Pressure Cooker:
Funding Nonprofit Mergers in Turbulent Times

Executive Master’s in Nonprofit Leadership
Summary Project

Prepared by:
Amy Zimerman

Seattle University
College of Arts and Sciences
Center for Nonprofit and Social Enterprise Management

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EXECUTIVE SUMMARY

It is impossible to predict the consequences of an unfinished crisis; however, the collapse of the U.S. financial markets will likely magnify current trends toward financial oversight and away from strategy. The consequences of this now global crisis will likely be regulatory reform, increased oversight, international accounting standards, improved disclosure and customer protections, which will eventually make their way in some form to the nonprofit sector. The long term effects of the crisis are reminiscent of, and will be perhaps more stringent than, the imposition of Sarbanes–Oxley-inspired changes to the new Form 990. In the near term, however, the chaos on Wall Street will undoubtedly have a significant effect on the operations of nonprofit organizations. Nonprofits face an enormous level of uncertainty with regard to levels of charitable giving, while at the same time the demand for their services is expected to increase in light of the recently declared recession in this country. The need for uninterrupted services at this critical juncture can not be underestimated, but the current crisis may prove insurmountable for the sector if a protracted, global economic meltdown takes hold. Now, more than ever, nonprofit organizations must confront the business realities of their operations. Financial uncertainty requires fiduciary governing, but it also requires strategic direction and results (Chait, 2005; Gill, 2005).

As endowments drain, donors review their giving patterns, government spending becomes increasingly uncertain, and access to credit is temporarily suspended, competition for funding will increase. Funders are likely to continue to require greater efficiency, effectiveness, and accountability of the nonprofit organizations they support. In the wake of earlier crises, nonprofit organizations were urged to focus greater attention on governance, transparency, and accountability. In today’s environment, nonprofit organizations should build upon that focus and soberly consider consolidation as a strategic alternative.

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Conventional wisdom suggests that one of the main reasons nonprofits contemplate merging with another entity is that funders pressure them into doing so. An extensive review of the literature on nonprofit mergers reveals that this is not the case. While there is anecdotal evidence to support that some nonprofit organizations have been pressured by funders to collaborate and consolidate, this is not universally true of all nonprofit mergers. Indeed, empirical evidence demonstrates that the least important motivation for restructuring is pressure from funders (Kohm et al., 2002).

The purpose of this paper is to explore the role that funders play throughout the merger process between nonprofit organizations. Whether funders pressure nonprofits into merging with another entity is a question of no small relevance. Reorganization is a complex and uncertain undertaking, and the existing body of literature lacks important research in the areas of process, motivation and evaluation – all of which are inextricably linked. The insights gained from this study are intended to lead to a greater understanding of why nonprofits should merge their organizations, the overall effectiveness of merger as a strategy, and whether process determines outcome.

As part of the research, this author studied a recent nonprofit merger between two Community Development Financial Institutions. Beginning in the summer of 2004, Cascadia Revolving Fund and ShoreBank Enterprise Pacific engaged in a mutual exploration that ultimately concluded with the formation of ShoreBank Enterprise Cascadia in January of 2007. The case outlines the rationale for the merger and describes the participation of funders at various stages of the process. Interestingly, the landscape was not the only, or even primary, impetus for merging. It merely provided the opportunity for the two organizations to achieve a shared vision of scope, impact, and sustainability in the economically distressed communities both organizations serve. Funders – government, foundations and socially responsible investors
– all had a hand in creating the current landscape and therefore had a responsibility to fix it. In this situation, by providing financial support, technical assistance and counsel, funders acted as true partners throughout the process rather than performing an oversight function. The case clearly demonstrates that funding pressure is not the same as pressure from funders, an important conclusion given today’s financial and economic crisis. Furthermore, it underscores the need and the ability of philanthropy to fund systemic change through nonprofit mergers.

Nonprofit organizations should consider mergers in light of the current financial and economic crisis. Indeed, they should solicit funders for support in order to create the business/mission case for merging. Then, and only then, can two organizations determine whether a merger makes sense. For their part, funders should foster systemic change by reversing the existing, enormously robust, yet highly inefficient delivery of nonprofit services in this country and should support nonprofit organizations through all stages of the merger process.

More research is required to debunk the myth that funders pressure nonprofits into merging if, for no other reason, than to prevent them from doing so in the future. Additional areas of research should: a) explore the relationship between leadership, authority and culture during the merger process to determine their effects on post-merger integration; b) vet the existing motivations identified as precipitating nonprofit mergers in order to better understand not why nonprofits merge, but rather, why they should; and c) determine the overall effectiveness of nonprofit mergers as a strategy, establishing when and how merged entities should evaluate their results.
INTRODUCTION

The current financial chaos on Wall Street will undoubtedly have a significant effect on the operations of nonprofit organizations. Nonprofits face an enormous level of uncertainty with regard to levels of charitable giving, while at the same time the demand for their services is expected to increase in light of the recently declared recession in this country.

While foundations are required to disburse five percent of their assets each year, the asset base on which that five percent is calculated has fallen sharply since September. The Dow Jones Industrial Average lost 25% of its value since mid-September, when Lehman Brothers filed for bankruptcy protection. One bailout package, FDIC-sponsored bank mergers, and a coordinated global reduction in interest rates have not prevented volatility in the marketplace. Indeed, if the stock market fails to rebound or worse, continues to fall further, the asset losses experienced by foundations and high net worth individuals will likely create a situation in which overall funding to nonprofit organizations decreases.

As endowments drain, donors review their giving patterns, government spending becomes increasingly uncertain, and access to credit is temporarily suspended, competition for funding will increase. Funders are likely to continue to require greater efficiency and effectiveness, and accountability of the nonprofit organizations they support. In the wake of earlier crises, nonprofit organizations were urged to focus greater attention on governance, transparency, and accountability. In today’s environment, nonprofit organizations should build upon that focus and soberly consider consolidation as a strategic alternative.

There is a continuum of strategies that nonprofit organizations can employ to consolidate. This paper will focus on one specific form of strategic restructuring: mergers. The research on nonprofit mergers, while growing, is not extensive, but it provides the foundation for us to begin to understand why nonprofits merge.
REVIEW OF THE RELEVANT LITERATURE

The research on nonprofit mergers, while growing, is not sizeable. An extensive review of the literature produced only three empirical studies involving nonprofit organizations that had participated in, or contemplated, mergers. Rather, the literature offers “a close-up or insider account of merger practice” (Harrow & Cripps, 2004, p. 3). Most of the scholarly research involves a single case study or a comparison of a small handful (three or fewer) of mergers. The remaining publications comprise a variety of how-to manuals and treatises addressed to boards of directors and leaders of nonprofit organizations (Arsenault, 1998; La Piana, 2000a, 2000b; La Piana Associates, 2004; McLaughlin, 1996).

This lack of research stands out against the prevalence of nonprofit mergers per se (Kohm, La Piana, & Gowdy, 2000; Norris-Tirrell, 2001; Schmid, 1995; Toepeler, Seitchek, & Cameron, 2004). Nonprofits in the United States appear to have executed more mergers, though there is even less research on the merger experiences of the third sector in other countries to confirm that. The voluntary sector in the U.K. seems to be at the vanguard of a new trend in nonprofit mergers, as papers on the topic are emerging there (Harrow & Cripps, 2004; Sargeant & Jay, 2002). In the U.S., these “transactions have been used for some time” (Golensky & DeRuiter, 1999, p. 138) and indeed date back to the mid-1980s (Singer & Yankey, 1991; Toepeler et al., 2004). The emergence of nonprofit mergers as a strategic consideration appears to have followed a trend of corporate reorganizations between 1985 and 2000 (Kohm et al., 2000; see also Arsenault, 1998; Singer & Yankey, 1991).

Research tends to visit one of three recurring themes: a) the merger process; b) restructuring alternatives, of which merger is but one example; and c) motivations for merging. One notable piece of work has emerged in each of the three areas. In their seminal work on nonprofit mergers, Singer and Yankey (1991) note that “mergers and consolidations have been
conceptualized as a process” (p. 358). Using a framework developed by The Greater New York Fund/United Way in 1981, the authors interviewed 39 nonprofit leaders in the Cleveland area representing 18 distinct transactions (p. 361), about the four phases of their mergers: decision-making, planning, implementation and evaluation (p. 358). Subsequent authors have used this framework in their research (e.g., Golensky & DeRuiter, 1999, 2002). More recently, Toepler, Seitchek, and Cameron (2004) discuss a case study in terms of its merger partners, pre-merger stage and the merger. This author could not find any formal research on the nonprofit merger process undertaken in the past 27 years.

