INTRODUCTION

Since the coming of the Industrial Revolution, mergers and consolidations of business enterprises have been a critical aspect of capitalism and market economies.\(^1\) Even today, private sector corporations continually adapt and reorganize to survive and thrive. Although mergers and acquisitions are occurring at an unprecedented level in the private sector,\(^2\) mergers between nonprofit organizations\(^3\) continue to be rare.


The author would like to thank Victoria Bjorklund, Daniel Halperin, Amy McManus, Martha Minow, Mark Moore, Christina Nooney, and the late David Charny for their thoughtful comments and suggestions.


However, a merger is a powerful strategic option for a nonprofit to gain economies of scale, fulfill its mission, and achieve specific goals. Although a merger may not be appropriate for every organization, it most certainly deserves serious consideration as part of a complete self-examination by an organization’s governing body and officers of its mission, competitive position, and strategic alternatives. Many nonprofit organizations, however, have missed potential opportunities to improve their effectiveness by failing to consider the possibility and advantages of a strategic merger.

While most Americans are familiar with the work, scope, and significance of business and industry (i.e., the private sector) and of federal, state, and local governments (i.e., the public sector), a huge, complex, and important third sector, consisting of private nonprofit organizations (i.e., the independent or nonprofit sector), garners far less attention and understanding. This independent sector, which includes churches, schools, colleges and universities, research institutes, hospitals, foundations, social-action organizations, welfare agencies, arts and cultural organizations, community development groups, and a host of other organizations, is critical to the health and fabric of our nation.

The past several years have been a time of significant change for both private sector businesses and nonprofit organizations. Corporate America has struggled with increased competition in the global marketplace, heightened pressure for accountability and performance from shareholders, and consolidation, driven by increased competition and a desire for economies of scale. The same is true for nonprofit organizations, which have faced similar pressures to merge and consolidate in order to achieve economies of scale, fulfill their mission, and achieve specific goals.

Throughout this Article, my analysis and use of the terms “nonprofit organizations” and “nonprofits” generally applies to grant-seeking, public charities that qualify for federal tax exemption under the Internal Revenue Code. See I.R.C. § 501(c)(3) (1994). It is important to note that the overwhelming majority of these organizations do not have members and are led by self-perpetuating boards (i.e., boards in which directors choose their own successors).

While many other types of tax-exempt entities exist, such as private or community foundations, I have intentionally excluded such organizations from my analysis because of their distinct organizational structures and purposes.

and continual calls to grow revenues and expand markets. Nonprofit organizations are similarly challenged by increased competition for sources of revenue and financial support, heightened pressure for accountability from financial supporters and the public, and continual calls to develop new programs and improve organizational efficiency to meet increased demand for services. To meet their respective challenges, many corporations and nonprofits have reexamined their mission, strategy, and management.

In the corporate arena, these new changes and pressures have led many private sector firms to consider and pursue mergers and acquisitions as a strategic management option to enhance their companies’ long-term position, maximize the effective use of resources, and benefit shareholders. By comparison, to a great extent, nonprofit organizations continue to ignore or fail to consider nonprofit mergers—mergers between two nonprofit entities—as a strategic management tool. By failing
adequately to consider mergers, nonprofit organizations miss important opportunities to advance their organizational objectives, provide long-term benefits to the entity’s stakeholders, and ensure that society benefits from the efficient uses of charitable resources.10

The private sector has set consecutive records in the rate of merger activity in recent years.11 Practically every industry in America has been affected by the consolidation craze—with the glaring exception of the nonprofit sector.12 The failure of the nonprofit sector to pursue mergers contrasts sharply to the fact that over the past decade leaders of nonprofit organizations and corporate America have shared common management strategies and recognized that there is much the two sectors can learn from one another.13 Although corporate mergers have always been a cyclical business, even as merger activity reaches record highs in the private sector, the trend has not followed in the nonprofit sector.14


10. Interestingly, many nonprofit entities have pursued joint ventures, facility sharing arrangements, and other forms of collaboration to pool resources, see DIANE J. DUCA, NONPROFIT BOARDS: ROLES, RESPONSIBILITIES, AND PERFORMANCE 140–43 (1996), but the ultimate form of collaboration—the merger—has been largely ignored.

11. See Judy Radler Cohen, M&A Rings In Another Record Year, MERGERS & ACQUISITIONS REP., Jan. 4, 1999, at 1, available at 1999 WL 8303701; Paul M. Sherer, Review of Markets: The Lesson From Chrysler, Citicorp and Mobil: No Companies Nowadays Are Too Big to Merge, WALL ST. J., Jan. 4, 1999, at R8 (noting that in every year since 1995, the volume and value of U.S. deals have shattered previous records). In 1993, the total of all 2,663 merger deals valued $176.4 billion; in 1994, the total of 2,997 deals valued $226.7 billion; in 1995, the total of 3,510 deals valued $356 billion; in 1996, the total of 5,848 deals valued $495 billion; in 1997, the total of 7,800 deals valued $657.1 billion; in 1998, the total of 7,809 deals valued $1.19 trillion; in 1999, the total of 9,218 deals valued $1.43 trillion; and in 2000, a record 9,566 deals valued $1.33 trillion. See Mergerstat, M&A Activity—U.S. Transactions, at http://www.mergerstat.com/free_reports (last visited Feb. 8, 2001).

12. See WILLIAM G. BOWEN, THOMAS I. NYGREN, SARAH E. TURNER & ELIZABETH A. DUFFY, THE CHARITABLE NONPROFITS: AN ANALYSIS OF INSTITUTIONAL DYNAMICS AND CHARACTERISTICS 100 (1994) (noting that merger rates have been more than twice as high in the for-profit sector than in the nonprofit sector).


14. Although rare, mergers certainly do occur within the nonprofit sector. See, e.g., Reed Abelson, Spending It: Seeking Unity in Jewish Giving, N.Y. TIMES, Aug. 9, 1998, § 3, at 1 (describing
Like their corporate counterparts, nonprofit organizations can reap many benefits from consolidation. The nonprofit merger is a powerful management tool that has the potential to improve performance, delivery of services, and efficiency of the nonprofit sector. This Article argues that, in comparison to the private sector, the current norms, incentives, and structures of nonprofit governance pose systematic obstacles to achieving widespread consideration of nonprofit mergers. Although the key impediments to nonprofit mergers—a misplaced focus on entity survival, the loss of power for directors and managers, and high transaction costs—also exist in the private sector, it is only the nonprofit sector where these impediments go unchecked without counterbalancing incentives. Accordingly, any effort to successfully increase consideration of nonprofit mergers will require creative solutions from law and public policy.

Part I begins by explaining the rationales behind the public’s vested interest in a healthy nonprofit sector and strategic restructuring. It devotes some attention to social, political, and economic theories underpinning the existence of and commitment to the nonprofit sector. Part II outlines some of the potential benefits that the public and nonprofit sector might reap from increased merger activity. Part III surveys the current legal landscape that governs mergers of nonprofit organizations and explores some of the institutional impediments to nonprofit mergers. The emphasis is on the structural forces that disfavor nonprofit mergers, primarily board and managerial resistance, and understanding the corporate sector’s responses to similar impediments. Finally, Part IV identifies potential legal and policy changes and solutions[^15] that might help encourage nonprofit organizations and their leadership to consider mergers as a strategic option.

I. THE PUBLIC’S INTEREST IN HEALTHY NONPROFITS AND UNDERSTANDING THE NONPROFIT SECTOR’S CURRENT CHALLENGES

Described as “a kind of Holy Ghost of the American Trinity,”\textsuperscript{16} the nonprofit sector’s size and scope are enough to make it worthy of significant attention. Although no universally accepted theory definitively explains the purpose, vitality, and durability of America’s vast nonprofit sector, each of the major competing theories make it plainly clear that nonprofit organizations serve important and compelling purposes in our democratic society.\textsuperscript{17} Currently, the independent sector is facing a multitude of challenges (e.g., fiscal, accountability, legitimacy). Accordingly, the nation’s network of nonprofits warrant our attention and efforts to ensure that our legal and policy structures benefit and support their important work.

A. THE SIZE AND INFLUENCE OF THE NONPROFIT SECTOR

Simply put, the nonprofit sector is vast and diverse. The nonprofit sector “has had a major impact on the history of the nation, continues to shape its social and cultural values, and provides services to millions of its most needy citizens.”\textsuperscript{18} Drug and alcohol dependence, child abuse, homelessness, spousal abuse, and teen pregnancy are only a few of the nation’s most pressing, recalcitrant, and difficult problems that social service-nonprofit agencies tackle on a regular basis. Most people recognize that a variety of different educational, religious, research and development, art, cultural, health, human services, and civic groups affect the lives of numerous citizens every day. Collectively, these organizations have a tremendous influence on the quality of life in the United States.

Nonprofit organizations also have a powerful impact on the nation’s economy. For instance, nonprofit organizations control more than $1 trillion in assets and earn nearly $700 billion annually—approximately ten percent of the U.S. gross domestic product.\textsuperscript{19} In fact, the nonprofit sector

\textsuperscript{16} Nielsen, supra note 4, at 5.
\textsuperscript{18} O’Neill, supra note 4, at 2.
employs more civilians than the federal and state governments combined.\textsuperscript{20} One in two adult Americans volunteer time for nonprofit causes.\textsuperscript{21} “Calculating the work year for a full-time employee at two thousand hours, these volunteers equaled the unpaid labor of an additional 7.5 million workers, or 6.1 percent of the employed labor force in the United States.”\textsuperscript{22}

In addition, evidence reveals that the sheer number of nonprofit organizations in the United States has been proliferating. Internal Revenue Service data indicate that the number of active charitable organizations organized under Section 501(c)(3) of the Internal Revenue Code increased by 58.2% between 1989 and 1998.\textsuperscript{23}

