

Dangers and Opportunities: Navigating Nonprofit Partnerships, Collaborations, Joint Ventures and More

**Jeffrey S. Tenenbaum
David R. Warner
Lisa M. Hix**

**Venable LLP
Nonprofit Organizations Practice**



Need Drives Structure

What Is Motivating this Change?

Administrative Partnership
Consolidation or Expansion of Programming

First Step Is Assessment

- Financial
- Mission
- Organizational Willingness
- Outside Pressure

How Much Time Do We Need – or Have?

- Speed/Permanency of Transition
 - Large Scale Cost or Program Consolidation Needs Time
 - Strategic Partnership Can Start Slowly



Collaboration Continuum

Greater Autonomy → Greater Integration

–Contractual Vehicles

- Administrative Consolidation
- Program Collaboration

–Entity Collaboration

- LLCs
- Affiliated/Subsidiary Entities

–Full Integration

- Asset Transfer
- Consolidation or Merger



Contractual Vehicles

Key Elements

- Organizations Remain **Autonomous**
- Bound by **Contract Terms, Length of Contract**
- Appropriate for **Administrative Consolidation** or **Programmatic Collaboration**
- Appropriate for **Related** or **Unrelated Functions** (but Beware of “Substantiality”)
- Appropriate for **Tax-Exempt** or **For-Profit Partner**



Contractual Vehicles

Advantages

- Appropriate Where **Unsure of Long-Term Sustainability or Need**
- **Less Need for Due Diligence**
- Flexible
- Scalable



Contractual Vehicles

Downsides

- Continue to Think with “**Two Minds**”
- Potential **Synergies** of Deeper Partnership Not Necessarily Realized
- More **Limited Ability to Shield** from Liabilities
- **Activities** of the Joint Venture Directly **Attributed** to the Tax-Exempt
- **Unrelated Activities** a Greater Concern



Key Terms – Joint Ventures

- **Scope**
 - Program: Specific Program and Mission
 - Administrative: Key Shared Staff/Facilities
- **Exclusivity**
 - No Competitive Harm
 - Limitation on Similar Programs or Hiring Staff
- **Decision Making**
 - How Are Decisions Made?
 - How Are Disputes Settled?



Key Terms

- Allocation of Costs
 - Contracts
 - Financial Contributions
- Distribution of Profits
 - How Calculated
 - Percentage Split
- Issues of Authority to Bind



Key Terms

- **Ownership of IP**
 - Define Joint IP from Joint Efforts
 - Ability to Use Without Limit? With Prior Approval?

- **Allocation of Risks/Indemnification**
 - Financial Losses
 - Legal Claims
 - Can Be **Difficult to Apportion Responsibility** as Contemplated by Typical Indemnity



Key Terms

- **Term and Termination**
 - Watch Length of Term
 - Advance Notice of Termination
- **What Happens Upon Termination**
 - Post-Split of IP, Goodwill of Event



Entity Collaboration

- “Parent” Entities Remain Autonomous, but a Separate Combined Entity Is Created
- Forms:
 - Corporations
 - Partnerships
 - Limited Liability Companies
 - Low Profit LLC



Creation of Separate Entity

Advantages

- Greater **Shield from Liability**
 - Financial Liability
 - Vicarious Liability for Claims
- **House Unrelated Activities** Without Jeopardizing Tax-Exempt Status (but Beware of Attribution)
- Raise **Capital**
- More Competitive **Compensation**

Downsides

- Less **Control**
- Greater **Start-Up Costs**
- Administrative **Burden & Cost of Running**



Choosing A Form

- Choice Made on the Basis of **Who Will be Liable for the Debts Incurred** in the Venture — a State Law Question, and
- **How its Profits Will be Taxed** — a Federal Law Question
- **Tax Considerations** Most Often Paramount
- **Capital Raising Aspects** Also Important



Corporation

- Can Be Tax-Exempt or For Profit

Advantages

- Complete Protection from Liability for the Debts of the Company (Beware of “Mere Instrumentality” and Corporate “Piercing”)
- Activities Not Attributed to Parent – Important Where Activities Are Not “Related” (Beware of Observing Separate Entity Status – “Sham or Fraud”)



Corporation

Downsides

- Start-Up
 - Incorporation, Bylaws, Board of Directors
- Director Meetings
- Annual Reports
- Tax Filings
- Taxation Issues



