Mergers and Acquisitions

Legal, Financial and Tax Considerations for Independent Schools

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Dear Colleague,

Those of us working in, or on behalf of, independent schools today operate in an increasingly complex and competitive education landscape. The current environment may encourage trustees, heads of school and business officers to consider business strategies that were once deemed drastic or even off the table.

As many readers will know, the mission of the National Business Officers Association (NBOA) is to develop, deliver and promote best business practices to advance independent schools. Mindful of this mission, we have leveraged relationships with legal, accounting, tax and consultative experts to develop "Mergers and Acquisitions: Legal, Financial and Tax Considerations for Independent Schools." The piece provides insight for independent school leaders who may be considering a merger with or acquisition of another independent school to secure a more financially sustainable future and enable the school to fulfill its mission in perpetuity.

Over the past several months, I have received numerous questions from schools along these lines: "We are considering a merger, but we don't know where to start. Can you help us?" Our goal here is to provide a starting point for these important discussions by laying out the business perspective of independent school mergers and acquisitions (M&A).

It is important to note that this white paper does not provide a how-to guide to mergers and acquisitions. The many variables involved in each school's decision processes make a one-size-fits-all approach impractical, and schools are best served by seeking experts' advice on their specific circumstances. Ultimately, only your school leadership can determine whether an M&A business strategy is an advantageous path for your school. This publication offers leaders potential avenues to inform expectations, launch dialogue, consider a case study, and forecast the legal, financial and tax implications of an M&A business strategy.

I believe in the spirit of independent education and am excited by the opportunity we have to infuse new thinking into our well-established institutions. Myriad challenges face the independent school community as we seek to provide world-class education supported by world-class business operations. My sincere hope is that the expert counsel on the following pages helps you and other leaders at your school continue to meet these challenges and enjoy future success.

Regards,

Jeffrey Shields, FASAE, CAE
NBOA President and CEO
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A NOTE ON TERMINOLOGY

The terms "merger," "consolidation," and "acquisition" have technical meanings in accounting, finance and law, and may be used in different ways by business and nonprofit leaders, who may employ one term in internal conversations and another in public announcements and when driving change forward. Use of these terms will differ depending on context. The first section of this paper, which provides an overview of primary issues, uses "merger" and "acquisition" in ways that school leaders tend to use them. The second and third sections, on legal and financial considerations, provide technical definitions of each term.

SECTION 1

The Consultant's Perspective

By Chad Tew, Founder, LearnCollab

Mergers and acquisitions (M&A) can be a cornerstone of business success. In my career—from teaching entrepreneurship at UCLA to judging new venture seed competitions—I've learned that businesses achieve many of their organizational objectives through sustainable growth. When your business reaches market saturation, you seek new markets. When demand dries up or a competitor undercuts you on price, you innovate and reconnect with market demand at a competitive price.

Organizations can bootstrap growth and innovation internally, but a more common route to success is through M&A. Eighty percent of the for-profit entrepreneurs I work with as a consultant and 99% of their investors are focused on the exit, the liquidity event that occurs when another large player acquires their start-up or they "go public" and sell their company to investors. Fortune 500 companies tout those strategic acquisitions in their annual reports as ways to build market share and move into new business areas.

With this background, my short answer to the question, "Who should consider mergers and acquisitions?" is "Everyone." I know, however, this is easier said than done at independent schools.

Objections and Responses

Why is it so hard for schools to talk about mergers and acquisitions? Four reasons stand out.

First, the media often portrays M&A activity as a rough-and-tumble battle between profit-seeking companies—the type of conflict that nonprofits are usually mindful to avoid.

Second, many schools also think a merger is a last-ditch option to save a struggling enterprise, or they worry that one will be perceived that way. In the for-profit world that's rarely the case. Combining two or more entities that complement each other or expand geographic reach is a business success strategy that growth-minded organizations embrace. Schools may dismiss M&A as a for-profit tactic, but contracts, budgeting and accounting are also key underpinnings of for-profit business success that nonprofits fully accept. Familiarity with the M&A process is another element independent schools should add to their success toolbox.

Third, the conviction to set your own course with curriculum, methodology and mission is often the driving force that leads to a new school's creation. That strong independent streak is also a reason schools don't easily consider mergers and acquisitions. A culture of independent governance can lead to incredible accomplishments, but also to avoidable errors, when doing it "our way" becomes more important to volunteer boards and parents than committing to strategic, professional management.

