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Summary of Legal Aspects of Mergers, Consolidations, and Transfers of Assets

by Jefferson C. Glassie

Associations and nonprofit corporations may consider mergers with similar organizations as a way of maximizing financial and organizational efficiencies or converging the sometimes disparate activities of competing groups. There are a number of legal and practical options for effecting such combinations, with different implications and hurdles. This article describes the basic factors of such transactions, practical issues, and the due diligence obligations on nonprofit corporation directors in connection with approving mergers, consolidations, or transfers of assets.

Legal Requirements

The basic requirements for mergers, consolidations, and transfers of assets are provided in state statutes and must be followed to effect the combination appropriately. A merger essentially involves one corporation becoming part of another “surviving” corporation; all assets, liabilities, and activities of the merging corporations vest in the surviving corporation by operation of law. The non-surviving corporation as a separate entity goes out of existence as part of the merger process, but does not technically “dissolve,” which is a separate kind of corporate transaction.

In a consolidation, two or more corporations combine into one new corporation, with both consolidating corporations going out of existence. The act of consolidating creates the new corporate entity automatically, and it is not necessary to incorporate a separate entity. While most statues permit consolidations, other states only provide for mergers. This is because a consolidation can practically be effected by simply incorporating a new corporation and merging the two or more associations into the new corporation.

From a legal perspective in the typical association situation, a merger or consolidation is usually preferable, because by operation of law the merging or consolidating corporations automatically are combined and all assets, liabilities, memberships, contracts, copyrights, trade marks, and all other aspects of the corporation are simply assumed by the surviving or new corporation according to the plan of merger or consolidation. The old corporations essentially become part of the surviving or new corporation, and any future payments, debts, or transfers to the old simply go to the new. For example, because the merger or consolidation occurs by operation of law, contracts are not technically assigned from one corporation to the other, and so approval for assignment is not required from vendors having contracts with the merging corporations.

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A consolidation may be selected when the merging associations do not want one or the other to be the surviving entity. Usually, this determination is made for political or "pride" reasons, but the difference is not legally significant. A merger is generally simple and easier, and more favorable from a tax exemption perspective, as explained below.

Under most state laws, both mergers and consolidations require that each corporation's Board of Directors approve a merger proposal (called a plan or agreement of merger/ consolidation) and send it to the respective voting members, with approval generally required by the voting members present in person or by proxy (if permitted) at a meeting called upon proper notice and at which there is a quorum.

It is important that the plan of merger or consolidation be developed and agreed to in advance, since most state laws require that the merging corporations agree to the same plan of merger/consolidation, and that the members vote on the same plan, or a summary of the plan. Since the plan of merger/consolidation is a statutory vehicle that is filed with the state corporate authorities, it is often advisable that the parties also enter into a more detailed, comprehensive agreement detailing all of the specific terms and conditions of the transaction that do not need to be in the public record. Such terms would include Board and officer transition, membership dues and categories in the new association, any changes to the bylaws of the surviving corporation, budget and financial matters, as well as staff and benefits provisions.

In addition, the voting mechanics are extremely important. The Boards of Directors will typically vote to approve of the plan of merger or consolidation, and the comprehensive agreement, following review of the "due diligence" reports. However, members also must usually vote, and typically that vote must be conducted at a meeting of members. Thus, it is most typical that a special meeting be held, with members voting by proxy for or against the merger. Usually, members cannot vote without a meeting for a merger, although some state laws do permit such voting by ballot. In addition, many states require a "supermajority" vote, such as two-thirds of those members voting at an annual or special meeting at which a quorum exists in person or by proxy, but some even require a majority of all members to vote in favor of the merger. Such supermajority votes can pose practical challenges and the voting requirements should be carefully reviewed and considered well in advance.

Another option for combining nonprofit corporations is simply for one corporation to sell, transfer, or otherwise combine assets and activities with the other, followed by dissolution of the transferring corporation. If the transaction involves the sale, lease, exchange, mortgage, transfer, or other disposition of "all or substantially all" of the assets of the transferring corporation, then most state laws require (as with a merger or consolidation) Board approval of the transaction and a vote of the members of the corporation transferring its assets (present and voting at a meeting or represented by proxy). However, the members of the corporation receiving the transferred assets are not required to vote, but it generally would be advisable for the Board of the recipient corporation to vote to accept the assets (especially if any liabilities also are being assumed).

The legal requirements are quite specific and the respective state's law will control. In a merger or consolidation, Articles of Merger or Consolidation must be filed with the state authorities, but no formal filing is required for a transfer of assets and activities. Also, while a routine notice to the IRS is all that would be required for a merger of two or more corporations that are tax exempt under the same section of the Internal Revenue Code, a new tax exemption application is required for a statutory consolidation because a new corporate entity is created; a new tax exemption is not required for a transfer of assets.

