Nonprofit Mergers, Acquisitions and Affiliations (Webinar)

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READY REFERENCE PAGE

NO. 121
FOR YOUR FILE

Mergers and Acquisitions Can Take Many Forms

Since boards fear taking on known and unknown liabilities, most "mergers" are really changes in control rather than statutory mergers

Nonprofits are regularly urged to consider merging or acquiring organizations that will complement their mission and make them stronger, particularly in economically turbulent times such as those of the Great Recession. Foundations fund major projects promoting collaboration, affiliation, and outright mergers.

Unlike the business world where generally all it takes is money (and/or stock) for one for-profit company to buy another, money is often in short supply in the nonprofit world. Boards psychologically invested in their own organization are often not particularly interested in joining with, or being taken over by, another. Directors legitimately fear taking on known or unknown liabilities. Negotiating a merger or acquisition demands a lot of effort to reach consensus on all sides.

Traditionally, most "mergers" in the nonprofit field have been a form of take-over of a weak or failing organization by a larger and stronger one. A true merger of equals has not been the general rule. For groups considering a merger or acquisition option, it is useful to consider several different ways in which it might be accomplished. Each method has benefits and detriments that affect its suitability for the transaction.

Purchase of Assets

One common approach is for one organization to acquire some or all of the assets (including programs and people) of another, with the intent of continuing the activities within the program of the acquiring organization. Such an acquisition usually, although not always, requires a cash payment to the seller, or at least an assumption of certain liabilities.

If the selling entity is a charity that will not continue to do business, its net remaining assets must be given to another charity or used for another charitable purpose upon dissolution. As an alternative, the selling entity may continue as a grantmaking foundation. Several hundred charitable hospitals have been sold to for-profit organizations in the last 20 years, and most have become, or created, "conversion foundations" to make grants for health-related purposes in the community. (See Ready Reference Page: "Conversion Foundations Face Key Issues Early")

If the selling charity will be going out of business and dissolving, it may be appropriate to try to obtain a court order that the income from any charitable trusts designated for the charity, or bequests or charitable remainders not yet available, will go to the purchasing organization. If there is no trust income and has been no serious planned giving program, it may be less of an issue.

Where the seller is saddled with debt, it may be possible to purchase assets out of a bankruptcy proceeding without accepting all the liabilities. However, if the creditors are not friendly, they may push for an increased purchase price or even force the sale to an unfriendly higher bidder in order to collect more on their unpaid debt. Since a charity cannot be put involuntarily into federal bankruptcy proceedings (although it may be possible to force an involuntary state receivership), an insolvent organization has substantial negotiating leverage with its creditors before filing. State bankruptcy proceedings,

which are seldom used and few people know the rules, may offer a more flexible approach than federal bankruptcy proceedings.

A purchase of assets requires real money, however, and in the nonprofit world where real money is often in short supply, a merger or acquisition may take another form.

Dissolution and Transfer of Assets

Where there isn't any money to purchase the assets and the parties are not ready for a full merger because of potential liabilities, it may be possible for the "selling" organization simply to dissolve and transfer its remaining net assets to the acquiring entity. Although claims may be made against the organization going out of business during its dissolution proceedings, dissolution will eventually cut off claims in a way that a true merger will not.

Acquisition of Stock

A few nonprofit organizations are formed on a stock basis so that control is vested in those who hold the stock of the corporation. In such a case, an acquisition can be made by acquiring the stock of the entity from the present shareholders, with or without payment, if state law allows such a transfer.

Substitution of Members

Where a nonprofit corporation is formed as a membership corporation, members function essentially the same as shareholders of a business corporation and are responsible for major corporate decisions, including, in most cases, selection of members of the board of directors.

A change of control can be accomplished by having the current members appoint representatives of the acquiring corporation as members of the acquired organization, and then having the old members resign. Such a transition gives the acquiring entity control over the old corporation without payment (although payment may be made if permitted by state law). The new members can then appoint appropriate directors of the corporation.

It will probably be appropriate to amend the bylaws of the acquired corporation to assure that the acquiring organization retains control through its appointment process and a veto power on changes in structure.

Substitution of Directors

A similar result can be accomplished in a nonmembership corporation (controlled by a self-perpetuating board of directors) by having the existing board members (or at least a majority of them) arrange resignations and appointments so that all, or a majority, of the board is selected by the acquiring corporation. Again, an amendment to the bylaws will probably be appropriate to assure the continued control of the acquiring entity.

Controlling the acquired organization through change of control such as those discussed above gives the acquiring organization a level of protection from the liabilities of the acquired corporation. If the acquired entity is operated as a separate entity, and not legally merged into the acquirer, it should be difficult for a claimant to "pierce the corporate veil" and impose liability on the controlling entity for obligations of the controlled entity.

If uncertainties exist about potential liabilities, it may be appropriate to acquire control and operate the organization for a period of time before effectuating an actual merger or consolidation.

Merger or Consolidation

At some point, it may make sense to legally merge the organizations. Under some state nonprofit corporation laws there is a distinction between a merger, in which two or more entities merge but one of

them continues as the "surviving" entity, and a consolidation, in which two or more entities come together and create a new consolidated entity. In each case, the continuing entity succeeds to all the rights, privileges, assets, obligations and liabilities of the former organizations.

A consolidation may be psychologically more attractive to the participants than a merger, especially to the "acquired" entity. In a merger, one entity "survives" while the other does not. In a consolidation, a new entity supersedes all the participants, usually with a new name different from all of the former corporations. Those from the acquired organization who continue to serve may feel less like second class citizens on the board of a "new" organization than on the board of a "surviving" organization.

A consolidation requires a new recognition of exemption from the IRS, however, since it creates a new entity. The IRS ought to be notified of any fundamental change such as this, but a new exemption will not be required for a "surviving" entity. These methods are obviously creatures of state nonprofit corporation law, which must be reviewed to be sure that the proposed transaction is permitted. In some states, for example, a nonprofit may merge with an out-of-state nonprofit only if the in-state nonprofit is the surviving entity.

The state attorney general undoubtedly has jurisdiction to review a fundamental change of a charity, and may have either statutory or administrative rights to review the transaction before it is consummated. In some cases, court approval may be required, especially if any assets committed to a charitable purpose will be diverted from the purpose to which they were originally committed.

A New "Parent" Organization

If the boards of the two (or more) organizations considering the merger or affiliation cannot agree on which entity ought to be the surviving one, or if there are legitimate legal reasons why they should not cease to function separately, it may be possible to create a new "parent" organization, composed of representatives of each of the continuing operating entities, to control the operating entities and provide strategic planning for a new "system" of organizations.

Representations and Warranties

The acquiring organization ought to do a thorough "due diligence" review of the organization being acquired (See Ready Reference Page: "Mergers and Affiliations Require 'Due Diligence'") and the acquired organization ought to be asked to make a series of representations and warranties. The warranties should particularly cover financial issues, contingent liabilities, and pending or potential litigation.

In the business world, where people pay for acquiring an organization, such reps and warranties provide a means of recourse to recover part of the purchase price for damages if the warranties turn out to be incorrect. But if the take-over is a no-cash deal, as is more usually the case with a nonprofit, the warranties have essentially no financial value. The acquiring organization already has all of the assets which might be used to pay for the losses, and it is unlikely that it would seek to impose personal liability on individual members of the old board.

An acquiring organization may want to retain an "exit strategy" in the acquisition agreement, perhaps allowing it to give the stock or membership interests back to the old group. Or it may just dissolve the acquired entity if things do not work out as anticipated.

As with most of the nonprofit world, there is no one-size-fits-all method for acquisitions, mergers or affiliations. Understanding the various possible options can help decision makers make better decisions.

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READY REFERENCE PAGE

NO. 122
FOR YOUR FILE

Mergers and Affiliations Require 'Due Diligence'

Information gained in the process will help you know what you are getting into and may help structure the form of the transaction to protect what you have

Nonprofits considering strategic alliances with other entities will want to consider a range of legal risks and requirements before embarking on the partnership.