\section*{B. The Public Subsidies Given to the Nonprofit Sector}

Nonprofit organizations enjoy generous public subsidies through the federal and state tax codes. The tax exemptions and benefits bestowed on nonprofits represent a financial investment by the government and its citizens. Most obviously, nonprofit organizations receive an exemption from federal individual and corporate income taxes.\textsuperscript{24} However, the tax code and accompanying regulations also support the nonprofit sector through such perks as reduced postal rates,\textsuperscript{25} the ability to issue tax-exempt bonds,\textsuperscript{26} and exemption from federal unemployment taxes.\textsuperscript{27} Moreover, charitable donations are encouraged by the fact that donors to 501(c)(3) organizations\textsuperscript{28} are eligible to claim income tax, gift tax, and estate tax deductions for gifts and bequests.\textsuperscript{29} Even state and local entities provide

\begin{itemize}
\item \textsuperscript{20} O’Neill, supra note 4, at 1.
\item \textsuperscript{21} Cindy Loose, \textit{New Breed of Volunteers Tackles D.C. Schools’ Needs}, WASH. POST, Apr. 11, 1999, at C1. \textit{See also} Lisa Black, \textit{Half of American Adults Volunteer, Lions Club Survey Says}, CHI. TRIB., Apr. 24, 1998, Metro, at 8 (noting that 50% of Americans volunteer compared to lower rates of 32%, 26%, 19%, 17%, 12%, and 11% in India, Brazil, France, Germany, China, and Japan, respectively); David G. Tuerck, \textit{America’s Volunteers Deserve a Tax Break}, WALL ST. J., Apr. 28, 1997, at A18 (citing a report by Independent Sector that 50% of Americans volunteer their services).
\item \textsuperscript{22} Hawks, supra note 19, at 15.
\item \textsuperscript{24} See I.R.C. \textsection 501(a), (c)–(f) (1994).
\item \textsuperscript{25} See 39 U.S.C. \textsection 3626(a) (1994); 39 U.S.C.A. app. \textsection 4358(d)(1), (j)(2) (West 1980) (detailing the postage rate schedule for and definition of “qualified nonprofit organization”).
\item \textsuperscript{26} See I.R.C. \textsection 145.
\item \textsuperscript{27} See id. \textsection 3306(c)(8).
\item \textsuperscript{28} As defined by the Internal Revenue Code, Section 501(c)(3) organizations, a subset of nonprofit entities, include those “organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes.” Id. \textsection 501(c)(3).
\item \textsuperscript{29} See id. \textsection 170(a), (c).
\end{itemize}
substantial subsidies by exempting nonprofits from property taxes and sales taxes.\(^{30}\)

Although the sector is not run by the government, it is heavily subsidized by government funds.\(^{31}\) From multimillion dollar research awards to small fee-for-service reimbursements, nonprofit entities in the aggregate receive approximately thirty to thirty-five percent of their revenues from federal, state, and local governments.\(^{32}\) Since the nonprofit sector is a major recipient of government funds, often charged with a wide variety of tasks, state and federal governments have a vested interest in the success and maintenance of a vibrant nonprofit sector.

C. THE RATIONALES AND PUBLIC BENEFITS OF THE NONPROFIT SECTOR

Over the years, academicians have debated and proposed multiple theories to explain both the existence of the nonprofit sector, and, more important, the reason the United States continues to provide the sector with special privileges. While it is certainly not possible to examine in detail the rationales and philosophical underpinnings of the nonprofit sector within the scope of this Article,\(^{33}\) a general understanding of some of the most oft-cited rationales reveals the important role that the nonprofit sector holds in our society and underscores why the health of the sector warrants government and public attention. In general, I believe that the majority of the competing theories are grounded and best understood in the context of social, economic, and political theory.

1. Social Theories

One of the first and most perceptive commentators to write about the critical role of nonprofit organizations in American society was Alexis de Tocqueville. During his famous visits to America, de Tocqueville wrote about the importance of the nonprofit sector.

---


31. See SALAMON, supra note 4, at 90.

32. See HAWKS, supra note 19, at 16; SALAMON, supra note 4, at 91.

Americans of all ages, all conditions, all minds constantly unite. Not only do they have commercial and industrial associations in which all take part, but they also have a thousand other kinds: religious, moral, grave, futile, very general and very particular, immense and very small.

There is nothing, according to me, that deserves more to attract our regard than the intellectual and moral associations of America. We easily perceive the political and industrial associations of the Americans, but the others escape us; and if we discover them, we understand them badly because we have almost never seen anything analogous. One ought however to recognize that they are as necessary as the first to the American people, and perhaps more so.

In evaluating de Tocqueville’s views, one scholar has noted that “[s]ince de Tocqueville’s famous commemoration of the American propensity to form voluntary associations, we have primarily viewed ourselves as self-reliant in ‘community,’ somehow defined independently of government.”

Nonprofit organizations play a pivotal role in developing human connections, creating associational ties, and sustaining social capital—the bonds of trust and reciprocity necessary for a democratic society and market economy to operate effectively.

Many social-theory scholars believe it is the nonprofit sector, not business or government, that provides a sense of community for citizens. By encouraging individual initiatives for the public good, nonprofits promote the values of pluralism, freedom, and social integration. As David Horton Smith explains, “partly through directly expressive groups, whose aims are explicitly to provide fellowship, sociability and mutual companionship, and partly through the sociability aspects of all other kinds of collective and interpersonal forms of voluntary action.

34. 2 ALEXIS DE TOCQUEVILLE, DEMOCRACY IN AMERICA 489, 492 (Harvey C. Mansfield & Delba Winthrop trans. & eds., 2000) (1840).


sector] helps . . . satisfy some of the human needs for affiliation [and] approval."

In addition, various theorists have suggested that the nonprofit sector enhances participatory democracy by teaching citizens the basic skills of self-governance. Certain any publicly supported group requires involvement and some form of community or interconnectedness—organizations such as the local boys and girls clubs or the regional theatre troupe are helpful illustrations. The social theory argument posits that societal benefits are generated from the manner in which nonprofits produce and distribute their work, focusing on the intrinsic advantages of fostering altruism and pluralism.

2. Economic Theories

Another group of theorists, primarily those based in economics, has focused on the argument that nonprofit organizations exist to correct for inherent limitations of both the private market and government as providers of collective goods (i.e., market failure, government failure, and contract failure). Those taking an economic approach view nonprofit organizations as playing a pivotal role in addressing the free-rider problem. Nonprofit organizations “provide a level of collective and individual goods beyond that which government and business will provide, goods that do not have enough money-making potential to attract business and that have insufficient popular appeal to attract [a majority] of voters.” “The limitations of the market are easy to see: the particular goods and services offered by the nonprofit sector are usually ones which the beneficiaries themselves could not afford and which require some form of collective action to be produced.” For example, basic scientific and social-science research often benefits multiple individuals or entities, but it would be

39. See Bucholtz, supra note 30, at 576.
41. In economic terms, free riders are citizens who understate their demand for public services or fail to support or underwrite a public good, but enjoy the benefits of the goods or services without sharing in the costs. See Crimm, supra note 17, at 440 & n.83.
42. O’NEILL, supra note 4, at 15. See also SALAMON, supra note 37, at 12–13 (discussing public goods and the free-rider problem).
practically impossible to charge those individuals or entities. Similarly, the nonprofit sector can provide goods that indirectly benefit the public and that a smaller segment of society deems valuable.\textsuperscript{44} For example, an art museum makes its community “a more appealing and exciting place for all persons to live . . . [benefiting] those persons who utilize the facility by providing them with access to art they otherwise would not have.”\textsuperscript{45}

Another related explanation for the nonprofit sector is the concept of contract failure.\textsuperscript{46} Mostly associated with the influential work of Professor Henry Hansmann, the contract failure theory relies on the fact that some goods or services either are so complex or are purchased under such conditions that consumers are unable to evaluate them effectively. Specifically, this circumstance arises wherever the purchaser differs from the ultimate consumer (e.g., the recipient of welfare services or care for the aged). Hansmann explains that this inability to evaluate leads to failure of ordinary contract devices; normal market contracts fail when consumers are unable to police prices effectively.\textsuperscript{47} In such situations, Hansmann argues that the nonprofit producer brings an advantage through a “legal commitment to devote its entire earnings to the production of services.”\textsuperscript{48} Hansmann offers the following example:

\textit{[S]uppose that a profit-seeking counterpart to [the non-profit organization] CARE were to promise to provide one hundred pounds of dried milk to hungry children in Africa in return for a payment of ten dollars. Because the patron has no contact with the intended recipients, he or she would have no simple way of knowing whether the promised service was ever performed, much less performed well. Consequently, the owners of the firm would have both the incentive and the opportunity to provide inadequate service and to divert the money thus saved to themselves.\textsuperscript{49}}

\textsuperscript{45} Crimm, \textit{supra} note 17, at 441.
\textsuperscript{47} \textit{Id.} at 843.
\textsuperscript{48} \textit{Id.} at 844.
Compared with their for-profit counterparts, nonprofit organizations presumably have fewer incentives to abuse the trust that consumers necessarily place in them.50

3. Political Theories

The basis for another set of theories lies in a third discipline: politics. The foundation of many of the political theories is the argument that a partnership has developed over time between government and the nonprofit sector that has made nonprofits indispensable. Through a pervasive pattern of “third-party government”—in which government has turned to nonprofit organizations to provide direct services—nonprofits are carrying out governmental responsibilities.51 Congress has granted tax-exempt status to these organizations because in their absence the Government would have to provide many of the services. In McGlotten v. Connally, the court observed that allowing a federal income tax deduction for charitable contributions is justified:

[By doing so, the Government relieves itself of the burden of meeting public needs which in the absence of charitable activity would fall on the shoulders of the Government. “[T]he Government is compensated for [the] loss of revenue by its relief from financial burden[] which would otherwise have to be met by appropriations from public funds . . . .”52]

This rationale is best understood in the context of the health, human, and social services sector. For example, there are hundreds of community-based nonprofit organizations in America that provide much of the health care, job training, educational assistance, and other services to poor families and children.53 In fact, nonprofit organizations deliver a larger percentage of these services that are financed by the Government than do actual government agencies.54 Moreover, nonprofits provide society with a wide variety of partially tested social innovations, from which the public

---

50. See id. at 507; Hansmann, supra note 46, at 863. For critiques of Hansmann’s work, see Atkinson, supra note 40, and Ira Mark Ellman, Another Theory of Nonprofit Corporations, 80 MICH. L. REV. 999 (1982).

51. See SALAMON, supra note 4, at 33; Salamon, supra note 43, at 111. See also HAWKS, supra note 19, at 22 (describing many nonprofits as “dependent upon and aligned with government”).


53. See O’NEILL, supra note 4, at 97 (“Millions of Americans are directly affected by [the nonprofit sector’s] work, and millions of others are indirectly affected: every drug addict cured means fewer people mugged, every marriage problem solved means fewer children emotionally scarred or physically abused.”).