Kohm, La Piana and Gowdy (2000) published the largest single piece of empirical research to date involving strategic restructuring. In this study, 192 respondents were surveyed about the types of strategic alternatives they had undergone and the reasons for the restructuring. These 192 respondents, together with 555 partner organizations participating in the transactions, represent 747 nonprofit social service and cultural organizations in the U.S. The study revealed that 45% of the restructurings took the form of alliances, which are characterized as partnerships focusing more on programming-related collaborations where the organizations retain greater levels of autonomy, vs. 55% of restructurings that took the form of integrations, characterized as partnerships focusing both on administrative and programming issues where the organizations achieve greater levels of integration (p. 9). The most frequent type of integration observed was mergers, at 32% of the overall sample (Ibid).

Golensky and DeRuiter (2002) presented the first formal model of merger motivations. This model suggests that it is the relationship between nonprofit executives’ decision-making style and the availability of resources that determine “whether (a) merger is driven primarily by mission, practicality, stability, or fear” (p. 169). The authors conclude that the factors described
in the model shape the initial decision to merge but call for additional research to determine its potential value as a predictor of merger success (p. 185).

Interestingly, the vast majority of research on nonprofit mergers tends to focus predominantly on certain fields within the sector, namely, health and human service agencies. While there are some cultural agencies discussed (Kohm et al., 2000; Toepler et al., 2004), the purpose of one study is, pointedly, to determine whether the literature on health and human service agency mergers could be applied to smaller nonprofit organizations and/or nonprofit mergers in the arts. The writers concluded that “the current knowledge and analyses are indeed universal rather than field specific and sufficiently suited to help smaller groups and other agencies” (Toepler et al., 2004, p. 110).

The attention to nonprofit mergers in health and human services can be attributed in part to the fact that those organizations are one field within the sector that is “clearly marked by a growing reliance on fee and earned income and for-profit competition” (Op. cit., p. 96). Arguably, certain arts and culture organizations would also fit that description. If the research is any indication, these types of agencies – health and human services and arts and culture – have been the two fields most involved in mergers over the years. As a result, writers tend to discuss the incentives for merging in corporate perspectives (Harrow & Cripps, 2004; Schmid, 1995). For example, Schmid (1995) describes the “desire of organizations to control a large share of the market, and to attain more resources and position themselves in the market” (p. 377).

Mergers may have become an “increasingly viable option” (Wernet & Jones, 1992, p. 368) for nonprofit organizations, yet the paradigm may be shifting in terms of the way people view how leaders come to consider mergers as a strategic alternative. In 1991, Singer and Yankey depicted mergers as “last resort efforts to survive in response to environmental pressures rather than well-planned and well-executed growth strategies” (p. 358). Five years later,
McLaughlin refuted this “regressive posture” and asserted that mergers were no longer a “sign that a nonprofit has failed” and that they were “becoming a strategic option for dealing with the nonprofit challenges of the 21st century” (p. 1).

Practitioners began to advocate that boards and executive directors, having acquired greater sophistication in their roles (McLaughlin, 1996), should consider the unthinkable (La Piana, 1994), and by 1998, they stated that their clients were considering mergers “increasingly as the result of strategic planning processes” (Arsenault, 1998, p. 4). Notably, there is one firm of consultants preparing workbooks to guide the sector through the process of merging (La Piana, 2000a, 2000b; La Piana Associates, 2004).

More recently, Harrow and Cripps (2004) observe that there are “anecdotal accounts of a public mood in which there are “too many charities serving a similar purpose”” and that mergers “appear increasingly on policymakers’, funders’, and leaders’ agendas” (p. 2). The question researchers have been asking is why nonprofits merge, not why they should. In addition, there is no broad consensus among scholars as to whether there is a conscious strategy underpinning a nonprofit’s desire to merge let alone what the appropriate reasons to merge should be.

The literature “focuses more on external than on internal circumstances that lead to strategic restructuring” (Kohm et al., 2000, p. 6). Schmid (1995) argues that “the main catalyst for mergers is economic uncertainty, which is caused by market fluctuations, paucity of resources, and dependence on shared sources of funding” (p. 378). Sargeant and Jay (2002) contend that nonprofit leaders “are viewed … as rationally deciding that economic benefits of some form would result from a merger and actively seeking partnership thereafter” (p. 955); however, they go on to say that other authors have suggested that “managers may require an additional impetus to push them towards merger” (p. 956). Golenksy and DeRuiter (2002) emphasize that there is no clear path from to A (potential or real threat) to B (course of action)
and that the decision to merge may “come down to which potential partners are available and interested at a given moment” (p. 172). Kohm et al. (2000) hedge their bets by saying that nonprofit mergers “arise from both idealism and pragmatism” (p. 3) but are the “result of forecasting and planning” (p. 2). Toepler et al. (2004) underscore the difference between the act of considering a merger strategy in response to “environmental turbulence and pressures” and evaluating “the choice of a merger over other (strategic) options” (p. 103).

Several authors highlight the tension between economic factors and mission fulfillment (Arsenault, 1998; McLaughlin, 1996; Norris-Tirrell, 2001). Given the unique nature of nonprofit organizations, as compared to for-profit businesses, this is not surprising. Golensky and DeRuiter (2002) state that “the impetus for a nonprofit merger seems to be some combination of economic incentives and moral imperative, with perhaps greater emphasis on the former” (p. 170).

Many authors mention funders as a possible motivation for merging (Golensky & DeRuiter, 1999; Kohm et al., 2000; Norris-Tirrell, 2001; Sargeant & Jay, 2004). Sargeant and Jay (2002) mention the “considerable anecdotal evidence of the direct or indirect role that funders can have in precipitating a merger decision” (p. 659). Scholars have identified several ways that funders have directly intervened in the process. (Norris-Tirrell (2001) provides anecdotal evidence of funders, namely, the United Way, “actively encouraging local nonprofit agencies to explore merger options, with promises of increased financial support” (p. 315). Golensky and DeRuiter (1999) relay that “recommendations by funding bodies were a primary impetus for merger” (p. 139) in the case studies they reviewed. That said, in one of the mergers, an interesting dynamic took place. A large foundation provided grant assistance to the two entities exploring a merger, while the government agency publicly opposed the merger outright (Op cit., p. 145). It is important to note that even within the same transaction, funders may have conflicting viewpoints and different behaviors. Kohm et al. (2000) assert that “giving guidelines
of funders around the country reflect (a) concern about duplication” (p. 5). They also indicate that “a few grantmakers have established special funding initiatives to encourage nonprofits to consider and plan strategic restructurings” particularly in light of significant reductions in public funding (Op. cit., p. 6).

The indirect role that is ascribed to funders vis à vis the merger process is that of a market clearing agent. Sargeant and Jay (2002) posit that “in the absence of the market forces so often driving merger activity in the for-profit sector, it may thus be argued that funders play a critical role in fostering the delivery of efficiency gains across the sector” (p. 966). McLaughlin (1996) contends that, by merging, nonprofit organizations are “putting an end to fragmented service delivery and the inefficient use of economic resources” (p. 3). However, Kohm et al. (2000) warn that the survival of nonprofit organizations “is not based on demand among consumers for their services, but instead on the decisions of funders and policymakers based on an inevitably imperfect knowledge of demand and on their own interest and concerns” (p. 5).

To a degree, therefore, scholars believe that funders had a hand in creating the current landscape, one marked by a proliferation of nonprofits providing unfunded, fragmented, and/or duplicative programs and services (Kohm et al., 2000; McLaughlin, 1996; Norris-Tirrell, 2001). McLaughlin laments that “fragmented services are so common that they are hardly questioned” (p. 3), pointing out that “the reasons often have to do with how each service is funded … rather than efficiently responding to the (client’s) needs” (p.3). Norris-Tirrell (2001) agrees with McLaughlin’s depiction of “an enormously robust but inefficient nonprofit service delivery program” (p. 312), which McLaughlin (1996) attributes to the “traditional philanthropic notion of funding only pilot programs, (thereby causing) the landscape to be dotted with small, underfunded programs when fewer large programs would have more clout and institutional credibility” (pp. 2-3). Kohm et al. (2000) note that “organizations can be hard pressed to raise
operating dollars because private funders often favor supporting discreet programs over operating costs” (p. 6). Hence, widespread restructuring efforts are both necessary and underway. Yet “no government agency is charged with protecting the interests of the community-at-large, the nonprofit market, or the industry impacted by the merger” (Norris-Tirrell, 2001, p. 320).

It is important to understand that “no one has as yet formally evaluated the success of a merger” (Sargeant & Jay, 2002, p. 957). Scholarly research omits the evaluation of nonprofit mergers in spite of a belief that evaluations “should be viewed as part of an organization’s ongoing responsibility for self-evaluation” (Singer & Yankey, 1991, p. 361). Kohm et al. (2000) confirm that “because strategic restructuring is a nascent area of inquiry, current writers have more to say about motivations than about actual benefits” (p. 6). According to La Piana Associates (2004), “funders increasingly require evaluation efforts as a condition of their grant or contract” (p. 35). However, there is no consensus in the literature about the appropriate time frame in which nonprofits should conduct their evaluation.