The "ultimate" strategic alliance is a merger or consolidation of two or more entities into one. Under general provisions of corporate law, the surviving organization in a merger owns all of the assets but also has all of the liabilities of the others. If the surviving organization did not discover hidden liabilities in its process of "due diligence" investigation, it generally has no recourse to cover the losses.

Unlike a purchase of the assets from another entity, where money can be held back from the purchase price at settlement or a claim can be brought against the seller, there is generally no one to look to for recompense if unanticipated liabilities surface after a merger. Even where the merged corporation made representations and warranties that there were no undisclosed liabilities, the surviving corporation would only be claiming against itself if it sought redress. The acquiring charity is not likely to sue individual board members of the other organization for personal liability for inaccurate representations or warranties

For a variety of reasons, including the potential for hidden liabilities, many nonprofit "mergers" take the form of a shift in control rather than a legal joining of the organizations. (See Ready Reference Page: "Mergers and Acquisitions Can Take Many Forms") Whatever form the alliance takes, it is important to do your "due diligence" to find out as much as you can about what you are getting into.

The checklist below sets forth some of the areas of investigation that nonprofits may want to undertake when considering a merger or other strategic alliance. Information gained through the due diligence may affect the choice of the form of the transaction. If certain approvals were to be required for a true merger, for example, and could not be obtained, the organizations might accomplish essentially the same integration by naming the same board at each entity. Where an accrediting agency prohibits certain activities carried on by the other potential party to the merger, it may be necessary to retain separate entities and create a new parent organization.

The depth of the investigation will depend on the type of the relationship being considered. A merger requires considerably more due diligence than co-sponsorship of a joint project.

It is not possible to give a detailed list of inspection items in a short space. (The list for a hospital purchase can take more than 50 pages.) But some of the areas are set out below. This is a list of technical issues. It does not cover questions of culture, history, or mission, which may ultimately be more important than the legal ones.

I. Organizational Documents. The articles and bylaws of the corporation should reflect the basic corporate structure, should reveal the constituencies involved, and would normally show formal organiza-

tional approvals that must be obtained for any reorganization proposal. The parties should consider what changes, if any, may be required to implement the reorganization.

Corporate minutes should reveal the issues the board deemed important in recent years, may suggest factionalism on the board, and may give a picture different from the organization's publicity releases and newsletters. You want to be sure that the corporation has legitimately followed its corporate procedures in its activities.

Since the appearance of conflict of interest can undermine public support for a charity, you want to see the conflict of interest policy, the annual questionnaires, whether any conflicts exist, and how they have been dealt with.

II. Financial. Audited financial statements and the auditor's management letters should reflect the basic financial status of the organization, its contingent liabilities, and its financial procedures. Be sure that the statements are current. You may want to obtain permission to interview the accountants. Review all outstanding loan agreements to assure that the intended transaction is permitted.

III. Federal and State Taxes. Determine the tax-exempt status of the organization and whether it creates any problems for a merger. If exempt, is it in the current IRS listing of exempt entities? Assure that all required tax returns have been filed, and that the figures are not inexplicably different from the financial reports.

IV. Pending or Threatened Litigation. Obtain a representation as to all recent, existing or potential claims, particularly those that might not be covered by insurance. If claims exist, what do they say about the organization? Check also for any potential violation of laws or other governmental regulations -- federal, state and local -- affecting the operation of the organization, such as OSHA, environmental, employment, or antidiscrimination acts.

V. Insurance. Review all policies for scope and amount of coverage. Is there insurance for risks you hadn't thought about, or a lack of coverage for risks you understand? Are there pending claims, contingent liabilities, weak spots in the program, or weak management which has not controlled risks adequately? Will the policies cover claims after the contemplated transaction?

VI. Personnel, Benefits. Since integrating staff will be a major issue for implementation, you need to know personnel policies, salary and benefit schedules, and general working environment. Since employment claims, particularly equal opportunity claims, are the largest single source of claims under Directors and Officers insurance, you want to assure that the policies, forms, and practices comply with legal requirements, even if no claims have been brought in the past. Check turnover rates for anything abnormal. Carefully check the ERISA benefits programs because substantial penalties can be imposed for failure to comply with technical requirements.

VII. Property. Assure that the organization has the full right to use any real, personal or intangible property which is essential for the program and that you are aware of any foreseeable capital costs or environmental problems. Particularly review leases or mortgages to assure that there is no prohibition on the proposed transaction or that approvals can be obtained. Be sure that all the property listed on schedules is actually there.

VIII. Operating licenses, accreditations, etc. Assure that any required licenses or accreditations are in place and can be transferred if necessary.

IX. Grants and Contracts. Review grants and significant operating contracts for compliance and seek assurance that they will not be terminated because of the transaction. It may be important to let your funders know what you are intending to do before you do it. Be particularly careful of contracts that may have Medicare or Medicaid implications. If the contracts are subject to audit, investigate the history and status of the audits.

X. Fund Raising Program. Review all restricted fund agreements and documentation to assure compliance with the restrictions. Review fundraising procedures for legality and compliance with charitable solicitation registration requirements. Check whether there is an overlap in contributors that is likely to cause a substantial drop-off in giving from donors who don't think they need to give to a combined organization as much as they previously gave to both.

XI. Subsidiaries. If the organization has subsidiaries or other affiliation agreements, you may need to conduct some or all of this process with those entities also.

If you actually get to the point of a merger, there are a whole lot of systems that need to be harmonized, including accounting, budgeting, payroll, personnel, word processing and computers, purchasing, and many more.

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Nonprofit Mergers, Acquisitions and Affiliations

READY REFERENCE PAGE

NO. 55
FOR YOUR FILE

Conversion Foundations Face Key Issues Early

The process of thinking through the preliminary questions is critical for obtaining legal and public approval—and benefiting the community after the sale of charitable assets

As hundreds of community hospitals and other charitable nonprofits have sold out to for-profit service providers in recent years, a whole new group of "conversion foundations" has grown up to receive the proceeds of the sale and make grants in the community.

Directors and trustees considering a possible sale must also consider what to do with the proceeds, and how to organize the process. In many cases the state Attorney General will be involved, at least in reviewing the proposals. Court approval may be required. In some states, the Legislature has passed conversion statutes setting forth certain requirements. The process of thinking through the preliminary questions is critical to getting the requisite legal and public approval — and benefiting the community after the transaction.

Some of the preliminary questions are as follows.

Selection of Entity. Should the proceeds remain in the selling entity, or be transferred to an existing separate foundation, a new foundation, or some other organization? In most cases, it will probably be appropriate to move the funds to a different entity than that which is selling the assets, in order to insulate the funds to the extent possible from possible liabilities of the seller, particularly any which might be created or come to light after the closing on the transaction. This is a particular problem if the seller retains any assets, like real estate, which could generate new liabilities.

If the assets are to be transferred to a new entity, what will happen to income from existing trusts for the benefit of the old operating charity, bequests coming in wills of people not yet dead, or remainders of charitable remainder trusts where the life income beneficiaries are still receiving income? The organization may want a court order requiring that these gifts go to the new entity when they become available.

Structure of Organization. A critical question about the organization is: Whose organization is it? (See Ready Reference Page: "The Key Question: Whose Organization Is It?") Who should be on the Board? Should they be the same as those on the Board of the seller? What interests must, or should, be represented? Should there be broader representation of the public? How will they be selected? How will the successors be selected? Should they be subject to term limits? The Attorney General or a statute may have requirements for the Board.

It is important to answer these questions well at the outset. It may be difficult to change the structure after the organization is established.

Role in the Community. One of the critical questions for the new Board will be: what role do they want to play in the community? This will have implications for the tax status of the organization.

Do they want to make grants only from the income from the investment funds? Are they going to limit the use of those funds to the purposes of the seller? Do they want to become a "community founda-

tion" to raise additional funds for the same or other charitable purposes in the community? If so, the articles of incorporation should be written now to permit this broader role.