54. See SALAMON, supra note 4, at 87–89.
sector and private sector can select and institutionalize those innovations which seem most promising.\textsuperscript{55}

The nonprofit sector may also address government limitations. Unlike the Government, the nonprofit sector may act without being constrained by political feasibility and other demands of the electorate at large.\textsuperscript{56} For instance, nonprofit organizations lend support to controversial issues, such as AIDS research and birth control education, in order to complement or fill gaps in governmental efforts in the public health domain. In some cases, citizens may prefer "some nongovernmental mechanism to deliver services and respond to public needs because of the cumbersomeness, unresponsiveness, and bureaucratization that often accompanies government action."\textsuperscript{57}

D. CHALLENGES LEADING TO RESTRUCTURING

In a recent report, nonprofit scholar Lester Salamon identified four threats or challenges facing the nonprofit sector:

(i) \textit{Fiscal threat}: increased demand for services coupled with losses in government funding;

(ii) \textit{Economic threat}: competition with profit-making business that distract and harm traditional charitable activity;

(iii) \textit{Accountability threat}: concerns about the effectiveness of nonprofit activities and the need for improved performance measures; and

(iv) \textit{Legitimacy threat}: challenges to the sector’s exempt status and the general public’s weak level of confidence in nonprofit organizations.\textsuperscript{58}

To survive these threats, nonprofits must maximize their resources, management talent and tools, and rethink the status quo. Annoyed by overlapping programs, troubled by poor service delivery, and frustrated by a lack of coordination among organizations, foundations and corporate funders have encouraged nonprofits to collaborate with one another to improve their work and the sector’s health.\textsuperscript{59} While nonprofits have

\textsuperscript{55} See Nat’l Ctr. for Nonprofit Bds., \textit{The Construction of a Merger Mindset}, BOARD MEMBER, Sept. 1997, at 2, 3 ("[N]onprofits have acted as researchers and developers for the government, which frequently assumed responsibility for programs initiated in the nonprofit sector.").

\textsuperscript{56} Each organization, of course, remains subject to the politics, demands, and feasibility issues imposed by its own more limited group of stakeholders.

\textsuperscript{57} SALAMON, \textit{supra} note 37, at 13.

\textsuperscript{58} See SALAMON, \textit{supra} note 6, at xiii–xvi.

engaged in active collaboration for the past decade, the need for closer coordination remains. Although mergers certainly occur, anecdotal evidence and what little statistical evidence is available indicates that nonprofits rarely consider this ultimate collaboration. Considering the nonprofit sector’s size, the significant public resources devoted to it, and its social, economic, and political importance, the Government and the rest of society have a vested interest in its success. To the extent the nonprofit sector is weakened by its failure or unwillingness to consider mergers, society is weakened. Accordingly, creative legal and policy solutions are needed to ensure that strategic consolidation and its benefits receive serious consideration.

II. THE VALUE OF CONSOLIDATION IN THE NONPROFIT SECTOR

Unquestionably, the nonprofit sector is a powerfully positive force in American life. But in exchange for the advantageous tax treatment, society expects that nonprofit organizations and their resources will benefit and serve the public interest. In light of the current challenges facing nonprofits, the public interest may be served best by creating a legal and political environment that encourages nonprofit organizations to consider and to pursue, if and when appropriate, consolidation and restructuring. Mergers may fulfill many different organizational needs.

After more than a century of mergers, acquisitions, and consolidation in the private sector, it has become apparent that mergers are not universally advantageous. In fact, the terminology that has developed around corporate mergers—e.g., “shark repellent,” “white knight,” “hostile bid,” “poison pill”—reveals some of the tension and conflicting

60. See Bowen et al., supra note 12, at 100–01.
62. A shark repellent is an amendment to a target corporation’s articles of incorporation to make the company less desirable or more difficult to acquire, and thereby “encourage the ‘shark’ to seek a more appetizing or more easily digested alternative.” Ronald J. Gilson, The Case Against Shark Repellent Amendments: Structural Limitations on the Enabling Concept, 34 Stan. L. Rev. 775, 777 (1982).
63. Drawn from the image of a valiant knight who rescues the damsel in distress, a white knight refers to a stock bidder friendly to management who “will save [a target company] from the first offeror by offering both the shareholders and themselves a more attractive deal.” McCarron v. FDIC, 111 F.3d 1089, 1096 n.3 (3d Cir. 1997) (alteration in original) (quoting Robert Charles Clark, Corporate Law § 13.6, at 572 (1986)).
64. A hostile bid is an offer “made by a suitor, often characterized ... as a ‘corporate raider,’ who seeks to acquire control of the company and oust incumbent management.” David N. Hecht, Note,
feelings associated with consolidation. Indeed, experts disagree about to what extent merger activity benefits corporate entities, their shareholders, and society.\textsuperscript{66} I do not intend to suggest that all mergers are desirable and that the nonprofit sector should engage in thoughtless consolidation with abandon; I do, however, believe that under the right circumstances nonprofit organizations and the public can reap benefits from consolidation.\textsuperscript{67}

In this Part, I will discuss the potential costs and benefits associated with nonprofit consolidation to establish that a merger can be a useful management tool. Primarily, I will focus on outlining the circumstances under which a merger may add substantial value and identifying potential advantages, savings, and management rationales to support consolidation. Although the underlying premise of this Article relies on the presumption that there are virtues in consolidation, nonprofit mergers are not a panacea; there are potential costs as well as benefits.

A. CRITICALLY EXAMINING THE COSTS OF STRATEGIC CONSOLIDATION

Of course, nonprofit mergers are not risk-free transactions without potential pitfalls. They can have beneficial or harmful effects for an organization, its employees, and constituents. For instance, if an organization becomes too large it may lose its client focus, flexibility, and community ties. Similarly, a poorly executed or poorly planned merger could cause an organization to weaken ties to its base of financial support. Additionally, the public may be harmed if too much consolidation occurs, leading to a system with too few choices and too little competition among service providers, as well as an adverse impact on the employment of many Americans. Accordingly, some critics charge that nonprofit mergers are often harmful transactions, leading to a reduction in services and weaker...
community support. While this may occasionally be true, it is not uniformly so.

Nonprofit corporations as well as business corporations have the statutory power to reorganize themselves by merger. However, unlike those in the private sector, nonprofit corporations are not subject to “corporate takeovers” or “corporate raiders.” There is no equivalent of a hostile takeover or direct purchase of shares in the nonprofit setting. Instead, nonprofit organizations engage in consensual, “friendly” transactions. Since financial inurement and premium payments to stockholders do not occur in the nonprofit sector, consolidation decisions should be based solely on strategic grounds.

In fact, a well-conceived “mission-based” merger in the nonprofit sector—especially if directors are true to their fiduciary duties—will always strengthen both organizations by improving upon the effectiveness of fulfilling the organizations’ mission. Due to the absence of personal benefits, the only rational grounds to merge would be to advance the mission of the organization.

As noted in Part I, nonprofit organizations contribute to a healthy society by providing an opportunity for directors and other volunteers to be involved in civic life. However, nonprofit mergers may actually decrease the opportunity for citizens to be engaged in community affairs through a loss of volunteer opportunities. While I acknowledge that civic participation is an important by-product of nonprofit governance, I do not

69. See, e.g., CAL. CORP. CODE § 6010 (West 2000); MASS. GEN. LAWS ANN. ch. 180, §§ 10, 10A (West 1998); N.Y. NOT-FOR-PROFIT CORP. LAW § 901 (McKinney 1997); REVISED MODEL NONPROFIT CORP. ACT § 11 (1987).
70. Only if a nonprofit organization were organized as a member corporation (in which the members elect the board of directors) could an individual or organization wage the equivalent of a proxy fight to encourage the members to elect a slate of directors that would favor consolidation. However, this scenario is largely irrelevant to most public charities since they are usually run by self-perpetuating boards, where boards choose their own successors because there are no members with legal authority.
71. If a proposed combination does not advance the mission of the organizations involved, but rather represents a dramatic shift in the nature of the organization’s activity, the organization should use the voluntary dissolution proceedings to distribute its assets to another charitable purpose.

Procedurally, voluntary dissolution requires a majority vote by the board of directors, and often entails court approval or attorney general notice. See, e.g., MASS. GEN. LAWS ANN. ch. 180, § 11A (court approval); REVISED MODEL NONPROFIT CORP. ACT § 14.03 (attorney general notice); E.C. LASHBROOKE, JR., TAX EXEMPT ORGANIZATIONS 321 (1985) (majority vote).
72. See supra Part I.C.1.
believe it can trump the benefits of an efficient and effective operation of public resources. Most nonprofit organizations are founded to achieve an important purpose; we must expect and demand that organizations use their resources wisely.

B. STRATEGIC RATIONALES FOR NONPROFIT MERGERS

Why would a nonprofit merge? One or more of many different motivations may drive a nonprofit merger. While the advantages of merging are numerous, ultimately the merger provides a strategy for an organization to achieve one of three primary strategic objectives: mission survival, the desire for growth, or improvement in service delivery or operations.

1. Survival of an Organization’s Work, Services, and Mission

A strategic merger can be an effective tool for strengthening a weak organization. While many nonprofits grow and flourish over time, many others falter; often faced with severe financial shortfalls, some entities are unable to meet the expectations of founders, directors, funders, and clients. As one scholar noted:

A study commissioned by Independent Sector claims that congressional balanced-budget plans would reduce direct federal support for nonprofits by $263 billion from 1996 to 2002. Even with the most optimistic forecasts about growth in individual charitable contributions, the study concludes, nonprofits could be facing a $235 billion shortfall in coming years.73

Rather than engaging in feeble and ultimately wasteful attempts to cling to life in the face of inadequate cash flow, crippling scandal, substantial loss of revenue, or a lack of managerial or board leadership, a merger can provide a means of survival for a weak organization.74 By consolidating with another organization, whether another struggling entity or a healthy organization, a nonprofit organization can often continue to pursue its mission. Rather than viewing the survival of the established organization as the primary objective, nonprofits should shift their focus to maintaining the work, services, and mission of the entity.75

In 1997, for instance, an educational organization in western Massachusetts effectively used a merger to ensure the survival of its work.

73. HAWKS, supra note 19, at 17.
74. See LA PIANA, supra note 9, at 2–3.
75. See infra Part IV.B.
and mission. The ailing Citizens Educational Resources Center, which had trouble attracting adequate funding, merged with the Alliance for Education. Through the union, the Citizens Educational Resources Center was able to maintain its programs and salvage its remaining resources by merging into the larger and more secure entity.\textsuperscript{76} In this case, resources and programs that otherwise may have been lost if the Center had ultimately folded were salvaged.

Also consider the example of two progressive political advocacy organizations—once “pillars of the American left”—that merged to ensure their survival in 1998.\textsuperscript{77} The Center for Constitutional Rights, born out of the turbulence of the 1960s, combined with the National Emergency Civil Liberties Committee, an organization created in 1951 to battle McCarthyism and social injustice. Both organizations faced declining donor support and found themselves competing for the same philanthropic dollars; the organization leaders concluded that “it was a case of pooling resources or else withering away.”\textsuperscript{78} By merging, the two organizations were able to avoid a slow death and ensure mission survival. Although the name of the National Emergency Civil Liberties Committee may be an artifact of the past, by joining forces with another nonprofit with a similar mission, the Committee’s work and impact will be significantly greater and extend much further into the future under the banner of the Center for Constitutional Rights.

