A Guide to Mergers of

ENTITIES

By Gaetan J. Alfano and John W. Kettering

Nonprofits generally consider mergers for a variety of reasons, such as to avoid financial duress, to obtain stronger operational resources or to expand the scope of services. This article explores the statutory mechanisms available to nonprofits considering merger as well as discussion of the fiduciary duties of directors who may be considering a merger.

Effects of Merger

Section 331 of the Pennsylvania Transactions Law allows for the merger of two domestic (Pennsylvania) nonprofit entities. In such an instance, it is contemplated that Nonprofit 1 (NP1) would remain as the surviving association, with Nonprofit 2 (NP2) as the merged entity. For this to occur, each board of NP2 and NP1 would need to approve of a plan of merger, and a statement of merger would be filed with the Pennsylvania Department of State. Upon filing of the statement, the merger would be complete, and NP2 would no longer exist as a legal entity.

Upon the effectiveness of the merger, all property of NP2 would become the property of NP1 (automatically, by operation of law), and all debts, obligations and liabilities of NP2 would be the debts, obligations and liabilities of NP1, without reversion, impairment or transfer. All rights, privileges, immunities and powers of NP2 would be vested in NP1, assuming there is no concern with diverting the charitable purpose of the assets.

Effects of Dissolution

As an alternative to merger, Section 5972 of the Nonprofit Corporate Law (NCL) allows for a voluntary dissolution of a Pennsylvania nonprofit corporation by the directors and/or members of the corporation. The NP2 board would adopt a resolution that it be voluntarily dissolved. The articles of dissolution would be filed with the Pennsylvania Department of State.

NP2 would be able to wind up its affairs either prior to or following the filing of the articles of dissolution. The winding-up process would require that NP2 collect all amounts owed to it and then pay all outstanding liabilities and claims.

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Statutory Limitations on Asset Transfers

Under either a merger or dissolution analysis, the assets of a nonprofit corporation incorporated for charitable purposes may not be diverted from the charitable purposes for which the assets were originally donated without prior approval of the orphans' court. This "nondiversion" principle is known as the charitable purpose doctrine.

Section 314(c) of the Transactions Law (governing mergers) states that property held for a charitable purpose: may not, as a result of [a merger], be diverted from the objects for which it was donated, granted, devised or otherwise transferred unless ... the association obtains an appropriate order of a court of competent jurisdiction specifying the disposition of the property.

Section 5547(b) of the NCL (governing nonprofits generally and also dissolution) provides that: [p]roperty committed to charitable purposes shall not ... be diverted from the objects to which it was donated, granted or devised, unless and until the board of directors or other body obtains from the court an order ... specifying the disposition of the property.

In order to determine whether these limitations apply to a proposed merger, such as the hypothetical NP1 and NP2

transaction, the following factors must be considered: (a) Was NP2 incorporated for "charitable purposes"? (b) Are NP2's assets "property held for a charitable purpose"? and (c) Are the "charitable purposes" of NP1 and NP2 so similar or correlative that a transfer of the NP2's assets to NP1 would not violate the legal prohibition against diversion of charitable assets absent court approval, as required by Pennsylvania law?

What Are "Charitable Purposes"?

As a threshold matter, the Pennsylvania courts have articulated a difference between nonprofit corporations and charitable nonprofit corporations. As set forth by the Pennsylvania Commonwealth Court in *Commonwealth v. New Foundations* in 2018: Nonprofits that do not have a charitable purpose are a form of organization that is used to serve their members without profit — e.g., homeowners associations and country clubs. Unlike ordinary nonprofits, charitable nonprofits are incorporated to aid an indefinite number of persons for "charitable purposes …"

This differs from "charitable purposes," which is defined by statute as: [t]he relief of poverty, the advancement and provision of education, including postsecondary education, the advancement of religion, the prevention and treatment of disease or injury, including mental retardation and

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mental disorders, governmental or municipal purposes and any other purpose the accomplishment of which is recognized as important and beneficial to the public.