Finally, school leaders simply don't know much about it. M&A may be familiar to some trustees who spend their work lives in the corporate and professional worlds where these activities are common. But those board members are part-

In 2013, ***Severn School*** *(left) merged with a long-time feeder school, Chesapeake Academy, a preschool-grade 5 school. Severn now serves 830 students preschool-grade 12 in Severna Park, Maryland. "Our enrollment is strong and we have waiting lists in many grades," said Terry Del Prete, director of business and finance. "We feel our brand is both broader and stronger, with an improved continual experience for students." Two years earlier in Philadelphia, an all-girls and all-boys school merged to form* ***Springside Chestnut Hill Academy*** *(right), a co-ed 1,050-student preschool-grade 12 school. "For years and years we had worked together but separately," said CFO Frank Aloise. "Our boards recognized that we could be stronger together."*

Combining two or more entities that complement each other or expand geographic reach is a business success strategy that growth-minded organizations embrace.

time volunteers. School administrators that drive the agenda are usually full-time professional educators who have little M&A experience. Much of their knowledge comes from the headlines and experiences of friends and family, who may have sad stories of downsizing and layoffs. Usually the only administrator with more rounded M&A knowledge would be the business officer, and then only if his or her previous career was in a for-profit sector.

Nonprofit M&A

Years ago when I was an independent school business officer, I helped bring two schools together, which resulted in one of the largest K-12 schools on the West Coast, Viewpoint School. There was no textbook or roadmap for the process. Later, as a consultant on schools' financial sustainability issues, I wanted to understand M&A from a professional context, so I became a Certified Merger & Acquisition Advisor.

I discovered the world of nonprofit M&A is extremely different from for-profit M&A. Profitability drives for-profit mergers and acquisitions. The focus is on determining the valuation of each company, whether the companies would be more profitable as a single entity, and the ideal purchase price for the company being acquired. In contrast, the core motivation for a nonprofit merger or acquisition is its mission to provide a public benefit—in this case, giving children a quality independent education. This focus on mission is the starting point for exploring whether a merger or acquisition might help your school better achieve its public benefit mission.

A merger, in theory, involves two relatively equal parties becoming one. An acquisition can suggest a conquest, when a larger, richer party takes over and dissolves a smaller, weaker party. The truth is, a merger of equals almost never happens. One school usually has a higher enrollment, larger endowment or better campus, and most school combinations are technically acquisitions. With nonprofit schools, however, there's no success in conquest. If you want to bring two faculties, two student cohorts, two alumni groups and two parent communities together successfully, you need to initiate and maintain a conversation that has a tone of mutual respect, openness and caring. If you approach the process with the bravado of a conqueror, you will fail. Regard the M&A process as collaboration.

New Environment, New Thinking

The market for independent school education is undergoing its most significant transformation since the 1950s, when the sector expanded beyond prep school for the elite to meet the middle and professional classes' demand for life-changing education for their baby-boomer children.

Change hit independent schools across the country beginning in the late 1990s and early 2000s. The U.S. birth rate declined at the same time as the number of women in their childbearing years dropped, reducing the number of potential K-12 students. New categories of competition also emerged, including taxpayer-supported charter schools, online schools and for-profit schools using venture capital funding to further their national expansion plans. The 2007–9 recession also had lingering impacts.

Add to this a major pricing problem and shifting consumer tastes. In many schools, tuition has ballooned, and fewer customers are able, or willing, to purchase our private school product. Furthermore, the core pedagogical approach championed by many traditional independent schools is no longer the only model that parents are considering.

From a macro sense, fewer kids, more competition, financial sustainability issues and changing consumer tastes are creating a perfect storm. The marketplace for independent private schools is heading into a consolidation phase, and the schools that survive and thrive will need to employ every available success tactic.

So again, the answer to the question, "Should my school learn about mergers and acquisitions?" is "Yes." A full-on merger may not be right for your school, but it may be for two other schools in your market and that means your competitive environment is about to change. This topic needs to be on your radar.

In-House Inventory

Any M&A discussion should start internally with the focus on your particular school's mission, strengths and weaknesses. A deep-level strengths, weaknesses, opportunities and threats (SWOT) analysis can help you prepare for changes ahead. Strengths and weaknesses in this context are internal to the school—your great science faculty and labs versus your $500,000 budget deficit. Opportunities and threats are elements over which you have little or no control, such as an economic recession, a declining birth rate or the expansion of a competing school.

