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# What Nonprofit Leaders Should Know About Bankruptcy

*By Professor Brian Link*[1]

## Executive Summary

- When a crisis leaves an organization unable to meet its financial obligations, filing for bankruptcy may be an option worth exploring in order to protect the organization's mission.
- While bankruptcy is not necessarily the answer for every organization, the process does offer important advantages for organizations in financial distress. These benefits include the automatic stay, potential avoidance actions, and the opportunity to reject certain pre-petition contracts.
- A chapter 11, or reorganization, bankruptcy can provide an organization room to breathe while continuing to operate and conduct its activities.
- If the organization's financial pressures are too great to be managed through a reorganization, a chapter 7 can allow the organization to liquidate and dissolve in an orderly fashion.
- While a trustee or debtor-in-possession will likely be able to use unrestricted gifts to satisfy payments to creditors, they probably are still bound to use the restricted gifts for the charitable or religious purpose for which the gifts were donated.
- To avoid bankruptcy, organizations should maintain cash reserves and practice strong communication with vendors and third parties. When the parties have a trusting relationship, they may be able to restructure debt outside bankruptcy court, saving both parties time, money, and stress.
- If an organization does proceed with a bankruptcy filing, the organization should work with counsel to properly notify donors and constituents of the process and answer the questions these supporters may have.

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## Introduction

Just as nonprofit organizations can present interesting issues in governance and complex problems of accounting, they also pose specific bankruptcy concerns. Still, some general comments can help guide nonprofit leaders and their agents when it comes to pre-bankruptcy planning and knowing what to expect as a bankruptcy debtor.

While state laws still play a major role (including defining the organization's property interests for purposes of the bankruptcy), bankruptcy is governed by its own set of federal laws and some complex rules, so any entity considering filing for bankruptcy would do well to consult an experienced bankruptcy attorney to advise as to the particulars of both state *and* federal law.

This paper will highlight some bankruptcy concepts and then discuss their application to the nonprofit world, with an eye toward helping leaders intelligently discuss their options with counsel, and plan effectively so as to minimize (where practicable) interruptions to the organization's charitable purposes.

## What Is Bankruptcy?

Bankruptcy in the United States refers to those federal laws[2] governing debtor-creditor relations – creating an orderly legal process to, generally speaking, either liquidate assets or restructure payments to creditors over time. Broadly speaking, its goals are twofold: (1) to afford the "honest but unfortunate" debtor a breathing spell,[3] and (2) create an orderly distribution to creditors.[4] One need not necessarily prove that it is insolvent (completely unable to meet its financial obligations) to file for bankruptcy.[5]

Individuals and entities alike are eligible to file for bankruptcy (though some types of debtors, such as railroads, farmers, and government entities, must file under their own particular chapter of the law,[6] which will be beyond the scope of this article). Most debtors voluntarily file for bankruptcy protection, but for much of history debtors would be involuntarily put into bankruptcy as well. Involuntary bankruptcy still exists

[2] U.S. Const., Art I., § 8, Cl. 4; *see also* 11 U.S.C. § 101 *et seq*. (the "Bankruptcy Code").

[3] *E.g. Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934); *Marrama v. Citizens Bank of Mass.*, 549 U.S. 365 (2007).

[4] *E.g. In re NM Holdings Co.*, 407 B.R. 232, 277 (Bankr. E.D. Mich. 2009) (citing sources).

[5] There is a means test for individuals and chapter 7 eligibility. However, solvency is generally not a requirement for chapter 7 or 11 business debtors. *See* 11 U.S.C. §§ 109, 1112.

[6] 11 U.S.C. § 109.



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but is not nearly as frequent (and as discussed below, may not be a concern for nonprofit entities).[7]

In general, there are two types of bankruptcy: liquidation, and reorganization (sometimes called rehabilitation). While all bankruptcy cases proceed under Title 11 of the U.S. Code, there are different "chapters" to govern the different types of bankruptcy: chapter 7 refers to liquidation, while reorganization will proceed under chapter 13 (for individuals) and chapter 11 (organizations and, in certain cases, individuals as well). This whitepaper will focus on the two options available for nonprofits: chapter 7 and chapter 11.[8]

## What to Expect: The Mechanics of Any Bankruptcy Case

Bankruptcy operates under its own special federal laws—there is even a separate court system in nearly every district in the United States just for bankruptcy cases (called "Bankruptcy Court" and, in most jurisdictions, even a special appellate court called "Bankruptcy Appellate Panels"). Bankruptcy judges are not like other federal judges appointed under Article III of the U.S. Constitution (they do not enjoy life tenure), and there is an additional set of rules (the "Federal Rules of Bankruptcy Procedure") with which lawyers must be familiar in addition to the Federal Rules of Civil Procedure and Federal Rules of Evidence (on top of myriad local rules). Like other courts, filings with the Bankruptcy Court are generally matters of public record.