Singer and Yankey (1991) suggest that merged entities should set “a target date of one year after formal completion of the merger to review the entire process” (p. 361). The authors’ recommendation is again based on the guidelines set forth by the Greater New York Fund/United Way in 1981. McLaughlin (1996) counsels nonprofits to “consider having an independent evaluation after 12-18 months have elapsed to fine-tune your newly-formed entity” (p. 21). Golensky and DeRuiter (2002) state that “at the time of the study, the mergers were still too new for us to do a more traditional evaluation” (p. 176). Conspicuously, all three mergers reviewed for the study had been completed four to five years prior to the paper’s publication.

Furthermore, there is no consensus in the literature on the set of criteria on which to base an evaluation. Various authors propose merger incentives, espoused merger goals, and the
impact on fundraising as sample criteria, with limited explanations of how they would be measured. Toepler et al. (2004) posit that the “ability to realize (merger) incentives after the merger contributes to the perception of its successfulness” (p. 103). Schmid (1995) approaches it from another angle, asserting that if the merged organization deviates from its espoused goals, “this poses a threat to the organization’s legitimacy and ultimately, to its survival” (p. 389). Sargeant and Jay (2002) identify “a need for quantitative work to determine the exact impact of a merger on the amounts raised” (p. 967).

Finally, in the absence of any theoretical or even practical suggestions for evaluation frameworks, scholars are somehow able to distinguish successful nonprofit mergers from failed ones. Golensky and DeRuiter (1999) assert that “it is undoubtedly too soon to expect a formal evaluation of the full impact of the … merger” (p. 151) that has closed three years earlier; however, they describe it as a “success story” because “the individuals involved recognized the impending threats in their environment … and decided to take action while their options were still open” (p. 140). Moreover, scholars believe that when funders pressure nonprofits into merging with another entity, the results are disappointing. Kohm et al. (2000) state that “some feel that nonprofit mergers succeed when they are not forced by such outside players as funders” (p. 7). Sargeant and Jay (2002) observe that “mergers that had been enforced by funders appeared to be less successful than those undertaken willingly and based on a shared vision” (p. 955).

With an awareness of this vast, untapped body of literature on nonprofit mergers and the often-cited influence of funders in the merger process, this paper examines the conditions and forces that give rise to nonprofit mergers.
STATEMENT OF THE PROBLEM

Market Failure

Over the past three months, after a year of tempered effects resulting from the biggest housing and credit bubble in history, the United States financial markets collapsed. The Federal Government has expanded its gross liabilities by more than $1 trillion dollars – almost twice as much as the cost of the Iraq war (“When Fortune Frowned,” 2008, pp. 3-4). Money markets have seized up. Stock markets around the world have plummeted. To date, five European banks have failed, and European governments are propping up their banking systems in much the same way as the U.S. government (Ibid).

In mid-November, the G-20 representatives identified the root causes of the now global crisis, noting the financial industry’s increasingly complex products, failure to properly conduct due diligence, weak underwriting standards, inadequate appreciation of risks, unsound risk management practices, and excess leverage (“Summit,” 2008). The G-20 also highlighted the vulnerabilities of policymakers and regulatory agencies that “did not (…) address the risks building up in the financial markets, keep pace with financial innovation, or take into account the systemic ramifications of domestic regulatory actions” (Ibid).

The current financial chaos on Wall Street, albeit significantly more widespread, is reminiscent of the high-profile business scandals that occurred between 2000 and 2002, which resulted in the Sarbanes-Oxley Act of 2002 (“SOX”). SOX addressed the need for increased corporate scrutiny in the wake of those corporate and accounting scandals based on a realization that focusing on financial performance does not prevent mismanagement or fraud. Indeed, Sarbanes-Oxley imposed stricter standards of ethical practices and accountability measures on corporations in order to reverse the lack of public confidence in the business sector. While only two provisions of the new law applied directly to nonprofit organizations (“Sarbanes-Oxley
Act,” 2002), SOX underscored the heightened expectations for corporate governance – even at nonprofit entities.

Much debate ensued about the applicability of these standards on the nonprofit sector and the extent to which nonprofits need to be regulated in a similar fashion. An often-cited argument was the fact that nonprofits do not calibrate success purely with business metrics. As Jim Collins (2005) argues, a key difference between nonprofits and business is that “performance must be assessed relative to mission, not financial returns” (p. 5). In spite of the noble work that nonprofits perform in service to society, the sector is not immune from corporate governance failures or heightened scrutiny. Scandals linked to nonprofit organizations were also widely publicized during this period. As a result, the Internal Revenue Service is now obligating nonprofit organizations to comply with elements of SOX indirectly, through the introduction of the new Form 990 that all tax-exempt organizations are required to file annually. The IRS may be legislating by form, but the expected result of this regulation is no different for nonprofits than the SOX changes that were intended for the private sector: increased transparency, good governance, accountability and ethical practices.

Sarbanes-Oxley and the revised Form 990 are two examples of the push for greater emphasis on financial accountability, changes in reporting/auditing standards, broader legal requirements, and a stricter interpretation of governance for nonprofit organizations. These trends toward greater transparency and new disclosure requirements have been coupled with an increasing focus on impact, outcomes and measures by funders and nonprofits alike. The nonprofit sector has brought focus and discipline to their missions by adopting strategic performance measures through the use of logic models, program evaluation tools, theory of change models and the balanced scorecard. In addition, the nonprofit sector has incorporated greater levels of sophistication through the application of for-profit business models to structure
and serve nonprofit constituencies. In their search for legitimacy, nonprofit boards have imitated the roles of boards in the business sector based on a widely-held belief that corporate boards were doing their jobs well. Recent corporate scandals suggest the contrary, and as a result of corporate board ineffectiveness, nonprofit boards have been compelled to redouble efforts on traditional fiduciary responsibilities in the wake of Sarbanes-Oxley, as stricter standards and Form 990 compliance have been imposed.

While the sector is regularly criticized for not having enough financial acumen, we have seen that, even in business, financial competency is not enough. Chait, Ryan and Taylor (2005) argue that “behind every scandal or organizational collapse is a board (often one with distinguished members) asleep at the switch” (p. 11). This is due, in large part, to board work that focuses on financial oversight rather than strategy. Nonprofit boards still need to advance the mission. Axelrod (2005) describes three main functions of strategic focus: a) boards need to “establish the mission at the time the organization is formed,” review it regularly, and revise it if necessary; b) they need to ensure that the “mission is clearly articulated and understood and supported by board members;” and c) they need to “engage in strategic thinking to determine the strategic directions and priorities,” making sure that the priorities are aligned with the mission, vision and values of the organization (p. 136). In other words, boards need to formulate strategy. A “board’s ability to envision and shape institutional direction” is one of the key dimensions of board effectiveness (Chait et al., 2005, p. 66). Implementing a functional board that looks inward to “check on trouble” (Op cit., p. 40) is not appropriate for nonprofit organizations, nor is it enough.

It is impossible to predict the consequences of an unfinished crisis; however, the current financial collapse will likely magnify these trends toward financial oversight and away from strategy. The consequences of this global crisis will likely be regulatory reform, increased
oversight, international accounting standards, improved disclosure and customer protections, which will eventually make their way in some form to the nonprofit sector. In the near term, however, the chaos on Wall Street will undoubtedly have a significant effect on the operations of nonprofit organizations. Nonprofits face an enormous level of uncertainty with regard to levels of charitable giving, while at the same time the demand for their services is expected to increase in light of the recently declared recession in this country (“Determination,” p. 1).

The effective use of limited charitable resources is critical to the sustainability and success of the nonprofit sector. However, the third sector has not always performed well during crises. As Lester Salamon observed, “…the fragile systems of charitable action were nearly overwhelmed by the enormity of the September 11 tragedy” (as cited in Young, 2002). 9/11 demonstrated that even the largest and most prestigious nonprofit organizations in this country could waver by neglecting governance, operating without transparency and cultivating an organizational culture resistant to change. Specifically, the Red Cross was heavily criticized for its response to the 9/11 attacks (Sontag, 2001). In the aftermath of the crisis, nonprofit organizations were urged to “widen the frame from which to make (their) economic decisions” (Young, 2002). The need for uninterrupted services at this critical juncture can not be underestimated, but the current crisis may prove insurmountable for the sector if a protracted, global economic meltdown takes hold. Now, more than ever, nonprofit organizations must confront the business realities of their operations. Financial uncertainty requires fiduciary governing, but it also requires strategic direction and results (Chait et al., 2005; Gill, 2005).

