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Considerations in Mergers and Asset Transfers of Credit Counseling Agencies

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In recent years, the number of tax-exempt credit counseling agencies ("CCAs") consolidating and dissolving their operations has grown significantly. As more CCAs experience a decrease in revenue due to a drop in debt management plan ("DMP") enrollment and increased legal and regulatory challenges, CCAs continue to weigh their options for survival and for best serving their communities; among these options are mergers and other combinations with fellow CCAs.

A number of CCAs are having strong years due to housing counseling and other activities, along with related revenue, but there are many other agencies that feel their ability to succeed is less in light of the economy and new regulations. As a consequence, transactions between CCAs have become a frequent topic of conversation.

There are two frequent scenarios that may drive transactions: first, is a CCA that no longer can make it on its own due to the financial and legal costs of its business, and wants to ensure that its clients and communities can continue to be supported without interruption. Second is the CCA that is looking to expand its scope or depth of services, strategically trim portions of its areas of service by transferring them to others that can engage in the activity, or gain operational efficiencies.

Here are some basics to consider when CCAs evaluate the options available:

Types of Combinations

An agency interested in combining with another organization has several options to consider, including merger and acquisition of an organization's assets. These types of combinations each involve different legal steps and procedural requirements and have varying benefits and considerations. Often decisions to combine are based on legal, tax or economic concerns, sometimes power and politics will dominate the decision-making process, and usually it is a combination of all of these factors.

A. Merger

Nonprofit corporations can fully and completely integrate their programs, functions and assets by merging. When two nonprofits merge, one entity legally becomes part of the surviving entity and dissolves. The surviving entity takes title to all of the assets, and assumes all of the liabilities, of the non-surviving entity. By merging, CCAs may combine their assets, reduce costs by eliminating redundant administrative processes, and provide broader services and resources to their members. CCAs that merge may increase the base of clients served, expand educational program offerings as well as be positioned to provide services offered through grants from government entities and creditors.

Mergers between two CCAs are complex processes, which require the approval of the boards of directors and membership, if any, of each organization. As a practical matter, it can be difficult to combine and coordinate the governing bodies, staffs and operations of two or more existing CCAs. Additionally, the institutional loyalties of members, officers, and professional staffs often come into play, particularly when the organizations considering merger or consolidation are unequal in size and resources.

To merge with another CCA, each agency must follow the procedures mandated under the nonprofit corporation law of its state of incorporation, as well as any specific procedures in its governing documents, provided such procedures are consistent with the nonprofit corporation statute. While nonprofit corporation statutes differ by state, the laws governing merger and consolidation of nonprofits typically set forth certain core procedural requirements.

Typically, the details of the deal between the two organizations are set forth in a “Merger Agreement” that is not required to be filed under nonprofit law, although state regulators may very well request a copy. This document usually covers items such as integration of the staff and voluntary leadership, corporate governance changes, and programmatic consolidation. It often is quite detailed.

Additionally, following the merger, all parties to the transaction must notify the Internal Revenue Service (“IRS”) of the merger and provide supporting legal documentation. If the newly merged entity will carry out substantially the same activities as its predecessors, the IRS will typically grant an expedited approval on a *pro forma* basis and there will be no lapse in tax-exempt status.

B. Acquisition of Assets

Another legal mechanism for “absorption” is the *dissolution and distribution of assets* of a target CCA. This statutory procedure generally involves the adoption of a plan of dissolution and distribution of assets, satisfaction of outstanding liabilities, transfer of any remaining assets to another nonprofit entity, and dissolution. Where the dissolving nonprofit is exempt under Section 501(c)(3) of the Internal Revenue Code, the Treasury Regulations require the organization to distribute its assets for one or more exempt purposes under Code Section 501(c)(3).

While the dissolving entity must adhere to specific statutory procedures, a dissolution and transfer of assets is in theory much less onerous on the entity that acquires the dissolving entity’s assets (the “successor” entity) than a merger or consolidation. Because the successor entity is merely absorbing the assets of another organization, corporate filings are typically not required for that corporation. Furthermore, receipt of a dissolving CCA’s assets typically does not affect the successor organization’s tax-exempt status. However, just as with merger, a tax-exempt organization must be cautious when taking on programs or activities to ensure that they support its stated tax-exempt purposes.

Asset transfer and dissolution may be strategically preferable for combining organizations when one CCA is of a much smaller size than the other. In addition, this type of transaction is particularly useful when a CCA wishes to acquire the assets of another CCA with significant future contingent liabilities, because the successor organization does not, by operation of law, assume the liabilities of the dissolving corporation. Further, the successor organization may seek to limit the liabilities it will assume in a written agreement. The agreements typically can be quite complex and detailed depending upon the assets involved.

Even though by operation of law a successor organization does not automatically assume the liabilities of a dissolving organization, an asset transfer always poses some risk of a finding of *successor liability*, particularly if adequate provisions have not been made for pre-existing liabilities. Successor liability can occur if, for example, a court determines that an organization that acquired the assets of a dissolved corporation impliedly agreed to assume the dissolved corporation’s liabilities. Alternatively, a court may find that the successor corporation serves as a “mere continuation” of the dissolved corporation, that the asset transfer amounts to a *de facto* merger, or that the transaction was actually a fraudulent attempt to escape liability. It is also often problematic to extinguish liabilities, such as employee benefit programs, rather than assuming them.

