Legal Considerations for the Nonprofit Sustainability Initiative Grantees

Nonprofit organizations contemplating a strategic restructuring such as a merger or collaboration with another nonprofit partner can ensure a smoother process by identifying potential legal issues early on. This publication discusses four legal self-checks your organization should undertake when considering a strategic restructuring: (1) confirming your organization's good standing with all relevant corporate and tax regulatory agencies; (2) assessing whether any new activities contemplated by the strategic restructuring are outside the scope of what is described in your founding documents; (3) reviewing your organization's key contracts for provisions that may affect decisions regarding the strategic restructuring; and (4) identifying employment-related legal issues which must be addressed at the outset of planning a strategic restructuring.

If you have questions about how to address these issues, Public Counsel can help. Public Counsel provides free transactional legal assistance to nonprofit organizations that serve low-income and underserved communities in Los Angeles County. Our services are free to qualifying organizations. We employ a *pro bono* model that leverages the expertise of Public Counsel staff attorneys with the talent of volunteer lawyers from major law firms and corporations.

For further information, or to apply for legal services, call **Annie Marquit at (213) 385-2977, ext. 246 or Ritu Mahajan at (213) 385-2977, ext. 135** and say you are an NSI grantee.

I. Good Standing

One easy legal self-check is to confirm that your organization is in good standing with all relevant corporate and tax regulatory agencies. A California nonprofit public benefit corporation exempt from taxation under Section 501(c)(3) of the Internal Revenue Code with corporate or tax-exempt status suspended or revoked by the California Secretary of State (SoS), California Franchise Tax Board (FTB), California Attorney General Registry of Charitable Trusts (AG), or Internal Revenue Service (IRS) will have difficulty partnering with any other organization until the compliance issue is rectified. Here's how to check your organization's status:

Corporate Good Standing with the California Secretary of State. A nonprofit corporation doing business in California, regardless of where incorporated, must make sure that a current Statement of Information[1] is on file with the SoS in order to maintain its corporate good standing. If it is not current in its filings, then the nonprofit is at risk of having its corporate status suspended, which means, among other things, that *it cannot enter into legally binding contracts and its corporate name can be adopted by another organization.*

> **What to do.** To check corporate compliance status, visit the SoS website at https://businesssearch.sos.ca.gov/ – the status should be listed as "Active." If the corporation has been suspended, contact the Secretary of State to learn what is needed to resolve the matter.

Federal Tax Exemption. Despite initially qualifying for tax-exempt status with the IRS, it is possible for a nonprofit to lose that status by breaching the operational requirements of section 501(c)(3) somewhere along the way. For example, 501(c)(3) organizations must annually submit to the IRS an information return on Form 990, Form 990-EZ, or Form 990-N (the applicable form depends on the value of an organization's assets and that year's gross receipts). A nonprofit's federal tax-exempt status will be automatically revoked if it fails to file the appropriate Form 990-series return for three years in a row.

> **What to do.** You can quickly confirm your organization's 501(c)(3) status through an IRS online tool called Tax Exempt Organization Search (formerly Select Check) at https://www.irs.gov/charities-non-profits/tax-exempt-organization-search, which will note whether the organization is eligible to receive tax-deductible charitable contributions.

[1] California nonprofits file Form SI-100 with the California Secretary of State, available at http://bpd.cdn.sos.ca.gov/corp/pdf/so/corp_so100.pdf.

California Tax Exemption.

Nonprofits exempt from the California franchise tax must submit an annual information return similar to the federal Form 990-series to the FTB. Every year, such organizations must file [Form 199](#) (or [Form 199N](#), depending on the organization's gross receipts.) Failure to file these returns for three consecutive years will result in automatic revocation of state tax-exempt status.[2]

> **What to do.** You can confirm your organization's continued section 23701d tax exemption on the FTB website at https://www.ftb.ca.gov/businesses/Exempt-organizations/Entity-List.shtml or by using the FTB "Self Serve Entity Status Letter" service at https://webapp.ftb.ca.gov/eLetter/Search.aspx?Lang=en-US.

California Registry of Charitable Trusts.

In the state of California, the Attorney General regulates charities in order to protect charitable assets for their intended use and ensure that the charitable donations are not misapplied. Most nonprofit organizations holding assets for charitable purposes in California must register with the California Attorney General's Registry of Charitable Trusts by filing [Form CT-1](#) within 30 days of first receiving any property or assets. A nonprofit subject to this requirement needs to register before it may legally continue to hold or raise charitable funds. After this initial registration, a nonprofit must annually file a financial and activity update report, [Form RRF-1](#), along with a copy of its federal Form 990-series return.

