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Merging Wisely

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Merging Wisely

WITH THE ECONOMY IN TURMOIL, FUNDERS ARE INCREASINGLY PRESSURING NONPROFITS TO MERGE. YET MERGERS ARE NOT ALWAYS THE RIGHT PATH FOR NONPROFITS IN FINANCIAL DISTRESS. FOR A HEALTHIER NONPROFIT SECTOR, FUNDERS SHOULD CONSIDER A WIDER VARIETY OF PARTNERSHIP OPTIONS.

BY DAVID LA PIANA | Illustration by Heads of State

IN THE MIDST of the worldwide financial crisis, funders are increasingly suggesting that nonprofits consider merging—that is, fusing their boards, management, and legal entities to form a single organization. In 2009 alone, my consulting firm delivered nearly 60 presentations and workshops on mergers and other partnership forms to more than 6,000 participants—double the previous year’s tally. Similarly, our strategic restructuring practice (which handles mergers and other partnerships) grew 60 percent last year, during the worst part of the recession.

Now 2010 is upon us, and the urge to merge shows no signs of abating. Underlying this trend are two core beliefs: The nonprofit sector has too many organizations, and most nonprofits are too small and are therefore inefficient. Mergers, the thinking goes, would reduce the intense competition for scarce funding. Consolidating organizations would also introduce economies of scale to the sector, increasing efficiency and improving effectiveness.

Yet a closer look at the nonprofit sector suggests that this thinking is too simplistic. Mergers are risky business. They sometimes fail, although not so frequently as in the corporate world. They usually cost more than anticipated. They sometimes create more problems than they solve. And the problems that they allegedly solve—too many nonprofits, too small in size—may not be problems after all.

Instead of reflexively pulling out the biggest gun in the partnership arsenal, nonprofits should consider a variety of ways of working together. After facilitating some 200 nonprofit restructurings (including mergers, administrative consolidations, and other partnerships), my colleagues and I have developed a few rules of thumb for when nonprofits should merge, when they should remain fully independent, and when they should undertake unions that lie

between these two poles.¹ We’ve also identified how funders can help—or hurt—the formation of nonprofit partnerships.

