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*Charity Law Unit*

*Legal Issues in Charity  
Mergers*

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## THE CHARITY LAW UNIT

The Charity Law Unit was established in October 1994 to provide a focus for the already well established reputation of the Faculty of Law, University of Liverpool for research and teaching in Charity Law. The Charity Law Unit has grown from strength to strength since its establishment and it is the only such unit in England and Wales.

The Charity Law Unit's mission is to be recognised as the centre of excellence for legal research of the charity sector. It aims to do this both by responding fully to the demands for legal research raised by the charity sector and by being pro-active in highlighting and pursuing legal research in areas where the law and its application requires clarification, guidance or possible reform.

The report, *Legal Issues in Charity Mergers*, was written by Debra Morris, Director of the Charity Law Unit. She is author of *Schools: An Education in Charity Law*, published by Dartmouth Press in 1996, and she is assistant editor of the leading text on Charity Law, *Tudor on Charities*, published by Sweet & Maxwell. She is also case note editor of *Charity Law & Practice Review* and has written many articles in the area of Charity Law.

The empirical work for *Legal Issues in Charity Mergers* was largely undertaken by Louise Platt who was employed as Research Assistant on the project. Other members of the research team were Jean Warburton and Andrew Cartwright.

## ACKNOWLEDGEMENTS

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To respect their confidentiality, participants' names and potentially identifying circumstances have been altered.

Within the Charity Law Unit, this report is very much the result of team work. Thanks are extended to Louise Platt, Research Assistant on *Legal Issues in Charity Mergers*. Her ability and good nature meant that the empirical side of the project ran very smoothly. Her contribution to the project as a whole is gratefully acknowledged. Andrew Cartwright is also thanked for his role in this project, especially in the preliminary stages. Finally, my colleague, Jean Warburton is thanked both for her specific role in this project but, more importantly, for her constant support and advice.

Debra Morris

January 2001

## OVERVIEW

As a subset of the voluntary sector, charities are regulated by their own special rules, yet like other voluntary agencies they have been affected by reductions in funding and shifts from local authority grants to payment for services performed under contract. To improve their capacity for action, increasing numbers of charities have had to consider new ways of organising themselves. The option to merge with another charity is only one form of co-operation which may be appropriate in certain circumstances.

If a charity has decided that it wishes to merge, the legal problems encountered may be complex. For example, restrictions placed on a charity's assets can prevent all the funds from both charities being available to the new body unless appropriate, sometimes complex, steps are taken. Designing an effective constitution for a new body formed from two or more pre-existing organisations involves skilful legal drafting.

Based on an analysis of the experiences of 13 charity mergers, involving 29 individual charities, this work aims to assist charities contemplating merger by outlining in detail the legal problems that are involved and the different strategies which have been employed in practice to deal with them.

One principal aim of the research was to construct a guide to good practice for dealing with legal problems of merger and this report should be read along-side the accompanying document, *Mergers: A Legal Good Practice Guide*.

## INTRODUCTION

Within the last few years, there has been an increase in merger activity within the charitable sector. Against the background of a recent MORI poll suggesting that the majority of people (58%) think that there are too many charities (MORI / Charity Commission, 1999), one in seven charities in a recent survey were actively considering merger (Wethered, 1999) and 75% of businesses felt that charities carrying out similar purposes should be encouraged to merge (Buzzacott and Third Sector, 2000).

However, although the question of merger is one which trustee boards are increasingly beginning to ask themselves, there is very little guidance available about the process of merging, especially from a legal point of view. The information that is available tends to focus upon the organisational and managerial issues of merger rather than the legal (e.g. Cornforth, 1997, Cowin and Moore, 1996 and Guthrie, 2000). Those publications which do focus upon legal issues are limited in number and size, and appear to be written on the basis of personal experience. A recent NCVO project on joint working and mergers in the voluntary sector concludes that trustees and staff should consider carefully the implications of legal issues and restrictions associated with joint working (Leat and Passey, 2000). There was thus a need to provide an overview in order to guide trustees through the legal problems of merger.

Many charities that had experienced merger that were contacted during the course of the research spoke of their feelings of isolation when going through the process.

The aim of this research was to identify the legal issues arising in charity mergers and the different responses to them, and to consider the most appropriate solutions to commonly experienced problems. The aim was then to produce a guide to good practice, useful to charities considering merger in the future.

It should be emphasised right from the start that there are no neat answers to the legal issues raised, and it is certainly not a case of 'one size fits all'. The aim is therefore to examine a range of possible solutions that may be appropriate for individual charities to consider when thinking of merger.

This research is focussed on merger. Yet, there are many other ways that charities may work jointly. For example, Wilson has argued that instead of the pursuit of exclusively competitive strategies, voluntary organisations would find it beneficial and effective to pursue co-operative strategies, such as joint ventures, co-ordination and strategic alliances between organisations in the same line of service provision (Wilson, 1992). Returns in a recent survey showed that most charities that *had* entered into some form of joint venture or collaborative agreement considered that the arrangements had proved successful (Wethered, 1999). The NCVO work revealed a range of advantages to joint working between voluntary organisations, ranging from benefits to current service users to increased knowledge and understanding (Leat and Passey, 2000). During the course of this research, the idea of federations of charities was mooted on several occasions. This involves charities sharing common services through an

umbrella body, whilst maintaining their independent status. Federation was also discussed as a precursor to merger. There were mixed feelings about this. Some believed that some sort of partnership arrangement prior to merger actually facilitated the merger and made the transfer process smoother. It gives time to discover the culture, working methods, assets etc. of the charities in the federation and how each one will be identified with the new body. These are many of the issues which arise during merger negotiations. However, others were of the opinion that knowing too much about a potential merger partner could be counter-productive, and that often petty disputes could arise within a history of co-operative work. Another problem raised was that finding funding for an umbrella body can be difficult. This is an area which would benefit from further research.

### Method

The methodology involved discussing the legal issues of merger with those who had first hand experience from as many different types of charity as possible. As such, this work aimed to draw on and pool the personal experiences of those in the charitable sector and their legal advisors, in order to give an overview of the issues arising and the different ways of tackling them.

#### *Stage 1*

The first step was to identify as far as possible a preliminary list of the legal issues in charity mergers. Some of the legal issues were identified from a review of existing literature in the area (e.g. Phillips, 1995 and Piper, 1998) and an analysis of the relevant legal principles. This was followed up by some preliminary interviews with charities that had been involved in mergers, in order to confirm what had been learned from the written material. They were asked what had been the biggest legal issues at the time of merger. This was done to ensure that as many of the issues arising, and their relative importance in the process, had been identified prior to the beginning of the data collection from the sample.

#### *Stage 2*

It was then necessary to identify the research sample. The research deliberately looked at a wide range of charities in terms of size, objects (grant-making or service providing) and legal structures. Approximately fifteen mergers were required for the study. This was felt to be sufficient to fulfil the aim of the research to give a clear account of the legal difficulties arising in merger and their possible solutions. As possible participants were identified, details of their size, structure and method of work were charted on a spreadsheet in order to ensure that there was a good distribution of different types of charity within the sample. This was important in the light of the initial hypothesis that different features of the charities involved in merger would impact on the legal issues raised. These factors were found subsequently to be largely irrelevant, and in fact, the vast majority of legal problems and their potential solutions would have emerged had all the mergers studied been between, for example, large service providing charities which were all companies limited by guarantee.



In line with the commitment to the research participants that their confidentiality would be respected, all information gathered from the research sample is presented on an anonymous basis.

### *Stage 3*

Background information about the charities included in the research sample was collected by looking at the public access files at the Charity Commission. Where it was available, written material detailing the process of the merger was sought from the charities involved.

### *Stage 4*

Having constructed the sample, the next task was to design a set of questions to ask each of the participants. The interviewing of participants involved in mergers was chosen as the main method of data collection. The literature already collected about the issues surrounding mergers had led to the identification of the major legal issues in debate.

Broad areas, encompassing a number of different issues, were identified. These included:

- whether or not there was power to merge the two organisations;
- issues surrounding the constitutions of the merging organisations, and whether any changes to either or all were necessary;
- property holding;
- conducting of a due diligence exercise;
- liabilities of trustees during and after a merger;
- general transfer of liabilities and consents required for a merger;
- membership structures;
- Employment Law issues; and,
- the availability and quality of legal advice received.

These were the broad headings around which the questionnaire was structured.

Because knowledge of the area was limited, it was expected that new issues would emerge from the interviews, so a set of general questions was used as a broad guide. The questions were posed at interview rather than as a mailed questionnaire to give the interviewer discretion to pose further questions as necessary. The interviews were semi-structured and the questionnaire was revised as knowledge increased.

It was decided to interview several people involved in each merger: the Chief Executive (or Finance Director); a legal advisor; and, a trustee. This would help to build up a clear picture of the events of the merger, and it would limit the possibility of important details of the merger being forgotten or misrepresented.

When collecting data empirically, there are a number of problems which have to be faced, each of which could affect the validity of the results. There is the problem of interviewees having forgotten details of the merger, or of it being in their interests to play down the importance of certain issues. To limit the effect of these problems, the sample was for the most part limited to mergers which have occurred in the last five

years, in the hope that the details would be clear in the minds of the participants. Where possible, written documentation of the merger was studied, to check fine details and timing. More than one person from each charity was contacted to ensure that a variety of different perspectives were canvassed, and to ensure that all details were discovered. Each person was assured of confidentiality, to encourage them to talk more openly. Finally, a one day conference for the research participants gave another opportunity to ensure that all the ground had been covered, and inaccuracies corrected. Although as much as possible was done to eliminate the problem of inaccuracies, some of the data collected did give conflicting accounts of events. It was then necessary to endeavour to discern the true account. Also, some of the mergers within the research sample were live, with ongoing issues still to be resolved.

### *Stage 5*

Once the interview stage had been mostly completed, attempts were made to draw together the material and categorise the issues. It was found that legal issues arising in mergers are very inter-linked and one issue might be dealt with in a specific way as a result of the particular approach adopted to another issue. The background, ethos and motivations of the charities involved in a merger can also have an impact. The initial analysis was laid out in an interim report, which was sent to all participants. The intention was to give them an opportunity to offer their comments. The interim report was divided into four main areas, looking at: Employment Law issues; property questions; the conducting of the due diligence exercise; and, the form and process of a merger.

### *Stage 6*

Before the final guide was produced, research participants were invited to attend a conference to try to identify the best practices in relation to the legal issues identified. Those who could not attend were invited to make written comments. The one day conference included both a plenary session and small discussion groups focusing on one particular area. The aim of the conference was to finalise which of the different approaches to legal issues was considered to be the best practice.

The conference had been intended as a forum at which to bring together all of the research participants. However, owing to busy schedules, only one representative from each charity was able to attend. Also, as the conference neared, it was considered necessary to have present some people with more knowledge of certain areas than could be gained from participating in only one merger. To assist with the discussion on Employment Law, an employment specialist was invited. This need had not been envisaged in the original plan for the conference, and serves to illustrate the complexity of some of the issues faced by charities in merger. The presence of Charity Commission representatives was also felt to be valuable.

One of the most important aspects of the analysis of the data collected was the conference, providing the most effective and thoughtful form of feedback. It gave an opportunity to involve the research participants in another stage of the research process, to ensure as many of the issues as possible had been uncovered, and to gauge the response of the sector to preliminary conclusions in order to test their validity. The chairing of each of the small discussion groups was as much as possible given over to

research participants, in order to limit the researchers' influence on the shape of the discussion.

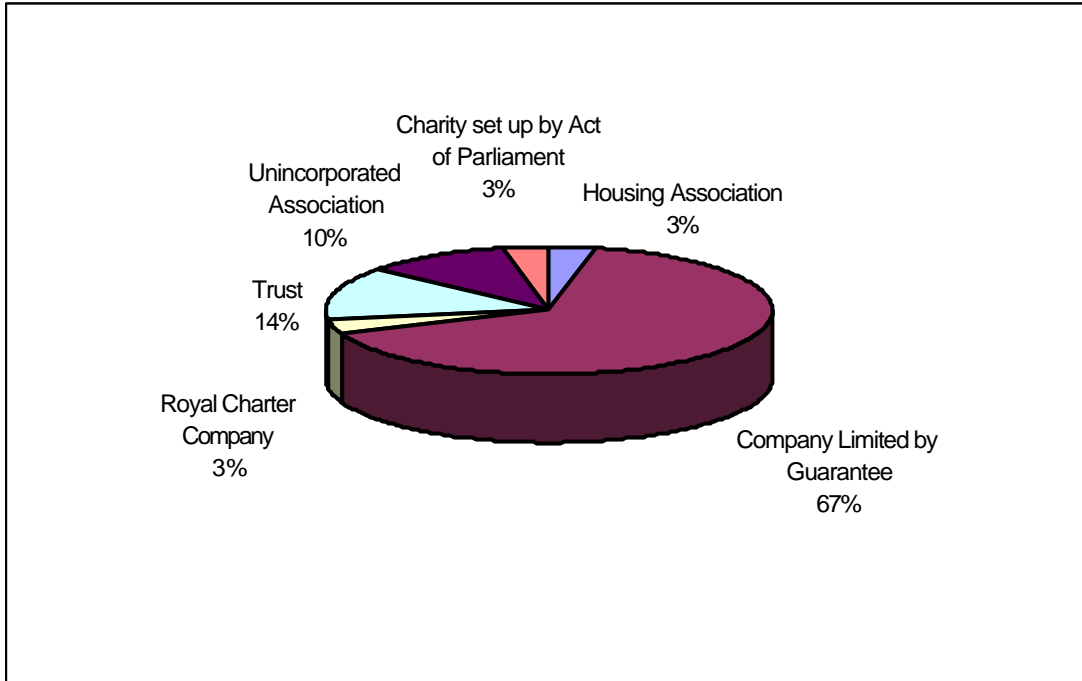
The conference succeeded in drawing out points which had not been considered in the initial phase of the research, although the main conclusions of the initial analysis were found to be sound and the additional information was relatively minor.

### The Mergers

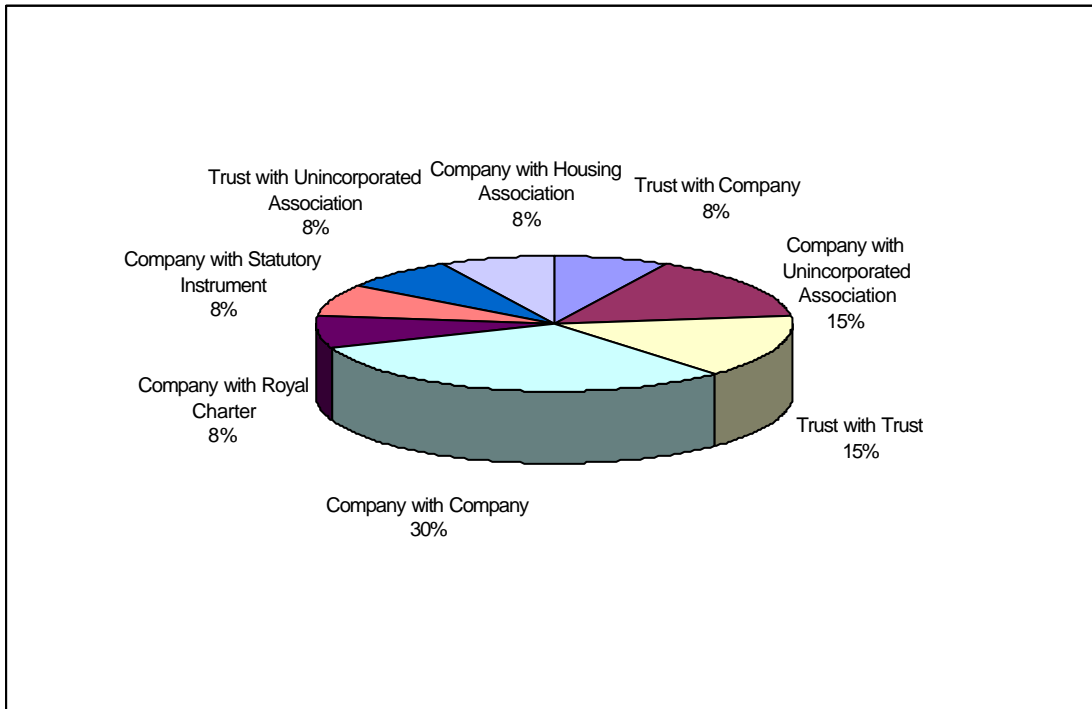
Initially, it was presumed that the size of the charities, their legal structure, and whether or not they were grant-making or service providing would affect the way in which they approached a merger. Therefore, as mergers were identified they were charted according to these details, to ensure that there was a spread of different types of charity. Their relative sizes were measured according to income and the geographical area covered by the charity. The size of the original charities prior to merger was the relevant factor here, because it was the coming together of the two charities which was of interest, and not the end result of the merger. Income was divided into three bands. Small charities were those with an income under £100,000, medium charities those between £100,000 and £1,000,000, and large charities those with an income above £1,000,000 per year. In terms of legal structure, the research required combinations of the same and different legal structures: trusts; unincorporated associations; and, companies limited by guarantee. One merger involving a Royal Charter charity and another involving a charity set up by statutory instrument were also studied. The examples of mergers involving grant-making bodies were somewhat limited, although one solely grant giving body and two bodies who make some grants were found. It was also difficult to find examples of mergers involving unincorporated associations, although again, three instances where unincorporated associations had merged with trusts or companies were found.

Altogether, thirteen different mergers were studied across a broad range of different types of charities.

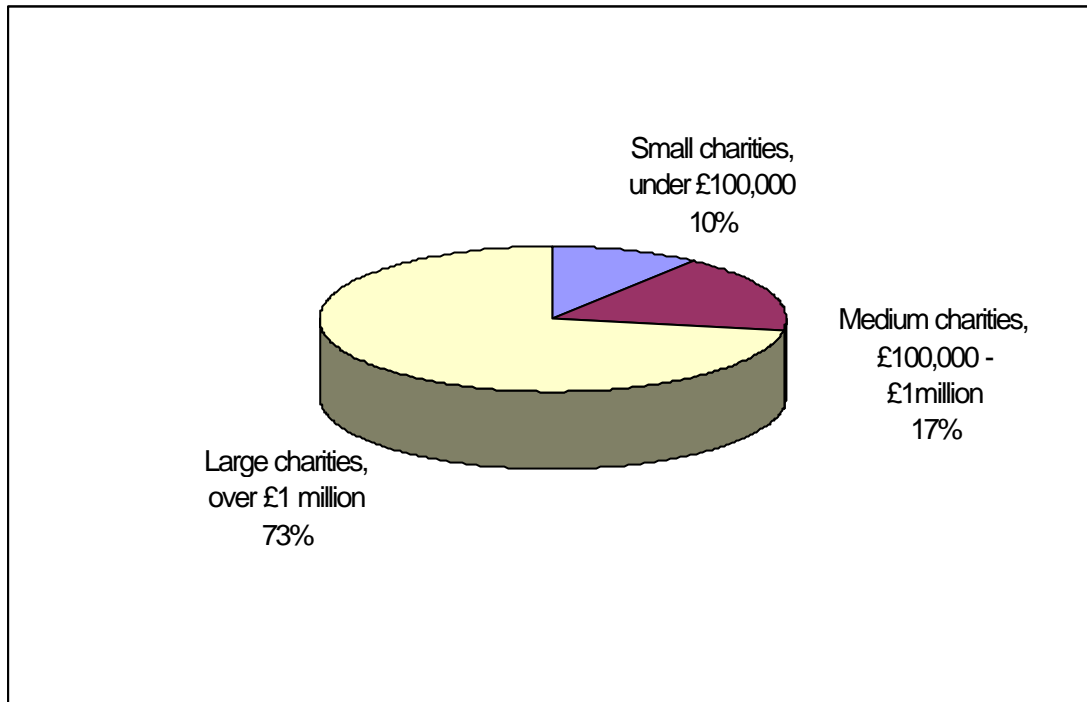
### 1. Legal Structures of Individual Charities Pre Merger



### 2. Combinations of Legal Structures on Merger



### 3. Size of Individual Charities Pre Merger



What follows is a summary of the background to each merger and some details of the charities involved.

