Guide to a Successful Charity Merger

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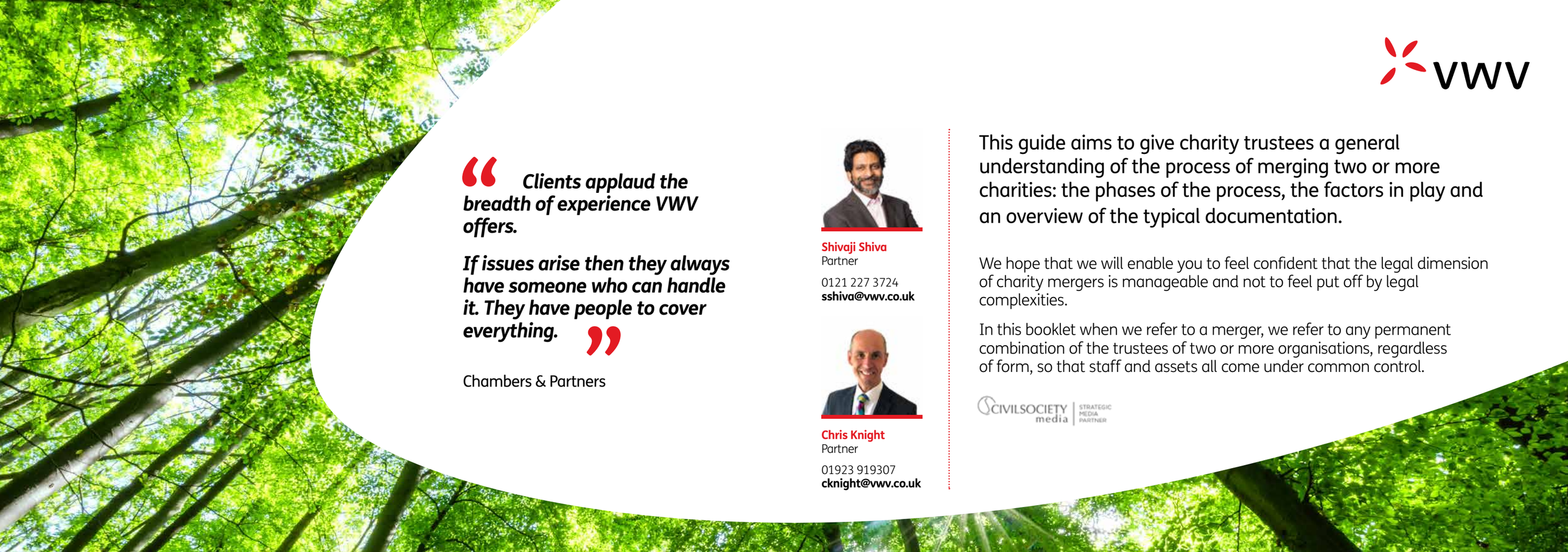

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>
> ***If issues arise then they always have someone who can handle it. They have people to cover everything.***
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This guide aims to give charity trustees a general understanding of the process of merging two or more charities: the phases of the process, the factors in play and an overview of the typical documentation.

We hope that we will enable you to feel confident that the legal dimension of charity mergers is manageable and not to feel put off by legal complexities.

In this booklet when we refer to a merger, we refer to any permanent combination of the trustees of two or more organisations, regardless of form, so that staff and assets all come under common control.

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Thinking Strategically

What is in the best interests of your charity? This is the most important factor in considering whether to undertake a merger. In particular, could you advance your charity's purposes more effectively by combining with another charity?

You should always be thinking strategically about your charity in order to identify opportunities to do things better and evaluate the risk of things that might make pursuing your objects more difficult.

You may feel under an obligation to keep your charity in being. In most cases, though, that is not an actual requirement at all. On the other hand, the need to see that **the charity's purposes are pursued effectively** is paramount.

As a general rule, the objects do not have to be pursued using any particular structure. Therefore, if some other structure proved more effective, the trustees are positively bound to consider it, and if appropriate implement it.

The issue needs to be considered objectively and free from personal bias. This can be difficult to achieve where a merger might lead to fewer trustees and fewer managers, and it may take **strong leadership** to overcome this kind of reluctance or inertia.

Did You Know?

In 2016/17, there were approximately **167,000** registered charities.

However, there were only **70** mergers of which 13% were between organisations that were already federated and 19% were in the supported housing sector.

What Are the Benefits of a Merger?

- cost savings
- succession, especially where a founder or some other strong figure is moving on
- changing needs, especially where the need for your charity's work has fallen away or cannot be fulfilled
- investment, for example, the cost of replacing IT or other infrastructure
- regulatory issues, especially as regards to the cost of regulatory compliance, and the training and management implications
- access to donors - charities working in the same sector can find themselves competing for the same donors. In the corporate donor space, a charity's scale, reputation and depth of organisation can be major factors in considering whether it is a realistic partner for corporate support.