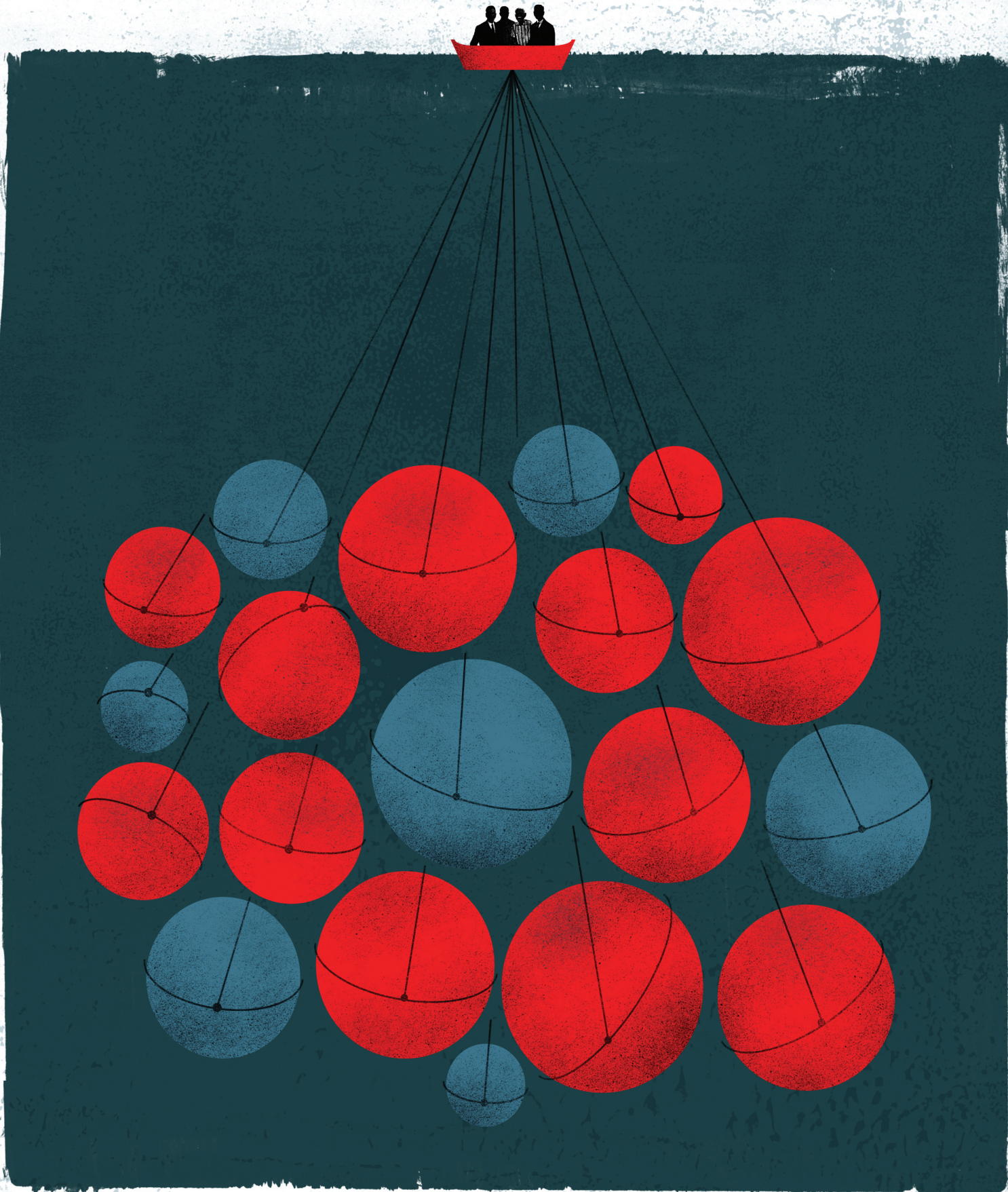
The Right Number of Nonprofits

A familiar cry in the nonprofit sector, particularly among funders, is that there are just too many organizations competing for too few dollars. The sector has allowed not only thousands of flowers to bloom, but also quite a few weeds, the critics say. With the recession upon us, they conclude, the time has come to prune.

But are there indeed too many nonprofits? Let’s take a look at the numbers. When funders talk about mergers to reduce competition for funding, they are usually discussing the small subset of nonprofits that have annual operating budgets above \$100,000. They aren’t discussing the myriad small, mostly volunteer groups that make up the bulk of the sector, because these organizations are not filling funders’ inboxes with grant requests.

In 2005, only 170,000 of 1.4 million U.S. nonprofits reported expenses of more than \$100,000.² And only 55,000 nonprofits had expenses greater than \$1 million, including the 5,000 hospitals and colleges that are typically not included in discussions of the sector.

In contrast, 6.7 million of the nearly 30 million U.S. businesses had receipts of at least \$100,000, and 1.4 million had receipts greater than \$1 million.³ Compared to business, the nonprofit sector is tiny, in both overall number and average size of organizations. Thus the cause of the sector’s current feverish competition for funding would not appear to be “too many actors” in the marketplace. Instead, the principal reason for the run on funding is that, as if by some fiendish design, there are too few dollars available to support the vital services that nonprofits offer and that communities need.



Most nonprofits respond to what economists call market failure: Nonprofits provide desperately needed services to constituents who lack the means to pay the full cost. Government and private funders must then bridge the funding gap. In bad economic times these third-party payers pull back, leaving nonprofits with inadequate funding—often at the very moment that they are experiencing increased demand for their services.

Mergers cannot directly counter this dynamic, which is played out in every recession. When third-party funders curtail their support, nonprofits whose business models depend upon periodic infusions of cash from these sources are at risk of failure.

