VENABLE® LLP

Nonprofit Contracts: Best Practices, Negotiation Strategies, Practical Tips, and Common Pitfalls

May 17, 2012
12:00 p.m. – 2:00 p.m. EDT

Venable LLP
575 7th Street, NW
Washington, DC 20004

Moderator:
Jeffrey S. Tenenbaum, Esq.
Panelists:
George E. Constantine, Esq.
Audra J. Heagney, Esq.

VENABLE® LLP

Presentation

Nonprofit Contracts: Best Practices, Negotiation Strategies, Practical Tips, and Common Pitfalls

Thursday, May 17, 2012
12:30 p.m. – 2:00 p.m. EDT
Venable LLP
Nonprofit Organization Practice
Washington, DC

Moderator:
Jeffrey S. Tenenbaum, Esq.

Panelists:
George E. Constantine III, Esq.
Audra J. Heagney, Esq.

Upcoming Venable Nonprofit Legal Events

June 13, 2012 - Ten Best Practices for Protecting Your Nonprofit's Intellectual Property

July 12, 2012 - Nonprofit Chapters and Affiliates: Key Legal Issues, Pitfalls and Successful Strategies

August 2, 2012 - How Nonprofits Can Raise Money and Awareness through Promotional Campaigns without Raising Legal Risks – Details coming soon

Presentation Overview

- Contracting Trends
- Identifying Risks
- Negotiating Contracts
- Key Contract Provisions
- Managing the Internal Contracting Process
- The Top “Take-Aways”

Contracting Trends

- Low or no tolerance for risk or responsibility
  - Renegotiation despite long relationships
  - More legal review
- Pressure on prices
- In-house counsel doing more with less

VENABLE® LLP

Identify Risks

- What are the obligations of each party?
- What risks are created by the contract?
  - Tax and tax exemption
  - Antitrust
  - Regulatory
- Know enough to spot the issues and when to ask questions of your tax and/or legal advisors

Contract Drafting and Negotiation – Four Corners Rule

- Clear and unambiguous – contract speaks for itself
- Most litigation arises because contracts are unclear
- Otherwise, most disputes are settled

Contract Drafting and Negotiation – A Few Tips

- Your negotiation posture will determine your ability to address the points we will discuss today
  - Maximize position by leading with your own contract draft
    - Know which contract points are central for your organization
  - Competition reaps savings – consider RFPs
  - Consider markets, particularly with meeting contracts

Contract Drafting and Negotiation – The RFP Process

- What is an RFP?
- Why does my nonprofit need an RFP?
  - Formalizes the process
  - More professional approach to contracting

Contract Drafting and Negotiation – The RFP Process (con't)

- Key provisions
  - Take advantage of your leverage
  - Not just price and timeline
  - Address indemnification, liability, independent contractor
  - Get signature from contractor

Contract Drafting and Negotiation – Everything Is Negotiable

- The big lie – "it's a standard provision"
- Read everything in the document
- Consider using your organization's form agreement as the starting point
- Be ready to walk away
- If you ask for something after a contract is signed, it's called <u>begging</u>

Key Contract Provisions

- Payment and Ownership:
  - Budget and scope control
  - Ownership
- Risk Allocation:
  - Damages
  - Indemnification
  - Insurance
- Managing Disputes
- Term and Termination

Key Contract Provisions: Payment and Ownership – Scope

- Define “scope” – carefully define what the organization is obligated to do or what you are paying for
  - Particularly important in “soft” contracts – research, writing
- Define material terms, obligations, and defaults
- Avoid disclaimers of warranties

Key Contract Provisions: Payment and Ownership – Payment Terms

- Clear payment terms
  - Fixed price vs. time-and-materials
  - Payment obligations upon termination
- Withhold final payment until all items are delivered – always need an incentive to perform
- Renegotiating prices/payments
  - Consider renegotiation triggers
- Beware of third parties receiving funds due to you

Key Contract Provisions: Payment and Ownership – Budget Management

- Be careful with commissions/exclusivity
  - Housing contracts
  - Ad sales
- Require mitigation of damages
  - Particularly in hotel/meeting agreements

Five Essential Tools for Budget Management with Meeting Agreements

Key Contract Provisions: Payment and Ownership – 5 Essential Budget Management Tools for Meeting Agreements

1. **<u>Mitigation Clause</u>**: Hotel shall undertake all reasonable efforts to resell canceled rooms, and will credit those revenues against the liquidated damages in an amount not to exceed the full amount of such damages.
2. **<u>Timing of Payment</u>**: Damages, if any, shall be due and payable X days after [original meeting date] provided the Hotel provides proof of its efforts to mitigate damages and proof that rooms being held for Group's attendees were unsold.

Key Contract Provisions: Budget Management – 5 Essential Tools for Meeting Agreements (con't)

3. **Exclude Fees/Commissions/Taxes**: Fees, penalties, or liquidated damages, if any, shall exclude service charges, surcharges, commissions, and rebates as well as state and local sales taxes, unless required by law.

Key Contract Provisions: Budget Management – 5 Essential Tools for Meeting Agreements (con't)

4. **Deduct Overhead/Profit Margin**: If nonprofit is required to pay an attrition fee, the fee shall be calculated by multiplying X% of the Single Room Rate by the difference between the number of actually used rooms and the Room Block with credits from guaranteed no-shows, cancellations, and early departure charges, if applicable.
   - » Guest Rooms – 75-85%
   - » F & B – 20-40%

Key Contract Provisions: Budget Management – 5 Essential Tools for Meeting Agreements (con't)

5. **<u>Average Occupancy Rate – Not Last Sell</u>**: nonprofit shall not owe any fees, penalties, or liquidated damages if Hotel meets or exceeds its average occupancy level for that particular period of the year.

- How do you establish "Average Occupancy?"
  - Hotel ledgers
  - Have a formula, such as last three years

Key Contract Provisions: Payment and Ownership – Intellectual Property

- nonprofit name, trademarks, logo, mailing list, copyrighted information
- nonprofit trade secrets and confidential information
- Who owns what is being created?
- What if a contractor provides something that is owned by a third party?

Key Contract Provisions: Risk Allocation – Damages

- Increase of proposals to cap damages to the value of the contract
  - Evaluate potential maximum harm and costs to repair in the event of breach
- More suggestions to limit damages to actual damages
  - Consider possible exclusions

Key Contract Provisions: Risk Allocation – Indemnification

- **Indemnification**. Compensation. Making reimbursement to another for a loss already incurred.
- Can apply to negligence, IP, breach, data breach, etc.

Key Contract Provisions: Risk Allocation – Indemnification (con't)

AVOID

- "Sole," "Gross," or "As determined by a court" – limits provider's responsibility
- Coverage for third party's acts, omissions, negligence, etc.
- No provider indemnification
- Any occurrence related to a meeting

Key Contract Provisions: Risk Allocation – Indemnification (con't)

CONSIDER

- Reciprocal/mutual – each indemnifies the other for its own negligence
- Control – each party is responsible only for what is within its control
- Includes defense costs
- Limit scope to insurance coverage

Key Contract Provisions: Risk Allocation – Special Indemnification Considerations

- Consider duty to defend
  - Choice of counsel (insurance may limit)
- Consider how long the indemnity obligation should survive beyond termination of the contract
- Government agencies
  - Consider "to the maximum extent allowed by applicable law" clause
- Intellectual property infringement

Key Contract Provisions: Risk Allocation – Limiting Third-Party Reliance

- Endorsements
  - Clear language that nonprofit does not endorse provider's products or services
- Warranties
  - Avoid disclaimer of warranties by provider

Key Contract Provisions: Risk Allocation – Managing Liability and Indemnification Obligations

- “Flow down” to third parties, contractors
- Waivers
- Insurance

Key Contract Provisions: Insurance

- Secure and maintain coverage
  - Understand scope and coverage
  - Consider event insurance
  - Cancellation insurance
- Coverage types and amounts should correspond to indemnification obligations and potential liability exposure
- Reassessments
  - Reconsider risks as activities (and potential liabilities) expand
  - Monitor legal developments affecting kinds and amount of potential liability

Key Contract Provisions: Insurance (con't)

- Who should be insured?
  - Use legal name for nonprofit organization and identify trade names or other identifiers
  - Subsidiary, parent, and affiliated organizations
  - Directors and officers
  - Employees
- Document that your providers have it
  - Additional insured
  - Notice of cancellation
- Important nuances
  - Waiver of subrogation

Key Contract Provisions: Dispute Resolution

- Litigation
  - Inclusion of venue and choice of law
  - Attorneys' fees and costs
- Mediation
- Arbitration
  - Inclusion of venue and choice of law
  - Choice of arbitrator(s)
  - Expenses

Key Contract Provisions: Term and Termination

- Avoid long-term deals
- Seek no-fault exit provisions
- Avoid long-term renewals
- Think carefully about “automatic” renewals
- Provide for termination upon breach (watch for long “cure” periods)

Managing the Internal Contracting Process

- Reevaluate the current review process
  - Identify types of lower risk contracts that can forgo legal review
  - Identify certain dollar thresholds for requiring contract review

Managing the Internal Contracting Process (con't)

- Use contract templates and guidelines for non-legal staff
- Implement and communicate the revised process
- Seek review and counsel from outside legal, fiscal, and other advisors

VENABLE LLP

The Top "Take-Aways"

1. Negotiate a contract that has clear terms that address and manage potential liability and risk
2. Push back when reasonable on clauses for limitation on liability and indemnification
3. Minimize cost overruns by narrowing attrition and cancellation clauses
4. Reexamine and revamp internal contracting procedures

Questions and Discussion

Venable LLP
575 7th St., NW
Washington, DC 20004
(202) 344-4000

Jeffrey S. Tenenbaum, Esq.
jstenenbaum@venable.com
t 202.344.8138

George E. Constantine III, Esq.
geconstantine@venable.com
t 202.344.4790

Audra J. Heagney, Esq.
ajheagney@venable.com
t 202.344.4281

To view Venable's index of articles and PowerPoint presentations, recordings and upcoming seminars on nonprofit legal topics, see www.venable.com/nonprofits/publications, www.venable.com/nonprofits/recordings and www.venable.com/nonprofits/events.

Speaker Biographies

VENABLE LLP

our people

Jeffrey S. Tenenbaum

Partner

Washington, DC Office

T 202.344.8138 F 202.344.8300

jstenenbaum@Venable.com

Jeffrey Tenenbaum chairs Venable's Nonprofit Organizations Practice Group. He is one of the nation's leading nonprofit attorneys, and also is an accomplished author, lecturer and commentator on nonprofit legal matters. Based in the firm's Washington, D.C. office, Mr. Tenenbaum counsels his clients on the broad array of legal issues affecting trade and professional associations, charities, foundations, think tanks, credit and housing counseling agencies, advocacy groups, and other nonprofit organizations, and regularly represents clients before Congress, federal and state regulatory agencies, and in connection with governmental investigations, enforcement actions, litigation, and in dealing with the media.

Mr. Tenenbaum was the 2006 recipient of the American Bar Association's Outstanding Nonprofit Lawyer of the Year Award, the inaugural (2004) recipient of the *Washington Business Journal*'s Top Washington Lawyers Award, the 2004 recipient of The Center for Association Leadership's Chairman's Award, and the 1997 recipient of the Greater Washington Society of Association Executives' Chairman's Award. He also was a 2008-09 Fellow of the Bar Association of the District of Columbia and is AV Peer-Review Rated by *Martindale-Hubbell*. He started his career in the nonprofit community by serving as Legal Section manager at the American Society of Association Executives, following several years working on Capitol Hill.

HONORS

Listed in *The Best Lawyers in America 2012* for Non-Profit/Charities Law, Washington, DC (Woodward/White, Inc.)

Washington DC's Legal Elite, *SmartCEO Magazine*, 2011

Fellow, Bar Association of the District of Columbia, 2008-09

Recipient, American Bar Association Outstanding Nonprofit Lawyer of the Year Award, 2006

Recipient, *Washington Business Journal* Top Washington Lawyers Award, 2004

Recipient, The Center for Association Leadership Chairman's Award, 2004

Recipient, Greater Washington Society of Association Executives Chairman's Award, 1997

Legal Section Manager / Government Affairs Issues Analyst, American Society of Association Executives, 1993-95

AV® Peer-Review Rated by *Martindale-Hubbell*

Listed in *Who's Who in American Law* and *Who's Who in America*, 2005-present editions

AREAS OF PRACTICE

Tax and Wealth Planning

Antitrust

Political Law

Business Transactions Tax

Tax Controversies

Tax Policy

Tax-Exempt Organizations

Wealth Planning

Regulatory

INDUSTRIES

Nonprofit Organizations and Associations

Credit Counseling and Debt Services

Financial Services

Consumer Financial Protection Bureau Task Force

GOVERNMENT EXPERIENCE

Legislative Assistant, United States House of Representatives

BAR ADMISSIONS

District of Columbia

EDUCATION

J.D., Catholic University of America, Columbus School of Law, 1996

B.A., Political Science, University of Pennsylvania, 1990

MEMBERSHIPS

American Society of Association Executives

California Society of Association Executives

New York Society of Association Executives

ACTIVITIES

Mr. Tenenbaum is an active participant in the nonprofit community who currently serves on the Editorial Advisory Board of the American Society of Association Executives' *Association Law & Policy* legal journal, the Advisory Panel of Wiley/Jossey-Bass' *Nonprofit Business Advisor* newsletter, and the ASAE Public Policy Committee. He previously served as Chairman of the *AL&P* Editorial Advisory Board and has served on the ASAE Legal Section Council, the ASAE Association Management Company Accreditation Commission, the GWSAE Foundation Board of Trustees, the GWSAE Government and Public Affairs Advisory Council, the Federal City Club Foundation Board of Directors, and the Editorial Advisory Board of Aspen's *Nonprofit Tax & Financial Strategies* newsletter.

PUBLICATIONS

Mr. Tenenbaum is the author of the book, *Association Tax Compliance Guide*, published by the American Society of Association Executives, and is a contributor to numerous ASAE books, including *Professional Practices in Association Management*, *Association Law Compendium*, *The Power of Partnership*, *Essentials of the Profession Learning System*, *Generating and Managing Nondues Revenue in Associations*, and several Information Background Kits. He also is a contributor to *Exposed: A Legal Field Guide for Nonprofit Executives*, published by the Nonprofit Risk Management Center. In addition, he is a frequent author for ASAE and many of the other principal nonprofit industry organizations and publications, having written more than 400 articles on nonprofit legal topics.

