
Legal Aspects of Microfinance Mergers and Affiliations:

*A practical discussion of the legal issues involved
when microfinance institutions “join forces”*

Saturday, May 19, 2001
11:15 - 12:45

Timothy R. Lyman, Esq.


**DAY, BERRY & HOWARD
FOUNDATION, INC.**

Ellen Dale Willmott, Esq.


**Save the Children
Federation/U.S.**

Introduction: the objectives of the session

- Provide participants with conceptual tools for thinking about joining forces with other MFIs
- Explain the terminology and concepts involved in a merger or other form of legal affiliation among MFIs

Introduction: the objectives of the session (continued)

- Highlight the programmatic issues that drive legal decision-making about mergers and affiliations
- Discuss a case study of a successful “merger” of two microfinance programs in the region
- Engage participants in discussion on these issues

A quick survey

- How many of your organizations operate microfinance programs through a local legal entity?
- Are these local legal entities commercial companies? Cooperatives? Some form of NGO?
- How many of your organizations have “combined” programs with another organization?
- How many of you have thought about combining programs in some manner?

A quick survey (continued)

- How many of you have ever transferred a loan portfolio to another organization?
- How many of you have ever received a transferred loan portfolio from another organization?

Vote on how to spend our time

- Terminology and concepts
- More detailed discussion of “merger mechanics”
- A partial roadmap of program merger issues
- Key legal issues to consider
- Case study of the program merger of Save the Children and CRS in Armenia in MDF-Kamurj
- “Free form” questions and answers on legal issues of mergers

Terminology and concepts

- “Legal merger” - Combining of two or more legal entities into a single legal entity (more detail later)
- “Program merger” - Combination of two or more microfinance *programs*, which may or may not constitute a legal merger (more detail later)
- “Affiliation” - A range of possible relationships among legal entities short of a legal merger (more detail later)

Terminology and concepts (continued)

- “Founder” - A natural person or legal entity who participates in the founding of an NGO MFI (and usually reserves ongoing rights)
- “Local legal entity” - Any kind of legal entity formed under the laws of the country in question, rather than the laws of a foreign country
- “Foreign sponsor” - A foreign legal entity that sponsors a microfinance program or an MFI formed as a local legal entity

Terminology and concepts (continued)

- “Registration” - (1) The process by which a local legal entity is recognized as having begun legal existence, **OR** (2) the process by which a foreign sponsor receives permission to operate a branch office in the country in question
- “Post-merger business plan” - A business plan that spells out, among other things, the roles and responsibilities of the parties to a merger after the merger is completed

Terminology and concepts (continued)

- “Control” - Legal power to determine the activities of the post-merger legal entity (such as through the power to name more than 50% of its directors)
- “Influence” - Power to affect the activities of the post-merger legal entity without the power to control (such as through the power to name less than 50% of its directors)

Terminology and concepts (continued)

- “Asset transfer” - A means of accomplishing a merger by transferring assets from one legal entity to another (whether by a grant or a sale)
- “Tangible assets” - Movable equipment, vehicles and real property
- “Intangible assets” - Cash, deposit accounts, contract rights (such as a leasehold interest), and, most important, **LOANS**

Terminology and concepts (continued)

- Some thoughts to remember about loans in the context of a merger or affiliation:
 - ◆ A loan is **NOT** the same as cash
 - ◆ A loan is an intangible asset that represents a borrower's promise to pay (plus any loan security, such as a group guarantee)
 - ◆ Transferring a portfolio of loans in a merger or affiliation can be complicated

Why consider merging or affiliating?

- Expand geographic impact
- Shared objectives, ideology and mission
- Enhanced cash flow
- Enhanced access to capital (such as a new donor source)
- Economies of scale
- Other?

What do practitioners mean by “merger”?

- A combining of microfinance *programs*, that may or may not involve changing the legal entities involved into a single legal entity
- In other words, a “program merger” is not necessarily a “legal merger”

Examples of “program mergers” that are not “legal mergers”

- A branch office of a foreign sponsor transfers part or all of a loan portfolio to a branch office of another foreign sponsor
- A branch office of a foreign sponsor transfers part or all of a loan portfolio to a local legal entity
- A local legal entity of one type transfers part or all of a loan portfolio to another legal entity of a different type

What do lawyers mean by “merger”

- Combining of two or more legal entities into a single surviving legal entity
- **REMEMBER:** each country’s laws vary
- The following examples are generalizations, and may not hold true or be legally feasible in your country

Examples of “legal mergers”

- Combining two or more legal entities of the same type into a single new legal entity of the same type, while extinguishing the old entities
- Combining two or more legal entities of the same type in a way that leaves one of the entities surviving but extinguishes the others

Examples of “legal mergers” (continued)

- An asset transfer of all net assets of one legal entity to another legal entity, followed by the extinguishing of the transferor

What do lawyers mean by an “affiliation” that is not a “legal merger”?