As funders complain that there are just too many nonprofits, they should also recall their own role in founding, growing, and rescuing many of the very same groups that are now in grave financial trouble. In good times, foundations develop new interests. They find holes in the tapestry of needed services and encourage the creation of new programs—as well as entirely new nonprofits—to fill the voids. They then buffer their grantees from the vagaries of the market. When grantees cannot generate adequate revenues from membership, sufficient gifts from donors, or a sustaining level of earned income from their operations, funders step in with well-timed grants that stave off the inevitable crisis. Then, when a recession shrinks foundation endowments, or the foundation shifts its funding priorities, it complains that there are too many nonprofits competing for its funds.

Cases for Merging

What of the proposition that many nonprofits are too small and too inefficient, that the sector would be more stable if it comprised fewer but stronger organizations? The sector is inefficient, this criticism holds, because too many groups provide the same services.

Yet this conceptualization is also too simplistic. When several organizations do similar work within a community, the community likely needs more services, not less. For example, consider an inner-city neighborhood that has five homeless shelters with a combined capacity of 100 beds. A survey of this neighborhood reveals that there are nearly 500 homeless persons living in the area. Even though these shelters offer so-called redundant services, together they can serve only one in five of the homeless people in their community. The problem here is too few shelter beds, not too many.

A better conceptualization of the problem here is not the duplication of services, but the duplication of service provider infrastructures. Each organization employs an executive director, recruits a board of directors, and backs an administrative structure. Each also likely struggles to support information systems, human resource management, and budgeting and accounting processes. Merging organizations to combine their infrastructures often makes sense.

The merger between the Support Center for Nonprofit Management, based in San Francisco, and the Nonprofit Development Center (NDC), based 40 miles away in San Jose, is an example of a successful integration that improved service delivery by combining infrastructures.

In 1998, the Support Center was nationally respected among nonprofit consulting and training organizations. Meanwhile, NDC was struggling with infrastructure, cash flow, and management (the executive had recently departed). Several major funders suggested that the two organizations undertake a merger.

Initially, NDC balked at the suggestion. Like many nonprofits, NDC had trouble accepting the loss of autonomy that would come with a merger. Board members also worried about entering into a partnership with a group of people they did not know. With falling revenues and a leadership vacuum, however, NDC had few options. Meanwhile, funders made it clear that they would no longer support NDC without a merger.

Integrating the Support Center and NDC was challenging. Convening a board of busy leaders from all over the San Francisco Bay Area proved difficult. Even deciding where to hold the board meetings was fraught. Cultural differences between the San Francisco- and San Jose-based operations and staff led to inevitable tensions.

But missteps are the rule with mergers, not the exception. “You have to budget for errors,” says Jan Masaoka, then CEO of the Support Center and later head of the merged organization, CompassPoint Nonprofit Services. “You will hire the wrong person, or set up the wrong system.”

Still, the merger ultimately preserved and strengthened NDC’s essential nonprofit management services in Silicon Valley. “The alternative was a total shutdown of NDC,” says Masaoka. “So yes, it was a success and it met most of the goals of the pre-merger organizations.” Indeed, many observers now consider CompassPoint the leading nonprofit management support organization in the nation.

Another potential merger situation arises when an organization is close to failing, but has one or more valuable programs with solid funding, such as ongoing government contracts or a loyal donor base. In this kind of merger, a larger and more stable nonprofit integrates the single program into its suite of services, salvaging the program while adding little administrative cost. Although less drastic than fully melding two organizations, this form of merger still requires negotiations, agreement on terms, and ultimately, the assent of each board of directors.

In 1994, for instance, PediatriCare, an Oakland, Calif.-based nonprofit, was on the brink of closing. Two part-time psychologists led the organization, which offered support groups to dozens of families affected by devastating illnesses. The two overworked codirectors not only recruited, supervised, and led PediatriCare’s volunteers and interns, but also raised funds, managed finances, and handled all of the organization’s other infrastructure requirements. By merging with Oakland-based East Bay Agency for Children (EBAC), a larger multiservice nonprofit that I led at the time, PediatriCare’s staff could focus on service delivery. Meanwhile, its board members, several of whom joined the EBAC board, could devote themselves to fundraising. Through this merger, PediatriCare, now known as Circle of Care, averted closing down. More than 16 years later, the organization remains a valuable resource for its community.