2. \textit{Desire to Achieve or Handle Growth}

Mergers can also be an effective tool for helping a well-functioning nonprofit organization grow or expand its range of services provided. Traditionally, when nonprofits want to develop new projects or expand into new areas, they begin from scratch by raising new funds, hiring new staff, and developing new programs. Mergers provide an alternative means for nonprofit groups to grow and to move into new or related areas. For example, a strong nonprofit may grow by “acquiring” a smaller weaker organization that could be revitalized with good management, providing more diversified revenue sources, or permitting expansion into new market segments or venues. Alternatively, a nonprofit organization can expand into a new, but related, area by “acquiring” another agency or one of its programs; this growth strategy permits the less experienced organization to


\textsuperscript{78} \textit{Id.}
take advantage of a more experienced player’s learning curve and to increase its base of support by bringing on new clients and funders.\textsuperscript{79}

In 1998, for example, an international relief and development agency merged with a smaller organization based in Washington, D.C. to expand its capabilities.\textsuperscript{80} The merger provided Oregon-based Mercy Corps International with a presence in Washington, D.C., and federal public policy influence, and provided Pax World Service with instant credibility, expertise, and an existing infrastructure.\textsuperscript{81} Moreover, Mercy Corps also acquired a program with experience organizing educational fact-finding delegations abroad.\textsuperscript{82} This growth in staff, expertise, and program would have taken Mercy Corps several years to develop on its own.

Additionally, as some nonprofits may become victims of their own success, mergers may be a way to handle growth from an increasing demand for services. For example, Harpeth Academy, a private school in Tennessee struggling with “swelling rosters,” merged with Battle Ground Academy.\textsuperscript{83} The merger enabled the combined schools to reengineer the use of their facilities to meet increased demands.\textsuperscript{84} “We had to decide whether to pursue a big capital campaign or a merger,” explained a school representative.\textsuperscript{85} Alternatively, a capital campaign would have taken several years to complete and used extensive resources and organizational capital.

3. \textit{Opportunity to Improve Service Delivery}

While most nonprofits focus on continual day-to-day operations, a merger presents a unique and infrequent opportunity for both organizational and client service improvement. Just as for-profit corporations focus on generating a profit for shareholders, nonprofits should focus on fulfilling their mission and ensuring that their work has an

\textsuperscript{79} \textit{Senior Services Merges With Catholic Charities}, SAN ANTONIO EXPRESS NEWS, Oct. 7, 1999, at B2 (describing a merger between an agency providing employment and volunteer opportunities to older residents and Catholic Charities of the Archdiocese of San Antonio which allowed Catholic Charities to outreach to older people and provided the senior services agency with a larger base and network).


\textsuperscript{81} \textit{See id.}

\textsuperscript{82} \textit{Id.}

\textsuperscript{83} Travis Hawkins, \textit{Growth Pushes Schools Together: Harpeth Academy Aims to Accommodate More Students in Merger with BGA}, TENNESSEAN (Nashville), Sept. 30, 1997, at 4W.

\textsuperscript{84} \textit{See id.}

\textsuperscript{85} \textit{Id.}
impact. Frequently, consolidation assists nonprofit organizations in better using their resources to achieve their stated mission and to impact their communities.86

In a merger described as a “marriage between resources and innovation,” the Museum of Modern Art (MOMA) merged with the P.S. 1 Center for Contemporary Art (P.S. 1) in 1999. In this growth merger, MOMA gained a presence in another borough of New York City, access to additional exhibition space, and a toe-hold into the most cutting-edge wing of the modern art movement. The merger benefited P.S. 1 by providing access to MOMA’s substantial curatorial expertise, financial resources, and marketing talent.87 The merger enabled both entities to expand their audience reach, thereby achieving their respective missions.

In another recent example, four nonprofit agencies serving disabled adults in Virginia merged together in order to permit the integration of employment supervision, job training, and goods-production services.88 The combined revenues and resources permitted hundreds of additional disabled individuals to receive services.89 Similarly, a museum merger in Boston between the Computer Museum and the Museum of Science provided a unique opportunity to improve service delivery and program offerings.90 Through the merger, the larger Museum of Science was able to augment its program offering with a computer technology program.91

By taking advantage of economies of scale or economies of integration92 or both, a well-planned merger often can help an organization access new resources, integrate services, reach additional clients, and develop new programs—essentially doing more with less. Merger opportunities should be seized when it is likely that a combined entity can do as well or better than what each group would have otherwise achieved on its own.

86. Dan Cook, Partnerships Crucial to Nonprofits, BUS. J. PORTLAND, Dec. 17, 1999, at 24 (Nonprofit mergers “have led to improved delivery of services with reduced overhead . . . [and] a ‘deeper and wider range of services.’” (quoting a nonprofit executive)).
89. Id.
91. See id.
92. See discussion infra Parts II.C.1, II.C.2.
C. ORGANIZATIONAL AND PUBLIC BENEFITS FROM NONPROFIT MERGERS

In addition to the compelling strategic rationales, there are several ancillary benefits for both merging entities and the greater public that are generated by nonprofit mergers and the mere existence of an environment where mergers are a viable option. While some of these benefits dovetail with the strategic rationales, it is important to identify clearly the full range of potential benefits of increased consideration and use of nonprofit mergers.

1. Efficiency Gains through Economies of Scale

The consolidation of two or more nonprofit organizations into one often leads to significant efficiency gains through economies of scale. The combined organization is able to deliver services more efficiently by reducing administrative costs, development costs, and/or overhead expenses.\textsuperscript{93} Economies of scale are further achieved through the efficient allocation of labor and resources.

Just as administrative efficiencies benefit a private corporation’s profit margin through reduced expenses, nonprofits benefit from reduced expenses by freeing additional dollars for program services.\textsuperscript{94} For example, when two neighboring divisions of the American Cancer Society announced their pending merger, the entities projected $500,000 in annual cost savings as a result of the consolidation.\textsuperscript{95}

The increased size and resources of a merged nonprofit organization also provide greater opportunities for nonprofits to invest in organizational development and human resources.\textsuperscript{96} Small nonprofits often are unable to invest in “luxuries” such as new technologies, human capital, and staff training. However, as most for-profit corporations increasingly recognize, organizational and human resource issues are critically important in order to succeed in the marketplace and to operate effectively.\textsuperscript{97} All


\textsuperscript{95} Thomas J. Billitteri, National Health Charities Face Challenge of Preserving Local Focus Amid Mergers, CHRON. PHILANTHROPY, May 7, 1998, at 28.

\textsuperscript{96} See Applegate, supra note 88 (noting that a merger of nonprofit organizations would allow the agencies to offer improved health plans to employees).

organizations, in both the for-profit and nonprofit sectors, depend on a well-trained and motivated staff. For some organizations seeking to focus on the effective use of technological innovation, human capital, and personnel issues, mergers may provide a means to gain sufficient scale to address such problems efficiently.

Additionally, over the past few years, foundations and corporate funders have placed increasing emphasis on program evaluation; funders are beginning to request and expect their nonprofit grantees to document measurable outcomes resulting from their activities. Unfortunately, evaluation is both difficult and expensive, and is therefore simply not a realistic activity for many organizations. Strategic mergers can help nonprofits achieve a minimal degree of staff size, fiscal resources, and expertise to develop the organizational capacity to undertake and to sustain constructive and sophisticated evaluation initiatives, staff development and training programs, and to harness the advantages of modern technology.

2. Efficiency Gains Through Economies of Integration

Consolidation can also help nonprofits take advantage of vertical integration—the combination of distinct related processes or services within the confines of a single organization—to improve the delivery of client services and further to advance their social goals. For example, consider a compact geographic area offering multiple services to its disabled population. These services can be provided by multiple nonprofit organizations, each carving out its own niche: a day program, a transportation program, a residential program, a family support program, and a medical care program. However, such a fragmented system is inefficient and often difficult and frustrating for clients. Consolidation may lead to better coordination, linked services, or co-location which, in turn, will likely lead to a higher level of service, treatment, and benefit for the client.


98. See Brody, supra note 35, at 503 (noting that donors, foundations, and government agencies are placing increasing importance on quantifiable measures of program achievement and effectiveness); James A. Joseph, Future Directions in Foundation Philanthropy, FUND RAISING MGMT., Apr. 1994, at 25, 26, available at 1994 WL 2810947 (“[F]oundations will require [from nonprofits] greater accountability and demonstrations of effectiveness through more and more evaluation.”).

99. This example is excerpted from The Construction of a Merger Mindset, supra note 55, at 4.
Integrated operations provide substantial opportunities for improved client focus and benefits from improved scheduling, coordinated operations, emergency management, holistic problem solving, shared information, strategic partnerships, and the reduction of transaction costs. In addition to being a waste of resources, the duplication of services can be detrimental to client service; program enhancement opportunities are lost when multiple agencies overlap rather than coordinate their services. Just as the private sector has reaped benefits from vertical integration, nonprofit organizations and their clients can benefit from a more efficient delivery of services that comes from mergers.\(^{100}\)

By combining resources, rather than competing for them, consolidation may provide opportunities for some nonprofit organizations to establish financial stability, thereby benefiting clients and employees. In particular, the increased fiscal stability of a stronger post-merger organization can help reduce employee turnover. Moreover, clients benefit because financial stability and size help sustain organizations; research demonstrates that small and young nonprofit organizations are those most likely to fail.\(^{101}\)

Since fiscal pressures have created new competitive pressures in the nonprofit sector, fiscal health will be an essential element to effective operation.\(^{102}\) In some circumstances, as the Center for Constitutional Rights and Civil Liberties Committee realized, similar organizations may have more to gain by combining rather than struggling alone to compete for support and resources.\(^{103}\)

3. **Salvaged Public Resources**

In return for their favored tax treatment, exempt organizations are expected to operate in the public interest. Society and local communities benefit when nonprofit resources—e.g., financial capital, volunteer time, and political goodwill—are not wasted. When a failing nonprofit organization struggles to maintain its corporate existence and imprudently


\(^{101}\) See Mark Hager, Joseph Galaskiewicz, Wolfgang Bielefeld & Joel Pins, *Tales from the Grave: Organizations’ Accounts of Their Own Demise*, 39 AM. BEHAV. SCIENTIST 975, 991 (1996).

\(^{102}\) See HAWKS, supra note 19, at 24 (“With too many groups chasing too few dollars, competition among tax-exempt organizations with similar missions or constituencies has heated up.”).

\(^{103}\) See supra text accompanying notes 77–78.
expends scarce resources that might have been better used by another organization achieving the same or similar mission, the public interest has not been served, and those valuable public resources are permanently forsaken.

Six months before beginning dissolution proceedings, the chairperson of a nonprofit board stated: “Why would we want to merge? We would lose our independence. We have our own way of doing things. We don’t want to be taken over by some other group with different priorities. We would lose our identity. This will never happen while I am President.”

This short-sighted and institutionally selfish view aids no one. Leaving unpaid debts, clients without services, and fourteen employees without work, this organization wasted a great deal of funds and resources during its final months that might have been better put to use if placed under the stewardship of another organization with a similar mission. In these circumstances, the entire community loses resources. In addition to serving organizational purposes, mergers can also serve a greater public interest of preventing public resources from being wasted.