#### **Merger A**

Merger A involved two charities, Charity 1 and Charity 2. Charity 1 is a large Housing Association (registered as a Friendly Society), working with the homeless. Charity 2 is a fairly small, service providing charity which ran a day centre for homeless people. Set up as a company limited by guarantee, its main funding source was the local authority. Charity 2 had serious problems with funding and organisation and was advised by an independent consultant that merger was the only real option to preserve the service to the beneficiaries. Charity 1 was selected as a suitable partner. Charity 1 saw the merger as an opportunity to reach their client base through another means. The initial phase of the merger was a management agreement between the two bodies whereby Charity 1 ran the day centre on Charity 2's behalf. The merger plan was to transfer Charity 2 into Charity 1 as a subsidiary, thereby obviating TUPE (see below at p.49) and protecting Charity 1 from any unidentified liabilities. Charity 2's board of trustees voted to resign and to nominate Charity 1 as the corporate trustee. Charity 2's board of trustees all gradually drifted away.

#### **Merger B**

Two professional representative bodies were involved in merger B: Charity 3 and Charity 4. Charity 3 was the older body, and held a Royal Charter. Charity 4 was founded more recently as a company limited by guarantee. Both were membership

charities. The strategy for the merger was to transfer the subscribers and the assets of Charity 4 to Charity 3 and to change the name of Charity 3, so as to reflect the fact that it is differently constituted although legally it is the same body. Charity 3 needed membership approval to effect the merger. Charity 4 did not, but conducted a vote amongst its members anyway. A date was set on which Charity 3 was re-named Charity 5, the assets of Charity 4 were transferred and Charity 4 was struck off. Charity 5 changed its rules of association to adopt some of the provisions of Charity 4's governing documents and to widen its own objects, reflecting its status as in effect a new charity. Trustees from Charity 4 took positions on Charity 5's board of directors and council.

### **Merger C**

Merger C involved two charities. Charity 6 was set up in the late 1920's, and was a fairly small trust. Charity 7 was set up by Charity 6 in the 1980's to expand their work beyond research into grant-making, and to raise funds for Charity 6. It soon became very successful, having over 15,000 members. Conflicts emerged, especially because the newer Charity 7 appeared to be branching out further than its original role of supporting the work of Charity 6. The two charities decided to merge, although both sides were worried about losing control. A merger sub-committee was established, containing members of both bodies, 32 in all. The final merger was achieved through the dissolution of Charity 7, and the transfer of all its assets to Charity 6. The trustees of each board stood down, and six from each of the old charities were voted to be the new council. At the same time, Charity 6 was re-named Charity 8, to reflect the fact that it was, in practice, a new body, despite the fact that it remained the same legal entity.

### **Merger D**

This merger involved a large service providing charity (Charity 9) working with children, which held within it 90 small trusts. These trusts were very specific and were becoming difficult to apply. The Finance Director of Charity 9 sought to rationalise the trusts by creating six broad umbrella categories into which the money from the trusts could be divided. Charity Commission approval was sought for the new categories and a Scheme was established to change the objects of the individual trusts. The Scheme maintained some separation between those funds that had to remain endowed and those that could be split into non-endowed and endowed funds.

### **Merger E**

Charity 10 was a service providing and grant giving charity, set up by Act of Parliament over 200 years ago and working with actual and potential young offenders. Charity 11 was working with a similar group but in another part of the country, and was experiencing financial difficulties. Charity 10 stepped in to 'rescue' Charity 11. In conjunction with the Charity Commission, it was decided to make Charity 10 the corporate trustee of Charity 11, transferring all the assets from one to the other, and to wind up Charity 11's holding company, leaving the charity itself intact. Charity 10 was also re-named Charity 12. First, via a Charity Commission Scheme, Charity 10's powers were amended so it could act as corporate trustee of another charity. This amendment also required Home Office approval. By another Scheme changes were

made to Charity 11's constitution to authorise transfer of funds. There were some complicated property transfer problems which had to be overcome in merger E.

### **Merger F**

This merger involved two grant-making trusts which were established by a businessman. The first, Charity 13, was set up in the 1960's with very general charitable purposes. The second, Charity 14 was established in the 1980's to fund more specific objectives involving healthcare, care of the poor and medical research. The trusts were housed in one property and were administered by the same staff. It was suggested by the Finance Director that administering two separate charities was not very economically efficient, and that a merger would be expedient. It was decided to create a new body, Charity 15, and transfer all the assets and liabilities of the old trusts into it. Unusually, the trustees decided to set up the new charity as a trust, rather than a company limited by guarantee.

### **Merger G**

Three charities (2 companies - Charity 17 and Charity 18 - and an unincorporated association - Charity 16) were forced into merger because of cuts in local authority funding. A large merger committee was established to oversee the merger process. There was some mistrust between the trustee boards of the 3 bodies, so district councils, with limited powers, were set up to allay fears that there would be no local representation. The overall aim of the merger was to create a new central body, Charity 19, as each of the original bodies had power to dissolve but not to merge.

### **Merger H**

Charity 20 and Charity 21 were both charitable companies working in childcare and special needs. They had a history of working together since the 1970's. The trigger for change was a belief that merger would enhance the effectiveness of the services provided by each. Charity 20 was the smaller, but older and more asset rich charity. Charity 21 was set up in the 1950's, and had a heavy membership involvement. A new body, Charity 22, was created to avoid implications of take-over and to create a new governing structure. Most of the property and some of the contracts of both charities were held by trading companies. One merger deed whereby each charity transferred all assets and liabilities (including trading subsidiaries) into the new body was produced. The old charities were left dormant for the sake of legacies.

### **Merger I**

Merger I involved four companies limited by guarantee. Three were carrying out youth work (Charity 23, Charity 24 and Charity 25) and one (Charity 26) also dealt with environmental issues. A new charity, Charity 27, was set up to provide some services to the other four, particularly research and information services. This new Charity 27 was arranged as a subsidiary of the other four. The trustees of the original four became the council of Charity 27, and Charity 27 ran a head office. Charity 27 began to provide other common functions, for example, IT and finance services. It was decided that it would be better to make Charity 27 a holding company rather than a subsidiary of the others. Charity 27 became the sole member of each of the four,

thereby creating a common board of trustees. A year later all four original bodies merged into Charity 27.

### **Merger J**

Charity 28, a company limited by guarantee, was a representative body for charities working in the drug field, undertaking research, publishing, and advising government. Charity 29, also a company limited by guarantee, was mainly a library and resource body working in same sphere. Both shared the same building, owned by Charity 29. Merger was promoted as a means of improving the effectiveness of the charities. Charity 28 became part of Charity 29, the latter having narrower objects and being more asset rich. However, Charity 28 had a very different, more democratic, governing structure and changes were necessary to Charity 29's governing documents in order to appease Charity 28 employees and trustees. Charity 29 was also made into a membership body. Within Charity 28, membership approval was required to effect the merger. Charity 29 was also re-named Charity 30.

### **Merger K**

Charity 31, an unincorporated association, merged with Charity 32, a company. Charity 31 owned the site which they both occupied, except for one building which was jointly owned with Charity 32. The charities had shared a site for 25 years. The main purpose of the merger was to deal with Charity 32's failure adequately to maintain their building, although other cost savings were expected to result. A new charity was established, Charity 33, and into it were transferred all the assets, liabilities etc. of Charity 31 and Charity 32. Membership approval for the merger was required, which proved problematic because of the large membership base.

### **Merger L**

Charity 34 was a medium sized fund-raising and service providing charity, a company limited by guarantee. Charity 35 was a small fund-raising charity, a trust. Both worked with children affected by a particular disease and their families. The possibility of a merger was first discussed in 1996, although no action was taken at that time. In 1998, Charity 34 was looking to expand and contacted Charity 35, who were still interested in a merger, and negotiations began. It was decided that Charity 35 would transfer into Charity 34, because the former's objects were restricted to child work, whereas Charity 34's were broader. The employment contracts and property of Charity 35 were transferred to Charity 34. However, Charity 35 continues to raise funds under its own name for an outstanding project.

### **Merger M**

Charity 37, a company limited by guarantee, was a small, struggling, service providing charity. Its main funding came from contract work with the local authority. Its property was limited to an office. Charity 36, also a company limited by guarantee, had identified Charity 37 as a potentially suitable partner for merger. Charity 37's trustees contacted Charity 36 for assistance. Charity 36 took over the management of Charity 37 on the condition that this led to merger. Charity 37 was absorbed into Charity 36, and the old trustees stood down. They were replaced by Charity 36



trustees and staff. Charity 36 wanted to keep Charity 37 as a 'shell' charity to collect legacies.

### The Report

This report examines some of the main legal issues raised in charity mergers. Clearly, in such a diverse sector, there is no model for charity mergers. The style and content will reflect the character of the organisations, whether or not they have a previous working relationship and the events that brought about the decision to merge. This diversity means that it is not possible to identify the best practice in relation to any particular legal problems faced during merger. Rather, the report considers the range of legal options which are available to merging charities.

Charity mergers are complex, something reflected in the numbers of aborted mergers. This report examines some of the legal issues that seemed to be of greatest significance:

- the form and process of the merger;
- due diligence, risk assessment and trustee liability;
- employment issues; and,
- asset preservation and transfer

Each chapter concludes with a number of recommendations, some of which are of a technical legal nature and some of which relate to general practical issues. The final chapter contains conclusions and a series of recommendations.

The report is based on the original research described in this chapter. However, earlier findings from other projects are referred to throughout the report, where relevant. The bibliography contains full references to these earlier publications. Research in this area continues and therefore the bibliography also contains additional references which may provide supplementary background reading.

## FORM AND PROCESS

Although this research was focussed on the *legal* issues surrounding mergers, it became very apparent at an early stage in the research that the reasons or drivers for the merger could not be isolated from the legal issues. This was particularly the case when it came to a consideration of the form and process of the merger. It was found that legal reasons rarely dictated either the way that a merger took place or the final form of the merged charity.

### Reasons for Merger

Whilst an American study of 18 non-profit mergers found that financial reasons were the chief motivation (Singer and Yankey, 1991), the mergers examined for this research came about for a variety of reasons, largely in line with the main motivations for merger found in an earlier study of voluntary sector mergers in the UK (Cowin and Moore, 1996). In some cases there was a merger of equals where the charities had made a strategic decision that they could develop as charities, operate more efficiently and provide more effective services as a merged body. Several spoke of the existence of a 'good fit' and 'synergy', and all recognised the savings associated with sharing resources etc. For example, in Merger B, the Finance Director of Charity 5 spoke of 'a marriage of equals' and even preferred to use the word 'integration' rather than 'merger'. The focus here was on the beneficiaries:

*Providing a comprehensive service set of activities to the world out there who are our customers, members and stake-holders because at the moment I think it's fair to say that there has been some overlap ... to provide a better service, and if you were talking to any of the trustees, that is what they would say. That really has been the ultimate objective. (Chief Executive, Charity 30)*

A merger of equals also occurred where a number of charities all suffered cuts in their core funding. Such a merger is sometimes forced by a common funder, as in Merger G. A similar driver for merger is described in a study of non-profit organisations in metropolitan Jerusalem, Israel, where the municipality pressed organisations to merge in order to economise and offset the struggle for municipal funds (Schmid, 1995).

In other mergers, for example, Merger A, one of the charities has been dominant and often approached by a charity struggling because of funding pressures or the cumulative effects of poor governance (or quite often a combination of both, as in Merger M). In effect, a take-over occurred.

More unusually, in Merger D, six new charities were created into which 90 small trusts, associated with Charity 9, were amalgamated. Most had purposes which were out of date, with the result that their funds could not be applied and were therefore not available for Charity 9's modern programme of work. The changes allowed the cost of administering the small trusts to be reduced, and their assets effectively applied, whilst keeping faith with the spirit of the original donations.

Another reason for a merger of previously connected charities was in order to maintain a stronger grip from the centre:

*One of the difficulties was that the scale of the operation was such that things like trading companies were not always being used ... So one of the purposes of bringing the thing together was to be able to impose the controls that would keep us truly within the Charity Laws. (Finance Director, Charity 27)*

Johnson and Carter summarised three reasons why an organisation considers merger: survival, opportunity and ideology (Johnson and Carter, 1999).

### Form / Structure

'Merger' was given a wide meaning and covered arrangements ranging from the voluntary transfer of assets from one charity to another (which Cornforth terms a 'consolidation' Cornforth, 1997) to a coming together of two or more charities in a completely new charitable body (which Cornforth terms an 'amalgamation' Cornforth, 1997). The research did not look at partnerships, joint ventures or other forms of co-operation between charities.

A merger of charities is more likely to be seen as a 'true' merger than it is the commercial world. With a commercial merger (see below at p.31) a 'merger' is more often a euphemism used to disguise a take-over.

The research revealed in some cases a staged approach to merger involving more than one form of merger. Two or more charities may merge initially by becoming subsidiaries of a new holding charitable company but then eventually may be merged into the holding company to become one charity. A number of mergers occurred originally by one charity becoming the corporate trustee of the other leaving the second functioning as usual but under different control. The second charity was sometimes then merged fully into the first when, for example, the full extent of the liabilities of the second were known.

### *Forms*

The following list of forms of merger is not presumed to be a complete list and forms may be combined, for example, there may be a transfer of a subsidiary company and the application of the other assets of the transferring charity for charitable purposes.

- Transfer of the assets of Charity A to Charity B and the dissolution of Charity A.
- Transfer of the assets of Charity A to Charity B, the re-naming of the receiving charity as Charity C with revised governing documents and the dissolution of Charity A. (**Merger B, C and J**)
- Charity A becomes corporate trustee of Charity B. (**Merger A and L**)
- Charity A becomes corporate trustee of Charity B, transfer of the assets of Charity B to Charity A (**Merger E**) and the dissolution of Charity B.

- Transfer of the assets of Charity A to Charity B with Charity A remaining as a 'shell' charity, possibly with Charity B as the sole member. **(Merger M)**
- Charity A and Charity B transfer their assets to a new Charity C with Charities A and B remaining as 'shell' charities. **(Merger G and F)**
- Charity A and Charity B transfer their assets to a new Charity C and are then dissolved. **(Merger H and K)**
- Charities A and B become subsidiaries of a new Charity C, a holding company, which is the sole member of Charities A and B. **(one stage in Merger I)**
- A number of small charities are grouped together by Scheme. **(Merger D)**
- Charity A carries out its operations through a subsidiary trading company. Shares in the trading company are transferred to Charity B, Charity A may then dissolve. **(parts of Merger H and K)**

Dissolution may be by winding up or striking off, but the latter was claimed to be cheaper in Merger B.

The actual form of the merger chosen may not necessarily reflect charities' own perceptions of the merger. For example, a merger can be effected by transferring the assets of one charity to another without there being a dominant charity; that form simply happens to be the most convenient and a genuine new charity is formed 'in the skin' of one of the original charities which acts as a 'host' charity. This was the case in Merger B:

*If I say not a lot of members appreciated exactly what was happening, that's not a bad thing, because there might have been a perception about one taking over the other and we didn't want that at all. That was the legal formality. In effect, they all became one on the same day. So we had to dress that quite carefully in terms of presentation without deceiving the membership. The wording of the resolution was quite critical. (Finance Director, Charity 5)*

### *Shell Charities*

In the majority of cases, where a charity is transferred into a different body, it is a good idea to maintain a shell of the original charity post merger. The primary purpose of this appears to be for the collection of future legacies named for the original charity. It is necessary to maintain some remnant of the former charity in order to collect legacies because in *Re Faraker* [1912] it was held that when a charity has power to dissolve itself and does so, it ceases to exist. Any legacies left to the charity subsequently will lapse. However, a charity does *not* cease to exist because it is re-organised, re-named or amalgamated, whether this is done by a Charity Commission Scheme or under powers contained in the governing documents.

Some complained that the requirement for the retention of a shell was rather clumsy and gave the merger an unfinished feel:

*We have to keep some of the companies alive just so that they can receive the benefit of legacies. So you can't just simplify it and wind it all up and bring it to an end. (Finance Director, Charity 27)*

Most solicitors considered that every other function which a shell could perform should in fact be fulfilled by transferring funds into the new body with restrictions, and that, if aspects of the original charity are still being run by the shell after merger, it is questionable whether merger was in fact the right route to pursue. However, the solicitor in Merger M considered that the maintaining of a shell charity was appropriate during a 'transition period' post merger. He described the function of the trustees of the shell charity as 'almost like a monitoring of how the post-merger arrangements are working'. He felt that this could be a mechanism for easing the anxiety of the trustees of the transferring charity, helping to give them confidence in the merger.

It was also suggested in Merger A that the largely dormant Charity 2 might be used in the future in order to apply for funding from particular sources separately from any applications by the merged Charity 1.

### *Choice of Form*

No one particular form of merger was revealed by the research to be the first choice of either charities or their advisers. Different routes for merger were taken to a number of different final forms.

### Non-Legal Reasons

The non-legal reasons usually outweighed the legal reasons when choosing the form of merger. The rationale for the merger appeared to be significant.

Trustees, staff and members of merging charities often had strong views about a proposed merger, for example, not wishing to be seen as the subject of a take-over, and this influenced the form the subsequent merger took.

The relative financial positions of the merging charities appears to be a factor in deciding the form of the merger itself; a failing charity was more likely to be wholly absorbed into the rescuing charity.

In some cases, the vision or plans for the merged charity was a factor in choosing to create a new body or to merge the charities into that with the constitution most easily adaptable to carry out broader objects or accommodate members.

Pre-conceived notions are often difficult to break down. For example, in Merger J, despite reassurances to the contrary from the solicitors concerned, the trustees were adamant that creating a new charity would be more expensive than transferring Charity 28 into Charity 29, and therefore the latter process was used, with some re-working of the governing documents of Charity 29 (and re-naming).

Both the forming of a new charity and absorption were said to be better methods, the former because it enabled charities to leave behind their 'baggage', and the latter because it was less complicated and generally cheaper:

*The only time I would say is if they were so politically at odds with one another that neither could agree to be absorbed by the other and I did do one recently, which failed, which might I suppose just possibly have succeeded if we'd gone the expensive route by clearly creating a third organisation which they both liked, but it would have caused all sorts of unnecessary costs to them and it was a very big price to pay for company egos. (Solicitor, Merger A)*

A point raised against the take-over structure was that it is easier when merging in this way not to address all of the issues, such as distribution of power and marketing strategy, at the time of the merger, leaving these issues to arise as problems later. However, this is considered to be more of an argument for thorough due diligence (see Chapter 3) than for a particular merger structure.

The psychology of the merging organisations may also influence the chosen structure. In Merger H, the trustee cited 'psychological difficulties' as a reason for deciding against one charity being absorbed by another. Again, in a reluctant merger, which is funder-forced (as in Merger G) the creation of a new charity may be the best route for the same reasons. Charities often want to have a level playing field so that they can protect their individual identities during the merger, and will not accept anything which appears to be a take-over.

A staged merger might also be for psychological reasons:

*If one had enunciated back in '95 that we would create a single charity with one board, with a common purpose, with none of these other things, we would never have got through stage one. (Finance Director, Charity 27)*

Keeping the original charities in place may sometimes allow greater flexibility in relation to funding. For example, in Merger A, it was considered advantageous to keep Charity 2 in existence so that in the future lottery grant applications might be made in its name.

The issue of de-merger was also raised. Some charities may want to have an option to de-merge, and some merger structures will accommodate this better than others. Clearly merger causes fear of being locked-in solid, so escape routes are important, especially for the 'weaker party' in a merger who might fear that their interests will be ignored:

*There is a natural wish to have some sort of un-wind provisions, but when you've transferred across all your assets, your power base and your building, what in reality can you do? The prospect of trying to un-wind might actually lead to the destruction of everyone if you're not careful. We came to the conclusion in the end that it was appropriate to accede to the request for an un-wind provision, but on a precise and fairly limited basis. (Trustee, Charity 36)*

The trustee in that case also emphasised the need for the get-out clause to be time limited, 'so there comes a point when you know you can't go back'. Here a period of three years post merger was chosen.