SPEAKING ENGAGEMENTS

Mr. Tenenbaum is a frequent lecturer for ASAE and many of the major nonprofit industry organizations, conducting over 40 speaking presentations each year, including many with top Internal Revenue Service, Federal Trade Commission, U.S. Department of Justice, Federal Communications Commission, and other federal and government officials. He served on the faculty of the ASAE Virtual Law School, and is a regular commentator on nonprofit legal issues for *The New York Times*, *The Washington Post*, *Los Angeles Times*, *The Washington Times*, *The Baltimore Sun*, *Washington Business Journal*, *Legal Times*, *Association Trends*, *CEO Update*, *Forbes Magazine, The Chronicle of Philanthropy, The NonProfit Times* and other periodicals. He also has been interviewed on nonprofit legal issues on Voice of America Business Radio and Nonprofit Spark Radio.

VENABLE LLP

our people

George E. Constantine

Partner

Washington, DC Office

T 202.344.4790 F 202.344.8300

geconstantine@Venable.com

George Constantine concentrates his practice exclusively on providing legal counseling to and advocacy for trade and professional associations and other nonprofit organizations. He has extensive experience with many of the major legal issues affecting associations, including contracts, tax, antitrust, governance, and political activity matters.

Mr. Constantine has represented exempt organization clients undergoing Internal Revenue Service examinations; he has assisted associations and other nonprofit organizations going through mergers, consolidations, joint ventures, and dissolutions; and he has provided ongoing counseling on numerous transactional and governance matters that are unique to nonprofit organizations.

Mr. Constantine has been appointed to the 2009-10 Legal Section Council of the American Society of Association Executives. In addition, Mr. Constantine is the former Staff Counsel of the American Society of Association Executives (ASAE), the 25,000-member national society for trade and professional association executives. As ASAE's sole staff attorney, he gained in-depth experience with the many legal issues facing associations. He also represented ASAE's interests before Congress and federal agencies.

PUBLICATIONS

Mr. Constantine is the author of numerous articles regarding legal issues affecting associations and other nonprofit organizations published by ASAE, the Greater Washington Society of Association Executives, the American Chamber of Commerce Executives, the New York Society of Association Executives, and the Texas Society of Association Executives.

- May 2012, Representing Foreign Entities
- May 2012, Tax-Exempt Organizations the Focus of Upcoming Congressional Hearings
- April 26, 2012, Changes In Store for Group Exemptions?
- January 10, 2012, Top Ten Things Every New Nonprofit General Counsel Should Know
- December 19, 2011, The New D.C. Nonprofit Corporation Act Takes Effect on Jan. 1, 2012: Everything You Need to Know to Comply
- November 18, 2011, The New D.C. Nonprofit Corporation Act Takes Effect on Jan. 1, 2012: Everything You Need to Know to Comply
- November 4, 2011, Top Ten Things a New Nonprofit General Counsel Should Investigate
- September 27, 2011, Protecting and Licensing Nonprofit Trademarks: Key Trademark and Tax Law Issues

AREAS OF PRACTICE

Antitrust

Antitrust Investigations

Political Law

Tax-Exempt Organizations

Tax Controversies

Tax and Wealth Planning

Regulatory

INDUSTRIES

Nonprofit Organizations and Associations

Credit Counseling and Debt Services

BAR ADMISSIONS

Maryland

District of Columbia

EDUCATION

J.D., University of Maryland School of Law, 1998

Recipient, Order of the Coif law school honors society

Recipient, Judge R. Dorsey Watkins Award for excellence in torts

B.A., Loyola College In Maryland,

1989

- August 3, 2011, Could Your Nonprofit's Chapters Be Considered "Franchises" under State Law?
- Summer 2011, Grassroots Lobbying: A Legal Primer
- July 20, 2011, Related Foundations of Associations: Top Five Legal and Tax Pitfalls to Avoid
- February 2011, Recent IRS Determination Highlights Importance of Separation Among Affiliates
- December 16, 2010, So You Want To Be On The Internet ®
- November 3, 2010, Cyberspace Risk: What You Don't Know Could Hurt You
- July 22, 2010, Lobbying for Your Agency: Avoiding the Tax and Legal Pitfalls
- May-June 2010, The IRS Tax-Exempt Examination Process
- April 27, 2010, IRS Provides Guidance to Nonprofits Assisting Homeowners
- April 9, 2010, Legal Traps of Internet Activities for Nonprofits
- March 30, 2010, D.C. Circuit Paves Way for Unlimited Contributions for Independent Expenditures
- March 2010, D.C. Circuit Paves Way for Unlimited Contributions for Independent Expenditures, Political Law Alert
- February 18, 2010, *Citizens United:* How the Supreme Court's Decision Will Impact Associations and Their Members
- January 2010, Supreme Court Strikes Down Laws Banning Corporate Expenditures, Political Law Alert
- October 6, 2009, Legal Traps of Internet Activities for Nonprofits
- July 16, 2009, Steering Clear of the Most Common Legal Hazards in Hotel, Convention Center, and Meeting Contracts
- March 3, 2009, Steering Clear of the Most Common Legal Hazards in Hotel, Convention Center, and Meeting Contracts
- September 22, 2008, The New IRS Form 990: What Does It Mean for Your Organization?
- May 19, 2008, The New IRS Form 990: What Does It Mean for Your Nonprofit Organization?
- March 4, 2008, The New IRS Form 990: What Does It Mean for Your Nonprofit Organization?
- February 15, 2008, Political Activity, Lobbying Law and Gift Rules Guide
- January 10, 2008, The Honest Leadership and Open Lobbying Act: New Lobbying and Ethics Rules
- June 13, 2007, Contracts - 10 Steps to a Better Contract
- November 2006, Pension Protection Act of 2006: Provisions of Interest to Exempt Organizations
- October 1, 2006, New Tax Law Establishes Additional Standards and Requirements for Credit Counseling Agencies
- September 7, 2006, Legal and Tax Issues for Nonprofit Associations
- January 2005, IRS Issues 'Virtual' Trade Show Guidance
- January 4, 2005, Characteristics of a Tax-Exempt Credit Counseling Agency
- October 27, 2004, New IRS Ruling Could Have Taxing Impact on 501(c)(3) Associations with Certification Programs
- August 10, 2004, Association Codes of Ethics: Identifying Legal Issues and Minimizing Risk
- April 16, 2004, Antitrust Concerns with Association Information Exchanges
- March 25, 2004, Untangling the Web - Internet Legal Issues for Associations
- November 4, 2003, Avoiding Association Tax Pitfalls in Cyberspace
- May 6, 2003, Summary of Provisions in S. 476 — The Charity Aid, Recovery, and Empowerment Act of 2003
- December 16, 2002, Good Governance — Ensuring That Your Association's

Governing Documents Pass Legal Muster

- September 1, 2002, Association Activities Targeted in Recent Antitrust Enforcement Actions
- May 1, 2002, Corporate Sponsorship: The Final Regulations
- April 1, 2002, Associations and Campaign Finance Reform
- January 1, 2002, Recent Antitrust Decision on Salary Surveys Highlights Risks to Associations
- November 1, 2001, Legal and Tax Considerations for Capital Campaigns
- January - February 2001, New Campaign Finance Disclosure Law Hits the Wrong Target, *Journal of Taxation of Exempt Organizations*

SPEAKING ENGAGEMENTS

Mr. Constantine is a frequent lecturer on association and tax-exemption organization legal topics, including corporate and tax issues.

- July 12, 2012, Nonprofit Chapters and Affiliates: Key Legal Issues, Pitfalls and Successful Strategies
- May 17, 2012, Nonprofit Contracts: Best Practices, Negotiation Strategies, Practical Tips, and Common Pitfalls
- May 2, 2012, "Risk and Reward – Keeping Your Tax-Exempt Status" for the Nonprofit Risk Management Center
- January 18, 2012, "Generating New Revenue Streams—Legal and Tax Issues for Nonprofit Organizations" at NYSAE Finance & Management Institute Luncheon
- January 10, 2012, Legal Quick Hit: "Top Ten Things Every New Nonprofit General Counsel Should Know"
- December 19, 2011, The New D.C. Nonprofit Corporation Act Takes Effect on Jan. 1, 2012: Everything You Need to Know to Comply
- October 21, 2011, "IRS Group Exemption Procedures" for ABA
- September 27, 2011, Webcast: "Protecting and Licensing Nonprofit Trademarks: Key Trademark and Tax Law Issues" for the Association of Corporate Counsel's Nonprofit Organizations Committee
- July 20, 2011, "Related Foundations of Associations: The Top Five Legal and Tax Pitfalls to Avoid" for the Association Foundation Group
- June 22, 2011, "Play on Natural Turf: Authentic and Transparent Grassroots Lobbying" for the American Society of Association Executives
- May 12, 2011, "Starting and Sustaining the Growth of a Nonprofit Organization" for the Washington, DC Economic Partnership Program
- November 12, 2010, Protecting Your Association from Cyber Attacks and Financial Fraud
- November 3, 2010, "Cyberspace Risk: What You Don't Know Could Hurt You," Nonprofit Risk Management Center
- September 13, 2010, "Board Leadership: Legal Issues" at Greater DC Cares Nonprofit Board Leadership Program
- July 22, 2010, "Lobbying for Your Agency: Avoiding the Tax and Legal Pitfalls" at the Association of Independent Consumer Credit Counseling Agencies Summer 2010 Conference
- June 8, 2010, Legal Quick Hit: "Lessons in Tax Compliance: The Broad Impact of the IRS' Interim Report on the Colleges and Universities Compliance Project" for the Association of Corporate Counsel's Nonprofit Organizations Committee
- April 9, 2010, "Legal Traps of Internet Activities for Nonprofits" a Lorman Teleconference
- March 16, 2010, The Form 990: Dealing with the Fall Out (Audioconference)
- February 18, 2010, *Citizens United*: How the Supreme Court's Decision Will Impact Associations and Their Members
- February 18, 2010, "Legal Issues 2010: Keeping Your Association Out of Trouble" for

the American Association of Medical Society Executives

- October 13, 2009, "Risk Management for Events and Meetings" course at the George Washington University's School of Business
- October 13, 2009, Presentation on meeting contracts to George Washington University students
- October 6, 2009, Legal Traps of Internet Activities for Nonprofits
- July 16, 2009, Steering Clear of the Most Common Legal Hazards in Hotel, Convention Center, and Meeting Contracts
- July 16, 2009, Steering Clear of the Most Common Legal Hazards in Hotel, Convention Center and Meeting Contracts: A Roadmap for Nonprofits
- March 3, 2009, Steering Clear of the Most Common Legal Hazards in Hotel, Convention Center and Meeting Contracts
- February 24, 2009, Legal Issues for Nonprofit Associations
- October 1, 2008, The New IRS Form 990: What Does it Mean for Your Organization?
- September 22, 2008, The New IRS Form 990: What Does It Mean for Your Nonprofit Organization?
- May 19, 2008, New IRS Form 990 Audio conference
- January 10, 2008, The Honest Leadership and Open Lobbying Act: New Lobbying and Ethics Rules
- November 5, 2007, American Public Health Association Annual Meeting
- September 28, 2007, Annual Association Law Symposium
- June 13, 2007, Contracts - 10 Steps to a Better Contract
- September 7, 2006, Legal and Tax Issues for Nonprofit Associations
- February 10, 2004, American Society of Association Executives Winter Conference
- November 4, 2003, Avoiding Association Tax Pitfalls in Cyberspace
- October 3, 2003, American Society of Association Executives 2003 DC Legal Symposium
- August 25, 2003, American Society of Association Executives’ Annual Meeting
- April 17, 2003, Board Fiduciary Duties
- March 13, 2003, Protecting Your Chamber's Intellectual Property
- March 7, 2003, The Ins and Outs of Nonprofit Liability
- February 7, 2003, Legal and Tax Aspects of Raising Non-Dues Revenue
- December 10, 2002, ASAE 2002 Winter Conference

VENABLE LLP

our people

Audra J. Heagney

Associate

Washington, DC Office

T 202.344.4281 F 202.344.8300

ajheagney@Venable.com

AREAS OF PRACTICE

Regulatory

Tax-Exempt Organizations

INDUSTRIES

Nonprofit Organizations and Associations

BAR ADMISSIONS

District of Columbia

Virginia

EDUCATION

J.D., Duke University School of Law, 2006

B.A., History, University of Virginia, 2001

Audra Heagney is an associate in Venable's Nonprofit Organizations and Associations Practice Group. She provides counsel to trade and professional associations, charities and foundations, and other nonprofit organizations on a wide variety of legal matters, including tax exemption, lobbying and political activity, regulatory compliance, copyrights and trademarks, certification and accreditation, contracts, and corporate governance, among others.

Ms. Heagney advises clients on all aspects of mergers and other corporate combinations and alliances, including the drafting and negotiating of contracts, conducting due diligence reviews, advising on tax exemption and other legal implications, reconciling bylaws, and effecting the relevant corporate and tax filings. She also regularly assists with the drafting and negotiation of agreements between nonprofits and other entities. In addition, Ms. Heagney assists with other aspects of tax-exempt organizations, including formation, corporate governance policies and practices, obtaining recognition of tax-exempt status from the IRS, and providing advice on structuring programs and activities to maintain tax exemption and minimize taxable income.

Ms. Heagney serves on the Legal Section Council of the American Society of Association Executives. Prior to joining Venable, Ms. Heagney worked for five years in the nonprofit organizations practice group of a large national law firm.

ACTIVITIES

Ms. Heagney is a member of the Legal Section Council of the American Society of Association Executives, and previously served on the ASAE Legal Symposium Planning Committee. She serves on the Executive Committee of the Board of Directors of Metro TeenAIDS, a community health charitable organization in the District of Columbia. Ms. Heagney also volunteers for the Washington Humane Society.

PUBLICATIONS

- November 18, 2011, The New D.C. Nonprofit Corporation Act Takes Effect on Jan. 1, 2012: Everything You Need to Know to Comply
- October 17, 2011, Lobbying: What Does It Mean for Nonprofits?
- October 17, 2011, Lobbying: What Does It Mean for 501(c)(3) Organizations?
- October 6, 2011, Nonprofit Strategic Partnerships: Building Successful Ones and Avoiding the Legal Traps
- September 15, 2011, Lobbying: What Does It Mean for Nonprofits?
- June 2011, Conducting International Operations: Keys for Nonprofits, *Associations Now*

- June 20, 2011, IRS Announces First Round of Revocations for Nonprofits that Failed to File Form 990

SPEAKING ENGAGEMENTS

- June 12, 2012, Legal Quick Hit: "Nonprofit Contracts: Best Practices, Negotiation Strategies, Practical Tips, and Common Pitfalls"
- May 17, 2012, Nonprofit Contracts: Best Practices, Negotiation Strategies, Practical Tips, and Common Pitfalls
- February 29, 2012, "Managing Risk in International Operations and Meetings" at Meetings Beyond Borders
- November 30, 2011, "Updating your Association RFP and Contract Process - Latest in Association Legal Contract News" for MASAE Annual Conference
- October 6, 2011, Nonprofit Strategic Partnerships: Building Successful Ones and Avoiding the Legal Traps

Additional Information

Articles

August 16, 2011

Nonprofit Partnerships: A Guide to the Key Legal Issues and Pitfalls

AUTHORS

Jeffrey S. Tenenbaum

RELATED INDUSTRIES

Nonprofit Organizations and Associations

ARCHIVES

2012 2008 2004
2011 2007 2003
2010 2006 2002
2009 2005

Related Topic Area(s): Copyrights and Trademarks, Corporate Governance, Meeting, Vendor and Government Contracts, Tax and Employee Benefits

This article uses the term "partnership" as most people would use the word when speaking to one another. When two or more people, or two or more groups of people, pool their resources together and collaborate to achieve a common purpose, it is fair and accurate to call them "partners." From a legal sense, however, the term "partnership" is a term of art—when lawyers describe two entities as "partners," they are speaking about a particular type of legal arrangement. From a lawyer's perspective, a "partnership" is a complex interaction of business law, tax law, and the rules of intellectual property.