**Effects of the Crisis on Philanthropy**

The annual Giving USA report showed that in 2007 total charitable giving in the United States exceeded $300 billion (Hrywna, 2008, p. 17). However, the asset base on which philanthropy is determined has fallen sharply since September of this year. The Dow Jones
Industrial Average lost 25% of its value since mid-September, when Lehman Brothers filed for bankruptcy protection (“Dow Jones,” 2008). One bailout package signed into law, FDIC-sponsored bank mergers, and coordinated global reductions in interest rates have not prevented volatility in the marketplace. Indeed, if the stock market fails to rebound or worse, continues to fall further, the asset losses experienced by corporate America, individuals and foundations will likely create a situation in which overall funding to nonprofit organizations decreases.

Market volatility affects giving at year end, which is the busiest time of year for most fundraising programs. Nonprofit organizations are already experiencing a slow down in overall giving this year (“Briefing,” 2008; “Weathering,” 2008). The prospect of sustained volatility could negatively affect philanthropy in 2008, 2009 and 2010. As the U.S. economy continues to show signs of deterioration, corporate gifts are predicted to decline significantly – and not only by the banking industry (Fabrikant, 2008; Strom, 2008; Spector, 2008). Nonprofit organizations that receive gifts from corporate America are bracing themselves for the worst; yet, since corporate gifts represent only 5% of annual giving in the United States (Hrywna, 2008, p. 17), it is the individual and foundation giving that is more worrisome to nonprofits.

A study by the Center of Philanthropy at Indiana University revealed that donors with incomes of less than $50,000 may stop giving during an economic crisis, but individuals with higher incomes are more likely to reduce the size of their donations rather than stop giving altogether (“Briefing,” 2008). Individual giving represents 82.3% of all charitable giving in the United States (Hrywna, 2008, p. 17), and the assets of high net worth individuals as well as other individual donors are shrinking. The verdict is still out on the net effect that the financial crisis will have on individual giving.

A study released by the Foundation Center indicates that recessions historically do not lead to a precipitous decline in foundation giving (Lawrence, 2008). In fact, during each of the
four recessionary periods since 1975, U.S. foundation giving increased on an inflation-adjusted basis. Foundation giving did decline by 4.4% following the most recent recession in 2001; however, the decline in giving was relatively small compared to the 16% decline in foundation assets that was recorded between 2000 and 2002.

While foundation giving represents only 12.6% of annual giving in the U.S., the number of foundations and the amount of their giving have been increasing steadily over the past 15 years (Hrywna, 2008, p. 17). This growth is expected to “explode as the baby-boom generation ages and declines” (Deep & Frumkin, 2001, p.2). Before the current economic crisis, this potential transfer of wealth had been estimated to be as much as $40 trillion, with much of it expected to go to foundations (Ibid). Of course, the actions of the Bill & Melinda Gates Foundation will be closely monitored throughout this crisis, as changes in the largest donations often act as a bellwether for overall charitable giving (Guth, 2008; “Weathering,” 2008). Jeff Raikes (2008) acknowledged that “funders are having an increasingly difficult time meeting their commitments” but said that the Gates Foundation would grow its pay out in 2009 by approximately 10%, a figure that is less than what the foundation originally planned to disburse.

Private foundations are required to pay a minimum of five percent from their endowments each year. Looking ahead, the actual amount going to charity is somewhat difficult to predict. First, the mandated payout requirement comprises administrative and operating expenses of the foundation as well as its grants to charitable organizations, so the full value of the payout does not go to charity. Second, private foundations are technically required to pay from their endowments each year at least five percent of the average monthly value of their endowments during the previous year (Deep & Frumkin, 2001, p.3). However, because the requirement is a minimum annual payout, foundations often calculate their payout rates using a rolling two-, three-, or five-year average (Lawrence, 2008; Strom, 2008).
Statement of the Problem

As endowments drain, donors review their giving patterns, government spending becomes increasingly uncertain, and access to credit is temporarily suspended, competition for funding among nonprofits will increase. Funders are likely to require even greater efficiency, effectiveness and accountability of the nonprofit organizations they support. In the wake of earlier crises, nonprofit organizations were urged to focus greater attention on governance, transparency, and accountability. In today’s environment, nonprofit organizations should build upon that focus and soberly consider consolidation as a strategic alternative in response to the current crisis. There is a continuum of strategies that nonprofit organizations can employ to consolidate. This paper will focus on one specific form of strategic restructuring: mergers.

Conventional wisdom suggests that one of the main reasons nonprofits contemplate mergers as a strategic alternative is that funders pressure them into doing so. An extensive review of the literature on nonprofit mergers reveals that this is not the case. While there is anecdotal evidence to support that some nonprofit organizations were pressured by funders to collaborate and consolidate, this is not universally true of all nonprofit mergers. Indeed, empirical evidence demonstrates that the least important motivation for restructuring is pressure from funders (Kohm et al., 2002).

The purpose of this paper is to explore the role that funders play throughout the merger process between nonprofit organizations. Whether funders pressure nonprofits into merging with another entity is a question of no small relevance. Reorganization is a complex and uncertain undertaking, and the existing body of literature lacks important research in the areas of process, motivation and evaluation – all of which are inextricably linked. The insights gained from this study are intended to lead to a greater understanding of why nonprofits should merge their
organizations, the overall effectiveness of merger as a strategy, and whether process determines outcome.

As part of the research, this author studied a recent nonprofit merger between two Community Development Financial Institutions. The case outlines the rationale for the merger, describes the participation of funders at various stages of the process and will be used to demonstrate that funding pressure is not the same as pressure from funders, an important conclusion given today’s economic crisis.

METHODOLOGY

Data were collected through interviews of key participants in the merger process and a review of the merger files associated with the transaction. The primary source data source consisted of in-depth interviews with five individuals who played key roles before, during and after the merger process. These key informants include: the CEO of Cascadia Revolving Fund; and the Board Chair, CEO/founding employee, Executive Vice President/founding employee, and Chief Operating and Financial Officer of ShoreBank Enterprise Pacific. Each interview lasted between seventy-five minutes and two hours. The interview questions covered the following areas: the rationale for the merger; the role of each organization’s board of directors; participants’ previous experience with mergers and acquisitions, challenging issues and obstacles that arose during the process; due diligence; risk; the role of funders; goals and anticipated outcomes of the merger; and evaluation. All interviews were recorded and transcribed.

All records concerning the merger were reviewed and analyzed. These documents include: the merger process (planning documents, timelines, task lists, responsibilities, teams, closing check list); legal and compliance (board resolutions, Memorandum of Understanding, Agreement and Plan of Merger (and Amendment), Articles of Merger, bylaws amendments,
Private Letter Ruling research, correspondence, and request, Washington and Oregon Secretary of State merger and name change filings); lending (description of loan products, audit of lending portfolio, Portfolio Administration Agreement); administration (program organization, proposed organizational chart, geographical coverage area); finance (comprehensive business plan, pro forma merged balance sheet, template for new financial forecasting model, financial projections, merger expenses, required consents/notices, loan term modification requests, audited financial statements); development (merger briefing letters and materials, grant application request letters, list of grants supporting merger); communications (media/PR strategies, key messages, press releases, merger fact sheet, FAQs, client notification templates, PowerPoint presentations).

**CASE DESCRIPTION**

As a background for the analysis and discussion, this section provides a brief summary of the merger between two Community Development Financial Institutions (“CDFIs”): ShoreBank Enterprise Pacific (“ShoreBank”) and Cascadia Revolving Fund (“Cascadia”) into ShoreBank Enterprise Cascadia (“SBEC”). While both for-profit and nonprofit CDFIs exist, both of the organizations that participated in this merger are certified nonprofit organizations with special tax exemptions. CDFI certification is a designation conferred by the CDFI Fund under the auspices of the United States Department of the Treasury. These organizations are, in essence, microfinance funds for the developed world, where the tools of small-business and nonprofit lending facilitate the CDFI’s core business of getting people firmly into the middle class. CDFIs provide credit, capital and financial services to communities and populations underserved by traditional financial institutions. As a result, they work in specialized market niches (products) and geographies (economically distressed markets).
Cascadia Revolving Fund was founded in 1985 as a means for socially conscious investors to direct their capital toward the support of locally-owned small businesses. Historically, Cascadia supported low-income, marginalized entrepreneurs striving for economic independence. The organization provided loans and technical assistance to small businesses as well as nonprofit organizations. By the time Cascadia entered into merger talks with ShoreBank, it had lent more than $35 million to small businesses owned by women, minorities, immigrants and entrepreneurs and to nonprofits serving similar populations in the urban areas of Seattle, Washington and Portland and Bend, Oregon. Cascadia was a high-profile, nationally-known organization within the CDFI community and was active in the policy/advocacy arena.