When considering a potential merger or acquisition, it is also essential to focus on the people and the cultures involved. The legal, financial and tax implications are important, but come later, as they are not what will ultimately drive a school merger's success. This is where the educators in the room need to be strong, because trustees who live M&A in the for-profit world will want to jump straight into balance sheets and cost savings. Instead, schools should take a step back and articulate their goals from a broader viewpoint: What aspects of the current organization cannot be sacrificed? Where are the two organizations already aligned? School leaders must understand and agree on their own culture and value proposition, as well as that of the other school, before digging into the business and operations implications.

A SWOT analysis may pose these types of questions:

- What might our school do better than the other school and vice versa?
- How could partnership or collaboration with another school help us overcome our weaknesses and/or leverage our strengths?
- What program and/or facility capacity does one school have that would benefit the other school?
- What are the external market realities for our school and how do they create opportunities and threats?

Each school needs to make a realistic projection of where it will be in three to five years if current trends persist. To get a balanced view of the situation, it can be helpful to involve a consultant to perform an unbiased sensitivity analysis. The consultant can plot scenarios showing how your school might benefit from joining with another school and where it might be if it goes it alone.

Assessing a Potential Partner

A successful merger or acquisition is mutually beneficial and well-defined, with the idea that the partners are more likely to succeed together than apart. Consider these big questions: How might a merger help you serve your current students and families better

POTENTIAL PITFALL: SCHOOL SPIRIT

The inward-focused enthusiasm of a school's most ardent supporters can sometimes verge on the cultish (positively speaking), leading them to believe that if their beloved school just works harder to be its special, wonderful self, or if the admission and advancement offices can just get the word out better, then the school can overcome all problems. The hard reality is that no matter what you do internally, it's not going to change the outside environment. You can't create more children or more families wealthy enough to afford your school.

and how might it help you advance your mission? Also, would the combined entity have a stronger market position and would it become more compelling for donor support? People want to support a winner. When considering a potential partner, look at these factors:

- **Mission Alignment:** Compare missions and value statements. Schools should share core values, but they need not be identical. A full-on merger will require schools to be more fully in sync, but differences need not prevent collaboration. Project-based collaboration is also an excellent way to test the waters and build trust for a potential merger or acquisition down the road.
- **Educational Focus:** Progressive/traditional, day/boarding, religious/non-denominational, single-sex/coed—schools needn't be the same type to merge or collaborate if their core values resonate. In fact, sometimes collaborations succeed because of differences.
- **Target Audience and Geographic Market:** Are the two schools competitors or complementary? How do—or don't—their markets overlap? The highest value merger or acquisition in the for-profit world expands a company's market area and/or product line. This can also be true for schools, but need not be the case.

For example, a big-city K-12 school that draws middle and high school students from a wide geographic area will have trouble convincing families to put their youngest children on a long bus ride to the primary school. They might collaborate with or acquire a feeder elementary school on their periphery to create what could become a small network of neighborhood elementary schools supporting the middle and high schools.

People and Processes

Each side needs a lead person to initiate contact and guide communication. That person is usually the head of school, but can occasionally be a board chair or officer, especially if one school is contemplating an unannounced head transition or retirement.

After a SWOT analysis, the board should form a collaboration task force that includes the heads of school, business officers and no more than two or three trustees to discuss potential M&A or other collaborative opportunities. This structure keeps discussions within a tight circle until there is something to share.

The trustees on the task force don't need to be M&A professionals. In fact, trustees with M&A experience can sometimes scuttle a deal if they can't resist diving into the financial and legal details too soon. The key criteria for task force members is their stature as thought leaders and ability to champion an opportunity if one arises. Contemplating a merger or acquisition is scary. There will be fear-of-change types on the board and in the community that can foment doubt if a deal takes shape. There will also be inevitable setbacks as the parties negotiate terms. The task force members must be leaders with the power to reassure their timid comrades to stay the course until the benefits of change are within sight.

If both sides confirm their interest, these board leaders can bring a motion to explore a potential merger or collaboration to

CREATIVE COLLABORATIONS

Two Delaware schools, Catholic Archmere Academy and non-denominational Independence School, both excel in traditional pedagogy. Independence is a feeder for Archmere, and they share many alumni. The schools are currently exploring a number of collaborative initiatives, including shared faculty professional development, facilities and transportation.

Ethical Culture Fieldston School in New York City has a progressive, social justice mission, but that doesn't stand in the way of collaborating with more traditional neighboring Riverdale and Horace Mann schools on some bus transportation.