Still, for all the legal complexity that often comes with forging partnerships, maintaining them, and amicably parting ways, there are a few basic steps that every nonprofit can take to better understand the law of partnerships. This article lays out some basic terminology, then explains the tax and intellectual property implications involved in forming partnerships. It concludes by highlighting provisions that should be included in every partnership agreement, no matter what the technical form of the relationship.

I. Terminology

Strictly speaking, a "partnership" is an unincorporated business organization created by contract between two or more entities in order to carry out a common enterprise. Each partner contributes money, property, labor, or skill, and expects to share in the profits and losses of the undertaking. Generally speaking, a partnership does not pay income taxes; instead, the individual partners report their share of the partnership's profits or losses on their individual tax returns.

Within this legal definition, there are several categories of partnership, each with its own balance of management rights and personal liability. There are also several forms of cooperation that fall short of the technical definition of "partnership," but are nonetheless advantageous to nonprofits not yet ready to commit to a long-term relationship with another entity.

A. General Partnership

In a general partnership, each partner shares equal rights and responsibilities in connection with the management of the partnership, and any partner has the authority to bind the entire partnership to a legal obligation. Unlike shareholders in a corporation, the members of a general partnership are personally liable for all of the partnership's debts and obligations. That amount of personal liability is often daunting, but it comes with a significant tax advantage: partnership profits are not taxed to the business. Instead, profits *pass through* to the partners, who include the gains on their individual tax returns.

B. Limited Partnership

In a limited partnership, partners are divided into two classes—general partners and limited partners. The personal liability of a limited partner is limited to the amount he or she has actually invested in the partnership; as a trade-off, however, limited partners are not permitted to participate in management decisions. At least one partner in a limited partnership must be a general partner. General partners retain the right to control and manage the limited partnership, but assume full personal liability for the partnership's debts and obligations.

C. Limited Liability Partnership

In a limited liability partnership ("LLP"), all partners may directly participate in the management of the partnership and are granted some protection from the partnership's liability—although the extent of that protection varies from state to state. Some states tax limited liability partnerships as corporations, although they are considered partnerships under federal law. Many states also make the LLP available only to certain professional businesses—*e.g.*, law and accounting firms—and mandate that LLPs adhere to specific filing requirements.

D. Limited Liability Company

A limited liability company ("LLC") is a relatively new type of business structure created by state statute. Unlike general partnerships, which were developed over time by case law and require no formal documentation for creation, LLCs are created by filing a document (usually referred to as "Articles of Organization") with the state. LLC owners (called "members") are not personally liable for the debts and obligations of the LLC. In most cases, an LLC will be taxed like a general partnership—that is, the LLC itself will not be taxed, and the individual members will report their share of profits and losses on their individual tax returns. An LLC may, however, elect to be taxed as a corporation.

E. Joint Venture

A joint venture is an enterprise jointly undertaken by two or more entities for the limited purpose of carrying out a single transaction or isolated project. Unlike a partnership agreement, which creates a new entity and anticipates a long-term and continuous relationship, a joint venture usually ends once the limited purpose of the joint venture is complete. A joint venture can be structured like a general or limited partnership or an LLC, although LLCs are often preferred because of the additional liability protection and tax advantages. Similarly, joint ventures can be structured with an increasingly overlapping set of commitments between the parties and an eye towards eventually entering a more formal relationship. In any event, a well-structured joint venture will be codified in a written agreement that details the precise obligations and allocation of risk between the parties involved.

In a *whole joint venture*, one or more of the partnering entities contributes all of its assets to the enterprise. Nonprofit organizations more commonly engage in ancillary joint ventures. *Ancillary joint ventures* are essentially small-scale joint ventures—enterprises that do not become the primary purpose of the organizations involved. Organizations typically engage in ancillary joint ventures for a limited duration, and memorialize the terms of their arrangement in a written agreement. For example, nonprofits may enter into an arrangement with another organization to host a convention, publish a newsletter, or provide a series of educational programs. Tax-exempt organizations seeking additional sources of revenue also may enter into ancillary joint ventures with for-profit corporations, as long as doing so furthers the tax-exempt organization's purposes and the tax-exempt organization retains ultimate control over the underlying activity. Nonprofits often create new entities from which to undertake the joint venture. Depending upon the nature of the activity contemplated, such an organization may or may not be eligible for tax-exempt status.

Joint membership programs allow individuals to join two nonprofits typically, for a reduced fee. These initiatives allow the members of one organization to become more familiar with another, and are typically conducted in the context of other jointly-run programs and activities. Again, programs in this vein are designed to bring nonprofits closer together, often as a precursor to a more formal alliance, but allowing the entities to tinker with the arrangement or disengage altogether if circumstances or expectations change.

F. Independent Contractor Relationships

An independent contract relationship is an agreement between two or more entities for the provision of goods or services under the terms specified in the agreement. For the most part, independent contractors are defined by the IRS's "facts and circumstances" test. For instance, if the nonprofit hiring the contractor has the right to control or direct the result of the work, but not the means of accomplishing the work, then this will be a factor in favor of characterizing the arrangement as an independent contractor relationship. Otherwise, the contractor may be treated as an employee of the nonprofit, whose earnings are subject to withholding for employment tax purposes. The employee also may be eligible for employee benefits from the nonprofit, among other significant implications.

G. Commercial Co-Venture

A commercial co-venture (sometimes referred to as a "charitable sales promotion") generally consists of an arrangement between a charitable organization and a for-profit entity that otherwise engages in a trade or business. In most cases, the for-profit entity agrees to promote the sale of a product or service and represents that part of the sales proceeds will benefit a charitable organization or charitable purpose. Commercial co-ventures generally resemble independent contractor relationships more than partnerships, LLCs or joint ventures.

Commercial co-ventures are a relatively new idea, and the body of law addressing them is still developing. Presently, 24 states expressly regulate commercial co-ventures. Although none of these states require the commercial co-venture to form a separate business entity, many do require that both the for-profit corporation and the charitable organization file a written contract with the state before engaging in any sales or charitable solicitations.

II. Tax Issues for Tax-Exempt Organizations[1]

Because the terms of a partnership often implicate the tax-exempt purposes of an organization, tax-exempt entities must be mindful of the Internal Revenue Code ("IRC") and the conditions of tax-exempt recognition. This section discusses four central tax concepts for nonprofits to consider before signing any partnership agreement: unrelated business income tax, control by the tax-exempt organization, private inurement and private benefit, and compliance with state charitable solicitation laws.

A. Unrelated Business Income Tax

In general, tax-exempt organizations are exempt from federal taxes on income derived from activities that are substantially related to the organization's exempt purpose. A tax-exempt organization may still be subject to unrelated business income tax ("UBIT"). UBIT is a federal income tax imposed on tax-exempt organizations for income derived from a trade or business that is carried on regularly, but is not substantially related to the organization's exempt purposes. This tax is generally imposed at the federal corporate income tax rates.

For the purposes of determining UBIT, an activity is considered a "trade or business" where it is carried on for the production of income from the sale of goods or performance of services. Income from a passive activity—*i.e.*, an activity in which the exempt organization allows another entity to use its assets, for which the organization receives some payment—is not considered a business. The IRC specifically excludes certain types of passive income from UBIT—dividends, interest, annuities, royalties, certain capital gains, and rents from non-debt financed real property. UBIT also does not include income generated from volunteer labor, qualified corporate sponsorship payments, or qualified convention or trade show income.

In determining whether an activity is "regularly carried on," the IRS will examine: (1) the frequency and continuity with which the activity is conducted; and (2) the manner in which it is pursued. These factors will be compared with the same or similar business activity of non-exempt organizations. Discontinuous or periodic activities are generally not considered "regularly carried on," and generally do not result in UBIT.

An activity that is substantially related to an organization's tax-exempt purposes will not be subject to UBIT. A "substantially related" activity contributes directly to the accomplishment of one or more of the organization's exempt purposes. Alone, the need to generate income so that the organization can accomplish other goals is not considered a tax-exempt purpose.

In the context of trade and professional associations, for example, an activity is "substantially related" if it is directed toward the improvement of its members' overall business conditions. Particular services performed to benefit individual members, although often helpful to their individual businesses, usually results in UBIT to the association where those services do not improve the business conditions of the industry overall.

UBIT is even a consideration where a partnership is formed by two otherwise tax-exempt organizations. To the extent that the activities of a partnership do not further the exempt purposes of either organization, income from the partnership may be subject to UBIT. Notably, if two tax-exempt entities form an LLC operated exclusively for exempt purposes and consisting solely of exempt members, the LLC itself may seek exemption under Section 501(c)(3) of the IRC. Accordingly, if such exemption is recognized by the IRS, the income of the LLC would not be subject to tax. In contrast, the IRS will not grant general or limited partnerships exempt status, even if all of the partners thereof are exempt organizations.

Under the UBIT rules, deductions are permitted for expenses that are "directly connected" with the carrying on of the unrelated trade or business. If an organization regularly carries on two or more unrelated business activities, its unrelated business taxable income is the total of gross income from all such activities less the total allowable deductions attributable to such activities.

An organization can jeopardize its tax-exempt status if the gross revenue, net income, and/or staff time devoted to unrelated business activities is "substantial" in relation to the organization's tax-exempt purposes. In an effort to prevent loss of exempt status, many tax-exempt organizations choose to create one or more taxable subsidiaries in which they may house unrelated business activities. Taxable subsidiaries are separate but affiliated organizations. A taxable subsidiary can enter into partnerships and involve itself in for-profit activities without risking the tax-exempt status of its parent. Moreover, the taxable subsidiary can remit the after-tax profits to its parent as tax-free dividends.

B. Control

In a partnership, a nonprofit organization continues to qualify for tax exemption only to the extent that (1) its participation furthers its exempt purposes and (2) the arrangement permits the organization to act exclusively in its own interests and in the furtherance of those exempt purposes. If a tax-exempt entity cedes "control" of partnership activities to a for-profit entity, the IRS will consider the partnership to serve private aims, not public interests.

In a partnership with a for-profit entity that involves all or substantially all of a tax-exempt organization's assets, the IRS generally requires the tax-exempt organization to retain majority control over the partnership—*e.g.*, a majority vote on the governing board. In a similar arrangement that involves only a portion of the tax-exempt organization's assets, the IRS has approved a structure in which the for-profit and tax-exempt organizations share most management responsibilities but leave the exempt organization in charge of the exempt aspects of the partnership. Even in a partnership consisting solely of tax-exempt organizations, the management of the partnership must remain with tax-exempt organizations and may not be delegated to for-profit entities.

Nonprofits frequently enter into short-term partnerships with for-profit corporations in order to conduct a particular activity. These ventures should not jeopardize the nonprofit's tax-exempt status in most cases—even if the nonprofit does not maintain operational control over the venture—because the nonprofit will still carry on substantial tax-exempt activities.

C. Private Inurement and Private Benefit

In general, organizations recognized as tax exempt under Sections 501(c)(3) and 501(c)(6) of the IRC are prohibited from entering into a transaction that results in "private inurement." Private inurement occurs where a transaction between a tax-exempt organization and an "insider"—*i.e.*, someone with a close relationship with, or an ability to exert substantial influence over, the tax-exempt organization—results in a benefit to the insider that is greater than fair market value. The IRS closely scrutinizes partnerships between tax-exempt organizations and taxable entities to determine whether the activities contravene the prohibitions on private inurement and on excess private benefit (see below).

Private inurement through dealings with tax-exempt organizations can carry with it individual penalties as well. The IRS may levy excise taxes (referred to commonly as "intermediate sanctions") against "disqualified persons" that receive better-than-fair-market-value in transactions with 501(c)(3) and 501(c)(4) organizations. A "disqualified person" is any person who is in a position to exercise substantial influence over the tax-exempt organization, or has been in the past five years. Directors, officers, and the immediate family of directors and officers are all disqualified persons, among others.

501(c)(3) organizations also are prohibited from entering into transactions that result in more-than-incidental "private benefit" to another party, including unrelated third parties. Incidental benefits related to an organization's tax-exempt purposes are not considered private benefits, but the benefits must be both quantitatively and qualitatively incidental. To be quantitatively incidental, the private benefit must be insubstantial when compared to the overall tax-exempt benefit generated by the activity. To be qualitatively incidental, the private benefit must be inextricable from the exempt activity, in that the exempt objectives could not be achieved without necessarily benefitting certain individuals privately.

While the private inurement prohibition and the private benefit doctrine may substantially overlap, the two are distinct requirements which must be independently satisfied.

D. Charitable Solicitation Statutes

Over the last two decades, the vast majority of states and the District of Columbia have enacted and strengthened charitable solicitation statutes, designed to guard against fraudulent or misleading fundraising solicitations. The term "charitable solicitation" generally refers to requests for contributions to a tax-exempt organization or for a charitable purpose. Many state statutes restrict the application of their charitable solicitation statutes to organizations recognized as tax-exempt under Section 501(c)(3); others apply such statutes to all tax-exempt entities. Solicitations may take many forms, including Internet and telephone appeals, special fund-raising events, and direct-mail campaigns. Any partnership that engages in a charitable solicitation must adhere to the state requirements in each state in which such solicitation occurs.

While the specifics of these statutes vary by state, they generally require tax-exempt organizations to register before soliciting contributions from residents of the state. Registration typically involves providing general information (*e.g.*, name, address, corporate status, purpose, proposed registration activities, tax status, information about officers and directors, etc.) about the tax-exempt organization.

Many states also impose reporting and disclosure requirements. Tax-exempt organizations are typically required to file a report or other financial information with the state on an annual basis. Many states make all or most of these reports and registrations available to the public. Some states also require solicitors to disclose certain information—*e.g.*, the nature of the organization's activities and the amount of a donation actually designated for charitable purposes—at the request of a prospective donor.