Founded in 1994, ShoreBank Enterprise Pacific focused primarily on rural development in the coastal areas of Washington (Port Townsend, Port Angeles, Forks, and Ilwaco) and Oregon (Astoria, Coos Bay). ShoreBank’s borrowers were predominantly those who were no longer able to make a living from the extractive-based economies of the once abundant natural resources of the Pacific Northwest bioregion. In addition to advancing economic and social justice objectives (similar to the mission of Cascadia and other CDFIs), ShoreBank also promoted environmental goals, giving it a triple bottom line focus. By the time ShoreBank entered into merger discussions with Cascadia, the organization had loaned over $30 million to these communities. ShoreBank was a younger organization still building its reputation, but it was affiliated with ShoreBank Corporation located in Chicago, Illinois. ShoreBank Corporation is a holding company comprising for-profit banks, real estate development, a minority venture capital fund and nonprofit affiliates dedicated to community development and the environment. It was established in 1973 and was the first CDFI in the country to set up an umbrella organization by creating affiliates that would extend the bank’s lending activities (in 1978). The
details of the merger will be presented using the convention promulgated by Singer & Yankey (1991): decision-making, planning, implementation and evaluation.

**Decision-Making**

The initial approach was made by the CEO of Cascadia Revolving Fund in the summer of 2004. Several preliminary conversations took place between the CEO and the two founders of ShoreBank before management formally presented the idea to their respective boards of directors. Then, over the next six months, they surveyed the proverbial landscape and discussed the opportunity. The scan involved the CEOs talking to those who were knowledgeable about or observing the CDFI field, including practitioners, trade organizations, and funders, and it led to a number of important realizations for these two leaders.

The preceding ten years had been characterized by a robust funding environment in which the creation of the U.S. Treasury’s CDFI Fund provided direct support to CDFIs while the government encouraged regulated financial institutions (traditional banks) to fund CDFIs in their local markets. Moreover, foundations and socially responsible investors began to put significant amounts of capital toward organizations addressing social and economic justice. The rapid growth in funding resulted in a proliferation of more than 600 CDFIs across the country. Two scenarios emerged: a) a duplication of services caused by overlapping geographies, markets and borrowers; and b) very small organizations focusing on niche markets in certain geographies. Funder fatigue set in, as funders began to question the need for so many organizations and to look more closely at the results of the organizations they were supporting.

With the prospect of receding funding sources, the CEO of the Opportunity Finance Network, a nationwide membership organization of CDFIs, introduced a phrase that would come to epitomize the challenges facing the field: “Grow, change or die.” This moniker represented the options available to all CDFIs, including ShoreBank and Cascadia, and quickly became
shorthand for explaining both the strategic alternatives that needed to be considered and the consequences of not articulating clear strategies for long term community development. Organic growth would be possible, not plausible, given the funding environment and the organizations’ focus on small business lending. Scale would be required to achieve permanent, lasting change in economically distressed communities but would be difficult to achieve with a high concentration of small loans. In order to broaden the scope of their work, deepen the level of impact and achieve long term sustainability, the two organizations, represented by their board chairs and CEOs, signed a Memorandum of Understanding (“MOU”) in December, 2004 to explore the business and mission rationales for merging the two organizations.

At around the same time, ShoreBank and Cascadia jointly requested $100,000 from the John D. and Catherine T. MacArthur Foundation (the “MacArthur Foundation”) and $30,000 from the Heron Foundation to finance the mutual exploration of a possible merger. The grant applications explained to funders that the landscape was not the only, or even primary, motivation for merging. Rather, the possibility of achieving several key expected outcomes inspired their actions. These outcomes were: a) order of magnitude – resulting in a credible institution viewed by people as a permanent fixture in the community; b) deeper commitment to mission – with investment functioning as a means to an end; c) leadership – through a collaboration of seasoned professionals; and d) policy – a vehicle for affirmative economic policy in the Pacific Northwest. The merger simply presented an opportunity to achieve this shared vision of the future. The grants would allow ShoreBank and Cascadia to create the business case, strategic plan, and financial modeling tool for the combined entity. Both grants were approved.

The two boards acted very differently during the exploratory period. The Cascadia board was reticent about the merger, and the directors did not act in unison during much of the pre-
merger stage. The board identified another possible partner and asked the CEO to evaluate this entity against ShoreBank. Ultimately, the CEO determined that ShoreBank represented the best partner under consideration. However, a series of internal tensions emerged among board members that brought about unexpected consequences, including the departure of the board chair and three directors. The board was not actively involved in the merger, but once a new chair was elected from among the remaining directors, the process moved forward more quickly. Anticipating a successful conclusion to the merger negotiations, the directors who had revolved off the board were not replaced. After approximately four to six months, the board adopted a resolution to proceed with the merger process.

The ShoreBank board reacted with caution to the merger proposal. They invested the greatest amount of energy in the area of strategy, mission and tactics, specifically, in order to understand why the larger platform would be more advantageous. When the idea for the merger surfaced, the board recognized the attractiveness of Cascadia as an institution. A merger with Cascadia would bring with it credibility, increased capital, a regional presence, and the ability to write more and bigger loans. At the same time, there was the risk of mission creep, given Cascadia’s focus on urban areas and ShoreBank’s focus on rural communities. There were also fiduciary concerns in combining the assets and liabilities of another entity, namely the noteholders and the value of the loan portfolio.

At the time, ShoreBank was considering various strategies for growth, such as off-balance sheet lending via New Market Tax Credits, expanding into the State of California, and introducing a new loan product to finance septic systems together with the State of Washington and the Bill & Melinda Gates Foundation in Hood Canal, Washington. The board and CEO determined that it would take ShoreBank anywhere from three to five years to grow to the same size organically (without the prescience of an impending recession). The ShoreBank board,
while cautious, evaluated the opportunity on financial and mission terms and decided that the merger ultimately proved to be an opportunity for ShoreBank to solidify its platform for growth. The board acted in concert throughout its deliberations, and at the end of this process, it concluded that it wanted to absorb Cascadia into its existing operations, retaining the ShoreBank CEO as the head of the merged entity and maintaining the headquarters in a rural community. This intentionality would color the rest of the merger process, though it is unclear whether the intent of ShoreBank was communicated directly to the board or CEO of Cascadia at this time.

The MOU stated that the organizations would appoint an ad hoc committee comprised of members of each of the two boards of directors, who would meet regularly during the planning process. This ad hoc committee never came to fruition. It wasn’t until the dysfunction on the Cascadia board was resolved that a few of their directors attended a meeting of the ShoreBank board in an attempt to bridge the gap between the two organizations and move the merger forward. No substantial negotiations took place between the boards of the two organizations. In conjunction with the MOU, the ShoreBank board authorized the CEO to conduct due diligence as the next step in the process.

**Planning**

Due diligence was comprehensive. Given the nature of the operations of these financial institutions, the areas of credit policy, lending practice, and loan portfolio were paramount to the viability of the transaction. In addition, concerns about Cascadia’s Rural Development Investment Fund (“RDIF”) arose. This high-risk program represented approximately one-third of Cascadia’s total loans outstanding. The portfolio was deteriorating, with as much as half of the loans classified as non-performing. An internal assessment by the CEO of Cascadia concluded that the RDIF was financially unsustainable without a dramatic improvement in performance. To wit, the manager of the RDIF resigned.
Over the next six to eight months, three audits were performed on Cascadia’s revolving loan fund. In September, 2005 and at the request of the ShoreBank CEO, a team of individuals from ShoreBank Corporation’s Risk Management Department conducted on-site due diligence of Cascadia Revolving Fund. The purpose of the first audit was threefold: a) to understand Cascadia’s risk rating system, lending practices and nomenclature; b) to audit the portfolio using Cascadia’s internal policies and procedures; and c) to provide a valuation of the portfolio. All of this information was required to determine how the two portfolios would be combined under a common set of policies and procedures and valuation techniques. The audits revealed that only a modest number of loan assets were troubled. The policy review compared credit, risk and investments with a view to aligning the two lending practices. The second audit, conducted in December, 2005, confirmed that Cascadia had converted and reclassified its loan portfolio in conformance with ShoreBank’s risk rating system and credit policies. A senior staff member from ShoreBank’s local risk management department led this process. In February, 2006, a third and final audit was conducted to ensure compliance for reporting purposes and alignment between the two funds.

The audits had been conducted in preparation for ShoreBank taking over the administration of Cascadia’s loan portfolio later that year. In contrast, the due diligence conducted on ShoreBank involved a review of the portfolio reports, financial audits and product offerings. The due diligence on ShoreBank focused more on an analysis of product offerings and balance sheet and was geared toward the creation of a financial model for the combined entity. Prior to the merger, the two organizations had worked on some transactions together in the past, but generally speaking, Cascadia and ShoreBank offered differentiated loan products to distinct markets in two adjacent geographies. An extensive analysis of both entities’ assets and liabilities
confirmed that there were opportunities for the organizations to combine existing assets and relationships to achieve growth. A business plan would need to be developed.

