CPA CHARTERED PROFESSIONAL ACCOUNTANTS CANADA

20 Questions Directors of Not-for-Profit Organizations Should Ask about **Mergers**

Mark Blumberg • Andrea Cohen Barrack

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Preface

The Corporate Oversight and Governance Board (COGB) of the Chartered Professional Accountants of Canada (CPA Canada) has commissioned this publication to assist directors and senior staff of Canadian not-for-profit (NFP) organizations in understanding and evaluating potential mergers.

Determining whether an organization should explore or proceed with a merger is one of the most important strategic and governance questions a board of directors can face. This document addresses the major elements directors should consider when contemplating a merger, grouped into the following areas:

1. Evaluating merger as a strategic option
2. Exploring a merger
3. Negotiating a merger
4. Implementing a merger

This publication will provide directors and senior leadership of NFP organizations, which include non-profit organizations and registered charities, with a greater understanding of the issues involved in negotiating and implementing a merger, and assist the board in determining if a merger is the best option for the organization.

The COGB thanks the authors, Mark Blumberg and Andrea Cohen Barrack, and acknowledges the contribution of the Not-for-Profit Organizations Committee.

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Introduction

There are over 160,000 NFP organizations in Canada, of which approximately half are registered charities. Difficult economic times, an increasingly competitive NFP sector, and the desire for greater effectiveness and impact are driving some organizations to explore options for closer collaboration and merger.

In some cases, governments and funders are encouraging increased collaboration. In other cases, organizations find they are struggling to implement their mission amidst a multitude of organizations with overlapping programs and activities, and merger appears to be a logical option.

However, the costs of a merger can be significant in terms of time, resources and focus. Careful and thorough analysis in the preliminary stages can reduce the costs and increase the likelihood of a successful merger.

There are a number of key factors for a successful NFP merger, including a focus on strategic and community benefit, full commitment of the leaders of both organizations, deployment of necessary resources and cultural compatibility.

What Is a Merger?

A merger is an integrated restructuring in which two or more organizations combine their operations into a single entity. A merger can be effected in different ways but ultimately it is the most integrated form of cooperation between organizations.

The Charities Directorate of the Canada Revenue Agency (CRA) defines the terms 'amalgamation', 'merger' and 'consolidation' in relation to registered charities (which terms are equally applicable to other NFP organizations) as follows:

Two or more registered charities can join together as one body in response to changing circumstances or changed objectives. They can join through an amalgamation, merger, or consolidation. Although these terms are sometimes used interchangeably, there are important distinctions between them for charities.

Amalgamation
When charities amalgamate, they bring their memberships, assets and liabilities into the entity that emerges. The original charities do not cease to exist or dissolve. Although they no longer have separate identities, they continue to exist within a single entity — the amalgamated charity.

Merger
In a merger, one or more entities wind up their affairs and transfer their assets to another registered charity.

Consolidation
In a consolidation, all the original bodies dissolve and transfer their assets to a new entity.[1]

The exact form or structure of a merger is generally determined after significant due diligence with the benefit of advice from legal and financial advisors. This publication uses the term 'merger' in general terms, regardless of the exact structure of the transaction, and is not limited to the CRA definition.

Directors should be mindful that an NFP's ability to fulfill all of the steps suggested in this document may vary based on the size and resources of the organization. Ideally, an organization is able to fulfill all of the oversight elements of a merger. However, an NFP with limited capacity can pick the elements it deems most critical and achievable to oversee the merger as best possible given its capacity.

1 CRA Charities Directorate, *Amalgamations, Mergers and Consolidations.* (www.cra-arc.gc.ca/chrts-gvng/chrts/prtng/chngs/mlgmtns-mrgrs-cnsldtns-eng.html, 2015).

Part I: Evaluating Merger as a Strategic Option

1. What Problem Is the Organization Trying to Solve?

In order to effectively evaluate merger as a strategic option, the board must ensure it has a clear understanding of the reasons it is being considered.

Internal and External Drivers

Often there are both internal and external drivers for contemplating a merger.

External drivers include funder pressure, shifting community and client needs, and environmental changes.

> Many sectors have experienced a push from funders to consolidate with other 'like' organizations. Some government funders have a mandate to integrate services and are strongly encouraging mergers as one way to better align and utilize resources. Other services like as legal aid clinics, children's aid societies and housing cooperatives are investigating or implementing consolidations and mergers. Even funders like Community Foundations and United Ways have joined the ranks of organizations that have undergone mergers to realize strategic goals.

Internal drivers are often rooted in sustainability and capacity issues. Sustainability is one of the biggest concerns in the NFP sector. Many government funders are moving away from traditional core funding in

favour of project funding or purchase of services. Years of austerity have often resulted in funding freezes. For organizations that rely on fundraising and philanthropy, there is increasing competition for donors.

> In a 2012 survey of over 1400 applicants and grantees of the Ontario Trillium Foundation, sustainability was identified as a primary issue. When asked what would be the most pressing needs facing Ontario's NFP sector in the next two to three years, more than 25 per cent of the needs identified were related to funding and sustainability.[2]

Mergers may also be motivated by a desire to increase organizational capacity. Funders are requiring more complicated forms of reporting and making greater demands on NFP organizations for measurement and evaluation. A merger may allow one organization to benefit significantly from the technical, financial, fundraising and other resources of another. A more robust operational team resulting from a merger can allow for greater specialization and provide needed expertise.

Many organizations seek opportunities to provide expanded or improved services, reach new populations, or offer more comprehensive programming. This goal may be due to a desire to grow the organization or to respond to changes in needs and demographics. It may also be to gain competitive advantage. The NFP sector has traditionally been wary of speaking about competition, but in order to succeed, organizations must 'win' at securing resources, reputation, clients and staff, which is why merging with another organization may be a useful strategy.

The Real Issue for the Board: Value Creation

Value creation is the key issue when analyzing a potential merger and must be the primary motivation for any further exploration.

In the NFP sector, value can be described as community benefit or public value. Public value is often articulated by three questions, which form the strategic triangle.[3]

1. *Is there legitimacy and support for the issue?* Do key external stakeholders such as government, partners, users, interest groups and donors support the cause?

