

CHARITY MERGERS

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Introduction

Consolidating and merging charities is a major issue for the charity sector. A report² has highlighted that the general public think that there are too many charities and that charities with similar objects should be merged. Following the Charities Act 2006 and greater scrutiny of public benefit by the Charity Commission, it is possible that more charities will consider merging to increase their public benefit output.

Furthermore, it is likely that in the future, organisations such as Guidestar³ and CaritasData⁴ that collate data about charities will be in a position to provide comparative studies on efficient and by comparison less efficient charities⁵. This in turn could lead to the more efficient charities attracting more funding, with a greater pressure on the consolidation of the charity sector. The Charities Act 2006 has introduced new measures designed to facilitate charity mergers. This article looks at these new measures and the issues involved with a merger of charities established in England and Wales⁶.

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² See Morris D “Legal Issues in Charity Mergers” (2001). www.liv.ac.uk/law/units/CLU.htm.

³ See www.guidestar.org.

⁴ See www.caritasdata.co.uk

⁵ For current developments in this area see “Intelligent Giving to launch “Which-style guide” to Charity”, Plaza Publishing, 20 May 2009.

⁶ Additional issues arise in the case of a cross-border merger, including a merger involving charities established in different jurisdictions within the United Kingdom. In relation to the latter case see the Summary Report of a Cross-Border Symposium held on 4 November 2008, Charity Law Association, 2009 at pp. 13-24.

1. The Objects

It is essential that the objects of merging charities are compatible. If they are, then property can be transferred from one charity to another by way of charitable application.⁷ Where the transferor charity's objects are wider than the transferee's objects, then this again will not cause difficulties. However, where the transferee charity's objects are wider than the transferor's or where the two charities' objects otherwise differ, then either the objects will need to be amended to make them compatible, or property will need to be transferred on restricted trust. This could be achieved through a scheme of the Charity Commission or possibly through a transfer of assets under a contract.

2. The Charity Commission

The Charity Commission can assist mergers in a number of ways:

2.1 *Cy-Pres* Schemes

Where charities lack the power to amend their objects, they can apply to the Charity Commission for a *cy-pres* scheme. This is a legal document created by the Charity Commission which has the legal effect of amending the charity's objects. *Cy-pres* means 'as near as', therefore theoretically it means an extension of the objects to the nearest charitable objects. Traditionally the Charity Commission has taken a conservative approach when exercising *cy-pres* powers but it has recently come under pressure to apply the doctrine of *cy-pres* more flexibly.⁸ In its review of *cy-pres* the Commission confirmed the main principle - that a regard needs to be had to the original trust; it also emphasised that it would apply *cy-pres* flexibly and without any artificial barriers.⁹ This would include considering widening objects under one head of charity in order to include objects under another head of charity.

Section 13(1)(C) Charities Act 1993 allows for the *cy-pres* application of property of charities with similar purposes, which can be more effectively used in conjunction with common purposes. Section 15, Charities Act 2006¹⁰ inserted a new consideration in relation to *cy-pres*.¹¹ In addition to considering the spirit of the gift, the Commission will need to consider 'the social and economic circumstances'

⁷ *IRC v Helen Slater Charitable Trust Ltd.* [1981] 3 WLR 377.

⁸ See Cabinet Office, Strategy Report, "Private Action, Public Benefit. A review of charities and the not-for-profit sector", (2002), para. 4.75-4.62.

⁹ *Ibid.*

¹⁰ In respect of section 13 (1) (C), 13 (1) (D) and section 13 (1) (E) (iii) (Charities Act 1993).

¹¹ S.13 (1) (A) & (B), Charities Act 1993.

prevailing at the time of the proposed alteration of the original purposes. This should encourage a more frequent and radical application of *cy-pres* schemes and in turn assist charities seeking to merge.

2.2 Power for Unincorporated Charities to Amend Purposes

Unincorporated charities with a gross income in the last financial year of not more than £10,000, which do not hold designated land and which are not companies, can amend their objects without the need for a *cy-pres* scheme.¹² This can happen through a resolution by the trustees. Before doing so, the trustees must be satisfied that it is expedient in the interests of the charity to amend the purposes, and that so far as it is reasonably practical, the new purposes consist of the included purposes that are similar to those that they replace. Although this procedure has the advantage that trustees need not apply for a scheme, which can be time-consuming, the resolution route is more restrictive than the new *cy-pres* provisions provided by the Charities Act 2006 as it does not make reference to social and economic considerations.

2.3 Power to Spend Permanent Endowment

‘Permanent endowment’ is defined in the Charities Act 1993¹³ as property held for the purposes of the charity, which can only expend its income for the purposes of the charity. Permanent endowment can cause a problem in the context of mergers, because provision will need to be made for the transferee charity to hold the property, subject to the permanent endowment trust, if it does not already hold its general property in such a manner. The most common situation in practice when this causes a problem is in the case of a transfer of permanent endowment to charitable companies which do not hold their general property subject to trust and cannot therefore hold permanent endowment.¹⁴ In such cases the Charity Commission will make a scheme appointing the charitable company as trustee of the permanent endowment property.¹⁵ Theoretically, there seems to be no reason why the permanent endowment property cannot be transferred under a transfer agreement, in such a way that the company holds the property on terms that it is permanent endowment.