4. **Enhanced Community Position**

The increased size and impact of an organization following a merger can lead to greater visibility and market recognition. A larger, more efficient nonprofit organization often wields more clout, maintains political power, and lends a stronger voice which can permit the organization to influence government affairs, media relations, and public education initiatives. A merger may also provide a means to build a brand image or expand an existing platform.

5. **Incentives to Management**

Creating an environment where nonprofit mergers occur (or at least are considered) more often may indirectly enhance nonprofit management. Some economists theorize that in the corporate sector, takeover activity “induce[s] managers to maximize shareholder wealth” and increases “the pressure applied to managers to pursue projects that maximize market

---

104. L A PIANA, supra note 9, at 1.
105. Id.
106. See Karen Robinson-Jacobs, 2 Valley Chambers Decide to Merge, L.A. TIMES, June 20, 2000, at B10 (noting that two Chambers of Commerce planned to merge for increased “political clout”).
107. See Nicola Hill, Force For Good: Twin Attack in Merger of HIV Charities. GUARDIAN (London), Oct. 4, 2000, at 5, 2000 WL 27815144 (describing the merger of London’s two largest HIV nonprofits and the “powerful national voice” that the merged organization will have).
value. In some cases, nonprofit organizations have suffered from the decisions of inefficient, entrenched management who have failed to adequately guard nonprofit resources or to pursue new solutions to problems, or both. Increased merger activity might have the added benefit of providing additional incentives to nonprofit staff, ensuring that their activities add public value through innovative problem-solving in order to avoid being viewed as a ripe takeover target or becoming a disposed employee in the event of a merger.

D. SUMMARY

There are many rationales for nonprofit mergers and benefits that mergers can bring to organizations, their clients, and the entire sector. While more widespread consideration of merger options offers exciting opportunities and possibilities, directors must be vigilant in exploring both the costs and benefits of a merger. However, many nonprofits do not seriously explore a merger as a strategic option. To capture the potential benefits of consolidation, boards must fully consider a merger as a viable weapon in the nonprofit management arsenal.

III. UNDERSTANDING AND OVERCOMING THE LEGAL AND SYSTEMIC IMPEDIMENTS TO NONPROFIT MERGERS

America’s nonprofit organizations must combine a compelling mission, effective leadership, and innovative programming to succeed. Strategic, mission-based restructuring can help many organizations, especially those with a need to survive, a desire to grow, or an impulse to strengthen their mission and forge a successful path. Unfortunately, there are several serious institutional impediments preventing the nonprofit sector from taking advantage of merger activity: a misdirected entity focus, director and management agency problems, and high transaction costs. Since these are systemic problems, the most effective combination of

109. See, e.g., HAWKS, supra note 19, at 86–93.
110. I use this term loosely because, as I have stated earlier, hostile takeovers do not exist in the nonprofit sector. See supra text accompanying note 70. However, the entity’s board of directors may decide to pursue or accept another organization’s merger proposal over management objections.
solutions will draw upon law, policy, and philanthropic activity to alter the system.

In this Part, I outline the legal mechanics governing nonprofit mergers and explain the systemic impediments that hamper merger activity in the nonprofit sector.

A. LEGAL MECHANICS OF NONPROFIT MergERS

Since modern nonprofit corporations typically form under state nonprofit corporation statutes, I will focus my review on general nonprofit corporate law procedures.

For most nonprofit organizations, mergers and consolidations are conceptually straightforward legal procedures. In a merger, one corporation liquidates into another and the transferor’s existence ceases; the other organization acquires the assets and liabilities of the transferor and survives. In a consolidation, two or more corporations liquidate into a third, new corporation, and the two old corporations cease to exist.

Since consolidations and mergers are governed by state corporate law, the pertinent state statute will dictate the procedures for effecting a merger or consolidation between nonprofit organizations. Those procedures vary somewhat among states, but they all follow basically the same pattern.

1. Statutory Requirements

If a merger receives approval from the majority of each board of directors, most states permit organizations to merge as they see fit. For instance, the typical state statute governing charitable corporations

111. Some nonprofits are authorized directly by the federal government. See, e.g., 36 U.S.C. § 1 (1994) (authorizing the American Red Cross); id. § 21 (authorizing the Boy Scouts of America). The other major exceptions are institutions organized as charitable trusts that therefore are subject to limitations imposed by a founding donor, such as the Barnes Foundation and the Isabella Stewart Gardner Museum. See, e.g., Holland Cotter, A Legacy Thieves Could Not Steal; Despite Devastating Losses, the Gardner Museum Is Rebounding, N.Y. TIMES, Mar. 31, 1997, at C11 (describing the Gardner Museum’s trust, which stipulates that should any art leave or be added to the collection that the entire collection be auctioned with proceeds to Harvard University).

112. This assumes that the merging corporations are two or more public-benefit or religious corporations, and that the surviving corporation will maintain nonprofit status.

113. See, e.g., REVISED MODEL NONPROFIT CORP. ACT § 11.01 cmt. at 285 (1987).

114. See id. § 11.03. See, e.g., D.C. CODE ANN. § 29-542(4) (1996); 805 ILL. COMP. STAT. ANN. 105/111.15 (West 1993).

115. In the case of membership organizations, often the merger agreement must also be approved by two-thirds of the voting members. E.g., MASS. GEN. LAWS ANN. ch. 180, § 10(c) (West 1998); 805 ILL. COMP. STAT. ANN. 105/111.20 (West 1993); N.Y. NOT-FOR-PROFIT CORP. LAW § 903 (McKinney 1997). However, public-benefit nonprofit corporations are rarely membership organizations.
identifies specific items to be included in the plan of merger or consolidation, including:

(1) the names of the corporations involved in the transaction;\textsuperscript{116}
(2) the purposes of the surviving or resulting corporation;\textsuperscript{117}
(3) the terms and conditions of the consolidation or merger;\textsuperscript{118}
(4) any changes to the articles of incorporation of the surviving corporation;\textsuperscript{119}
(5) the effective date of the transaction;\textsuperscript{120} and
(6) any other provisions deemed necessary or desirable.\textsuperscript{121}

The final agreement is filed with the state secretary to certify that charitable purposes are maintained by the new organization.\textsuperscript{122} Upon issuance of the certificate, the merger or consolidation is effected.\textsuperscript{123} After a merger or consolidation, the surviving or new corporation succeeds to all rights, powers, liabilities, and obligations of the original corporations.\textsuperscript{124} Generally, a domestic corporation may be merged or consolidated with a foreign corporation (one not authorized to operate within the state) if the state laws permit such a merger.\textsuperscript{125}

As previously stated, procedures for executing mergers vary from state to state. For example, although the Revised Model Code does not require court approval or attorney general notice, New York law requires that a plan of merger or consolidation be approved by one or more

\begin{footnotes}
\item[118] E.g., Cal. Corp. Code § 6011(a) (West 1990); Mass. Gen. Laws Ann. ch. 180, § 10(b)(iii); Revised Model Nonprofit Corp. Act § 11.01(b)(2).
\item[121] See, e.g., Cal. Corp. Code § 6011(f); Mass. Gen. Laws Ann. ch. 180, § 10(b)(iv); Revised Model Nonprofit Corp. Act § 11.01(c)(2).
\item[124] See Revised Model Nonprofit Corp. Act § 11.05(3) (1987); Lashbrooke, supra note 71, at 310.
\end{footnotes}
government agencies and a justice of New York’s Supreme Court. It is customary to submit a proposed merger plan to the New York State Attorney General’s Office for internal review prior to seeking court approval. The Attorney General examines the merger plan and use of assets and may require changes. Moreover, additional governmental approvals may be required for certain types of nonprofit organizations. New York adopts these additional approvals to “ensure that assets intended for charitable or public purposes are not diverted.”

Statutory requirements, however, can sometimes hinder or disrupt efforts to implement well-conceived mergers. For instance, New York’s merger statute contains a provision that conflicts with another portion of the Not-for-Profit Corporation Law; this statutory conflict confuses practitioners, leads to additional legal expenses, and, when applied, punishes merging organizations. Section 907(c) of New York Not-for-Profit Corporation Law, triggered by a merger or consolidation, grants the court discretion to transfer assets held for a specified purpose to the surviving corporation “upon an express trust.” Accordingly, this authority imposes a trust framework upon asset transfers in merger contexts raising a host of difficulties. In contrast, section 513 of the same code explicitly shifts away from traditional trust concepts for nonprofit organizations organized under corporate law even in circumstances where the organization receives specific purpose assets “in trust.”

With section 907(c), New York courts or the Attorney General can require merging entities to create trusts to hold restricted assets. As a

---

126. See N.Y. NOT-FOR-PROFIT CORP. LAW § 907(b) (McKinney 1997).
127. See id. § 907.
128. See id. § 907(b).
129. See VICTORIA B. BJORKLUND, JAMES J. FISCHMAN & DANIEL L. KURTZ, NEW YORK NONPROFIT LAW AND PRACTICE: WITH TAX ANALYSIS § 8-3(c), at 257 (1997).
130. Id.
131. For example, an organization that includes among its purposes day care services for children or “residential programs for victims of domestic violence” must seek approval from the commissioner of social services; whereas an organization that includes among its purposes “combating juvenile delinquency” or “the study or prevention of poverty” must seek approval from the secretary of state. N.Y. NOT-FOR-PROFIT CORP. LAW § 909 (incorporating N.Y. NOT-FOR-PROFIT CORP. LAW § 404(b)).
132. BJORKLUND ET AL., supra note 129, at 250–51.
133. The author would like to thank Mimi Lukens for pointing out this conflict.
134. N.Y. NOT-FOR-PROFIT CORP. LAW § 907(c) (McKinney 1997).
135. See id. § 513 (“A corporation . . . formed under this chapter . . . shall hold full ownership rights in any assets . . . that may be given, granted, bequeathed or devised . . . in trust . . . or with a direction . . . and shall not be deemed a trustee of an express trust of such assets.”). See, e.g., Alco Gravure, Inc. v. Knapp Foundation, 479 N.E.2d 752, 762 (N.Y. 1985).
result, assets that were fully owned by a nonprofit corporation can become reclassified if that entity chooses to merge. If the trust were invoked and upheld, the formalities of ownership could have real and detrimental consequences; if the assets become subject to an express trust, the board of directors become trustees with regard to those assets meaning that those directors would be held to a more stringent standard of fiduciary duty and face more restrictive investment options.\textsuperscript{136} Imposing a different standard of care for one set of assets or even introducing trust concepts creates uncertainty and confusion for directors, and the provision unnecessarily punishes an organization for consolidation by changing the status of assets it formally owned outright.\textsuperscript{137} Placing the assets into an express trust is unnecessary because even after a merger a New York corporation would be required to apply restricted-purpose assets in accordance with the donor’s wishes under corporate standards.\textsuperscript{138} Of course, sound public policy dictates that assets received for a specific purpose should be required to be used for such purposes, but an express trust is not necessary to achieve such an end. New York provides just one example; since each state has its own laws, the degree to which the statutory legal mechanics may or may not hinder mergers varies.