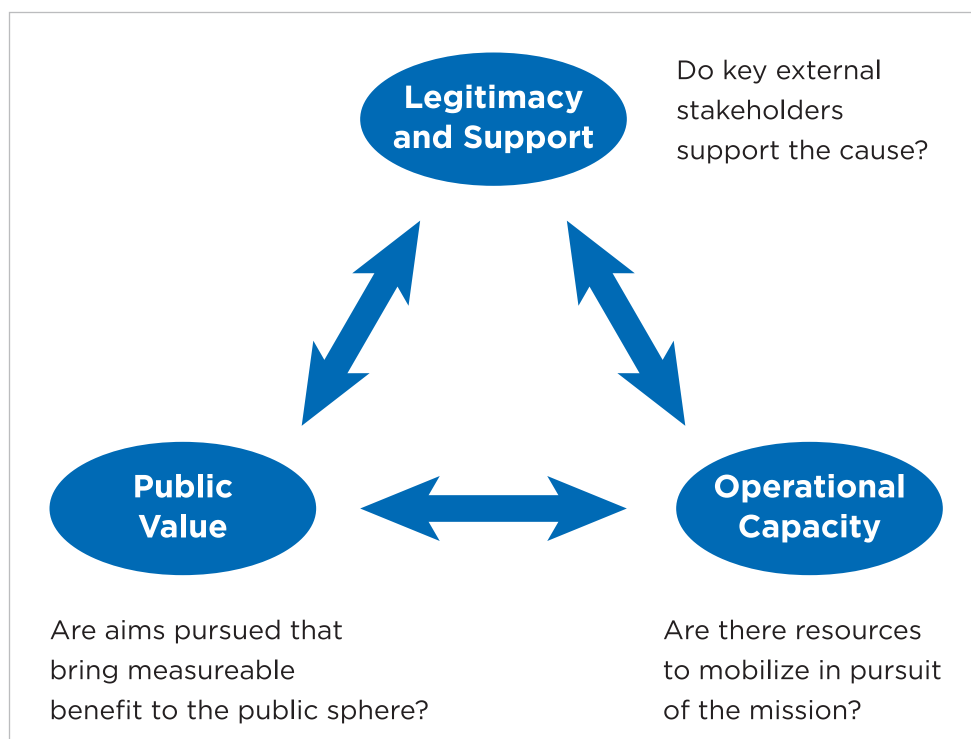
2 Centre for Effective Philanthropy, *Applicant and Grantee Perception Report*. (Unpublished internal report. Ontario Trillium Foundation Head Office, Toronto, 2012).

3 Moore, M., *Creating Public Value: Strategic Management in Government*. (Harvard University Press, 1995).

2. *Does the organization have the operational capacity to deliver?* Are there sufficient resources (e.g., finances, personnel, skills, technology) that can be mobilized in pursuit of the mission?

3. *Is the organization pursuing aims that will bring measurable benefit to the public sphere and which address the expressed or revealed priorities of a given population?*

PUBLIC VALUE STRATEGIC TRIANGLE



Adapted from Moore 1995

The board should consider whether a merger would enhance or increase overall value creation or, alternately, whether a merger will add transaction costs or have other negative impacts which would ultimately decrease value creation. By answering the three questions related to public value, the problem will be more clearly defined and the board can determine whether merger may be the solution.

2. What Options Are Available to Solve the Problem?

Once the board has determined what problem(s) the organization needs to solve, there may be a multitude of options that can be considered, depending on the nature of the problem. One option is for an organization to find a merger partner with strengths in that area.

There are different options available to organizations interested in cooperating, coordinating or collaborating. Some options provide greater autonomy, while others lead to greater integration. Collaboration can include:

- informal networking
- participation in membership organizations
- creation of umbrella groups or coalitions
- sharing of premises and facilities
- group purchasing of products or services
- joint ventures
- joint research, training, programming, or fundraising

Solutions to Problems of Operational Capacity

Shoring up operational capacity is a frequent justification for contemplating a merger. Assuming the organization has public support and is providing measurable benefit, there may be alternate approaches.

- Back office integration can deliver economies of scale without a merger. Sharing space is one way to accomplish this goal, but virtual back office integration is also possible. Many smaller organizations are experimenting with shared platforms, using common HR, finance, governance and IT resources while keeping programming and branding separate.

- Lack of operational capacity may also signal a need for new leadership or additional skill sets. While leadership transition can be painful, it may be less so than undergoing a merger.

Solutions to Problems of Creating Measurable Public Benefit

If the problem is the need to enhance or increase measurable public benefit, there is a range of options such as:

- program-based partnerships
- front office integration and shared service agreements
- process improvements to enhance value without increasing resources

For organizations that need to shore up operational capacity **and** increase measurable benefit, a merger may be a better option than pursuing a broad array of front and back office integrations.

Solutions to Problems of Legitimacy and Support

The toughest problem to solve is a lack of legitimacy and support. If the mission of the organization isn't sufficiently relevant to muster support from the public, potential donors and other stakeholders, a merger may solve the problem if it involves absorption of the organization's infra-structure and resources by another more credible organization. Other alternatives include repurposing the mission and cause to garner broader support, or winding down the organization.

3. How Should the Board Evaluate Merger as a Strategic Option?

When evaluating merger as a strategic option, there are a number of key considerations for the board.

Benefits versus Risks

Directors need to understand the possible benefits and risks of a merger in order to determine if public value will be created. While anticipated benefits and risks will be further explored and validated during the due diligence phase, the board should have a sufficient understanding at the outset in order to determine whether to proceed with exploring a merger.

It is important to realize that when considering the benefits and risks of proceeding with a merger, directors must also explore the benefits and risks of **not** undertaking a merger. In other words, what is the potential opportunity cost if the organization does not pursue a merger?

> One of the main reasons NFP organizations consider merging is to solve financial pressures, whether internally or externally generated. Sector experience has, however, demonstrated that mergers do not usually result in cost savings, although they may lead to stronger administrative structures which can better manage finances.[4] When looking at benefits and risks, realistic assessment of anticipated financial benefits is critical.

4 LaPiana, D. *Merging Wisely.* (Stanford Social Innovation Review, Spring 2010).

Organizational Readiness

Another key factor in assessing the viability of merger as a strategic option is the organization's readiness. Directors should assess management's capability and capacity to negotiate and implement a merger, as the time and effort required for these activities will necessarily take away from other activities that may impact on public value creation. Merger plans frequently underestimate costs, including time costs. If sufficient time, skills and financial resources cannot be devoted to merger implementation, the likelihood of success is markedly decreased.

Organizational Resilience

While bigger is not necessarily better, a larger organization is usually more resilient to the volatility that is inherent in any merger. If one of the anticipated benefits of a merger is revenue growth, this can translate over time into growth in public value. When organizations become larger, however, they risk losing public support due to the perception that local service planning, community governance and responsiveness to stakeholders have been sacrificed.

Risk Tolerance

Related to resilience is the organization's risk tolerance, in particular, merger risk tolerance. The board should consider how much risk the organization is comfortable assuming. Merger is often a high-risk strategy for NFP organizations as it is generally very difficult or impossible to unwind a merger once it has occurred.