Like a merger, an asset transfer and dissolution must follow the applicable state nonprofit corporation laws and each entity’s governing documents. The procedure for dissolution and asset distribution is fairly simple for the successor entity, as it will simply be entering into a transaction – albeit a significant one – to acquire assets and absorb members, if any. The process is more complicated, however, for the dissolving entity. In most instances, the nonprofit corporation statute of the dissolving CCA’s state of incorporation imposes a number of express requirements to effectuate a transfer and dissolution that must be followed.

As part of the asset distribution process, the parties typically execute a written agreement detailing their understanding of the transfer of the dissolving corporation’s assets. The parties may utilize such an agreement where they wish to obtain warranties regarding the absence of liabilities to be assumed by the successor corporation; account for any outstanding contractual obligations of the dissolving entity; provide for third-party consents where necessary to transfer any contractual obligations to the successor organization (*e.g.*, DMPs); or detail terms for the integration of the dissolving entity’s members. Note that in the event of any breach of warranties by the dissolving corporation, it generally will not be possible for the successor corporation to obtain redress unless the agreement specifically obligates some third party to indemnify the successor corporation, as the dissolving corporation will no longer exist.

Additional Considerations

Setting aside the legal considerations, any combination between two CCAs has a set of practical implications, including an emotional aspect. CCAs, perhaps more than many other nonprofits, have mission focused cultures that are often tied to their local communities. Therefore, both organizations will need to have a clearly defined set of goals they want to achieve. Along these lines, it also is important that they publicly and internally communicate these goals consistently, so that both organizations are well positioned to avoid a more than normal amount of scrutiny by regulators, creditors, and other stakeholders with whom they work with to provide their services to consumers.

For those that are contemplating an organizational change, there will always be a question as whether counseling staff will continue to be available to serve the community and at what level of engagement. Sometimes these are issues that need to be carefully considered because for both organizations' identities and strengths may be connected to particular key persons and their relationships with relevant stakeholders (*e.g.*, creditor relationships, community outreach, and unpaid referral networks).

In addition, there are several important steps that should be taken in planning for a combination to enhance the possibility that a transaction will be consummated. First, the organizations should consider appointing a group of transaction representatives. This group of selected staff and board members from each organization will have two roles: (1) to develop a plan for the transaction (*e.g.*, merger or asset transfer) and communicate this plan to each organizations' stakeholders such as boards, leadership, and staff; and (2) to work through the issues which will inevitably arise in the due diligence process and transaction process.

Importantly, the representatives also will need to plan for and address the scope of due diligence. Due diligence is a critical part of any corporate transaction process, and typically involves gathering sufficient information for the governing body of each organization to ascertain the financial and legal condition of the other organization or of a particular set of assets. This process is achieved through a review of the other entity's books, records, governing documents, meeting minutes, pending claims, employment practices, leases and insurance policies, financial obligations, and (especially important to CCAs) vendor contracts, grants, DMP portfolios, legal and regulatory compliance programs (both historic and current), and the like. Due diligence is the step which requires the largest commitment from each CCA and a great deal of analysis, but will mean the difference between a gamble and an educated guess in the decision to consummate the transaction.

CCAs also have to do a careful analysis of the approval requirements for the transaction, including those of relevant regulators related to the services provided, such as DMPs and related licensing. Due to the high amount of state regulation of activities of CCAs, it is important for the parties to carefully review state laws and regulations to ensure compliance. CCAs may want to review state law to determine if they are required to follow certain procedures and provide notices under each regulatory scheme in which the CCA holds a license or registration and in each state in which a transferred consumer resides, as many state laws differ from each other on the subject. It is important to also realize state licensing laws and business practices do not always coincide, and that a transfer of a DMP does not absolve the dissolving CCA from compliance obligations and may trigger new obligations for the receiving entity.

Next, the representatives must come to an understanding on tough questions such as what will be the roles of the respective staff and others once the transaction is complete. Obviously, one of the efficiencies in a merger is avoidance of duplicative roles, and both organizations should be clear on what the end organizational chart will look like and how the consolidation will be effectuated in a successful integration. In an asset transfer, it is conceivable that no staff at all would be automatically transferred.

In a merger situation representatives will also need to develop an overall merger plan which should include an outline of the combined governance structure, mission, core activities, and a broad staffing plan. Likewise, in an asset transfer situation careful planning related to the assets to be transferred may be necessary.

Additionally, the parties to the transaction should work together to develop an internal and external communications strategy for educating staff, board, clients, regulators, and the general public about the transaction. Release of information should be carefully coordinated between the CCAs and each party should agree to give the other notice before making any announcements to the public.

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The economic crisis has presented CCAs with opportunities and challenges. CCAs must remain flexible and adapt their business models, which will invariably include consideration of mergers and other combinations. For CCAs the decision to merge or enter into a significant transaction should be heavily dependent on fully identifying the goals of the transaction and the potential ramifications for both groups. Federal and state regulators, clients, and the public scrutinize arrangements between CCAs, so they must be carefully structured and executed. With careful planning, CCAs can enhance opportunities to further their tax-exempt missions and meet their financial goals through mergers and other combinations.

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