2. \textit{Fiduciary Duties}

Beyond the aforementioned state statutory requirements, the only additional duties or legal requirements governing a merger plan or proposed merger are the duties of care, loyalty, and obedience.\textsuperscript{139} In some circumstances, these fiduciary duties may pose indirect limitations on

\textsuperscript{136} See Evelyn Brody, \textit{The Limits of Charity Fiduciary Law}, 57 MD. L. REV. 1400, 1426–29 (1998) (explaining that “trustees” are held to an ordinary negligence standard in contrast to “directors” who enjoy the protection of the business judgment rule and are shielded from liability except for willful misconduct or gross negligence).

\textsuperscript{137} Interestingly, New York’s nonprofit dissolution statute permits transfers of restricted assets without the creation of an express trust. See N.Y. NOT-FOR-PROFIT CORP. LAW § 1005(a)(3)(A) (McKinney 1997). This seems to support the argument that applying trust law concepts only in the case of mergers or consolidations makes little sense and does not lead to desirable results.

\textsuperscript{138} See \textit{In re} Multiple Sclerosis Serv. Org., 68 N.Y.2d 32, 39 (1986). See also N.Y. NOT-FOR-PROFIT CORP. LAW xix (McKinney 1997) (Explanatory Memorandum No. 1 (1969)).

\textsuperscript{139} The duty of care requires that directors and officers discharge their responsibilities in good faith with the care, skill, and diligence of an ordinarily prudent person. Directors also owe a duty of loyalty to their nonprofit corporation which requires them to avoid using their position to harm the corporation or obtain improper personal benefits. The duty of obedience, somewhat less recognized, refers to a duty to carry out the purpose of the corporation. See REVISED MODEL NONPROFIT CORP. ACT § 8.30 (1987); DANIEL L. KURTZ, \textit{BOARD LIABILITY: GUIDE FOR NONPROFIT DIRECTORS} 22–48, 59–90 (1988); 1 MARILYN E. PHELAN, \textit{NONPROFIT ENTERPRISES: CORPORATIONS, TRUSTS, AND ASSOCIATIONS} § 4:04 (2000).
consolidation plans. I call them indirect limitations because they are general rules that apply to nonprofits in all contexts, regardless of whether a merger is involved.

In the context of mergers between nonprofits, the duty of obedience traditionally has been most relevant. Nonprofit directors are prohibited from substantially deviating from the duty to fulfill the purposes for which the organization was created.\textsuperscript{140} In particular, court approval may be required if a merger will result in a significant change in use of restricted funds\textsuperscript{141} or a significant change in the use of general assets. When nonprofit mergers face legal roadblocks, the problems often involve the proposed use of restricted assets.\textsuperscript{142} Despite a merger or change of control, any surviving organization carries formerly existing obligations regarding the use of restricted assets.\textsuperscript{143} Thus, if a merger would lead to a material change in how an organization wanted to use pre-existing restricted assets, court approval might be required before the funds could be used in a new way.\textsuperscript{144}

Similarly, a significant change in the use of general assets of an organization may be subject to court approval. Although courts are often reluctant to intervene in business judgments made by directors, a nonprofit organization may not use a merger as a tool to avoid the \textit{cy pres} requirements or voluntary dissolution procedures. For instance, in \textit{Attorney General v. Hahnemann Hospital},\textsuperscript{145} the court ruled that a nonprofit organization does not have unfettered discretion to apply funds to amended charitable purposes.\textsuperscript{146} A hospital that sought to sell its assets to become a grant-making institution, without court approval, was blocked by the

\textsuperscript{140} See \textsc{Kurtz}, supra note 139, at 64–90 (defining the duty of obedience as a third fiduciary duty to the purposes of the charity).

\textsuperscript{141} A nonprofit corporation and its board are obligated to apply funds in accordance with the directions of the donor. See, e.g., N.Y. NOT-FOR-PROFIT CORP. LAW § 513(b) (McKinney 1997). When the donor’s purpose becomes impossible or impracticable, the \textit{cy pres} doctrine permits state courts to alter the use of such property. See \textit{In re Will of Goehringer}, 329 N.Y.S.2d 516, 520 (1972); \textsc{Restatement (Second) of Trusts} § 399 (1959); \textsc{Phelan}, supra note 139, § 13:11.

\textsuperscript{142} See generally \textsc{Bjorklund et al.}, supra note 129, at 257 (noting New York State Supreme Court’s attention to restricted assets when scrutinizing merger plans).

\textsuperscript{143} See, e.g., MASS. GEN. LAWS ANN. ch. 180, § 10(b) (West 1998); N.J. STAT. ANN. § 15A:10-6(d) (West 1984); \textsc{Revised Model Nonprofit Corp. Act} § 11.05 (1987) (“[A]ll real estate and other property owned by each corporation party to the merger is vested in the surviving corporation . . . subject to any and all conditions to which the property was subject prior to the merger.”); Richard C. Allen, \textit{Regulation of Public Charities and Fund-Raising}, in \textsc{Massachusetts Nonprofit Organizations} § 9.8 (1998), available at WL NPOI MA-CLE 9-i.

\textsuperscript{144} See MASS. GEN. LAWS ANN. ch. 180, § 8A (1998). See also \textsc{Brody}, supra note 136, at 1463.

\textsuperscript{145} 494 N.E.2d 1011 (Mass. 1986).

\textsuperscript{146} See \textit{id.}, at 1021.
attorney general. While this case does not deal directly with mergers, the principle would apply in a merger context. One commentator has noted:

[M]any charities have been strongly supported financially by their local communities. If two such charities from different geographic areas were to merge and if the result would be that assets accumulated over time with the support of one community would be transferred to a use in another community, court approval may be called for.\textsuperscript{147}

In practice, however, these issues rarely interfere with nonprofit mergers.\textsuperscript{148} If the directors are faithfully fulfilling their fiduciary obligations, the proposed transaction should combine entities with complementary missions and, if relevant, consider the provision of services to a particular geographic region as part of that mission. A truly strategic nonprofit merger should rarely cause significant change.

3. Enforcement Mechanisms

In theory, there are several individuals and institutions available to challenge the decisions made on behalf of a nonprofit and to ensure that directors faithfully discharge their duties: lawsuits may be filed by dissident directors or members, interested individuals, and state attorneys general. Despite these multiple levers the enforcement mechanisms are quite weak in practice.

Although assets of nonprofit organizations are owned by the entire community, the general public lacks the standing to bring a derivative suit against a nonprofit organization.\textsuperscript{149} Only persons with a specific and definite interest in the organization have standing to institute a legal action. The statutory system has purposefully limited the general public’s power to bring derivative actions in order to protect the organizations from an avalanche of frivolous and vexatious lawsuits.\textsuperscript{150} Specifically, directors and members have an interest in an organization and are authorized to

\textsuperscript{147} Allen, supra note 143, at § 9.6.3.


\textsuperscript{149} See, e.g., ARIZ. REV. STAT. § 10-3631 (West 2000); GA. CODE ANN. § 14-3-741 (1994); N.Y. NOT-FOR-PROFIT CORP. LAW § 720 (McKinney 1997); REVISED MODEL NONPROFIT CORP. ACT § 6.30 (1987).

bring derivative suits.\footnote{See REVISED MODEL NONPROFIT CORP. ACT § 6.30(a); Blasko et al., supra note 150, at 56.} In practice, however, most nonprofits are run by self-perpetuating boards, without outside members.\footnote{See BJORKLUND ET AL., supra note 129, at 257 (noting that relatively few organizations have members).} Since directors make the organization’s decisions, the chances are slim of a dissident director emerging and willing to take on the onerous task of bringing suit against his or her colleagues.

While members and directors can easily bring lawsuits, private parties may only bring suits against nonprofits if they prove that they have a “special interest.”\footnote{See e.g., Paterson v. Paterson Gen. Hosp., 235 A.2d 487 (N.J. Super. Ct. Ch. Div. 1967) (residents of city had standing to sue to prevent relocation of hospital); Alco Gravure, Inc. v. Knapp Found., 479 N.E.2d 752 (N.Y. 1985) (beneficiaries of nonprofit corporation had standing to challenge trustees’ dissolution of nonprofit organization and transfer of assets). But see Associated Students of the Univ. of Or. v. Or. Inv. Council, 728 P.2d 30 (Or. Ct. App. 1986) (student recipients of scholarships did not have standing to protest Investment Council’s holding of certain stocks in violation of Board of Higher Education resolution).} Although the traditional standing limitations have been relaxed to permit individuals to bring lawsuits,\footnote{See e.g., Hardman v. Feinstein, 240 Cal. Rptr. 483 (Ct. App. 1987) (city taxpayers and museum visitors could not sue trustees of art museum charitable trust to prevent mismanagement); Steeneck v. Univ. of Bridgeport, 668 A.2d 688 (Conn. 1995) (a “life trustee” was not a beneficiary of the university or an individual with special interest distinguished from other members of the public for a lawsuit over contractual agreement entered into by the university); Weaver v. Wood, 680 N.E.2d 918 (Mass. 1997) (holding that individual members of church were not beneficiaries and had no special interest).} proving a sufficient special interest occasionally imposes a significant hurdle for plaintiffs. Often private plaintiff suits are dismissed for lack of standing because they cannot demonstrate a distinct interest or benefit that is different from those of the general public.\footnote{See infra text accompanying note 156.} Courts’ willingness to allow a private party to sue for enforcement of a nonprofit organization’s obligations depends on the following elements of importance: (1) “the extraordinary nature of the acts complained of and the remedy sought”; (2) “the presence of fraud or misconduct on the part of the charity or its directors”; (3) “the state attorney general’s availability or effectiveness”; (4) “the nature of the benefitted class and its relationship to the charity”; and (5) the “subjective and case-specific factual circumstances.”\footnote{Blasko et al., supra note 150, at 61.}

In most jurisdictions, the state attorney general usually has the responsibility and authority to oversee nonprofit organizations and protect the public interest.\footnote{See Brody, supra note 136, at 1406 (“The state attorney general enjoys nearly exclusive authority and discretion to challenge a charity manager’s actions.”).} In Massachusetts, for instance, the role evolved
under common law\textsuperscript{158} and was later codified.\textsuperscript{159} The attorney general’s enforcement role permits intervention in a nonprofit organization’s affairs in order to prevent the waste of funds and to ensure that beneficiaries of charitable funds receive their intended benefits.\textsuperscript{160} As a general rule, mergers do not warrant the involvement of the attorney general unless the merger would cause the nonprofit to violate one of its existing duties.\textsuperscript{161} In some states, such as Massachusetts, for example, the Public Charities Division of the Office of the Attorney General will review merger plans at the request of the merging parties (i.e., before the transaction is completed) to determine if existing duties are violated and if there is reason to block the consolidation.\textsuperscript{162}

Although the state attorneys general serve as the primary enforcement party, in practice, this enforcement is also flawed. Given the scarcity of regulatory resources, the offices of most state attorneys general have devoted few resources to nonprofit organizations. In fact, only eleven such offices employ two or more full-time staff people to monitor the nonprofit sector and charitable solicitation, while twenty-four states have no particular person assigned to monitor nonprofits.\textsuperscript{163}

**B. KEY IMPEDIMENTS TO INCREASED MERGER ACTIVITY IN THE NONPROFIT SECTOR**

A review of the nonprofit governance and incentive structure reveals substantial hurdles limiting widespread consideration of the merger as a strategic management tool for nonprofit organizations. Essentially, the system suffers from several classic problems that work together to undermine the willingness of nonprofit leaders to consider and to pursue mergers as a strategic management tool.