As commercial co-ventures have gained popularity, many states have enacted statutes that specifically address and regulate arrangements between non-profit and for-profit entities. Under these statutes, the for-profit partner may be subject to reporting and accounting requirements to both the tax-exempt organization and the state. Alternatively, states may subject the partners of a commercial co-venture to the registration and bonding requirements usually reserved for professional fundraisers and solicitors.

Failure to comply with charitable solicitation statutes may result in sanctions against the tax-exempt organization, including investigations, revocation of registrations, injunctions, and civil and criminal penalties. Because of the variances in state filing requirement, compliance is often burdensome when nonprofit organizations contemplate solicitation programs that will span several states. This burden is somewhat eased by the fact that 35 states and the District of Columbia have agreed to accept a uniform registration form; however, many of these jurisdictions also require state-specific attachments—*e.g.*, a Form 990, audited financial reports, and/or copies of partnership agreements—to complete the charitable organization's registration.

III. Protecting Intellectual Property within Partnerships

The various types of partnerships discussed previously all likely will result in the creation of or involve the use of some form of intellectual property. Perhaps a company and a charity partner together to promote a "green" program on each other's websites. Nonprofits often come together to produce an educational conference, convention or trade show. Several different types of organizations might enter into a partnership to create the definitive publication on best practices in a given field or industry.

These business ventures, and many others, likely involve the development of products or written works, advertising and marketing literature, the sharing of logos and organization names, and/or the use of membership and customer lists to market the program. In addition, business activities like these often require a nonprofit to share its trademarks, trade secrets, and copyrights. All of these things constitute intellectual property. When such intellectual property assets are managed poorly, an organization runs the risk of damaging or diluting its rights in its own intellectual property assets and potentially infringing upon the rights of others. If managed properly, these assets can remain protected even as they are used to accomplish the goals of the business venture.

In short, a rudimentary understanding of the basics of trademark, trade secret, and copyright law can go a long way toward giving an organization the flexibility it needs to successfully launch new partnerships and business activities.

A. Trademark Basics

An organization's name and acronym may be "trademarks" protected by law. By definition, a trademark is any word, phrase, symbol, design, slogan, or tag line (or combination thereof) used by a company, individual or nonprofit to identify the source of a product. A service mark is the same as a trademark except that it identifies the source of a service. A certification mark is a mark used by an authorized third party to indicate that their products or services meet the standards set by the owner of the mark. It is important to note, however, that there are several exceptions that prevent a mark from being a protected trademark under the law, including the fact that the mark is too generic or is a merely descriptive term.

B. Trade Secret Basics

The term "trade secret" is generally defined as information used in a business that provides a competitive advantage to its owner and is maintained in secrecy.[2] Almost any type of information, if truly valuable, not readily known in the industry, and properly protected, may constitute a trade secret. Trade secret information might include (1) business information; (2) customer or member lists and related confidential information; (3) procedures, such as employee selection procedures, business methods, standards and specifications, inventory control, and rotation procedures; (4) financial information; (5) advertising and marketing information; (6) processes and methods of manufacture; (7) designs and specifications; and (8) computer software.

C. Copyright Basics

While they often may not realize it, organizations create and use copyrighted works on a regular basis. Under the federal Copyright Act, a copyright automatically vests in the author of a work as soon as the work is fixed in some tangible medium of expression. Essentially, when any entity puts pen to paper and an original work appears, a copyright exists. The copyright may be owned by a single author, or by two or more contributors who are joint authors or co-authors. A "joint work" is one created by two or more authors who intend their contributions to be merged into a single work. As a matter of law, each co-author of a copyrighted work has an independent right to use and exploit the entire work, but must share the profits equally and provide an accounting to the other co-author.

Organizations frequently miss a key copyright principle: the law treats works created by independent contractors and other non-employees differently than works created by an organization's employees. Materials created by an organization's employees generally are presumed to be the property of the organization, even absent a written copyright transfer or agreement, thus making the organization the owner of the copyright in such works. However, even if an organization has conceived of the idea for a work, supervised its development, and funded its creation, an independent individual (*e.g.*, an independent contractor or any other non-employee) hired to create a work retains the copyright in that work unless he or she explicitly transfers it back to the organization by way of a written agreement. Even articles and graphics used and reused in the regular publications of a nonprofit may remain the intellectual property of their original creators and owners. If the organization wishes to continue to use such a work, it must obtain permission from the copyright owner and may be required to pay a licensing fee.

D. Preventative Measures

To protect and maximize an organization's intellectual property rights and avoid infringing upon the intellectual property rights of others, the organization should take the following preventative steps, either on an ongoing basis or in contemplation of a new business venture:

- **Register copyrights.** Register the content on websites, publications and all other important, original, creative works that are fixed in any print, electronic, audio-visual, or other tangible medium with the U.S. Copyright Office. Although such registration is not required to obtain and maintain a copyright in a work, it is a prerequisite to filing a lawsuit to enforce the rights in such works and it confers other valuable benefits. Copyright registration is generally a simple, inexpensive process that can usually be done without the assistance of legal counsel.
- **Register trademarks.** Organizations should register their name, logos, slogans, certification marks, and all other important marks with the U.S. Patent & Trademark Office. While federal registration of marks is not required to obtain and maintain trademark rights, it can be extremely helpful in enforcing and maintaining them. Trademark registration, although a bit more expensive than obtaining copyright registration, is still an affordable process, particularly when one considers that trademarks and service marks generally protect the actual identity of an organization or its brand(s). As a result, the ability to fully enforce an organization's trademark or service mark rights through registration is paramount.
- **Use copyright and trademark notices.** Use copyright notices (*e.g.*, "© 2011 Venable LLP. All rights reserved.") on and in connection with all creative works published by your organization, and trademark notices on and in connection with all trademarks, service marks, and certification marks owned and used by your organization (*e.g.*, "TM" for non-registered marks and "®" for federally registered marks). While copyright and trademark notices are not required, their effective use can significantly enhance intellectual property rights, including putting others on notice as to their protection and preventing others from asserting the defense of "innocent infringement."
- **Verify ownership and permission to use all intellectual property.** An organization should ensure that it owns all intellectual property or has appropriate permission to use all intellectual property belonging to third parties that

appears in its publications, on its website and in any other media, and should maintain and update such permissions on a regular basis. It is notable that, generally speaking, more copyright problems arise in this area than any other. If an organization discovers that it does not own intellectual property that it seeks to use as part of a partnership or business venture, it may be required to obtain permission from and pay a licensing fee to the owner of the work in order to make lawful use of the work.

- **Police use of your intellectual property.** Police the use of your copyrights and trademarks by others and enforce your rights where necessary. Trademark law requires the owner of a trademark or service mark to take measures to enforce its rights in such trademarks or service marks. An organization may use periodic web searches, outside watch service vendors, or other means to do so. Enforcement does not necessarily involve the filing of a lawsuit.

E. Contractual Protections

It cannot be emphasized enough that organizations entering into a business venture should memorialize their arrangement in a written contract. Among the other issues discussed in this article, a written agreement will ensure that the ownership rights (or at least sufficient license rights) to all intellectual property created under the agreement are apportioned among the business partners as they intend. If ownership of works is not spelled out in an agreement, the default copyright laws discussed above will apply, among others. The following are key issues that partnering organizations should address in their written agreements:

- **Ensure confidentiality—either up-front or in the partnership contract.** Potential business partners should enter into a written confidentiality agreement up-front—while they are ironing out the business terms—to protect the tentative deal, trade secrets, and any other intellectual or proprietary property revealed through the process of negotiations and due diligence investigations. Alternatively, the parties can address confidentiality in the comprehensive written contract that outlines their business venture.

- **Include an intellectual property license.** Any time an organization allows any other individual or entity—be they members, affiliated entities, or business partners—to use its trademark, service marks, name, logos, copyrighted works, other intellectual property, or proprietary information (such as names, addresses, and other contact information contained in its membership or customer directory or list), it is licensing those rights to the other party. The terms and conditions of such a license should be in writing and the writing should include certain provisions regarding the policing of the use of such intellectual property by others.

The license of an organization's intellectual property to the other partner generally should be limited solely to the scope and purpose of the business venture contemplated under the agreement, and should cease immediately upon termination. The owning partner should explicitly retain all key copyright, trademark, patent, and domain name rights created under the agreement; retain its ownership and control of the "look and feel" of any of its content used on a website; retain quality control over the use of any trademark, service mark, name, logo, or other indicator of source of any product or service; restrict the use of its name, logo and membership list; obtain confidentiality and security assurances regarding the use of its customer or membership data and other information; and obtain a warranty by the licensee partner that it will use no infringing or otherwise illegal material in connection with its use of the owning partner's intellectual property.

- **Minimize liability risk through representations and warranties.** An effective contract will include sufficient representations and warranties that each partner's intellectual property, software, website, and other elements that it brings to the venture do not infringe any intellectual property or other rights of third parties, do not violate any applicable laws and regulations, and that each partner will perform as promised.

- **Spell out rights upon termination.** While the parties may intend for their brilliantly-conceived business venture to continue forever, even the best plans end or change. Thus, one of the most important issues to address in advance in the original written contract is what happens to each party's intellectual property assets upon termination. Joint authors who formerly shared all rights, expenses and revenues may want to buy one another out upon termination, or ensure that the other party cannot use or alter their joint work once they part ways. Partner organizations should consider whether derivative works can be created after termination, and if so, to what extent. The key is for partners to think ahead about what assets they expect to keep or to gain, what rights they wish to protect, and how to enforce those rights at and after termination. In certain cases, a written agreement may be required to alter the statutory default provisions that govern ownership rights related to these types of considerations.

- **Maintain agreements with contractors, authors and speakers.** Partnering organizations also should maintain written contracts with any contractors and non-employee authors and speakers utilized under their business plan. If the ownership of works is not spelled out in a written agreement, the default copyright rule generally will apply, *i.e.*, the person who creates the work is the one who owns it, regardless of who conceived of or paid for the work. An exception to that general rule is represented in the work-made-for-hire doctrine. If a work qualifies as a "work-made-for-hire" under the law, the entity commissioning the work is considered its author and is the copyright owner, not the individual who created the work.[3] This area of the law is complex and many works may not qualify under the word-made-for-hire doctrine (the doctrine is only applicable to certain limited, expressly-defined categories of works). Among other requirements, in order for a work to be considered a work-made-for-hire, a written agreement reflecting such status is necessary.

A written agreement with any non-employees should contain a section that provides that (1) works created pursuant to the agreement are "works-made-for-hire;" (2) to the extent a work is not a work-made-for-hire under the statute, the non-employee author, creator or speaker assigns the copyright to the organization; and (3) in the event that the non-employee will not agree to assign its work to the organization, the non-employee grants the organization a broad, irrevocable, worldwide, royalty-free, and exclusive license to the work in any manner in the future.

IV. Issues to Consider before Signing the Agreement

After considering the relevant tax and intellectual property issues and choosing the appropriate legal structure for the partnership envisioned, a nonprofit's staff must delve into the specific details. No partnership agreement is complete without taking certain matters under consideration:

- **Due Diligence and Quality Control:** Before entering into any partnership agreement, a nonprofit should become familiar with its potential partner. Nonprofit leadership is obligated to exercise due diligence on this front, and nonprofit staff should be prepared to check references and review key legal, financial, corporate, and insurance documents. Avoiding negligence in the selection process—and on an ongoing basis—is key to avoiding liability for the errors and omissions of a partner.
- **Confidentiality:** While not essential, it often is prudent for a nonprofit to enter into a confidentiality agreement with a potential partner *prior* to beginning negotiations over the partnership agreement. Such an agreement can help ensure that the nonprofit will not be damaged or put at a competitive disadvantage by the disclosure or improper use of sensitive information or documents.
- **Intellectual Property:** Engaging in a business venture with another entity almost always involves the use of one another's intellectual property and frequently the creation of new works. Each organization should include a license to its intellectual property that limits the other partner's use of that property solely to the purposes of the partnership. An organization must preserve the right to maintain quality control over any use of its trademarks, service marks, name, logos, or any other indicator of the source of a product or service. Both partners should address who will own any works created by the partnership—both while it exists and after it terminates—as well as the rights to share in revenue related to such works and the right to create derivative works based on such works.
- **Choosing the Right Form:** As discussed above, each form of partnership has its own liability and tax considerations. Be specific. For example, an agreement to enter into a joint venture should state so explicitly. An agreement that represents a limited, one-time arrangement should contain a clause that states that is the intention of the parties that it be a limited, one-time arrangement.
- **Comply with Tax-Exemption Requirements:** As previously noted, tax-exempt organizations have to abide by special tax rules in order to maintain their tax-exempt status. A nonprofit's tax-exempt status is preserved by continuously monitoring the amount of the resources devoted to a partnership that generates unrelated business income, as well as limiting the unrelated business income itself. The agreement should state that the tax-exempt entity, at the very least, maintains control over the tax-exempt purposes and activities of the partnership.
- **Performance Obligations and Performance Standards:** A partnership agreement must be clear about the precise obligations of each partner, and should err on the side of being too specific. Partners should be required to perform with high standards of quality, professionalism and expertise, and the agreement should contemplate adverse consequences for a party that fails to satisfy these standards.
- **Timeline:** Any time constraints should be stated in the agreement. The phrase "time is of the essence" may be used to prevent late performance.
- **Indemnification:** Most partnership agreements contain an indemnification clause. The basic obligation is that if one partner's negligence or misconduct causes another partner to be sued by a third person, then the party at fault is responsible for any expenses resulting from the suit, including judgments, damages, settlements, and attorney's fees and court costs.
- **Antitrust Compliance:** Any provision that fixes prices, limits competition, allows for the exchange of competitively-sensitive information, attempts to set industry standards, restricts membership in a nonprofit, limits access to particular products or services, limits the production of particular products or services, or attempts to restrict who may do business with whom in an industry, likely is suspect to scrutiny under federal and state antitrust laws. While not necessarily illegal, extreme care and prudence should be exercised. If the agreement implicates any of these—or otherwise limits competition in any way—consult with legal counsel before proceeding.
- **Representations and Warrantees:** Every party to a partnership agreement should be willing to make certain basic guarantees (often called representations and warranties)—to respect the rights of third parties, to follow all applicable laws and regulations, to sign the agreement only if actually authorized to do so, and to perform all obligations in good faith and fair dealing. Many partnership agreements also spell out particular consequences for breach of these guarantees.
- **Term, Termination and Transition:** All good partnership agreements contemplate an exit strategy at every stage of the enterprise. A solid agreement will spell out the initial term of the contract, whether and how the term will automatically renew, and when and how the agreement may be terminated. Unless the agreement specifies otherwise, the law generally will permit a partner to assign its rights and obligations under the partnership agreement to any third party, as well as to terminate the agreement at any time for any reason. Nonprofits can avoid costly disputes at the end of a relationship by deciding, up front, which partners will take which assets with them when they leave the partnership, or at least specifying a process for making such determinations.