A transfer of assets has some inherent uncertainty and more paperwork to ensure that all necessary assets, equipment, copyrights, trademarks, contracts, etc. of the corporation will actually be covered by the transfer if there are significant assets being transferred. This is because a list of transferred assets and bill of sale generally should be prepared, with the possibility that certain items may be inadvertently left out. Also, some contracts may not be assignable or transferable, or may only be assigned or transferred upon written approval of the other party to the contract; this can lead to the possibility of unenforceable contracts unless properly assigned. On the other hand, an asset transfer is advisable in certain cases because it can be structured to avoid transfer or assumption of any liabilities by the corporation receiving the assets (although claims may be brought that such corporation was a successor in interest and should remain liable).

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We generally recommend a statutory merger to effect a restructuring to combine two or more relatively equivalent associations. However, a transfer of assets and activities by written agreement may be advisable to avoid a member vote of the corporation receiving the assets. In any event, based on the legal requirements and our experience with association mergers, it is also clear that the implementation of the merger or consolidation approval process is very important, specifically and particularly with respect to the notice that must be provided to members (if any), quorum requirements, and obtaining the required votes.

Due Diligence

Additionally, corporate law principles require a "due diligence" review of each of the proposed merger or consolidation partners, to ensure that no unanticipated material liabilities will be assumed; the same level of due diligence review may not be required in an asset transfer, depending on the circumstances. Failure to conduct due diligence review can be the basis for personal and individual liability on the part of a nonprofit corporation's directors who approve and recommend mergers to members. Under general corporate law principles, directors have a fiduciary relationship with the nonprofit organiza¬tions for which they serve. This relationship gives rise to three commonly-recognized duties that are owed by the director to the nonprofit corporation: the duties of care, loyalty, and obedience.

The duty of loyalty is an obligation to act only in the best interests of the organization. This duty bars a director from using his position or information concerning the organization to secure a financial or other benefit for her or himself. The duty of obedience is the obligation to pursue the objectives that make up the organization's general "purpose" or "mission." These objectives are generally set out in the legal documents creating the organization.

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as stringent as that imposed upon a trustee, who can be found liable for simple negligence; this was the holding in a case frequently cited for guidance on nonprofit director obligations. *Stern v. Lucy Webb Hayes National Training School . . .* , 381 F.Supp. 1003, 1013 (D.D.C. 1974). Rather, the duty of care is more akin to the duty owed by a for-profit corporate director, as measured by the "business judgment" rule, under which a showing of gross negligence is needed to impose liability. *Louisiana World Exposition v. Federal Insurance Co.*, 864 F.2d 1147, 1151-1152 (5th Cir. 1989).

Further, there is support for the position that a more flexible standard applies: under the Revised Model Nonprofit Corporation Act ("RMNCA"), directors must discharge their duties "with the care an ordinarily prudent person in a like position would exercise under similar circumstances." This language has been interpreted as intending to distin¬guish the duty of care of a director of a nonprofit corporation from that same duty of a director of a business corporation. The greater leeway provided by the RMNCA may be due in some part to the existence in the nonprofit sector of voluntary and part-time directors. It would follow, then, that even under the RMNCA's more flexible approach a more stringent standard would be applied to directors who are full-time employees of the organization. Where the directors are voluntary, part-time, unpaid board members, the most prudent approach for them would be to follow the requirements of the traditional business judgment rule; while a less stringent, subjective standard might apply, their actions should always be shielded if they remain within the para¬meters of the business judgment rule.

Under the business judgment rule, there is "'a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action was taken in the best interests of the company.'" *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985). Thus, the party attacking a board decision must rebut this presumption in order to prevail. The object of the business judgment rule is to allow directors use their best abilities to make necessary judgments quickly and finally without the fear of personal liability if they make mistakes.

In determining whether a board's business judgment was made on an informed basis, the question will turn on "whether the directors have informed themselves 'prior to making a business decision, of all material information reasonably available to them.'" *Van Gorkom*, 488 A.2d at 872. This inquiry reflects the rule's focus on the motivation or process taken by the directors in reaching the business decision, rather than the substance of the decision itself.