Do they want to be the organization that convenes other charities in the community, with the resources to encourage cooperation among existing entities and the funds to help start new ones to deal with unmet needs? Do they want to operate their own programs?

Tax Status. Almost all of the foundations created from the disposition of charitable hospitals have sought tax classification as charitable organizations exempt from tax under Section 501(c)(3) of the Tax Code. A few, which apparently will not seek additional contributions, have been classified as (c)(4) civic groups. Assuming the group opts for charitable exemption, the Board members need to think about whether they want to be a private foundation or a public charity. It is generally more advantageous to be a public charity.

A private foundation has to pay an excise tax, usually 2%, on its net investment income, including net capital gains. It must distribute and expend for charitable purposes an amount equal to at least 5% of its net investment assets every year. It faces significant self-dealing limitations and is more restricted in its ordinary grantmaking activities. One of the more significant limitations, which has concerned some conversion foundations, is the practical inability of a private foundation to support or oppose legislation or to fund lobbying activity, including legislation on public health issues or funding for public health services. Several conversion foundations with which we have dealt decided to qualify as public charities in large part so that they could play a role in lobbying for public health legislation.

To qualify as a public charity and avoid the limitations of private foundation status, the new organization will need to raise new funds from the community continually. If it wishes to be considered a public charity on the basis of new funds received, it will need to raise at least 10% of its support, based on a five-year average, from new funds from the public. (See Ready Reference Pages: "Calculating Public Support Percentage" and "New Schedule A Reflects Change in Public Support Rules")

To translate this public support test into very rough numbers, assume that the foundation has investment funds of $20 million and earns dividend and interest income of 3.5% on the entire portfolio, or $700,000 a year. (Net capital gain is not counted in the formula, only ordinary investment income. Depending on the portion of funds invested in stocks as opposed to bonds, it may have more or less income from interest and dividends.) The interest and dividend income cannot be more than 90% of the organization's total income. In this example, it would need to raise at least $77,778 (10% of total support of $777,778) through qualified gifts, grants and contributions on the average each year from other sources.

There are limitations on the amount of each individual or corporate gift that will qualify as public support, but all of the money given by a governmental agency or by a publicly supported charity is considered public support.

The Board will want to consider whether it is likely to be able to raise enough each year, which is, in significant part, a function of the size of the foundation and the investment income it will have to match. If it does not expect to raise sufficient new funds on a regular basis, it might be possible to be a "supporting organization" to support another public charity in the community. (See Ready Reference Page: "Supporting Organizations Qualify as Public Charities") Supporting organizations are not required to raise new funds but are still classified as public charities. Because a conversion foundation in

many communities is likely to be considerably larger than any public charity it might support, however, this is often not a preferred option.

The Board does not necessarily need to make a final decision on this question at the outset because the funds coming from the seller will be considered public support (so long as the seller is a publicly supported organization) and the new organization will be deemed a public charity for the first five years without raising any new funds. If it ultimately falls back to private foundation status, it will have to pay the excise tax that would have been due on its investment income, plus interest. There is no further penalty.

Staffing. The Board will need to determine the staffing required for the Foundation, which will depend in part on what it decides to be its role in the community. The Foundation should hire someone other than the person who is winding up the affairs of the seller, since the job is very different and requires attention that would be diluted if the same person were handling both jobs.

Needs Assessment. Many conversion foundations have conducted a "needs assessment" to reviewing existing studies on the needs in the community and to gauge community views on what most needs to be done at the moment. If the selling entity is a hospital, it may have already done a needs assessment for the community. Even though the Board is likely to have a relatively substantial amount of money available for grants, the requests will outstrip the funds, and its efforts will be more effective if it works according to a strategic plan.

Procedures. The Board will also need to develop its internal procedures for operating the Foundation, handling investments, and obtaining and acting on requests.

This is not an easy process. But it can be an opportunity to make a difference. That is what most people in the charitable community want to do.

NONPROFIT MERGERS, ACQUISITIONS AND AFFILIATIONS (WEBINAR)

Nonprofit Issues®
Pennsylvania Association of Nonprofit Organizations

Hypothetical Situations

Donald W. Kramer
Montgomery, McCracken Walker & Rhoads, LLP
123 S. Broad Street
Philadelphia, PA 19109
215-772-7277
dkramer@mmwr.com

Virginia P. Sikes
Montgomery, McCracken Walker & Rhoads, LLP
123 S. Broad Street
Philadelphia, PA 19109
215-772-7275
vsikes@mmwr.com

1. Local Color, a 501(c)(3) organization that educates the public about local history, has been struggling for many years. Its founders and other board members finally determined last spring to cease operations. No tours, lectures or plays have been produced in the last year. The organization owes a local bank about $40,000 on a loan and has approximately $15,000 in a checking account at the lender bank. The funds in the account, a couple boxes of books about the history of the area (that the organization has sold at its events), some historical artifacts, and its highly regarded name and reputation are the organization's only assets other than a computer and office furniture of nominal value. The talented and popular husband and wife founders are considering continuing to lecture and perform in a sole proprietorship. In addition to the $40,000 owed to the bank, the organization owes approximately $20,000 to long-time vendors who helped it stage its plays for work in prior years and would need to spend about $5,000 to prepare final tax returns, charitable solicitation registration reports and dissolve the corporation. What should they do?

2. Bright Horizons, a medium sized 501(c)(3) social service program, is having financial troubles. Its board has been struggling for many years trying to improve its services and its finances, but to no avail. The state Budget cutbacks forced it to cut staff and services. High Hopes, another 501(c)(3) organization providing similar services in a different part of town, is in slightly better financial shape but is still struggling and has a retiring Executive Director. High Hopes has several unencumbered buildings. Its board is looking for a hot-shot new executive to expand its program to the next level. Should they be talking to each other? If so, what should they be saying?

3. Make Us Well, a small 501(c)(3) mental health service, is struggling to find capital to expand its program. Health and Wealth Corporation of America, a for-profit MH/MR chain, expresses interest in acquiring the facility and converting it to a for-profit entity. How should the agency respond?

4. Heavenly Residence, a system of faith-based skilled nursing homes in Pennsylvania, is looking to expand in other areas. It learns that Golden Sunset, a non-sectarian home in another state, is also interested in expanding and may be interested in an affiliation. What options are available?

National Girl Scouts May Not Force Local Councils to Reorganize

Court of Appeals reverses trial court and applies Wisconsin franchise law to stop change

The Seventh Circuit Court of Appeals has reversed a Wisconsin District Court decision and held that the Wisconsin fair-dealership law prevents the Girl Scouts of America from forcing the "reorganization" of local chapters over the objection of one of them. (*Girl Scouts of Manitou Council v. Girl Scouts of the United States of America*, No. 10-1986, 5/31/11.)

As part of a national reorganization effort to shrink the number of local councils from about 300 to about 100, the national Girl Scouts had sought to "realign" the boundaries of councils in Wisconsin. After lengthy negotiations, the Manitou Council was slated to be dissolved and its territory split between several surviving councils. Manitou sued to stop the change.

The trial court agreed that the action would violate the state's franchise law because it would constitute a "constructive termination" of the Council's rights. But it held that to apply the statute would adversely affect the national's freedom of expression. Relying on the Supreme Court's decision in the *Boy Scouts* case of 2000, the trial court said the franchise law would be a "direct affront" to the Scouts' efforts to organize itself "in a means it judges most effective in proclaiming its expressive message." (See *Nonprofit Issues*®, 4/16/10.)

The Court of Appeals, in an opinion written by Judge Richard Posner, one of the most colorful conservative jurists in the nation, essentially mocked the constitutional argument. The Court agreed that the state could not require the national organization to promote different values in Wisconsin, but said "it does not follow that the First Amendment exempts the Girl Scouts from state laws of general applicability that have only a remote, hypothetical impact on the organization's message."

