Spinning Off - Effective Transitions: Lessons to be applied when an organization creates a new nonprofit or for-profit spinoff

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Abstract

In a preliminary study of successful and non-successful spinoffs (from the corporate and voluntary sector), Pepin, Tranquada, Baker & Associates has identified some general lessons that can improve the likelihood of a spinoff obtaining funding and becoming a successful organization.

1. **Clean Break** - It is desirable in the long term to strive for a clean-break and completely separate the child[1] and parent organizations. The new structure should be transparent and focused.
2. **Share Resources Formally** - During the transition phase, it is legitimate and healthy for the organizations to share some resources, however, clear and written contracts should be established to clarify roles, expectations, costs, payment and ownership.
3. **Legal and Managerial Independence** - The parent should be a significant but minority partner. A controlled subsidiary can scare away new partners and minimize the benefits of the spin-off.
4. **Market Relationship** - When purchasing services between the entities, market mechanisms should be used to set price. Transactions should be arms length and the child should have the option to purchase from someone other than the parent.
5. **Avoid Conflicts of Interest** - Simplify the structure and strive for arms length relationships. In the interim, use a trusted objective outsider to act as an overseer of major decisions.
6. **Sharing Management** - In the short term, sharing of management may be vital to the success of the spinoff. However, in the long term it can lead to misunderstandings with the board and stakeholder groups. Establish a transition plan early on to replace shared management with an independent team.

[1] Throughout this article, the organization being spun off is referred to as the "child" and the original organization is referred to as the "parent".

7. **Transition Plan** - Ultimately, management and staff should decide what organization they will work for. In a reasonable manner, staff of the parent should begin to concentrate their efforts on one organization or the other, ultimately transferring to the organization where most of their effort is being directed.
8. **Completing the Transition** - Investment from an external partner and/or corporate profitability will trigger implementing the final phase of the transition plan.

Introduction

Nonprofit organizations engaged in commercial activity frequently decide to "spin off" these ventures into separate charities or companies. Spinoffs can also be a good solution for charities pursuing multiple missions or operating large unrelated programs. Pepin, Tranquada & Associates has examined case studies of a number of organizations undergoing spinoffs, looking at both the nonprofit and corporate sectors. These stories have been evaluated to identify strategies that are generally effective and strategies that can lead to issues. This article is a brief summary of these lessons.

Why Spin Off?

In many cases, there is not a regulatory requirement to spin off a commercial venture. Indeed, many charities have very successful businesses operating under one umbrella organization. However, there are some good reasons beyond the regulatory to serious consider making your commercial venture a separate entity:

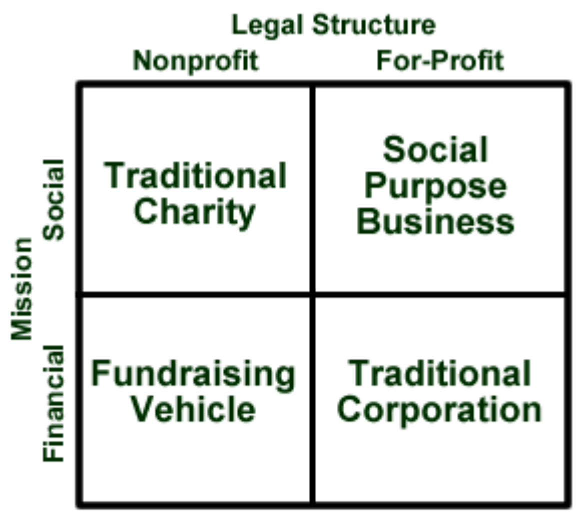
- Provides focus to your management team. Each organization has its own mission to pursue.
- Avoids management distraction. Setting up a business and dealing with a business crisis takes a lot of work. A separate management team keeps the charity on the ball and on mission.
- Reduces bureaucracy. A small independent venture can be nimble. A small program in a big charity can be forgotten.
- Aligns talent. Managing a charity requires a different skill set than managing a business. Similarly, a separate business can attract a board of experts in your industry.
- Transparency and simplicity. Donors or investors can support the organization that is the right fit for their needs.
- Shielding the parent. Commercial ventures are risky. A separate legal entity helps reduce the potential that a parent's core mission will be sacrificed if the business encounters problems.
- Attracting investment. If your business is profitable, you can attract venture capital or private investment.