What Are the Most Common Factors Against a Merger?

- failure to recognise that the only real alternative is to close
- determination not to be "taken over"
- excessive sentiment in relation to "our" charity
- lack of realism about strengths and weaknesses
- governance issues in relation to control of the combined entity
- CEO not being ready to retire or give way
- lack of openness and transparency by one or both merger partners
- lack of merger experience, or bad previous experience of a merger, on the part of one or both
- the practical effect of TUPE and the redundancy rules
- misconceptions about the need for transfers to keep their charity going
- inability/unwillingness to think strategically
- difficulties of due diligence

The Charity Commission

The Charity Commission is generally supportive of charities merging.

Except in some cases, including CIOs, charities merging does not require the Commission's consent or intervention.

You may want to seek the Commission's assistance:

- if there are issues over the **compatibility of the objects or the suitability of powers**, in which case the Commission can amend the objects or confirm the extent of powers
- where **land is being transferred**: careful attention will need to be paid to the regulations if the transferor trustees will be on the board of the transferee

One particular Commission resource that is valuable in the context of asset transactions is the **register of mergers**.

Registering a merger reduces the risk that legacies and other gifts intended for the transferor charity do not fail.

However, the register arrangements have their limitations and transferors should take advice about how best to deal with them.

Choosing the Right Merger Structure

Assets Transaction	Control Based Transaction
• one charity transfers its assets to the other, or • both charities transfer their assets to a new third entity	• one charity gives control to the other, or • both charities give control to a new third party
The transferee can choose what assets and liabilities to take or leave.	No transfer of assets, it is the whole charity that is transferred.
Particular attention needs to be paid to assets that cannot be transferred without some other party's consent.	Control of the merger partner is the subject matter of the transaction and the key step is to change the composition of the board of trustees.
Liabilities cannot be freely transferred. Each asset has to be transferred according to its property rules: conveyances for land, assignments for trade marks, etc.	For companies, the charity ceding control will become the subsidiary of the other and continue in being.
Staff employment rights are automatically transferred under TUPE.	The merging charities remain as separate legal entities. The assets and liabilities of the acquired charity remain isolated from the balance sheet of the acquirer.
Pros	
Opportunity to select what you want to take over.	Simpler transaction. Separate balance sheets. No transfer under TUPE: employees remain employed by their original charity.
Cons	
• Staff consultation obligations can lead to compensation claims if not correctly dealt with. • Where the transferor is insolvent, extreme care needs to be taken to ensure that its creditors are not prejudiced.	The transferee must rely on due diligence to know about all the assets and liabilities of the transferor.

Phases of a Merger

The details of the merger process will vary greatly from one transaction to another, but a number of phases are common to most: early discussions, reaching an understanding, agreeing the deal, due diligence, agreeing documentation, contract and completion, and implementation.

Early Discussions

Ideally, this should begin at the highest levels, between chairmen or CEOs or their equivalents. This should ensure an appropriate level of engagement from the outset.

However, a merger approach is not a matter only for the Chairman or the CEO to decide, but also for the whole board of trustees, who will need to decide whether to explore discussions further.

The trustees on each side should then **clarify in writing** the general scope of the discussion.

This might take the form of a memorandum of understanding but it need not: an exchange of email is quite sufficient.

It is a major purpose of the process at every stage to **reduce uncertainty**, so an exchange of views in writing at an early stage to avoid misunderstanding before matters get too far is very helpful.

Moreover, having a high level view of what the parties are working towards can be vital in developing a sense of perspective and proportion around the work to be done.

Reaching an Understanding

Once it has been decided that the charity will commit significant resources and time (perhaps with professional advisers), serious consideration should be given to protecting the interests of the charity with a confidentiality or non-disclosure agreement and possibly an exclusivity agreement.

A confidentiality agreement will oblige both sides to keep each other's information confidential.

An exclusivity agreement will prevent the other party from entering negotiations with another party with the consequent risk of wasted time, effort and cash. This can be particularly important where there are assets, such as land that might be disposed of separately in another transaction.

Also at this stage, you should consider establishing a **communications plan** agreeing what to say and who will say it if media approaches are received.

Agreeing the Deal

One of the most important steps in the process is to set out 'the deal' in a heads of terms document.

It does not matter what the document is called. What matters is that it should **set out in a non-technical way the agreement** about what each party will do to enable the end result. It should deal with the structure, the main regulatory issues and the main commercial terms. It does not need to be professionally drafted but it should be reviewed by the parties' advisers in order to be able to identify any major technical issues.

In general, heads of terms should not be legally binding. The reason is to allow the parties the freedom to negotiate further. Nevertheless, some legally binding provisions might be included particularly if they have not already been dealt with elsewhere. This would normally only be confidentiality and, if appropriate, exclusivity.

Careful thought and planning at this stage will repay dividends later.

Due Diligence

Due diligence is the process of validating assertions and assumptions. At its most basic, it is about ensuring you don't end up with things - especially liabilities - that you did not expect.