"The original stated reasons for reducing the number of local councils were to improve the marketing of Girl Scout cookies, exploit economies of scale, and do more effective fundraising — all by increasing each surviving council's resources. But in this appeal, the national organization emphasizes instead a goal of increasing the racial and ethnic diversity of the Girl Scouts," the Court wrote.

"The First Amendment was barely hinted at in the first appeal of this case, and was just a small part of the national organization's argument in the district court, but when it became the district court's sole ground for ruling in its favor the national organization embraced it eagerly. Yet this ground for overriding the fair-dealership law cannot be taken seriously in the absence of any evidence of a connection between realignment of the councils and promotion of diversity — and none was presented."

The national argued that the fair-dealing law was inapplicable to nonprofits because it was based on "commercial" activities. But the Court said that "nonprofit enterprises frequently do engage in 'commercial' or 'business' activities, and certainly the Girl Scouts do. Proceeds of the sale of Girl Scout cookies are the major source of Manitou's income. The local councils sell other merchandise as well.

Sales of merchandise account for almost a fifth of the national organization's income, and most of the rest comes from membership fees and thus depends on the success of the local councils in recruiting members; that in turn depends on the council's revenues and thus gives the national organization an indirect stake in the cookie sales…. From a commercial standpoint the Girl Scouts are not readily distinguishable from Dunkin' Donuts."

The Court went on to say: "No gulf separates the profit from the nonprofit sectors of the American economy. There are nonprofit hospitals and for-profit hospitals, nonprofit colleges and for-profit colleges, and, as we have just noted, nonprofit sellers of food and for-profit sellers of food. When profit and nonprofit entities compete, they are driven by competition to become similar to each other. The commercial activity of nonprofits has grown substantially in recent decades, fueled by an increasing focus on revenue maximizing by the boards of these organizations, and this growth has stimulated increased competition both among nonprofit enterprises and with for-profit ones."

The Court recognized that nonprofits could not distribute profits, but said "that does not seem to alter the incentives of the people who run such organizations much, if one may judge from the many scandals involving nonprofit colleges and universities, which seem to compete for students, faculties, research grants, and alumni gifts with a zeal comparable to that of their for-profit counterparts."

The Court said that the fair-dealing law was intended to prevent abuses, and it declined to read an exemption for nonprofit enterprise into the Wisconsin law.

YOU NEED TO KNOW

Although the sale of Girl Scout cookies can be significant for local councils, the several weeks of effort hardly make the Girl Scouts serious competitors to Dunkin' Donuts. Nevertheless, Judge Posner undoubtedly expresses a growing public perception that there isn't much difference these days between nonprofit and for-profit activities in a lot of spheres. There are a whole lot of areas where the for-profit world doesn't venture — homeless shelters, food pantries and most youth development organizations, for example — but where substantial governmental or other funding exists — healthcare and education, for example — for-profits have made serious inroads in what was previously the almost exclusive realm of nonprofit enterprise.

Despite the language of the opinion, the ultimate holding is likely to be trouble for national organizations that try to impose changes on their local chapters. Depending on state law, there may be a whole new area of defense available to the local units.

Don Kramer's NONPROFIT ISSUES An Electronic Newsletter of "Nonprofit Law You Need to Know"

Creditors May Sue Directors
For Breach of Duty Before Bankruptcy

Court reverses trial court, allows case to proceed
on claims of lack of good faith, fraud in deepening insolvency

The Third Circuit Court of Appeals has reversed a trial court and allowed a committee of unsecured creditors to sue the directors of a nonprofit nursing home personally for breach of fiduciary duty in administering the home during insolvency prior to bankruptcy. The federal District Court in Pittsburgh had ruled that the directors were protected by the business judgment rule and granted summary judgment against the creditors. (See *Nonprofit Issues*®, 12/1/10.) The Court of Appeals has held that there were sufficient questions of fact to require a trial. (*In Re: Lemington Home for the Aged*, No. 10-4456, 9/21/11.)

The recitation of facts in the Court of Appeals opinion presents a much bleaker picture than that in the District Court opinion. There was basic agreement that the Lemington Home, which was founded in 1877 and predominantly served the African-American community, had been in financial difficulty for many years. But the Court of Appeals puts significantly more emphasis on the failure of the board to learn the facts and take action.

According to the Court of Appeals, the Home hired a new administrator in 1997, but was insolvent by 1999. Its audits for fiscal years 2002 and 2003 carried "going concern" warnings. The Pittsburgh Foundation, which held a fund for the benefit of the Home, made a grant of more than $175,000 for a study of each department, but the new administrator spent it for something else.

A new chief financial officer was hired in 2002 but failed to maintain a general ledger and the Home's billing and financial records were in "deplorable condition." The administrator had health problems, and according to testimony in the case, was absent for periods up to six or eight weeks at a time. The board had no treasurer from November 2003 until January 2005 and no oversight of the Home's finances during that period.

The administrator recommended bankruptcy in May 2004, but the board put off the determination. Two residents died under circumstances suggesting insufficient care. The Home's accountants quit in the fall of 2004 due to nonpayment of bills, shortly after a medical records and billing consultant had quit for the same reason.

The board itself was "in disarray," the Court said. Minutes were incomplete or non-existent. Attendance was often below 50%. There was no treasurer even though the board chair testified that the board was aware the CFO was not maintaining adequate records. The Home finally

filed for bankruptcy protection in April, 2005. The creditors were granted leave to sue for breach of fiduciary duty.

Under Pennsylvania law, "fiduciary duties are owed not only to the corporation … but also to the creditors of an insolvent entity," the Court said. "It is material whether the directors' reliance upon the information provided by one or more officers or employees was in 'good faith,' and whether there was a reasonable basis for relying upon officers and employees of the corporation. It is likewise material whether the officers have exercised 'reasonable inquiry, skill and diligence' in performing their duties."

The Court cited the Pennsylvania Nonprofit Corporation Law for the business judgment rule that actions of directors "shall be presumed to be in the best interests of the corporation," "absent breach of fiduciary duty, lack of good faith or self-dealing."

"The District Court relied upon the fact that the Board was assisted by counsel, conducted several meetings, and pursued various options before approving the bankruptcy filing. To be sure, this is the type of evidence that could support application of the business judgment rule as a matter of law. But it is countered by evidence that the Board received numerous red flags as to the competence and diligence of [the administrator and CFO]. The fact that the Board eschewed a viability study also calls into question the adequacy of a pre-bankruptcy investigation. And finally, there is evidence that the directors favored Lemington Elder Care [on whose board they also served and which would become beneficiary of the Pittsburgh Foundation fund if the Home went out of business] over the Home." It said the issues of good faith and reasonable care could not be decided on summary judgment.

The directors argued they should be protected by the doctrine of *in pari delicto,* under which they could not be liable if they got bad information from the officers. But the Court said that the rule was narrowed by the Pennsylvania Supreme Court (See *Nonprofit Issues*®, 2/16/10.) and does not apply when a person acts for a personal interest. Since the directors had an interest in the Lemington Elder Care organization, it was an issue of material fact about whether the doctrine could be invoked.

Finally, the Court said that a claim of "deepening insolvency" would be recognized under Pennsylvania law although no Pennsylvania court had ruled on the question. Deepening insolvency is defined as "an injury to a debtor's corporate property from the fraudulent expansion of corporate debt or prolongation of corporate life." Because there was evidence that the board had concluded it had to file for bankruptcy several months before it did so, there was a material question of fact which also precluded summary judgment.

YOU NEED TO KNOW

The District Court's decision in the case at the trial level gave directors significant comfort that they were not likely to be personally liable merely because a struggling organization ultimately has to file for bankruptcy protection. If the rule of deepening insolvency stands as enunciated by the Court of Appeals, there will be a lot more personal concern, and a lot more sense that it is necessary to pull the plug on a failing organization at a much earlier time. Not every state has accepted the rule of deepening insolvency, which only clouds the issue in Pennsylvania and other states elsewhere where there is no decision on point by a state's highest court.