Viewpoint School in Southern California acquired neighboring Meadow Oaks School and tripled the size of its campus, doubled its enrollment, enhanced its market position and improved economies of scale.

The largely boarding Winchendon School in rural Massachusetts opened a day school in Brooklyn to extend its mission to a day population in an urban area.

the board for approval. The CFO is the ideal staff liaison for this task force. Both schools should sign a non-disclosure agreement (NDA) to reinforce confidentiality and also authorize the confidential sharing of certain private information.

After initial conversations confirm interest on both sides, it is time to broaden the conversation. Under the protection of an NDA, both parties might exchange audits, financials, accreditation reports and information focused on specific proposed collaboration topics. This could also be a good point for the full membership of both boards to meet for an informal trust-building session.

It is important to pull discussions and ideas into a shared working document. This process might start as meeting minutes or notes shared by the heads and board leaders via email, but those communications need to grow into something more formal, but still flexible—a dynamic document I call the "collaboration framework." This document might list existing, in-process and potential projects; noted status and timelines where applicable; and shared ideas and issues that arise in various meetings.

A formal presentation of this collaboration framework can be an ideal way to bring the two boards together for the first time. You might consider meeting in a neutral space for an informal dinner, where trustees talk about their connection to their schools and their missions. If trustees at both schools mention similar values, engagement will build and set the stage for a productive conversation.

Building Community

While the money part has to make sense, independent school mergers and acquisitions are not all about money. Don't forget about the stakeholders, both in your own school community and outside. Here are some things to consider:

- **Economies of scale** are a key benefit of a merger or acquisition. A combined school will likely need only one business officer, one advancement director, one human resources director and one head of school. Discuss these realities early. Sometimes one head is planning retirement in a year or two and a combination might be an alternative to an expensive head search. Boards also want to reassure leaders, including the head and business officer, that they will be retained and/or rewarded for the extra work involved in exploring a combination, possibly with multi-year contracts or milestone-linked bonuses.
- Nonprofit entities receive significant tax benefits and obtain zoning and development rights because they provide a **public benefit.** Don't forget to consider outside community members' perception about how a new or combined entity will impact them. You may not need the town council to approve your final decision, but keep the political and accrediting authorities informed, as you'll likely need their help in the future.
- **Past donors,** whether they have a name on a building, a brick in the courtyard or a gifted book on the library shelf, need to know that the new entity will continue to nurture their motivations for giving. I have seen schools knock down named buildings and bulldoze memorial playgrounds, but maintain support by treating donors with respect and providing extensive communication.
- Creating a more robust **learning and teaching community** should be a huge plus for faculty. Larger enrollment will create not only more job security, but also more opportunities, such as new electives or specialized teaching. Make sure you communicate these new opportunities to faculty and seek their feedback. Academic collaborations or shared professional development can help ease teachers into a more structured relationship down the road.

POTENTIAL PITFALL: BREACH OF CONFIDENTIALITY

As internal discussions move forward, your board and administrative team need to be tight-lipped. The first time Viewpoint School sought to acquire the neighboring Meadow Oaks School, the deal hit a snag over permitting and zoning issues, which required time to resolve. Word of the potential acquisition leaked and caused upset in both communities because there was no clear message about the path forward. Meadow Oaks suffered lost enrollment and damaged trust. The deal did go through two years later, but the failure to safeguard against leaked information almost wrecked the reinvention of what has become one of California's top schools.

Ethical Culture Fieldston School, a 1,700-student preschool-grade 12 day school in New York City, has a progressive, social justice mission, but that doesn't stand in the way of collaborating with more traditional neighboring Riverdale and Horace Mann schools on some bus transportation.

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Hard Truths

Proper due diligence is a much longer discussion, but here are a few considerations for schools to think about as they explore the merger or acquisition process. Regarding the potential partner school and your own, ask:

- Are there operating deficits? Enrollment declines? Program attrition? Chart these elements over the past five years and project them into the next five years. How might a merger or acquisition change those projections?
- Are there cash flow problems? Is either school using next year's deposits to meet salary and expense obligations in the spring of the prior year? That's a red flag.
- Are there any undisclosed liabilities like a festering potential lawsuit, pension liability, sweetheart employment or retirement deals, inappropriate financial aid commitments, or deferred maintenance? Trust and honesty work both ways. The business and/or risk management officer is usually the best person to answer these questions.
- Do both sides have the bench strength and competency to plan and implement a merger or acquisition, a process that requires extra time and often specialized knowledge? You will invite delay and potentially costly errors if you add this project to an already overburdened team's list of tasks.
- Can you co-fund a consultant to help coordinate the process? Even when board members have M&A experience, adding a disinterested third party can help defuse tensions. Having an outside consultant also means that neither heads nor business officers need to expend their full political capital and risk career or reputation damage if problems arise.