> **What to do.** You can check the compliance status of your nonprofit at http://rct.doj.ca.gov/Verification/Web/Search.aspx?facility=Y – the registration status should be listed as "Current." If your agency has fallen out of compliance with the AG, you should file the missing RRF-1(s) or 990-series return(s) as soon as possible in order to avoid late fees and potential revocation of tax-exempt status.

For more information, please see Public Counsel's publication, "Guide For Reinstatement of Good Standing With Corporate and Tax Regulatory Agencies For California Nonprofit Public Benefit Corporations," at http://www.publiccounsel.org/publications?id=0247.

[2] The CA FTB makes available a "Revoked Exempt Organizations List" at https://www.ftb.ca.gov/businesses/Exempt-organizations/Revoked-Entity-List.shtml.

II. Changes to Exempt Purpose

Will the strategic restructuring result in your organization engaging in exempt activities that are different from those described in your organization's articles, bylaws, and state and federal tax exemption applications? With the passage of time, it is very common for the exempt purpose originally stated in a nonprofit corporation's articles of incorporation and bylaws to no longer correlate with its actual current activities. It is also possible that through a proposed strategic restructuring, a nonprofit will seek to engage in new programs with a partner organization that are beyond the scope of its stated purpose. Any material change in exempt activities has both corporate and tax implications for a 501(c)(3) organization.

Articles of Incorporation.

Articles of Incorporation are a nonprofit corporation's founding document and, among other things, state its exempt purpose and frame the authority in which it may act. There is a corporate law doctrine called *ultra vires* that essentially categorizes acts outside the permissible scope of authority set forth in the articles as *unauthorized activity that cannot be ratified by the board*. As an example, if a nonprofit enters into a contract to engage in an activity that is outside the scope of its exempt purposes, arguably the contract could be challenged by the California Attorney General or other stakeholder. Further, under the *charitable trust doctrine*, a nonprofit corporation is legally required to use its charitable assets only in furtherance of the exempt purpose described in its articles. If a nonprofit operates in a manner that is inconsistent with its charitable purpose, the California Attorney General has the authority to determine that the nonprofit's assets are being misused, and to restrict the use of those assets to the charitable purposes described in the articles.

Bylaws. Bylaws set out the rules and operating procedures for the activities and conduct of the nonprofit. It is not uncommon for the bylaws to describe a charitable nonprofit's purpose using language that is different than that of the articles of incorporation. Bylaws are subsidiary to and cannot be inconsistent with a nonprofit organization's articles. So activities that are permitted by the bylaws, but not by the articles of incorporation, are also susceptible to challenge under the *ultra vires* and charitable trust doctrines.

Federal and State Exemption Applications. To be classified as tax-exempt under IRS regulations, a nonprofit organization must be *organized and operated exclusively* for purposes specified in the Internal Revenue Code. Part of the assessment that the IRS makes when initially considering an organization's 1023 application for 501(c)(3) status is a review of the exempt purposes stated in its articles of incorporation and bylaws. Once an organization is determined to be tax-exempt, it may rely on this determination so long as there are no substantial changes in its character, purposes, or methods of operations. If the activities of an exempt organization become *materially different*, and the IRS determines that the new activities *do not further a charitable purpose*, then the IRS has the authority to revoke the tax exemption retroactively back to the date the new activity began. Of course, many of the material changes that a nonprofit undertakes are in furtherance of otherwise exempt charitable purposes different from those stated in its original founding documents. The IRS has indicated that some deviation from the activities originally described in the 1023 application will not automatically jeopardize exempt status.

> **What to do.** If your organization's actual or proposed activities are inconsistent with its articles or bylaws, or beyond the description of activities contained in its tax exemption applications, then you will need to assess (i) whether amendments to the articles or bylaws are required; (ii) what steps need to be undertaken to notify regulatory bodies; and (iii) whether seeking a new determination letter from either the IRS or the FTB is warranted. For further information, please see Public Counsel's publication, "Notification Requirements for California Public Benefit Corporations," at http://www.publiccounsel.org/publications?id=0241.