The form of merger in some cases was influenced by the previous experience of the charities themselves or their advisers, for example, a previous successful merger using a particular form:

*As far as [Charity 37] was concerned, we pretty much followed the pattern which we developed for [a previous] merger. (Trustee, Charity 36)*

## Legal Reasons

### *Legal Structure*

In general, the basic form of merger did not seem to be dictated by the original legal structure, whether corporate or unincorporated, of the charities save where one charity had a legal structure, such as a statutory corporation (for example, Charity 10 in Merger E), which was more difficult to change. A statutory corporation is a body which has been set up and declared to be a charity by an Act of Parliament. Section 17 of the Charities Act 1993 makes provision for the Charity Commission to make Schemes for, or alter provisions of, charities regulated by statute. Effect is given to the Scheme by an order of the Home Secretary made by statutory instrument which is laid before Parliament.

Also, generally, charities preferred to move away from the trust structure, and merger has sometimes been used as an opportunity to do away with an unincorporated charity. This was the case with Charity 31 in Merger K. Unusually, however, in Merger F, the newly created Charity 15 was formed as a trust, with the explanation being that this was the simplest and least disruptive change for the trustees of Charity 13 and Charity 14, both of which had been trusts.

### *Liabilities*

In other cases, consideration of actual and potential liabilities to employees (see Chapter 4) and other contractors indicated a preference for a form of merger which did not involve a transfer of business but the retention of two charities, one now controlled by the other. However, despite following this route, the solicitor in Merger A did acknowledge some negative aspects to this approach: first, he considered that there was a risk of misunderstandings arising in relation to accounting for VAT, where groups are concerned; and secondly, he acknowledged that most people involved with the charity would not understand the parent / subsidiary arrangement, which could cause complications, in Employment Law, for example, when trying to ascertain who is the employer of a particular individual.

### *Owning Real Property*

In Merger J, the fact that Charity 29 was the freeholder of its property was cited as one of the reasons for transferring Charity 28 into Charity 29.

### *Restricted Funds*

The presence of restricted funds in one of the pre-merged charities may affect the form which a subsequent merger takes (see below at p.59).

### *Objects*

The particular route to merger was in some cases affected by the objects and powers of the merging charities. These issues have been described as ‘constraints that might limit what is possible’ and it has been suggested that they should be considered in the exploratory phase of a proposed merger (Cornforth, 1997).

If one charity has broader objects than the other, it is only possible to transfer from the charity with broader objects to the charity with narrower objects (as opposed to vice versa). This is because in Charity Law there is a duty on charity trustees only to apply the assets of the charity for the purposes for which the charity was created, as set down in the objects clause in the governing documents of the charity (Duke, 1676). Therefore, to transfer the assets of a charity into another charity with wider objects would be a misapplication of funds and a breach of trust by the trustees of the transferor charity. This was cited as one of the reasons for using Charity 29 as the ‘host’ charity in Merger J. In a survey of charities undertaken in 1997, the prominent reason cited for aborted mergers was incompatibility of objects (Trowers and Hamblins, 1997).

### *Powers*

One issue is whether or not there is a clear power to merge. To effect any change in the constitution of a charity the trustees of the charity must have a clear power to do so, to avoid being in breach of trust. In practice, for mergers, the power has been drawn from several different sources.

There may well be a power contained in the governing documents of the charity which will allow the trustees to effect a merger. The most straightforward of these is a specific clause in the governing documents stating that the trustees of the charity have the power to amalgamate it with any charity with the same or similar objects if the action would be beneficial for their charity (see, for example, the Charity Law Association model trust deed for a charitable trust which contains an amalgamation clause).

If this specific power is not available to the trustees, there are other powers which may be given in the governing documents that could be drawn upon instead. The trustees may have a dissolution provision which allows the trustees to wind up the charity and, after all debts and liabilities have been cleared, to apply the surplus assets to another charity (see, for example, the Charity Commission’s model memorandum and articles of association for a charitable company, containing such a clause). This could be one way of transferring assets to another charity as part of an amalgamation. However, there are limits upon the use of this power. Money can only be distributed to a charity with the same or broadly similar objects, and if this route is used the charity will have to be wound up and will not then be available to collect legacies (see above at p.14). Alternatively the trustees may be able to rely on a general residual power ‘to do all such other lawful things as are necessary for the achievement of the objects’. Such a clause is contained in the Charity Commission’s model documents for a charitable trust, a charitable company and a charitable unincorporated association.



Even if there is a power within the governing documents to transfer the assets of the charity, there may also be constraints placed upon the exercise of this power. One constraint is the requirement that changes to the structure etc. of the charity must be approved by a membership vote (see below at p.27). Other consents may also be required by the governing documents. For example, if the charity is a statutory corporation, any changes to the governing documents will require a statutory instrument (see above at p.17).

If there is no power to merge provided by the governing documents, it may be possible to alter the documents in order to create one. With unincorporated charities, the governing documents may contain a clause giving the trustees a power of amendment. If so, changes may be made in line with this clause without reference to the Charity Commission. In many cases, however, the clause will impose further restrictions. For example, changes to key provisions (including a charity's objects) may require Charity Commission consent. The amendment clause will also set out the procedure for implementing the change. For most unincorporated associations, the usual requirement is for a resolution to be passed at a general or special meeting of the charity. Charitable companies have the power to amend their memorandum and articles of association. The procedure is laid down in Company Law and will usually be reflected in the articles of association. For example, a charitable company may alter its objects by special resolution (Companies Act 1985, section 4, as amended by Companies Act 1989, section 110(2)). However, the charity must obtain prior written consent from the Charity Commission before passing any resolution which changes the charity's stated objects or the way in which its property may be used or applied (Charities Act 1993, section 64(2)).

If the charity is small, as defined in the Charities Act 1993, there are various statutory powers which may be used in order to effect a variation. Under section 74, if a charity had a gross income of not more than £5,000 in its last financial year, does not hold any land for use by the charity, and is not a charitable company, the trustees may resolve to transfer the property of the charity to another charity or charities, or to replace the charity's existing purposes or to modify their powers as set out in the governing documents. Under section 75, if a charity that has permanent endowment (which does not comprise any land) had a gross income in the last financial year of not more than £1,000, and is not a charitable company, the trustees may resolve to spend the permanent endowment as income. The charity will cease to exist when all the permanent endowment has been spent. The use of these powers has led to some streamlining and significant numbers of small charities leaving the Register of Charities (Carpenter, 1999).

If there is no power available to the trustees to effect a merger, it may be possible to apply to the Charity Commission for a Scheme (see Charity Commission, September 1999b). Under section 16 of the Charities Act 1993, the powers of the court to make Schemes for the administration of charities are exercisable concurrently by the Charity Commission. A Scheme is a legal document by which the Charity Commission may amend, replace or amplify a charity's governing documents. A Scheme can be used *both* to change the administrative provisions, for example, the composition of the trustee body, *and* to amend what the charity is set up to do. Alternatively, the Charity Commission may decide that it is appropriate to make a Scheme giving the charity a power of amendment. In particular a Scheme may:

- change the purposes of a charity;
- set up or appoint a new body of trustees to run the charity;
- give the trustees powers, which they do not already have, to take certain actions; or
- amalgamate the charity with other charities having similar purposes.

It should be noted that the purposes of a charity (the objects for which it is established) may only be altered in the circumstances set out in section 13 of the Charities Act 1993 and then only to the extent necessary to give effect to the donor's intention (termed *cy près*). Section 13(1)(c) is most relevant to mergers and states that one occasion for applying property *cy près* is:

*where the property available by virtue of the gift and other property applicable for similar purposes can be more effectively used in conjunction, and to that end can suitably, regard being had to the spirit of the gift, be made applicable to common purposes.*

A Scheme authorised under section 17 of the Charities Act 1993 to amend the governing documents of a statutory corporation will also require a statutory instrument, to be made by the Home Secretary (see above at p.17).

The method of gaining the power to merge has in some cases affected the form of merger. For example, the existence of a power to wind up but not a power to merge may require the creation of a new charity. For example, in Merger K, Charity 31 did not have the power to merge. As a 'host' charity for Charity 32, it was considered inappropriate too as it had an unincorporated structure. Therefore, by a process of elimination, the decision was made to create a new Charity 33.

## The Process

The research revealed a number of matters which particularly affected the merger process:

- the need to ensure that all charities had the required objects and powers to allow merger to take place;
- in the case of charities with a membership, the need to obtain the consent of the appropriate number of members and to ensure that their membership was transferred to the merged charity;
- the need to obtain the consent of funders and lessors for the merger; and,
- the need to attain a workable governing body for the merged charity whilst retaining the goodwill and interest of the governing bodies of all the merging charities.

Guthrie considers that it is desirable to achieve merger (or to end work towards merger, if no merger will take place) as quickly as possible (Guthrie, 2000). Mergers took varying lengths of time but the research revealed that the process is usually quicker and more straightforward where the merging charities have previously co-operated in a particular area. For example: in Merger H, both charities were already jointly running some services before merger; and, in Merger K, both charities wholly and jointly owned a trading subsidiary before merger. In Merger C, however, Charity 6 had actually been set up by Charity 7 many years ago, and yet it still took 5 years for the merger to go through, with the main debate surrounding the name of the merged Charity 8! Similarly, in Merger A, the merger was preceded by a management

agreement, whereby Charity 1 would run Charity 2's service, but Charity 2 was still constitutionally in charge. This was not, however, recommended:

*So until [Charity2's] full control was transferred to [Charity 1], which happened about nine months later, there was confusion in the system. (Chief Executive, Charity 1)*

The constitutional structure of a receiving charity may need to be changed in order to take into account the governing structure of the charity being absorbed, or the constitution of a new organisation may need to be written to include elements of both the original organisations rather than just using the constitution of one or the other. This can take some time to achieve. For example, in Merger J, the transferring Charity 28 wanted to change the constitution of the receiving Charity 29 (which was re-named Charity 30) to reflect a more democratic approach to the election (rather than appointment) of trustees.

A regular review of the governing documents of a charity seemed to contribute to the ease of merger. Those charities (for example, Charity 34 in Merger L and Charity 36 in Merger M) which had recently revised their constitution and governance structure found the process of merging much more straightforward. This is because they already had in place the structures necessary to effect a merger simply, and had no need to make extensive constitutional alterations.

### *Merger Committee*

Most mergers, after the initial decision by two or more charities to merge, involved delegating merger negotiations to a joint group from all charities.

The composition of this 'merger committee' (referred to as a 'steering committee' in Cowin and Moore, 1996) varied greatly in number and personnel. For example, some committees involved trustees, others did not. It is advisable to have represented on the merger committee the Chief Executive, chair of trustees and Finance Director of each of the charities involved, because of their in-depth knowledge of their respective charities. The normal pattern was to have 'equal' representation from each charity. However, if there are several charities involved, the group can become rather oversized (as in Merger G) and this can cause delays.

The 'merger committees' also varied in the way that they worked. For example, in Merger H, a steering group was set up, with sub-groups dealing with such matters as fund-raising, service delivery etc. In Merger B, three working parties operated in order to see through the merger: the first one produced what was called a 'vision document' which went to the governing bodies of Charity 3 and Charity 4 for approval; the second was formed in order to facilitate the gaining of the required membership vote; and the third oversaw the detailed steps required for merger.

It is important that the committee is trusted by the rest of the charity trustees, and that the committee regularly reports back and consults with all the trustee boards involved because final decisions must be made with the agreement of the boards:

*The biggest difficulty has been to persuade the trustees of the individual charities that it is in the interests of their particular programmes to do this. Essentially they have each joined an organisation with a particular programme of activity which they had an affinity for and wished*

*to work for and, therefore, to then extend and suggest that their programmes in any way might be compromised for the benefit of the whole, has worried them ... That was a very significant issue, I mean for all the right reasons.* (Finance Director, Charity 27)

It is a general principle of trust law that trustees must act in person. Decisions concerning the charity must be taken by the trustees acting together. They can always invite some of their number to look into particular matters connected with the charity and to make recommendations, but the decision whether or not to act on the recommendations is for the trustees to take together (Charity Commission, September 1999a). No single trustee should be allocated responsibility for distribution of a part of the income of a charity or manage any particular aspect alone. In some cases the governing documents of a charity may permit the trustees to set up committees with limited powers to carry out particular functions. The trustees of some charities, because of the scale or nature of the work of the charity may, of necessity, have to delegate to employees decisions on day to day management matters. But the scope of the delegated authority must be clearly laid down in writing and instructions given for decisions on important matters to be reported to the trustees. The trustees remain legally responsible and must supervise and control the work of the officers. (The Trustee Act 2000, which received Royal Assent in November 2000, gives wider powers of delegation to trustees, but this is limited for charity trustees and still requires supervision.)

The idea of a neutral committee facilitator, also recommended in other studies (e.g. Cornforth, 1997) was mooted:

*They were like three groups, nobody there just with a neutral position; everybody came from one of the three [charities].* (Trustee, Charity 19)

Interestingly, in a study of aborted voluntary sector mergers, each had a steering committee without an independent chair with whom all parties were satisfied (Cowan and Moore, 1996). Ideally, the facilitator should be an independent volunteer whose role is to keep things moving along. It was found that it was easy for committee members to become distracted:

*I think what I've learnt from this particular merger is that with two quite big charities like this, with membership and one with non-membership and all that sort of thing, it's important to set out a path which is to be followed I think quite religiously, because you can be distracted. Both charities can be distracted and I think you have to keep on the straight and narrow.* (Solicitor, Charity 30)

The committee needs to be committed to holding regular meetings, and to consulting with and reporting back to interested parties. This can, however, help to draw out the process:

*Among the problems are, and it's inevitable, if you're trying to do a thing like that, there are problems with timing. You come up with questions and they can't be answered until the next meeting of the steering committee happens because everybody's got to be taken along with it.* (Solicitor, Charity 19)

It might therefore be helpful to give a time limit to the workings of the committee (for example, until the next AGM or the end of the financial year).

### *Communication*

One of the tasks of the merger committee is to ensure that, as well as consulting with charity workers (both paid and volunteer), the subscribers, members, patrons and funders of the charities are also carried along with the merger plans and are not going to block change:

*Get the big issues up front and resolved very decisively. If you put them off or think, 'well they're difficult, we'll wait till the crunch comes', the danger is it won't happen at all. (Trustee, Charity 37)*

*We went to great lengths to make sure everybody understood why we were doing it - the effect would be to improve service delivery - and that was presented to parents, staff, trustee boards, to explain what we were doing. (Trustee, Charity 22)*

*Again, that's something else we learnt is that we need to talk to funders. Not just, 'do you mind?', but, 'can we have it in writing, and you will fund us next year won't you?' (Finance Director, Charity 36)*

*Always talk to the banks. There's a vital issue, because you don't want to fall foul of that lot if you've got an overdraft. (Finance Director, Charity 27)*

*In about four cases, either the original donor, or I think more accurately relatives of the original donors, were still in touch with us so, although we didn't need to by the terms of the Schemes, we did take the precaution of writing to them and saying, 'this is what we are proposing to do, have you got any objections?' (Company Secretary, Charity 9)*

Johnson and Carter refer to the contribution of all these 'key players' as being an important part of the process (Johnson and Carter, 1999).

### *Professional Advice*

The research showed considerable variation in the extent to which professional advice was taken and when it was taken. There were cases where solicitors were very much involved throughout the merger process. Sometimes, solicitors are even part of the initiation process, whereby merger is suggested as a solution to a problem. In other cases, (for example, Merger J) solicitors were brought in towards the end of the process and simply given instructions to carry out particular tasks, thereby acting in a responsive, rather than a steering capacity. This was also the case with Merger M, where Charity 36 had already had experience of several previous mergers:

*Again, as we've got more used to doing things, then we draw up documents ourselves. If we've got documents to play with, we just change a name and change a few details. So originally the lawyers were in on doing the agreements and then coming up with a contract. With [Charity 37], we had to do much more of that work ourselves. Obviously we had to get lawyers in at the end to check everything. (Finance Director, Charity 36)*

In Merger G, initial advice was taken from the charities' umbrella body, some of whose members had already merged.

In some cases, a professional consultant was used. For example, in Merger J, a grant was provided by both charities' main funder in order to cover the costs of consultancy services. The work on Crossroads mergers talked of the benefits of using an 'independent broker' (Palmer, 1999) and an American text on non-profit mergers and

alliances suggests that consultants can bring two distinct advantages to a merger: an educated outsider's perspective and specialised knowledge and skills (McLaughlin, 1998). Not all charities thought that this would be a good idea. A trustee of Charity 8 felt it was better, when there are sensitivities to be handled, to deal with it internally. It would have been more antagonistic to have an 'outsider' come in and suggest merger:

*If we'd got somebody in from the outside could it have speeded it up? Possibly, but I think it might have upset more people ... I think if you get consultants in, the consultants have to be in the background ...* (Trustee, Charity 8)

Most took the view that legal advice should be taken as soon as possible. This is in line with Piper's experience. She laments the fact that often merger talks are well advanced before anyone considers taking legal advice. This regularly leads to disappointment because clients learn that there are legal difficulties with the plans that they have painstakingly negotiated (Piper, 1998). It is harder (and more expensive) for an advisor to unravel work done badly than to be involved from day one:

*If you tell me what you want, I'll try and draft it. If you draft it yourself, I've got to work out what I think you meant by what you drafted and then draft it.* (Solicitor, Charity 19)

An advisor involved from the outset can also facilitate discussions, give timely advice and offer the client a different viewpoint and different options to consider:

*I do think lawyers are often not involved until far too late because very often you say to someone, 'look, we can deal with all that as follows', and you are able to take it out of discussion and something which is looking like it is going to take weeks of discussion and you'll say, 'well let me go away and draft something', and you put something down which achieves the balance, which allows the parties to stop talking about the theory of what independence within a group structure means and see some wording.* (Solicitor, Charity 1)

It might also add some independence to the discussions:

*When you've got two main parties who want something to happen and one of them is giving advice, you do get punched and actually it's not advice that's being given, it's guidance or a bit stronger than that. It's not exactly persuasion, but the advice wasn't mutual, let's put it that way.* (Trustee, Charity 19)

Many charity mergers involve one firm of solicitors advising on the merger, rather than each charity appointing its own solicitors. Where one firm of solicitors is used for both charities, the trend is often to use the solicitors of what might have been perceived to be the smaller or weaker party to the merger:

*We were very keen to use [Charity 20's] solicitors rather than [Charity 21's] solicitors because they [Charity 20] were the smaller party and we didn't want them to feel that we were taking over ... So by using their solicitors that sort of helped.* (Trustee, Charity 22)

*We used the lawyers of [Charity 35] to put the legalities in place. This was so we could demonstrate that we weren't taking them over. We were very much the senior partner, but it was a partnership.* (Finance Director, Charity 34)

The solicitor in that case (Merger L) commented:

*I immediately had a huge red flag waving because of this conflict of interests point. It is impossible to act for two clients at once, other than in circumstances where each party is absolutely clear where the line is drawn and there is a marker down from day one that you, as*

*a solicitor, have to pull out, you have to stop acting for either charity if a problem suddenly arises.*

The solicitor in Merger J also commented on this point:

*The difference with this sort of merger and a commercial merger, acquisition or take-over is:*

- (a) there is no consideration involved generally; and,*
- (b) both charities' organisations are working for the same end and it's simply helping out each other as opposed to one being a bully.*

*To be honest there always is a weaker party and a stronger party, but:*

- (a) we don't stress that; and,*
- (b) charities don't seem to operate like that I don't think and I think it is a less confrontational environment than a commercial role.*

The solicitor in Merger L, considering the conflict of interest issue, lamented the fact that, unlike commercial mergers, when it comes to charity mergers, there are no conventions:

*What you have to do is to think on your feet and try and be practical and try and come up with answers which actually achieve what everybody wants to achieve, and the priority is ... you don't go spending huge sums of money which has been collected laboriously for charitable purposes on paying lawyer's fees to do a gilt edged merger deal which in commercial terms could run up tens of thousands of pounds worth of bills, when neither charity wants to spend their money on it.*

Conversely, and reflecting, perhaps, his legal and commercial background, the trustee of Charity 36 explained why two firms of solicitors were used in Merger M:

*Clearly, because of legal conflict of interest issues, we couldn't have one firm of lawyers acting for all the parties even though we had common aims.*

A charity needs to choose its advisor with care. It was said to be better to have an advisor who understands the dynamics of the sector, rather than one who is very used to dealing with transactions in the commercial sector. When appointing a legal advisor, it is generally advisable to appoint someone who specialises in Charity Law (see also Cornforth, 1997). One charity within the research suggested that their solicitor (not a Charity Law practitioner) was 'on as much of a learning curve' as they were.