No school is perfect. Sometimes it takes facing an imperfection or challenge to open a school's eyes to the benefits of a merger or acquisition. But there are few problems that can't be overcome when all parties are willing to compromise and keep their focus on the mission. How you think about and prepare for a merger or acquisition will determine your ultimate success.

SECTION 2

The Legal Perspective

By Anne Gerson, Grace H. Lee and Caryn Pass, Venable LLP

Legal considerations are critical when deciding if one school should combine, affiliate or form strategic alliances with another school or acquire its assets. The different legal paths to school combinations often impact operational and educational decisions, including integration of curriculum, staffing and facility needs as well as the decisions around governance and leadership. Federal, state and sometimes local laws may impact how schools affiliate. Generally, options to consider include merger or consolidation, acquisition of assets, or other strategic alliances.

Here we assume that the schools involved are organized as nonprofits or, in some states, education corporations under state law, and exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code.

Mergers and Consolidations

Mergers and consolidations are similar tools, where two separate entities combine, and a surviving entity assumes all the assets and liabilities of the two organizations. Differences and nuances, however, may impact school strategy moving forward.

In a **merger**, two separate entities can fully integrate their programs, functions and operations by joining together and continuing as one corporate entity. Generally, when schools merge, a merging school becomes part of a continuing school and the merging school ceases to exist as a separate legal entity. The continuing school takes title to all of the assets and assumes all of the liabilities of the merging school. The continuing school adopts amended bylaws that reflect the new combined governance structure.

In a **consolidation**, each legal entity dissolves and an entirely new nonprofit corporation forms. That new corporation takes title to all the assets and assumes all the liabilities of the former schools. The new nonprofit corporation establishes new bylaws and a new governance structure.

There are benefits and detriments to using one method over another. One benefit of a consolidation is that it provides the perception that neither organization has an advantage over the other and that the new entity houses the history, culture and heart of two previously separate schools. One benefit of a merger is limited changes to administrative, legal and other business-related requirements. For example, the remaining school has no reason to reapply for recognition as a federally recognized tax-exempt entity as long as it retains the purposes that both schools fulfilled before they combined. In contrast, a consolidation results in an entirely new corporation that must apply to the IRS for recognition as a newly formed tax-exempt corporation—a potentially time-consuming process.

State nonprofit corporation statutes provide information on the procedural requirements for carrying out a merger or consolidation, and those statutes might affect the course

of action taken by the schools. Because nonprofit corporation statutes differ greatly from state to state, it is recommended that schools consult legal practitioners who are familiar with the state's requirements. Many states also require that the combining organizations create a plan of action that outlines how the merger or acquisition will follow the state's voting and notice requirements.

Schools should also ensure any combination complies with provisions in their governing documents. Certificates of incorporation, charter and bylaws all address issues such as dissolution and distribution of proceeds.

Procedures and Documents

Both mergers and consolidations entail a number of procedural steps and documents, some required by law and others recommended as principles of best practice and wise governance. Here are some to consider:

- **Initial Discussions**: School representatives often hold informal conversations in the early stages of considering a school combination. That's fine, but even those informal talks should be confidential to avoid unsettling both communities and causing negative impacts on admissions, faculty retention and other priorities. At the same time, the parties involved also need the ability to conduct an open and transparent dialogue.

  To that end, many schools establish a written document that confirms all parties' commitment to maintaining confidentiality and nondisclosure. Schools can create a separate confidentiality agreement, i.e., an NDA, or include the provision in a non-binding letter of intent. The letter of intent is simply a document that establishes both parties' desires and plans to move forward. Both options can encourage open communication and negotiation.