Unlike other court systems, the Bankruptcy Courts work closely with a division of the Department of Justice called the Office of the U.S. Trustee (OUST). It is the OUST that oversees most of the day-to-day administration of bankruptcy cases (described in further detail below).[9]

### *What happens when you file for bankruptcy?*

The first step in beginning a bankruptcy case, after discussion with counsel, is to file a petition with the local federal Bankruptcy Court. At that exact moment, the entity filing for bankruptcy creates an "estate" and the entity is called a "debtor." The

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[7] 11 U.S.C. § 303.

[8] If a nonprofit organization is operating a trust, there may also be some special issues presented that certainly merit consultation with an experienced attorney. This paper will generally presume operations as an incorporated entity or unincorporated association.

[9] For a helpful online resource, *see generally* https://www.uscourts.gov/services-forms/bankruptcy.



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debtor's assets become property of the estate,[10] to which creditors will look for the satisfaction of the debts which the debtor owes.

Also immediately upon filing the petition, debtors are automatically given the benefit of a powerful tool called the "automatic stay." Under federal law, the automatic stay ("stay" effectively means "stop") means all creditors must immediately cease any and all debt collection activities, such as payment demands and foreclosures, *including pending litigation* in which the debtor is a defendant.[11] The automatic stay is very broad, and all courts take it very seriously: creditors must affirmatively seek a court order granting relief from the stay if they want to resume collection or litigation. Courts can even reward a debtor punitive damages from noncomplying creditors.

Within a couple weeks of the petition date, all debtors must also file a detailed set of statements and schedules listing *all* of the debtor's assets and liabilities, income and expenses, as well as co-debtors and pending (executory) contracts to which the debtor is a party.[12] This is a detailed and often time-consuming process that will usually begin before the petition is even filed. On top of that is a "Statement of Financial Affairs" that requires listing payments to creditors in the 90 days preceding bankruptcy (and in the case of "insiders" of the debtor,[13] payments within a year or potentially more pre-petition). Debtors will probably need to close pre-petition bank accounts, and must also hand over copies of financial statements (audited or unaudited) and tax returns to the OUST.[14] Because disclosing and providing such accurate information is a requirement of federal law (failing to comply could lead to dismissal or liquidation, or other sanctions or consequences), **it is imperative that all organizations keep detailed, accurate, and up-to-date information on an ongoing basis** so as to reduce costs and time expenditures when filing for bankruptcy (and also just because it is good practice to do so).

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[10] 11 U.S.C. § 541.

[11] 11 U.S.C. § 362. However, the automatic stay will not act as a bar to criminal prosecution and certain regulatory action, nor will it halt actions by creditors to *perfect* their interests. *Id.*

[12] Federal Rule of Bankruptcy Procedure (FRBP) 1007.

[13] In addition to some case law guidance, "insider" is defined in 11 U.S.C. § 101.

[14] Though districts may differ in their requirements, very often in chapter 11 cases there will be additional disclosure requirements. For instance, in the Central District of California, within seven days of the petition, chapter 11 debtors must also close all pre-petition bank accounts, open new accounts listing themselves as a "debtor-in-possession," and provide proof of insurance and detailed questionnaires about any real property (land) owned or leased by the debtor, to the OUST. This is informally referred to as the "7 Day Package." https://www.justice.gov/ust-regions-r16/file/ch11_debtors_possession.pdf/download.



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While federal law governs bankruptcy proceedings, property is still generally defined by state law.[15] While there is much accord among the states, there can also be significant differences. Accordingly, it is imperative an organization's bankruptcy attorney also be familiar with relevant state property laws. While individuals can seek to exempt certain assets from the estate, organizations do not have such exemptions.[16] However, as will be discussed below, nonprofits often present issues of restricted gifts which may not be property of the estate (and therefore not susceptible to distribution to creditors).