The legal and regulatory issues were complex. First, while both organizations were certified nonprofit organizations as publicly supported charities exempt from taxation under Section 501(c)(3) of the Internal Revenue Code (the “Code”), each entity had received a different sub-classification in its determination letter. The Internal Revenue Service (“IRS”) classified ShoreBank as other than a private foundation under Sections 509(a)(1) and 170(b)(1)(A) of the Code; however, the IRS classified Cascadia as other than a private foundation because it satisfied Section 509(a)(2) of the Code. Due diligence was required to determine what effect a prospective merger might have on the surviving entity. Because this was the first merger of two CDFIs in the country, there was no precedent with regard to the charitable status, unrelated business income arising in conjunction with the merger, or the transfer of assets and liabilities from one CDFI to another. Ultimately, this work would result in the submission of a Private Letter Ruling request seeking favorable treatment of all three issues during the merger.

Due diligence also revealed multiple legal requirements that would be required for the proposed transaction to be consummated. Legal counsel would be necessary to address the following: drafting the Agreement and Plan of Merger, the Portfolio Administration Agreement and the Articles of Merger; amending the bylaws of ShoreBank to reflect structural changes to governance (board composition, creation of advisory committees and compensation of officers); dissolving Cascadia; and filing with the Washington and Oregon Secretaries of State.

Due diligence led to the realization that the budgeting tools of the existing entities would be insufficient for purposes of forecasting the combined operations of the merged entity. A more sophisticated forecasting model would be required in conjunction with the merger. This analytical tool would incorporate an emerging vision of the new identity as a hub of
management, risk, compliance, and back office operations supporting various spokes of product and program expertise areas. For purposes of modeling and forecasting, one description of the merged entity entailed five separate companies: urban loan fund; rural loan fund; shared back office; program-oriented nonprofit; and consulting services. This breadth of scope would be buttressed by layers of detail concerning: staffing; schedules of loans payable and loans receivable; sources of restricted and unrestricted fund balance; loan loss reserves; on- and off-balance sheet revenues; and key performance ratios.

Accordingly, additional financial expertise would be required on an ongoing basis to manage the increasingly complex financial structure of the new entity. ShoreBank submitted a grant application to the M. J. Murdock Charitable Trust (the “Murdock Trust”) seeking assistance with the appointment of a new Chief Operating and Financial Officer (“COFO”). A multiple-year grant was approved by the Murdock Trust in the amount of $175,000, and a new COFO was hired in September, 2005.

Due diligence shaped the information technology (“IT”) needs of the merged entity. The two systems would not be integrated per se. Instead, all of Cascadia’s portfolio information would need to be converted, reclassified, and transferred to ShoreBank. Going forward, a greater emphasis would be placed on utilizing technology in order to minimize the distance between offices spread out across two states. All employees would have equal and real-time web-based access to all systems, people and data regardless of location – including accounts payable and accounts receivable. In addition to purchasing new customer relationship management (“CRM”) software, all employees would need to be trained on its functionality and proper usage.

Moreover, the merged entity would be organized into a hub and spoke network where production, reception, and administrative support would all be centrally located. In addition to providing safe, secure and reliable technology, all of the facilities, equipment, phones and
operating supplies would be centrally managed. Technology would supplant the need for mail, copying and fax machines.

Due diligence revealed that all of the aforementioned changes would be born out by a new set of staffing requirements (number) and arrangements (posts). A new organizational chart was proposed to combine and reorganize staff. In addition, a detailed review of human resource policies, compensation and benefits would be undertaken. Orientation and professional development programs would be developed. Change management, team-building retreats, regular staff meetings and internal communications would be designed to facilitate the transition.

Development activities would be vital to effect the merger. Chief among the goals were to retain the existing money in the institution, to raise new money, and to raise funds to cover the cost of merging. The lenders and investors of both organizations would need to be evaluated, and a complete stakeholder analysis would need to be performed. A review of the terms and conditions of each long term debt instrument would be required to determine the effect of a consolidated balance sheet on loan covenants. Targeted development activities would focus on the merged entity’s ability to offer a broader array of products and services and the possibility for accelerated, deeper impact in the expanded geography.

Other areas of concern were also reviewed, including: policy development for new products, insurance (board and operations), communications strategy and marketing (website and collateral materials). All of the components of the merger process were documented during the due diligence phase. Presentations were made by the CEOs to their respective boards, which resulted in the conditioned approval by both boards to pursue the merger. A merger budget of $550,000 was jointly adopted. A project manager was hired to assist the organizations for approximately nine months. A senior staff member of ShoreBank Corporation was seconded to Washington, and her salary was subsidized in the amount of $35,000 in the form of in-kind
assistance by the holding company while she supported Cascadia and ShoreBank through the planning and implementation phases.

At a joint meeting of all employees from both organizations held in April, 2006, the project manager worked with the staff to map out the ‘critical path’ – a series of key milestones that would need to be completed. Over time, the milestones were broken down into a detailed list of tasks, which were captured on a print-out that was six pages in length. They would require assignment, sequencing and monitoring in order to effect the merger. A target date for resolution was set, and responsibilities were assigned for each area. Work began in earnest on each of the components outlined in the due diligence phase (i.e., legal, regulatory, financial, IT, HR and development). The work was carried out by the appropriate staff members, attorneys, accountants, and/or external consultants. As part of this process, the organizations began to solicit support from funders to cover the cost of merger expenses. The merger costs were positioned not only as fundamental to the process and mechanics of merging but as critical investments to build the future organization post-merger.

In July, the boards of directors of ShoreBank and Cascadia each resolved to enter into an Agreement and Plan of Merger with the other party. The intent of the two parties was asserted via an Agreement and Plan of Merger signed August 1, 2006. In it, Cascadia was referred to as the merging entity and ShoreBank the surviving entity. Provisions related to dissolution, transfer of assets and liabilities, articles of incorporation, bylaws, membership, and board composition would take effect as a result of the planned merger on a target date in January, 2007. No mention of the CEO position was made.

**Implementation**

As the merger process unfolded, many activities occurred in quick succession. The sources of income were analyzed to ascertain whether the merged entity would meet the public
A Private Letter Ruling request was submitted to the IRS. Loans to individual investors of Cascadia who were not classified as ‘accredited’ by the Securities and Exchange Commission were repaid in full to reduce the membership of Cascadia to zero. The Management Committee of ShoreBank Corporation approved the merger subject to certain “continuing conditions,” including a favorable Private Letter Ruling from the IRS. A Portfolio Administration Agreement was executed whereby ShoreBank would take over the accounting and processing of Cascadia’s existing loans. Going forward, new loans would be made directly on the ShoreBank balance sheet. Cascadia staff was hired, and the portfolio transfer and data migration were initiated.

Funders that supported the work of either or both entities were provided a briefing on the merger process and, where applicable, consents were formally requested and modifications to the terms and conditions of their loans were proposed and negotiated. To provide context to the volume of work this entailed, the staff reviewed 37 loans, 4 grants, 1 contract and 7 accredited individual investments to determine which of these stakeholders were required to give their consent for the merger and which financial instruments needed to be restructured in order to prevent the merged entity from breaking covenants such as liquidity, leverage, credit quality and loan loss reserves, which would constitute a technical default by virtue of merging. In addition, ShoreBank and Cascadia asked lenders to renegotiate some of the interest rates and maturities to provide additional liquidity for the merged entity in its first year of joint operations.

Borrowers of both CDFIs were informed of the decision to merge, and a press release was issued announcing the two organizations’ intent to merge. The transaction was described as a merger of peers. The CEO of ShoreBank would become CEO of the new entity; the CEO of Cascadia and the Deputy Director/co-founder of ShoreBank would become Executive Vice Presidents. Significant pledges of public and private financial support were reported, including a
$585,000 grant from the U.S. Treasury’s CDFI Fund and $2.5 million in grants and investments from the Ford Foundation and Meyer Memorial Trust. In addition, $469,000 of merger support, or 85% of the total merger expenses, was successfully raised from lenders and grantors. A presentation was made at the annual Opportunity Finance Network conference in October, sharing the rationale, process, projections and lessons learned with fellow professionals of other CDFIs around the country.

