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Program Preservation, Evolution, and Financial Change: Structuring Options
Structuring a Strategic Alliance

The term “strategic alliance” is often used to broadly describe many different business relationships and transactions. It is important to understand the differences between these different structuring options because the impact on a nonprofit organization will depend on the precise nature of the transaction.

In most cases, the objectives of the proposed collaboration should drive the structure of the strategic alliance. However, there are certain other factors which may need to be given significant consideration as well. These factors commonly include timing constraints, desire to isolate liabilities of a potential partner organization, and funding restrictions (such as those found in funding agreements from private foundations or government services contracts).

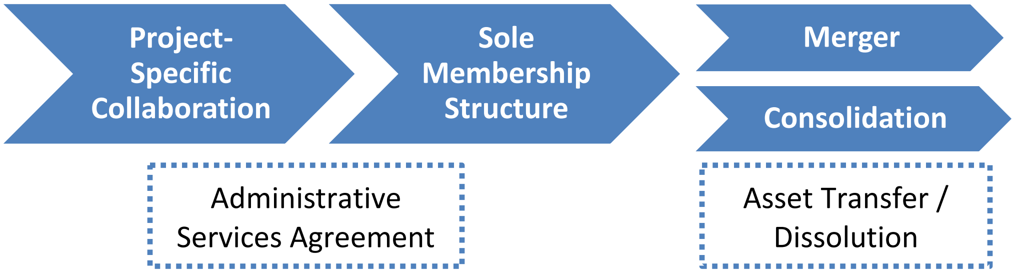
Below is a description of the various structures available to New York State nonprofits, as well as a discussion of relevant considerations for the available options.

Introduction

Before negotiating the terms of a strategic alliance, the Board of Directors and management of a nonprofit should be as clear as possible about the intended goals of the alliance. These goals may include program expansion, increased financial stability, or more efficient service delivery. Clarity about the goals of the strategic alliance reduces the risk that time and energy will be wasted on negotiations with a potential strategic alliance partner that is not the right fit.

Once a potential partner organization has been identified, the parties should assess whether they can agree on the goals of the collaboration and the mechanics of the relationship (including timing, financials, and measures of success). A mutual understanding of these ultimate goals will inform the legal structure of the strategic alliance.

No matter which structuring route is taken, the parties should develop a written agreement that documents the specifics of the relationship, including the day-to-day operational issues and responsibilities of each party. We outline below several different structuring options for a potential strategic alliance or other restructuring, ranging from least- to most-integrated:


Project-Specific Collaboration
Sole Membership Structure
Merger
Consolidation
Administrative Services Agreement
Asset Transfer / Dissolution

Project-Specific Collaboration

A project-specific collaboration (sometimes referred to as a joint venture) occurs when two corporations choose to collaborate on a specific project, but otherwise remain independent entities. In this arrangement, there is no joining of assets or liabilities of the two organizations, and the collaboration is limited in time or scope. Examples might include a situation where a nonprofit community-based organization partners with another nonprofit that provides mental health services, so that a mental health counselor can be located onsite at the community-based organization. As another example, two nonprofit organizations might jointly apply for a grant opportunity that they will implement together.

Advantages	Disadvantages
• Independence of each organization is maintained • Access to the other organization's strengths, resources, and expertise • Strengthens relationships with other nonprofits • No external, regulatory approval needed for transaction	• Certain projects may raise joint employment concerns and potential liabilities • Need to carefully negotiate and document agreed allocation of costs and revenue between the two organizations • Requires staff time to negotiate the relationship and to oversee the collaboration

Implementation: The boards of both organizations should be involved throughout the process of negotiating, documenting, and overseeing a project-specific collaboration. It is highly recommended that the two organizations sign a written agreement—such as a joint venture agreement or a collaboration agreement—to accurately reflect the expectations of each organization.

In addition, partners in a project-specific collaboration may often find it makes sense to enter into an **Administrative Services Agreement** (discussed to the right), pursuant to which one of the organizations will provide (often for a fee) specified services for the other organization, such as accounting or bookkeeping.

