysis of Key Financial Ratios in Nonprofit Management,” Indiana University-Purdue University at Indianapolis, presentation posted at [www.iupui.edu](http://www.iupui.edu).

<sup>15</sup> McLean, Chuck and Suzanne E. Coffman (2004), “Why Ratios Aren’t the Last Word,” Guidestar, June 2004.

<sup>16</sup> McLean and Coffman (2004)

<sup>17</sup> Holtzman et.al. (2005)

however, that due diligence is not a matter of approving only “perfect mergers,” as boards can also approve and recommend a “less-than-perfect merger partner,” such as an organization facing litigation challenges. Chan states that the goal of due diligence is simply to assure that the board has engaged in sufficient inquiry and acquired enough information to make an informed decision about the risks associated with any merger, be it “perfect,” or less than so. She also cites the ever-present David La Piana, who states that “the essence of the due diligence process is an effort to make everyone on each board, as aware as a prudent board member can be of any liabilities the other party may bring to the transaction in order to create a ‘no surprises’ situation so that no one can claim that a matter was hidden.<sup>18</sup>”

To give some sense of what a due diligence process will entail, the following template is provided at the highest level of the taxonomy of areas requiring disclosure, review and discussion:

- Organizational Documents;
- Licenses and Accreditations;
- Facilities and Equipment;
- Financial Performance and Information;
- Debt Obligations and Financing;
- Medical, Clinical and Professional Staff Relationships;
- Contracts and Other Service Agreements;
- Employee Information, Relations and Benefits;
- Insurance and Risk Management;
- Legal Proceedings;
- Sponsorship and Mission;
- Compliance Programs;
- Information Systems;
- Affiliations;
- Tax Information;
- Acquisition and Disposition Agreements;
- Intangible Property.

Within each of these broad categories, there may be as many as 50 different types of items that must be located, shared, discussed, and resolved to the satisfaction of the merger committee members from both of the current organizations. Some of these items are arcane, obscure, old, archived or possibly even nonexistent. The due diligence process will be no small undertaking accordingly, and it will require a significant commitment of time, resources (human and financial), and space. Organizations should research and seek additional resources to fund this work if possible, either from existing donors (low likelihood of success, since they’re often suffering donor fatigue already), through regional capacity building grants from governments, through national or regional foundations, or through in-kind donations of legal or other

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<sup>18</sup> Chan, Emily and Gene Takagi. “Mergers and Due Diligence,” Nonprofit Law Blog, October 4, 2008, <http://www.nonprofitlawblog.com/home/2008/10/mergers-and-due.html>

consultative services.<sup>19</sup> If a Board and its management team are unwilling or unable to commit such resources internally or with contract support, then their organization will simply not be able to successfully enter into a merger or acquisition planning situation, and should cease and desist with evaluations in that regard.

Ultimately, a nonprofit would not want to go through the convulsions associated with a merger only to discover at the back end that it has weakened its position, programmatically or financially. Hopefully the literature review and evaluation considerations provided above may provide focus to allow Boards and management teams to move forward smartly, creating better organizations that serve more of their neighbors as a result of their efforts.

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<sup>19</sup> Butzen, Jean. "How to Fund Nonprofit Mergers and Partnerships," *Stanford Social Innovation Review* Opinion Blog, January 12, 2009.