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Donald W. Kramer
Editor and Publisher
Lisa T. Chatburn
Managing Editor
Virginia P. Sikes
Tax Editor

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Nonprofit Issues ®
P.O. Box 482
Dresher, PA 19025-0482
Phone (215) 542-7547
1-888-NP-Issue
Fax (215) 542-7548
E-mail info@nonprofitissues.com
www.nonprofitissues.com

Jury Finds Officers and Directors Liable for $5.75 Million in Damages

Court upholds verdicts for breach of fiduciary duty in bankruptcy case involving "deepening insolvency"

A federal District Court in Pittsburgh has refused to disturb jury verdicts imposing personal liability for $5.75 million in compensatory and punitive damages against 15 officers and directors of a bankrupt nursing home. The Court found that there was sufficient evidence in the trial record to justify the verdicts. (Official Committee of Unsecured Creditors v. Baldwin, W.D. PA, No. 10cv800, 5/17/13.)

The Lemington Home for the Aged was founded in the 19th century and predominantly served the African-American community in Pittsburgh. It ran into financial difficulties during the 1990s and ultimately filed for bankruptcy in 2005. When the unsecured creditors committee originally brought suit, the District Court held that the officers and directors were protected by the business judgment rule and had paid enough attention to their duties that they would not be liable for damages. (See Nonprofit Issues®, 12/1/10.)

On appeal, the Third Circuit Court of Appeals predicted that, although no Pennsylvania court had ruled on the matter, the Pennsylvania Supreme Court would find an independent cause of action against directors who put creditors at risk by deepening insolvency and fraudulently expanding corporate debt and prolonging corporate life. It also held that there were sufficient allegations to allow a jury to find that the officers' and directors' actions were not made in good faith and they did not exercise reasonable inquiry, skill and diligence in performing their duties. The Court of Appeals remanded the case for trial. (See Nonprofit Issues®, 9/16/11.)

After a six-day trial and three days of deliberation, the jury returned its verdicts. It found 15 of 17 officers and directors jointly and severally liable for $2.25 million in compensatory damages, and imposed separate punitive damages of $1 million for the home administrator, $750,000 for the CFO, and $350,000 for each of five directors. The defendants filed motions to reverse the judgments as a matter of law, for a new trial, and for a reduction in the damages. The Court said that the verdict had to be sustained "if the record contains even the minimum quantum of evidence upon which a jury might reasonably afford relief" and denied the motions.

On the deepening insolvency count, the Court said the creditors had to show that the defendants' actions "caused the deepening of insolvency," but that they did not have to show the amount of the increased debt. The jury heard evidence that debt increased after the first suggestion of bankruptcy and that the rising debt was of concern to potential buyers. It was reasonable for the jury to conclude, the Court said, that but for the increase in debt, a potential buyer may have been found and the Home could have avoided liquidation.

On the requirement to prove fraudulent conduct, the Court said the Board's decision to stop admitting new residents and close the Home was not disclosed to creditors, governmental authorities or the Bankruptcy Court, the monthly bankruptcy disclosures were not accurate, and $1.4 million in receipts was not reported. In addition, the officers continued to contract with vendors after the decision to close the home but before filing bankruptcy.

On the duty of care, the Court said that, in view of the bylaw protection under the director liability act, the creditors had to prove the individuals' actions constituted self-dealing, willful misconduct or recklessness. Defendant directors argued they reasonably relied on the reports of the officers. But the Court said they could not rely on the reports when there was good reason to doubt the validity of the reports and that the evidence showed there was "ample reason" to doubt them. Among the reasons was the fact that the CFO did not provide adequate financial information because he did not maintain a general ledger and only maintained a spreadsheet with a running bank balance. The directors also ignored the advice of their bankruptcy counsel.

The Court said that the extent of the officers' failures might not have been known because the directors failed to set up a finance committee as required by the Home's bylaws. "Violating the Home's bylaws goes beyond basic negligence and meets the recklessness standard," the Court said.

The Court provided a long list of failures that justified the findings against the officers, including the administrator's failure to overcome service deficiencies, failure to keep minutes of board meetings, and failure to oversee the CFO, who was not keeping adequate financial records and failing to bill properly for Medicaid and Medicare services the Home was providing.

The trial court had granted the defendant directors' motion to dismiss the claim for breach of loyalty, but did not do so for the officers. The administrator was being paid her full salary during 2004 although she was working only part time, which could be deemed unjust enrichment, the Court said. There was also evidence that the CFO took actions in his own interest rather than the Home's and that the actions could reasonably be seen as an opportunity to receive a direct financial benefit in the future. It said his "unjust enrichment was the chance of a future financial gain."

On punitive damages, the director defendants argued it was unreasonable to assess damages against only five directors because they did not constitute a quorum of the board. But the Court said the issue called for individual assessment and the five held liable were the directors most involved in the oversight of the organization. They were aware of the administrator's deficiencies but refused to remove her. They disregarded the advice of the bankruptcy lawyer about closing the home while continuing to accrue new debt. Their names were regularly mentioned in documents contained within 14 three-inch binders of evidence submitted to the jury.

The evidence against the administrator and CFO was also sufficient to justify the awards against them, the Court said.

YOU NEED TO KNOW

This case will cause shivers among a lot of directors of nonprofit organizations on the brink of insolvency and will probably cause many of them the pull the plug faster than they might otherwise have done.

The case is based in part on an unclear premise, that Pennsylvania courts would recognize the tort of deepening insolvency, although no state court has done so. Such a tort has not been universally recognized and has been rejected in many states. It may not be possible to get a state court decision in a federal bankruptcy action now unless the Third Circuit certifies the question for state Supreme Court consideration.

The concept that failing to establish a committee set forth in the bylaws is evidence of reckless behavior is a really frightening one. Although it might have made a difference in this case, the inquiry should be on whether the failure made a difference, not whether they failed to check a box on the organizational chart, as the decision seems to suggest. It is definitely a reason not to list a whole string of committees in bylaws that may not be used. (See Ready Reference Page: "Bylaws Function as 'Constitution' of Nonprofit Corporations")

If the corporation has Directors' & Officers' insurance, the joint and several liability for compensatory damages is likely to be covered and paid by the carrier, but the punitive damages against the individuals are unlikely to be covered because it would be considered to be against public policy to do so. The potential for that kind of personal liability for volunteer directors may cause a lot of them to flee when the going gets tough if these verdicts stand.

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Article Archives >> Lead Stories **>> December 1-31, 2009**

Merger of Nonprofit into Other Does Not Constitute "Closing"

Court denies constructive trust to hold property to go to Township upon closing of ambulance company

The merger of one local nonprofit ambulance company into another does not constitute a "closing" of the merged company that requires the company to transfer its station to the Township in which it is located, according to two courts in Pennsylvania. But a trial court's order creating a constructive trust to hold the property for the benefit of the Township has been reversed by the state's Commonwealth Court. (*Williams Township v. Williams Township Emergency Company*, Pa. Com Ct., No. 2435 C.D. 2008, 12/11/09.)

The Williams Township Emergency Company, though financially sound, was having difficulty maintaining a sufficient staff for its volunteer provision of basic life support ambulance service in the community. It proposed to merge with the Easton Emergency Squad, which provided advanced life support in the same area and had a larger operation. They agreed to merge in 2006 and continue the same services.

When the Williams company originally approached the Township, the supervisors endorsed the merger, but later filed suit to stop it. Court-ordered audits gave the company a clean bill of health and the state Attorney General did not oppose the merger.

The Township argued, however, that it had given more than $125,000 to the company in the prior three years and that the bylaws of the company provided that it would turn over its assets to the Township if it "closed." The company argued that it had acquired title to the property before the Township made any contributions. It also changed its bylaws during the litigation to say it would give its assets "to a similar nonprofit organization of our choice" if it closed.