- **Due Diligence**: As the school's fiduciaries, trustees and senior administrative leaders must conduct a comprehensive assessment of the conditions of any agreement to join forces. The assessment must be based on a careful review of key factors affecting the operations and facilities of the institution, as well as potential legal, governance, financial, administrative and other matters that could create liability exposure. Issues for investigation include:
  - Major claims or investigations and internal allegations that will inform liability and insurance decisions
  - Requirements for terminating, transferring or assuming existing contractual obligations
  - Property rights and ownership, including donor-restricted funds, endowment funds, property easements and any intellectual property issues
  - Debts and other financial liabilities, including potential legal claims

- **Agreement and Approval:** Once schools complete their due diligence and decide to move forward, they must articulate a plan of merger or consolidation and incorporate those terms into a formal agreement that covers governance and operational issues, including amendments to governing documents. Issues to include:
  - Combined governance structure, including identification of key board members and officers of the surviving/new school
  - Appointment procedures for those key board members and officers
  - Mission
  - Core activities and programmatic consolidation
  - Branding
  - Broad staffing plan, including identification of key leaders of the surviving school
  - Employment issues
  - Benefits and deferred compensation plans for staff
  - Analysis and use of restricted funds
  - Alumni and donor communications
  - Insurance and risk management plans
  - Enrollment management and tuition plans

Acquisition of Assets

In an **acquisition**, one school dissolves and ceases to exist as a separate legal entity and another school acquires the dissolving entity's assets. The remaining entity is typically shielded from assuming the predecessor's debts and liabilities, making this type of transaction particularly useful when one school wishes to acquire the assets of another organization that has significant future contingent liabilities. This mechanism can also be beneficial when one organization is much smaller than the other, or when one entity only acquires discrete programs or assets of the dissolving entity.

This statutory procedure generally involves the adoption of a plan of dissolution and distribution of assets, satisfaction of outstanding liabilities, transfer of any remaining assets to another nonprofit entity, and dissolution. While the dissolving school has to follow statutory procedures, this path is less complicated than a merger for the school absorbing the dissolving entity's assets. Because the successor school is merely absorbing the assets of another organization, school trustees usually don't have to vote on the action nor does the school have to file documents with the state.

An asset transfer always poses some risk of successor liability, particularly if the successor school has not made adequate provisions for pre-existing liabilities. A carefully drafted agreement between the schools can anticipate and help address some of these risks. As with the process for a merger or acquisition, states' statutes outline the procedural requirements for a dissolution and distribution of assets. The dissolving entity will also need to notify the IRS of its termination and file a final Form 990.

Couple a careful and proactive analysis of staffing needs based on skills and performance with an analysis of the potential adverse impact on certain groups, the general defensibility of decisions, and clear strategies to mitigate potential claims.

Strategic Alliances

Short of a merger or acquisition, schools can consider other kinds of strategic alliances or combinations. These can be a short-term test before a full combination or part of a longer-term plan to work cooperatively without fully integrating operations. For consideration:

- **Limited asset purchase or transfer:** This tactic allows one school to transfer a discrete property, activity, program or business unit to another school, based on a written asset-purchase agreement.
- **Joint venture:** Two or more schools may lend their efforts, assets and expertise to achieve a common purpose such as a joint educational program or a broader coordination of educational or recreational activities. A well-structured joint venture features a written agreement that details the precise obligations and allocation of risk between the schools involved. Joint ventures can be permanent, set to expire on a given date or after the accomplishment of a certain goal, or structured with an increasingly overlapping set of commitments and an eye towards an eventual merger or acquisition.

Employment Issues

A school combination will impact the school's faculty and staff. While joining forces may provide certain advantages, schools should consider the potential risks that come with bringing workforces together and the impact the change will have on morale and culture. Before schools merge, it is important to develop strategies for potentially reducing staff and examine how the remaining school structure will manage handbook policies, pay practices and employee benefits.

Risk Management

In a merger or consolidation, both sides should seek disclosure of potential employment claims and risks, including outstanding demand letters, government audits and investigations, existing litigation, and any internal complaints of harassment, discrimination or other unlawful activity. Schools should also gather information regarding potential claims arising from misclassification of employees, independent contractor issues, record-keeping issues, and potential landmines such as skeleton claims of abuse against former employees. Carefully consider the potential impact of such risks and agree about how such claims or liabilities will be absorbed and managed going forward.

Rightsizing Faculty and Staff

An affiliation between two separate schools will likely result in redundancies in staffing, especially in key leadership positions, and in the business and administrative offices. Schools should carefully evaluate how to reduce their staff, keeping in mind that a process that results in a negative impact on a particular protected category, such as age, could lead to a discrimination claim, including a class action.

Couple a careful and proactive analysis of staffing needs based on skills and performance with an analysis of the potential adverse impact on certain groups, the general defensibility of decisions, and clear strategies to mitigate potential claims. Also separations may trigger obligations to provide prior notice to affected employees under the WARN Act as well as employee rights to continue health benefits under COBRA, depending on the timing and nature of the separations. State laws may provide additional rights and benefits.