In January, 2007, the boards of directors of each entity approved the merger of Cascadia into ShoreBank. This decision was made in acknowledgment of the fact that a ruling from the IRS might not be forthcoming for an additional 12 to 24 months and that the directors believed that the merger was consistent with the exempt purposes of the existing entities. For all intents and purposes, the two organizations had effectuated the merger, save the Private Letter Ruling and transfer of long term debt from Cascadia to ShoreBank, and the directors believed that it would be detrimental to postpone the merger until such time as the IRS responded. In three separate resolutions, the ShoreBank board authorized the merger, amended the bylaws of the organization and assumed $10 million in debt from Cascadia.

The merger was completed on January 22, 2007, when an Amended Agreement and Plan of Merger was signed and the Articles of Merger were filed with the Secretary of State of the State of Washington. A new trade name, ShoreBank Enterprise Cascadia, was registered with the Secretaries of State in the States of Washington and Oregon. The remaining staff of Cascadia were brought over or made redundant. One of Cascadia’s directors joined the SBEC board. ShoreBank relied on the bookkeeper, accountants and auditors of Cascadia to put its financial records into alignment with ShoreBank’s as of the fiscal year end December 31, 2006.
Evaluation

A presentation was made at the annual Opportunity Finance Network in October, 2006, as the planning phase was nearing completion. In it, the CEOs shared the rationale, process, projections and lessons learned with CDFI colleagues from around the country. Thus far, however, SBEC has not conducted any formal evaluation of the merger process or compared the strategic and financial outcomes achieved in 2007/2008 with the original projections and business plan.

DISCUSSION

At the outset, this author sought to explore the role that funders play in the merger process and posed the question of whether funders pressure nonprofits into merging their organizations with another entity. A study conducted by Kohm, La Piana and Gowdy (2000) concludes that the primary reason nonprofits consider some form of restructuring is an internal decision to increase the efficiency or efficacy of their organizations (83%) while the least important motivation for restructuring is pressure from funders (30%) (pp. 15-6). Table 1 summarizes the motivations of nonprofit executives with regard to strategic restructuring.

<table>
<thead>
<tr>
<th>Table 1: Top 8 Reasons for Restructuring</th>
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</thead>
<tbody>
<tr>
<td>1. Increase efficiency/efficacy</td>
</tr>
<tr>
<td>2. Increased competition for funding</td>
</tr>
<tr>
<td>3. Increased overhead expenses</td>
</tr>
<tr>
<td>4. Reduction in public funding</td>
</tr>
<tr>
<td>5. Approached by other organization(s)</td>
</tr>
<tr>
<td>6. Increased competition for clientele</td>
</tr>
<tr>
<td>7. Reduction in private funding</td>
</tr>
<tr>
<td>8. Pressure from funders</td>
</tr>
</tbody>
</table>

Source: Kohm, La Piana & Gowdy (2000).
There is anecdotal evidence to support that some nonprofit organizations have been pressured by funders to collaborate and consolidate. Giving guidelines and recommendations by funding bodies are subtle ways of encouraging restructuring. In addition, some funders actively encourage nonprofits to consider merging by promising greater financial support or they set up funding programs to assist nonprofits with strategic restructuring. Indeed, the Kohm et al. study conveys that 30% of the respondents felt pressured into merging. However, the results of the study were presented as follows: the percentages were calculated on the number of respondents who indicated that a specific motivation was an “important” or a “very important” reason for their restructuring. Since the ranking system used in the survey allowed respondents to identify multiple reasons as “important” or “very important,” it is difficult to ascertain which of the other motivations, if any, might have coincided with pressure from funders. Regardless, it is clear that funders intervened directly in the process in only a minority of cases.

In the absence of any theoretical or practical suggestions for evaluation frameworks, scholars are somehow able to distinguish successful nonprofit mergers from failed ones. They believe that when funders pressure nonprofits into merging with another entity, the results are disappointing. Indeed, scholars advocate for mergers to be undertaken willingly and based on a shared vision. That said, given the anecdotal evidence that some funders do pressure nonprofits into merging, and the lack of research concerning whether that pressure was appropriately and/or successfully applied, more research is required to debunk the myth that funders pressure nonprofits into merging if, for no other reason, than to prevent them from doing so in the future.

The case study of the SBEC merger indicates that neither of the two organizations was pressured by funders to merge. After surveying the landscape, the two CEOs predicted a declining trend of funds available to a large number of CDFIs, along with an onset of funder fatigue due to the size of the sector and a desire for reassurance about the outcomes that CDFIs
were achieving. Funding was tightening for the industry as a whole, and there was caution due to the realization that CDFIs were relying on funders, rather than earned income strategies, to advance their missions. However, the landscape was not the only, or even primary, impetus for merging. It merely provided an opportunity for the merged entity to achieve a shared vision of the future. That vision of SBEC can be characterized by one word: impact. As Figure 1 illustrates, the merger would only be successful if the new entity achieved all seven of the goals established by the CEOs.

![Figure 1: Vision of SBEC](image)

Prepared using information provided during the interviews.

Merging is not for the faint of heart, if the case study of SBEC is any guide. It took the two organizations 31 months, or just over two and a half years, from the time the preliminary conversations began in the summer of 2004 until the transaction closed in January, 2007, to merge Cascadia Revolving Fund into ShoreBank Enterprise Pacific. Table 2 below highlights the time frame required and the amount of funds raised during each phase of the merger process as well as the 12-month period immediately following the transaction.
Table 2: Funding Support for SBEC

<table>
<thead>
<tr>
<th>Phase</th>
<th>Time Frame</th>
<th>Funding</th>
<th>Observations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Decision-making</td>
<td>6 months</td>
<td>$0</td>
<td>• Preliminary conversations</td>
</tr>
<tr>
<td>Planning</td>
<td>20 months</td>
<td>$305,000</td>
<td>• Mutual exploration</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>• Capacity building</td>
</tr>
<tr>
<td>Implementation</td>
<td>5 months</td>
<td>$469,000</td>
<td>• Merger costs</td>
</tr>
<tr>
<td>Evaluation</td>
<td>0 months</td>
<td>$0</td>
<td>• No evaluation</td>
</tr>
<tr>
<td><strong>Subtotal</strong></td>
<td><strong>31 months</strong></td>
<td><strong>$774,000</strong></td>
<td></td>
</tr>
<tr>
<td>Ongoing Support</td>
<td>12 months</td>
<td>$3,635,000</td>
<td>• Investments of $2.5 mm</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>• Grants of $1.1 mm</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>43 months</strong></td>
<td><strong>$4,409,000</strong></td>
<td></td>
</tr>
</tbody>
</table>

Prepared from the records of SBEC. Adapted from Singer & Yankey (1991).

SBEC raised a total of $4.4 million in conjunction with the merger. Of this amount, $774,000 was earmarked specifically for the planning and implementation phases of the merger. The remaining $3.6 million of support was contingent upon the transaction and was therefore disbursed after the merger was completed. Notably, it was SBEC who approached funders to solicit support and funders who responded favorably. Interestingly, no funding requests were made to support the decision-making and evaluation phases of the merger. While it could be considered premature for two organizations to solicit support for the former, there is ample opportunity for the prospective partners or the merged entity to ask for help with the latter.

This author was unable to reconstruct from the transaction records a comparison of requests for funds and subsequent approvals/declines and could not, therefore, calculate a success rate for SBEC’s fundraising efforts. However, it is clear that over 20 funders supported the SBEC merger, including four new funders who provided a total of $2.3 million in investments plus an additional $500,000 in grants. Figure 2 below illustrates that support for the transaction came from a variety of public and private sources. Foundations contributed the most money to the merger, providing $3.1 million, or 71%, of the total amount raised. It would be interesting to understand what the rationale was for each funder’s participation in the SBEC
merger and whether they had ever supported nonprofit mergers previously. To this author’s knowledge, no research has yet been undertaken to study nonprofit mergers from the funder’s perspective. Research in this area would be beneficial to funders who are interested in nonprofit mergers as well as nonprofits who are contemplating a merger.

![Figure 2: Sources of Support for SBEC](image)

*Prepared from the records of SBEC.*

The reason SBEC was successful with the merger was twofold: a) the CEOs anticipated changes in the sector and b) both organizations had sufficient resources to pursue the merger while at the same time continuing to provide regular services. Applying Golensky & DeRuiter’s (2002) *Prospective Partner’s Motivations to Merge* model to SBEC, both organizations were focusing on mission (p. 173). Using SBEC as a test case, and acknowledging that this is only one merger under consideration, it would appear that there may be some predictive value to this model. Significant additional research is needed, however, to confirm the validity of this author’s assertion. The model has been recreated in Figure 3 below.
Both the research and case study indicate that funding pressure is not the same as pressure from funders. Based on findings in both areas of research, this author has developed *The Merger Cycle*, which is presented in Figure 4 below. The merger cycle begins with the manifestation of a pressure to merge. This pressure frequently surfaces in the wake of environmental turbulence and pressures and is modulated by economic and moral incentives. The pressure to merge prompts the consideration of merger as a strategic alternative; it could be one among several alternatives to be considered. Next, an internal decision is made as to whether to pursue a merger. In order to arrive at a decision, a business case or mission case must be constructed to justify a merger on the basis of financial, strategic and programmatic grounds. Hence, the pressure to merge can be clearly seen to be distinct from the motivation to merge.