The trial court cited the state's nonprofit corporation law, which specifically authorizes mergers or consolidations and provides that the assets and liabilities of the merged entities will become the assets and liabilities of the surviving entity. It concluded that a merger did not constitute a closing. It went on to conclude, however, that the station was purchased with funds solicited from the citizens of the Township to provide services for the benefit of the Township. It said that the Township supervisors, as the citizens' representatives, had an equitable interest in the station. It created a constructive trust allowing the merged entity to hold the station so long as it was used to provide emergency services to the Township, but giving the supervisors the right to enforce the trust if the station ever ceased to be so used.

On appeal, the Commonwealth Court agreed that the merger was permitted, but reversed the order with respect to the constructive trust.

The Commonwealth Court noted that a constructive trust "is an equitable remedy that is designed to prevent unjust enrichment." But it said it could not conclude that the facts supported a conclusion of unjust enrichment. "There is no evidentiary connection definitively linking" contributions from the Township to the station, it said, and "there is no basis to conclude that [the company's] retention and transfer of the [station] at this time to its new nonprofit entity results in any inequity to the Township." It also cited the state statute providing that all assets become property of the surviving entity in a merger, subject to all of the restrictions and liabilities existing before the merger.

It did not comment on the question of whether an attempt by the new surviving entity to divest itself of the station would result in unjust enrichment because the issue was not before it.

YOU NEED TO KNOW

This case clearly reaches a correct result, but with some odd diversions. The law of merger is pretty clear. All of the assets and liabilities of the merged entities become, by operation of law, the assets and liabilities of the surviving entity. None of the entities "closes" or dissolves. They simply join together with all of the benefits and warts they had before. If property was held in trust before, it is held in trust afterwards with all of the same limitations and restrictions. Although people get excited by mergers, their legal rights are basically not changed. The diversion into constructive trust law was fundamentally irrelevant.

One of the interesting questions that seems to have been ignored in the case is the Township's standing to contest the corporate action. Another question which the court did not need to reach was the validity of the bylaw change to remove the Township as a beneficiary upon closing. Ordinarily, a corporation may change its bylaws without approval of a named entity unless the bylaws specifically require its approval.

Article Archives >> Lead Stories >> **August 1-31, 2007**

Surviving Nonprofit May Enforce Contract Rights Of Entity That Merged

Hospital may enforce indemnification agreement of nursing services provider for merged hospital

The surviving corporation in a nonprofit hospital merger retains the right to enforce contract rights of its merger partner, a federal District Court in Virginia has held. The surviving entity has been permitted to seek enforcement of an indemnification provision against a nursing services provider who provided services to the merged hospital before the merger. (*Sentara Hospitals v. Maxim Healthcare Services*, E.D. VA, Civ. Action No. 2:07cv1, 8/17/07.)

Maxim Healthcare Services provided nursing services to hospitals affiliated with Sentara Healthcare, including Virginia Beach General Hospital. Virginia Beach had entered into a separate contract in 1996. In 2001, Maxim entered into an agreement with Sentara Hospitals, a first-tier subsidiary of Sentara Healthcare, for services for several hospitals, including Virginia Beach. In 2002, Virginia Beach merged into Sentara Hospitals.

In 2000, while Virginia Beach was a subsidiary of Sentara Healthcare, but before it merged with Sentara Hospitals, a patient fell in his room and ultimately died. Sentara Hospitals settled the family's claim after the merger and sought to enforce the indemnification agreement in the 1996 contract between Virginia Beach and Maxim. Maxim argued that the rights of the old contract had not passed to Sentara Hospitals in the merger.

Maxim's argument was based primarily on the Virginia statute which, it claimed, did not make provision for the transfer of contract rights until it was amended in 2007 to specifically so provide. The Hospital argued, without relying on the statute, that the Plan of Merger between the hospitals specifically provided that the survivor would "succeed to and possess all of the properties, rights, privileges, powers, franchises and immunities" of the merged entity.

Maxim argued that as a matter of public policy, there have long been restrictions on assignment of contracts. A business should be entitled to choose the parties with which it does business and permitting a transfer would create unintended relationships, perhaps with greater risks, it argued. The Court responded by saying the argument was "undercut by the simple fact" that the legislature had amended the statute to make clear that rights and liabilities were passed as a matter of law. It was also undercut by the fact that Maxim continued to contract with the merged entity.

Sentara argued that the statute calls for a Plan of Merger and that its Plan, which transferred the rights, was not inconsistent with the statute.

The Court said the question was one of first impression under Virginia state law, but "it would make sense" that the right to merge was "a baseline provision that can be supplemented with terms in a plan of merger" adopted pursuant to the statute.

Maxim also argued that the right to indemnification could not be transferred because the contract had expired and was no longer in force. But the Court noted that the statute did provide that liabilities of a merged corporation would pass to the successor. "That a contract right to seek indemnification might somehow be less durable than the concomitant liability and obligation to indemnify is difficult to fathom." In addition, since the patient died before the merger, the "contingent" claim for indemnification had arisen before the merger.

YOU NEED TO KNOW

Because the statute in question was silent on the effect of a merger on the passage of assets, the Court was required to create a more elaborate rationale for what is obviously a correct conclusion. In a merger, neither entity goes out of existence; they are joined together with all of the rights and liabilities of the group. It would be hard to imagine that the provider would argue

that the obligation to pay would lapse with a merger. It would not be appropriate that only the right to services would lapse.

Article Archives >> Lead Stories >> **May 16-31, 2007**

Partner In Virtual Merger Is Not Liable For Other's Obligations When Deal Is Undone

Nonprofits signed intent to merge, elected identical boards, but failed to file final papers when financial projections were not met

The Supreme Court of New Hampshire has ruled that a prospective merger partner of Goodwill Industries is not separately liable on a 10-year real estate lease when Goodwill filed for bankruptcy before the merger was completed, even though the lease was entered into after merger activities had begun.

Although the organizations had signed a tentative agreement to merge, had elected identical boards of directors, and had filed an intent to merge document with the state, they ultimately undid the transaction when Goodwill's financial results did not live up to projections. (*JGMCJ Corp. v. CLASS*, No. 2006-558, 5/15/07.)

In 2001, the Goodwill Industries branch in Lowell, MA, was facing financial difficulties but sought to expand its retail operations in the area. It approached CLASS, a nonprofit providing vocational and other services to developmentally disabled individuals located in Lawrence, MA, about a possible merger. In June, 2002, Goodwill's director of retail operations presented the expansion plan to the CLASS board, which voted to proceed cautiously with a merger.

The two organizations executed a nonbinding agreement expressing their intent to merge and elected identical boards of directors. Goodwill's president was dismissed. CLASS's president became CEO of Goodwill and CLASS's CFO became CFO of Goodwill, while both retained their positions with CLASS. The groups also entered into a Service Agreement under which CLASS would administer Goodwill's finances from Goodwill accounts for a fee of $32,395 a month.

In July or August, the retail operations manager, now working for CLASS, and the CFO advised a prospective landlord that the organizations had merged and that they would provide consolidated financials in connection with a new lease. Goodwill and the landlord entered into a 10-year lease in August, without a third party guaranty or any other obligation of CLASS.

In September or October, the two nonprofits submitted an intent to merge document to the Secretary of State of Massachusetts, but did not file the articles of merger to complete the transaction. In March 2003, when the financial results had not met projections, CLASS called off the deal and both boards held new elections to elect different members. In August, Goodwill filed for bankruptcy.

Prior to the bankruptcy, the landlord sued Goodwill, CLASS, and their boards for breach of the lease. It also sued CLASS's board for negligent misrepresentation, breach of fiduciary duties, and breach of duties created by a *de facto* merger. CLASS and its directors moved for summary judgment to dismiss the claims. A trial court granted the motion and the Supreme Court has affirmed.

The Court pointed out that there had been no legal merger because the articles of merger were never filed with the state as required to effect a merger under the state nonprofit corporation law. The landlord argued that there was a *de facto* merger based on the conduct of the organizations.