An argument was advanced that it is better to conduct due diligence (see Chapter 3) to find out if the merger is viable, or at least go to the Charity Commission to check that the merger is technically feasible, before involving advisors. This may be true for organisations which have staff or trustees competent to conduct a due diligence exercise, but may be more difficult for a charity which needs advice on how to carry out due diligence.

### *The Role of The Charity Commission*

Similar variation was shown in relations with the Charity Commission varying from involvement from the beginning (this was so in the majority of mergers studied) to merely notification after the merger had taken place (for example, in Merger B).

In line with Guthrie's recommendation (Guthrie, 2000) it is generally considered better to involve the Charity Commission early in the merger process, as charities may be frustrated if their plan (which has already cost time and money) is later thwarted by technical difficulties. A typical comment reflecting this viewpoint, came from the solicitor for Charity 36:

*Very much we took the view here that, tell the Charity Commission. Make sure they know what's going on. Make sure that we get any views and comments early so that we don't find that you have a regulatory problem, you know, just before you're trying to do the deal.*

Sometimes, for example, in Merger J, the Charity Commission is approached, even before solicitors are appointed:

*I met with them at the outset because I thought it would be a very good idea to get them on our side. I didn't want them queering the pitch later on, so I met with them even before we commissioned the lawyers and wanted to seek their advice. (Chief Executive, Charity 30)*

Not everybody takes this view, however:

*We're not keen on involving the Charity Commission, it's costly ... They are a regulator and they should find out about it when they get sent an annual return saying, 'we've now got rid of our assets, please strike us off the register'. It's the trustee's responsibility to ensure proper application of the assets and as long as that's done ... but a lot of people don't take that view and get the whole thing pre-agreed by the Charity Commission. You can add quite a lot to your legal fees if you go down that route. (Solicitor, Charity 1)*

The Charity Commission itself welcomes early involvement, especially when there are constitutional issues (relating to the powers and objects) of the merging charities which may need to be addressed (Carpenter, 1999).

It was suggested that the Charity Commission could extend its role to include the instigation of charity mergers. This reflects an earlier recommendation that the Charity Commission should encourage charities with similar aims, objectives and missions to merge and unite their assets and liabilities (Disabilities Trust, 1997). The NCVO also recommended that the Charity Commission should consider counselling those seeking charitable status regarding the costs of running a charity and should give advice on alternative ways in which applicants may achieve their charitable goals (Leat and Passey, 2000).

Although the Charity Commission is under some pressure to rationalise the sector, even to the point that there had been some suggestions that the granting of charitable status should be rationed in areas where there are already too many charities working, it does not have prescriptive powers to determine that a category of charity is now 'closed' (Carpenter, 1999). This does not mean that the Commission is against mergers or collaborations. In its leaflet on registering a charity, new charities are invited to consider the following (Charity Commission, 2000):

*It is very likely that a charity already exists which is doing the kind of work which you would like to carry out, and there may be one working in your area of the country. We suggest that you think about whether it would be better to offer your services to, or combine with, an existing charity. It is usually less effective to have several organisations trying to carry out the same work in the same place, and it duplicates running costs.*



In relation to *existing* charities, the impetus must come from charities themselves, and the Commission is there to facilitate once the wheels have been set in motion. The solicitor in Merger L seemed to understand how the Commission operates:

*The Charity Commission doesn't like telling charities what to do. The Charity Commission, in my experience, likes to tell the charities what the law is and if there is any question then they say to the charity, 'go off and get legal advice as to how it applies to you'. But they are getting better at producing help booklets and guidelines and that sort of thing. (Solicitor, Charity 35)*

Similarly, a trustee in Charity 22 recognised the problems:

*No, I think it's wrong. I think it's like using any regulator to draw up things. I don't think they should. I think they should give advice and guidance and make sure you're operating within the rules, but if they're going to use their powers as regulators, it's difficult to advise as well. I don't think they can. I don't think they can stand on both sides of the fence.*

Another suggestion was that the Charity Commission could help to form a legal vehicle for umbrella charities, and so encourage more networking and federations.

### *Membership*

One issue to be considered with a membership charity is when to involve them in the merger process. This was said to be a difficult balancing act because input from members could jeopardise merger negotiations in their early stages. Also if a merger does fall through, precious funds will have been wasted in contacting members. However, membership approval is often required to complete a merger so it is vital to have their support, and often this takes time to win, so it is necessary to start communicating with them about the merger as soon as is reasonably possible. For example, in Merger J, an initial announcement at one AGM, suggesting that a merger was under consideration, was followed by an informal survey of members, then consultative workshops, culminating in a vote in favour of merger at the next AGM. Similar events took place in Merger B, where a professionally produced joint document, presenting the benefits of merger was sent to members of both charities before the vote took place.

It is very important to reassure members that their involvement with the charity can continue after the merger. It maintains a base of support for the charity, and personal involvement is often the only thing that a charity member will personally gain from his association with the charity:

*If we were going to get a consensus we had to give, especially to those who were the old guard, some assurances that it wasn't going to be like that. They were still going to have a say, they wouldn't lose their identity, it wouldn't be taken over, it would be an amalgamation. (Chief Executive, Charity 33).*

There are two main hurdles which may need to be overcome with charity memberships: First, securing a vote of agreement from the members where their approval is required to effect the merger (see above p.19); Secondly, maintaining membership by effectively transferring the members to the new charity. In both situations, the problems may be exacerbated if records of existing members are lacking (as in Merger A).

Sometimes the percentage of members votes needed to effect the merger is quite high, and this can make the process slow or difficult if the membership is large. Generally the requirement is a positive vote from 75% of those present at a special general meeting called specifically for the purpose of voting on the change. For example, in Merger B, Charity 3 required at least 75% of members present at a special general meeting voting in favour (and, in order to maintain equality, Charity 4 set up a similar procedure, although this was not required by its governing documents).

Problems can be overcome. For example, Charity 31 in Merger K had a particularly exacting procedure laid down in its governing documents, whereby approval of 75% of the membership was required for merger, and all those voting had to be *present* at the special general meeting. Charity 31 also had a rule allowing it to amend its rules and this only required the approval of 75% of those present at a special general meeting. It was therefore decided in this case to hold a special general meeting to amend the merger rule, and (in line with the charity's rule on amendment) this would only require approval of 75% of those present. The rule was successfully amended so that merger could then proceed on the basis of an amended rule which only required a majority vote in favour of merger.

Voting may prove difficult where there are no records of existing members. Charities may find assistance from the decision in *Abbatt v Treasury Solicitor* (1969) where it was held that in the absence of an express power to alter the rules governing a club, such power could be implied from a favourable response by a majority of members by their acquiescence in a change of constitution. In that case a club (with 180 members) had neither a written constitution nor a provision in its rules for alteration or its dissolution. Nevertheless, at a special meeting by a majority of twenty votes to five, it was decided to change the character of the club. None of the other members took objection to the change. It was later held that the members' agreement to effect the change could be implied from their subsequent notification and acquiescence.

In order to transfer the members of a pre-merged charity into the new merged body and thereby gain the benefit of their membership subscriptions, it is necessary to have a contractual agreement between the individual members and the new body. Members thus need to be contacted and asked to agree to let their membership of the old organisation lapse and join the new organisation. In order to do this, up to date records of members are required. Charities that are maintaining their old bodies as shell charities (see above at p.14) after the merger may wish to delay contacting members to transfer membership until the time when subscriptions would have to be renewed anyway. This avoids the cost of having to contact all the members twice, and means that the charity is less likely to lose supporters at the time of the merger. The solicitor in Merger B suggested that it may also be possible to gain implied consent from members to the transference of their membership. This may occur under normal rules of contract, by simply notifying members of the change and relying on the fact that they do not object. If subscriptions are then paid to the new body, the consent of individual members to their membership of the new body can be easily implied.

### *Trustee Boards*

Generally, there is no legal regulation concerning the number of trustees. The Charity Commission has stated that a well-run charity should have a trustee body of a

manageable size, whose members together have the skills, knowledge and experience needed to run the charity economically and effectively, given its complexity (Charity Commission, March 1999). Many mergers led to enlarged trustee boards. These often consisted of all the trustees from the pre-merged charities. Many recognised that this was not ideal and considered it to be an interim arrangement, partly to appease those who may have been against the merger. It was often left to the first AGM after the merger to whittle down the number of trustees.

Others gave careful thought and consideration to their merged charity's operational requirements and this led to the creation of a very effective governing body. For example, in Merger H, under the new governing documents, an effective board of trustees has been created:

*Nobody's on [the trustee board] just because they want to be a trustee, everybody has to do a role, so everybody on the executive is shadowing somebody with a profession, whether it's human resources, whether it's treasury, whether it's IT ... And for things that are bigger we put two people on, if it's a very big role, and I mean we reckon it works very well and that means there's a great relationship between the trustees and the professionals. So the lay leadership works very well which is really important, that's the key to driving it forward. (Trustee, Charity 22)*

All alterations made to the size etc. of the trustee board must be made in accordance with the procedures laid down in the governing documents of the relevant charity. For example, the Charity Commission model document for an unincorporated association provides for the election of members of the committee at the annual general meeting of the association. In addition, provision is made for members of the committee to be nominated by outside bodies. If the merger is effected by the use of a Scheme (see above at p.19) the Scheme itself may lay down the rules governing appointment of trustees. Depending on the form used for the merger (see above at p.13), the rules may derive from the governing documents of the pre-merged charity or (more likely) these will be amended rules or new rules of a new body. For example, in Merger J, Charity 29's rules were changed on merger in order to allow for election of trustees (see above at p.21).

## Recommendations

### *Legal*

A charity with modern governing documents will generally find it easier to merge if and when that is considered desirable. With this in mind, a regular review of the governing documents of *all* charities should be undertaken (referred to throughout as a 'legal health-check').

The 'legal health-check' should ensure that the charity's governing documents actively reflect the charities' current activities. The governing documents should not act as a barrier, deterring the charity from developing so as to act in the best interests of its beneficiaries.

As part of the 'legal health-check' charities should ensure that their governing documents give them the power to merge.

The 'legal health-check' should include the compilation of an up to date list of the names and contact details of all the charity's members, if there are any.

Careful thought should be given to the optimum legal form for the merged charity.

Early consultation with the Charity Commission and legal advisors is recommended, if only to re-assure the parties at that stage that what they plan to do is feasible. Early legal advice may also save money in the long run.

Solicitors should give careful consideration to a request to act for both (or all) parties to a charity merger. Whilst this is not appropriate in a commercial merger, it can often be a way of speeding things up and reducing costs in a charity merger. It should only be undertaken, however, if solicitors are fully aware of the potential conflict of interest and are willing and able to manage this appropriately.

The law on consent by members to charity merger should be clarified.

### *Practical*

Planning was felt to be a key element in any successful merger, whatever the legal form chosen. It was suggested that every merging charity needs to do a proper cost-benefit analysis and a proper merger plan before they start. This would certainly be a useful exercise.

The role of merger committees is a vital one in the merger as a whole. Membership of merger committees should be limited in number and committees should meet regularly in order to ensure that things progress.

All of a charity's 'stakeholders' (and this includes charity workers - both paid and volunteer - subscribers, members, patrons and funders) should be kept informed of merger developments and consulted if that is considered necessary.

Merger should not be used as an excuse simply to let the trustee board grow in number. By contrast, merger should be used as an opportunity to rationalise and justify the trustee board membership.

Further consideration should be given to the use of umbrella bodies, which may allow networks and federations to achieve similar aims to merger.

## DUE DILIGENCE, RISK ASSESSMENT AND TRUSTEE LIABILITY

This is one area where there seems to be a real conflict between following the model which applies to mergers and acquisitions in the commercial context, and tailoring that model to suit the particular circumstances of charity mergers. Currently, there appears to be some divergence of views as to the best way to proceed.

Mergers involve the risk of potential trustee liability. Charities considering merger therefore need to know what the potential liabilities are and which charity will be responsible for particular liabilities. For example, which charity will be liable to pay employees' salaries and what is the cost? What is the rent on the property that the merged charity will be using and is there any liability for arrears? In order to identify the potential liabilities, it is necessary to carry out what is known in the context of commercial mergers as a 'due diligence exercise'. It will be seen that the commercial process of due diligence provides a helpful starting point for merging charities but, in practice, charities have to adopt a far more flexible process.

In order to set this in context, and by way of introduction, this chapter begins with an overview of the issues as they would be considered in the commercial context.

### Commercial Mergers

#### *Form*

In a commercial take-over, control of a company (commonly referred to as the 'target company') is acquired by a third party. In a merger, two (or more) companies transfer their shares or assets to a third company which thereafter takes the place of the merging companies.

With a share-based transaction, the restructuring is effected by a transfer of shares of the target company to the new parent company or by a transfer of shares of all the merging companies to the new merged company, with shares in the new merged company being issued in exchange. In an asset-based transaction, the original entities may continue to exist (and even to retain their original shareholders) but the assets of the companies concerned are transferred to the new parent company or merged company as the case may be.

#### *The Need For A Due Diligence Exercise*

From the buyer's point of view, one of the greatest fears in undertaking a merger and acquisition exercise is that of finding hidden debts and liabilities of the target company after the sale is completed. In the case of both a share purchase and an asset acquisition, the principle of 'caveat emptor' (buyer beware) applies and the buyer must be satisfied that the business being acquired is worth acquiring at a particular price. Unless expressly imposed by contract, the seller is under no legal obligation to disclose

problems or liabilities attaching to the business. One of the most important components in any merger and acquisition is therefore the investigation or due diligence exercise to be carried out on the target company.

The due diligence exercise should be carried out from an accounting, legal and business point of view and the task is mainly left to the buyer's professional advisers (primarily solicitors and accountants). These professionals produce reports and if they are prepared negligently in some respect and one side suffers loss as a result, it may well be possible to sue them for their negligent conduct.

Basically, the objectives of the due diligence exercise are:

- to determine that the target company has good title to all the assets required to run the business, free from any encumbrances (for example: intellectual property; licences; specific machinery; and, equipment);
- to uncover any hidden liabilities of the target company;
- to ascertain the warranties and representations required to be obtained from the seller;
- to uncover any specific nature or circumstance of the business or the target company which may affect the purchase (for example: dependency on certain key employees; supply of raw material being limited or restricted in any way; lease of land due to expire soon); and,
- to assist in evaluating the worth of the target company.

The due diligence process of itself does not provide the buyer with any legal protection; its purpose is to assist the buyer in making the decision whether to acquire the company and perhaps to negotiate the final terms of the acquisition. If as a result of the due diligence process the buyer discovers, for example, that the company has a liability of which he was not previously aware, he may well seek to renegotiate the purchase price.

### *Timing Of Due Diligence*

The buyer will want the due diligence exercise to be carried out before the acquisition contract is signed and commitment to purchase is given. This is unlikely to be acceptable to the seller, due to the need to maintain confidentiality. It is common in such circumstances for the seller to disclose only the minimum information as the basis of the sale and purchase, subject to the confidentiality undertaking of the buyer. The agreement is then conditional upon the buyer's completion of the due diligence exercise. After the sale and purchase agreement has been signed, the buyer is likely to require more in-depth due diligence to be carried out before the completion date.

### *Liabilities*

The buyer and seller have opposing interests in relation to liabilities. The aim of the buyer is to identify the risks in a transaction, assess the chances of those risks turning into costs or liabilities and to apportion and allocate those risks in the light of that assessment. The seller, on the other hand, wants to put an end to any liabilities that it might have as soon as the transaction is completed.

Under the law of contract, only the rights and benefits under a contract can be assigned; the burdens and all the liabilities of the seller (with the exception of obligations relating to employees – see Chapter 4) are not automatically transferred to the buyer.

A broad outline of the principles of assignment and novation follows. (For further details, see Treitel, 1999, ch.16.)

The benefit of a contract may be transferred to the buyer by way of assignment. The seller (entitled to the benefit of the contract) enters into a transaction with the buyer as a result of which the buyer (assignee) becomes entitled to sue the person liable under the contract (the debtor). The debtor is not a party to the transaction and his consent is not necessary for its validity.

The converse process of the transfer of a contractual liability without the consent of the creditor is not possible by way of assignment. This requires novation. Novation is the replacement of one contract between two parties with another contract, either between the same parties or others. Contrary to assignment, novation requires the consent of all parties. The effect of novation is not strictly to transfer a liability, but to extinguish it and put a new one in its place. Consideration is still required for the new contract but it is usually assumed to be the discharge of the former contract. The criteria for a successful novation is the complete acceptance of the liability by the new debtor, the acceptance of the new debtor by the creditor, and the acceptance by the outgoing creditor of the new contract as full performance of the old contract. Novation tends to be uncommon because of the requirement of the agreement of all parties.

If the seller company has certain contracts, licences, or benefits which are non-transferable but crucial to the business, then purchase by way of a share-based transaction may be the only option. However, it is important to note that the benefits sought to be secured together with the business are often subject to the condition that any change of shareholding of the company requires the approval of the relevant issuing body.

Clearly, the sale of a business does not *per se* absolve the seller of the liabilities associated with the business. On a purchase, all liabilities remain vested in the target company. If a seller cannot terminate its responsibilities on completion, it must consider the extent to which they are allocated. A buyer may be prepared to take on future liabilities where there is:

- a full disclosure of information;
- the risks involved are small or the price reflects the value of the company with known costs and liabilities; and,
- the buyer accepts the risks because they are involved in similar operations.

Where liabilities remain with the seller, it may be possible to set aside funds to meet any potential costs or liability. The amount clearly depends upon the risk involved.

### *Warranties and Indemnities*

The most common way of allocating the responsibility for risks between the merging parties is by inserting warranties, indemnities and / or other contractual terms in the

transactions. As part of the terms and conditions of the acquisition contract, the seller may be required to give certain warranties and indemnities to the buyer as regards the state of the business and its assets and liabilities.

A warranty operates as an assurance that a particular state of affairs exists, and if it is not as stated the warrantor will be liable (see, for example, Sale of Goods Act 1979, section 61(1)). Claims for breach of warranty are based upon general contractual principles. Breach of warranty gives rise to a right in contract to damages upon proof of the agreement between the parties, breach of the warranty, and proof that the damage in respect of which the claim is made flowed from that breach. The buyer will also have to take steps to mitigate his loss and to show that any loss suffered was reasonably foreseeable.

An indemnity is a contractual obligation by which one party agrees to keep another protected from a specific loss (*Yeoman Credit v Latter* [1961]). In the case of a breach of indemnity, a buyer should, subject to any contractual limitations, be able to recover any loss actually incurred by him as a result of the breach. The amount recoverable will depend upon the specific wording of the indemnity. Where a seller indemnifies in respect of a specific liability, there is no need to prove damage to the buyer if the liability in question crystallises (Tolley's, 2000).

As a basic rule, a warranty is more likely to provide information to a buyer and to 'flush out' potential problems, while an indemnity is likely to give better protection.

It is common for contractual limitations on the warranties and indemnities (for example, as regards duration and the financial minimum and maximum amounts of a claim) to be accepted by the buyer. In addition, written disclosures to the warranties and / or indemnities which are acceptable to the buyer and in respect of which no liability will arise, are commonly accepted by a buyer from the seller prior to the completion date (called 'a disclosure letter').