Timing

The other key consideration is timing. Directors should consider the time frame over which they expect to see results. There will be different risks and benefits in the near, medium and long term. The highest-value mergers may not create value immediately, but rather provide the foundation from which an organization can enhance public value creation over the long term.

Tips for managing a NFP merger:

- Start preparing six months to a year in advance of engaging in serious discussions with potential merger partners.
- Before beginning discussions, take steps to 'clean up' the organization. Governing documents, processes and assets, etc. will be scrutinized like never before.
- It is better to approach a merger from a position of some strength, not as a last resort before insolvency.

4. What Are the Governance Implications When Considering a Merger?

Fiduciary Duty

The decision to pursue a merger is likely the most significant strategic decision the board will ever make. As part of their fiduciary duty, directors have a duty of loyalty which requires them to act in good faith in the best interests of the organization. The directors' duty is to the organization itself, but directors can and should take into account the interests of stakeholders such as members, funders, clients, beneficiaries and others.

The directors' duty of care requires them to be informed and to act with competence and diligence. Directors should be fully informed about the issues before making decisions.

For more information, see the CPA Canada publication **20 Questions Boards of Not-for-Profit Organizations Should Ask about Fiduciary Duty**.

Board and Management Roles

Most directors understand that they are responsible for overseeing strategy and would list it among their board's top priorities.

In the largest and most sophisticated organizations, management may develop and execute strategy (including merger strategy), while the board focuses on oversight and approval of significant transactions. However, boards must assert themselves more directly in strategic oversight because directors offer valuable experience and an independent perspective, and management cannot objectively assess its own performance, capabilities and plans. Furthermore, as NFP executives often do not have significant merger experience, there may be increased reliance on the expertise of directors.

Additionally, directors should be cognizant of the inherent conflict of interest for senior management, in that mergers frequently involve a threat to the positions of the leadership team.

Importance of Advisors

As part of the directors' duty to act diligently, the board should obtain the advice of qualified professionals when necessary. Advisors might include strategy consultants, legal counsel and financial advisors.

It is important to establish clear mandates and deliverables for each advisory engagement, as well as a clear reporting structure. It is not usually necessary to have the board engage advisors directly, as long as the board has direct access for briefings and questions. Although advisors often play an important role in mergers, they should not be involved in decision making or negotiations without clear instructions.[5]

Impact on Directors

Finally, the board should be aware of the probable impact on directors. Merger negotiations are high stakes, labour intensive and time-sensitive. The board of an organization that is contemplating, negotiating or implementing a merger will likely be called upon to meet with much greater frequency than usual. This involvement will be amplified for directors playing a direct role in overseeing negotiations or implementation.

5 Adapted from Caldwell, J. and Smith, K.E., *Overseeing Mergers and Acquisitions: A Framework for Boards of Directors.* (Toronto, CPA Canada, 2015).

Part II: Exploring a Merger

5. How Should the Board Oversee the Exploration of a Merger?

The depth of the board's involvement in a merger will vary depending on the size and nature of the merger and the organization's experience and capabilities. Putting appropriate governance structures and processes in place helps equip directors to make a reasonable business decision based on complete information. It also generates a record that shows how the board fulfilled its duties.

Resolution of the Board

At a minimum, the board of directors should approve the expenditure of time and resources required to conduct an in-depth exploration, discussion and potential negotiation of a merger. Once a partner is identified (but before negotiations begin), the boards of both organizations should agree to negotiate in good faith and agree on the process for discussion, due diligence and negotiation, including milestones and deadlines.

Terms of Reference of Special Committee

Many organizations choose to establish a special committee to oversee merger exploration, allowing a smaller group of directors to undertake an intensive review. The mandate of the committee is generally to explore possible options and provide a recommendation to the board regarding potential partners. The scope of the committee's mandate should be set out clearly, including:

- composition
- meeting procedures
- authority to retain advisors or negotiate on behalf of the organization
- decision making process
- budget
- time frame for finalizing its recommendation to the board

For more information, see the CPA Canada publication **20 Questions Directors Should Ask about Special Committees (2nd Ed.)**.

6. What Unique Characteristics of Not-For-Profit Organizations Should Be Considered?

There are some key considerations specific to NFP organizations that directors should take into account when considering a merger. While unlikely to prevent a merger, these issues should be considered during the contemplation and exploration phases.

Importance of Objects

The objects of a NFP organization are its stated purpose, which is set out in its constating documents (such as the articles of incorporation or letters patent in the case of a corporation). These are key to establishing and maintaining non-profit and/or charitable status. A NFP organization may only carry on activities that fall within its objects and may thereby be restricted. Depending on the objects and activities of the merged corporation, it may be necessary to change the existing objects and obtain approvals from government and other regulators to do so. Specifically, if one or more of the parties involved in a merger is a registered charity and any changes to the objects are required, it is advisable to obtain prior CRA approval of the revised objects to ensure that CRA considers them to be exclusively charitable.

Procedural Restrictions and Approval Requirements

Directors should be aware of procedural restrictions and approval requirements which could impact the feasibility of a potential merger or merger partner.

For example, under the *Income Tax Act* (Canada), a registered charity can only transfer its assets to a 'qualified donee' upon dissolution. A qualified donee is one of a number of different categories of organizations that can issue official donation receipts under the *Income Tax Act* (Canada).

This restriction may affect the structure of a merger between a registered charity and an organization that is not a charity, since the charity cannot transfer its assets to a non-qualified donee, but the non-charity is not subject to such restrictions. Ultimately the charity and its directors are responsible for assets that are improperly disposed of, therefore, this is an important restriction for directors to be aware of.

An illustration of this restriction is provided in the case of three health care institutions wishing to amalgamate, some or all of which are registered charities. The amalgamated entity would need to be a registered charity, whether or not the merging organizations want to have charitable status. Otherwise any organization which loses its charitable status will have to transfer its assets to another qualified donee or face a CRA penalty of 100 per cent of its assets.

A detailed review of procedural restrictions and approval requirements is outside the scope of this document. Organizations should consult their professional advisors for further information.

Directors should also understand that the legislation under which NFP organizations are incorporated, or to which they are subject, varies and may restrict the manner in which a merger can be structured. Corporations must also consider their incorporation documents, by-laws and unanimous member agreements, if any. In the case of trusts, the terms of the trust deed must be examined. Unincorporated associations will need to look at the agreement between their members, usually called the constitution.

The governing documents will specify the approvals required for a merger. In some cases, organizations may be required to obtain the support of a significant portion of their membership or of different classes of members to authorize a merger. The likelihood of obtaining support and the time frame for getting it should be taken into account when evaluating a potential merger.