In a merger or consolidation situation, this means directors must ensure that the appropriate "due diligence" investigation is undertaken, so the directors can make a determination that the merger or consolidation furthers the interests of their organization. The directors should be able to reasonably conclude that the activities of the organization are compatible with the respective consolidation partners and that the legal, financial or other obligations of the other organizations pose no material and unacceptable risk of liability. Directors are generally allowed to rely, in this regard, on information, opinions, reports or statements, including financial statements and other financial data, if prepared or presented by: (1) one or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented;

(2) legal counsel, public accountants or other persons as to matters the director reasonably believes are within the person's professional or expert competence; or (3) a committee of the board of which the director is not a member, as to matters within its jurisdiction, if the director reasonably believes the committee merits confidence. RMNCA Section 8.30. In order for a board's decision to be considered informed, the members' actions must at a minimum rise above the gross negligence standard. *Van Gorkom*, 488 A.2d at 873.

The obligation of good faith that is key to this analysis is made up of essentially three components: honesty of intention, openness, and fair dealing. Courts will usually look to some tangible evidence that demonstrates good faith, rather than mere self-serving professions of good faith. Simply stated, directors must honestly believe that they have acted not in their personal interests or even the interests of others, but, rather, in the interests of the organization they are serving.

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Finally, there are a number of general considerations which, although not exclusively applicable to the merger or consolidation context, are nevertheless important guidelines for association or nonprofit organization board members to follow, such as: (1) attending meetings and reading correspondence carefully to keep fully aware of all policies and activities; (2) reviewing articles of incorporation, bylaws, and other governing documents; (3) avoiding any conflicts of interest and disclosing fully any potential conflicts; (4) insisting that meeting minutes accurately reflect any comments or votes in opposition to matters acted upon at meetings; (5) requesting that a legal opinion be obtained on any matter that has unclear legal ramifications; (6) obtaining and carefully reviewing both audited and unaudited periodic financial reports of the organization. In the context of a proposed legal combination, these duties have particular additional considerations, as stated below.

Duties of Board Members

In addition to the above-stated general duties of directors, there arise some duties that are unique to the merger and consolidation context, and also would be applicable to directors approving transfer of asset transactions. It is important first to note that the board of directors must always deliberate on fundamental changes in organizational character or other major corporate decisions. One such decision, of course, is whether or not to merge or consolidate with other organizations.

In assessing the duties owed by nonprofit directors during mergers and consolidations, it is essential to take account of the concerns that are unique to nonprofit organizations. In contrast with for-profit corporations, nonprofit corporations are usually more concerned, relatively speaking, with the activities of the merging organization—specifically, whether activities will be dropped or added—than with the added value that the merger could bring. Also, for-profit mergers are often faced with delicate issues of control when large companies merge with small ones. Sometimes, the smaller merger partner, by virtue of its fewer shareholders, will control the merged corporation.

A watershed case in the area of directors' duties in a merger/consolidation context is *Smith v. Van Gorkom*, supra. While Van Gorkom involved the merger of two for-profit organizations, the principles underlying the decision are generally applicable in the nonprofit context as well. In *Van*

Gorkom, the Delaware Supreme Court found the directors of Trans Union Corporation personally liable for approving an inadequate merger proposal. The court held that the direc¬tors were grossly negligent in approving the transaction and, consequently, held the directors personally liable for the difference between the “intrinsic value” of the corporation’s shares and the merger price. The court cited a number of factual bases for its decision, including the directors’ full reliance on a non-documented oral presentation, the hastiness and lack of consideration in the decision to accept the merger proposal, the directors’ insufficient inquiries of management for their input, and the directors’ acceptance of inadequately substantiated valuation information.

The significance of *Van Gorkom* is due in large part to the importance which the court placed upon the appearance of proper conduct.

The significance of *Van Gorkom* is due in large part to the importance which the court placed upon the appearance of proper conduct. Although the directors may well have possessed the necessary information concerning the transaction to make an informed decision, the court held that they failed to create an appearance or evidence of such knowledge and informed consideration.

A number of basic procedural safeguards which should be followed emerge from *Van Gorkom* and its progeny. When analyzing potential mergers or consolidations, directors should adopt procedures and methods that allow for the identification and examination of relevant risk factors. Use of independent experts, such as lawyers and accountants, is essential and their conclusions and recommendations should be reviewed closely. Copies of all proposed agreements should be available for review prior to the board meeting. Reasonable inquiry must be made into the bases of the price or values assigned to the transaction and the extent of negotiating with respect to the terms of the transaction.

Full disclosure of all material information must be made. Thorough documentation should be created and maintained of all activity taken in connection with the analysis of the proposed consolidation. Not only board minutes, but other reports should reflect what was considered, how it was considered, and why certain conclusions were reached.

Conclusion

Combination with another nonprofit corporation or association may be in the best interests of the organizations and its members or other constituencies. However, it is important that directors and employees of the organization understand the legal requirements and fiduciary obligations to ensure that legal claims or problems do not result.

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