## Charity Mergers

While the idea of a due diligence exercise is one that equally makes sense in charity mergers, the research shows that the commercial model of such an exercise is not always appropriate. The basic difference between a commercial merger and a charity merger is that no 'purchase' will be made of one body by another. Due diligence in a charity merger is not therefore about justifying a price:

*The thing is what you're looking for is a liability ... which could call it off ... So you're not merely trying to find out what the value of all this actually is. So it's not so much an actuarial exercise. (Solicitor, Charity 27)*

Ordinarily, it was not done in the same way as in a commercial context:

*The client did instruct a well known firm of accountants to look into this as a sort of preliminary to going ahead, but there wasn't a due diligence exercise such as you might find in the commercial mergers and acquisition field. There certainly weren't any warranties and representations ... but the 'level of comfort' was created by having an external firm of accountants doing due diligence in that way. But certainly I don't think we got involved in answering lots of detailed questions about leases and things. (Solicitor, Charity 3)*



Following the commercial model, it is the ‘buyer’ that is concerned with due diligence, not the ‘seller’. By analogy then, if a charity merger is effected by a straightforward transfer of one charity into another existing charity, it might be considered that there is no obligation on the transferor to undertake a due diligence exercise. The buyer has to beware but the seller (in this case transferor) is effectively winding up, so would not need to carry out a full due diligence exercise. However, in the charity context, there was agreement that, because there is a general fiduciary duty on trustees to act in the best interests of the charity, every charity merger requires *some* sort of a due diligence exercise to be conducted, and it is the responsibility of *all* the trustees to ensure that this is done:

*I think it is essential that people go through that process because I don't think they are discharging their charitable and governance duties if they don't. (Consultant, Charity 2)*

So, for example, with a straightforward transfer, the trustees of the transferor body would be under a duty to ensure that the transferee was a body with the same or similar objects and that any restrictions were honoured.

### *The Depth of the Due Diligence Exercise*

Almost all charities within the research conducted some form of due diligence exercise. The main differences between them were the depth of the exercise and the subsequent way in which liabilities were allocated. There was, however, agreement that the four main areas which the exercise must cover are:

- the culture of each charity;
- the management structure (paid workers);
- the governance structure (trustees); and,
- the financial state of affairs.

The first step in any merger is to ensure that the charities concerned are actually compatible. Therefore the initial assessment made should be to ensure compatibility. In fact, whilst solicitors were keen to focus on liabilities, others placed more emphasis on this ‘cultural fit’ being a key to a successful merger. This is consistent with a recent survey which found that the fear of losing a charity’s ‘culture’ was a significant factor deterring charities from considering merger (Wethered, 1999). Cornforth also notes that the failure of many commercial mergers stemmed from the fact that insufficient attention was often paid to the difficulties of integrating different organisations’ cultures (Cornforth, 1997). One consultant emphasised the importance of trustees finding out for themselves about the culture and values of the other charity before proceeding to use outsiders to carry out other elements of the due diligence exercise. Guthrie has created a list of issues to explore in order to identify potential merger partners’ ‘organisational culture’ and these range from how meetings are conducted to norms about what people wear (Guthrie, 2000).

If the cultural fit appears to match, then a more in depth due diligence exercise focussing on liabilities is usually carried out. The Chief Executive of Charity 1 in Merger A described due diligence:

*It's not a goal in itself, it's about doing your best to satisfy yourself that you have covered the basics, looked at all the options and you just have to do the best you can on the evidence you've got to enable you to make a decision, a very sensible stand.*

At this stage, it is helpful to prepare a checklist of aspects to be investigated. This will help to estimate the magnitude of the task in any particular merger, since all mergers are different. The main aim of the exercise is to discover the nature and extent of the liabilities of the merger partner in every aspect of the running of the charity. This would include an examination of the financial situation of the charity, including potential continuing obligations (for example, leases – see below at p.62), the number of workers and their employment status, and an investigation to ascertain whether or not there is any outstanding litigation. Lists of the sort of issues to be considered during a due diligence exercise are contained in Guthrie’s study (Guthrie, 2000) and in Johnson and Carter’s work (Johnson and Carter, 1999). Phillips also notes that potential tax liabilities need to be investigated; a charity will need to check that its potential merger partner has conducted its trading operations through an appropriate structure and that no tax liabilities are likely to arise as a result (Phillips, 1996).

A number of charities and their advisors spoke of the due diligence exercise ‘flushing out’ information that would otherwise not be available:

*All sorts of things came to light, such as a company that had been set up to operate a partnership with [a local authority], which hadn’t done anything, and it was a question of whether there were any liabilities in respect of that company. Just little asides like that, but nothing major. (Solicitor, Charity 11)*

Circumstances surrounding the merger may dictate the depth of the due diligence exercise. For example, in some mergers, especially those which are rescues by another name, although the rescuer charity might have wanted to conduct a proper due diligence exercise, this was simply not possible because of the state of record keeping, missing files and deeds, absent trustees etc. within the failing charity:

*It was impossible to carry out the most basic exercises into due diligence because of lack of records... We could never get a clear statement of the liabilities and be confident that it was comprehensive so we had to make a decision and accept it. (Chief Executive, Charity 1)*

In these cases, charities must work with what is available, interviewing staff and trustees to find out the terms on which property was held, the employment history of the staff, its main funders etc.

Another consideration which may impact on the depth of the exercise is the state of the relationship between the merging charities prior to merger. In line with earlier studies (e.g. Cowin and Moore, 1996), there was some prior relationship in many mergers within the research sample before merger was firmly on the agenda:

*I think because of the fact that we were on the same site ... we’d always had the same solicitor for [Charity 31 and Charity 32 and a related trading company]. We’d had the same auditors, who actually were also our accountants for all three. So everybody knew everybody else’s business so it really was unnecessary ... and because my job was the same on both and I was the controller of the finances, I knew exactly. (Chief Executive, Charity 33)*

When the question of due diligence was raised with the Finance Director of Charity 27 in Merger I - a merger of 4 related charities - his response was:

*The issue of due diligence by and large is to protect the trustees from something that they might not otherwise be aware of or exposed to, but in this case even though they were all acting in*

*separate roles they probably all shared that responsibility anyway ... There wasn't a great deal of point in spending legal money on it when it comes down to it because we would only be checking ourselves. It wasn't like acquiring a third party charity, in which case that would absolutely be necessary.*

Amongst some charities that had a prior working relationship, there was a sense that mergers are conducted in a 'trusting atmosphere' where insisting on thorough due diligence and the giving of warranties was not appropriate. Personal assurances were seen as being sufficient. For example, in Merger L, the Finance Director of Charity 34 talked about the merger process being conducted 'in good faith'. Amongst charity advisers, there were unsurprisingly few that took this view, preferring instead to be cautious about potential future liabilities:

*So really the aim is to try and get the clients to focus on [due diligence] at an early stage and not to assume necessarily that they know everything about the merging entity. (Solicitor, Charity 36)*

As a number of advisors pointed out, Charity Law imposes a series of burdens on trustees that they might not even be aware of themselves. For example, the rules regulating conflicts between a trustee's personal interest and the best interests of the charity may well be understood by trustees in the abstract but are often difficult to appreciate in context. Due diligence can be an educative process, revealing the extent of trustees' own responsibilities, as well as the assets and liabilities of their merging partner.

Given these considerations, it is not surprising that due diligence exercises differ in scope and depth as between one charity merger and another. There may not be one overall report drawn up, but a series of investigations, whereby specialist advisors deal with the different aspects, for example, the accountants report on financial aspects, while the solicitors report on employment issues and the state of property holding etc.

#### *Who Undertakes the Due Diligence Exercise*

In some charity mergers, it may well be appropriate to adopt the commercial model and call in professionals to produce a report. However, in the majority of cases in the research sample, this was not the case. Some legal advisers suggested that it may be best for their charity clients to undertake the due diligence exercise in relation to their merging partners themselves:

*There are real arguments for trying to get the client to do it, using guidance from professionals, because if the client does it what they're doing is educating their own staff about what is in the filing cabinet. If I go and look at a cabinet and I go through saying 'nothing in this, nothing in this', most of that information is wasted. I'm preparing a negative report. Whereas if they put their assistant manager in there, he at least knows what's in the cabinet. (Solicitor, Charity 1)*

In the case of Merger M, for example, Charity 36, already armed with the experience of previous mergers, sought professional advice as to what do, and then the Finance Director went into Charity 37 with a checklist covering a whole range of areas, such as property, personnel, fixed assets etc. The Finance Director managed to pick up on potential problem areas in relation to: licences; covenants in leases; potential employment disputes; and, a potential claw back on some funding. These matters were then passed forward to solicitors for further advice:

*It's getting the balance right really ... I mean due diligence is a very crucial area and you can't be cavalier about it and say, 'well I'll save some money and pop in one afternoon and do it myself'. It would be silly. You need to use your judgement and do what you need to do and where there is technical expertise needed, such as leases, fine, but you don't need to get auditors going in there and seeing what their assets are. You can do that, asking questions and getting assurances. A happy medium I think. (Finance Director, Charity 36)*

*The client had a very good feeling about what was there actually and had a concept in its mind about what needed to be done, whether or not there was a problem and how big that problem was. And what we tried to do was provide a kind of risk matrix on that. (Solicitor, Charity 36)*

In other mergers, the initial due diligence exercise consisted of the compilation of reports for each area of activity of both charities by those within each charity responsible for that area. So, for example, in Merger H, the Finance Directors of both Charity 20 and Charity 21 each compiled a report of their own activities and then fed that information back to the merger steering committee.

There was agreement that, in a complex merger it was important to spend money on getting the best due diligence search possible. The complexity is not determined by the size of the merging charities. It was accepted that solicitors might be best placed to conduct (or at least oversee) the due diligence exercise, where the nature and complexity of the merger so demanded.

### *Liabilities*

There are many different types of restructuring that take place under the heading of charity merger (see above at p.13). In some cases, the process will be fairly ordered and one step will follow another until there comes a point when all would agree that there has been a merger. Other mergers will be less clear cut. Both charities may remain on the Register of Charities so as to collect any future legacies. There may be a transitional stage when a new board composed of trustees from both pre-merged charities is running at the same time as the old boards continue to function.

The allocation of liabilities post merger will, to a large extent, depend upon the form that the merger took. For example, if the old charity winds up on merger, then its assets may be transferred over to the new body on the day that the old charity is wound up. Where, as is more common, the old charity continues in existence, not all liabilities will be transferred and the old trustees may still be liable. The sorts of liabilities that may arise include: contractual liabilities; obligations under leases; unpaid tax etc.

As with contracts by commercial bodies (see above at p.32), charities' contractual liabilities cannot be legally easily assigned to unconnected third parties. Quite often, however, informal assignment seemed to take place:

*They had a number of contracts: car leases, contracts with some suppliers, and they had some leasing contracts with photocopiers and things like that. Some of them ... were happy just to change the name and be paid by a different [Charity], they were happy to carry on. Others said, 'well exactly what happened?' and then we had to go through a more formal change. So it was very dependent on how people reacted. Most of our suppliers we just notified them of a change of name or we said that [Charity 4] had transferred over and in future please make*

*invoices payable to [Charity 5] and 90% of people were quite happy with that.* [Finance Director, Charity 5)

The types of informal assignment encountered, however, leave the potential for future liability. This may result back to the pre-merged charities, if they remain in existence and are incorporated. If they are unincorporated, there is the potential of personal liability for trustees.

Some contracts might be non-assignable. As with commercial mergers (see above at p.33), this problem may be resolved by choosing a form of merger in which the charity with the benefit of the contract remains in tact. However, again, as with commercial mergers, some contractors may stipulate, for example, that changes to the governing body of the relevant charity require the contractor's consent.

Novation is not considered to be an appropriate solution in charity mergers, due to the fact that it is time-consuming and costly (see above at p.33). Yet, in interview, most charities were of the view that post merger, all liabilities of the pre-existing charity or charities were subsumed within the post-merger charity. To take the example of Merger A:

*Oh yes, one of the things we resolved to do was to transfer the assets and liabilities of [Charity 2] to [Charity 1].* (Chief Executive, Charity 1)

If liabilities do remain with the old charity, as a way of offsetting the costs of those future liabilities, some assets might be left behind on merger. This is not ideal, however, if potential liabilities are unquantifiable or even unknown (a thorough due diligence exercise will, however, reduce the chances of the latter occurring). It is also not very neat:

*The trouble is that the old organisation generally wants to drop dead. All the trustees don't want to be coming to meetings just to pay bills.* (Solicitor, Charity 1)

There is obviously confusion in this area:

*No, we have taken on all their assets and all their liabilities, which includes trustees' liabilities. Although, having said that they did insist on retaining in the shell charity a sum of money, which I now realise was to cover the industrial tribunals, but we're dealing with those and we're paying for those and even though it says in the agreement that we have taken on all their liabilities, they've still got a retention. We'll get it in the course of time.* (Finance Director, Charity 36)

With employment matters, liabilities automatically transfer to the new charity, if there has been a transfer of undertakings (see below at p.49). In relation to other areas of litigation, practically, the dangers might not be as great as they might appear as many litigants will be deterred from suing a charity which has merged and appears to have few assets.

### *The Giving of Warranties*

The employment of warranties and their purpose varied within the research sample. This area, of all, perhaps provides the best example of the tensions which exist between adopting commercial practices and taking a more pragmatic approach, more

in line with the ethos of the charitable sector, and which recognises that charity mergers are different.

In the commercial context, those giving warranties are also those who have just been paid a sum of money in exchange for their business. They therefore have some proceeds of sale out of which to meet claims for breach of warranty. The transfer of assets in a charity merger appears to take the form of a gift. However, the true price of the asset is often the transferee's undertaking to settle some or all of the transferor's liabilities. Warranties and indemnities may be relevant if, for some unexpected reason, the assets transferred cannot be used to meet those liabilities, or, if the liabilities are greater than anticipated.

With charity mergers, if the charity giving the warranties is unincorporated, individual trustees act in a personal capacity on giving warranties. This means that if there is a breach of warranty the trustees may be sued personally for the damage caused as a result of the breach (see above at p.33).

This gives rise to both a practical and an ethical problem. First, practically speaking, if a problem were to arise, it might be unrealistic to sue the trustee for breach of warranty. A warranty or indemnity is only as good as the person giving it. Therefore, where liabilities are likely to amount to significant sums, the person giving the warranty must be able to cover such losses. Lack of resources, therefore, on the part of the individual trustee may mean that there is a chance that losses caused as a result of breach of warranty would not be recoverable. Secondly, an ethical issue was raised during the research. Would an action against an individual trustee for breach of warranty appear inequitable, regard being had to the voluntary nature of trusteeship? Although the view was expressed that it was unfair to expect volunteers to accept such liability, another view was that the voluntary status of trustees should not affect the question of giving warranties, especially bearing in mind the extent to which the liabilities could be limited. Trustees, upon undertaking their trusteeship, take on all the onerous obligations of a trustee, and these might include having to give warranties in certain situations.

These practical and ethical problems mean that not all charity mergers involve the giving of warranties. However, where the use of warranties *was* advocated in the context of charity mergers, it was often along with a recognition of their hidden value. This was that it sharpened the minds of the trustees giving them. It made them less complacent about what they signed and more interested in discovering the true state of affairs of their own charity, thereby enhancing the quality of the due diligence exercise. Perhaps this says more about trusteeship than it does about charity mergers. Trustees would warrant that certain statements (for example, that there was no outstanding litigation involving the charity) were true or, true, to the best of their knowledge or belief (the latter formula carrying a much lower risk of liability). Apart from this, the warranty would simply reflect what trustees ought to be doing anyway. For example, it would state that the trustees had acted prudently, had not committed any breaches of trust etc:

*We managed to get [Charity 37] to understand that it was right for their trustees to retain responsibility for certain issues, such as breach of trust and wilful default ... I think that's why you look at the issue and put some effort into it is that you should be able to come to a decision of getting some 'comfort' in relation to certain things even if you can't go the whole way. And*

*also it's important in that it tends to be part of the process. That kind of discussion will help 'flush out' issues that might not otherwise come out. So the mere fact of, say for example, including some proper reasonable warranties in the document, in the draft that was made between the parties, will actually raise these things. (Solicitor, Charity 36)*

As one adviser who used this method explained, should some untoward matter arise later, it was highly unlikely that the old trustees would actually be pursued for breach of warranty. At that time, they may be trustees of the new merged charity, or not worth suing anyway. Warranties, in this context, are a spur to greater trustee attentiveness with a sanction that, in practice, would seldom be invoked. So, the benefit of using warranties was that it was regarded as an aid to assessing (and managing) risk. It was also suggested several times that such warranties provided a 'level of comfort' to those in whose favour they were signed.

Even when there is agreement that warranties should be given by volunteer trustees, the content of those warranties is also contentious:

*In the charity sector, most people I think would say, 'look, you can't really ask a volunteer trustee to do anything more than give an assurance about what they actually know or have actually done'. So, it would be reasonable and I think proper to say to a charity trustee, 'I want an assurance from you that you haven't been stealing money from the charity' and I would say that should be an unqualified warranty. (Solicitor, Charity 34)*

To illustrate his point, the same solicitor went on to say that it would not, in his view, be appropriate to obtain a warranty from the same charity trustee to the effect that *nobody* had been stealing money from the charity. To add to the complexity, however, it might be considered appropriate for the trustee to warrant that he had taken all reasonable steps to *prevent* anybody from stealing money from the charity. A trustee of Charity 36 summed up the dilemmas in this area. This trustee was showing his charitable leanings, but also revealing his professional corporate background:

*The track I followed was to take a very hard line in negotiation and push for full warranties, full indemnities as a tool to 'flush out' any issues because the trustee on the other end feels totally self exposed and would, therefore, go slightly further than they might otherwise go to actually bother to find out. But when it came to the crunch, I was quite relaxed in watering them down quite significantly knowing perfectly well that:*

- (a) the people might not be financially good for it anyway, so what's the point;*
- (b) I didn't want to destroy the relationships, which needed to be good and ongoing; and,*
- (c) morally it just didn't seem right that when someone has committed voluntarily to do what they've done, to then try and penalise them financially. (Trustee, Charity 36)*

This trustee's tactic was to push hard for warranties as part of the *process*, but at the end of the day, he did not regard their ultimate signing as of such great importance. Some advisers went further and considered the signing of warranties to be ill-suited to charity mergers and a waste of time and money:

*You know, in the present case we ended up with no warranties if I remember rightly ... I could be criticised for allowing them to do it. But at the same time you're in this very difficult situation where nobody wants to spend any money writing a telephone book, so it's a difficult field. (Solicitor, Charity 34)*

The Solicitor interviewed in relation to Merger A complained that he had been involved with other charity mergers where the 'other side' had wanted to attach warranties. When he questioned their appropriateness, he was told that they were not

intended to impose personal liability on the trustees, simply to provide some reassurance to the other side:

*And my answer is, 'why are you writing in a whole series of promises which don't give you any benefit? All you're doing is charging them for work writing the warranties' ... I said 'if you're telling me that there's no penalties behind our trustees giving these warranties, why are your trustees getting any reassurance out of it?'* (Solicitor, Charity 1)

Even where warranties and indemnities are signed, as in the commercial context, the scope of liability can be restricted. In the charity context, restricting the scope of individual trustees' liabilities can be done by using one of the following methods:

- taking out insurance;
- making a disclosure to the warranty in respect of which no liability will arise; or,
- limiting the extent of liability to a fixed sum.

These are very similar to the techniques used in commercial mergers.

In cases where warranties are regarded as inappropriate, charities that are merging might take other steps to minimise the risk of being saddled with a great burden at some time in the future:

*I think a better way to deal with it [rather than by the use of financial indemnities and warrants] is to keep the charity going with some restricted ring-fenced fund in it for this particular purpose, or the other way of dealing with it is to actually put that money into a special account of the new charity, the merged charity, for that particular purpose and then if there is a balance at the end of the day then that's transferred to the general fund of the charity. So you can always deal with these.* (Solicitor, Merger J)

## Recommendations

### *Legal*

One legal adviser raised the possibility of having a standard set of questions (a template) that could be used by whoever was conducting the due diligence exercise. In effect, some charities that are merging are already operating such a system.

It might be appropriate for the Charity Commission, or the Charity Law Association to draw up a comprehensive list of issues to be considered as part of the due diligence exercise in order to ensure that all potential liabilities are covered.