Administrative Services Agreements:

A Useful Tool in Project-Specific Collaborations and Sole Membership Structures

- Instead of a sole membership structure, another mechanism is for one organization to have the right to nominate and appoint a *majority* of the Board of Directors of another organization. This is achieved when the Board of the constituent corporation elects the Board members designated by the dominant corporation, and then resigns.
- No approval of the NYS Attorney General is required.
- A key consideration for the dominant corporation is that controlling the appointment of Board members of an organization is not the same as actually controlling the corporation, since the members of the Board of the constituent corporation will still have a fiduciary duty to act in the best interest of the constituent corporation. The legal benefits of selecting a board control model for integration compared to a sole membership structure are negligible, and the dominant corporation runs the risk that the newly-appointed Board members are not truly under the control of the dominant corporation. In addition, it may trigger “change of control” notification requirements just like a sole membership.
- Much like a sole membership structure, additional steps such as signing an administrative services agreement would be necessary to achieve real integration.
- NPCL §717.

Questions to ask:

- What assets will each partner contribute to the joint project (e.g. real property, programmatic elements, cash, staff time, etc.)
- Who will have the ultimate decision-making authority for day-to-day management of the joint project?
- Who will have responsibility for finances: raising and spending of money, reporting on foundation grants, allocation of revenues (if any)?
- Who will have responsibility for staffing issues and oversight?
- Who will have responsibility for marketing the joint project, and under which organization’s name (or names) will the project or initiative be promoted?
- When or under what circumstances will the joint project be terminated?

Sole Membership (Parent/Subsidiary) Relationship

A parent-subsidiary style relationship between two nonprofit organizations can be achieved through a sole membership structure, in which one nonprofit corporation can effectively control another nonprofit corporation by serving as its sole member. Both organizations remain separate legal entities.

For many organizations, the sole membership structure is a stepping stone to a full merger; however, there is no time limitation on how long organizations can operate under a sole membership arrangement. The parties may decide at a later date whether to enter in to a full legal merger, to transfer assets of the subsidiary organization to the parent organization[1], or to continue to maintain the two organizations separately. Allowing for a more gradual transition to a full merger may allow contractual obligations, such as leases and funding agreements, to be met by the original party to the agreement while allowing time for the surviving corporation to develop its own relationship with funders, for example.

To form a sole membership structure, the “subsidiary” organization amends its bylaws to designate itself as a membership corporation, and the “parent” entity is named as the sole member of the subsidiary.[2] This gives the parent entity the right to appoint the board of directors of the subsidiary, which is the mechanism through which control is achieved. This arrangement protects the assets of the parent entity from the liabilities of the subsidiary entity, given that a nonprofit corporation’s members are not liable for the debts of the subsidiary corporation (provided typical corporate formalities are observed).[3]

Another benefit to this type of transaction is that the timing is easily controlled by the two potential collaboration partners, given that governmental approval is not needed as with a full merger. However, it is important to consider that a sole membership structure may trigger the need for “change of control” notification by the subsidiary organization to its funders and lenders. The subsidiary organization should carefully review its contracts and grants to determine if such provisions will apply.

The sole membership structure will not, on its own, result in integrated operations of the two affiliated organizations. Additional steps are needed to achieve integration, such as through a contractual agreement like an **Administrative Services Agreement**, discussed above.

It should be noted that from an IRS reporting perspective, organizations with a sole membership structure will be required to report on Schedule 990 R financial transactions of $50,000 or more between the two organizations. Both organizations should obtain accounting advice with respect to structuring fund transfers or grants from one organization to another.

[1] Note that if all or substantially all of the assets of the subsidiary organization are transferred to the parent organization, this process will require the consent of the NYS Attorney General.

[2] Note that if the subsidiary corporation already has existing members whose rights will be extinguished through the new sole membership structure, current members’ approval of the transaction will be required. NPCL §802(b).

[3] NPCL §517(a).