This list is by no means exclusive. All partnership agreements should be in writing and generally should be reviewed by legal counsel.

* * * * *

__Jeffrey S. Tenenbaum__ is a partner in and chair of the nonprofit organizations practice at the Venable LLP law firm. Resident in the firm's Washington, DC office, he can be reached at 202-344-8138 or __jstenenbaum@Venable.com__.

This article is not intended to provide legal advice or opinion and should not be relied on as such. Legal advice can only be provided in response to a specific fact situation.

AUTHORS

Jeffrey S. Tenenbaum

Lisa M. Hix

RELATED INDUSTRIES

Nonprofit Organizations and Associations

ARCHIVES

2012 2008 2004
2011 2007 2003
2010 2006 2002
2009 2005

Articles

May 7, 2010

Combinations and Alliances Among Nonprofit Associations

Related Topic Area(s): Corporate Governance, Meeting, Vendor and Government Contracts, Miscellaneous, Tax and Employee Benefits

There are a wide array of ways in which nonprofit associations can combine, affiliate or otherwise come together. Some involve a complete integration of programs, activities, membership, leadership, and staff, while some provide for maintaining varying degrees of separateness and autonomy. There are pros, cons and considerations to take into account for each option. And sometimes one option can be a stepping stone to a fuller combination. Often the decisions are based on legal, tax or economic concerns, sometimes power and politics will dominate the decisionmaking process, and usually it is a combination of all of these factors.

This article lays out some of the primary means by which nonprofit associations frequently combine, affiliate and otherwise come together in various ways. It explains what they each mean, and also highlights some of the primary considerations that come into play with each option.

I. Merger and Consolidation

A. General

Nonprofit corporations can fully and completely integrate their programs, functions, and membership by merging or consolidating. When two nonprofit entities *merge*, one entity legally becomes part of the surviving entity and dissolves. The surviving corporation takes title to all of the assets, and assumes all of the liabilities, of the non-surviving entity.

Unlike a merger, a *consolidation* of nonprofit entities involves the dissolution of each of the organizations involved, and the creation of an entirely new nonprofit corporation that takes on the programs, resources and membership of the former entities. Although the net effect of a merger and consolidation are the same – one surviving entity with all the assets and liabilities of the two previous groups – many associations prefer consolidation over merger because it tends to lend the perception that no organization has an advantage over the other. There is a new corporation which houses the activities of the two and each is dissolved pursuant to the consolidation.

B. Benefits of Merger or Consolidation

Merger or consolidation of entities with similar exempt purposes may offer a number of benefits to the participating organizations and their members. By merging or consolidating, associations may combine their assets, reduce costs by eliminating redundant administrative processes, and provide broader services and resources to their members. Furthermore, members who paid dues and fees to participate in the formerly separate associations are often able to reduce their membership dues and the costs and time demands of association participation by joining a single, combined organization. Finally, merger or consolidation may allow associations participating within the same field or industry to offer a wider array of educational programming, publications, advocacy and other services to a larger constituency in the public arena.

C. The Divisional Approach

The fact that two organizations have become a unified legal entity does not prohibit them from continuing with some measure of autonomy within the new corporation. Councils or divisions could be established to promote and protect the unique interests of the industry sub-sets. A prominent example of this organizational structure is the American Forest & Paper Association which has a separate Wood Products Council and other councils that represent pulp and paper and other interests. Under this approach, the Articles or Bylaws can cede certain distinct areas of authority to these subordinate bodies. Balancing these levels of authority, finances and management can be challenging, but the model is frequently used.

D. Other Considerations

The law imposes stringent fiduciary responsibilities on the members of an organization's governing body to ensure that any merger or consolidation is warranted and in the best interests of the organization. Directors and officers may be held personally and individually liable if they fail to act prudently and with due diligence. Due diligence generally requires an organization’s governing body to ascertain the financial and legal condition of the organization with which the entity will be merged or consolidated. This includes examination of the other entity’s books and records, governing documents, meeting minutes, pending claims, employment practices, contracts, leases, and insurance policies, and investigation into potentially significant financial obligations, such as the funding of retirement programs, binding commitments to suppliers, and the security of investment vehicles. Boards of directors often utilize accountants and attorneys to conduct due diligence reviews. The opinions of such experts may be relied upon when evaluating a plan of merger, provided that the board of directors establishes a full and accurate financial and legal profile of the other organization before approving the merger or consolidation.

In addition to conducting routine due diligence reviews, an organization’s board of directors should have legal counsel review the impact of a proposed merger or consolidation on competition within the industry. Federal antitrust laws prohibit mergers or consolidations that may substantially lessen competition in any line of commerce. The Department of Justice and the Federal Trade Commission may scrutinize any transaction that could lead to price fixing, bid rigging, customer allocation, boycotts, or other anticompetitive practices. That said, mergers and consolidations of nonprofit organizations typically do not pose an anticompetitive threat. If it can be shown that the joining of the two organizations will actually promote competition, there will be very little antitrust risk overall.

As described in more detail below, merger and consolidation are complex processes, which require the approval of the boards of directors and membership, if any, of each organization. As a practical matter, it can be difficult to combine and coordinate the governing bodies, staffs and operations of two or more existing organizations. Additionally, the institutional loyalties of members, officers, and professional staffs often come into play, particularly when the organizations considering merger or consolidation are unequal in size and resources.

E. Procedural Requirements

To merge or consolidate with another organization, each organization must follow the procedures mandated under the nonprofit corporation law of its state of incorporation, as well as any specific procedures in its governing documents, provided such procedures are consistent with the nonprofit corporation statute.

While nonprofit corporation statutes differ by state, the laws governing merger and consolidation of nonprofits typically set forth certain core procedures. The board of directors of each precursor organization must develop and approve a plan of merger or consolidation according to the requirements set forth in the nonprofit corporation statute of the state, or states, where the organizations are incorporated. Typically, the details of the deal between the two organizations are set forth in a "Merger Agreement" that is not required to be filed. This document usually covers items such as integration of the staff and voluntary leadership, corporate governance changes, and programmatic consolidation. It often is quite detailed.

The plan of merger or consolidation also must be submitted to the voting members, if any, of each organization for their approval. While the conditions for member approval vary from state to state, statutes generally require a vote of two-thirds to effectuate the plan merger or consolidation – a number that can be difficult to reach for practical and political reasons. Assuming the members of *both* organizations approve the board’s plan, “articles of merger” must be filed in the state where the new entity will be formally incorporated.

Where merging nonprofits are each tax-exempt under different tax classifications (*e.g.*, a 501(c)(3) and a 501(c)(6)), the resulting merged entity will generally need to file a new application for federal tax exemption with the Internal Revenue Service (“IRS”). Likewise, a new, consolidated entity must apply to the IRS for recognition of tax-exempt status. On the other hand, where merging entities share the same tax-exempt classification, the tax-exempt status of the surviving organization is typically not affected. Instead, following the merger, all parties to the transaction must notify the IRS of the merger and provide supporting legal documentation. If the newly merged entity will carry out substantially the same activities as its predecessors, the IRS will typically grant expedited approval on a *pro forma* basis and there will be no lapse in the tax-exempt status.

II. Acquisition of a Dissolving Corporation’s Assets

A. General

Another legal mechanism for "absorption" is the *dissolution and distribution of assets* of a target association. This statutory procedure generally involves the adoption of a plan of dissolution and distribution of assets, satisfaction of outstanding liabilities, transfer of any remaining assets to another nonprofit entity, and dissolution. Where the dissolving nonprofit is exempt under Code Section 501(c)(3), the Treasury Regulations require the organization to distribute its assets for one or more exempt purposes under Code Section 501(c)(3).

B. Benefits and Other Considerations

While the dissolving entity must adhere to specific statutory procedures, a dissolution and transfer of assets is much less onerous on the entity that acquires the dissolving entity’s assets (the “successor” entity) than a merger or consolidation. Because the successor entity is merely absorbing the assets of another organization, a vote of the membership and accompanying state filings are typically not required for that corporation. Furthermore, receipt of a dissolving nonprofit corporation’s assets typically does not affect an organization’s tax-exempt status. However, just as with merger or consolidation, a tax-exempt organization must be cautious when taking on programs or activities to ensure that they support its stated tax-exempt purposes.

Asset transfer and dissolution may be strategically preferable for combining organizations when one organization is of a much smaller size than the other. In addition, this type of transaction is particularly useful when an organization wishes to acquire the assets of another organization with significant future contingent liabilities, because the successor organization does not, by operation of law, assume the liabilities of the dissolving corporation. Further, the successor organization may seek to limit the liabilities it will assume in a written agreement, as discussed below.

While a successor organization is typically shielded from its predecessor's debts and liabilities, an asset transfer always poses some risk of *successor liability*, particularly if adequate provision has not been made for pre-existing liabilities. A court may determine that an organization that acquired the assets of a dissolved corporation impliedly agreed to assume the dissolved corporation's liabilities. Alternatively, a court may find that the successor corporation serves as a "mere continuation" of the dissolved corporation, that the asset transfer amounts to a *de facto* merger, or that the transaction was actually a fraudulent attempt to escape liability. It is also often problematic to extinguish liabilities, such as employee benefit programs, rather than assuming them.

C. Procedural Requirements

Like a merger or consolidation, an asset transfer and dissolution must follow the applicable state nonprofit corporation laws and each entity's governing documents. The procedure for dissolution and asset distribution is fairly simple for the successor entity, as it will simply be entering into a transaction – albeit a significant one – to acquire assets and absorb members, if any. Member approval for such a transaction is typically unnecessary unless the organization's bylaws require otherwise. The due diligence requirements imposed on the successor entity are also less stringent. Nevertheless, the governing body of the successor corporation should conduct a due diligence review of the dissolving corporation as a matter of course, particularly if the acquisition of the dissolving organization's assets will significantly alter the nature of the successor organization's operations.

The process is more complicated, however, for the dissolving entity. In most instances, the nonprofit corporation statute of the dissolving entity's state of incorporation imposes the following requirements to effectuate a transfer and dissolution:

- The governing body of the dissolving corporation is obligated to exercise the same level of due diligence as in a proposed merger or consolidation, as discussed above.
- After the governing body of the dissolving corporation has determined that dissolution and transfer of its assets are in the best interests of the organization, it must develop and approve a "plan of dissolution" (or "plan of distribution" according to some states). The number of directors that must vote to accept the plan varies by state.
- If the dissolving corporation has members, it must obtain member approval of the dissolution plan. Again, the requisite margin of member approval varies from state to state; most states require a two-thirds majority.
- The dissolving corporation must file "articles of dissolution" with the state in which it is incorporated. States typically accept articles of dissolution only after all remaining debts and liabilities of the dissolving entity are satisfied or provisions for satisfying such debts have been made.
- As part of the plan of dissolution, the dissolving corporation will transfer all of its remaining assets to a designated corporation.
- Once the plan of dissolution is executed, the dissolving entity is generally prohibited from carrying on any further business activity, except as is necessary to wind up its affairs or respond to civil, criminal, or administrative investigation.

As part of the asset distribution process, the parties typically execute a written agreement detailing their understanding of the transfer of the dissolving corporation's assets. The parties may utilize such an agreement where they wish to obtain warranties regarding the absence of liabilities to be assumed by the successor corporation; account for any outstanding contractual obligations of the dissolving entity; provide for third-party consents where necessary to transfer any contractual obligations to the successor organization; or detail terms for the integration of the dissolving entity's members. Note that in the event of any breach of warranties by the dissolving corporation, it generally will not be possible for the successor corporation to obtain redress unless the agreement specifically obligates some third party to indemnify the successor corporation, as the dissolving corporation will no longer exist.

III. Federation

A. General

A federation is generally an association of associations. Federations are most often structured along regional lines (*e.g.*, a national association whose members are state or local associations). In some cases, a federation consists of special interest groups that represent discrete segments of the industry represented by the" umbrella" association. The national or umbrella association's relationship with its affiliated associations is governed by formal affiliation agreements.

An affiliation agreement is a binding contract that sets forth the nature of the relationship between the parties. Most affiliation agreements include provisions that address the following: term and termination of the relationship; use of the association's intellectual property; the provision of management services; treatment of confidential information; coordinated activities; and tax and/or financial issues, among other provisions. Where an affiliated association fails to adhere to the terms of its affiliation agreement with the national association, the affiliate could lose privileges (*e.g.*, loss of ability to use the association's intellectual property), become disaffiliated, or suffer some other penalty. Similarly, where a national association violates the terms of an affiliation agreement with its affiliate, it may be liable for such breach.

B. Benefits and Other Considerations

In the federation context, the national association is, for tax and liability purposes, a separate legal entity from its affiliated associations. There are instances, however, in which the separateness between two entities (even though each entity may have separate corporate and tax statuses) will be disregarded by a court or the IRS, thus creating exposure to potential legal and tax liability to both entities. Specifically, the separateness can be disregarded where the national association so controls the affairs of its affiliates, rendering it a "merely an instrumentality" of the national association.

There are two primary areas of concern for national associations that are governed by a federated structure. First and foremost, because the national association is primarily (if not completely) comprised of other associations, the income and membership of the national is generally controlled by its affiliates. Without control over these two vital areas, the national association could be susceptible to secession by an affiliate (resulting in attendant loss of income), or have its power and authority undermined by an affiliate. Second, the federated structure could cause legal or policy problems if factionalism among affiliated associations arose. Additionally, the federated structure lends itself to diluted membership loyalty toward the national association.

C. Procedural Requirements

Preliminarily, all steps must be taken to form the national association in accordance with applicable state nonprofit corporation (or association) laws. Generally, this requires a minimum of filing articles of incorporation, selecting an initial board of directors, and developing bylaws for the association. Once the association is formed, it must apply to the IRS for recognition of tax-exempt status.

After formation, the national association must execute detailed affiliation agreements with each of its affiliated associations. There are generally no statutory requirements mandating the exercise of due diligence by any entity that chooses to enter into an affiliation agreement. Rather, the relationship is generally governed by the terms of the affiliation agreement and the general principles of contract law.

IV. Management Company Model

Associations with similar interests can affiliate through a common management structure, whereby the groups would realize the efficiencies of coordinated "back office" operations such as accounting, meeting management, IT, human resources and other supportive functions, possibly through the ownership of the non-profits by a for-profit umbrella organization. Although there are mechanisms that could be used to effect the coordinated operations that many associations seek, the idea of for-profit corporate "ownership" is problematic for several reasons, most notably tax law inhibitions on private inurement from a tax exempt entity and state corporate law restrictions.

This model (without the ownership feature) has been used in the past by a number of associations, particularly in the chemical industry, in which a nonprofit association provides management and staffing for another nonprofit corporate association which is within the scope of its exempt purposes. A historic example is the management by the Synthetic Organic Chemical Society of the Formaldehyde Institute in the 1980's and 1990's. SOCMA provided staff and management support for FI as well as a number of other chemical-specific, separate associations. This was done on a fee for service basis.