The Cost of Merging

Despite conventional wisdom, mergers themselves do not generate revenue or reduce expenses. In the short term, they actually require

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new money for onetime transactional and integration costs. Even in the long term, the act of merging itself did not lead to substantial cost savings for the vast majority of the mergers my firm has facilitated. Merged nonprofits can roll together annual audits, combine insurance programs, and consolidate staffs and boards. But they are also bigger and more complex and require more and better management—a cost that often exceeds the savings from combined operations.

When two Marin County, Calif.-based child welfare organizations—Sunny Hills and Children’s Garden—decided to merge in 1999, for example, they were able to eliminate one of two existing CEO positions. They also replaced two mid-level financial managers with a senior-level CFO—a move that should reduce costs slightly. But the larger, more complex multisite organization required a new COO position, and so the merger did not save much money. It did, however, result in an entity with improved financial management and administrative services, says Bob Harrington, former CEO of Children’s Garden, who now directs our firm’s Strategic Restructuring Practice. This merger was worthwhile from a strategic perspective, if not from a narrower cost savings viewpoint.

Casual observers often perceive cost savings after mergers. But a closer inspection usually reveals that the merger itself did not save the money. Instead, it created a structure within which management was able to make the tough decisions that ultimately led to better financial footing—decisions such as instituting layoffs, restructuring contracts, and launching new fundraising programs, any of which could also have been undertaken without a merger had the organizations’ leadership been willing or able to do so.

In 2004, for instance, Easter Seals and United Cerebral Palsy (UCP) affiliates in North Carolina merged. Headquartered in Raleigh

and with offices and programs throughout the state, the combined organization undertook a series of calculated risks that neither party would have attempted alone, including a second merger and the purchase of a for-profit organization, which was then converted into a nonprofit. Easter Seals-UCP North Carolina has since grown from an operating budget of \$33 million at the time of merger to a budget of \$80 million for fiscal year 2009, through both additional mergers and its own organic growth.

If two merging organizations under financial stress do not make the difficult but necessary decisions that will resolve major challenges after their union, they will experience a crisis just as surely as if they had remained separate. In other words, a merger may provide the right context for good leadership, decision making, and execution, but it cannot replace them.

In 1997, for example, Northern California’s two major research and teaching hospitals, Stanford University Medical Center and the University of California, San Francisco, merged. Health care cost pressures had intensified, and these two institutions thought that by combining their substantial strengths, they could better withstand the enormous shifts in their industry.

Within three short years, however, the two hospitals decided to dissolve their agreement. The challenges of academic medicine, which breeds a distinctive organizational culture of semi-independent fiefdoms, undermined the potential financial benefits of the partnership. Up and down the line, from administrative functions to clinical departments to medical education, the hospitals carried duplicate infrastructures on a massive scale. They were not able to consolidate because, among other reasons, the medical faculty was unmoved by management’s economic arguments and refused to get on board. As a result, the merger did not reduce costs. Instead, it added hundreds of new positions and caused a general financial crisis.