Clarification of the law on the informal transfer of contracts would be welcomed.

Merging charities should give greater attention to the allocation of liabilities.

There should be some clear-cut formulae adopted in order to allocate liabilities between pre and post merged charities on merger. At present, there appears to be some blurring around where liabilities lie and no guidance to ensure that charities clearly allocate liabilities.

The use of warranties and indemnities, as they are used in the context of commercial mergers, is not appropriate to charity mergers. Their negotiation is a time consuming process which can prove costly for charities and their use appears to provide no more than a false 'level of comfort' to merging charities. Their secondary use of enhancing



the due diligence process per se might be accommodated by an education programme for charity trustees in relation to their duties of disclosure upon considering merger.

Careful consideration should be given to the effect of warranties in the charity merger context.

If warranties are to be used, precedents should be developed with the sole purpose of being employed in charity mergers.

It is perhaps in this area above all others that charities and their advisors should acknowledge that many of the principles that apply in relation to commercial mergers do not sit comfortably in the context of charity mergers. As one solicitor put it:

*The application to a charity merger of all the rules, principles, processes and documents which apply to a commercial merger (or take-over) is like trying to play a violin concerto with a brass band! (Solicitor, Charity 34)*

### *Practical*

It is suggested that more charities might benefit from taking a ‘hands-on’ approach to the due diligence exercise rather than leaving it to solicitors to conduct in full. A three-stage process is recommended:

- Professional advice is taken from solicitors as to what needs to be ascertained (so the template is provided);
- Charity workers (either trustees or employees - whoever is best qualified to undertake certain aspects of the process) do their best to ascertain the relevant information, guided by the template; and,
- Having ascertained the information, they then refer to solicitors any areas which need further advice.

The trick, of course, in this third stage, is that the charity workers need to realise that further advice is required. If they are not able to fulfil this function, then it is suggested that solicitors will need to play a greater role in the exercise from the start.

## EMPLOYMENT

Guthrie suggests that, while Employment Law makes mergers more complex, the increase in legal prescription takes away much of the uncertainty that would otherwise exist for both organisations and individual employees (Guthrie, 2000). This research does not bear out this finding, largely due to the fact that the relevant legal principles, whilst admittedly complex, are neither clear nor fixed.

The problems surrounding employment which arise during merger situations have been some of the most difficult issues that charities within the research have had to face. There are a number of reasons for this:

- Employment law is a complex, often uncertain and constantly evolving area of law for all employers to understand and implement;
- The application of some areas of Employment Law may be particularly difficult for charity employers; and,
- These legal difficulties have to be overcome against a background of the ‘human element’ of mergers - dealing with people can be challenging in itself.

In about half of the mergers examined, Employment Law specialists were consulted. These usually came from within the firm appointed to deal with the merger as a whole, but in Merger E, specialist Employment Law solicitors were appointed, in addition to the general legal advice sought. In Merger H, independent employment consultants were appointed, simply to deal with the personnel aspects of merger. When it comes to mergers, taking into account the employment regimes of the workers of the pre-merged charities involves dealing with the interests of many different people and groups, each with their own point of view on the merger. As the Employment Law Solicitor in Merger E put it, ‘the difficulty in the merger was bringing together two wholly different organisations and in particular the ethos’. In Merger H, a trustee of Charity 22 commented:

*It's only now that we have a cohesive team that doesn't feel that it's [Charity 20] or [Charity 21]. They call themselves [Charity 22], and it's taken two, three years and it does. You can't expect people to say 'well I was working for them but now I'm working for a new organisation'. It doesn't work like that. It's taken a while. But we've virtually got there now.*

Workers, who may be justifiably concerned that their present jobs are under threat, may need constant reassurance. The Personnel Manager, originally with Charity 20 in Merger H summed up the feelings of many:

*I just think it took a long time and it was quite upsetting and a very anxious time for a lot of people. There is no way of changing that. ... Even people that knew that they weren't going to be affected in any way, there was still some anxiety around because half of you thinks, 'well I'm fine', and the other half thinks, 'well maybe'.*

Other research has also found that, in charity mergers, staff feared redundancy more often than it occurred (Cowin and Moore, 1996). This can make the process of negotiation and decision making very slow and an impasse may be reached. In a study

of aborted voluntary sector mergers, in three out of the four cases, the appointment of the new Chief Executive became a focus for conflict, and in one case, the merger negotiations foundered on precisely this point (Cowin and Moore, 1996). Billington also recounts a case where negotiations broke down because the Chief Executives involved realised that one of them would have to leave if the merger proceeded (Billington, 1998).

## Practice

In practice, more problems relating to employment turn out to be operational and managerial rather than legal, although the legal issues cannot be ignored.

The charities within the research recognised that the workforce is an extremely important resource, which should be maintained on a merger. Whilst Merger H provided a rare example of the charity staff leading the way for merger, it was found that, ordinarily, the decision to merge (or to consider merger) will have come from the trustee body and not from within the charity workforce. Yet, it was also acknowledged that the whole merger process will be much smoother if the workforce is willing and is persuaded of the advantages of merger. In an American study of non-profit mergers, a joint retreat for staff of both charities which were to merge, during which staff's questions and concerns were addressed, was credited as being the pivotal factor in enhancing morale and increasing productivity during the implementation of one merger (Singer and Yankey, 1991).

### *The Importance of Due Diligence*

The workforce within a charity can be very diverse, and their working arrangements unusual. For example, the workforce may include: workers who are paid in kind; workers with unusual terms of employment; individual workers whose terms and conditions are very different from the rest of the workers; and, people working voluntarily. Whilst it may be difficult to establish the employment status of workers and, if they are employees, who is their employer, these distinctions can be very significant for charities considering merger. It means that an operational due diligence exercise, to explore and discover the different employment arrangements, is invaluable (see, in general, Chapter 3). The process shines a light into dusty corners and may well reveal unusual employment practices within the charity. In Merger E, the due diligence check revealed, for example, that there was one employee in Charity 11 who had been on almost permanent sick leave for two years, with no warnings about absence having been issued. In Merger I, checks uncovered some 'amateur contract writing' including entitlements that one might not have expected. At the very least, the due diligence exercise must ascertain the number of workers and their cost to the charity. This sort of operational due diligence check need not necessarily be carried out by professional advisors. As well as looking at written contracts of employment, discussions should explore working customs and practices (which may also be considered to be contractual) within the charity. For example, there may be established practices concerning: work location flexible hours; taking days off in lieu, arranging cover; and, annual salary reviews, etc., which can only be revealed by asking the right questions.

Diverse working practices within the sector, together with uncertain funding regimes, may have contributed to the fact that, in general, charities do not have the best records as employers. Recent research has shown that employment tribunal cases involving charity employers were at almost double the levels reported in private and public sector organisations (Cunningham, 2000).

### *Volunteers*

Many charities have on their staff not only employees but also volunteers. It is important to try to retain those volunteers at the time of a merger for continuity within the new organisation. Within the research, the charities were unanimously of the view that volunteers should be regarded as fellow professionals and should therefore be treated in the same way during the time of merger, for example, with regard to consultation and the provision of information:

*We work a lot with volunteers. ... They are also rather more passionate about the things that they do. Not just the volunteers at a trustee level, but the volunteers in the field are passionate about making grants or whatever. We spent a great deal of time going over the country listening to people. (Finance Director, Charity 27)*

*There were other constituencies like volunteers, who were members as well as being people who were giving their time and resource, and consultation was generally done by public meetings at which volunteers were asked to come along to take the opportunity to ask questions and see the presentation from the board of trustees or seek their managers' views. (Trustee, Charity 36)*

### *Consultation*

Consultation of staff is an important element in a merger. Whether TUPE applies or not, (see below at p.50) it is suggested that the consultative process should adopt TUPE principles (see below at p.55). It should be done as early as possible in order to allow for meaningful discussions to take place, although it is necessary to balance this with the fact that if consultation is begun too early it could lead to problems of morale amongst staff. There is no point in informing staff of a possible merger if it is later considered not to be feasible. In most mergers within the research consultation did take place at an early stage. For example, in Merger J the consultative process started 'right from day one'.

The consultation process itself is very much a selling job. Irrespective of TUPE, the solicitor in Merger A said:

*We always advise it, a series of meetings, making people available to discuss things. It's part of the package of selling the change anyway.*

Charity workers can be quite conservative and do not want change, so it is necessary to convince them of the benefits of the merger. Staff tend to worry and need reassurance:

*We went to see them, and I went down to talk to the staff to make a presentation about our plans, which emphasised that we were not looking at cutting posts or removing people as a matter of top priority, but that we had to be sensible about the financial realities. So we weren't promising them complete security, but we were promising that we wouldn't come in and just slash and burn. (Chief Executive, Charity 1)*

*We gave them an undertaking that the [Charity 4] staff - because they were the ones changing from one Charity to another - their terms and conditions would not be adversely affected and there was a letter given to each of them from their past employer and one from their new employer just setting that out. (Finance Director, Charity 5)*

Information provided to staff must be of sufficient quality to allow them to understand both the reasons for the merger and its implications for them. It is important that staff are told the truth, so that they can appreciate the motivations for the merger. In Merger H, where bi-monthly updates were given to staff, the Personnel Manager commented that 'you can never have too much communication'. Similarly, during interviews carried out for a guide to mergers for Crossroads schemes, the most frequently mentioned word was 'communication' (Palmer, 1999). In relation to opportunities for consulting with staff, it has been suggested that as a general rule, it's better to err on the side of plenty and let the staff decide how many options they wish to take up (Johnson and Carter, 1999).

Often consultation is done via the relevant trade union if the workforce is unionised, and this will be necessary for a TUPE consultation (see below at p.55).

The research found that merging charities often place much emphasis upon consultation with their staff and feel that it is an area in which further guidance would be helpful. The Employment Law Solicitor in Merger E described the consultative process as 'tactical'. Legal requirements aside, charities consider this to be a process which must be handled with sensitivity in order to 'carry the staff (paid and volunteer) along' with the merger. It is considered important that employees feel 'part' of the merger, rather than having it forced upon them. Charities are often keen to avoid high staff turnover post merger, and like to give plenty of notice of impending changes. In Merger A, for example, the employees of Charity 2 were aware of the possibility of merger 'about a year before it happened'.

### *Pension Schemes*

Pension schemes caused concern for a number of mergers within the research, since it was often in this area that workers within the two merging charities saw the greatest discrepancies in their terms and conditions. Pension schemes do not fall within TUPE (see below at p.49) but can be an area where workers are not willing to compromise, especially if their pre-merged pension arrangements were generous. In Merger B, there was an attempt to start a new pension fund for the employees of the new merged charity. Obviously, the implications for each individual employee of stopping their original pension and transferring their funds to the new one, will vary. The Finance Director of Charity 5 was willing to provide a one-to-one counselling session by a financial advisor with members of staff, in order to discuss the individual implications of joining the new scheme. In Merger H, the pension scheme of Charity 20 was wound up after the merger, with a surplus being paid to its members. The Finance Director of Charity 36 (Merger M) suggested that pensions should be within TUPE so that they could be used as a bargaining tool when negotiating new terms, in order to harmonise terms and conditions post merger (see below at p.52).

## Problem Areas in Employment Law

### Employment Status of Workers

It is important to determine the employment status of individuals who work for a charity. From a legal point of view, generally protection is only given to 'employees'. A charity sometimes has difficulty in precisely defining the employment status of its workforce. It may be that the time of merger brings this issue into focus. For example, in Merger M, the due diligence search revealed the existence of a 'worker' claiming unfair dismissal, whose employment status was unclear. She had originally been an employee, had then resigned and had become a 'consultant / counsellor'. When her contract as 'consultant / counsellor' ended she claimed unfair dismissal and the initial issue was whether she was an employee or not, as only employees can claim the benefit of the right not to be unfairly dismissed (Employment Rights Act 1996, section 94).

Of much more general application within the charitable sector is the use of volunteers. The impulse to serve as a volunteer is strong and widespread. In 1998, the Institute for Volunteering Research published the third national survey of volunteering (Davis Smith, 1998). It was found that since 1991, when the last survey was conducted, the rise in volunteering had flattened out, so that, in the previous twelve months, just under half of the population had volunteered at least once. This represents a total number of 21.8 million volunteers in the UK, giving a total of 88 million hours per week.

For many years, charities have taken advantage of the services of their volunteers, generally without fear of such 'workers' being able to claim any employment protection rights. However, recent cases have sought to challenge the traditional non-protected status of certain 'volunteers'. For example, in 1994, an employment tribunal held that a Relate marriage guidance counsellor was in 'employment' within the meaning of the Race Relations Act 1976 (*Armitage v Relate*, 1994). The tribunal's decision was based largely on the obligation on counsellors to repay the cost of training provided by Relate, if they left before providing 600 hours of counselling, the requirement to work a minimum number of hours each week and the fact that training led to an opportunity for paid work with Relate. A rigorous selection and training process, including a day-long residential interview were also relevant factors.

Another case, which has caused concern for charities is that brought at the end of 1997 by Mrs Chaudri, who worked as a 'volunteer' for the charity, Migrant Advisory Service (MAS), and who successfully challenged her volunteer status when her services were dispensed with following her announcement that she was pregnant (*Chaudri v Migrant Advisory Service*, 1997, later upheld in the Employment Appeal Tribunal - *Migrant Advisory Service v Chaudri*, 1998). Since 1994, she had worked for MAS four mornings per week undertaking general typing and office administration duties. She was paid £25 per week (later increased to £40) which was stated to be weekly 'travel and subsistence expenses' by MAS. However, Mrs Chaudri lived near to the office where she worked and finished work by lunch-time each day, and therefore incurred no travel or subsistence expenses. The payments were also made when Mrs Chaudri was off work, either on holiday or due to sickness. Looking behind the 'label' placed upon the relationship, the tribunal was influenced by the fact that 'expense' payments were made to her at a flat rate, even though her expenses were

negligible. In effect, the payment was merely a disguised form of wages. Other influencing factors were that she worked regularly and for a substantial period of time.

These cases show that the tribunals are attempting to distinguish genuine volunteers, currently largely unprotected by Employment Law, from those whose real employment status is disguised, and whose relationship with their employers will in fact be governed by Employment Law provisions. The decision in *Chaudri* makes it clear that charities making payments to their volunteers may be creating a relationship of employer and employee. If that is the case, the individuals concerned will have all the normal statutory employment rights. The dividing line between reimbursement of expenses and payment for service is very fine. Some charities understandably want to give their volunteers some sort of perk as a token of their appreciation. Nevertheless, sessional payments, 'pocket money', subsistence payments, honoraria or lump sums to cover possible expenses may all be indistinguishable from a payment for service, thereby potentially bringing the 'volunteer' within the remit of employment protection legislation. Additional problems caused by payment include: volunteers on welfare benefits may have their benefits reduced; volunteers may become liable to taxation; and charities may find that they must pay their 'volunteers' the national minimum wage (Morris, 1999).

### Transfers of Undertakings

Provisions relating to employment rights on the transfer of an undertaking are contained in the Transfer of Undertakings (Protection of Employment) Regulations 1981, as amended (commonly known as TUPE).

#### *The Broad Effects of TUPE*

When there is a 'transfer of undertaking' to which TUPE applies, employees employed by the old employer when the undertaking changes hands automatically become employees of the new employer on the same terms and conditions (Reg.5). It is as if their contracts of employment had originally been made with the new employer. Thus employees' continuity of employment is preserved, as are their terms and conditions of employment under their contracts of employment (except for certain occupational pension rights - Reg.7).

When an undertaking is transferred, the new employer takes over the contracts of employment of all employees who were employed in the undertaking immediately before the transfer, or who would have been so employed if they had not been unfairly dismissed for a reason connected with the transfer (*Litster v Forth Dry Dock and Engineering Co Ltd* [1989]).

The new employer may not, unless the contract of employment so provides, unilaterally worsen the terms and conditions of employment of any transferred employee. Transferred employees who find that there has been a fundamental change for the worse in their terms and conditions of employment as a result of the transfer generally have the right to terminate their contract and claim unfair dismissal before an employment tribunal, on the grounds that actions of the employer have forced them to resign (*Berriman v Delabole Slate Ltd* [1985]).

Neither the new employer nor the old one may fairly dismiss any employee because of the transfer or a reason connected with it, unless the reason for the dismissal is an economic, technical or organisational reason entailing changes in the workforce (see below at p.51). Dismissal because of a relevant transfer will usually be automatically unfair (Reg.8).

There is also a duty to inform and, in certain circumstances, consult with any representatives of employees affected by a transfer (Reg.10).

TUPE protection against dismissal and its rights to consultation apply equally to the employees of the transferor and those of the transferee. Therefore, if one charity is merging into another, the staff in *both* charities, not merely those in the charity that is being merged into the other, fall within the protection of TUPE.

### *The Application of TUPE*

It is often assumed that TUPE automatically applies where employees are transferred from one body to another during a merger, but this may not be the case. A fundamental issue is whether TUPE will actually apply to the merger in question.

A charity merger is governed by TUPE when it comes within the TUPE definition of a 'relevant transfer' (Reg.3). A relevant transfer of an undertaking occurs when there is a transfer of an economic entity that retains its identity. In practice, this generally occurs where all or part of a business of a sole trader, partnership or company is sold or otherwise transferred. Other situations which are also considered to be relevant transfers are: where a company, or part of it, is bought or acquired by another, provided that this is done by the second company buying or acquiring the assets and then running the business and not simply acquiring the shares; where two companies cease to exist and combine to form a third; and, where a contract to provide goods or services is transferred in circumstances which amount to the transfer of a business or undertaking to a new employer.

Clearly, some of these situations are applicable to the way in which charities choose to 'merge'.

### *Avoiding the Application of TUPE*

However, there are some types of transfer upon which TUPE will not bite, thus avoiding the need to adhere to its provisions. This has allowed some charities to find ways of structuring their merger in order to avoid the application of TUPE. Avoiding TUPE might be seen as advantageous as its application is generally regarded as inhibiting for employers (who must maintain employees' terms) and any deviance from TUPE can prove expensive for employers in terms of compensation payable to employees.

A company is a legal person with a separate and distinct identity from its shareholders (*Salomon v Salomon Company Ltd* [1897]). TUPE does not apply to transfers by share take-over. When a company's shares are transferred to the new shareholder, there is no transfer of the business - the same company continues to be the employer. In practice, some charities have employed their employees through a trading subsidiary of



their charity. This was the case with some employees in Merger H who worked for Charity 20 and for all employees in Merger K. During the merger process, control of the subsidiary has passed to the new body via a transfer of the shares in the subsidiary, and this has therefore not been a TUPE transfer. (There may, however, be legal consequences if the new owner of the shares decides to make changes to the workforce, for example, by reducing its size or changing terms and conditions.)

Another method of avoiding TUPE has been used where Charity A is being transferred into an already established Charity B. The trustees of Charity A all resign and Charity B becomes its corporate trustee. This gives Charity B effective control, although there is no actual transfer for the purposes of TUPE. This was the situation in Merger A. However, this is only a temporary solution if it is intended that ultimately Charity A will dissolve and staff will then transfer to Charity B. At this later stage TUPE will apply as there will be a change of employer. Also, even where this structure of merger is used, it may simply be administratively 'cleaner' for all employees to be transferred to Charity B.

### *Dismissal of Employees at the Time of the Merger*

TUPE states that dismissal as a result of transfer amounts to an automatically unfair dismissal unless an employment tribunal decides that an economic, technical or organisational reason entailing changes in the workforce (ETOR) was the main cause of the dismissal and that the employer acted reasonably in the circumstances in treating that reason as sufficient to justify dismissal (Reg.8(2)).

An employee with at least one year's continuous service who is dismissed in such conditions may complain to an employment tribunal, which may award compensation up to the value of £50,000 (Employment Rights Act 1996, Part X, Chapter II).

The only 'defence' for the employer is to prove that the dismissal was for an ETOR. There is no statutory definition of what is an ETOR and case law in this area is not very helpful either. As the solicitor in Merger A put it:

*I've found that most people, when the complexities of an ETOR are explained to them say, 'you mean you can't give us any certainty?' and I say, 'no, because ETOR decisions are all over the place'.*

In general, an employer will only be able to claim an ETOR when there is a good business-related reason for re-structuring the workforce.