7. What Are the Important Considerations When Selecting Merger Partners?

Criteria

Once the board determines that a merger may be a viable solution to a strategic problem, the next step is identifying potential partners. The criteria used to select a potential partner should always relate to the creation of public value. Well-defined criteria will not only help identify candidates that are a good fit for the value proposition, but will weed out candidates that will not bring added value. Criteria should be weighted or prioritized to effectively evaluate options.

Criteria often include:

- mission alignment
- size
- geographic location and catchment area served
- revenue sources
- (apparent) culture
- depth and quality of management
- uniqueness of programs or services
- nature of clients or service recipients
- reputation

Type of Integration

Another factor in evaluating potential partners may be consideration of the possibility of concentric diversification or horizontal integration as part of the merger.

	Concentric Diversification	Horizontal Integration
Definition	Taking on different programs and services in order to offer a broader continuum of services to the same client base.	Taking on similar programs with a different client base in order to deepen or broaden the impact for that service.
Example	Healthcare organization A (which provides primary health care in an office) merges with healthcare organization B (which provides homecare), allowing patients to access a broader number of services from a single organization.	Healthcare organization B (which provides homecare in one catchment area) merges with healthcare organization C (which also provides homecare but in a neighbouring geographic catchment area), thereby serving more clients with a single organization.
Public value purpose	Increased comprehensive and coordinated services for a population.	Economies of scale and cost efficiency that can enhance operational capacity.

Power Dynamics

An important factor to consider when assessing the risks and benefits of potential merger partners is the power dynamic between the organizations. While the concept of merger may imply that both parties are equal partners, that is seldom the reality. Even if the organizations are of similar size and strength, one party usually exerts greater control over the new entity, either through board representation or the selection of the chief executive officer. Directors should consider how this dynamic may impact on the anticipated benefits and risks of a merger.

Trust

The most obvious merger partner may be an organization with which there is already a close and trusting relationship. Carrying out a merger of two organizations that have worked together and have good relations can be easier than trying to build trust from scratch. A partner should not be selected, however, based solely on good past relations and seeming compatibility without taking into account other factors. Rigorous criteria and a well-planned approach will support an optimal result.

First Contact

Once a potential partner has been identified, directors must consider how to approach it. The initial contact is important because, unless handled carefully, discussions about a possible merger could end there. In connecting for the first time, the objective should be to agree to continue to explore the idea. Even if the end result of discussions is not a merger, there may be opportunity for strategic partnerships that create greater public value.

Often the CEO will connect with his or her counterpart to have an initial discussion. There are two reasons, however, for a different approach, in which directors are involved in the initial contact. The first is an existing relationship between directors or between the CEO and a director at the other organization. The second is resistance (or anticipated resistance) on the part of one or both of the CEOs.

What to do if approached regarding a merger?
An organization not contemplating a merger may be approached by another organization interested in exploring the possibility. The analysis to be undertaken by the board of directors is very similar. Rather than simply determining how to respond to the inquiry, the board should take the time to consider the risks and benefits of merger versus non-merger *in general*, and then consider potential partners, not limiting the analysis to a single option.

8. Who Are the Stakeholders and What Consultation Is Required to Gain Support?

NFP organizations have large and complex stakeholder networks. Stakeholder groups include members, directors, employees, volunteers, government, partners, media, the public, funders, donors, clients and beneficiaries.

Understanding the views of and impacts on each of the different stakeholder groups is important when evaluating a potential merger. Obtaining the support of key stakeholder groups will be crucial to successful implementation. The key is a solid consultation and engagement plan. If done well, stakeholder consultation can build a foundation of goodwill that will support the ultimate value creation.

As stakeholder consultation is critical to realize the intended benefits of a merger, four roles of engagement should be considered:[6]

a. **Communicate information**. Inform stakeholders about the potential intent to merge the organizations, the expected benefits, and the process and timing.

b. **Manage change**. Generate buy-in and support for the change by building confidence.

c. **Solicit feedback to inform decision making**. Provide opportunities for stakeholders to have direct input as to what the potential benefits and risks might be and use this input to inform (but not control) decision making.

6 Cohen, Fairclough & Jass, *Optimizing Community and Stakeholder Engagement in a Merger of Community Health Centres.* (Healthcare Management Forum, Winter 2011: 192-195).

d. **Fulfill obligations**. Consultation with stakeholders may be required by funders or necessary to obtain required member support for a merger proposal.

Different groups have different engagement needs, and a well thought-out plan is key. Groups to be addressed include:

- **Staff** — Staff are usually a key constituency and will be the most anxious about the implications of a merger. Finding ways to ensure employees continue to work effectively and manage change is critical.
- **Members** — Members of the organization are usually required to vote on a merger and may have interests that are unique and necessitate special consideration.
- **Funders/Donors** — Directors should ask whether major funders and donors are supportive of the merger plans and should understand whether funder approval is required for a merger to take place.
- **Volunteers and Others** — Volunteers who interact episodically with the organization may be more difficult to reach, but finding ways to do so is critical to keeping them as supporters.
- **Government** — Some NFP organizations depend upon government departments or agencies and may require their support to amend legislation or regulations.
- **Consumers/Customers/Clients** — Consumers of the organization's services may be concerned about the loss of or change in services received.

The board should consider how feedback from consultations will be used, particularly if the feedback surfaces disagreements. The most effective consultation is one which establishes an ongoing dialogue with stakeholders, while not letting them control the negotiations and decision making.

Part III: Negotiating a Merger

9. What Process and Time Line Will Be Used to Make the Decision?

Once a potential merger party has been identified and has indicated interest in exploring a merger, the parties should establish a time line for negotiation and decision making, which may be set out in a negotiating agreement or memorandum of understanding.

The exploration of a merger involves the sharing of confidential and sensitive information between the parties. To ensure this information is protected, it is in the best interests of the parties and their stakeholders to have a confidentiality agreement in place. Such an agreement provides protection for the information being exchanged, and usually provides that the discussions themselves are also confidential. This step is critical to ensure that a potential merger is not 'leaked' to stakeholders before a decision is made and the organization's communications plan can be executed.

While merger exploration and negotiation can be concluded in a matter of months, the process more commonly takes six months to a year, and may take significantly longer. The length of time will depend on various factors including:

- amount of due diligence required
- issues raised during due diligence
- size and composition of the memberships
- regulatory approvals required
- decisiveness of the parties

The parties should agree on the amount and timing of information to be shared with stakeholders regarding the process and time line. The negotiation of a merger can be both distracting and stressful, particularly for staff. Being as transparent as possible about the process that will be followed and the timing for making a decision can help allay fears and anxiety. Of course, once a process and time line has been shared, directors are accountable for any deviation or delay that might occur.

