The Legal Side of Mergers and Acquisitions

What You Don't Know Can Be Costly

by Kathryn M. Vanden Berk

SCENARIO: When it was first built, Sam Cunningham's agency, Crowe Home for Kids, was surrounded by farmland, but it is now on highly desirable suburban property. But the past two years had treated Sam's agency badly. A new program director had implemented a questionable treatment model and his professional staff had bolted in protest. The turnover had filtered down throughout the organization and front-line staff were still confused. A few unfortunate incidents had hit the paper, causing a prominent litigator to suggest publicly that injured parties should sue Crowe Home. The state was investigating and admissions had just been frozen.

Sam decided to ask his friend and colleague, Sheila Lemons, what he might do to get things back on track. She ran Magnum Child Services, an organization that was solidly funded, well run, and well liked by state licensing officials. "You know, Sam," Sheila said, "My board has been telling me that we should establish an office in your part of town, and I've always liked that property. If you're interested, why don't we see whether we might merge our agencies?"

Sam readily agreed and so did his board. Within a few weeks Sam and Sheila had been given the go-ahead to explore a merger of their agencies. Sheila suggested that they get together to meet with Magnum's attorney. "I can't represent both of you if you decide to merge," the attorney told them. "Because I can only represent one at a time. But let me suggest that you re-think your approach to the merger idea." He turned to Sheila, "Sheila, you have a lot to lose in this deal. Right now, you're sitting pretty with a lot of valuable assets. Sam, on the other hand, looks like a lawsuit waiting to happen. If you merge your agencies, you will be stuck with what I see as a potential liability of significant proportions."

He continued, "I'm going to suggest an asset buy-out. The result will be virtually the same, in that Sam's agency will become a part of Magnum. But you'll leave the liabilities behind where they can't disturb the new entity. What you'll have is a transaction that looks to all the world like a merger, but in fact it will be an acquisition."

In the end, that is what they did, Sam's board settled claims that had already arisen and provided for future claims with insurance. Magnum picked up all current operating expenses, hired all the staff, and integrated all systems. The deal was accomplished with a number of asset purchase agreements, and no merger ever actually took place. But they did change the name to Crowe-Magnum Homes and Child Services to reinforce the public's perception that they had merged.

From my vantage point, there are dozens of mergers that are negotiated for every one that actually occurs. Perhaps this is because nonprofit boards just hate the thought of giving up their autonomy, or their special place in the community. Perhaps it's because they are suspicious of a process that is so legalistic. I hope to demystify the process somewhat by explaining its components, as well as bring to your attention an alternate process that can be substituted where merger is impossible or inadvisable.

Nonprofit merger partners are often more concerned with blending their programs and cultures than with blending two legal entities. For this reason, lawyers are often not consulted until well into the process, when it's time to cross the t's and dot the i's. For example, we sometimes get called into a situation after the executives and board have been working on merger details for a long time. By that time there is a huge investment of emotion and buy-in. At this point, they don't want to hear from a lawyer that the groundwork hasn't been properly laid, or that there is a faulty legal basis that will require a great deal of work to resolve.

In rare occasions, attorneys are asked to serve as the sole legal counsel for the entire merger. It is tempting to do this, and in some cases we have, but it is important to recognize that in most situations the merger partners will have at least some interests that are adverse, and it is the attorney's job to find these adversities and ensure they are not overlooked. My suggestion is this: as soon as you decide that a merger is possible and desirable, begin working with legal counsel.

Two Main Types of Mergers

In a *survivorship merger*, the assets and liabilities of both entities combine under the name of one of the pre-merger parties, and this entity is designated as the survivor. After the merger is official, the other entity is dissolved. In a *consolidation merger*, the two organizations form a new third entity into which all of their assets and liabilities are transferred. This entity is the survivor, and both merging organizations disappear. In a true merger, as either of these would be, the surviving entity will contain not only all assets of the merged entities, but all of the outstanding liabilities as well.

Many organizations can't afford to actually merge their legal entities because the liabilities of one or both would bring down the resulting organization. In this case, the partners actually engage in an *asset acquisition* rather than a merger, with one organization purchasing the assets of the other, and leaving the liabilities where they originally were. The transaction is usually announced to the world as a merger, but it is not. This asset buy-out approach is a particularly useful strategy when one of the partners is weak due to operational losses, lawsuits, or the loss of key contracts.

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Merger Documents

When merger discussions are about to begin, representatives of both parties sign two important documents. A *Letter of Agreement* officially establishes the parties' mutual intention to explore the merger, documents their boards' approval of that process, and identifies who will serve on the merger committee.

A *Confidentiality and Nondisclosure Agreement* is a pledge by each party that the information disclosed in the course of merger discussions will remain confidential. This is particularly important where there are merger discussions with more than one potential partner, or where the prospects may be in competition with each other due to overlapping geographic or programmatic involvements.

A *Due Diligence Checklist* will assign roles to key personnel so that all aspects of the merger can be examined. Due diligence reviews will examine legal documents, audits and other financial statements, program policies, third party contracts, organization charts and staffing lists, personnel policies and procedures, licenses, deeds, leases, and every other form of organizational document. The review can be even more thorough than an accreditation survey. By the end of the due diligence period, you will know each others' organizations from the inside out.

It is wise to issue a number of *Internal and External Announcements* that are carefully crafted to keep key stakeholders up to date and involved, but only as involved as your leadership wishes them to be. Key staff should be told what to say when asked by line staff. Licensing and accrediting bodies need to be informed about transitions. Church denominations and significant donors should be informed so as not to disrupt sensitive donor relationships.

The *Merger Agreement and Plan* that emerges from your discussions is a legal document that defines terms, identifies the parties, establishes the exact nature of the merger, sets forth your mission, vision, aims and objectives, and settles issues related to the integration of programs and staffing, transfer of titles of facilities and equipment, finances, the new management and governance structure, transfer of contracts, disclosure of all potential liabilities, etc. In some states this is filed as part of the merger process; in others it is simply referred to. It is extremely important that you pay

attention to this document. If anything goes wrong and the transaction has to be examined, it will be too late to negotiate these important relationships.

Because child- and family-related organizations are service oriented, your Merger Plan should be tailored to address issues that are important to direct care staff: who will have control over integration of work schedules and staff responsibilities; how you will integrate and/or replace personnel policies and procedures; how benefits (particularly seniority, retirement benefits and health insurance) will be transferred; and who will have control of compensation programs, must all be worked out between the two entities.

Articles of Merger are filed with the secretary of state, or other government entity that regulates business corporations in your state. The articles identify the merger partners, announce the surviving (or new) entity, describe the merger plan, and affirm that the plan was duly adopted. With that filing, the merger is formally recognized, and you are ready to operate as a new corporate entity.

If you plan to get into merger discussions, I urge you to be attentive to the legal aspects of the transaction. Most merger workbooks and facilitators are interested in programs and services rather than legalities, and that is as it should be. But the legalities are key to a merger's success as much as service integration. And they will go a long way to ensuring the long-term success of your new entity.

Disclaimer

This article has been prepared to convey general information on topics of interest to child care agency boards and executive staff. Although prepared by an attorney, it should not be used as a substitute for legal counseling in specific situations. Readers should not act upon the information contained in this article without professional guidance. ▲

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