The determination of whether a nonprofit corporation is a "charitable" nonprofit is highly fact intensive, but fundamentally the critical question is whether its essential purpose is to provide a social or public benefit.

What are "Charitable Assets"?

The NCL, in Section 5547(a), provides as a general rule that a charitable nonprofit corporation "may" hold property in trust as charitable assets:

Every nonprofit corporation incorporated for a charitable purpose or purposes may take, receive and hold such real and personal property as may be given, devised to, or otherwise vested in such corporation, in trust, for the purpose or purposes set forth in its articles. The board of directors or other body of the corporation shall, as trustees of such property, be held to the same degree of responsibility and accountability as if not incorporated, unless a less degree or a particular degree of responsibility and accountability is prescribed in the trust instrument, or unless the board of directors or such other body remain under the

> control of the members of the corporation or third persons who retain the right to direct, and do direct, the actions of the board or other body as to the use of the trust property from time to time.

This statute has been construed by the courts to mean that all property held by a nonprofit corporation is held in trust to carry out its charitable purposes. On this issue the law makes no distinction between property given to the nonprofit corporation and property generated from the corporation's internal operations. As stated in *In re Roxborough Memorial Hosp.*:

> All property held by a charitable nonprofit, including the operating revenues, grants, donations, bequests, etc. generated therefrom, constitutes property committed to charitable purposes.

A significant gloss to the general rule above was handed down in 2018 by the Pennsylvania Commonwealth Court in a case that remains active as of this article. In *Commonwealth v. New Foundations*, the court found that property donated to a nonprofit corporation (as opposed to property generated from internal operations) is held by the corporation "in trust" as a charitable asset. Conversely, revenues generated from a nonprofit corporation's operations are not deemed to be held "in trust." The fiduciary distinction articulated by the *New Foundations* court is better illustrated by example. In that case, allegations were made against the directors and officers of a charitable nonprofit corporation for self-dealing and the improper transfer of corporate assets. With respect to the assets held "in trust" (i.e., assets donated to the nonprofit corporation), self-dealing in those assets was absolutely prohibited (applying the heightened "trustee" fiduciary standard). With respect to the other assets, a corporate director standard is applied,

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and self-dealing may be permitted in certain limited circumstances, discussed in greater detail later in this article. The determination of whether property is held "in trust" is critical in determining whether a heightened fiduciary standard is applied to the nonprofit directors. However, even where corporate directors are not subject to heightened scrutiny, standard fiduciary duties, discussed later, still apply.

Nondiversion of Charitable Assets — *Cy Pres*

Under the charitable purpose doctrine, the entirety of a charitable nonprofit's assets are deemed to be committed to a charitable purpose and thus constitute "charitable assets." Furthermore, Section 314(c) of the Pennsylvania Transactions Law prohibits property committed to charitable purposes from being "diverted from the objects to which it was donated, granted or devised." As a result, when a charitable nonprofit ceases business (by merger, voluntary dissolution or otherwise), any funds or property that remain must be given to a charitable nonprofit with a similar charitable purpose — a doctrine known as *cy pres*.

In order to determine whether the nature or character of two nonprofit charitable corporations are sufficiently similar to warrant approval of the transfer of charitable assets, the court will apply a *cy pres* analysis, including a review of purposes of the organizations, the localities that the charities intended to serve and the nature of the population that was the intended object of the charitable gift. The ultimate application of *cy pres* requires the court to exercise its discretion in such a manner as to award the assets to a charity whose purpose most resembles (is "as near as") the one that the original donors intended to benefit.

For example, in *In re Women's Homeopathic Hosp.*, involving a trust set up for the endowment of hospitals "for the benefit and assistance of women and children primarily," the court approved the award of one-half of the trust to a women's hospital and the other half to a homeopathic hospital, with the particular institutions chosen because they "were qualified by character and services to carry out most nearly the intent of the donors." In another case, *In re Estate of Elkins*, funds dedicated to benefit a hospital were permitted to be transferred to use for education, research and clinical care under a finding by the court that the funds would be used to further the donor's original intent of providing medical services to patients in Philadelphia.