Schools may consider offering voluntary early retirement package incentives and/or severance packages to affected employees. Both tools can provide a financial benefit to affected employees, but they can also pose risks if they are not executed in a way that complies with legal requirements. For example, under the Age Discrimination in Employment Act, a school with 20 or more employees that offers a severance package in exchange for a release of claims must give employees 21 days to consider whether or not to accept a severance package and at least seven days to revoke the agreement. If a severance and release is offered to two or more employees over the age of 40, the required consideration period increases from 21 to 45 days, and the school must provide the over-40 employees with detailed information about each of the other employees who have been offered a severance package in exchange for a release.

Combining Staff

For employees that remain with the school, especially if two schools merge or consolidate, schools should review all employee policies, pay practices, procedures and benefit plans, and decide how to either implement new policies or continue with existing plans. These changes can be challenging and carry a high risk of negatively affecting employee morale and culture. For example, if a school that offers 15 days of vacation to staff merges with a school that offers 10 days of vacation, how many vacation days does a staff member receive after the merger? Does the school have an obligation to pay out accrued and unused vacation before a new policy takes effect? The answer may depend on state law, school policy or a collective bargaining agreement, if applicable. Schools should consult with an ERISA attorney to ensure that they handle these benefit plan changes in a legally compliant manner.

SECTION

3

The Financial Perspective

By Ben Aase, Sarah Reichling and Jennifer Tingley, CliftonLarsonAllen

Should your school decide to explore a merger, consolidation or acquisition, consider a gated approach, which will allow your school to set milestones and decision points at key stages. This "stop-or-go" method means you can revisit your goals and assumptions at these crucial moments and decide whether, or how, to proceed to the next step.

You might begin by considering whether combining schools in some way would:

- Advance the mission
- Make effective use of and build on core strengths and assets
- Improve reach into preferred markets
- Enhance reputation and industry position
- Support successful governance, management, services and operations
- Protect or enhance financial health
- Result in aligned cultures

These considerations are broad guidelines, but cover the main issues that school leaders will want to agree on before voting "yes" on a school combination. Some schools might want to gather more specific information on the individual criteria that are especially important to their situations.

Next, set up the gated approach. Here are four suggested phases:

1. Organize and initiate discussions
2. Perform arm's length diligence
3. Conduct deeper diligence
4. Prepare for close

After each step, your board and executive leadership can pause for discussion about whether you want to proceed to the next phase, make adjustments to the process, assign more research or negotiate updated terms based on changes or additions to your and the other school's objectives.

It's important to note that when the process starts, schools might not even know what form any final combination might take. A gated approach can help you make a well-thought-out, carefully researched decision.

Assessing Financial Health

Before you delve into the technical details of a school combination, make sure you understand each school's financial health. Take time to assess each side's historical financial performance and current position, business strategies and business office team strength, including the effectiveness and efficiency of their systems and automations. That crucial initial research lays the groundwork for good decisions in later stages that tackle what combined business operations might look like.

Do not neglect to investigate the full costs of each school's activities. If fully allocated cost accounting isn't in place, then take the time and effort to restate financial statements to match full-cost accounting. That precaution is the only way to prepare for the mission-meets-money conversations about which programs from each school will be viable in the long run.

School combinations are expensive. This is one reason schools shouldn't wait until their backs are against the wall financially before considering a merger, consolidation or acquisition. If a school is under financial duress, its options will be limited and that will increase the stress of figuring out how to move forward.

School combinations are expensive. This is one reason schools shouldn't wait until their backs are against the wall financially before considering a merger, consolidation or acquisition. If a school is under financial duress, its options will be limited and that will increase the stress of figuring out how to move forward. Costs to consider:

- **One-time cash costs** include legal, accounting and compliance work for a transaction; consulting for integration and team development; human resources expertise; IT and database planning and integration; and communications, name and brand development work. One or both parties will need to have the financial strength to carry the transition costs, and it helps to involve your development and advancement leaders to craft messages about the process and requests for support.
- **Capital costs** include relocation, disposition of assets, tenant improvements, furnishings and information technology.
- **Leadership and staff costs** include outside expertise and capacity needed to manage the various streams of work, including facilities, technology, change management and cultural integration.
- **Ongoing costs** related to operating at a different organizational scale can be especially important for organizations at the end of long-term agreements that were negotiated in different economic conditions.