Reasoning from an earlier case about the *de facto* merger of two business corporations, which the Court recognized was not directly applicable, the Court said CLASS did not continue the Goodwill enterprise as activity of CLASS. The Boards did not merge, but held separate elections. "Having common members does not necessarily demonstrate a continuity of management," the Court said.

The two corporations maintained separate addresses. Although a few employees shifted employers, there was only limited overlap in management of the companies. CLASS was not forced to pay Goodwill's bills, and although it advanced funds to Goodwill, it did so as documented loans, for which it claimed approximately $900,000 in the bankruptcy.

In the earlier for-profit case, an important factor was whether one of the organizations had been quickly liquidated and dissolved. Here, Goodwill did not liquidate and both corporations continued their separate existence. Finally, CLASS never formally assumed any of Goodwill's obligations.

"The Memorandum of Understanding states that it is only a preliminary document meant to summarize the terms of a prospective merger and is not to be read as binding upon Goodwill and CLASS," the Court wrote. "The only financial interactions between them were pursuant to the Service Agreement and the documented loans the Service Agreement authorized. Moreover, the Service Agreement specifically states that the duties assumed by CLASS pursuant to its terms are not to be construed as a commitment to merge.

"No assets changed hands, neither company ceased operations or liquidated, and CLASS did not assume Goodwill's business obligations. We agree with the trial court that until Goodwill and CLASS submitted articles of merger, which they did not do, they were two separate companies operating under a proposal to merge. For these reasons, we conclude that the trial court did not err in determining, as a matter of law, that Goodwill and CLASS did not complete a *de facto* merger."

The Court also held that there were no negligent misrepresentations or breach of fiduciary duty that justified enforcing the lease against CLASS.

YOU NEED TO KNOW

This case shows clearly the value of going slowly in considering a merger with another organization, especially when one of the organizations is facing financial difficulties. If the two groups had actually merged, CLASS would not only have lost the $900,000 it put into the deal before it cratered, but would have been liable for this 10-year lease and all of the other debt that forced Goodwill into bankruptcy. Even if it could have paid the bills, the cost would have significantly undercut its own program. Even though it did not avoid litigation, it carefully maintained separate operations so that it could avoid liability.

There are many ways to handle a "merger" without the irrevocable commitment of full liability. (See Ready Reference Page: "Mergers and Acquisitions Can Take Many Forms.") This case shows why it is often unwise to jump too quickly.

May Merged Children's Home Retain Income from Trusts?

Court reverses trial court's summary judgment cutting off funds from two trusts

Should the income from two trusts providing funds for a county children's home continue to be paid to the surviving entity when the home merges into another children's home and family service corporation? The Appellate Court of Illinois has reversed a trial court ruling that the named home had ceased to exist and the income should be used elsewhere. (*Citizens National Bank of Paris v. Kids Hope United*, Ct. of App., IL, Fourth Dist., No. 4-08-0162, 11/21/08.)

The case arose when a bank trustee sought guidance on how to handle two trusts after the Edgar County Children's Home merged in 2003 with Hudelson Children's Home and Family Services. Hudelson subsequently changed its name to Kids Hope United.

One of the trusts said the gift should lapse if the Home "should cease to operate or exist." The other said it should lapse if the Home "shall cease to function in its present capacity." The bank asked for the right to change the recipient of both funds. Kids Hope resisted.

On appeal, the Appellate Court cited the general provision of the Illinois statute which provides that the surviving corporation in a merger shall "thereupon and thereafter possess all the rights, privileges, immunities, and franchises" of each of the merging corporations. The general rule, however, does not apply, the Court said, if the grantor places a restrictive condition in the trust to otherwise cause the gift to lapse. It sought to determine the intent of each donor by considering the entire document.

In the first trust, citing earlier cases on the use of similar language, the Court found that the funds should continue unless the charity would no longer be suited to carry out the purposes of

the gift. Since it found that the mission of the original home would continue to exist in the surviving entity, the trial court erred in finding that the Home "ceased to exist," it said.

In the second trust, the Court found that the record was insufficient to determine whether the Home ceased to function in the same capacity as when the gift was made. The mere fact of the merger was insufficient to reach that conclusion, it said. The language was ambiguous and the result could not be determined on summary judgment.

The Court remanded the case to the trial court for further proceedings, presumably only on the second trust since it had held that the decision on the first trust was wrong as a matter of law. A dissenting judge said that the trial court should have been affirmed since the original Home ceased to exist as a legal entity.

YOU NEED TO KNOW

The specific language of an instrument is critical when a donor says what should happen with a gift if there is a significant change in the operation of a beneficiary. In most cases of a merger, the surviving entity will continue to receive the benefit of the funds, but as this case shows, that may not always be the case.

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Donald W. Kramer
Editor and Publisher
Lisa T. Chatburn
Managing Editor
Virginia P. Sikes
Tax Editor

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Nonprofit Issues ®
P.O. Box 482
Dresher, PA 19025-0482
Phone (215) 542-7547
1-888-NP-Issue
Fax (215) 542-7548
E-mail info@nonprofitissues.com
www.nonprofitissues.com

What happens to bequest when church closes?

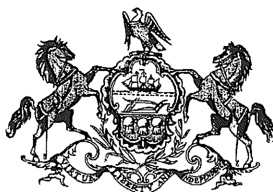
When Stanley Carpenter died in 1967, he left a farm in trust to provide income to family members and after their death to the First Presbyterian Church of Osceola, Arkansas, and the First Baptist Church of Osceola.

The First Presbyterian Church existed from the mid 1800s until it dissolved in 2004, transferring all of its assets and property to Covenant Presbytery. The Baptist church claimed that it should receive the income from the trust and the bank trustee went to court to get a resolution of the issue.

A trial court found that Carpenter's intention was to benefit the two churches and since the Presbyterian church no longer existed it was appropriate to invoke the doctrine of cy pres to give all of the income to the Baptist Church. Covenant Presbytery appealed the decision. The Court of Appeals of Arkansas has reversed.

To invoke the doctrine of cy pres, the Court said, a court had to find that the intent of the instrument was primarily charitable. While Carpenter "was a generous man and his trust does contain a measure of charity," his predominant disposition was not charitable, the Court concluded. His will contained 43 items that were not charitable, with gifts to employees, family and friends and the income from the farm to four relatives during their lifetime. "A reading of the whole instrument does not show that Carpenter had a solely or purely charitable purpose when he created his testamentary trust."

When Carpenter died, an undivided one-half remainder interest in the farm vested in each of the two churches, the Court said. "A vested remainder is a present interest held by a known and ascertained beneficiary that cannot be defeated by any contingency." It can also be transferred by deed, will or inheritance, and in this case was transferred by the Presbyterian church to its successor Covenant Presbytery. Therefore, the Court held, the trial court was wrong in giving the interest to the Baptist church and the case had to be reversed. (*Covenant Presbytery v. First Baptist Church,* Ct. of App., AR, No. CV-14-891, 4/15/15.)



COMMONWEALTH OF PENNSYLVANIA
OFFICE OF ATTORNEY GENERAL

TOM CORBETT
ATTORNEY GENERAL

REVIEW PROTOCOL FOR FUNDAMENTAL CHANGE TRANSACTIONS AFFECTING HEALTH CARE NONPROFITS

Underlying Principle

Whenever a nonprofit, charitable health care entity enters into a transaction effecting a fundamental corporate change which involves a transfer of ownership or control of charitable assets, regardless of the form of the transaction contemplated (i.e., sale, merger, consolidation, lease, option, conveyance, exchange, transfer, joint venture, affiliation, management agreement or collaboration arrangement, or other method of disposition); unless the transaction is in the usual and regular course of the nonprofit's activities; and regardless of whether the other party or parties to the transaction are a nonprofit, mutual benefit or for-profit organization; the Office of Attorney General, as parens patriae, must review each transaction to ensure that the public interest in the charitable assets of the nonprofit organization is fully protected. Consequently, to review each transaction, the OAG must be provided relevant financial, corporate, and transactional information, in order to reach a decision on whether or not to object to or withhold objection to the proposed transaction. This decision will determine the Attorney General's position relative to Orphans' Court proceedings required in fundamental change transactions under the Nonprofit Corporations Law.