The question is, therefore, whether the charitable purposes of each nonprofit are so similar that a transfer of the assets would not violate the prohibition against diverting charitable assets from their charitable purposes. Statements of "charitable purpose" are likely not identical in either nonprofit's articles of incorporation, but may be correlative; consequently, determination of the legal sufficiency of similar statements of "charitable purpose" can become a highly fact-intensive inquiry that should not be taken for granted.

In many instances, the more prudent course of action is for the board of the to-be-merged nonprofit — on its own or together with the surviving nonprofit — to seek an order from the orphans' court specifying the appropriate disposition of the entity's assets.

Involuntary Dissolutions

The NCL, in Section 5981, permits involuntary dissolutions, but only under extraordinary circumstances such as: (i) the objects of the nonprofit corporation have wholly failed or are entirely abandoned or their accomplishment is impracticable; (ii) the acts of the board of directors are illegal, oppressive or fraudulent; (iii) the corporate assets are being misapplied or wasted; or (iv) the board of directors is deadlocked and irreparable injury is being suffered by the nonprofit corporation.

An involuntary dissolution of a viable nonprofit corporation is a radical remedy. It is

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highly unlikely that a court would approve it in the absence of evidence of actual malfeasance or other extraordinary corporate behavior.

Fiduciary Duties of Directors

There are three specific fiduciary duties that directors of both nonprofits need to observe when considering merger:

- **The duty of loyalty** requires that corporate directors devote themselves to corporate affairs with a view to promote the common interests and not only their own, and that they cannot directly or indirectly utilize their position to obtain any personal profit or advantage.

- **The duty of care** requires that directors perform their duties in good faith, in a manner they reasonably believe to be in the best interests of the corporation and with such care, including reasonable inquiry, skill and diligence as a person of ordinary prudence would use under similar circumstances, taking into consideration that the primary purpose is to advance the charitable purposes of the corporation.

- **The duty of obedience** focuses on the "incidental profit" that a nonprofit entity derives from its operations and requires that the directors' decisions to expend funds substantively further the purpose for which the nonprofit was organized and not to further a director's personal financial interests. The duty of obedience is a subset of the duty of loyalty but with a focus on donor intent and the nonprofit's charitable purpose.

Special Rules for Self-Dealing Transactions

Section 5728(a) of the NCL contains specific provisions that address situations in which directors may have a personal interest, known as self-dealing:

> (a) General rule — A contract or transaction between a nonprofit corporation and one or more of its directors or officers … shall not be void or voidable solely for that reason, or solely because the director or officer is present at or participates in the meeting of the board of directors that authorizes the contract or transaction, or solely because the vote of the director or officer is counted for that purpose, if: (1) the material facts as to the relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors and the board authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors even though the disinterested directors are less than a quorum; ... [or] (3) the contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified by the board of directors or the members.

So long as these statutory provisions are complied with, self-dealing will not be considered a breach of a director's duty (except where trust assets are involved, in which case self-dealing is absolutely prohibited).

Conclusion

The merger of nonprofit entities requires a unique analysis unlike the one applied in a

transaction involving for-profit entities. The failure of the nonprofit board or its counsel to recognize the differing standards applied to nonprofit entities could lead to adverse consequences. Nonprofit mergers raise issues such as charitable purpose, "in trust" assets and heightened fiduciary duties that are not typically considered in other transactions. Failure to recognize these uncommon issues or rubber-stamping the transaction without the proper consideration will put the nonprofit and its board members at a substantial risk of liability. Through a close examination of the details of the proposed transaction, as well as an analysis of the unique standards applicable to nonprofits, the nonprofit board members, and their counsel, can properly complete a merger for the benefit of both nonprofit entities. ⚖

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