Tax Implications

- Must Apply for **Separate Tax-Exempt Status**
- Corporation Is Treated as a **Separate Taxpayer**, Subject to Income Tax at a Maximum Rate of 35%
- If **Not Controlled**, Distributions to Parent in the Form of Dividends, Interest, Rent, Will **Not Result in UBIT** to Parent



Exclusions from Taxation IRC 512(b)

1. **Dividends** (from Stock)
2. **Interest** (Typically from Extended Credit)
3. **Royalties** (Intellectual Property License)
4. **Rent** (Such as Rented Space)

But If a Subsidiary Is Controlled, 2-4 (Excluding Dividends) Do Not Apply



Slippery Slope of Control

An Entity Is a Controlled Organization if the Controlling Organization Owns:

- By Vote or Value More than 50 Percent of a Corporation's Stock (for an Organization that Is a Corporation)
- Control of a Nonstock Corporation Means At Least 50 percent of the Directors or Trustees of Such Organization Are Either Representatives of, or Directly or Indirectly Controlled by, the Controlling Organization



Net Unrelated Income Excess Benefits

- Controlling Organization Must Include the Payment as Unrelated Business Taxable Income (UBTI) to the Extent That the Payment **Reduces** the “**Net Unrelated Income**” (or **Increases** the “**Net Unrelated loss**”) of the Controlled Entity
- Also Be Aware of **4958 Excess Benefit Application** to Controlled Entities



Other Forms

Partnerships, LLCs and L3Cs

- **Less Formal Governance**
- Fewer Administrative Burdens
- Tax Implications for **Disregarded Entities**



Partnerships

- Creature of **State Law or Imposed by Law**
- Outlined in **Partnership Agreement**
- **General Partnership** - Partners Share Operating Responsibility and **Each One Is Liable** for the Debts of the Others
- **Limited Partnership** - Comprised of One or More General Partners Who Assume Operational Responsibilities for the Partnership and One or More “**Limited Partners**” Who Serve as Passive Investors and **Don't Have General Liability**
- **Disregarded** - Disregarded for Tax Purposes, and the Income and Deductions of the Partnership are **Passed Through to the Partners, Thereby Avoiding the Separate Level of Taxation Imposed on Corporations**



Limited Liability Company

- Creature of State Law – All 50 States
- Rights and Roles Outlined in Operating Agreement
- Note Appreciation of Value Issues
- LLC with a Single Owner Is Disregarded for Federal Tax Purposes Unless It Elects to Be Regarded Separately from its Member.



Limited Liability Company

- An LLC Owned by Two or More Entities Can Be Disregarded
- Exempt Owner Treats Operations and Finances of the LLC as its Own for Tax Purposes
- If LLC Activities Are Unrelated to the Owner's Exempt Purposes, Could Jeopardize Tax-Exempt Owner's Status
- However, If Advances Tax-exempt Purposes, Can Be Useful for Limiting its Owner's Liability on a Specific Project
- May Qualify for Tax-Exempt Status (See 2001 EO CPE Text Topic B)



Joint Ventures & Tax-Exempt Status

- Joint Ventures with For-Profit Entities or Between 501(c)(3) and Other Tax-Exempt
- **Joint Venture** – “Any Joint Ownership or Contractual Arrangement through Which There Is an Agreement to Jointly Undertake a Specific Business Enterprise, Investment, or Exempt-Purpose Activity.”



Joint Ventures & Tax-Exempt Status

- “Whole Joint Venture” – Where Nonprofit Contributes Substantially All of Its Assets.
 - 51% or More of Voting Rights and/or Veto Power
- “Ancillary Joint Venture” – Portion of Resources Are Contributed
 - Control over Tax-Exempt Aspects of the Joint Venture
 - Voting and Ownership Interests in the Joint Venture that are Consistent with Capital Contributions
 - Joint Venture Gives Priority to the Tax-Exempt’s Purposes over Maximization of Profit for Participants in the Joint Venture
 - Prohibition on Activities That Would Jeopardize the Tax-Exempt Owner’s Tax-Exempt Status



Low Profit Limited Liability Company “L3C”