It is prudent to consider in advance how directors will know if it is time to pull the plug on the merger discussions with a particular partner. Organizations should stop merger discussions or negotiations:

- When it appears reasonably certain that the public value created will not be greater than the cost or risks of a merger.
- If the other party has not been truthful in its disclosure or has acted in an inappropriate way such that trust has been lost.
- If no significant progress has been made at the end of an agreed-upon period.

Prolonging a merger discussion or negotiation when there is little chance of success is costly, distracting, and may be damaging to one or more of the organizations.

Tips for managing a NFP merger:

- Be honest and conservative about the benefits of a merger, and realistic about the costs.
- Be prepared to walk away from merger negotiations.

10. What Is the Role of the Joint Negotiations Committee?

A key element of the negotiation process involves the establishment of a joint negotiations committee with representatives from each party. This committee will be responsible for representing the interests of the merging organizations during the negotiations, overseeing the required due diligence, and developing the proposed terms of the merger for recommendation to the boards of each organization. The committee may also be given responsibility for overseeing the development and execution of the integration plan.

The terms of reference of the committee should clearly set out similar matters as those contained in the terms of reference for the special committee charged with the initial exploration, namely:

- composition
- meeting procedures
- authority to retain advisors or negotiate on behalf of the organization
- decision making process
- budget
- time frame for finalizing its recommendation

In many cases, the directors who served on the special 'exploratory' committee will continue to serve as the negotiating committee. However, this composition is not mandatory, and the board should consider directors' skills, experience and availability in order to identify the best candidates for the negotiating committee.

The joint negotiations committee will oversee the development of a merger agreement. The agreement establishes important details such as the time lines for the merger process, the mechanics of how the merger will take place, the objects, mission and governance of the new entity, and other related matters. The merger agreement should cover important issues while being flexible enough to allow the new merged entity to respond to events as they arise. Ideally it will be complemented by a detailed integration plan.

Tips for managing a NFP merger:

- If an organization is the bigger party to a merger, this fact does not mean that it has to compromise less. Often it must compromise more.
- Work hard to develop trust as trust can dramatically reduce the time required for merger.
- Lack of honesty during negotiations will undermine any trust that may have developed.

11. What Are Some of the Key Challenges the Joint Negotiations Committee Must Address?

In the contemplation phase, the board identifies anticipated benefits and risks of a merger in order to determine whether to proceed to negotiation. In the negotiation phase, the committee's role is to assess how best to achieve benefits and mitigate risks, thereby establishing the terms of the merger.

There are several challenges common to most mergers of which directors should be aware. The negotiation committee should seek to understand the implications of the following challenges and identify how the new organization may manage them:

1. **Emotional toll on employees.** There may be a high personal toll for employees that can create emotional baggage within each organization. This emotional toll can include loss of identity as the organization changes or the risk of job loss.

2. **Cultural integration is hard.** Culture includes attitude toward taking on risk, decision making processes, management style, beneficiary participation and flexibility to change. Failure to integrate culture can undermine the foundational strengths of the merging organizations and threaten the mission of the new organization.

3. **The merger penalty.** Although funders often encourage mergers, there is sometimes a 'merger penalty' in that, after the merger, the funder may provide the merged entity with less funding than it provided to the individual organizations collectively. As well, some funders who suggest a merger may not be interested in funding the significant costs related to the merger process.

4. **Distraction and costs.** A poorly handled or difficult merger can be a distraction from the work of both organizations and incur significant costs. In addition to the costs leading up to the merger, there may also be significant post-merger integration costs, including the need for new technology to accommodate the larger organization, costs of rebranding, and costs for terminations or equalizing pay.

5. **Building trust takes time.** It is difficult to select a partner and build trust between organizations. In many cases, organizations that come together in a merger were 'competitors' and may have a history that is not always positive.

6. **Bigger is not always better.** Larger organizations often have higher costs and more bureaucracy, which can reduce the ability to adjust to changing times. Bigger organizations also tend to use more staff and fewer volunteers.

7. **Different governance styles can create conflict.** Some boards are focused on policy while others are more involved with operational details. Systems that worked well for each organization individually may not be appropriate for the larger merged organization.

8. **Mythical cost savings.** Many NFP organizations spend little on administration and information technology, so there is little scope for savings due to merger. Human resources are the biggest expense for most organizations, and a reduction in employees is often the only way that significant savings will ever be realized, at least in the short term.

12. What Are the Critical Due Diligence Areas?

As part of the negotiation process, a comprehensive due diligence review will be conducted by each party on their potential partner(s) to identify any concerns or impediments to a merger. The purpose of the due diligence process is, in essence, to learn about each organization through an exchange and review of confidential financial and legal information, and also to identify any areas of concern, especially liabilities. Due diligence supports risk mitigation, but also helps directors determine if there are any impediments to the anticipated benefits of the merger.

The due diligence process will involve an in-depth review of information including:

- corporate and organizational documents
- financial statements
- current budgets
- the assets owned by each organization (and any relevant restrictions on those assets)
- ongoing liabilities and obligations (including service agreements, leases and employment agreements)
- funding and partnership agreements
- tax and insurance documents
- membership information
- human resources information (including collective bargaining agreements and pension information)

Sample questions for directors to ask:

- Are the organizations unincorporated, trusts or incorporated?
- Are any of the organizations registered charities?
- Do the organizations have the legal powers necessary to effect the proposed merger?
- Does either organization need to modify its governing documents (including its purposes)?
- How many classes of members does each organization have?
- Is member approval required to implement a merger and how difficult will it be to obtain?
- Who are the stakeholders of each organization and will they support a merger?
- Does any organization own real estate or have leased premises used in programming or administration?
- Do any organizations have special purpose trusts or restricted gifts?
- Have all debts, liabilities (including contingent liabilities) and obligations (such as contracts) been identified?
- What are the major sources of revenue for each organization?
- Will donors, funders, and earned income continue, and can donations and funding be assigned or transferred to the merged entity?
- Are any consents required from a landlord, funder or partner?
- Are there funder requirements that will not be met as a result of the merger?
- Is there potential conflict between funders/sponsors/supporters of the merging organizations?
- What obligations will the merged organization assume regarding continuing programs?
- Are there provincial or federal acts or regulations that could affect the merger?

Issues identified during due diligence may not prevent a merger, but care should be taken to address them appropriately during implementation.