\textsuperscript{159} See MASS. GEN. LAWS ANN. ch. 12, § 8 (West 1998). Cf. CAL. CORP. CODE § 5250 (West 1990); N.Y. NOT-FOR-PROFIT CORP. LAW § 112 (McKinney 1997); REVISED MODEL NONPROFIT CORP. ACT § 1.70 (1987).

\textsuperscript{160} See Blasko et al., supra note 150, at 45–47.

\textsuperscript{161} See supra Part III.A.2.

\textsuperscript{162} See Allen, supra note 143, § 9.6.4 at 15.

\textsuperscript{163} See Thomas J. Billitteri, Rethinking Who Can Sue a Charity. CHRON. PHILANTHROPY, Mar. 12, 1998, at 1, 35 (reporting the results of a survey conducted by the National Association of Attorneys General).
1. **Misdirected Entity Focus: Directors and Managers View Merger as Organizational Failure**

   The attitude and perception of trustees and management plays a significant role in the resistance to mergers in the nonprofit sector. Without an interest in return on equity or maximizing shareholder value, nonprofit organizations are driven solely by mission and passion, and, as a result, treat the idea of losing their identity as a failure. This notion is so ingrained that many weak nonprofit organizations “continue to cling to life, unable to pursue their mission, unwilling to die, but preferring death to merger.”

   Recall the example above of a chairperson of a nonprofit board, who stated six months before dissolution proceedings that the organization did not want to be taken over by “some other group.” All too frequently, some nonprofit managers and overseers mistakenly equate merger with failure; in doing so, those managers inappropriately value the organization’s (and their own) independence and identity over the long-term survival and well-being of the organization’s mission and its resources. This misdirected entity focus leads to a myopic view of the stewardship responsibilities of a nonprofit director.

2. **Loss of Power for Nonprofit Directors and Managers Without Compensation**

   Unlike their corporate counterparts, officers and board members of a nonprofit organization receive no material gain from a merger. While some individuals may benefit personally from leading a larger and perhaps more prestigious organization, others (most notably, directors and managers who are not invited to lead the surviving entity) lose: They lose independence, identity, job security, or some combination of the three.

   Nonprofit mergers frequently mean that directors, who receive no material gain from their board service, may lose their seat on the consolidated entity’s board. Accordingly, a decision to approve or

---

164. LA PIANA, supra note 9, at 17.
165. Supra text accompanying note 104.
166. In the corporate world, the directors who lose their jobs can reap enormous windfalls from stock options, accelerated vesting schedules, etc.
167. Directors and officers owe fiduciary duties to the corporation, which require good faith and fair dealing. While compensation for directors is permitted, board service on most nonprofit boards is voluntary. See KURTZ, supra note 139, at 6 (“Service for directors of nonprofit organizations is typically uncompensated . . . .”).
168. See LA PIANA, supra note 9, at 6. When faced with a merger, the board size and board seats of the consolidated entity become an issue. In order to avoid unnecessarily large and unwieldy boards, directors frequently limit the total number of board seats to a number considered reasonable and
pursue a merger may be tantamount to firing oneself from a powerful position from which many directors derive pleasure and value. In fact, some of those board members may have actually paid substantial sums of money, through a compelled “donation,” in exchange for the board seat. As a result, many directors may be reluctant to consider merger alternatives without outside pressure.

For the full-time, paid staff of a nonprofit organization, a merger could have graver consequences: the loss of employment. Therefore, unless managers are certain that they would be given a position in the new entity, they have a personal incentive to avoid pursuing a merger for fear of personal job loss.

Although a merger might benefit the organization and the public by enabling or positioning that organization so that it may better accomplish its mission, nonprofit mergers face severe hurdles because the decisionmakers, namely the directors and managers, may be reluctant to relinquish the power, prestige, or job security associated with their position. This situation presents a classic agency problem. In the merger context, the personal interests of the individual directors and managers who make decisions on behalf of the nonprofit organization may differ from the interests of those whom the organization seeks to serve and benefit (i.e., the public and the organization’s clients). The failure to address this problem leads to significant lost opportunities for nonprofits.

3. **Transaction Costs**

The transaction costs associated with nonprofit mergers are often quite high. Although no cash premiums are paid for a consolidation, manageable to maintain effectiveness, which does not always permit all directors of the former entities to continue to serve. Of course, in practice, various factors enter into the decision regarding board composition of the post-merger organization (including the actual size of the existing boards, the relative asset size of the merging institutions).

---


170. *See* Lisa Gubernick, *Buying Your Way On to a Board*, WALL ST. J., May 7, 1999, at W1 (noting that many elite nonprofits are establishing annual minimum gift levels from directors ranging from “an average gift of $20,000” to as much as $100,000 a year).

171. *See* La Piana, *supra* note 9, at 19.

172. In general, transaction costs include the costs of identifying the parties with whom one has to bargain, the costs of connecting with them, and the costs of the bargaining process itself. *See* R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).
mergers can be expensive. For instance, once a nonprofit decides to pursue a merger, it must identify potential partners, research and gather information about those organizations, and evaluate the information. Nonprofit suitors would need to be able to identify suitable potential partners (i.e., organizations with similar missions in an appropriate geographic market) and evaluate their activities, management, and finances. Furthermore, most organizations would probably prefer to gather and review much of this basic preliminary information before making an initial pass. Of course, this intelligence gathering and evaluation requires time, expertise, and resources. Moreover, the execution of a merger generates “[a]udit, legal, and consulting fees, as well as printing and other incidental costs, [that] add up. In addition to money, mergers take time—especially the time of chief executives, senior managers, and board leaders—which is most often already stretched to the limit.” The lack of resources necessary to evaluate effectively and to conduct the rigorous analysis necessary for a merger serves as a barrier to nonprofit mergers.

IV. OVERCOMING THE IMPEDIMENTS TO ENHANCE OPPORTUNITIES FOR NONPROFIT Mergers

This Article’s ultimate goal is to bring about a shift in attitude toward nonprofit mergers. Directors, government, and the public should view strategic, mission-based mergers as an effective management tool to maximize public resources. Encouraging such a shift, however, will require outside intervention from the powerful forces that influence private nonprofit organizations: government (through the imposition of rules and regulations) and funders (through the provision of resources). In this Part, I suggest ambitious, but workable and politically feasible, solutions to overcome those impediments to promote further consideration of nonprofit mergers.

In the corporate context, the legal, political, and economic regimes have adopted many rules and layers of control to guard against “alleged
unfairness and conflict of interest among managers and shareholders to address merger incentives. The courts and legislatures have developed several levers to ensure that board decisions regarding mergers are fair. In the nonprofit context, the legal, political, and economic regimes need to work together to ensure that the powerful possibilities of nonprofit mergers are adequately considered. The primary means of bringing systematic change can best be achieved through reconsidering notions of fiduciary duty and a convergence of information, pressure, and assistance.

A. HEIGHTEN THE DIRECTORS’ FIDUCIARY DUTIES IN MERGER CONTEXTS

When business corporations are faced with an organizational change, such as a merger offer, boards are held to more rigorous standards in reaching decisions than in ordinary matters and must satisfy more demanding requirements to show that they had reasonable grounds for their decision. The normal deference to board decisions granted by the courts is embodied in the traditional business judgment rule. Under the business judgement rule, “directors’ decisions are presumed to have been made on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.” In certain circumstances, however, such as those that arise in the context of mergers and acquisitions, courts do not defer to the board’s decision under the traditional application of the business judgment rule. In a change of control context, corporate directors are held to a higher “enhanced scrutiny” standard in which the board action is subject to judicial review. The court may examine the board’s process, its action, and the reasonableness of the directors’ decisions. Recognizing the inherent

175. ROBERT CHARLES CLARK, CORPORATE LAW 401 (1986).
176. This applies to decisions of both private and nonprofit corporations.
179. There are several limited situations in which Delaware courts will not defer to board conduct under the application of the traditional business judgment rule. These include the adoption of a defensive mechanism in response to an alleged threat to corporate control, see, e.g., Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985), and approval of a transaction involving a sale of control or break-up of the company, see, e.g., Revlon v. MacAndrews & Forbes Holdings, 506 A.2d 173 (Del. 1986).
conflict arising from the management’s and the board’s interest in retaining control of the company.\textsuperscript{180} heightened duties require that corporate directors act with extra care when making decisions regarding change of control issues. In altering the duties, the court ratchets up the standard of care required of an organization and its leaders to improve its level of decisionmaking in change of control transactions.

Similarly, the standard of care should be ratcheted up for nonprofit directors in change of control matters. Just as the \textit{Unocal} and \textit{Revlon} duties have forced for-profit directors to establish reasonable grounds for their decisions on mergers, heightened duties for nonprofit directors would lead to more careful consideration of mergers as a strategic option.

Legislation forcing hostile takeovers of nonprofit entities seems unnecessarily strong and politically unfeasible. While some mergers may be desirable, there is little value in developing a system in which nonprofit organizations waste resources defending against hostile takeovers. However, heightened duties in the consideration of a merger offer seem both reasonable and viable. Through legislative action or court interpretation of the standard of care, nonprofit directors could carry the burden of proving that their process and conduct was reasonable (rather than be granted that presumption under the business judgment rule).\textsuperscript{181}

Drawing from the \textit{Unocal} test, which focuses on the reasonableness of defensive tactics,\textsuperscript{182} the nonprofit enhanced standard could require that the board meet a two-pronged test: 1) The board must show its decisionmaking process was fair and thorough, which could be demonstrated by the directors’ reasonable investigation, thoughtful consideration, and appropriate debate on the merits and impact of the proposed transaction on the organization’s mission, community, and use of resources; and 2) the board must show that the decision reached was reasonable, which could be demonstrated by the objective reasonableness of the course chosen.