Some for-profit entities – association management companies ("AMC's") – manage the day-to-day business of numerous trade associations. The models vary depending on the resources and needs of the associations, but in almost all settings the AMC's provide the accounting, meeting planning, correspondence, communications, staffing and office requirements. In some cases, the association will have separate office identity including signage and limited access, while in others there will be common "association offices" with shared employees. There is a symbiotic relationship with respect to employees. Employees are formally employed by the AMC, but essentially report to the boards of the associations.

One critical aspect of this organizational model is that the AMC does not have an ownership interest in the nonprofit trade associations. They operate under management agreements that typically can be terminated with relatively short notice or at the conclusion of a stated term. The contractual arrangements are based on arm's length compensation, depending on the services provided.

The advantage of this model is the professionalism that an AMC or "managing association" can provide, particularly to associations that have limited means. On the other hand, there is a lack of permanency. One association could easily terminate its management company agreement and move on to a different AMC or in-house management arrangement, without the consent of the other associations. The AMC or managing association and the client association can also differ from time to time on a variety of staff or policy issues, as could two associations under this common management. In contrast, a merged or consolidated group has the solemnity of a corporate transformation which cannot be easily unraveled.

V. Other Types of Strategic Alliances

Merger, consolidation, acquisitions, and the creation of a federation involve a substantial level of commitment – but associations need not go so far in order to engage in alliances with one another. Nonprofit corporations may enter into other strategic alliances that are temporary or permanent, and allow both entities to “test the waters” before binding themselves to a more involved or permanent arrangement.

A. Partial Asset Purchase or Transfer

A lesser alternative to dissolution and transfer of all of a nonprofits assets is a limited asset purchase or transfer from one entity to another. In general, an asset purchase may be advantageous where one nonprofit entity wishes to acquire a discrete property, activity, program, or business unit of another. The directors of both organizations owe their members a significant level of due diligence prior to finalizing the deal, but, unless required under the organization’s governing documents, partial asset transfers typically do not require the approval of an organization’s membership. The transfer is executed pursuant to a written asset purchase agreement between the parties.

This approach has an obvious negative for the ceding organization in terms of prestige and justification for the hand-off.

B. Joint Venture

In a joint venture, two or more associations lend their efforts, assets, and expertise in order to carry out a common purpose. The associations involved may develop a new entity (such as a limited liability company or a partnership) to carry out the endeavor. Such new entity may receive tax-exempt status if it is organized and operated for exempt purposes. Generally, however, associations commit certain resources to a joint venture without forming a new entity. A well-structured joint venture is codified in a written agreement that details the precise obligations and allocation of risk between the associations involved. Joint ventures can be permanent, set to expire on a given date or after the accomplishment of a certain goal, or structured with an increasingly overlapping set of commitments and an eye towards an eventual merger. Although the bylaws of an organization might specify otherwise, joint ventures do not usually require the approval of the general membership.

In a *whole joint venture*, one or more of the partnering entities contribute all of their assets to the enterprise. Associations commonly engage in *ancillary joint ventures* with other organizations. Ancillary joint ventures are essentially small-scale joint ventures – enterprises that do not become the primary purpose of the organizations involved which are often for a limited duration. Tax-exempt organizations seeking additional sources of revenue may also enter into ancillary joint ventures with for-profit corporations, provided that the joint venture furthers the tax-exempt organization’s purposes, and the tax-exempt organization retains ultimate control over, at a minimum, the exempt purposes of the joint undertaking.

C. Joint Membership Programs

Joint membership programs generally allow individuals to join two associations for a reduced fee. These initiatives allow the members of one organization to become more familiar with another, and are typically conducted in the context of other jointly run programs and activities. Programs in this vein are designed to bring associations closer together, often as a precursor to a more formal alliance, but allow the entities to modify the arrangement or disengage altogether if circumstances or expectations change.

VI. General Tax Issues

Tax-exempt associations that choose to become affiliated with other taxable or tax-exempt entities must be mindful of certain legal requirements in order to ensure that the affiliation does not jeopardize the association's tax-exempt status. This section discusses three key tax-related concepts that associations must consider prior to affiliating with another entity: unrelated business income tax, control by the tax-exempt organization, and private inurement.

A. Unrelated Business Income Tax

In general, tax-exempt organizations are exempt from federal taxes on income derived from activities that are substantially related to their exempt purposes. Nevertheless, a tax-exempt organization may still be subject to unrelated business income tax (“UBIT”) on income received from the conduct of a trade or business that is regularly carried on, but is not substantially related to the organization’s exempt purposes.

For the purposes of determining UBIT, an activity is considered a “trade or business” if it is carried on for the production of income from the sale of goods or performance of services. Income from a passive activity – *e.g.*, an activity in which the exempt organization allows another entity to use its assets, for which the organization receives some payment – is not considered a business. The Code specifically excludes certain types of passive income – dividends, interest, annuities, royalties, certain capital gains, and rents from non-debt financed real property. UBIT also does not include income generated from volunteer labor, qualified corporate sponsorship payments, or qualified convention or trade show income.

An activity that is substantially related to an organization’s tax-exempt purposes will not be subject to UBIT. A “substantially related” activity contributes directly to the accomplishment of one or more exempt purposes. Alone, the need to generate income so that the organization can accomplish other goals is not a legitimate tax-exempt purpose.

In the context of trade and professional associations, an activity is “substantially related” if it is directed toward the improvement of its members’ overall business conditions. The receipt of income from particular services performed to benefit individual members, although often helpful to their individual businesses, usually results in UBIT to the association where those services do not improve the business conditions of the industry overall.

An organization jeopardizes its tax-exempt status if the gross revenue, net income, and/or staff time devoted to unrelated business activities is “substantial” in relation to the organization’s tax-exempt purposes. Although the "substantial" criterion has not been defined by statute or by the IRS, commentators generally agree that a level of 25-30% gives rise to concern. In an effort to prevent loss of exempt status, many tax-exempt organizations choose to create one or more taxable subsidiaries in which they house unrelated business activities. Taxable subsidiaries are separate but affiliated organizations. Generally, a taxable subsidiary can enter into partnerships and involve itself in for-profit activities without risking the tax-exempt status of its parent. Moreover, the taxable subsidiary can remit the after-tax profits to its parent as tax-free dividends. It is also beneficial in some situations to immunize the association from potential liability, by putting certain commercial activities in a separate subsidiary corporation.

B. Control

Where a nonprofit organization partners with another entity, it will continue to qualify for tax exemption only to the extent that (1) its participation furthers its exempt purposes, and (2) the arrangement permits the organization to act exclusively in furtherance of its exempt purposes. If a tax-exempt entity cedes “control” of partnership activities to a for-profit entity, the IRS will consider the partnership to serve private aims, not public interests.

In any arrangement with a for-profit entity that involves *all or substantially all* of a tax-exempt organization’s assets, the IRS requires the tax-exempt organization to retain majority control over the entire undertaking – *e.g.*, majority voting control. However, where the arrangement involves only an insubstantial portion of the tax-exempt organization’s assets, the IRS has approved a structure in which the for-profit and tax-exempt organizations shared management responsibilities, but left the exempt organization in control of the exempt aspects of the arrangement.

Associations frequently enter into short-term partnerships with for-profit corporations in order to conduct a particular activity. These ventures should not jeopardize an association’s tax-exempt status in most cases – even if the association does not maintain operational control over the ventures – as such activities generally are not substantial activities of the association.

C. Private Inurement

In general, organizations recognized as tax-exempt under Code Sections 501(c)(3) and 501(c)(6) are prohibited from entering into any transaction that results in “private inurement.” Private inurement occurs where a transaction between a tax-exempt organization and an “insider" – i.e., someone with a close relationship with or an ability to exert substantial influence over the tax-exempt organization—results in a benefit to the insider that is greater than fair market value. An association's affiliate or partner may be considered an insider. The IRS closely scrutinizes arrangements between tax-exempt organizations and taxable entities to determine whether the activities contravene the prohibition on private inurement. Thus, an arrangement with a for-profit entity, such as a management company, must be entered at arm's-length and carefully reviewed to ensure that any benefits to insiders are at or below fair market value.

VI. Conclusion

There is an array of possible mechanisms for combinations and alliances that ABC could enter with other organizations. The selection of an appropriate structure is heavily dependent on fully identifying the goals of the transaction and the potential ramifications for both groups. We would be pleased to discuss these matters with you in more detail.

AUTHORS

Jeffrey S. Tenenbaum

RELATED INDUSTRIES

Nonprofit Organizations and Associations

ARCHIVES

2012 2008 2004
2011 2007 2003
2010 2006 2002
2009 2005

Articles

June 15, 2007

Steering Clear of the Most Common Legal Hazards in Association Hotel Contracts

Related Topic Area(s): Meeting, Vendor and Government Contracts

Published in the February 2009 edition of *smartmeetings.com.*

Sometimes what seems like an innovative twist to a meeting contract with a hotel can result in unintended consequences for your Association when the language in the agreement doesn't accurately capture the intent of your negotiation. This article examines the language in association hotel contracts that is often the most problematic to understand, and the effects that it can have both on your meeting and on your Association. It also offers suggestions for successfully negotiating these most critical provisions of your hotel contract.

Attrition/Performance Clauses. "Attrition" occurs when a meeting is held, but fails to reach expectations, either in number of rooms or the food and beverage revenue to the hotel. A sample attrition clause might look like the following:

> *Hotel is relying upon Association's use of 2,610 Total Room Nights. Association agrees that a loss will be incurred by Hotel should there be a reduction greater than 10% in Total Room Nights actually used.*
>
> *Should the room nights actually used by Association be less than 90% of the Total Room Nights, Association agrees to pay, as liquidated damages and not as penalty, the difference between 90% of the Total Room Nights and Association's actual usage of rooms, multiplied by the average group room rate. At the Cut-Off date, you may elect to reduce your room block by up to the 10% allowable shrinkage.*

- Shrinkage is never fun. To avoid the let-down, under-forecast your room block.
- Don't agree to attrition provisions if you don't have to. Instead, attempt to negotiate a "best efforts" provision in the contract, i.e., your Association gets a special group rate in return for using its best efforts to promote the hotel to its meeting attendees. When using a "best efforts" clause, always negotiate a right of first refusal in the event the hotel receives a competing offer of business over the same dates.
- A sample best efforts clause: "Hotel agrees to hold the room block specified in this agreement for use by Association's attendees until the Cut-Off Date. In return, Association will use its best efforts to offer and promote the use of Hotel to its attendees. Association will not be responsible for rooms not used by its attendees unless Association later guarantees the rooms." Avoid use of the terms "reserved" or "reservations."
- If an attrition clause is unavoidable, specify a date before which the size of the room block can be adjusted by the Association without liability. Your group should be able to negotiate a minimum pick-up that represents 75%-90% of your total block.
- Be sure the contract clearly states how the attrition fee will be calculated. Usually this is the difference between the minimum pickup number and the actual number of rooms used by the Association and its attendees, multiplied by an agreed-upon dollar amount. This dollar amount should not be the confirmed room rate, but instead that percentage of the room rate representing the hotel's profit margin on the room.
- The Association should get credit for all rooms used by Association attendees, even for rooms booked outside the block. The Association should also receive a credit for cancellation, no-show, and/or early departure fees charged to individuals. No attrition fee should be assessed for nights in which the hotel is sold out. If the hotel is partially sold out, the attrition fee should be assessed on the lesser of the number of available rooms or the number of rooms unused by the Association.

Cancellation. Cancellation occurs when one party decides to end the agreement. A typical hotel meeting contract might provide the following:

> "The Hotel agrees to reserve the contracted guest rooms and/or meeting/banquet space to the exclusion of other business opportunities. Should the organization cancel the contracted guest rooms and/or

meeting/banquet space after contract signature, a cancellation fee will be assessed as outlined on the following schedule: Cancellation 0-60 days out: 100% of total contracted guest room revenue and estimated food and beverage revenue based on menu prices at time of cancellation."

- Without such a cancellation/liquidated damages clause, the hotel would be forced to prove its actual damages in the event your organization cancelled. But note that, under basic principles of contract law, the hotel's damages would be limited to lost profits, not total revenue. At minimum, you would want to re-word the sample cancellation clause above to base damages on estimated lost profit, not 100% revenue.
- Any cancellation fee should be calculated on a sliding scale, so that the farther out from the meeting date the cancellation notice is received, the smaller the fee.
- Cancellation fees should be paid AFTER the event would have been held (30 days after the meeting ends), not upon notice of cancellation.
- If the hotel meets or exceeds its average occupancy level for the week of the event, no cancellation damages should be due.
- The cancellation clause could also be negotiated to provide for a date change instead of a cancellation, for example, by providing that no cancellation fees will be due provided your organization agrees to hold an event of similar size within a certain period of time (typically, one year).
- Be sure to include a parallel provision in the contract to protect your organization in the event of the hotel's cancellation. (See the sample language in the contract addendum provided.)

Mitigation. Mitigation is a legal doctrine that requires the person injured to make reasonable efforts to reduce losses resulting from the injury.

- The hotel's form contract will rarely, if ever, include a provision to limit the Association's cancellation or attrition fee liability. Make sure you include such a clause, requiring the hotel to make reasonable efforts to resell unused rooms and function space and reduce the fee by the amount of resale revenue collected.
- The contract should provide that the hotel's exclusive remedy for the Association's termination of the agreement is the payment of a cancellation fee.
- The hotel also should be required to provide proof of its efforts to mitigate damages and evidence that the rooms or function space remain unsold.

***Force Majeure* (Termination) Clause.** *Force majeure* literally means "greater force."

- The force majeure clause excuses a party from liability if some unforeseen event beyond the control of that party prevents it from performing its obligations under the contract. Force majeure clauses typically cover natural disasters, war, or the failure of suppliers and subcontractors to perform their obligations to the contracting party.
- A typical hotel-drafted force majeure clause might provide: "Performance of the Agreement by either party is subject to strikes, acts of God, war, or civil disturbances."
- To protect your organization, you will want to add to this list, at minimum, government regulation, terrorism or threats of terrorism, outbreak of disease or illness in the host city, curtailment of transportation facilities preventing or unreasonably delaying at least 25% of event attendees and guests from appearing, or other similar causes beyond the control of the parties making it inadvisable, illegal, or impossible to hold the meeting or provide the facility.
- The contract should permit either party to terminate the agreement without penalty for such reasons.
- The contract should also reference the force majeure clause in any other section of the agreement (attrition, cancellation provisions) that provides for the payment of damages or performance fees.

Indemnification. An indemnification clause is a contractual promise to protect a party from financial loss, and a way to shift risk to the party who can best control it.