The Charities Act 2006 allows unincorporated charities with a gross income in the last financial year of less than £10,000, which do not hold designated land and are not companies, to resolve to transfer the property to another charity, in the

¹² S.74 (C), Charities Act 1993 as inserted by Charities Act 2006.

¹³ S.6 (3), Charities Act 1993.

¹⁴ *Liverpool & District Hospital for Diseases of the Heart v AG* [1981] Ch 193.

¹⁵ Under section 16 Charities Act 1993.

circumstances described in paragraph 2.2, and with the consent of the Charity Commission.¹⁶ Following the transfer, permanent endowment will continue to be held, subject to permanent endowment restrictions.¹⁷ Nevertheless, this power could be helpful in context of a merger because it at least saves the need for a scheme or a transfer agreement (as explained in paragraph 2.3).

2.4 Register of Charity Mergers

The Charities Act 2006 provides for new register of mergers¹⁸ which are notified to the Charity Commission¹⁹. ‘Relevant charity merger’ is defined²⁰ as:

- a merger of two or more charities where one of them (the transferee) has transferred to it all the property of the other(s) (transferor(s)) and the other(s) afterwards cease to exist; or
- a merger of two or more charities (transferors) which transfer all their property to a new charity (the transferee) and the transferors afterwards cease to exist.

Following registration on the charity merger, any subsequent gifts or legacies will automatically and legally transfer to the successor charity. Previously the problem was that if the charity had ceased to exist or no longer had trustees, then application would have been needed to be made to the Charity Commission to use its scheme making powers to transfer the property.²¹

There is a potential problem with the register of mergers where there are contingent legacies and conditional gifts where the precondition is that the charity is in existence at the date of death or the date of the gift and the charity merges. In such cases, it would appear that the legacies or gifts would fail as the transferor charity would have ceased to exist. The Charities Act 2006 did not provide for such contingencies. However, where charities are merging by way of a scheme of the Charity Commission it is arguable that the transferor charity will survive²². The

¹⁶ S. 74 (A & B), Charities Act 1993.

¹⁷ S. 74 (10) (B), Charities Act 1993.

¹⁸ S. 75 C (1) Charities Act 1993.

¹⁹ In accordance with S. 75 C (6)-(9) Charities Act as amended by the Charities Act 2006.

²⁰ S.75 C (4) (A) & (B) Charities Act 1993.

²¹ Under section 16 Charities Act 1993.

²² *Re Faraker* [1912] 2 Ch 488. For a discussion on this point see “The Law of Charitable Status: Maintenance and Renewal” by Robert Meakin (Cambridge University Press, 2008) pp. 76-80.

rationale for this argument is that the Charity Commission do not have the power to terminate charities through their scheme making powers. In such cases the contingent legacies and gifts will not fail.

In addition the Charities Act 2006, also provides for a vesting declaration²³, which will assist in the transfer of title of property to a transferee charity on a merger.

A vesting declaration must be made by way of a deed by the charity's trustees or the transferor's trustee. The declaration vests the legal title in the transferee without the need for any further legal transfer documents. However, there are exceptions to the type of property that can be transferred. These are:

- land held by the transferor charity as security;
- land, subject to a covenant against assignment without the consent of some other person such as landlord's consent to the assignment of a lease, unless the consent has been obtained before the specified date;
- any shares, stock, annuity or other property which is only transferable in books kept for a purpose, or is required by the legislation to be transferred in some other particular manner.

There are other practical limits to the vesting declarations. It only vests the legal title in property and the transfer agreement will still be needed²⁴ where there is a need to:

- transfer the beneficial ownership of the property;
- record the consent of the transferee;
- deal with the assumption by the transferee of liabilities;
- provide indemnities;
- provide warranties;
- transfer employees under The Transfer of Undertaking (Protection of Employment) Regulations 1981 (TUPE);
- transfer the benefit of contracts.

²³ S. 75 (E) Charities Act 1993.

²⁴ See King M & Phillips A, "Charities Act 2006" (Law Society, 2007), para 9.8.5.

In practice there will probably continue to be transfer agreements made by deed and containing a vesting declaration.

3. Ways of Merging

There are a number of ways of merging. Here are some examples:

- a) Charity A dissolves and passes its assets to charity B.
- b) Charity A and charity B dissolve and pass their assets to a new charity C. Charity C has a joint trusteeship made up of charity A and charity B trustees and, where relevant, a joint charity A and charity B membership.
- c) Charity A is appointed as the sole trustee of charity B which then becomes a subsidiary charity of charity A.
- d) Charity A has a representation on charity B's board of Trustees and vice versa. Charity A has powers of appointment and removal of charity B's trustees. Until those powers are exercised charity B is managed by charity B but there are funding and resource sharing arrangements.