- Capturing a return. A profitable venture can be sold to investors, employees or another company.

Corporate Form / Structure

A spinoff generated from a nonprofit has two critical structure questions to consider. First, will the new organization have a social mission, or does it exist as a financial tool for the parent organization? Secondly, is it better to incorporate as a for-profit or nonprofit entity. Note that these are not the same question. It can be acceptable to have a nonprofit that has an explicitly financial mission, as long as those financial returns are funnelled into the mission.

The mission orientation is entirely one of organizational philosophy, so we will not dwell on it here, although it does have implications on the type of fundraising that is available to the organization. At the heart, however, the mission orientation is a core principle. We recommend that an organization make this decision at a board level and as a precursor to other decisions of structure.



The legal structure is a more operational decision. Becoming a for-profit opens the door to the capital markets and market mechanisms for rewarding performance. Raising large amounts of capital can be much easier in a for-profit environment than through grant writing. For-profits also give the potential to sell a successful spinoff and immediately capture the financial value. Nonprofits cannot be sold. On the other hand, becoming a for-profit makes the government a financial partner without a corresponding investment. And few philanthropists will give money outright to a for-profit without the tax advantage of a donation status.

An organization which needs to secure a large capital infusion and has the potential of providing a return on that investment should consider being a for-profit, regardless of the social or financial orientation. An organization which will not generate an attractive financial return should probably remain a nonprofit.

	Nonprofit Structure	**For-Profit Structure**
Potential Benefits	• Tax deductible donations • Profits can be tax exempt • Can accept grants and donations • More flexibility to balance financial and social needs • All of profits can be channelled to the nonprofit parent	• Access to new sources of capital • Feedback from market forces, improving product quality • Ability to provide ownership to management team • Exit opportunities for nonprofit • Recruiting benefits
Potential Costs	• Limited opportunities for investors to provide capital • Not subject to discipline of market - could lead to complacency • May have limited access to management talent and limited means to provide incentives	• Difficult to maintain social focus - fiduciary duty to shareholders to manage for profit • May offend some non-profit customers and government • Lose access to grants and donors

Managing The Transition

We have found that in general, child organizations require significant independence in order to achieve their full potential. During the transition period, the stage should be set to allow for a clean-break. Employees should be aligned with a particular organization, and if resources are to be shared in the future, the organization should begin a transparent process to negotiate transfer pricing and service arrangements - before the spinoff actually takes place. Market mechanisms should be used to establish the price of services, which is best achieved by allowing the child the option to purchase potentially shared services from other providers. The new organization should have legal and managerial independence - the parent should be a significant, but minority partner. One rationale for spinning off is to attract new partners (employees, funders, investors, board members). A controlled subsidiary can scare-off potential partners, and with good reason. Partners need to have confidence that the organization will not be subservient to the interests of another organization. This is particularly true with for-profit subsidiaries of nonprofits. The separation of the parent from the child can:

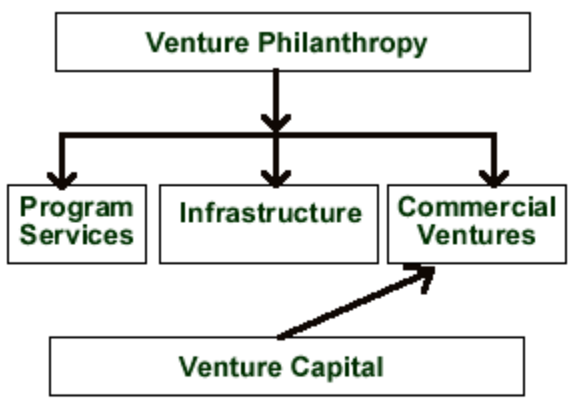
- Improve transparency for donors and regulators.
- Allow greater independence to succeed.
- Ensure that the spinoff is financially viable on own account.
- Reassure partners that there will not be inference from an entity with a different objective.