A merger may create redundancies, and a dismissal on grounds of redundancy will frequently count as being for an ETOR. This will mean that the dismissal may be fair, but employees may still be entitled to a redundancy payment (Employment Rights Act 1996, section 135). If the employer can claim the benefit of the ETOR 'defence' it does not follow that the dismissal will have been fair. It simply means that the dismissal was not *automatically* unfair. To establish that the dismissal is fair, the tribunal must still be satisfied that the employer has acted reasonably and has followed proper procedures, as in any other potentially unfair dismissal case. This means that individual consultation is important and must be made at an early stage. Attempts to look for alternative employment within the merged charity should be well-documented.

The burden will be on the employer to prove an ETOR if there is a dismissal around the time of a merger:

*A lawyer who does a lot of this would always say to people, keep your terminations in the context of TUPE transfer to a minimum and tackle it later. (Employment Law Solicitor, Merger E)*

To prove that there *is* an ETOR, it is necessary to start building up evidence right from the start of merger negotiations. Relevant evidence, to help ‘pave the way’, might include accountants’ reports on due diligence, where it may be stated that the merger will not be cost-effective without some re-structuring. Whilst the legal consultation requirements under TUPE are vague, it is suggested that such due diligence reports should be made available to all employees. However, the research suggests that some might find such information difficult to swallow, where there is a ‘pretence’ of a merger of equals:

*Yes, I think it’s a mistake to pretend the situation is different because it takes out of the equation the need for change. You see, if there really is an economic need for change, i.e. that’s why the merger’s taking place, to deny its existence means you are going to find it very hard under organisational or economic necessity to justify changes later. (Employment Law Solicitor, Merger E)*

### *Harmonising Terms and Conditions of Employment*

One contentious area is how far it is possible to change employment contracts to bring about a harmonisation between the employment regimes of two merging charities. For example, research into Crossroads mergers found that standardising pay and conditions can be ‘very hard and very painful’ (Palmer, 1999). In Merger I, the Finance Director of Charity 27 described it as ‘the single biggest issue’ in relation to the merger. Attempts to harmonise have been sporadic and many charities have opted to maintain the original terms of the staff transferred. This means that the merged charity ends up running three sets of employment contracts: the terms of each of the old bodies; and, a new set of terms which are drawn up by the new body and given to any new employees.

One reason for the lack of attempts at change is because charities believe that the TUPE regulations protect the terms of transferred employees and that therefore negotiations are impossible. It is correct that forced changes to terms and conditions of employment around the time of a transfer may entitle employees to resign and claim constructive dismissal, which would be automatically unfair. Charities fear incurring the liability of having to defend an employment tribunal application, and so consider it safer to leave all staff on their original terms, giving transferred employees some degree of protection. However, it *is* possible to change employment contracts whilst still keeping within the bounds of TUPE. It is suggested that in this regard, early TUPE advice from a solicitor well-versed in Employment Law is essential. In Merger E, for example, (with the ETOR defence in mind) the solicitor advised at every stage of the consultation, almost to the extent of telling the employers exactly what to say.

Any changes made sufficiently prior to the merger so that they could not be considered to be brought about as a result of the merger will not incur liabilities under TUPE. It may therefore be possible for the old charity employer to negotiate revised terms and

conditions with the workforce prior to serious merger discussion. This needs a lot of advance preparation though. If it appears that the changes have been made because of the merger, and the changes are sufficiently serious and detrimental to justify the employees resigning and claiming constructive dismissal, according to TUPE, those dismissals will be regarded as automatically unfair (unless, of course, for an ETOR) by the employment tribunal.

Another possibility is to wait for some time after the merger and then introduce changes to terms and conditions. It is uncertain how long the period of protection lasts - at what point would dismissal for refusing new terms cease to be for a reason connected with the transfer? When asked in interview about the option to change terms, and the timescale within which this was possible post merger, answers from charities and their advisors ranged from '3-6 months', to 'never'. TUPE itself does not provide an answer. The European Acquired Rights Directive (which is implemented by TUPE) offers a clue, as it allows Member States to limit the period for which the new employer could be required to observe terms and conditions laid down under a collective agreement which was previously applicable to the employment in question, as long as the period is at least a year in length. This option was not taken up in TUPE, and even if it had been, it would only apply where terms and conditions were derived from a collective agreement. Provided that the change can be linked back to the original transfer, the Employment Appeal Tribunal has recently held (*Taylor v Connex South Eastern Ltd*, 2000) that there is *no* time limit to TUPE's application. With post-merger changes, therefore, the employer will have to show that changes in market conditions, wholly unrelated to the transfer, prompted the variation. This will involve difficult questions of fact.

Minor changes (for example, to working practices) can be made to contracts - these are changes that would not be considered by the tribunal to be sufficiently serious as to go to the root of the contract, and therefore an employee would not be justified in treating the changes as a good reason to resign and claim constructive dismissal.

Similarly, changes can be made with the agreement of the employees. Often staff will agree to changes (even if detrimental) rather than face redundancy or the uncertainty of claiming constructive dismissal:

*The critical thing is that, if you're going to change terms and conditions, you have to do it when you've got a good negotiating position, namely the staff in the other organisation are facing redundancy and they realise what's going on. Once the merger has taken place and their terms are obviously transferred, it's hard to change.* (Employment Law Solicitor, Merger E)

Gaining employees' agreement will often mean an extensive period of negotiation, which could be costly and time consuming:

*It's quite often very possible to change things but over time and through a period of consultation and discussion. I would have thought that you are probably normally talking about at least six to nine to twelve months, if there are real difficult issues there.* (Solicitor, Merger M)

Following a recent House of Lords decision (*Wilson v St Helens BC; Meade & Baxendale v British Fuels Ltd* [1998]), it appears that there is another option open to merging charities that wish to change terms and conditions; the old charity can dismiss

(on proper notice) the employees at the moment of transfer so that there is no contract of employment to be transferred. The new charity can then engage the employees on new (different and worse) terms and conditions. The device constitutes a dismissal (probably unfair) but it will nonetheless enable the transfer of employees without their existing contracts being transferred with them. Following a cost-benefit analysis, the new charity might decide that the cost savings achieved through changes in conditions outweigh the cost of any unfair dismissal compensation. This 'fire and re-hire' strategy may not make for good industrial relations, but may save money in the long run. It should however, be noted, that with the increase in the upper limit on unfair dismissal compensation to £50,000 in 1999 (and now index-linked to the annual rate of inflation) this strategy may become less attractive.

Ultimately, there is also the option to force change and risk the fact that some employees may take the charity to an employment tribunal.

*You have to negotiate to the 'nth degree', but eventually you have to make a decision and give a decent amount of notice, three or four months notice and just say, 'look we've had consultation coming out of our ears, we've got to merge these terms and conditions'. At the end of the day the staff have to decide whether they want to leave and claim constructive dismissal or not. I think organisations are too frightened of this, they should take it on the chin that one or two might, but the fact is that most people would rather stay. ... I suspect with some charities that they are not too keen on biting the bullet. (Employment Law Solicitor, Merger E)*

If a decision is made to proceed with new terms, notice could be given, say, 6 months after the merger in order to put some time between the transfer and the imposition of new terms. One of the problems with a dismissal at the time of transfer is that an employment tribunal will assume it is a transfer dismissal until they are persuaded to the contrary.

A less pro-active approach is simply to wait and let nature take its course. In this respect charities can take advantage of the fact that they tend to have high turnovers in staff. A recent survey of voluntary organisations in a Human Resources Benchmarking Club found that staff turnover at 20% per annum and rising is higher than for all sectors in the UK (Dullahide *et al*, 2000). Also, existing staff may wish to be promoted or upgraded at some point. Another consideration is that staff, once they have become accustomed to the new merged charity, may have less difficulty with new terms, and therefore may agree to them.

A more robust approach was taken in Merger H (where employees were largely not subject to TUPE) where each employee in a duplicated role post merger (including the Chief Executives) had to re-apply for their position. This largely worked well, with some 'weaker' employees leaving of their own accord. The scheme was given a time-frame so that for around 3 months, post merger, Charity 22 was prepared to pay the salaries of all the employees (including those in duplicated roles) until re-appointments were made. During that time, new job descriptions were written and interviews were held.

### *Due Diligence*

The due diligence process is very important in this field (see, in general, Chapter 3). One of the implications of TUPE is that the transferee charity takes over all

outstanding liabilities of the transferor charity. It is therefore necessary for each charity to discover potential liabilities which might arise in the future, such as any potential tribunal applications relating to previous employment disputes. All of these need to be assessed so that provision is made for likely compensation awards or legal fees. In Merger E for example, the Employment Law Solicitor advised on the prospects and estimated costs of a number of potential tribunal cases that were outstanding in relation to Charity 11. Similarly, in Merger M, the due diligence exercise identified a number of outstanding employment disputes within Charity 37. Also, if the effect of TUPE is considered to be that employment terms cannot be changed, then the transferee charity must consider whether it would be too onerous for it to continue to support such terms.

### *Consultation*

When there is to be a transfer of an undertaking, both transferor and transferee employers have a duty to inform and consult appropriate representatives of any 'affected employees'. 'Affected employees' are any employees of the transferor or transferee who may be affected by the transfer or may be affected by measures taken in connection with it (Reg.10(1)). In many cases of charity merger, this is likely to extend to most, if not all, of the employees of all the charities within the merger.

The duty to provide information applies in relation to representatives of all 'affected employees'. However, the duty to consult applies only where the employer envisages 'taking measures' in relation to such employees. Measures are not defined, but would clearly include any proposed changes that may be anticipated in staffing arrangements. Therefore, if there is a possibility that certain jobs may be lost, the affected employees must have been made aware at an early stage, even though no decision has been made. Practically speaking, the earlier staff are involved, the easier it will be to gain their co-operation.

The information to be provided falls into four categories: the fact of transfer; the approximate timing and reason for it; its legal, economic and social implications for the affected employees; and, the 'measures' that it is envisaged will be taken in relation to the employees. The information must be provided 'long enough before a relevant transfer to enable consultations to take place ...'

Consultation with staff must be 'with a view to seeking agreement' (Reg.10(5)). It does not mean that agreement has to be reached, merely that the attempt should be made. This is usually established by showing sufficient information and documentation has been provided for meaningful discussions and agreement to take place.

Under the amended regulations (Reg.10(2A)), there is now a requirement for employers to consult and / or inform an independent trade union where it is recognised for collective bargaining purposes in respect of any of the affected employees. Where no union is recognised, the employer may choose whether to consult or inform existing employee representatives who have the appropriate authority or employee representatives elected specifically for the purposes of consultation and receiving information.

## Recommendations

### *Legal*

It is vital that a due diligence exercise is conducted in order to clarify the staffing situation of merger partners. In this respect, it would be helpful if (as part of a regular 'legal health-check' – see above at p.29) charities formalised the relationships of all their workers (irrespective of thoughts of merger) and made it clear whether they were regarded as employees or volunteers. As an example of good practice, in Merger I, each volunteer in the four charities concerned had a written agreement which had to be assigned post merger.

If specialist Employment Law advisors can be afforded, they should be used if necessary. This can be costly, but still less than the cost of a redundancy package or compensation awarded by an employment tribunal, so it is money worth spending.

Charities should not regard TUPE as a deterrent to merger.

TUPE simply needs to be managed. In this area, many charities appear to have been very cautious, being unsure of how far the law limits their scope for change and not wishing to expose themselves to onerous liabilities. Wherever possible, most charities have tried to avoid any changes to the employment regimes of the merging charities. Charities should not put these difficult subjects to one side.

In relation to harmonising terms post merger, the risk of an employment tribunal and the costs (in terms of money, time and goodwill) of negotiating should be carefully balanced against the gains to be made through having only one set of terms. All attempts should be made to harmonise terms, whilst staying within the confines of TUPE. It is not the best use of a charity's resources simply to accept the status quo.

Clearer guidelines on the EOTR defence would be helpful to all those involved in transfers of undertakings. Under section 199 of the Trade Union and Labour Relations (Consolidation) Act 1992, the Advisory, Conciliation and Arbitration Service (ACAS) may issue Codes of Practice containing such practical guidance as it thinks fit for the purposes of promoting the improvement of industrial relations. It is suggested that the EOTR defence could usefully form the subject matter of such a Code of Practice, with some worked examples.

### *Practical*

This whole area is one in which charities are crying out for some assistance. Charities feel very alone going through this process and really need to pool their experiences. It is recommended, therefore, that those charities that have successfully merged should share their experiences in order to disseminate good practice. This could be achieved with the assistance of umbrella bodies. This would be especially beneficial to smaller charities, who may not be able to afford specialist advisors.

All reasonable steps should be taken in order to retain the goodwill of staff (both paid and volunteer) during merger. Most charities found that this was simply a question of having a good communications strategy. Employees should not be left in the dark.

A number of charities within the research (for example, in Merger J) recognised the valuable role that the Advisory, Conciliation and Arbitration Service (ACAS) can play during merger negotiations.

## ASSET PRESERVATION AND TRANSFER

Charity Law regulates how resources can be held, whether money or real property. Generally, the boundaries within which different assets can be deployed are clearly marked. This regulation may create difficulties on a merger, where there is a need to transfer assets from one body to another (either pre-existing or new) because the receiving charity cannot simply wipe the slate clean on transfer and treat those transferred assets as new resources to be dealt with as they wish. Consequently, the body created as a result of the merger bears the imprint of the asset holding structure of the pre-merged charities.

Similarly, the goodwill and support of funders is an asset of any charity which should be protected during merger. Without funding it will be difficult to take the new organisation forward. Therefore, it is important to maintain the support of funders throughout merger. This means keeping funders informed of and involved in the changes taking place, and gaining their agreement to the plans for the charity. Most importantly, it means ensuring that funds are not lost as a result of the merger. Again, this can involve some complex procedures, depending on the source of funding and the nature of the funder.

The way in which charities within the research held their assets ranged from the straightforward to the complex and the byzantine. Charities gain their funds from a variety of sources, each with their own requirements as to how they may be held and deployed. Some of the pre-merged charities within the research were extremely old (for example, Charity 10 in Merger E was founded in 1788) and this, too, contributes to an eclectic mix of asset holding structures. Also, (as with the for profit sector) charities are not always run effectively and this may mean that occasionally assets are held on an *ad hoc* rather than a formal basis. Due to the disparate ways in which charities hold their resources, it is difficult to draw any blueprints for merging assets. However, it is possible to look at a range of solutions to a range of common problems.

### The Importance of Due Diligence

The physical transfer of assets during a merger is usually effected by a transfer document. Passing legal title is not legally difficult once the extent of charities' assets and the legal structures under which they hold them have been discovered as part of the due diligence exercise (see Chapter 3). Often merger (or thinking about it) has been a time when charities have had to ascertain their own and their merging partner's particular asset holding structures. This is vital, as it allows charities to respond as best they can to the problems of transferring their assets. As the solicitor in Merger M said, emphasising the importance of the due diligence exercise:

*Well the first thing with any merger is to identify the property that might be involved in the merger. And in this particular case, there, they hadn't kept ... records. So one way of improving future mergers and their thinking about it ... start getting things together right from day one ... Problems you are not aware of, they come up at the last minute, but again it's best to identify the problems right in the beginning and it is possible for charities to be given*



*property for specific purposes. And you need to know what these are so that you can either know that you can eventually assign those to the new body or you can make arrangements so that those purposes can be changed.*

The Finance Director of Charity 36 in Merger M noted that, compared with other mergers in which Charity 36 had been involved, property aspects had become a large feature as a result of the uncertainty surrounding the property holding of Charity 37:

*[Charity 37] don't have leases, they've got letters which imply that they've got some sort of licence. In fact, the letters were quite old and they took the 'lease' over from somebody else, who also didn't have a lease. It's quite messy and also the landlords aren't responding to our lawyers' enquiries ... legally what we are actually looking for is some sort of legal document saying 'this is a lease', but the landlord won't give it to us ... it's a bit messy, but that's ongoing. With the other mergers we've done it's been much more straightforward because we have kept the property and we have just transferred the lease over.*

Solutions have often been developed on an *ad hoc* basis, with the charities and their advisors steering what they see to be the best course through the issues.

Merger has been regarded by some charities as an appropriate time to modernise and to expand their charities, in order to improve their ability to respond to the current needs of their beneficiaries. This may be done by re-assessing the objects, streamlining the constitution, or re-assessing the basis on which assets are held. In some cases, merger has been the time to clarify the legal status of asset holding, to discover whether all necessary documents are held, and, occasionally, to re-allocate resources.

For example, in Merger E, the opportunity has been taken to rationalise a series of leases:

*There were also a dozen leases of varying length and varying obligations and some of them were quite onerous leases. Since the merger we've been trying to re-arrange the leases as best we can and those which were seen as onerous and which we've been able to get out of, usually by the effluxion of time, we have done. There are, I think, still two onerous leases, one of which has got quite a while to run. (Solicitor, Merger E)*

Similarly, in Merger K, property owned by Charity 31 was finally registered with the Land Registry as a result of the merger, and rent paid by a connected trading company was formalised on the merger, at the insistence of the Charity Commission.

### Restricted Funds / Endowment

Whereas general funds may be fully spent for the general purposes of a charity, restricted income funds may only be spent on particular objects, due to a limitation expressly applied by a donor in respect of a specific gift, or as a result of a donation to a particular appeal.

The restriction may apply to the use of income or to capital. Restricted capital may be permanent endowment, which the trustees have no power to convert into and apply as income, or it may be expendable endowment which the trustees may convert into and expend as income. Under Charity Law, it is important to pay close attention to the precise nature of the restrictions, in order to ensure that, on transfer, funds are used for the purposes for which they were intended. If trustees allow funds to be used for other purposes, they may be liable for breach of trust. In Merger E, one of the reasons that a

merger was considered in the first place was because Charity 11's endowment fund had fallen below its authorised level. The merger enabled Charity 10 to re-finance the endowment fund which is now kept entirely separate.

The Charity Accounting Statement of Recommended Practice (SORP) in 1995 required separate accounting for funds (see now the revised SORP, Charity Commission, October 2000). Trustees are required to distinguish between general and restricted funds, and definitions are given within the SORP, although, as found in a number of cases in the research, this is not always an exact science.

The question of restrictions can apply equally to real property held by charities. If land or a building has been given to a charity to be used for a specific purpose, then these restrictions may still have to be respected after a merger.

Restricted funds can be seen as a potential block to merger, although they should not be allowed to prevent a merger from taking place. In practice, the research found that usually, post merger, restrictions are maintained within the new body. This was the case, for example, in Merger C, where Charity 6 had restricted funds which were maintained in the merged Charity 8. The commitment to protect restricted funds may be placed within the merger agreement itself. This was the case in Merger M. As the solicitor for Charity 36 pointed out, this was more to provide 'comfort' to Charity 37, rather than anything else, since, even if it was not put into the agreement, the trustees would be required to respect the restrictions anyway. The agreement simply reinforced that commitment.

In practice, where there are restricted funds, merger might be effected in a form which retains the charity with restricted funds, so that they remain ring-fenced (see above at p.17). For example, in Merger B, Charity 3 had some endowed funds and therefore Charity 4 moved across into Charity 3, leaving the latter in tact.