The work of due diligence is usually organised under three headings: financial, commercial and legal.

In this guide we are only concerned with legal due diligence but the principles will be applicable in many respects to every type of due diligence.

It is essential to have experienced professional advisers on hand to assist with legal due diligence. The reason is that while you will find it relatively easy to focus on matters that are the main components of the negotiation, there are normally many other matters that need to be systematically checked such as assets, liabilities, operations etc. which are designed to elicit information in all the relevant areas.

- **Issuing the questionnaire**
  The questionnaire should cover all the areas that are likely to be relevant and take a proportionate approach to the amount of detail required.
- **Receiving a due diligence questionnaire**
  A due diligence questionnaire can feel quite indiscriminate or even irrelevant from the receiver's point of view. Nevertheless, you should be cooperative and provide helpful, constructive answers in a timely manner. After all, if both parties want to do the merger and something is a concern to one of them, the best approach is generally to satisfy the concern rather than argue over the question or give vague or incomplete answers.

Due diligence depends on the nature of the deal and will not be the same for each party.

Good planning of the due diligence exercise not only improves the prospects of a good outcome. It also has an important incidental function of **demonstrating that the parties can work effectively together.**

Scope of Legal Due Diligence

The extent of due diligence and the degree of detail will vary on a case by case basis.

The following list is merely indicative of the headings to be addressed. A carefully crafted list of specific questions will then be needed for each relevant heading:

- objects and powers
- restricted funds
- employed staff and other personnel
- pensions
- intellectual property
- contracts with suppliers (including IT)
- users and other stakeholders
- members rights especially where the organisation is membership based
- regulatory matters

Effect of Due Diligence

It is an essential part of the trustees' duties to exercise care, skill and diligence in negotiating the merger, and to satisfy themselves about the assets, liabilities, and operations of the other party.

A good due diligence questionnaire should lead to a good set of systematic answers with supporting documentation.

If the information turns out to be incorrect or misleading, the party giving the information, the warrantor, will be liable to compensate the other party in damages.

In theory, in a charity transaction, the warrantor might be the merger partner itself or its trustees. In reality, trustees are most **unlikely to accept personal responsibility for damages**. If the outcome of the merger is a complete combination of both parties' assets for common purposes, there will be no point in creating contractual provisions that can only be enforced against a party that has handed over all its assets, or against the assets of the merged entity that owns them.

Each situation needs to be considered carefully in the light of its own facts and circumstances. Some situations can lead to meaningful warranty arrangements being negotiated but in most cases, it is simply not possible or at least not realistic.

The result of this is that it may be impossible to attach any specific legal remedies to due diligence responses that are incorrect or misleading.

This is **potentially a major risk** for the party conducting due diligence. It requires an important judgment about the quality of the due diligence process.

The quality of the record-keeping and the speed, frankness and clarity of responses will all contribute to a judgment about the extent to which the due diligence answers are reliable.

Contract and Completion

Once the heads of terms have been concluded, you will progress to a fully worked-up agreement dealing with all the legal matters required to accomplish the transaction.

Exchanging contracts **commits you legally to going ahead**, subject to any conditions that may have been agreed.

- In a control transaction, if there are no conditions to be satisfied, you may want to exchange contracts and complete at the same time.
- In an assets transaction, it is usually preferable to have separate exchange and completion dates, so that you know that the transaction is going ahead before having to deal with the transfers of the assets and liabilities, and employee consultations.

Where separate exchange and completion have been designed, it is important that all conditions are fulfilled, to **avoid the risk of a party backing out** if a condition is not met.

- At completion of a control based transaction, the elements of control will be handed over. Where the charity is a company, this will normally be in the form of the directors (being also the charity trustees) appointing the other party as the sole member of the charity company and appointing new trustees.
- In an asset based transfer, the transferring charity will complete the transfer of title to the various assets and the other charity will assume whatever liabilities may have been agreed. Employees will automatically become employees of the transferee.

Top Tips for a Successful Merger

- **Have a strategic view of the rationale**
  This is essential for keeping a sense of proportion in relation to due diligence and negotiations generally. It is a major factor in keeping everything in perspective and realistic.
- **Have a clear common view**
  There can be a general working assumption that both sides do want the merger to happen: keeping that in mind is essential to deal with problems and avoid misconstruing communications and questions.
- **Carry out rigorous and robust due diligence and negotiation**
  This will ensure the clearest possible understanding of what is to be agreed and see that rights and interests are properly protected.

Meet the Team

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How We Can Help?

Our specialist charity lawyers are nationally recognised by the leading legal directories and are best placed to guide you to a successful merger.

We advise over 900 charities, including endowed trusts and foundations, large national and international charities, but also community organisations and social enterprises.

To discuss how we can support your charity, please contact Shivaji Shiva at sshiva@vwv.co.uk or on 0121 227 3724.