Advantages	Disadvantages
• Assets and liabilities of each organization remain separate • Can be achieved more quickly than a formal merger because Attorney General or Supreme Court approval not required • Each organization's corporate identity remains independent • Allows for administrative efficiency while two entities remain legally separate	• Still must maintain two corporate structures • Integration will not be achieved without additional steps (e.g. Administrative Services Agreement) • No transfer of licenses • May trigger "change of control" notice requirement

Implementation: Amend the subsidiary organization's bylaws or certificate of incorporation. Additional documents that may be needed include:

- Memorandum of understanding or other written demonstration of the intent of the parties

- Action by the board of directors and/or members to amend the bylaws

- Administrative Services Agreement

- See Appendix A for a list of Typical Due Diligence Documents exchanged

Board Control:

An Alternative to Sole Membership Structures

- An administrative services agreement is a contractual arrangement under which one organization is engaged (typically for a fee) to provide services for another organization, such as payroll and benefits administration, bookkeeping support, other staff time, office space, office supplies, or other administrative resources.
- The organizations remain legally separate, but efficiency can be achieved when one organization agrees to provide necessary services to the other. Fees paid under an administrative services agreement should not be subject to unrelated business income tax, as long as the services provided are in furtherance of the providing organization's charitable purposes and the fees charged are not in excess of the costs to provide these services. Whenever employees will be shared pursuant to an administrative services agreement, each organization should consult employment counsel regarding issues such as joint employment liability and insurance coverage (e.g. workers' compensation and disability).

Merger

A merger occurs when one corporation absorbs another. The assets, staff, and programs of the two corporations are joined together, as are the liabilities and obligations. The merged corporations usually operate under the name of the "surviving" corporation, i.e. the corporation which absorbed the other corporation. Once the merger is complete, the absorbed corporation's legal existence is terminated.

The Board of Directors of the surviving corporation manages the merged corporation, although it is common for the surviving corporation to invite a few members of the absorbed corporation's Board to join the surviving corporation's Board.

Advantages	Disadvantages
• Simplified corporate structure o One Board o One set of books and records o One payroll and employee benefits package o Clear corporate identity • Assets and liabilities joined • Possibility of enhanced billing rates (e.g. for Medicaid services)	• Because assets and liabilities are joined, surviving entity takes on liabilities of absorbed entity • Length and complexity of merger process • Due diligence can be costly and time-consuming • Loss of individual identity/culture • Possible cannibalization of each organization's funding • Difficulty of transferring licensure and government contracts

Important due diligence considerations:

- Must ensure that the surviving corporation will engage in activities that are "substantially similar" to those of the absorbed corporation.
- Are there any "red flags" in the organization's financial documents (*e.g.*, audits, I.R.S. Form 990 disclosures, budgets)? Are the organization's financial processes healthy?
- What are the organization's liabilities? Are they unrecorded, recorded, or contingent?
- Is the organization facing any pending litigation or investigations?
- What are the plans for human resources and staffing upon a merger?
- What real estate does the organization own or lease?
- Does the organization have capital needs assessments or adequate reserves?
- What does the organization's funding and donor base look like? Is there overlap with the potential merger partner? What is each proposed partner's reputation among funders? Will funding hold steady after the merger?
- What is the potential for growth after the merger?
- What are the projections for a combined budget?

- See Appendix A for a list of Typical Due Diligence Documents exchanged

Consolidation:

An Alternative to a Merger

- A consolidation occurs when two corporations join together and both former entities cease to exist, and a new corporate entity emerges. (NPCL §901(a)(2)). Though this structure is uncommon, it remains an option that organizations might consider, especially if the goal is a collaboration in which neither of the two organizations is considered "dominant" over the other.
- The assets, liabilities, staff, and programs of the two corporations are joined together. A newly constituted Board of Directors manages the new, consolidated entity, and the members of the new Board may be made up of directors from the former organizations, entirely new directors, or a combination thereof. The new, consolidated entity can operate under a new corporate name or under the name of one of the former corporations.
- One major drawback to a consolidation (and one of the reasons it is not often the chosen structure) is that the new entity will need to apply for tax exempt status with the IRS, in addition to any other city and state licensing and approvals that are needed. For this reason, it is typically not an ideal option for most organizations.