- Generally, this means some sort of contractual arrangement to combine operations or activities, without any intended change in legal status
- BUT countries’ laws vary, so there may be other ways to structure an affiliation that do not involve a legal merger

What do lawyers mean by an “affiliation” that is not a “legal merger”? (continued)

- An affiliation may be a means of achieving some of the **objectives** of a merger without merging
- BE CAREFUL because some forms of affiliation may have unintended legal consequences (such as a contract that inadvertently becomes a joint venture)

What do *we* mean by “merger”?

- We'll use the term to include both legal mergers and other forms of program mergers

A partial roadmap of program merger issues

- Identify the potential parties to the merger, what each party could “bring to the table,” and the specific objectives that might be served by a merger
- “Reality test” the idea by developing a rough draft of a post-merger business plan

A partial roadmap of program merger issues (continued)

- Examine the legal options:
 - ◆ What would be the optimal form of legal entity to carry out microfinance activities after the proposed merger?
 - ◆ Is either of the proposed parties to the merger this type of legal entity already?
 - ◆ If so, can the other party transfer net assets to it?

A partial roadmap of program merger issues (continued)

- Examine the legal options (continued):
 - ◆ If neither of the parties to the proposed merger is the optimal form of legal entity, can they create such a legal entity and merge their microfinance programs through an asset transfer to the newly formed legal entity?
 - ◆ If none of these options seems appropriate or feasible, is it possible for the proposed parties to join forces through an affiliation other than a legal merger?

A partial roadmap of program merger issues (continued)

- Plan the governance structure of the post-merger legal entity:
 - ◆ What form will the board of the surviving legal entity take, and if the parties to the merger will be represented, how?
 - ◆ Will either or both parties have special powers as founders?
 - ◆ Will either of the parties have influence or control over the merged program through other means, such as under the terms of a grant agreement or loan agreement?

A partial roadmap of program merger issues (continued)

- Plan the management and staff structure of the post-merger legal entity:
 - ◆ Who will choose the manager and other management personnel?
 - ◆ What will happen to other current microfinance program staff of the parties to the proposed merger?

A partial roadmap of program merger issues (continued)

- Plan the capital structure of the post-merger legal entity:
 - ◆ What assets and liabilities will the post-merger legal entity receive from the proposed parties to the merger?
 - ◆ What will the balance sheet of the post-merger legal entity look like after the merger?

A partial roadmap of program merger issues (continued)

- Plan the capital structure of the post-merger legal entity (continued):
 - ◆ What will the liquidity of the post-merger legal entity be like, and will bridge financing be needed?
 - ◆ Are there legal restrictions (such as donor limitations) on the assets that the parties to the proposed merger would transfer, and are any such restrictions incompatible with the merger?

A partial roadmap of program merger issues (continued)

- Plan the operations of the post-merger legal entity:
 - ◆ What clients or types of clients will be served?
 - ◆ What financial services products will be offered?
 - ◆ What lending methodologies will be used?
 - ◆ What plans for outreach and development of new markets are anticipated?

A partial roadmap of program merger issues (continued)

- Develop a detailed plan and strategy to accomplish the merger, incorporating the decisions made in the foregoing planning, but also the concrete steps that must be taken to:
 - ◆ integrate staff and operations
 - ◆ integrate information systems
 - ◆ harmonize lending methodologies and approaches to outreach

A partial roadmap of program merger issues (continued)

- Develop detailed post-merger business plan, including (but not limited to):
 - ◆ Pro forma financial statements
 - ◆ Specific roles and responsibilities of the parties after the merger is completed, including supplying additional capital or technical assistance

A partial roadmap of program merger issues (continued)

- Develop legal documentation, which may include, depending on the type of merger:
 - ◆ Organizational documents for the post-merger legal entity (if a new one will be formed)
 - ◆ Amendments to organizations documents of one of the parties to the merger (if it is to be the surviving legal entity)

A partial roadmap of program merger issues (continued)

- Develop legal documentation, which may include, depending on the type of merger (continued):
 - ◆ Asset transfer agreements
 - ◆ Agreements for ongoing funding or technical assistance to the merged legal entity by one or more of the parties to the proposed merger
 - ◆ Employment agreements

Some key legal issues to consider

- Legal mechanics of portfolio transfers:
 - ◆ Local law may place limits on a lender's power to assign a loan without the borrower's consent
 - ◆ Consider providing for this in all your loan agreements for the last cycle of loans before the merger

Some key legal issues to consider

(continued)

- Tax treatment of the post-merger legal entity:
 - ◆ Will the post-merger legal entity be entitled to beneficial tax treatment that the proposed parties to the merger enjoy (such as under a bilateral agreement)?
 - ◆ Will the transfers contemplated as part of the merger be taxed?