Some red flags to be aware of during the due diligence process include evidence that an organization:

- Does not have properly maintained records.
- Has recently lost a major donor or revenue source.
- Has recently lost its charitable status or been audited by CRA and signed a compliance agreement for non-compliance with obligations under the *Income Tax Act* (Canada).
- Is unwilling to provide full disclosure.
- Is involved in litigation that was not disclosed during the initial negotiation stages.

13. What Cultural Attributes of Each Organization Should Be Considered?

Proper due diligence includes an investigation of cultural differences between organizations. While there may be a great strategic rationale for undertaking a merger, the oft-repeated phrase, attributed to Peter Drucker, "culture eats strategy for breakfast" is true. There are many examples of mergers that failed due to cultural differences.

Incompatible cultures will hamper the ability of the new entity to create public value by fostering problems such as staff discontent and attrition, lost productivity, alienation of clients, volunteers, funders or other stakeholders, and potential reputational damage.

Directors should seek to understand the cultural compatibility of the two merging entities. However, cultural due diligence isn't straightforward. A planned and thorough approach is needed to gain an objective perspective. One of the benefits of a good stakeholder consultation process is that there is an opportunity to obtain feedback directly from staff and volunteers, which can reveal cultural differences.

Key Cultural Differences

Labour representation can be a key element of organizational culture. Organizations with organized labour are often very different culturally than organizations without union representation. Moreover, different unions can have very different cultures.

Other cultural issues may arise when combining secular and religious organizations, as attitudes towards issues such as marriage equality and end-of-life care may differ. Different organizations may also have very different concepts of fairness or justice, or orientation towards cooperation versus competition.

If a concentric diversification or a horizontal integration is contemplated, directors should note that organizations with similar offerings may be more culturally similar, although that may not necessarily be the case. In the healthcare examples used earlier, the primary healthcare organization with staff working out of a facility may have a very different culture than an organization with staff working more independently out of peoples' homes.

Power Dynamics

Directors should also consider the issue of power dynamics, and whether the merger is a merger of equals or a case of a stronger organization merging with a weaker one (a takeover). In the former, there may be a good opportunity to build a new shared culture. In the latter, the stronger organization may assume that its culture will prevail, which may or may not be seen as beneficial by staff and other stakeholders.

Tools to Assess Culture:
In addition to conducting stakeholder consultations, there are other tools that can be used to assess cultural differences. These tools can help directors understand the fundamental cultures of each organization, identify the primary differences that pose the greatest obstacles to a successful merger, and develop a preliminary plan for cultural integration.

Employee engagement surveys are among the most popular tools for assessing culture. In one merger case, the application of a good survey tool not only provided detailed information on the relative engagement of employees across various domains, but was instrumental in teasing out what issues were most likely to improve engagement.[7] In that example, the information was used to improve merger planning and post-merger integration management, which resulted in strong cultural alignment.

7 Chan, Jeff, *Avoiding "Culture Rejection" in Healthcare Mergers and Acquisitions.* (Healthcare Quarterly Vol.16 No.1 2013, 85-90).

14. What Will the Governance Structure of the New Organization Be?

Determining the appropriate governance structure for the new organization is critical to its success. While the details will depend in part on the structure of the merger (amalgamation, transfer of assets or creation of a new corporation), the issues to be considered are the same. Merger is an excellent opportunity to review the governance of the merging organizations and put in place governance structures for the new entity that support optimum functioning. It should never be assumed that the existing governance practices of one of the parties will simply be continued in the new organization.

Issues to be considered include:

- **Board size** — Careful thought should be given to the most effective board size for the merged organization. The new board should not simply combine the boards of the existing organizations.

- **Board composition** — Directors should consider whether it is appropriate or desirable to ensure representation from each of the merging organizations on the board of the new entity for a period of time following the merger or whether there should be a fresh start with none of the directors from the merging entities being on the new board.

- **Voting structure and minority rights protection** — Depending on the power dynamics between the merging organizations, it may be desirable to build in protections to ensure that the interests of the less powerful party are appropriately represented in the new organization, at least during the transition period. This may be accomplished via board representation, creation of separate membership classes, and approval requirements for fundamental changes.

- **Selection of initial directors** — Once the size, structure and composition of the new board are established, directors should consider how the initial directors will be selected. Frequently directors from the boards of each of the merging parties are appointed to the board of the new organization, at least until the new organization's first meeting of members. Director selection should involve careful consideration of the skills and expertise required on the new board.

Organizations should avoid tying the hand of the merged entity by being too prescriptive about structure. Pragmatically, in some cases a less than ideal governance structure may be agreed upon (for example, having all

board members of both organizations be members of the new board) in order to deal with stakeholder interests and concerns). Adjustments to the governance structure can then be made a few years later.

For more information, see the CPA Canada publication **20 Questions Directors of Not-for-Profit Organizations Should Ask about Board Recruitment, Development and Assessment**.

15. Who Will Lead the New Organization?

One of the most difficult issues to manage during a merger negotiation is the role of the incumbent CEOs and the senior leadership teams in the merging organizations. Depending on the individuals involved, there are a number of possible issues:

- Directors should be aware of potential conflicts of interest that can arise when an incumbent senior leader is unsupportive of the merger due to job security concerns. Only CEOs and leadership teams with sufficient confidence in their future employability will be able to focus solely on the best interests of the organization when engaging in merger negotiations.
- Opportunities may arise when the CEO of one organization is close to retirement and there is no obvious or available internal successor.

The board should have frank and ongoing communication with the CEO and, if necessary, with other members of the senior leadership team, about their interests and concerns. This dialogue will assist in developing the proposed organizational structure and help surface potential conflicts. Such conversations may be undertaken by the negotiating committee, human resources and compensation committee, executive committee or board chair, depending on the size of the organization and the strength of the relationships between the directors and the CEO.

The partner organizations should agree on the principles and process for selecting the CEO of the merged organization during the negotiation process. Options include appointing one of the incumbent CEOs, either on a permanent or transitional basis, or conducting a broader search for a new CEO.

Regardless of the method chosen for selecting the new CEO, the process should be made transparent to the incumbents. If there is a desire for the incumbents to stay on to assist with the transition if they are not selected, the terms of that agreement should be negotiated.

For more information, see the CPA Canada publication **20 Questions Directors of Not-for-Profit Organizations Should Ask About CEO Succession**.

Part IV: Implementing a Merger

16. How Will the Board Evaluate Whether a Merger Is Complete and Successful?

Once the terms and structure of the merger have been agreed and required approvals obtained, the focus moves to implementation. This stage is perhaps the most critical, because even mergers that look excellent on paper can fail to deliver any real benefits if implementation is flawed. Although it is likely that not all directors of the merging organizations will be involved in the implementation of the merger, all directors should have an understanding from the outset of what the process will entail.