Some mergers even created restricted funds, but this is not recommended:

*In terms of public perception and also to satisfy the trustees and the very interested parties in this, we made the brave statement that we would take, for example, the general reserves of [Charity 25] and make those into restricted reserves within [Charity 27] .... It wasn't a Charity Commission requirement ... It's a bit of a problem to us because, under this, we end up with more restricted and less unrestricted reserves than is good for the balance sheet. We are still debating whether we might renege a little - it wasn't a public promise. In practice, the money will still be spent there, it's just a question of presentation to the external world. (Charity 27, Finance Director)*

With funds that are not already restricted, it may be better simply to designate the funds that transfer over:

*[Charity 35] had about half a million pounds in the bank, which was just one capital project they had been putting money aside for ... So what we did, we put that half a million into a separate reserve fund. Technically we haven't restricted it, we've just effectively designated it. It's a designated fund. We show it, no problem, on the balance sheet and we allocate to it interest that we earn at the bank. (Finance Director, Merger L)*

In Merger H, additional steps were taken to protect funds post merger:

*One of the conditions of the merger was that ... capital [belonging to Charity 20] was frozen for three years from the merger date ... so that the new organisation wasn't able to eat into [Charity 20's] reserves. When that does become free, it will still be restricted to the original purposes of that trust so it will only be able to be used for anything within the objectives of [Charity 20]. (Finance Director, Charity 22)*

However, there may be other ways to tackle the problem. It might be possible for a charity to apply for a Scheme from the Charity Commission under section 13 of the Charities Act 1993 to apply the money for other purposes (see above at p.19). However, the availability of this method would depend upon the charity being able to show that one of the grounds for cy près within section 13 is applicable (see Charity Commission, September 1999b). Section 13(1)(e)(iii) may be most relevant and states that one occasion for applying property cy près is where the original purposes, in whole or in part, have, since they were laid down:

*ceased in any other way to provide a suitable and effective method of using the property available by virtue of the gift, regard being had to the spirit of the gift.*

Trustees should check the precise terms upon which funds are held in order to identify which funds are actually restricted. Once restricted funds have been clearly identified, trustees should ensure that these restricted funds, and not general funds, are always spent on the designated purposes. With careful financial planning, restricted funds need not cause difficulties for charities:

*Well [Charity 37's] reserves we are treating as a restricted fund, restricted for [a specific purpose].. That's not an issue because we do [the specific purpose], it's there to be used for that. Actually, most of the money we get ... isn't restricted, so actually we can run down that restricted fund quite rapidly because all the money coming in for it isn't restricted, and yet all the expenditure is. (Finance Director, Charity 36)*

Donors often want to donate money for a particular purpose, leaving a charity with a lot of restricted funds. Charities would prefer to have more unrestricted funds in one pot. It may be possible to encourage donors to agree to give their gift as a named fund, without a technical restriction, which recognises the donor without limiting the uses of the money. In Merger D, it was possible to regard some funds as unrestricted because there was no legally binding duty to apply the funds as the donor had stated. The donor had simply expressed a wish as to the funds' destination.

It does appear that, occasionally, restrictions are not understood and this can lead to them being ignored upon transfer of funds to the new merged body. This means that if funds are used for other purposes, trustees may be liable for breach of trust.

### Real Property

The discovery that either a charity or its merger partner holds property under some complicated and confusing arrangements has been one of the main problems to emerge as a result of the due diligence process. It seems that it is not unusual for charities' property arrangements to be complex:

*Its terms of occupation were, fairly typically for charities, unclear. I'm doing a current merger where ... they had built the building on a piece of land for which they had no lease, no freehold, no nothing. So it's commonly a problem. (Solicitor, Merger A)*

The problems identified have been quite diverse. For example: in Merger M, it was discovered that Charity 37 held a licence rather than a lease; in Merger A, Charity 2 had a complicated occupancy agreement between it and an intermediary charitable company, that was not the owner of the property; and, in Merger E, after the merger (and the due diligence exercise) had been completed, solicitors discovered that Charity 11 had issued long-term leases to its former employees at protected rents.

Property complications often add to the costs of a merger. For example, in Merger K, where both Charity 31 and Charity 32 owned freeholds, the Charity Commission required properties to be valued before being conveyed to the merged Charity 33.

### *Leases*

Most charities held leases rather than freeholds on properties. Occasionally, the assignment of leases to the merged charity was straightforward. For example, in Merger B, Charity 4's lease was assigned to Charity 5 without difficulty. More often, however, it was found that the assignment of leases created various problems on merger. First, the benefit of the lease has to be validly assigned to the new merged charity and this requires the appropriate legal formalities to be satisfied. Secondly, the landlord's consent may be required.

Ordinarily, assignments of interests in land must be effected by deed (Law of Property Act 1925, section 52 – this will not be the case with leases of three years duration or less, section 52(1)(d) and section 54) so this will require the signature to transfer of all those who are named as holding the original lease. With unincorporated charities, it may be difficult to obtain the signature to transfer, simply because all those named as holding the lease cannot be traced. This was a problem in Merger E where it was discovered that several leases had been entered into by trustees personally before Charity 11 had been incorporated. It then took a while to track down the old trustees who could authorise transfer. Acquiring signatures has often proven to be a time-consuming task, so the earlier in the merger process that it can be dealt with, the better. In Merger E, it took over one year to achieve all the necessary assignments.

The process of tracing trustees may be all the more difficult because, with charities which are unincorporated associations, the property holding trustees are often separate from the current committee of management and will often consist of the original charity trustees who acted as such when the charity was first set up and first acquired leaseholds. This may date back some time, making it difficult to locate such people.

Where the consent of the landlord is required for the transfer of the lease, failure to obtain consent could leave the merged charity with a lease that is later liable to forfeiture by the landlord (*Old Grovebury Manor Farm Ltd v Seymour Plant Sales and Hire Ltd (No.2)* [1979]). Trustee may then be in breach of their duty as trustees to conserve the trust property. Moreover, for leases entered into by charities after 1 January 1996, holding under 'new tenancies', the original tenant (which may be individual trustees) will remain liable on the covenants in the lease, as an assignment in breach of covenant would be an 'excluded assignment' within the Landlord and Tenant (Covenants) Act 1995, section 11.

Obtaining the consent of landlords requires co-operation, which is not always forthcoming:

*Trying to explain to the landlords 'this is not a commercial sale of a charity, you don't do that in charities, this is one stepping into the shoes of another'. We had varying degrees of obtuseness from some of the landlords. We eventually managed to get them to agree to assignments, but some of them were more on the ball than others. (Solicitor, Charity 12)*

In some cases, property issues were still not resolved for charities several years after merger:

*I think that the building rationalisation has been slower than it should have been. We should have just taken the steps to lose the building when we merged, but there were a lot of people and it was difficult to do. A lot of service people in [Charity 20] building. In terms of leases, I don't think we have completed as much as we should and you will probably find that there are still leases in the name of [Charity 20] and [Charity 21]. We didn't see that through as well as we should. (Finance Director, Charity 22)*

*Novation can take forever. We're still working on ones from last April and we're about to set into doing it again for next April. (Finance Director, Charity 27 - January 2000)*

It is possible to leave a shell charity (see above at p.14) to hold leases in order to avoid having to seek the agreements of the lessors to assign the lease. This has occurred so far in relation to Merger G. However, this may not be suitable in all cases, particularly where the leases are held in the names of individual trustees, who might want to pass over the responsibility to the new body and who would have no recourse to the assets of the new body in the event of a problem for which they incurred financial liability.

In other cases, effective assignment *appears* to have been achieved by simply paying rent to landlords with cheques drawn from the bank account of the new merged body:

*What would typically happen is that, if there aren't any practical difficulties, some day the cheque will start emerging from [Charity 1's] chequebook. The landlords won't notice. There will probably have been an effective assignment and a waiver of any rights for them to object and nobody will ever do anything. (Solicitor, Charity 1)*

He went on to add:

*I mean benign neglect is an enormously cost enhancing way of dealing with lots of Charity Law issues. Nailing everything down is wonderful if the charity's got the money for it. But you know, I would think that you could spend £2,000 or £3,000 sorting that out and what would you get? You'd get clarity. Whether you'd really benefit from it is another matter.*

Another solicitor, however, took a more technical view of matters:

*I would just say ... best ... to get things assigned legally, you know, on completion. Because people may, sort of, change. Energies change and you can go on to the next thing and things can get left behind. (Solicitor, Charity 36)*

Apart from the exception of leases of three years duration or less, interests in land *do* need to be assigned by deed, so whilst the Solicitor in Charity 1 might be giving good *practical* advice, the *theoretical* possibility of a legal challenge to the occupation of property by the new charity is open to the landlord if leases are not formally assigned. Also, without formal assignment, legally, liability for rent etc. remains with the original tenant, that is the pre-merged charity, which now has no assets to call upon.

Leases held by trading subsidiaries do not have to be assigned where the 'merger' is effected by shares in the trading subsidiary being transferred to another (or new) charity. So, for example, in Merger H, where some leases were held by a trading subsidiary of Charity 21, post merger, these leases remained in place.

Similarly leases will not have to be assigned if the merger is effected by absorption of one charity by the other, where the absorbing charity holds the lease.

### *Restrictions on Use of Real Property*

There may be restrictions attached to the occupation by the charity of its property. These may be in the form of leasehold covenant obligations which have to be fulfilled. If these restrictions are ignored, this could lead to the charity having to forfeit its rights to the property in question and the trustees may be in breach of trust, for failing in their duty to preserve the charity property. Consequently, as part of the due diligence exercise (see Chapter 3) a full investigation of title for each property that the charity uses prior to merger is required. Restrictions may be uncovered which affect decisions made about the future use of the buildings post merger.

Another problem revealed is the possible application of the Reverter of Sites Act 1987. Any property affected by this legislation is held on trust for the original owner when the property ceases to be occupied for the original purpose. If a charity has buildings affected by this Act, it may want to ensure that they are occupied for the original purpose after the merger, otherwise the charity may lose the property.

A cultural problem that was raised in relation to property is that charities and their staff may have a particular affection for the buildings which they occupy, so that the building effectively becomes part of the charity. This affection can clog the merger process because trustees and staff want to remain in a particular building which may not be suited to the needs of the new body. Neighbours too may value having a charity as a neighbour and may not want the building to be sold to a commercial body.

### Preserving Funding

A charity's funding is integral to its continued functioning and funding sensitivities should be thoroughly investigated prior to merger, perhaps as part of the due diligence exercise.

### *Donors' Consent*

Whilst it is important to keep funders fully informed of merger developments, in order to maintain their support for the merged body, there may be more formal steps that are required to be taken in order to retain funds provided by certain funders. Because of the restrictions imposed on funds by funders, there is often a need to obtain consent to transfer a fund. Sometimes this task can be onerous. For example, the research has found that there have been problems with grants given by the National Lottery Charities Board (NLCB), which will only transfer grants to a body which has a different legal personality from the original applicant under certain conditions. If the merger produces a new charity and the trustees wish to apply the lottery grant to that

charity, they must re-submit an application to the NLCB. For example, in Merger J, a re-submission to the NLCB was required. One way to avoid this problem could be to maintain a pre-merger charity to administer some grants. For example, in Merger G, lottery funding for a particular project was held by a pre-merged charity which was still in existence and functioning to the limited extent of implementing the NLCB-funded project.

### *The Effect Upon Fund-Raising*

Merger is often intended to make a charity larger, with more resources at its disposal to provide better services to its beneficiaries. It is also intended to enable the merged charity to compete more effectively against charities working in the same area for the funds available. However, some charities have noticed a decline in funding and fund-raising levels at the time of a merger:

*Whereas people gave to [Charity 20] and to [Charity 21] both, they now only give to [Charity 22] and that contributed to the fact that fund-raising is not as successful as we would like it to be. (Finance Director, Charity 22)*

One suggested reason for the reduction in fund-raising revenue for some merged charities is the perception of reserves both within the charity and externally. Various interviewees have pointed out that, under the SORP (see now the revised SORP, Charity Commission, October 2000), the requirement to aggregate income gives the impression that they have more resources available than they do in practice:

*That excess of reserves is now proving to be more than a mild embarrassment for fund-raising and we are looking at ways to re-establish the true position of separateness ... but it does mean that the consolidation created a level of reserves that jeopardised funding. (Finance Director, Charity 27)*

The trustees must be able to identify funds properly within the accounts, so that the spending restrictions placed upon them are clear to everyone. It is also necessary to educate funders so that they understand the distinction between free and restricted reserves, and do not pull out under the impression that the charity has access to more money than it does in practice. It is hoped that the revised SORP will aid this process because, in requiring trustees to report on their reserves (the policy, the level and the justification) it gives charities opportunities to stress why their funds are in different pots, and what each fund or reserve is for (Charity Commission, October 2000). This, in turn, could assist charities in explaining their shortfall, if they have one, and help them to attract new funders.

It was also pointed out that merger negotiations can be extremely time consuming and, if charities are not careful, distracting. Management should not take its eye off the ball, so that routine functions are disrupted as a result of the merger talks. If charities get bogged down in mergers and fail properly to manage what they have got, this may lead to losses of income. In fact, Allison goes so far as to suggest that since merger places huge demands on charities' support staff, with the danger that day to day activities may suffer, charities should consider whether additional staff should be appointed to relieve the burden (Allison, 1998).

### *Tax Effective Donations*

It is important to maintain existing tax effective donations post merger. Some charities have retained their original covenant donation arrangements, with the old dormant charities then transferring over the funds to the new charity. It is usually intended that this procedure will continue until the covenants expire. Gaining donors' consent to a change of recipient mid-covenant term is not considered practical:

*You're more in danger of losing. I mean we always do when a covenant runs out. As far as they're are concerned they think they're giving it to [Charity 27] anyway. Who are we to argue? When a covenant runs out, we always approach somebody and try and resell them with what we're doing now, but, it doesn't seem to us to be a good plan to interrupt in the middle of the stream. (Finance Director, Charity 27)*

Other charities have discovered that existing covenants can be easily transferred, with the agreement of the Inland Revenue, so that the new body is the direct recipient. This procedure does not require charities to gain the permission of the original covenantor for the funds to be applied by the new body.

Another approach adopted in practice, which does not involve the Inland Revenue, distinguishes between the legal structure of the original charitable recipient: in the case of a covenant to a charitable company, it is necessary to go back to the original covenantor in order to apply the funds for the new body. Yet, if the gift was to an unincorporated charity, then so long as the new body is applying those funds for the same general charitable purpose, it is considered that there is no need to go back to the original covenantor for permission.

In line with all charities, however, in the future, merged charities may find it better to persuade all donors to sign a Gift Aid declaration as soon as possible as such a declaration can cover future gifts. The new Gift Aid rules, introduced in April 2000 as a result of the Review of Charity Taxation (HM Treasury, March 1999), mean that tax relief will now apply to any donation whether large or small, regular or one-off, provided that, as before, the charity can demonstrate an audit trail from the donation to a donor who has given the charity a Gift Aid declaration which covers that donation. Donors will be able to give a declaration:

- in advance of their donation; or
- at the time of their donation; or
- at any time after their donation (subject to the normal time limit within which the charity can reclaim tax – normally around six years).

The declaration can cover a single donation or any number of donations. It can be made:

- in writing (for example, by post, by fax or electronically through the Internet); or
- orally (for example, over the phone).

### *Legacies*

It is also important not to lose legacies as a result of merger. This is one of the main reasons why shell charities are maintained post merger (see above at p.14).



## Recommendations

### *Legal*

This is another area where the merger process can be eased if charities have undertaken an earlier review (or ‘legal health-check’ – see above at p.29) so that documents are in place to explain property holding etc.

Trustees should ensure that they understand the nature of their charities’ property holding and comply with any restrictions which apply thereto. In this regard, additional educational initiatives, explaining the differences between, for example, restricted and designated funds, for charity trustees and staff would be helpful.

Assignment of leases should be undertaken formally in order to avoid any later problems arising.

### *Practical*

Property issues should be investigated as soon as merger is considered as they can take a long time to resolve.

Charities should attempt to limit their restricted funds as much as possible on merger. In particular, additional restricted funds should not be created on merger.

If possible, donors should be persuaded not to create restricted funds as a result of their gifts.

Merger negotiations should not be allowed to interrupt the day to day running of the pre-merged charities. The whole rationale for merger should be to improve (or at least) maintain a level of service for the charities’ beneficiaries. This should not decrease as a result of distractions caused by the merger and the activities leading up to merger.

## CONCLUSIONS

This research has revealed a number of different routes to achieving the same end. The forms which merger takes are wide-ranging as are the different legal solutions adopted to similar problems. This is inevitable due to the fact that although all the case studies involved *charity* mergers, the charitable sector itself is incredibly diverse. The way in which some charities are run is almost indistinguishable from commercial ventures. Here, mergers are often contemplated as part of a strategic plan to achieve the charities' objectives. These charities have a very professionally skilled board of trustees who may well have been involved in commercial mergers and acquisitions in the past. At least, they have a business awareness of the issues to be dealt with. At the other end of the scale are the more typical 'voluntary' bodies, surviving on a shoestring, run by well meaning but amateur volunteers. Here charities may be forced to consider merger as the only option for survival. In between are many variations where charities take on both commercial and non-commercial characteristics.

The same observations can be made of Charity Law practitioners. Some take the view that charities must dot every i and cross every t; check every proposed action with the Charity Commission; and they would never contemplate acting for both charities in a merger situation. Others take a more pragmatic view and a more realistic approach to risk assessment.

The four most important general lessons to be learned from research are:

1. Mergers need to be carefully planned and thought through. Funding is available from certain grant giving organisations to look into the feasibility of merger and these funding opportunities should be investigated when merger is first considered.
2. Charities and their advisers must adopt a pragmatic approach to legal problems, recognising that there is no set way of dealing with the legal issues that arise during charity merger.
3. A charity with good governing documents will find it much easier to achieve its aims in relation to merger. The merger process will expose any structural or constitutional weaknesses that a charity may have. With this in mind, it is recommended that, every five years, all charities undertake a 'legal health-check' of their governing documents, making any necessary amendments. Similarly all property holding should be clarified and the employment status of all charity workers should be clearly spelt out. Umbrella bodies of charities should pass on this message and encourage their members to undertake a 'legal health-check'. This may be a particularly appropriate task for umbrella bodies of specific types of charities (for example, umbrella bodies of rural charities - ACRE or citizens advice bureaux - NACAB).
4. Charities should not be afraid to spend money seeking professional advice in relation to a possible merger. It is important, however, that charities should be

clear about what they are looking for from their advisors, and clear information and instructions should be given. For example, in relation to the due diligence exercise to be undertaken (see Chapter 3), the extent and nature of the searches to be carried out should be clearly communicated to advisors. Charities should also ensure that advice is sought from *appropriate* advisors, who have preferably advised on charity mergers previously. Early advice from the right source can actually help to reduce cost.

Areas in which the law could be reformed, or at least clarified, that have emerged from the work include:

- The role of the Charity Commission, the Charity Law Association and charity umbrella bodies in relation to providing and updating best practice in charity mergers could be enhanced.
- At the very least, a Charity Commission booklet should be published outlining different routes to merger and issues that need to be considered.
- The law on consent by members to charity merger should be clarified.
- A check-list of issues to be considered as part of the due diligence exercise should be produced in order to ensure that all potential liabilities are covered. This may be an appropriate task for the Charity Commission or the Charity Law Association.
- Further consideration should be given to whether it is appropriate for charity trustees to sign warranties on merger. Should there be any differences in this respect between paid and non-paid trustees, for example?
- There should be some clear-cut formulae adopted in order to allocate liabilities between pre and post-merged charities on merger. At present, there appears to be some blurring around where liabilities lie and no guidance to ensure that charities clearly allocate liabilities.
- Any future consideration of the law of novation of contracts should have regard to charity mergers with a view to clarification and simplification.
- In the area of Employment Law, consideration should be given to the appropriate level of ‘employment’ protection that should be given to charity volunteers. Currently, a worker either falls within the definition of an employee under a contract of employment or not. Employers who fail properly to assess the working relationships that they have with their ‘paid volunteers’ may find that their workers are in reality employees. A legal definition of a ‘volunteer’ should be provided in order to make such relationships clearer for the future.
- The law governing Transfers of Undertakings is incredibly complex. This makes it difficult for accurate legal advice upon the consequences of any proposed action to be given. Some greater clarification as to the meaning of the ‘economic, technical or organisational reason’ defence would be helpful. In particular, this might assist in charities’ attempts to harmonise terms and conditions of employment post merger.

- Trustees occasionally misunderstand the nature of their charities' property holding and any restrictions which apply thereto. Clearer guidance to trustees, explaining the differences between, for example, restricted and designated funds, for charity trustees and staff would be helpful.
- A more flexible approach to permanent endowment would assist the merger process.

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