Some key legal issues to consider

(continued)

- Employment and labor law ramifications of staff “transfers”:
 - ◆ What rights, if any, do employees have if they are terminated from their employment with one of the merging entities, even if they are re-employed by the post-merger legal entity?
 - ◆ Are employees of the post-merger legal entity treated differently for tax and social benefits than employees of the proposed parties to the merger?

Some key legal issues to consider

(continued)

- Donor restrictions or approvals:
 - ◆ Will a party to the proposed merger be transferring property that is subject to donor restrictions, and if so, how will the parties assure that the post-merger legal entity will comply with those restrictions?

Some key legal issues to consider

(continued)

- Donor restrictions or approvals (continued):
 - ◆ Will a merging party continue to be contractually bound by agreements with its sponsors that it must worry about “passing along” to the post-merger legal entity?
 - ◆ Must a party to the proposed merger get donor approval before taking part in the merger or transferring property funded by that donor?

Case study:

Catholic Relief Services and
Save the Children/US in Armenia
join forces as MDF Kamurj

Save the Children - Armenia

- Operating microfinance program as part of a branch office
- Program reaching 1800 clients in Yereven and Sissian
- Implementation strategy included a spin-off to a local legal entity

Save the Children - Armenia

(continued)

- Determined that optimal legal form under Armenian law would be a “fund”
- Transfer of the program to the local legal entity would be via an asset transfer
- Funding shortfall while waiting for large grant

CRS - Armenia

- Operating microfinance program as part of a branch office in cooperation with a local partner organization (Caritas)
- Program reaching about 1700 clients in Gyumri and Vanadzour
- Commitment to localizing their program
- Funds on hand but no progress in expansion strategy

The program merger process (the roadmap in practice)

- Discussions between CRS and SC began in late 1999
- CRS's ability to provide immediate funding to SC was key
- SC's presence in Yerevan provided CRS with the ability to achieve planned expansion
- A merger plan and strategy (identifying key steps and issues) and a timetable was prepared

The program merger process (the roadmap in practice)

(continued)

- The parties agreed that the “fund” being established by SC (MDF – Kamurj) was the appropriate vehicle
- An agreement was executed to firm-up the parties’ commitment to the process
- Future board representation for each party was determined
- SC, as founder, had an additional role in the fund - beyond board representation

The program merger process (the roadmap in practice)

(continued)

- Each party determined that it was appropriate to transfer all assets of each microfinance program to the fund
- CRS and SC obtained donor consent to asset transfers
- CRS, SC and MDF-Kamurj developed a post-merger plan for staff development, technical assistance and other funding to ensure operational continuity

The program merger process (the roadmap in practice)

(continued)

- MDF-Kamurj developed personnel and financial policies, MIS, and filing principles – all subject to local law
- CRS and SC microfinance staff resigned and were hired by MDF-Kamurj
- MDF-Kamurj updated and combined CRS and SC manuals on lending methodology, internal monitoring and controls, and impact monitoring
- MDF-Kamurj filed registration documents reflecting post-merger board composition

The difficulties

- Different difficulties at different times and between different participants (headquarters, country offices and microfinance programs)
- Differences in institutional cultures, staffing and communication styles
- Different levels of participation between headquarters staff, country office staff and microfinance program staff
- Different visions for input into governance function in MDF-Kamurj

The difficulties (continued)

- SC's role as founder made it difficult to equalize CRS's and SC's continued "influence" over MDF-Kamurj
- Merging programmatic cultures and methodologies was a challenge
- Process took longer than expected
- Staff's stress and uncertainty at the program level

Lessons learned

- Set realistic time schedule – EXPECT DELAYS
- Clarify decision makers up front – TEAM BUILDING IS KEY
- Agree, in advance, to post-merger staffing structure
- Define a clear communication protocol
- Agree, in advance, on the governance structure

Lessons learned (continued)

- Identify and cultivate the board during the registration and merger process
- Involve the board in in strategic decision making
- Name and logo selection for a merged program is a big issue – the process should be participatory
- Avoid creating a “superiority/inferiority” complex

A final caution

- After you have analyzed the complexities involved in a merger – revisit your reasons for merging: will the benefits outweigh the costs?
- In the case of MDF-Kamurj – we thought the benefits far outweighed the costs