Assuming a compelling and convincing business/mission case is created, a merger will be selected and pursued as the appropriate course of action. Once the transaction is executed, an
evaluation is required to determine the success not only of the process but also of the results. A comparison is made between the anticipated benefits, or projected goals, and the actual outcomes. Finally, a new steady state of operations emerges for the combined entity. This steady state lasts until such time as another pressure to merge appears, and then the cycle repeats.

The research and the case study also indicate the need and ability of philanthropy to reverse the existing, enormously robust, yet highly inefficient delivery of nonprofit services in this country. The indirect role that is ascribed to funders vis à vis the merger process is that of a market clearing agent. Funders can play a critical role in reversing the fragmentation and inefficiencies of the nonprofit sector. Yet it must also be recognized that historic funding patterns helped create the current proliferation of underfunded, duplicative and competing programs, which, in all likelihood, are going to be exacerbated by the current financial and economic crisis in this country. Indeed, the traditional focus on programs and missions, as
opposed to organizations and results, necessitates a complete restructuring of the nonprofit sector nationwide.

In the SBEC case, funders – government, foundations and socially responsible investors – all had a hand in creating the current landscape. In this situation, by providing financial support, technical assistance and counsel, funders acted as true partners throughout the process rather than performing a mere oversight function. By supporting the merger, funders strengthened the combined entity’s overall resources, operating efficiency, average loan size, regional presence and platform for growth while at the same time allowing SBEC to provide products and services to both the rural and urban communities in which it operates.

In some respects, SBEC functioned as an acquisition of Cascadia by ShoreBank. The CEO, culture, staff and legal entity of ShoreBank prevailed. However, in other respects, SBEC functioned as a merger. The name, reputation, board of directors, service area, products and constituencies of both organizations persisted, reflecting a true merger of peers. It is important to understand that this merger was not a case of growth for growth’s sake. Instead, Cascadia and ShoreBank used consolidation as a tool to achieve scope, impact and sustainability for both organizations. In other words, the SBEC case demonstrates that the operating platform is equally as important as, and indeed, the lynchpin for, mission impact.

While no formal evaluation has been conducted by SBEC to date, it is merited for the organization’s, the industry’s and the funders’ sake. The merger is not the end point, but rather the departure point for the combined entity. During the interviews, board and management provided thoughtful reflections on the lessons learned from the merger process and suggested several criteria on which they might base an evaluation. As with any strategic plan or set of financial projections, the merger must be evaluated to find out whether the goals were achieved. Moreover, as the first merger between two CDFIs in the country, SBEC has received, and will
continue to receive, a lot of attention. If SBEC is at the vanguard of a trend in CDFI mergers, the industry will benefit from understanding whether SBEC accomplished what it set out to do. Similarly, funders will gain a greater appreciation for the use of mergers as a restructuring tool if they gather data on them.

Funders have an opportunity and a responsibility to participate in fixing the current landscape. Their funding patterns helped to create it, and in light of the current financial and economic crisis, more nonprofit organizations will need to consider consolidation to be able to provide services to their constituencies over the long term. Figure 5 below presents a Funded Intervention Model, which establishes a strategy for fostering systemic change through nonprofit mergers. It is not only possible, but recommended, that funders should support nonprofit organizations through all stages of the merger process.

<table>
<thead>
<tr>
<th>Figure 5: Funder Intervention Model</th>
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<tr>
<td>Funding Systemic Change through Nonprofit Mergers</td>
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<tr>
<td>Pre-Merger</td>
</tr>
<tr>
<td>- Fund exploratory studies and capacity building</td>
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<tr>
<td>Merger</td>
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<tr>
<td>- Underwrite the cost of merger expenses</td>
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<tr>
<td>Post-Merger</td>
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<tr>
<td>- Fund the evaluation of process and results</td>
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<tr>
<td>Ongoing Operations of Merged Entity</td>
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<tr>
<td>- Provide lasting, long-term, continuing support</td>
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</table>
This model represents a fundamental shift in the way funders would analyze and support nonprofit organizations. It requires a sectoral outlook, a strategic approach and a focus on infrastructure. Rather than fund programs, philanthropy would fund platforms. If done right, mergers can increase the quality and level of services to constituents. If funders want to strengthen the sector’s finances, strategies and programming, a series of well-designed and well-executed mergers can achieve those goals, thereby making greater progress – much sooner – on the complex, yet critical social issues facing our society.

In light of the current crisis, nonprofits should soberly consider mergers as a strategic alternative – a tool to achieve lasting impact in the communities they serve. They should solicit the support of funders to determine whether there is a business and mission case for merging with another entity. And if, and only if, a merger makes sense, should funders intervene.

CONCLUSION AND RECOMMENDATIONS FOR FUTURE RESEARCH

Empirical evidence demonstrates that funders do not pressure nonprofits to merge. In fact, the primary reason for nonprofits to consider some form of restructuring is to increase the efficiency and/or the efficacy of their organizations. While there is anecdotal evidence to support that some nonprofit organizations have been pressured by funders to collaborate and consolidate, this is not universally true of all nonprofit mergers. In fact, funders intervene directly in only a minority of cases.

In the absence of any theoretical or practical suggestions for evaluation frameworks, scholars are somehow able to distinguish successful nonprofit mergers from failed ones. They posit that when funders pressure nonprofits into merging with another entity, the results are disappointing. Indeed, scholars advocate for mergers to be undertaken willingly and based on a shared vision. That said, given the anecdotal evidence that some funders do pressure nonprofits
into merging, and the lack of research concerning whether that pressure was appropriately and/or successfully applied, more research is required to debunk the myth that funders pressure nonprofits into merging if, for no other reason, than to prevent them from doing so in the future.

Both the research and the case study indicate that funding pressure is not the same as pressure from funders, an important conclusion given today’s financial and economic crisis. Moreover, the pressure to merge has clearly been shown to differ from the motivation to merge. The pressure to merge surfaces in the wake of environmental turbulence, thereby prompting the consideration of merger as a strategic alternative. In contrast, the motivation to pursue a merger results from an internal decision that is based on a carefully crafted business/mission case.

The reason SBEC was successful with the merger was twofold: a) the CEOs anticipated changes in the sector and b) both organizations had sufficient resources to pursue the merger while at the same time continuing to provide regular services. In other words, both organizations were focusing on mission. Using SBEC as a test case, and acknowledging that this is only one merger under consideration, it would appear that there may be some predictive value to Golensky & DeRuiter’s (2002) Prospective Partner’s Motivations to Merge model. Significant additional research is needed to confirm the validity of this author’s assertion.

The research and case study also indicate the need and the ability of philanthropy to fund systemic change through nonprofit mergers. Funders had a hand in creating the current landscape, one characterized by a proliferation of nonprofit organizations and a duplication of services, and therefore, funders have a responsibility to help correct the situation. The merger of ShoreBank Enterprise Cascadia could serve as model for other nonprofit mergers in many ways. In particular, by providing financial support, technical assistance and counsel, the funders of this transaction acted as true partners in the process rather than performing a mere oversight function.
Nonprofits face an enormous level of uncertainty with regard to levels of charitable giving, while at the same time the demand for their services is expected to grow during the recession. The need for uninterrupted services at this critical juncture can not be underestimated, and now, more than ever, nonprofit organizations must confront the business realities of their operations. Financial uncertainty requires fiduciary governing, but it also requires strategic direction and results.

In light of the current crisis, nonprofits should soberly consider mergers as a strategic alternative – a tool to achieve lasting impact in the communities they serve. They should solicit the support of funders to determine whether there is a business and mission case for merging with another entity. If, and only if, a merger makes sense, should funders intervene. For their part, funders should foster systemic change by reversing the existing, enormously robust, yet highly inefficient delivery of nonprofit services in this country, and they should do that by supporting nonprofit organizations through all stages of the merger process.

To this author’s knowledge, no research has yet been undertaken to study nonprofit mergers from the funder’s perspective. Research in this area would be beneficial to funders who are interested in nonprofit mergers as well as nonprofits who are contemplating a merger. Additional areas of research should: a) explore the relationship between leadership, authority and culture during the merger process to determine their effects on post-merger integration; b) vet the existing motivations identified as precipitating nonprofit mergers in order to better understand not why nonprofits merge, but rather, why they should; and c) determine the overall effectiveness of nonprofit mergers as a strategy, establishing when and how merged entities should evaluate their results.
REFERENCES