Similarly, the California FTB's assessment of whether an organization is tax-exempt under Revenue and Taxation Code section 23701d requires a finding that the nonprofit organization is organized and operated exclusively for exempt purposes. An exemption granted in California may be relied upon only so long as there are no substantial changes in the law or the organization's character, purposes, or method of operation. An organization's exempt status may be revoked if it does not confine its activities to those permitted by the section under which the exemption was granted.

III. Key Documents

What to do. Nonprofit organizations contemplating a strategic restructuring with another nonprofit partner should conduct a key document review. Leases, loans, mortgages, grants, employment contracts, articles of incorporation, bylaws, and service provider agreements often contain provisions that may affect decisions regarding the strategic restructuring. Below are some common provisions to identify and consider.

Assignment and Change of Control Clauses. Contractual provisions about "assignment" and/or change of control provide whether, and under what circumstances, a nonprofit may transfer its obligations under an existing contract or lease to another entity. The ability to transfer such rights and obligations may be critical to the decision of how to structure a strategic restructuring. For example, a key services contract might prohibit a nonprofit from assigning its obligations to an unrelated third party without prior written permission, but allow it to freely assign the agreement to a parent corporation or to a successor. In that case, assignment would be permitted in the event of a merger or integration into a parent organization, but not permitted if the nonprofit were to transfer its assets to another organization.

Contract Term. When do key contracts end? This information is useful in setting the timetable for a new strategic restructuring. For example, will a nonprofit with a lease that ends before a proposed restructuring date be able to negotiate a short-term extension until it is able to move into new shared space? If one party's key services contract is ending before a planned merger will be effective, should the parties agree that both merger partners will be involved in negotiating a renewal of the contract?

Due-on-Sale Clause. A due-on-sale clause is a provision in a loan or promissory note that states that the full balance of the loan may be called due (i.e., must be paid in full) upon sale or transfer of ownership of the property used to secure the loan or note. For example, in the mortgage context, a due-on-sale clause could require that the mortgage be paid in full if the property subject to the mortgage is transferred. If real estate will be transferred to another organization as part of a merger or strategic reorganization, the owner may be required to pay off any mortgage on the property in full. If forced to refinance because of a due-on-sale clause, the owner may lose the benefit of favorable financing terms and interest rates.

Termination Clause. What if the strategic partners prefer to discontinue a program that one of the organizations is contractually required to provide for another year? It would be good to know whether and under what circumstances key contracts can be terminated early.

Donor Naming Rights. Will the restructuring involve rebranding, possibly including renaming programs or buildings? What agreements do you have with donors regarding naming rights?

Restricted Donations. If one nonprofit's program that is funded by a restricted donation will need to change or cease to exist post-restructuring, will the nonprofit partners be able to use the restricted funds for new programs? Is there a donor agreement that outlines the process for requesting that such funds be used for a different/new program?

Change of Management. Do you have multi-year grant agreements that require notice to the funder and/or written agreement if the funded program is to continue under the supervision of a different program manager than the one identified in the grant application?

Employment Contracts. A restructuring may involve a reduction in workforce or change in employees' job duties and responsibilities and/or salary and benefits. Do you have any employment contracts, oral or written, that may limit your ability to terminate or change an employee's position, salary or benefits? This topic is addressed in detail in Section IV.

Notice and Voting Rights. Do your nonprofit's organizational documents require notice to or approval by members or other third parties in order to elect board directors or effectuate a strategic restructuring? Do you have current contact information for all such persons?

Permits and Licenses. Is your organization's core activity licensed or regulated in such a way that will require a relicensing process if a new restructured entity is created?

IV. Employment and Benefit Issues

A strategic restructuring often involves combining workforces, with some or all employees becoming subject to new employment policies, pay scales, and/or benefits packages. These restructurings may create critical, but not insurmountable, legal challenges, and we strongly advise you consult with an attorney. Below are some of the potential issues that should be considered at the outset when one or more California-based organizations are involved.

General Employment Issues

Which organization will be the employer? A strategic restructuring can be accomplished in many different ways, some of which will impact employees. For example, in some cases, two or more organizations may be merged into a single organization. In other cases, separate organizations may continue to exist, but the workforces may be combined such that only one organization retains employees. It is important to identify which organization will be the employer after the restructuring is implemented. Depending on the structure selected, a new employer may be treated as a "successor employer" to the other organization's former employees, which means it will assume certain obligations and liabilities with respect to those employees. Similarly, for some purposes, the organizations may be treated as joint employers.