- Form of Limited Liability Company
- As of Today, an L3C Can Only Be Formed in 7 States
 - of Michigan, Vermont, Illinois, Wyoming, Utah, Louisiana, and North Carolina
- Once Formed in Any of These States, the L3C Can Operate Legally in All 50 States
- Designed to Facilitate “Program Related Investments” (“PRI”s) by Private Foundations (such as Below-Market Rate Loans)
 - Count Toward 5% Distribution Rule for Private Foundations



Low Profit Limited Liability Company “L3C”

L3C Must Be Organized and Operated at All Times to Satisfy the Following Requirements (Mirror PRI Definition):

- The Company Must “Significantly Further the Accomplishment of One or More Charitable or Educational Purposes”;
- “No Significant Purpose of the Company Is the Production of Income or the Appreciation of Property” (Though the Company Is Permitted to Earn a Profit); and
- The Company Must Not Be Organized “To Accomplish Any Political or Legislative Purposes.”

The IRS Has Not Ruled on Whether Investments to L3C's Will Qualify as PRIs



Consolidated Entity

- Mergers, Asset Transfers and Consolidations
- Complete Integration of Organizations
- Creation of New Entity (New Incorporation, Tax-Exempt Status Application)
- Both Predecessor Entities Dissolve and Transfer Assets or Both Entities Merge into “New” Entity



Consolidated Entity

Advantages

- Full Benefit of Consolidated Entity
 - One Mind
 - One Administration
- Long-Term, Permanent Solution

Downsides

- Due Diligence Is Crucial
- More Elaborate Process to Establish Entity



Merger

- One Entity Legally Becomes Part of the Surviving Entity and Effectively Dissolves.
- The Surviving Corporation Takes Title to All of the Assets, and Assumes All of the Liabilities, of the Non-surviving Entity.

Advantages

- Efficient Transaction
- Most Assets and Liabilities Transfer by “Operation of Law”

Downsides

- Due Diligence Is Especially Critical
- Approval of Both Organizations Can Be Logistically Difficult
- Significant Administrative and Financial Task



Merger

Mechanics

- The **Board of Directors** of **Each** Precursor Organization Must Develop and Approve a Plan of Merger Consistent with Relevant State Law
- The Plan of Merger Also Must be Submitted to the **Voting Members**, If Any, of **Each** Organization for Their Approval
- While the Conditions for Member Approval Vary from State to State, Statutes Generally Require a Vote of **Two-thirds** to Effectuate the Plan Merger – a Number That Can Be Difficult to Reach for Practical and Political Reasons



Acquisition of a Dissolving Corporation's Assets

- One Entity Dissolves and Transfers **Select** Assets to Acquiring Corporation
- The Acquiring Corporation Takes Title to **Select** of Assets, and Assumes **Select** Liabilities, of the Dissolving Entity.

Advantages

- May be Strategically Preferable
- Ability to Shield from Future Liability - BUT Depends on Structure of Deal and Set Asides

Downsides

- Potentially Less Efficient Transaction
- No Transfer by “Operation of Law”



Acquisition of a Dissolving Corporation's Assets

- The Board of Directors of Dissolving Organization Must Approve.
- Voting Members of Dissolving Organization, If Any, Must Approve
- Because the Successor Entity Is Merely Absorbing the Assets of Another Organization, a Vote of the Membership and Accompanying State Filings Are Typically Not Required for That Corporation



Final Note on Protection of Tax-Exempt Status

- Unrelated Business Income Tax
- Control
- Private Benefit and Private Inurement



Due Diligence and the Identification and Mitigation of Personnel Risk



Overview

- Key “Hot Spots” for Legal Risk
- Personnel Due Diligence in Mergers and Similar Transactions
- Affiliations and Joint Ventures
 - Unique Challenges of “Joint Employment” and “Integrated Employers”
 - Applying Due Diligence Concepts in the Context of Affiliations and Joint Ventures
- Mitigating Identified Risk Factors



Key “Hot Spots” for Legal Risk

- Untended Employee Relations Issues
- Contractual Commitments
- Pending Claims
- Imminent Claims
- FLSA and Wage/Hour Compliance
 - Misclassified Workers
 - Employee/Independent Contractor Problems
- Benefit Miscues



Due Diligence in Mergers

- “Audit” Is Not a Dirty Word
- Documents and Data for Review and Analysis
 - Employee Handbook and Policies
 - Employment Contracts
 - Position Descriptions
 - Time-keeping Records
 - Payroll