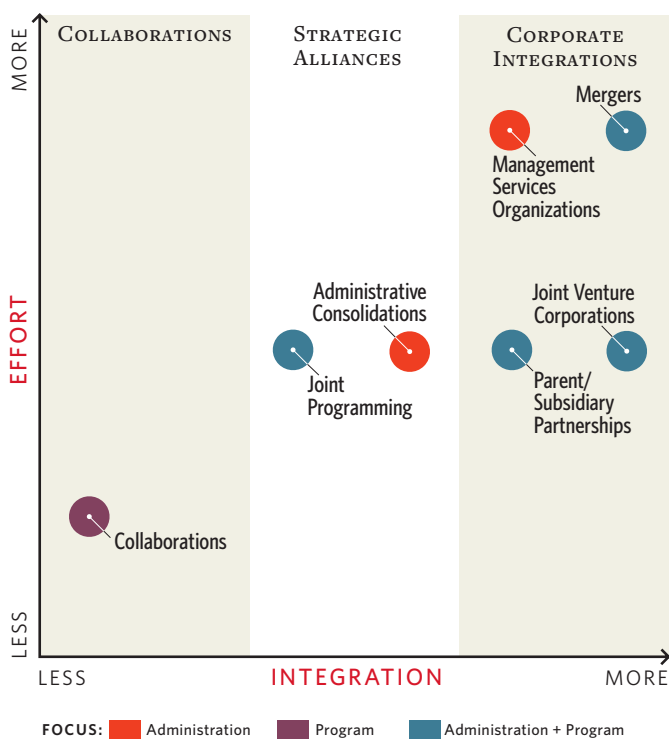
Although a merger is not a slam-dunk solution to financial problems, it can offer a stronger, more sustainable structure with which to weather an economic storm. Two volunteer boards can cast a wider net of donor contacts than can one. A combined leadership team can bring a wider array of perspectives and experience to problem solving. And two organizations can bring a greater diversity of programming. Mergers can encourage organizations to cut their costs and enhance their revenues. Organizations should therefore view merger as a means to implement other strategies, but not as a strategic end unto itself.

Other Corporate Integrations

Although a merger is the most familiar way that nonprofits can combine their fates, it is not the only way. As the matrix at left shows, three other forms of *corporate integration* change parties’ legal structures so that they can share their strengths. The first form, *management services organizations*, combines only the administrative functions of the partners. *Joint venture corporations* combine a subset of nonprofits’ programmatic functions. And the third form, *parent-subsidiary partnerships*, blends both administration and programs, usually when a merger is desired but is not technically possible.

A management services organization (MSO) is created when a group of nonprofits creates a legally separate corporation through which they share administrative services, most often including

The Partnership Matrix



finance, human resources, and information technology (IT). Usually MSOs are membership organizations whose bylaws name the founding nonprofits as the sole members. These bylaws give ultimate control to the nonprofits that form the MSO. MSOs can help the founding nonprofits avoid unrelated business income tax (UBIT) on non-mission functions. They also allow for equal control over the separate entity.

In 2007, MACC CommonWealth was formed when five human services agencies in Minnesota's Twin Cities decided to consolidate their back-office functions: finance, human resources, and IT. The board comprises the CEOs of the five partnering entities, while a staff of 15 offers a full range of administrative services to MACC's members. In addition to providing high levels of service, MACC has achieved notable cost savings. In its first year of operation, members experienced a 3 percent reduction in administrative costs and also saved more than 10 percent through reduced costs for things like employee benefits, payroll, and bulk purchasing.

A joint venture corporation uses the same structure as an MSO, but it combines programs rather than administrations. For example, Stanford Home for Children, Sacramento Children's Home, River Oak Center for Children, and Sierra Adoption Services are all child welfare programs located in central California. To consolidate their foster care offerings for troubled youth, these four organizations created a new nonprofit joint venture corporation called Family Alliance. Before their consolidation, the separate programs ran deficits because of their small sizes. After forming the joint venture corporation, they managed to break even, strengthening the program in the process.

No one ever begins with the idea of forming a parent-subsidiary partnership, but sometimes that is where they wind up. In 1999, Women's Crisis Support and Defensa de Mujeres decided to merge. These two Santa Cruz County, Calif.-based organizations provide shelter and other services to women recovering from domestic violence. They covered similar geographic areas and indeed had once been a single organization, prior to a split. They shared similar missions and values. Combined, they could serve the entire county and speak with a single voice in policy discussions. Moreover, uniting their boards and staff would create a more powerful and stable organization.

Nevertheless, a technical impediment stood in the way of their merger: The state government of California imposed a maximum grant size for services of their type, and each organization was already receiving the limit. A merger would have therefore cost the groups one of their biggest contracts.

So Women's Crisis Support and Defensa de Mujeres instead formed a parent-subsidiary relationship. They then consolidated most programmatic and administrative activity in the parent. In this way the organizations joined their programs and administration while maintaining separate legal structures.