Oversight

Implementation of a merger usually requires fairly intensive oversight by the board, particularly if a significant change of organizational leadership is involved. It is often expedient to designate a committee or smaller group to oversee implementation and provide updates to the full board. In many cases, the joint negotiations committee assumes this role due to its depth of understanding of the organizations gained during the negotiation and due diligence process, although not all members of the joint negotiations committee may be on the new board.

Indicators and Time Frame

In order to recognize whether or not a merger is complete and successful, key indicators of success should be established at the outset. When selecting indicators, directors must identify the time frame in which results are expected. There may be very different indicators for short term versus long term goals.

The purpose of short term transition planning is to immediately stabilize the new organization and support functional operations. Harmonization of systems, processes and policies will be required to ensure business continuity. One generally accepted best practice in change management is the importance of recognizing quick wins.[8]

In the longer-term, the focus will be on broader change strategies that will support longer-term value creation. These indicators should be tied to the strategic plan for increasing public value.

Sample Indicators		
	Short term	**Long term**
Organizational Capacity	organizational structure transition complete	improved staff engagement scores
	integration of finance and IT systems	operational efficiencies achieved
	rationalization of existing grants	increased grant funding
Delivery of Public Value	integration of key client services	enhanced / expanded service delivery
Legitimacy and Support	key stakeholder messages delivered	broader donor and volunteer base

Tips for managing a NFP merger:

- If a merger is to proceed, it should be implemented as swiftly as possible. Multi-year merger discussions are extremely costly.
- Communicate effectively with all stakeholders and involve them in the discussion or expect high levels of concern, anxiety and opposition.
- A legal merger is just that — only a legal merger. A true merger requires a well thought-out integration plan and a lot of hard work.

8 Kotter, John P., *Leading change*. (Harvard Business Press, 1996).

17. What Should Be Considered In Communications Planning?

Communications planning for merger implementation is key to realizing public value. In the initial engagement work, interested and affected stakeholders were identified. In post-merger communication planning, each of these groups will require tailored communications to address their specific interests.

Good communication is a key success factor in achieving results, building a positive culture and establishing goodwill. Post-merger implementation does not occur overnight. Communications plans should, therefore, include a variety of tools and should ensure that communication is ongoing throughout the transition. Communications should establish a dialogue, allowing stakeholders to provide input in the form of questions or comments.

Key messages at this stage mirror those of earlier engagements, but can be more detailed:

a. **The rationale for the merger and the expected benefits for each group**
This message bears repeating at every opportunity, particularly with staff. The implementation of a merger can be very stressful for internal stakeholders, and focusing on the benefits is important to maintain morale. When there is good news to report or milestones achieved, these should be broadly communicated to celebrate initial wins.

b. **The merger builds on the strong foundations of the predecessor organizations to create increased public value**
The new organization should nurture a shared culture that is respectful of the past but focused on the future. Acknowledging the legacy of the past in a way that doesn't overly favour one of the predecessors can help create unified goodwill toward the new organization and help avoid the perception of winners and losers. This is especially true if the new board and leadership team tends to (or is perceived to) adopt the policies, practices or culture of one of the predecessor organizations.

c. The new mission, vision and values

If not already determined during the negotiation phase, one of the first tasks of the new organization should be to develop the new mission, vision and values and incorporate them often in messaging. The mission, vision and values help to describe to both internal and external stakeholders what the new organization will be accountable for, what it aspires to and the culture it hopes to create. These foundational pieces will ensure clarity and consistency in messaging.

d. How the concerns of stakeholder groups will be addressed

There is no benefit to ignoring or denying negative implications for stakeholders resulting from the merger. One of the goals of the communications plans must be to build stakeholder trust. Messaging must, therefore, acknowledge both the positive and the negative aspects of integration. Such communications demonstrate transparency and allow stakeholder groups to know how the new organization intends to deal with their concerns. Effective communication on difficult issues can help build goodwill and trust in the new leadership.

e. Immediate and longer-range implementation plans

In post-merger implementation there are both immediate needs and longer-term objectives. Both contribute to the creation of public value.

Two key areas to be addressed as immediate needs are business continuity and organizational structure.

- **Business continuity** — This objective ensures that the lights stay on, bills get paid and services are not interrupted. Clients, beneficiaries and funders need to feel confident that these issues are being managed well.
- **Organizational structure** — Changes to staffing and structure are a priority to complete and communicate early so that staff can focus on value-creating work rather than the personal impact of the merger.

Communication of longer-term implementation plans is also important to ensure that stakeholders, including funders, have confidence in the long term health of the organization and its ability to deliver public value. Mission, vision and values will play an important role in these communications, along with the organization's longer-term goals and indicators of success.

18. Will There Be a New Organizational Name or Brand?

One of the most valuable assets of a NFP organization is its reputation and brand. Brand includes the legal name, business names, logos, website address, telephone numbers and trademarks. In a highly competitive NFP environment, the brand distinguishes one organization from another. Unless the merging organizations are from the same umbrella agency, each organization will have its own identity, name and branding. There are a number of possible options with respect to the branding of the merged organization, all of which have advantages and disadvantages:

- **Retaining the brand of one of the predecessor organizations** — Organizations often invest significant resources in creating their brand. Retaining a powerful brand can help ensure public recognition, client support and donor loyalty. It can, however, create friction and concern that the value and history of the other brand is being lost.
- **Launching a new brand** — It is likely more equitable to abandon both brands and create a new brand that is unconnected with either predecessor organization. This approach provides an opportunity to ensure that the new organization's brand is consistent with its new mission, vision and values. Creating a new brand, however, will take time and require the expenditure of significant resources, and will also lose the value of the old brands.
- **Combining brands** — Sometimes the best approach is to try and combine the brands in order that the new brand contains something recognizable from both organizations. This option can help smooth the transition and retain the loyalty of stakeholders during the transition period.

19. How Will Human Resources Be Integrated into the New Organization?

The implementation plan should prioritize the timely selection of the senior leadership team, followed shortly by other organizational structure changes. Some elements of the senior leadership structure may be agreed upon by the merging organizations during the negotiation process and implemented immediately upon the finalization of the merger. Other changes will occur after the merger, at the direction of the new CEO.

The senior leadership team will be required to lead the organization through the initial transition, so it is imperative that directors support those leaders and actively engage them in the change. In addition to being transparent about the process for transitioning to the new senior team and what exit packages may be offered, it is common for organizations going through a merger to identify key leaders required for the first phase of implementation and sometimes offer retention bonuses to ensure they are incented to stay and support the transition. The involvement of the senior leadership team is critical not just to operational continuity and the mechanics of merger implementation, but also because the tone set by the senior leadership team will establish the tone for the rest of the organization.