- A typical form contract will almost always include a one-sided provision requiring your organization to indemnify the hotel. The hotel or meeting venue will typically require your organization to indemnify the hotel against claims and liabilities incurred by the hotel as the result of the negligent acts or omissions of your organization or its directors, officers, and employees in connection with your organization's use of the meeting space.
- The indemnification clause should be parallel; that is, each party to the agreement should indemnify the other party against all loss, expense or damage arising out of the negligence or willful misconduct of the offending party, or the offending party's breach of the agreement.
- Specify whether indemnifying for negligence or gross negligence.
- You should not agree to indemnify the hotel for the acts or omissions of your event attendees. Push back on this front, as you do not ultimately control your attendees and should not be held responsible for their actions.
- In addition, you should require the hotel to indemnify your organization (and its agents and employees) against claims asserted against them arising from the acts or omissions of the hotel, or its employees, in connection with your agreed-upon use of the space. Note that this promise is worthless without the funds to back it up, and your organization should always insist on evidence of the meeting facility's insurance.

*For more information, contact Mr. Tenenbaum at (202) 344-8138 or **jstenenbaum@venable.com**, or Ms. Caseman at (202) 344-4495 or **bacaseman@venable.com**.*

VENABLE® LLP

AUTHORS

Jeffrey S. Tenenbaum

RELATED INDUSTRIES

Nonprofit Organizations and Associations

ARCHIVES

2012	2008	2004
2011	2007	2003
2010	2006	2002
2009	2005	

Articles

May 30, 2007

Association Meeting Contract Q&A

Related Topic Area(s): Meeting, Vendor and Government Contracts

Q: *What are common areas of concern associations should be aware of in meeting contracts?*

A: Once the business terms have been agreed on – that is, the specific dates, place, time, and rental rate for the meeting space – it is easy to overlook the provisions in a meeting contract that deal with the "what-ifs." Unfortunately, these are also typically the areas in a contract that contain the most legalese, and that are most likely to cause financial heartburn to your organization should plans go awry. As with all contracts, it is critically important to understand the fine print to protect your organization's interests – and assets. Four such principal areas of legal concern in almost every meeting contract are the cancellation, mitigation, force majeure, and indemnification provisions. Hotels, convention centers, and other meeting venues typically will negotiate these 'worst-case scenario' provisions hotly if you object to their form language, so you'll need to be well armed with knowledge before jumping into the fray!

Cancellation. A typical hotel meeting contract might provide the following:

"The Hotel agrees to reserve the contracted guest rooms and/or meeting/banquet space to the exclusion of other business opportunities. Should the organization cancel the contracted guest rooms and/or meeting/banquet space after contract signature, a cancellation fee will be assessed as outlined on the following schedule: Cancellation 0-30 days out: 100% of total contracted guest room revenue and estimated food and beverage revenue based on menu prices at time of cancellation."

Without such a cancellation clause, the hotel would be forced to prove its actual damages in the event your organization cancelled. But, under basic principles of contract law, the hotel's damages would be limited to lost profits, not total revenue. At minimum, you would want to re-word the sample cancellation clause above to base damages on estimated lost profit, not 100% revenue. The cancellation clause also could be negotiated to provide for a date change instead of a cancellation, for example, by providing that no cancellation fees will be due provided that your organization agrees to hold an event of similar size within one year. You also would want to include a parallel provision in the contract to protect your organization in the event of the hotel's cancellation.

Mitigation. Again, under basic principles of contract law, the injured party has a duty to mitigate its damages – here, by reselling the space. The hotel or meeting venue should be required to undertake all reasonable efforts to resell any unused or canceled rooms and any unused or canceled function space, and to credit those revenues against any performance clause fees or liquidated damages. The hotel also should be required to provide proof of its efforts to mitigate damages and evidence that the rooms or function space remain unsold.

Force Majeure. The force majeure clause is a critically important element in every meeting contract. A typical hotel-drafted force majeure clause might provide (if you're lucky!) that "performance of the Agreement by either party is subject to strikes, acts of God, war, or civil disturbances." To protect your organization, you will want to add to this list, at minimum, government regulation, acts of terrorism, curtailment of transportation facilities preventing or unreasonably delaying at least 25% of event attendees and guests from appearing, or other similar causes beyond the control of the parties. The contract should permit either party to terminate the agreement without penalty for such reasons. The contract also should reference the force majeure clause in any other section of the agreement - such as attrition and/or cancellation provisions - that provide for the payment of damages or performance fees. Note that, under the sample cancellation provision provided above, if your organization were forced to cancel its meeting as the result of a hurricane or other natural disaster, it would still have been on the hook for the cancellation fee.

Indemnification. Finally, a mutual indemnification provision is critical. Indemnification is a promise, usually contractual, to protect a party from financial loss. Note that this promise is worthless without the funds to back it up, and your organization always should insist on evidence of the meeting facility's insurance. A typical form contract almost always will include a one-sided provision requiring your organization to indemnify the hotel; here, as with the cancellation provision, what's left out of the agreement can be more important than what's included. The hotel or meeting venue will typically require your organization to indemnify the hotel against claims and liabilities incurred by the hotel as the result of the negligent acts or omissions of your organization or its employees in connection with your organization's use of the meeting space. You should not agree to indemnify the hotel for the acts or omissions of your event attendees. In addition, you should require the hotel to indemnify your organization (and its agents and employees) against claims asserted against them arising from the acts or omissions of the hotel, or its employees, in connection with your agreed-upon use of the space.

For more information, please contact Mr. Tenenbaum at 202/344-8138 or jstenenbaum@venable.com, or Ms. Caseman at 202/344-4495 or bacaseman@venable.com.

VENABLE® LLP

AUTHORS

Janice M. Ryan

RELATED INDUSTRIES

Nonprofit Organizations and Associations

ARCHIVES

2012	2008	2004
2011	2007	2003
2010	2006	2002
2009	2005	

Articles

February 2011

Understanding Force Majeure Clauses

Related Topic Area(s): Meeting, Vendor and Government Contracts

This article was originally published in the February 2011 edition of Smart Meetings.

The aftermath of recent large-scale disasters like the terrorist attacks of September 11, 2001 and the storm and flood damage caused by Hurricane Katrina in 2005 have reinforced the importance of carefully planning for the unexpected when negotiating meeting contracts. If disaster strikes, will you be able to cancel your meeting without liability for cancellation fees? Will you be able to go ahead with the meeting, despite reduced attendance, without liability for attrition damages? A key tool in managing the risk of such challenging circumstances is the force majeure clause.

A “force majeure” clause (French for “superior force”) is a contract provision that relieves the parties from performing their contractual obligations when certain circumstances beyond their control arise, making performance inadvisable, commercially impracticable, illegal, or impossible. In the absence of a force majeure clause, parties to a contract are left to the mercy of the narrow common law contract doctrines of “impracticability” and “frustration of purpose,” which rarely result in excuse of performance. Instead of relying on the common law, meeting planners can better achieve flexibility during times of crisis through a carefully negotiated force majeure clause. Whether negotiating with or without the assistance of legal counsel, the following key elements of a force majeure clause should be addressed:

Anticipate and Specify Force Majeure Events.

Determining which types of circumstances will be covered by the force majeure clause is essential. Provisions often cover natural disasters like hurricanes, floods, earthquakes, and weather disturbances sometimes referred to as “acts of God.” Other covered events may include war, terrorism or threats of terrorism, civil disorder, labor strikes or disruptions, fire, disease or medical epidemics or outbreaks, and curtailment of transportation facilities preventing or delaying attendance by at least twenty-five percent of meeting participants.

Courts tend to interpret force majeure clauses narrowly; that is, only the events listed and events similar to those listed will be covered. For example, while acts of terrorism might be a specified force majeure event, it does not necessarily follow that a court would also excuse a party’s performance based on “threats” of terrorism. Thus, it is especially important to specify any types of circumstances that you anticipate could prevent or impede your meeting from being held.

To the extent possible, take into consideration the location of the meeting and any special needs or responsibilities of your organization and the meeting participants. What types of weather-related incidents are common for the meeting location? If there are major disruptions to transportation systems, will your participants be prevented from attending? What percentage of reduced attendance would make continuing with the meeting inadvisable? Asking and answering these types of questions will help you anticipate and specify the most critical force majeure events for your meeting. Even so, not all potential events can be specified or anticipated in the contract. A concluding catch-all phrase should be appended to the list, such as “and any other events, including emergencies or non emergencies,” to cover other unforeseeable events.

Beware of Restrictive Language.

It is common to find boilerplate force majeure language in meeting contracts limiting excuse of the parties’ performance obligations only when it would be “impossible” to perform due to the unexpected circumstances. Impossibility is a high threshold; many circumstances will make holding a meeting inadvisable, even though it would still be possible to do so. For greater flexibility, consider instead excusing performance when it would be “inadvisable, commercially impracticable, illegal, or impossible” to perform.

Additionally, even if you have negotiated a specified list of force majeure events, be sure to carefully read the language that comes before and after the list. Language appended after a comma can significantly alter the scope of the force majeure clause. For example, adding the words “or any other emergency beyond the parties’ control” to the end of a list of specified force majeure events serves to narrow the scope of triggering events only to “emergencies.” With such language, non-emergency circumstances making it inadvisable to hold a meeting would not be covered.

Consider Excusing Underperformance Due to Force Majeure.

Although a force majeure clause should always allow for complete cancellation of a meeting without penalty, cancellation will not always be the meeting planner's preferred course of action. There may be circumstances in which going ahead with the meeting is preferred, despite the fact that the force majeure event will likely result in lower-than-expected attendance. However, groups that fail to meet minimum room or food and beverage commitments will often risk incurring significant attrition fees. To help make going-forward a viable option in such circumstances, the force majeure clause should be drafted to excuse liability associated not just with nonperformance (i.e. cancellation) but also with underperformance (i.e. failure to meet minimum guarantees).

A carefully negotiated force majeure clause is an important tool for reducing the risk of liability associated with cancelling or scaling back a planned meeting in response to a disaster. When significant resources are on the line, meeting planners should consider seeking advice of legal counsel prior to signing contracts, and should also consider obtaining meeting insurance. Taking appropriate precautions at the outset can provide reassurance that, even in the worst of circumstances, you will have the flexibility to make the best decision for your meeting.

This article also appeared in the Annual Legal Review section of the March 17, 2011 issue of Association TRENDS*. To read the entire section, visit the* **Association TRENDS *website***.

VENABLE® LLP

AUTHORS

Lisa M. Hix

RELATED INDUSTRIES

Nonprofit Organizations and Associations

ARCHIVES

2012 2008 2004
2011 2007 2003
2010 2006 2002
2009 2005

Articles

September-October 2010

The Ins and Outs of Alliances and Affiliations

Associations Now

Related Topic Area(s): Meeting, Vendor and Government Contracts, Miscellaneous, Tax and Employee Benefits

Q: We are considering an affiliation, combination, or possible merger, with another organization. What options do we have?

A: There is a wide array of ways in which nonprofit associations can combine, affiliate or otherwise come together. Some involve a complete integration of programs, activities, membership, leadership, and staff, while some provide for maintaining varying degrees of separateness and autonomy. A summary of several options is below.

Merger. Nonprofit corporations can fully and completely integrate their programs, functions, and membership by merging. When two nonprofit entities merge, one entity legally becomes part of the surviving entity and effectively dissolves. The surviving corporation takes title to all of the assets, and assumes all of the liabilities, of the non-surviving entity.

Benefits. By merging, associations may combine their assets, reduce costs by eliminating redundant administrative processes, and provide broader services and resources to their members. Furthermore, members who paid dues and fees to participate in the formerly separate associations are often able to reduce their membership dues and the costs and time demands of association participation by joining a single, combined organization. Finally, merger may allow associations participating within the same field or industry to offer a wider array of educational programming, publications, advocacy and other services to a larger constituency in the public arena.

Mechanics. To merge with another organization, each organization must follow the procedures mandated under the nonprofit corporation law of its state of incorporation, as well as any specific procedures in its governing documents. While nonprofit corporation statutes differ by state, the laws governing merger typically set forth certain core procedures. The board of directors of each precursor organization must develop and approve a plan of merger according to the requirements set forth in the nonprofit corporation statute of the state, or states, where the organizations are incorporated. The plan of merger also must be submitted to the voting members, if any, of each organization for their approval. While the conditions for member approval vary from state to state, statutes generally require a vote of two-thirds to effectuate the plan merger – a number that can be difficult to reach for practical and political reasons.

Acquisition of a Dissolving Corporation's Assets. Another legal mechanism is the dissolution and distribution of assets of a target association. While the dissolving entity must adhere to specific statutory procedures, a dissolution is much less onerous on the entity that acquires the dissolving entity's assets (the "successor" entity) than a merger. Because the successor entity is merely absorbing the assets of another organization, a vote of the membership and accompanying state filings are typically not required for that corporation.

Benefits. An asset transfer may be strategically preferable for combining organizations when one organization is of a much smaller size than the other, or the "successor" entity is only acquiring discrete programs or assets of the dissolving entity. Another benefit is that the successor organization is typically shielded from its predecessor's debts and liabilities, though an asset transfer always poses some risk of successor liability, particularly if adequate provision has not been made for pre-existing liabilities.

Mechanics. Like a merger, an asset transfer must follow the applicable state nonprofit corporation laws and each entity's governing documents. The procedure for dissolution and asset distribution is fairly simple for the successor entity. Member approval for such a transaction is typically unnecessary unless the organization's bylaws require otherwise. The process is more complicated, however, for the dissolving entity. In most instances, the nonprofit corporation statute of the dissolving entity's state of incorporation requires approval by both the board and any members having voting rights:

Other Types of Strategic Alliances. Mergers and asset acquisitions involve a substantial level of commitment, but associations need not go so far in order to engage in alliances with one another. Nonprofit corporations may enter into other strategic alliances that are temporary or permanent, and allow both entities to “test the waters” before binding themselves to a more involved or permanent arrangement.

Joint Venture. For example, in a joint venture, two or more associations lend their efforts, assets, and expertise in order to carry out a common purpose. The associations involved may develop a new entity (such as a limited liability company or a partnership) to carry out the endeavor. One example is joint trade shows.

A well-structured joint venture is codified in a written agreement that details the precise obligations and allocation of risk between the associations involved. Joint ventures can be permanent, set to expire on a given date or after the accomplishment of a certain goal, or structured with an increasingly overlapping set of commitments and an eye towards an eventual merger. Although the bylaws of an organization might specify otherwise, joint ventures do not usually require the approval of the general membership.

In the event that a contemplated joint venture would involve a taxable entity or an organization that is exempt under a different section of the tax code, there are additional precautions that may need to be taken in order to protect your organization from incurring taxable income or jeopardizing its exempt status.