* * * * *

Review Protocol

This Protocol was developed to be used as a guide by attorneys and reviewers in the Charitable Trusts & Organizations Section, and its outside experts, in reviewing fundamental transactions affecting nonprofit, charitable health care entities. It provides broad, general guidelines with respect to issues that routinely appear in such transactions and is not intended to be an exhaustive or exclusive list of items to be reviewed and investigated, as these will vary on a case-to-case basis.

1. **Notice to the Attorney General**

The parties to the transaction shall provide written notice of same to the Attorney General at least 90 days prior to the contemplated date of its consummation. The Attorney General shall be given sufficient time from the receipt of the written notice within which to review and evaluate adequately and fully the proposed transaction. This notice shall include any and/or all of the following documents as the Attorney General may determine to be necessary:

a) all information, including organic documents such as Articles of Incorporation, bylaws, endowment fund documentation, trust restrictions, expenditure history, and other information necessary to define the trust upon which the charitable assets are held;

b) all complete transaction documents with attachments, including collateral or ancillary agreements involving officers, directors or employees (i.e., employment contracts, stock option agreements in the acquiring entity, etc.);

c) all documents signed by the principals or their agents which are necessary to determine the proposed transaction's effect, if any, on related or subsidiary business entities, whether nonprofit or for-profit;

d) all asset contribution agreements, operating agreements, and management contracts, if any, which comprise part or all of the transaction;

e) all financial information and organic documents regarding the post-transaction successor or resulting charitable entity (foundation), including the information detailed in Item (a), supra; and including relevant information with respect to officers, directors, and employees (current and post-transaction), in order to determine independence, board composition, charitable purpose, and to review any financial arrangements with officers, directors, or employees which may be affected by the transaction, particularly those which have the potential of affecting an individual's objectivity in supporting or approving the transaction;

f) all information necessary to evaluate the effects of the transaction on each component of an integrated delivery system, where transactions involve hospitals, including any changes in contracts between the integrated delivery system entities and related physician groups;

g) all financial documents of the transaction parties and related entities, where applicable, including audited financial statements, any fiduciary accounts whether or not filed with the various Orphans' Courts of the

Commonwealth, ownership records, business projection data, current capital asset valuation data (assessed at market value), and any records upon which future earnings, existing asset values and fair market value analysis can be based;

h) all fairness opinions and independent valuation reports of the assets and liabilities of the parties, prepared on their behalf;

i) all relevant contracts (assets and liabilities) which may affect value, including, but not limited to, business contracts, employee contracts such as buy-out provisions, profit-sharing agreements, severance packages, etc.;

j) all information and/or representations disclosing related party transactions, which are necessary to assess whether or not the transaction is at arms length or involves self-dealing;

k) all documents relating to non-cash elements of the transaction, including pertinent valuations of security for loans, stock restrictions, etc.;

l) all tax-related information, including the existence of tax-free debt subject to redemption, disqualified person transactions yielding tax liability, etc.;

m) a listing of ongoing litigation, including full court captions, involving the transaction parties or their related entities, which may affect the interests of the parties and the valuation of charitable assets;

n) all information in the possession of the transaction parties relative to the perspective of the nonprofit's beneficiary class or representatives thereof (e.g., the community);

o) all information, including internal and external reports and studies, bearing on the effect of the proposed transaction on the availability or accessibility of health care in the affected community;

p) organizational charts of the parties to the transaction, as they exist both pre- and post- consummation of the transaction involved, detailing the relationship between the principal parties and any and all subsidiaries thereof; and

q) any and all additional documents that the Office of Attorney General deems necessary for its review purposes.

Any and all information provided in the course of the review will be held in confidence by the Office of Attorney General as a part of its investigative files and, as such, will not be returned to the transaction parties. No information will be privately or publicly disseminated concerning any transaction that is not objected to by the Attorney General, unless such a dissemination is ordered by a court of competent jurisdiction. The Attorney General will notify all transaction parties of any formal or informal request seeking access to the information provided.

2. The Review Process

The Attorney General is entitled to retain outside experts and consultants for the purpose of evaluating information detailed in Item 1, supra. This is more likely to occur in a nonprofit to for-profit transaction. These consultants may be either from state agencies, the private sector, or both. They shall be retained pursuant to written contracts, and the costs for retaining such consultants shall be paid by the parties requesting transaction approval.

The review of the transaction shall include, among other components:

a) information gathering;

b) review of fiduciary responsibilities of directors, particularly relative to the exercise of due diligence, the assessment of self-dealing and whether or not the transaction is at arms length;

c) fair market valuation analysis;

d) inurement inquiry, including stock options, pension plans and perquisites, performance bonuses, consulting contracts or other post-transaction employment agreements, corporate loans, golden parachute provisions and severance packages, salaries, and related party transactions;

e) public interest review to evaluate the transaction's effect upon the availability and accessibility of health care in the affected community, to include community involvement and antitrust review; and

f) appropriate cy pres determination, to ensure that all restricted funds remain segregated and used for their restricted purposes; and that the remaining or successor charitable organization competently and efficiently utilizes the assets for a like charitable purpose benefiting the same class of beneficiaries. The analysis is particularly important when the transaction results in the reallocation of charitable funds from operational use to grant-making use, to ensure that a constancy of charitable purpose is maintained. It is critical to evaluate whether the acquiring entity will maintain control of the charitable assets, post-

transaction, through the creation of a newly controlled foundation or through appointments to the existing charity's board.

3. Notice to the Public

The role of the Office of Attorney General in its review of the proposed transaction, is to ensure that the actions of nonprofit directors satisfied their fiduciary duties to the public beneficiaries of the health care entity, and to ensure that the charitable assets thereof are preserved and used for their proper charitable purpose. Further, the Attorney General will consider the broad public policy issue of whether the transaction is in the public interest, specifically whether the proposed transaction will adversely affect the availability or accessibility of health care in the affected community or region.

Implicit in this review is that reasonable public notice of a proposed transaction shall be provided by the parties to the affected community or region, along with reasonable and timely opportunity for such community to contribute to the deliberations of the parties and the Attorney General relative to the health care and charitable trust issues.

In this way, a thorough and complete review of the transaction can be accomplished in a manner that is open to public scrutiny, and the interest of public beneficiaries of nonprofit health care entities may best be protected.

4. Response of Attorney General

Upon completion of its review of the transaction, the Office of Attorney General may: issue a letter indicating that it has no objection to the transaction; bring judicial proceedings to enjoin consummation of any disputed transaction; seek to void any transaction consummated as being in derogation of the law or contrary to public policy; or take any other action it deems appropriate. If, in the opinion of the Office of Attorney General the public interest will be best served thereby, the Office of Attorney General may request that the parties to the transaction seek approval of the Orphans' Court in the county of the nonprofit charitable corporation's registered office. This is more likely to occur in a nonprofit to for-profit transaction.

The procedures set forth in this protocol are in addition to all other powers conferred on the Office of Attorney General by statute or common law.

5. Post-transaction Oversight

The Office of Attorney General will maintain oversight of the transaction after its consummation to ensure that no subsequently executed contracts or arrangements between the parties or their agents effect a denigration of its terms. This oversight may mandate that the resulting entity or surviving charity report on some basis to the OAG to ensure that the terms of the transaction are fulfilled.

Additional Resources

The Nonprofit Mergers Workbook by David La Piana

Part I: The Leader's Guide to Considering, Negotiating, and Executing a Merger (2008)

Part II: Unifying the Organization after a Merger (2004)

http://www.lapiana.org/research-publications/publications/books/the-nonprofit-mergers-workbook-part-i-the-leaders-guide-to-considering-negotiating-and-executing-a-merger