4. Issues to Consider Before Merging

The trustees of each charity must be satisfied that the merger is in the best interests of that charity. The Charity Commission expects each charity to carry out an appropriate disclosure or due diligence exercise that is proportionate to the size and nature of the merger²⁵.

There are a number of issues to consider:

4.1 Name

What would be the name of the merged charity?

4.2 Trusteeship

How would each charity be represented on the board of merged charities? How will future trustees be elected or appointed? The resolution of this issue will be sensitive as it will suggest an answer to the question whether there is a merger or a takeover.

²⁵ See "Policy Statement on Mergers, Collaborative Working and Due Diligence", (Charity Commission, October 2007) and "Collaborative working and mergers resources", (Charity Commission, April 2009), which includes useful checklists for trustees to use. See www.charitycommission.gov.uk/enhancingcharities/cwmresources.asp

4.3 Membership

Will all the existing members of each merging charity continue to be members? Is there any need for new categories of members? Is the membership structure flexible to take into accounts any future members?

5. Potential Liabilities

There can be potential liabilities. In particular:

5.1 Employees

The Transfer of Undertaking (Protection of Employment) Regulations 1981 (as amended) apply in the context of mergers where employees are transferring employment from one charity to another. The effect of these regulations means that any employee who was employed 'immediately before the transfer', automatically becomes the employee of charity B from the time of the transfer on the terms and conditions they previously held. Crucially, charity B inherits charity A's rights and liabilities in relation to those individuals. It is important therefore for charity B to carry out a due diligence process to ensure that there are no major liabilities.

The dismissal of any employee as result of the merger would amount to unfair dismissal unless dismissal qualifies as an 'economic, technical or organisational' (ETO) reason entailing change in the work force²⁶. In order to avoid claims for unfair dismissal, it needs to be shown that redundancies are genuinely due to ETO reasons such as 'duplication of jobs'. Employment is an important area to check because latent liability can throw the whole financial viability of a merger into doubt.

5.2 Value Added Tax (VAT)

Where the transferor charity is carrying on a business activity for VAT purposes a transfer of assets in the course of a merger could give rise to a taxable supply. The transfer of assets from one charity to another in these circumstances is usually treated as a transfer of a business as a going concern and therefore outside the scope of VAT²⁷. However, in respect of let properties where an option to tax the rent payable by the tenant has been exercised, and therefore the exemption from VAT

²⁶ Regulation 8 (1) & (2).

²⁷ S44 Value Added Tax Act 1994 and Article 5 VAT (Special Provisions) Order 1995 (S.I 1995/1268). Where an asset transferred as part of a TOGC was subject to the Capital Goods Scheme (CGS) in the hands of the transferor, the transferee will inherit the transferor's CGS position and become liable for any tax arising as a result of a subsequent change of use of the asset during the remainder of the CGS period.

has been waived, the successor charity must give notice of its option to tax before or at the date of the transfer. If this notice is given, then the transfer is likely to be treated as a transfer of a going concern (TOGC). Otherwise VAT will be charged to the successor charity on the transfer of assets.

5.3 Pensions

Charities with defined benefit pension schemes will need to seek clearance from the Pensions Regulator when they merge if the sponsoring employer is withdrawing from the scheme, as is the case when one charity transfers all its assets to another and then dissolves. This is because a statutory debt will be triggered²⁸ calculated on the full cost of buying out annuities for all members of the scheme whom it employed and their dependents. This can be a very large debt and many pension schemes may not have the assets to meet such a liability due to poor investment returns, tax changes and people living longer.

The solution is to persuade the Pensions Regulator that the recipient charity will be as likely or, if not, more likely to be in a position to discharge this liability. If a small charity is merging into a larger charity then, in practice, this should not be an issue. In other cases it will be a matter of negotiation.

6. Forced Mergers

In the context of the Charity Commission's inquiries where a charity is failing, the Charity Commission has been known to use its protective powers²⁹ to appoint additional trustees³⁰, an interim manager³¹ or to make schemes³² which leads to the dissolution of the charity and its assets being transferred to another charity or charities.

Furthermore, the Commission has a new power³³ to direct the application of the charity's property where it is satisfied that it is necessary or desirable to make an order for the purpose of securing proper application of that property for the purposes

28 Under s75A Pensions Act 1995.

29 Ss. 18 and 19 Charities Act 1993.

30 For example, The Alzheimer's Foundation for Research into Alzheimer's disease. See "Third Sector" 18 August 2004.

31 For example, Tracheotomy Patients Aid Fund Inquiry: see www.charity-commission.gov.uk/investigations/inquiryreports/afiad/asp

32 For example, Iran Aid: www.charity-commission.gov.uk/investigations/inquiryreports/afiad/asp

33 S.19(B) Charities Act 1993, inserted by the Charities Act 2006.

of the charity. Theoretically, this power could be used to transfer property from one charity to another by way of a forced merger, but this is unlikely as the Commission has gone on record as saying it will not force charities to merge.³⁴

7. Conclusion

With increasing consolidation within the charities sector, it is important that charities are aware of new opportunities made available by the Charities Act 2006.

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See RS4a “Collaborative Working and Mergers: summary” (March 2003).