Financial Due Diligence

During the due-diligence phase of discussions, it is important to get into the fine details of each organization's financial position. Your school needs to feel comfortable with all potential assets, liabilities and potential new revenue and expense streams that may become part of the new entity. Some questions to ask include:

- What assets are under donor control? Can the new entity satisfy those donor restrictions? If not, what spending needs to occur or requests need to be made to donors or state attorneys general to repurpose those funds?
- What debt obligations might be acquired? Will future debt payments affect the cash flow analysis of the new organization?
- What reserves do each organization have to cover the one-time costs previously discussed?
- What internal systems are in use in each school and which will continue into the new organization? Have the schools planned for the time and cost associated with data migration and potential new system implementation?
- What tax exposure does each school have that might create a potential conflict once the new entity forms? Are there new activities that might be considered unrelated business income based on the mission of the newly formed organization? Or is this an opportunity to establish a new mission and work with the IRS to update the approved nonprofit's charitable status?

Final Decisions

Schools that decide to combine must decide whether to pursue a merger, consolidation, acquisition or other business combination, such as a joint venture.

Mergers, consolidations and acquisitions have different accounting treatments. For instance, if the organizations consolidate and create a new entity, the transaction will allow the new entity to use a carry-over method of accounting—essentially pooling the two organizations' assets and liabilities. In an acquisition, assets acquired, liabilities assumed and noncontrolling interests should be measured at fair value as of the acquisition date. Certain exceptions may apply depending on the relationship and determination of the acquisition.

Schools also have the option to enter into an agreement to form a joint venture by both parties, which allows the two entities to operate independently while gaining support from one another. Joint ventures often have a limited life or give the parties the ability to dissolve the relationship at any time. In a merger or acquisition, the new or surviving entity will continue to file a 990. The entity that is no longer in existence will need to file a final 990 with the IRS within the required filing deadlines.

ADDITIONAL RESOURCES

- "Where To Start with Mergers and Acquisitions? Three Considerations" (*CEO Notebook*, April 2019)
- "Stronger Together: the Case for School Mergers" (*Net Assets* magazine article, March/April 2017)
- "How To Save a Nonprofit: the Care Steps Required in Mergers and Acquisitions" (*Nonprofit Quarterly* article, June 2017)
- "Consolidation, Collaboration or Closure? How Colleges Stay Alive in 2018" (*EdSurge* article, January 2018)

CASE STUDY

By Ben Aese, Sarah Reichling and Jennifer Tingley, CliftonLarsonAllen + + + + + + + +

This hypothetical case study outlines the path that School A and School B take toward a merger.

BACKGROUND

School A's head of school plans to retire. School A's board is eager to join School B. Trustees believe a merger would eliminate brand confusion and competition between the two schools and also improve the services both schools have been providing. School B has strengths that School A lacks, and School A leaders want to add those strengths through a merger. School A approaches School B approximately three to four years before the ultimate agreement.

The process starts with conversations about:

+ Deal-breakers for each school
+ Strategic direction of each school and how those directions would change
+ Thorough financial review of each school
+ Systems to manage and merge data
+ Responsibility and budget for one-time costs
+ Maintaining both campuses or retaining just one
+ Additional student capacity
+ Marketing the new entity
+ Streamlining or combining administrative staff

The schools take time to pursue these conversations, perform due diligence and build a budget to pay for personnel time and other costs of the merger process. The schools hire a consultant to help with identifying unexpected costs such as merging systems and benefits plans and to create a sequence of events that helps keep the process on track.

After handling these issues, the merger process moves quickly. Within six months, the boards of both schools approve the transaction, the articles and bylaws for the new entity are updated, and employee and financial information are housed together.

Next steps for the newly combined schools include:

+ **Communicating to the public:** The leaders of Schools A and B decide to tell their story as a merger, even though School B technically acquired School A, to help with community and donor relations.

+ **Determining board structure:** The two boards join as equals, but update how trustee terms are staggered so that both schools have equal representation during the early years of the merger.

+ **Handling inevitable turnover:** The newly combined school works with the new staff cohort to promote cohesiveness and transparency.

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The **National Business Officers Association** *is the only national association focused exclusively on supporting independent school business officers and business operations staff, and fostering financial and operational excellence among independent preschool-grade 12 schools. NBOA membership includes more than 1,400 schools from every region in the United States as well as international schools from more than 20 countries around the globe.*

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