Joint Membership Programs. Joint membership programs typically allow individuals to join two associations for a reduced fee. These initiatives allow the members of one organization to become more familiar with another, and are usually conducted in the context of other jointly run programs and activities. Programs in this vein are designed to bring associations closer together, often as a precursor to a more formal alliance, but allow the entities to modify the arrangement or disengage altogether if circumstances or expectations change.

Conclusion. There is an array of possible mechanisms for combinations and alliances that available to associations. The selection of an appropriate structure is heavily dependent on fully identifying the goals of the transaction and the potential ramifications for both groups.

Lisa M. Hix *is an attorney with Venable LLP and a member of ASAE & The Center's Washington, D.C. Legal Symposium Planning Committee. Email:* ***lmhix@venable.com***.

This article was originally published in the September-October 2010 edition of ASAE & The Center's Associations Now Magazine.

VENABLE® LLP

Articles

May 30, 2006

Federal Government Grants and Contracts: Key Requirements and Pitfalls for Nonprofit Recipients

AUTHORS

Rebecca E. Pearson

RELATED PRACTICES

Government Contracts

RELATED INDUSTRIES

Credit Counseling and Debt Services

Nonprofit Organizations and Associations

Government Contractors

ARCHIVES

2012	2008	2004
2011	2007	2003
2010	2006	2002
2009	2005	

Related Topic Area(s): Meeting, Vendor and Government Contracts

I. Introduction

Contracts and grants between federal agencies and nonprofit organizations are subject to requirements imposed by law and regulation that may vary from practices that are legal and customary between commercial parties. Contractors and grantees must understand and comply with these requirements. The consequences of ignoring them can be significant.

A. Contracts

The Federal Acquisition Regulation ("FAR") [1] is the primary regulation for use by all Federal agencies in their acquisition by contract of supplies and services with appropriated funds. The FAR together with agency supplemental regulations, [2] Cost Accounting Standards, [3] as well as specific contractual provisions, should be the primary guidelines for contractors' conduct in administering contracts. [4]

B. Grants

While grants generally are not subject to the same wide variety of clauses in federal contracts, they are also subject to certain regulations, such as 2 C.F.R. Part 215 (formerly known as Office of Management and Budget ("OMB") Circular A-110), Uniform Administrative Requirements for Grants and Agreements With Institutions of Higher Education, Hospitals, and Other Non-Profit Organizations. This regulation establishes the common requirements for grants. Many agencies, such as the Department of Defense ("DoD"), [5] Bureau of Justice Assistance, [6] and U.S. Department of Health and Human Services, [7] also publish guidance for obtaining and administering grants in their agencies. As with the FAR, agencies may tailor these requirements.

II. Administration of Contracts and Grants [8]

A. Understanding The Government's Constraints

There is no substitute for reviewing clauses in a contract or grant to determine what requirements apply. However, in understanding what requirements you will encounter and what is negotiable, it is helpful to understand the government's limitations on its ability to contract or to fund work.

The grantor agency and the status of the grantee will determine the requirements contained in the grant. For example, if a grantee is a nonprofit entity, then a different set of regulations apply than a for profit grantee.

While the FAR also distinguishes between whether an entity is nonprofit or for profit, it further establishes simplified procedures at certain thresholds for certain products or services that minimize contractual requirements for competition and for compliance with many laws.

Micro-purchase Threshold [9]
- An acquisition of supplies or services (except construction) which does not exceed a specified limit (usually $2,500).

Simplified Acquisition Procedures [10]
- For noncommercial items, applies from $2,000 to $100,000.
- For commercial items, applies from in excess of $2,500 to $5 million.

Standard
- Requires full compliance with many laws.

Micro-Purchase Threshold:
- Purchases below the micro-purchase threshold are exempt from virtually all procurement laws, including the

Competition in Contracting Act ("CICA") and domestic preference requirements such as the Buy American Act.

- The government personnel who purchase under this threshold do not need to receive a warrant designating them as contracting officers.
- The government often purchases services under this threshold with a government commercial purchase card, but may use any purchase method.

Simplified Acquisition Procedures:

- Competition is required to the "maximum extent practicable," –typically satisfied by obtaining quotes from at least three sources. The agency must justify a decision to solicit only one source. FAR 13.106-1(b)(1).
- Exempt from certain laws, such as Small, Small Disadvantaged and Women-Owned Small Business Subcontracting Plan (FAR 52.219-10) and Contract Work Hours and Safety Standards (FAR 52.222-4).

B. Cost Principles & Accounting

Federal grants and contracts for non-commercial services and cost-type contracts require nonprofit contractors to comply with OMB Circular No. A-122, Cost Principles for Nonprofit Organizations ("OMB A-122"). [11] For a cost to be allowable under OMB A-122, the costs must conform to allowability limitations in OMB A-122 and generally accepted accounting principles and must be reasonable, allocable, "consistent with policies and procedures that apply uniformly to both federally-financed and other activities of the organization," treated consistently, and "adequately documented." OMB A-122, Atch A, ¶ A.2. Certain costs are expressly unallowable, even though they may be customary or necessary business expenses in the commercial business sector. For example, the costs of the following are expressly unallowable: alcoholic beverages, [12] contributions and donations by the organization to others, [13] "defense and prosecution of criminal and civil proceedings, claims, appeals and patent infringement," [14] "the value of donated services," [15] "entertainment costs," [16] and interest on borrowed capital. [17] Moreover, the government considers that interest earned by a grantee on funds advanced to the federal agency and not yet obligated by the grantee belongs to the government, not the grantee.

Grants also require accounting systems of a nonprofit organization to maintain certain accounting standards and records set forth in 2 C.F.R. § 215.21, including:

- "Accurate, current and complete disclosure of the financial results of each federally-sponsored project or program." Id. § 215.21(b)(1).
- "Records that identify adequately the source and application of funds for federally-sponsored activities," including information on "Federal awards, authorizations, obligations, unobligated balances, assets, outlays, income and interest." Id. § 215.21(b)(2).
- "Effective control over and accountability for all funds, property and other assets," that ensure property and assets "are used solely for authorized purposes." Id. § 215.21(b)(3).
- "Written procedures for determining the reasonableness, allocability and allowability of costs in accordance with the provisions of the applicable Federal cost principles and the terms and conditions of the award." Id. § 215.21(b)(6).
- "Accounting records including cost accounting records that are supported by source documentation." Id. § 215.21 (b)(6).

Nonprofit grantees that expend $500,000 or more in a year in federal grant awards must "have a single or program-specific audit conducted for that year in accordance with" OMB Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations. [18] They must also flow this audit requirement down to any subrecipients that exceed this threshold.

On termination or grant closeout, grantees must also "refund any balances of unobligated cash" that the agency advanced. Id. § 215.71(d). Financial records must be retained for a minimum "period of three years from the date of submission of the final expenditure report" and "records for real property and equipment shall be retained for 3 years after final disposition." Id. § 215.53.

C. Compliance

Government contractors and grantees must follow high standards of conduct and comply with an array of laws and regulations that may vary in application depending upon the size of the procurement or grant, and for contracts, whether the services being sought are commercial. These standards include proscriptions against bribery (18 U.S.C. § 201), false claims (31 U.S.C. § 3729 (civil), 18 U.S.C. § 287 (criminal)), or false statements (18 U.S.C. § 1001). Violation of standards of conduct can carry harsh civil or criminal sanctions that might include fines or imprisonment, forfeiture of all rights under the contract, and suspension or debarment from other government business.

For example, the civil False Claims Act ("FCA") prohibits the knowing submission of false or fraudulent claims to the government for payment. [19] Knowing is defined under the FCA as actual knowledge, deliberate ignorance, or reckless disregard of the truth or falsity of the claim. [20] As such, the knowledge standard is not difficult for the government to establish, and the government need not prove specific intent to defraud. With civil penalties ranging from $5,500 to $11,000 per each false request, which would include $5,500 for each false invoice, the price of ignorance can be high. The potential payout has not escaped the notice of whistleblowers or competitors, who have the ability to file as private litigants on behalf of the in return for a share of any recovery achieved on the government's behalf.

The government also has a broad array of administrative powers to deal with grantee or contractor compliance. It has the ability to exclude contractors or grant recipients who lack business integrity and honesty from government business through suspension for an indefinite period of time or debarment for a specific period. Exclusion by one federal agency renders a contractor or grantee ineligible to participate in other federal procurements and grants. Many states will also follow the federal rules. In the federal procurement context, suspension or debarment is governed by FAR Part 9; for nonprocurement transactions, including grants, it is governed by the Suspension and Debarment Common Rule. [21] State suspension or debarments will be governed by state statute or regulation, which, in many states, is modeled on the American Bar Association's Model Procurement Code for State and Local Governments.

D. FlowDowns

A key part of compliance is ensuring that requirements are flowed down to the appropriate level to subcontractors or subgrantees. The clauses incorporated in procurement contracts should contain the terms that a contractor must flow down to its subcontractors or vendors. 2 C.F.R. § 215.5, Subawards, states that for grants, the general rule is that all clauses that are not excepted should be flowed down to subgrantees. Specifically, it states, "Unless sections of this part specifically exclude subrecipients from coverage, the provisions of this part shall be applied to subrecipients performing work under awards if such subrecipients are institutions of higher education, hospitals or other non-profit organizations." It is critical for a grantee to ensure that its subgrantees also comply with the records reporting and retention requirements in 2 C.F.R. § 215.

E. Intellectual Property

Contractors and grantees should ensure they protect their intellectual property rights when dealing with the federal government, especially where they developed the intellectual property at private expense.첵 Protection may require that data be marked as proprietary in a certain manner. In federal, non-commercial contracts, the government will obtain unlimited rights in data or software first produced in performance of the contract, which allows the government to distribute it to others for any purpose. However, in contracts for commercial items, which include commercial services, an agency may accept the contractor's standard commercial terms and conditions regarding its patent and intellectual property rights.첵

Where the government funds the development of the data for a nonprofit organization under a contract or grant, the contractor or grantee retains its ownership and copyright, provided it provides the government with certain license rights. For a grant, the nonprofit grantee must provide the government with a "royalty-free, nonexclusive and irrevocable right to reproduce, publish, or otherwise use the work for Federal purposes, and to authorize others to do so." [22] FAR 52.227-14, Alt. IV and DFARS 252.227-7013, Alt. I provide similar license rights to the government for contracts. Consequently, when conveying rights to publishers, the grantee or contractor must preserve the government's rights. If a grantee wants additional rights in data, it must so specify in its grant agreement.

2 C.F.R. §215.36(d) requires a grantee to provide its research data to a requester under the Freedom of Information Act, provided the data does not contain "[t]rade secrets, commercial information, materials necessary to be held confidential by a researcher until they are published, or similar information which is protected under law," or "personnel and medical information." [23] Therefore, it a grantee wants to protect research data for either of these reasons, it should mark and treat it as confidential from the time of its creation.

Grant agencies typically allow grantees to publish their research findings. In so doing, grant recipients must acknowledge the government's sponsorship. In addition, grant agencies typically require grantees to allow researchers funded with grant funds to publish the results of their research.

Nonprofit contractors and grantees generally will be able to retain patents to federally funded inventions pursuant to the Bayh-Dole Act, 35 U.S.C. §§ 201-211, provided they notify the government and give the government a royalty-free license to the invention for government purposes. Timely notice is critical to preserve a contractor or grantees ability to retain title.

III. Conclusion

The federal government's contract and grant money comes with weighty responsibilities. A nonprofit organization, like any contractor or grantee, should build accounting and compliance controls into its systems before seeking and performing government work and should ensure that its employees understand the standards to which they must perform.

For more information, contact Rebecca Pearson at 202/344-8183 or **repearson@venable.com**.

[1] The FAR is codified at 48 C.F.R. Parts 1-53. The FAR is normally available in the reference section of most major public libraries and online at **http://farsite.hill.af.mil**; **http://arnet.gov/far**; or **http://www.access.gpo.gov/cgi-bin/cfrassemble.cgi**. [2] The DoD FAR Supplement ("DFARS") is an example of one such agency supplemental regulation.[3] Cost Accounting Standards ("CAS") are available at 48 C.F.R. Part 99. CAS do not apply to certain contracts, including negotiated contracts that do not exceed $500,000, "[c]ontracts or subcontracts of less than $7.5 million, provided that, at the time of award, the business unit of the contractor or subcontractor is not currently performing any CAS-covered contracts or subcontracts valued at $7.5 million or greater," nor to "[f]irm-fixed-price contracts or subcontracts awarded on the basis of adequate price competition without submission of cost or pricing data." 48 C.F.R. § 9903.201-1(b). [4] The agency supplements to the FAR are also at title 48 of the C.F.R. [5] DoD Directive No. 3210.6, Defense Grant and Agreement Regulatory System ("DGARS") (Dec. 17, 2003) (**www.dtic.mil/whs/directives/** corres/pdf/d32106_121703/d32106p.pdf). [6] Bureau of Justice Assistance, Guide to Grant Assistance (**http://bja.ncjrs.gov/g2g**). [7] HHS Grants Policy Directive

(**http://www.hhs.gov/grantsnet/adminis/gpd/index.htm**); see also National Institutes of Health Grants Policy Statement (December 2003). [8] The issues addressed in this article include only a sample of the many issues that arise during contract administration. [9] Thresholds will differ if the procurement is for construction subject to the Davis Bacon Act (threshold is $2,000) or in support of contingency operations or to facilitate the defense against or recovery from nuclear, biological, chemical, or radiological attack. [10] Thresholds will differ if the procurement is in support of contingency operations or to facilitate the defense against or recovery from nuclear, biological, chemical, or radiological attack. [11] This article focuses on the requirements applicable to grants with private nonprofit organizations and therefore discusses OMB A-122 (**http://www.whitehouse.gov/OMB/circulars/a122/a122.html#b**). However, as 2 C.F.R. § 215.27 recognizes, "[f]or each kind of recipient, there is a set of Federal principles for determining allowable costs." Id. For example, "the allowability of costs incurred by institutions of higher education is determined in accordance with the provisions of OMB Circular A-21." Id. Appendix E of 45 C.F.R. Part 74 governs the allowability of costs incurred by hospitals and OMB Circular A-87 governs the allowability of costs incurred by state, local, and Indian Tribal Governments. [12] Id., Atch B, ¶B.2. [13] Id. at ¶B.9. [14] Id. at ¶B.10. [15] Id. at ¶B.12. [16] Id. at ¶B.14. [17] Id. at ¶B.23. [18] OMB Circular A-133 ¶ ___.200 (**http://www.whitehouse.gov/omb/circulars/a133/a133-lead.html**). [19] See 31 U.S.C. § 3729(a)(1). [20] See 31 U.S.C. § 3729(b). [21] 68 Fed. Reg. 66533-66646 (Nov. 26, 2003) [22] 2 C.F.R. §215.36(a) and (b) (2005). [23] Id. § 215.36(d).