Strategic Alliances

Not all partnerships knit organizations as closely together as do corporate integrations. *Strategic alliances* let organizations unite programs and cut costs while remaining somewhat independent.

If nonprofits want to partner primarily to reduce costs, they should examine a possible *administrative consolidation*. This form

allows them to share administrative services while remaining entirely separate entities. In most cases, one group provides services for others essentially as a vendor.

Such an arrangement brought together three Chattanooga, Tenn.-based nonprofits in 2001. The first of these, the Creative Discovery Museum, operated in the red from its opening in 1995 because it was designed to accommodate far more visitors than ever materialized.

The second organization, the Hunter Museum of American Art, faced an entirely different although equally challenging situation. Chattanooga's oldest cultural institution, the Hunter had become disconnected from the community. Its outdated operational infrastructure, with dial-up Internet access and paper-based systems, only exacerbated the museum's detachment. To modernize, the museum needed major funding.

Meanwhile, the much larger Tennessee Aquarium was thriving. Indeed, this nonprofit had excess administrative capacity: Its finance, human resource, and other back-office functions could take on more work without adding new staff or systems and their attendant costs.

The two museums approached the aquarium with the idea of merging. The aquarium countered with a proposal for an administrative consolidation: The aquarium would provide financial, human resources, IT, and other services for the museums. Because the aquarium would incur only minimal costs to do this extra work, it would charge the museums far less than they were spending. Each group would maintain its separate mission, board, and leadership.

The three groups agreed to the arrangement. In the eight years since the consolidation, the Creative Discovery Museum and the Hunter have saved nearly \$4 million in administrative costs. Over the same period, the aquarium earned more than \$1 million in fees from its partners, most of which dropped straight to its bottom line.

Like administrative consolidations, *joint programming* uses the same mechanism—a written agreement or contract—albeit to combine programs rather than administrative functions while otherwise maintaining organizational independence. Joint programming is quite common in the nonprofit sector. We see it when a foundation grant or government contract requires several actors to tackle a complex problem together. Rather than making separate grants to each party, the funder makes a single grant to one of the nonprofits. This organization, now known as the lead agency, then subcontracts some of the funds to the other parties.

Joint programming does not always entail money changing hands. Ten years ago, Big Brothers Big Sisters of America and Boys & Girls Clubs of America began a joint programming alliance. Big Brothers Big Sisters recruits, screens, and trains would-be mentors, while Boys & Girls Clubs identifies kids in need of mentoring. To date, more than 40 Big Brothers Big Sisters affiliates have worked with about 300 Boys & Girls Clubs to make hundreds of matches.

Strategic alliances preserve greater organizational independence than corporate integrations, often making them more palatable to the partners. If the desired result of a partnership is to share administrative services such as accounting, or to coordinate service provision, a strategic alliance is the way to go. Only when the desired result is a fuller strategic alignment does a merger or other corporate integration make sense.

Collaborations

Collaboration is the least intense form of partnership among nonprofits and also perhaps the most common. Unlike corporate integrations, collaborations do not change the parties' corporate, legal, and governance arrangements. And unlike strategic alliances, they do not require a written agreement specifying the roles and responsibilities of the parties. Collaborations are informal and usually undertaken for a specific occasion or a limited purpose.

For example, as an executive director in the 1980s, I belonged to a collaboration made up of 25 nonprofits that all received funding from the Alameda County (Calif.) Department of Mental Health. Once a year, the county's annual budget process threatened to reduce funding for its nonprofit contracting agencies. Although for much of the year our collaborating organizations competed for contracts, staff, private donors, and media attention, we set aside those issues during the budget process, when we united to oppose budget cuts to any members of our group. We fought this annual battle without needing to become partners in a larger sense. This collaboration continues today.

Collaborations are appropriate when the need that brings the parties together is either narrowly defined, time limited, or, as in the example above, both. Despite their limited scope, collaborations cannot succeed without a basic level of trust and transparency. Parties that distrust one another cannot work together, at least not effectively. I was once hired to help a group of nonprofits that were trying to share staff recruitment. But because they distrusted one another, they did not believe that their partners would route résumés in the agreed manner. As a result, some parties broke the agreement, preemptively deciding that if others were going to cheat, they should beat them to it. Needless to say, the collaboration fell apart.