This approach still affords the board substantial latitude to make its own decision. It would not be advantageous to take the decision about whether to merge outside the hands of the directors. The heightened duties


\textsuperscript{181} Cf. Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34, 45 (Del. 1993) (holding that corporate boards must prove that they met the \textit{Unocal} standard); Barkan v. Amsted Indus., 567 A.2d 1279, 1285–86 (Del. 1989) (same).

\textsuperscript{182} The two-pronged \textit{Unocal} test requires the board to show “reasonable grounds for believing that a danger to corporate policy and effectiveness existed” and that the defensive measure chosen was “reasonable in relation to the threat posed.” \textit{Unocal}, 493 A.2d at 955.
will help to ensure that valid, well-conceived merger proposals receive full and fair consideration. Although legal enforcement remedies are far weaker in the nonprofit sector, the mere existence of the heightened duties and knowledge of the standard would change board behavior. As I believe most directors would attempt to follow the law and meet the heightened standards, the increased scrutiny would serve as an important counterbalance against the emphasis on the impact on individual managers and officers of the organization. By providing the board of directors with a concrete process and standard, we can focus the decision process and minimize the agency problems. The heightened standard would lead to active participation in the decisionmaking process by a well-informed board; since courts might examine the extent to which a board acted after reasonable investigation, a prudent board would carefully document its decisions and the decisionmaking process.

While this process may impose some additional costs on small nonprofits (i.e., reasonable investigation and documentation), the benefits seem well worth these costs. Certainly, small nonprofit organizations play a pivotal role in society, and policymakers should always pay special attention to the ramifications and burdens that policies and decisions place on that part of the sector. However, we must remain mindful that these organizations also receive public benefits from their nonprofit status, and


185. Cf. Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140, 1151–52 (Del. 1989) (according great deference to the board’s decision, stressing the evidence of the board’s active engagement throughout the decisionmaking process).
their directors and managers should be held accountable for those public resources. Furthermore, research indicates that it is the small organizations that are most likely to fail\textsuperscript{186} and fritter away precious resources in the process. Therefore, it is critically important that small organizations bear the burdens of investigation and documentation to ensure that they too adequately consider strategic mergers.

**B. DIFFERENTIATE BETWEEN ORGANIZATIONAL SELF-PRESERVATION AND MISSION STEWARDSHIP**

Directors must be taught and encouraged to differentiate between their desire to preserve the organizational entity and their responsibility to guard and manage the mission and resources of the nonprofit institution. Rather than focus on preserving the organizational entity, directors should understand that, as representatives of the public and society, they are guardians of the organization’s mission and resources. This is a critically important distinction. In some cases, the best thing for the organization’s mission, its clients, and the use of public resources may be a strategic merger, but if the directors view their primary responsibility as maintaining the entity’s independence and identity, they cannot serve the mission, the clients, nor the public.

Nonprofit organizations and their leaders need to realize that they exist not to operate as a nonprofit, but rather to benefit communities and society. As long as directors operate under a paradigm where a merger represents organizational failure or where maintaining the entity is the primary objective or both, increased merger activity can never materialize. Only when directors understand and view their position as public advocates working to ensure that an organization uses its resources to effectively fulfill its mission can they begin to sort through the difficult and emotional considerations involved in evaluating a merger. “It falls to board members, as guardians of the organization’s mission, to remain open-minded when considering whether a merger is a sound alternative . . . .”\textsuperscript{187} In order to achieve open-mindedness, directors must be of a frame of mind in which mergers are an acceptable management option. The state attorney general is well-positioned to incorporate this message into its brochures. Additionally, information provided to board members, as well as funders,

\textsuperscript{186} See Hager et al., supra note 101, at 989 (stating that their study of nonprofit closures revealed that small size was one of the most important factors leading to nonprofit closure).

\textsuperscript{187} LA PIANA, supra note 9, at 23.
lawyers, and consultants who advise nonprofit organizations, must educate
directors and emphasize this shift in thinking about survival issues.

C. REASSESS AND REVISE STATUTORY REQUIREMENTS

State attorneys general and legislatures, particularly those in states that
have not relied on the model code, should at least review their nonprofit
merger statutes with an eye toward revision to ease the merger process and
eliminate unnecessary burdens. When nonprofit organizations decide to
merge, unnecessary or confusing statutory requirements should not provide
additional roadblocks to an often sensitive and difficult set of
circumstances.

New York, for example, would benefit from amending its law to
address conflicts between its merger and corporate finance provisions with
regard to treatment of restricted assets. To remedy the conflict, section
907(c) of the New York Not-for-Profit Corporation Law should be revised
to omit those portions that conflict with section 513. Amendments to
state codes that simplify and clarify merger requirements, harmonize
conflicting provisions, or remove unnecessary hindrances will aid
nonprofits organizations navigate the legal requirements associated with
carrying out a merger.

D. CREATE FINANCIAL INCENTIVES TO MERGE

The private sector uses financial rewards to align management,
director, and shareholder interests to motivate managers and directors to
relinquish their positions for the good of the company and its owners.
While corporate directors often lose power and their board seats when for-
profit corporations merge, they also share in the financial benefits of the
merger. In other words, the business world induces its directors and senior
managers to relinquish their power and prestige with an upside potential of
financial compensation. Thus, by acting in their own financial best
interests, based on potential for long-term growth or the reality of short-
term profits, corporate executives can minimize the agency problems in
merger decisions.

188. See infra notes 133–38 and accompanying text.
189. Following the approach used in voluntary dissolutions, section 907(c) can be rewritten to
achieve the state’s goal of expressly ensuring fidelity to the purposes and restrictions on specific
purpose assets without imposing a trust framework. See N.Y. NOT-FOR-PROFIT CORP. LAW
§ 1005(a)(3)(A) (McKinney 1997) (“Such disposition shall be devoted by the acquiring corporation or
organization to the purposes intended by the testator, donor or grantor.”). Such an approach is
consistent with the rest of section 513.
Although personal payments to individual directors of merged organizations would be inappropriate, the philanthropic community could help provide a financial incentive to merge by providing general operating support grants (or at least the potential of receiving such) to organizations after completion of the merger. For example, directors might be more willing to see the benefits of merging if there was the possibility of additional grant money for their organization after the merger. In fact, the additional funds could help organizations recoup the financial “transaction” costs associated with the merger.

While the philanthropic community cannot create an entitlement to fund every merged organization, foundations and other donors could devote resources to support consolidation. More specifically, the philanthropic community could develop and fund initiatives that support consolidation by offering supplemental general operating grants to newly merged organizations. For instance, grantmakers could provide a financial incentive to nonprofit organizations by creating an awards program providing general operating support grants to organizations that have recently carried out well-conceived and well-executed nonprofit consolidations, or funders could take steps to reward the new efficiency of merged organizations by providing increased grant support. Additional grant money supporting strategic consolidation might provide the type of bottom-line benefit to encourage organizations to consider mergers.

E. Employ Problem-Solving Lawyering Skills

As advisors to and negotiators for nonprofit organizations, lawyers can play an integral role in helping overcome the obstacles and disincentives to nonprofit mergers. Lawyers facilitate and implement mergers by advising clients, negotiating terms on their behalf, drafting written agreements, and filing documents and negotiating with regulatory bodies. However, by understanding many of the institutional impediments and disincentives of mergers, lawyers can help directors and managers overcome some of the obstacles by proposing novel solutions to address

190. “The defining characteristic of a nonprofit organization is the prohibition against distributing any part of the net earnings to persons who are private shareholders, officers, [or] directors . . . of the organization.” See LASHBROOKE, supra note 71, at 5. While salaries for nonprofit directors are not prohibited, such payments are quite rare. In fact, most directors are expected to contribute (i.e., donate substantial sums of money) to their organization’s annual fund drives. See supra note 170 and accompanying text. See also BOWEN, supra note 169, at 78–79. Direct payments to directors of merging organizations would create unacceptable conflicts of interest that would undermine purely “mission-based” consolidation.
spoken and unspoken concerns. \footnote{191} For instance, lawyers can negotiate transitional and advisory boards for displaced directors, arrange power sharing relationships between managers of merging entities, and offer strategic counsel to alleviate concerns that may hinder a merger.

F. PROVIDE TECHNICAL ASSISTANCE TO MERGING ORGANIZATIONS

In order to ensure that mergers are executed successfully, nonprofit organizations will need a variety of professional support, expertise, and advice. As previously discussed, mergers can be costly and difficult endeavors.\footnote{192} Organizations could benefit greatly from expert resources and possibly additional funding as they go through the process of merging. Private funders could play an important role by funding projects providing technical assistance to organizations as they go through the difficult processes of merging; there are many national and local organizations which could develop and coordinate workshops, training, and consulting services. Technical assistance would expand the capacity of nonprofits to successfully engage in strategic restructuring.

Moreover, private funders can play an important role in helping to raise the level of awareness about the benefits of nonprofit mergers. As a key constituent for all grant-seeking organizations, foundations can help publicize and educate the rest of the sector about mergers. For instance, funders could develop research, identify best-practices, and prepare reports to begin fostering discussion and education. Private philanthropic awareness efforts could support the aforementioned proposals to help directors and management differentiate between organizational self-preservation and their responsibility to guard the mission and resources of the nonprofit institution.\footnote{193} By communicating with grantee board members and executives (e.g., identifying duplicative programs or service


\footnotetext[193]{See supra Part III.B.1.}
gaps), funders can help shape the way the nonprofit sector thinks about mergers and acts upon consolidation opportunities.

CONCLUSION

Despite a challenging external environment, many nonprofit organizations are thriving. However, the nonprofit sector remains highly fragmented. It duplicates efforts, it is competitive, and many organizations are too small to meet community needs with efficiency. Even in the face of these circumstances, nonprofits have proven reluctant to merge or even to consider mergers. Interestingly, both thriving and floundering organizations can benefit from well-conceived, strategic, mission-based consolidation. However, much of the nonprofit sector suffers from a “deep-seated anti-merger sentiment.” The tendency of nonprofit boards and managers to resist strategic mergers harms society: valuable assets are wasted or frittered away and efficiency or synergy opportunities are lost. Government and private funders, both of which have a vested interest in a healthy and vibrant nonprofit sector, should use their authority and resources to motivate the nonprofit sector to rethink consolidation. More than ever, the public needs a healthy and effective nonprofit sector to address pressing problems and challenges.

As in all board decisions, mergers require that the directors “maintain a clear view of the organization’s mission as the highest priority.” Currently, there are many institutional and systematic impediments that obstruct that clear view. This Article offers several legal and policy suggestions that may help directors and management begin to give nonprofit mergers adequate consideration.

To merge, nonprofit organizations must overcome old conceptions, fears, and incentives. The potential benefits from such expanded consideration of mergers are significant. In corporate America, the advantage of merging is higher profits for shareholders. In the nonprofit sector, a well-planned, strategic merger leads to the better use of public resources and improved organizational effectiveness—something we all profit from.

195. La Piana, supra note 9, at 16.
196. Id. at 23.