When considering issues of structure and arrangements for shared salaries and oversight, remember that a complex structure does not isolate management from criticism over potential conflicts of interest. Simple arms length arrangements work best. These can be facilitated by a trusted and objective outsider. If transactions are not arms length, complicated safeguard mechanisms can be misunderstood - the appearance of a conflict is enough to cause concern with donors and regulators.

In the long term, the sharing of top executives can lead to misunderstandings with the board and various stakeholder groups. Organizations that have tried to share CEOs have experienced hostile stakeholders accusing the CEO of spending inappropriate attention on the other organization - especially if the CEO owns stock. In the intermediate term, some overlap may be vital the to the success of the child organization, but it should be established up front that these are temporary arrangements. A transition plan should be in place before management takes on any new responsibility.

Above all, as a guiding principle always refer back to the rationale for the spinoff. In making decisions about structure, test them against this rationale. For example, if the idea is to free an organization to be more entrepreneurial, then a complex joint governance structure is counterproductive.

Funding The Spin Off



A commercial spinoff provides new opportunities for funding beyond traditional grants. Successful venture capitalists and entrepreneurs have demonstrated the ability to turn business ideas into results and are now turning their attention to helping charities as venture philanthropists investing in charities, seeking a social return on the investment.

There are also social venture capitalists, who will invest in commercial ventures in order to realize a financial return in addition to the social return. Some venture funds or angel investors focus on socially beneficial businesses and are willing to sacrifice some financial return. In the US, there is an emerging Community

Development Venture Capital industry that invests in this light, in some cases supported by government tax credits.

Venture philanthropists, whether they be venture capitalists, entrepreneurs or corporations, invest by supporting the:

- Development and implementation of new service solutions or expansion of current service solutions.
- Growth of a charity's infrastructure to prepare for and sustain expansion.
- Commercial ventures to provide for long-term sustainability.

Venture philanthropists want a close relationship with the entrepreneurial organization investing time, human and financial resources intimately helping to achieve the business plan targets. They also demand accountability for a social return on their investment, and work closely with management to measure process and assumptions, and outcomes. They assist with problem solving and implementation to help achieve the agreed upon social goals.

Key Questions asked by Venture Capitalists and Venture Philanthropists are as follows:

Venture Capitalists	Venture Philanthropists
Good Business Idea • Is this a good business idea? • Is there a significant customer base for the products or services to be produced? • Can they be sold at a good enough price so a profit may be made? • Is there a competitive advantage?	**Good Service Idea** • Is this a product or service that is really needed in the community? • Would it result in significant improvement in the life of enough people? • Can it be provided at a cost that makes sense? • Does this approach to solving the problem offer some competitive advantage over other ways of doing it?
Right Strategy • Is there a good strategy to achieve business success, financial return on investment? • From the strategy, is there a credible business plan with a reasonable exit strategy?	**Right Strategy** • Is there a good strategy in place to achieve social return on investment, social success? • Has a good business plan with a sustainable exit strategy been developed to implement the strategy?
People to make it work • Are the people in the business the ones who can make it successful?	**People to make it work** • Are the people running the organization capable of making this successful?

Conclusion

Spinning off a nonprofit's commercial venture can be a tremendous opportunity to find new sources of funding, attract different talent, reduce conflicts between commercial and social objectives, and improve the likelihood that the commercial venture will be a valuable asset of the charity. The process of spinning off, however, is one that needs to be undertaken with a clear plan towards achieving true independence for the spinoff, or else there is the risk of missing out on these benefits.