Due Diligence in Mergers

- Documents and Data for Review and Analysis – *Cont'd*
 - Personnel Files
 - Employee Discipline Records
 - Employee Transaction Data
 - Benefit Plans and Contracts
- Key “Discussions”
 - Chief Executive
 - In-house Counsel
 - Senior HR Personnel



Shared Staffing; Shared Risk

- Pre-existing Risk of Liability for Conduct of Third-parties
 - Vendors
 - Members
 - Directors
- Unique Issues in Shared Staffing Arrangements
 - The “Integrated Employer” Doctrine
 - “Joint” Employment



Shared Staffing; Shared Risk

- Integrated Employers
 - Common Management
 - Interrelation Between Operations
 - Centralized Control of Labor Functions
 - Degree of Common Ownership/Financial Control



Shared Staffing; Shared Risk

- Joint Employment
 - Employers Need Not Be “Integrated”
 - Determination Is “Employee-specific”
 - Applies When Entities “Handle Certain Aspects of Employer-employee Relationship Jointly”
 - Common Law Element of “Control” Is Principal Guidepost
 - Compensation
 - Hiring/firing
 - Supervision



Shared Staffing; Shared Risk

- Hidden Issues Under Integrated Employer and Joint Employment Doctrines
 - Unanticipated Liability of “Unknown” Violations
 - Number of Employees Might Trigger Additional Legal Rights
 - 15 Employees – Title VII, ADAA
 - 20 Employees – ADEA, COBRA, DC FMLA
 - 25 Employees – Increased Leave Entitlement Under DC Accrued Sick and Safe Leave Act
 - 50 Employees – FMLA, EO 11246



Due Diligence in Joint Ventures and Affiliations

- Less Access to Documents and Data
- Greater Dependence Upon Informal Discussions and Fact-Gathering
- Hot Spots Remain the Same
 - Focus Upon Points of Contact Between Organizations
 - Often Requires Greater Reliance on Contract Strategies for Mitigation of Potential Risk



Addressing Identified Risk Factors

- “Whistle Past the Graveyard”
- Remediate
- Apportion Risk and Duty to Defend Through Contract



Doing Nothing

- “Don’t Just Do Something, Stand There!”
 - Avoids Current Expenditure of Resources
 - Avoids Potentially Delicate Negotiations Between Entities or Entities and Individual Employees
- BUT:
 - Issues Swept Under the Rug Create Pool of Potentially Expanding Liability for Several Years
 - Intentional (or Unreasonable) Ignorance Is Not a Defense
 - Not Consistent with Duties as Officers or Directors



Proactively Addressing Identified Risk Factors

- Remediation
 - Provides for “Correction” or Mitigation of Identified Risks
 - May Require Difficult Decisions and Delicate Negotiation
 - Could Potentially Scuttled Desired Corporate Transaction
 - Actions Should Be Confirmed as Part of Reps and Warrants Within Deal Documents



Addressing Identified Risk Factors Through Contract

- Apportioning Risk via Contract
- Indemnification Agreements
 - Does Not Require Specific Identification of All Issues
 - Does Not Require Remediation of Issues
 - Down-side Risk of “Kicking the Can”
- Practical/structural Problems with Indemnification Agreements
 - Post-hoc
 - Expensive
 - Capable of Varying Interpretation and Enforceability



Addressing Identified Risk Factors

- Alternatives to Indemnification
 - Acceptance of Specific Potential Liabilities
 - Incorporation of “Duty to Defend”
 - Still Not a Panacea:
 - Who Picks/Controls Counsel?
 - Who Has Settlement Authority?
 - Who Pays?



Joint Defense – We All Hang Together or We Hang Separately

- Advantages
 - United Front
 - Pooling of Discovery, Work Product and Resources
 - Reduced Costs
- On-going Past Practice of Cooperation Is Insufficient for “Common Interest” to Arise



Wrap-up

- No “One Size Fits All” Form for Teaming and Other Combinations of Resources
- Necessity of Due Diligence - Look Before Your Leap
- Understand What Liabilities You are Retaining, Avoiding, or Accepting
- Document That Understanding in Clear Terms
- If Things Do Go Wrong, “Hang Together” If You Can



Questions and Discussion

Venable LLP
575 7th St., NW
Washington, DC 20004
(202) 344-4793

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