Promoting Partnerships

As the economic crisis continues to take its toll, many foundations ask whether a wave of mergers and other partnerships could strengthen vulnerable nonprofits. The answer is, quite definitely, "it depends." Many factors go into partnership decisions. In the case of a merger, for example, the most important of these factors are mission compatibility, executive leadership, and the strength of the proposed business model.

Partnerships also raise myriad practical issues. Corporate integrations, for instance, require combining compensation plans, cultures, programs, budgets, and donors. Strategic alliances must ensure a fair exchange of value among the partners. And collaborations demand the ability to align goals and to build effective working relationships among groups that may also be competitors. Each of these challenges is usually solvable, but interpersonal issues between the groups—for example, whether they trust each other—will often determine whether a partnership produces real value.

Given these complexities, funders should work to create a climate where mergers and other partnerships can succeed. A first step they can take is to advertise their support for partnerships. Many nonprofits fear that funders view partnering as a sign of weakness. Funders can address this fear head on by announcing the availability of grant support for mergers and other partnerships. Some already do so, often calling these initiatives *strategic restructuring*, a term we coined

more than a decade ago to cover the entire array of nonprofit partnership options. For example, the Hawaii Community Foundation has a Strategic Restructuring Fund, the Dyson Foundation in New York's Hudson River Valley has launched a Strategic Restructuring Initiative, and the Foellinger Foundation in Indiana features strategic restructuring in its Strengthening Organizations grants.

Funders should also stop rescuing failing enterprises. If the argument for making a grant is that the grantee will fail without it, the funder should let it fail. A better use of the money may be to invest in a partnership that could save some of the failing organization's services, or to support an orderly dissolution.

Time is of the essence in partnerships, so funders should also quickly support partnerships. The critical window of opportunity is often about 30 days. Once the idea of a partnership is on the table, it needs to start moving forward quickly or it will begin to generate rumors and organizational anxiety that could inhibit the parties' motivation to move forward.

To invest swiftly in partnerships, funders should also use phased grants that first cover negotiation costs and then pay attorney fees. Only after the parties agree to a deal should the funder support implementation. This approach incentivizes the right behavior—doing what is best for the organization's mission—and discourages faux partnership attempts that aim to attract funding.

Because executives can often be the biggest barriers to partnerships, funders should take care to anticipate and address their concerns. If executives fear for their jobs, they may sabotage negotiations. Funders can also support "stay pay" or severance for certain employees. The promise of a fair and reasonable severance allows executives to relax and do what is right.

Finally, funders should model partnership, and not just preach it. Nonprofit leaders note that their funders urge them to collaborate but seldom follow their own advice. Funder partnerships can both demonstrate the power of working together and give the funders credibility in the eyes of their grantees.

One funder who takes collaboration seriously is Jerry Hirsch of the Lodestar Foundation in Phoenix. For several years he has encouraged collaboration among funders interested in supporting nonprofit partnerships.

In today's economic environment, with increased competition for resources, funders increasingly look to mergers to save threatened nonprofits. A merger is indeed a powerful intervention. Widespread use of mergers, however, will not reduce competition among nonprofits because "too many nonprofits" is really not the problem.

Instead, funders, nonprofits, and taxpayers alike need to rethink how to fund activities that are socially necessary but that, by their very nature, will never earn enough money to pay for themselves. Mergers are just one choice on a continuum of strategic restructuring partnership options. ■

Notes

- 1 Amelia Kohm and David La Piana, *Strategic Restructuring for Nonprofit Organizations: Mergers, Integrations, and Alliances*, Westport, Conn.: Chapin Hall Center for Children, 2003.
- 2 Kennard T. Wing, Thomas H. Pollak, and Amy Blackwood, *The Nonprofit Almanac* 2008, Washington D.C.: The Urban Institute Press, 2008: 140, Table 5.1.
- 3 United States Census Bureau, *The 2009 Statistical Abstract of the United States*.