Reconciling Employment Terms. Before combining two workforces, it is important to identify and address differences in the employment policies and practices of both organizations. You should carefully review all employment documents to identify differences in employment terms. Look for differences in compensation and benefits, such as pay scales, bonus plans, vacation accrual, sick leave accrual, overtime practices, holidays, and fringe benefits. Also look for differences in workplace culture, such as whether the organization allows flex time or telecommuting, how the organization deals with breaks, meal periods and vacation use, and whether the organization has a dress code or open door policy.

Unions and Collective Bargaining Agreements. Special issues arise if individuals in one or both of the workforces are represented by a union. There may be an obligation to bargain with the union over the terms of employment and the working conditions after the workforces are combined, and there may be special notice requirements. The new employer will also have to determine whether it will adopt the collective bargaining agreements of the prior employer, and if so, how that will impact its existing workforce. The terms of the collective bargaining agreements may affect how the organization makes decisions regarding lay-offs, demotions, and compensation.

Will employees be terminated and rehired? If

Gathering the Documents.

Before entering into a restructuring that may affect the employment status of individuals, each organization will have to turn over documents, including employment-related documents, as part of the due diligence process so that the

the strategic restructuring involves rehiring employees by a new employer, it is important to determine how employees who join the staff of the new employer will be treated from a legal perspective. If they are treated as having been terminated by an old employer and rehired by a new employer, they may be entitled to severance pay and cash-out of accrued vacation. Often rehired employees will be treated as having experienced a termination of employment for some purposes but not all purposes. For example, an employee may be treated as terminated for purposes of severance pay but not for purposes of receiving a distribution from a 401(k) plan.

Avoiding Discrimination. If there will be a reduction in the workforce, it is important to avoid potential claims of unlawful discrimination when deciding which employees to retain. Retention decisions should be objective, and based on the work to be done, the skills required, and the employees who have the necessary skills. Consider whether such decisions could be viewed as disproportionately affecting employees in a protected class, such as employees of a particular age, race or gender. Similarly, if employees' compensation will change, care should be taken to avoid claims of unlawful discrimination. For example, California's Fair Pay Act requires equal pay for substantially similar work. You should evaluate job descriptions and employee experience in setting salaries to make sure employees are paid fairly and in conformance with employment laws.

Government Contracts and Grants. Are there government contracts or grants that include employment restrictions? Some arrangements have specific requirements related to affirmative action, employment of women and people with disabilities, and similar issues. They may include reporting requirements. These should be evaluated as you negotiate the terms of the restructuring so that you do not inadvertently violate the terms of the grant or contract.

Employee Benefit Issues

Retirement Plans. Advance planning is imperative when dealing with retirement plans. If plans are ignored until the restructuring occurs, an organization may find that it has inadvertently assumed the other organization's retirement plan, the unintended consequence being that all employees are now entitled to participate in both organizations' plans. There are three general options for handling retirement plans when workforces are combined: 1) merging the plans of both organizations, 2) terminating or freezing one of the plans, or 3) maintaining two separate plans. Each option should be carefully evaluated with an attorney who specializes in retirement plans.

Deferred Compensation Plans. Deferred compensation arrangements, particularly those of tax-exempt organizations, can be subject to strict tax rules under the Internal Revenue Code. If not handled correctly in a strategic restructuring, they can result in adverse tax consequences for employees. Care should be taken when terminating deferred compensation plans, or making any changes to payment schedules, to avoid unintended tax consequences.

Affordable Care Act (ACA). The ACA has complex administrative and compliance requirements that should be carefully considered in any strategic restructuring. In addition to evaluating whether the organizations have independently complied with the ACA prior to a restructuring, the organizations should consider ACA issues that will come up after the restructuring goes into effect. For example, when the workforces are combined, an organization may become a “large employer” under the ACA, triggering new ACA requirements. Challenges may also arise if the organizations use different measurement methods for determining full-time employee status under the ACA. Given that ACA penalties can be significant, advance planning to address ACA issues is essential.

Benefit Continuation: COBRA and Cal-COBRA. COBRA generally requires that employees (and their spouses and dependents) be given the opportunity to continue coverage under a health plan at their own expense if they lose coverage for certain reasons, such as termination of employment or a reduction in hours. When combining workforces, it is important to determine whether employees will become entitled to COBRA coverage, and which plan will be required to offer the COBRA coverage. In some cases, the plan required to offer COBRA coverage may not be the plan in which the employee originally participated.