The transition period will be a time of great ambiguity and anxiety for staff, and the more quickly it is resolved, the more energy employees can devote to effective merger implementation. It is critical that staff know their role in the new organization, their accountabilities and their reporting structure as quickly as possible. The most highly valued employees will have other employment options and each day of uncertainty increases the risk of unwanted departures. Some of these considerations may also apply to volunteers who have played key roles in the merging organizations.

In doing this initial structural work, it should be noted that decisions made at this juncture need not be permanent. The goal is to create a structure that is functional and eliminates duplication. Where role duplication exists, there should be a transparent process for competition or selection for positions.

In order to speed integration of staff in the new organization, differences in the treatment of staff should be resolved as quickly as possible. The due diligence process should have examined a broad range of human resources issues. The implementation plan will need to address how any differences will be resolved.

Key questions regarding human resources:

- How many employees are there?
- What was last year's total payroll?
- Will all employees move to the merged entity?
- Is a review of factors relevant to termination and severance required?
- How will compensation differences between the two organizations be resolved?
- Will there be employment law issues or pension liability issues, etc.?
- If one organization is unionized, will all the employees become unionized or will there cease to be a union?
- If both organizations are unionized but have different unions, which union will represent employees in the merged entity?
- What consideration should be given to the roles, activities, and support structures of volunteers coming together from the two organizations?

20. What Other Items Should Be Addressed in the Merger Implementation Plan?

The details of the implementation plan will be different in every case, and will depend on the structure of the merger and the nature of the merging organizations. There are certain key issues, however, common to all implementation plans, and directors should ensure these are addressed.

Costs

Setting a reasonable budget for post-merger implementation is critical to success, but is also extremely difficult. It is important to try and fully factor in the costs of integration, and determine responsibility for meeting them. Directors should be aware that operational efficiencies expected in a merger may be outweighed by transition costs during the first few years.

While there are some examples of organizations that have successfully implemented a merger on a shoestring budget, limited funding generally slows the integration process and increases the risk of failure. Identifying sources of funding to cover implementation costs will help mitigate the risk.

Accountability and Support

Accountability for key areas of implementation should be clearly established. Some areas will rest with the board, such as the harmonization of governance structure and practices, and team-building among the board. Many areas will rest with the new CEO who may assign responsibility for specific integration areas to the appropriate staff member of the new senior leadership team.

It is useful, especially in large NFP organizations, to put in place an integration support office that can ensure effective project management for the implementation. This office can be staffed by a mixture of employees and consultants, and may report to the CEO and/or to the committee overseeing implementation. Employees from across the organization can be involved with sub-committees for each functional area. This type of structure can help build bridges and generate support within the new organization.

Celebration

One very important element of merger completion is celebration. The efforts involved in merging two or more organizations can be draining and stressful for directors, staff and other stakeholders. Planning to take time to celebrate merger completion, even if all the intended benefits are not yet fully realized, is important to keep morale high and provide motivation to continue the hard work ahead. Organizations that undertake a merger need to be resilient in the face of challenges inherent in the process. Taking care of the people who are facing those challenges by recognizing and celebrating milestones will position the organization well in achieving increased public value.

Conclusion

Mergers of NFP organizations can be a viable strategic option to address environmental or organizational challenges, and can enhance an organization's ability to provide public value. Boards must, however, ensure that potential mergers are carefully considered and properly implemented in order that the associated costs and risks do not outweigh the potential rewards. Obtaining a clear understanding of the process involved and seeking expert advice as appropriate will help directors make the best possible decisions for the organizations they serve.

Where to Find More Information

CPA Canada publications on governance
(available at www.cpacanada.ca/governance)

The Not-For-Profit Director Series

20 Questions Series

- 20 Questions Directors of Not-For-Profit Organizations Should Ask about Board Recruitment, Development and Assessment
- 20 Questions Directors of Not-For-Profit Organizations Should Ask about CEO Succession
- 20 Questions Directors of Not-For-Profit Organizations Should Ask about Fiduciary Duty
- 20 Questions Directors of Not-For-Profit Organizations Should Ask about Human Resources
- 20 Questions Directors of Not-For-Profit Organizations Should Ask about Mergers
- 20 Questions Directors of Not-For-Profit Organizations Should Ask about Risk
- 20 Questions Directors of Not-For-Profit Organizations Should Ask about Social Enterprise

Board Briefings

- Accountants on Board — A Guide to Becoming a Director of a Not-For-Profit Organization
- A Guide to Financial Statements of Not-For-Profit Organizations — Questions For Directors to Ask
- Board Oversight of Not-For-Profit Program Evaluation — Questions For Directors to Ask
- Governance for Not-for-Profit Organizations — Questions for Directors to Ask

Board Bulletins

- Advocacy and Political Activities — Questions for directors to ask
- Canada's Anti-Spam Legislation ("CASL"): It's the Law on July 1, 2014 — Questions for directors to ask
- Cloud Computing for Not-For-Profit Organizations — Questions for directors to ask
- The New "Ineligible Individual" Provisions — Considerations for Directors of Registered Charities And Registered Canadian Amateur Athletic Associations

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Mark Blumberg is a partner at the law firm Blumberg Segal LLP (Blumbergs) in Toronto and works almost exclusively advising non-profits and registered charities on their work in Canada and abroad. He has written numerous articles, is a frequent speaker on legal issues involving charity and not-for-profit law and is the editor of **www.CanadianCharityLaw.ca** and **www.globalphilanthropy.ca**™—Canadian websites dedicated to news about the Canadian charitable sector as well as legal and ethical issues for Canadian charities operating in Canada or overseas.

Mark is particularly interested in the regulation of non-profits and charities in Canada, philanthropy, transparency requirements for the voluntary sector, providing accessible information on regulatory issues, and the use of data to make more informed decisions on the charity sector.

He is quoted regularly in print media and appears frequently on radio and television on topics relating to philanthropy and the regulation of charities in Canada. Mark has appeared on a number of occasions in front of the House of Commons Standing Committee on Finance on topics such as charity regulation, transparency, accountability and tax incentives for philanthropy and lectures frequently on these topics.

Mark has a B.A. in Political Science from the University of Toronto, an LLB from the University of British Columbia and a LLM from Osgoode Hall Law School in Tax Law.

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Andrea came to OTF following a lengthy and successful career in community healthcare, most recently as CEO of Unison Health and Community Services. She is recognized for her expertise in making organizations more effective by ensuring that systems are integrated and impact is both measured and assessed.

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