Dissolution & Transfer of Assets

In a full merger, the surviving entity must assume both the assets and liabilities of the other entity it is absorbing, which may not be appealing if the surviving corporation is concerned about the other organization's liabilities. To avoid this, organizations might instead opt for an asset transfer and dissolution, which can achieve some of the objectives of a merger, but allows an organization to transfer its assets only—but not its liabilities—to the receiving entity, and then dissolve. An asset transfer does not create any affiliation between the transferee organization that is dissolving and receiving entity. The receiving entity is not a "successor" of the dissolving organization and does not inherit all aspects of the dissolving organization; it just takes on certain of its assets.

However, one important caveat is that, if the asset transfer/dissolution transaction looks very much like a "de facto" merger, i.e., the receiving entity also takes over the dissolving organization's staff, Board members, programs, image or corporate name, or intellectual property, regulatory authorities and courts may allow claims against the dissolving organization to be brought against the other entity that received the assets. Both parties should consult legal counsel to appropriately assess this risk.

An asset transfer/dissolution does require governmental approval. When a charitable nonprofit corporation is seeking to dissolve and transfer its assets as part of such dissolution, it must get authorization from the NYS Attorney General or the New York State Supreme Court.[4] The organization's Board of Directors will need to prepare a plan of dissolution and submit a verified petition to either the NYS Attorney General or the New York State Supreme Court for its review and approval. One important factor for obtaining approval is that the dissolving organization's assets that are restricted to specific purposes by donors must only be disposed of in a manner that is consistent with the intention of the donor. Sometimes, particularly during

[4] New York Not-for-Profit Corporation Law ("N-PCL") Article 10.

an unexpired grant period, the dissolving entity may need to get approval from the funder to transfer the grant funds to another organization.

Advantages	Disadvantages
• Independence of each organization is maintained • Receiving organization can take over assets without having to assume liabilities	• Restrictions on charitable assets may present difficulties • Approval from NYS Attorney General or Supreme Court required, which can be time consuming • If transaction is really a "de facto" merger, may expose receiving organization to potential liability

Implementation: An organization must take several steps to gain approval for the dissolution and asset transfer.

- Obtain membership approval (if the organization has members entitled to vote on the transaction) and/or board approval of the plan of dissolution.
- Draft the petition to the NYS Attorney General or the Supreme Court that details the terms of the transaction.[5]
- Submit the petition to either the NYS Attorney General or Supreme Court. Once the plan of dissolution is approved, within 270 days, carry out the plan, pay any liabilities, and distribute assets in accordance with the plan.
- After the plan of dissolution is carried out, prepare and seek approval from the NYS Attorney General or Supreme Court of a certificate of dissolution. Obtain approval for dissolution from the New York State Department of Taxation and Finance.
- Once approval is obtained for the certificate of dissolution, file it with the NY Department of State.

[5] N-PCL § 1002.

Appendix A

Typical Due Diligence Documents

The list below may be helpful for organizations considering a **sole membership structure, merger, or consolidation**.

Governance

- Current governing documents of each organization (including the certificate of incorporation and bylaws with all amendments);
- List of Board of Directors and their respective affiliations;
- Copies of any Board of Directors or member resolutions and minutes regarding the proposed collaboration;
- IRS form 1023 for each organization;
- IRS determination letter for each organization;

Financials and Related Reporting

- Proposed budget for the current year;
- IRS Form 990 for each organization for the past 3 years with audited financial statements, as well as any auditor's letter and management response letters (if available);
- Any correspondence in the last 3 years between the IRS or any city or state authorities regarding audit or tax matters;

Operations & Funding

- A list of the organization's licenses (if relevant), including a description of pending applications and the organization's plans for obtaining license renewals upon expiration;
- Any correspondence in the last 2 years between the organization and any licensing authority or other governmental agency;
- Most recent Vendex form (if relevant);
- Detailed list of any endowments and restricted funds/assets for each organization;

Proposed Documents/Drafts

- Proposed new governing documents after the proposed collaboration;
- List of proposed directors, officers, and members after the proposed collaboration (if relevant);
- Any letters of intent or agreements entered into in connection with the proposed collaboration;
- List of all entities whose approval is required for the proposed transaction.

This alert is meant to provide general information only, not legal advice. If you have any questions about this alert please contact Rafi Stern at rstern@lawyersalliance.org or visit our website at www.lawyersalliance.org for further information. To become a client, visit www.lawyersalliance.org/becoming-a-client.

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