The goal of individuals and organizations alike is generally to obtain a "discharge" of debts[17] (meaning the debts are no longer owed[18]) after certain payments (as available) to creditors. Debtors cannot hide (or fail to disclose) assets, and must make truthful reports to creditors, trustees, and interested parties.

## Chapter 7 (Liquidation)

In a chapter 7 bankruptcy, known as "a liquidation bankruptcy," the assets of a debtor are "liquidated" (reduced to cash) creating a "pool" from which creditors will be paid in an orderly scheme. The automatic stay prohibits the proverbial "rush to the courthouse steps" by creditors by assigning to them a certain priority which will dictate the order in which they are paid. It is not uncommon for many creditors of chapter 7 debtors to never see *any* payout when all is said and done.[19]

After filing a chapter 7 petition, the OUST appoints a "Chapter 7 Trustee" to effectively take over and administer the estate (which, again, is comprised of all the

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15 *See, e.g.*, *Butner v. United States*, 440 U.S. 48 (1979).

16 11 U.S.C. § 522(b).

17 Non-individual debtors in chapter 7 do not really obtain a discharge; rather once all the assets are liquidated and distributed, the organization effectively ceases as a going concern. Chapter 11 individual and non-individual debtors-in-possession only obtain a discharge per the terms of the Plan and statute, usually upon confirmation or when payments under the Plan have been made. *See* 11 U.S.C. § 1141. Additionally, the discharge can be denied pursuant to 11 U.S.C. § 727(a) for various reasons such as fraud, hindering creditors, or failing to keep adequate records. On top of that, certain debts are simply non-dischargeable, such as certain taxes, debts obtained by fraud or embezzlement, unscheduled debts, domestic support obligations, and student loans.

18 *See* 11 U.S.C. § 524.

19 And generally if there is not enough money to go around to fully satisfy a particular priority (or class) of creditors, the creditors have to share *pro rata* in what is available.



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debtor's assets). The bankruptcy estate is *broadly* defined by law[20] and goes beyond real property (land) and personal property (non-land tangible assets) to include bank accounts, insurance, accounts receivable, intellectual property rights,[21] and even potential legal claims against others.

The Chapter 7 Trustee may hire lawyers, accountants, brokers, and other professionals to help investigate, administer, and ultimately liquidate the estate. Throughout the process, debtors will be expected to promptly provide any information and cooperate in liquidating the assets.

In addition, the Chapter 7 Trustee will critically examine pre-petition transfers, and under federal and state law, in many cases can demand turnover of certain payments or transfers to third parties (and will sue such parties in Bankruptcy Court if they do not comply). Generally, regular payments to creditors "in the ordinary course" of business will not be considered for turnover. The purpose behind this trustee "look back" period is to avoid fraudulent transfers or transfers that indicates the debtor "preferred" certain creditors over others.[22]

### Chapter 11 (Reorganization)

The contents of the estate and the priority schedule of creditors is similar in both chapter 7 and chapter 11 cases, but the goals and mechanics differ. (Additionally, chapter 11 cases are far more complex and expensive.) A chapter 7 case seeks a prompt liquidation, whereas in a chapter 11 case, the debtor seeks to restructure its debts and make payments over time to effectively reorganize or rehabilitate itself in a court-approved manner (including putting future income to use to pay creditors). Organizations may file under chapter 7 or chapter 11 depending on their goals (chapter 13 is a form of rehabilitation as well, but is only open to eligible individuals).

In a chapter 11 case, rather than a trustee being appointed at the outset, the debtor becomes a "debtor-in-possession" that becomes responsible for managing the estate for the benefit of creditors. Said another way, the debtor itself must continue to manage the estate (as it did pre-petition) like a trustee, to preserve assets and maximize return to creditors. Usually, the same management remains in place as before the petition was filed. In addition to submitting accurate schedules, the debtor must also

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[20] 11 U.S.C. § 541. For instance, 11 U.S.C. § 541(a) includes in the estate "all legal or equitable interests of the debtor in property as of the commencement of the case."

[21] Although there are protections in the Bankruptcy Code to prevent or limit the sale of "personally identifiable information" (PII), databases of donor information would constitute an important asset of a nonprofit. *See* 11 U.S.C. § 363(b).

[22] *See generally* 11 U.S.C. §§ 547-48.



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work with counsel to engage in ongoing reporting and compliance (such as submitting Monthly Operating Reports disclosing all bank account activity, and status reports). A debtor-in-possession is given powers similar to those of a Chapter 7 Trustee (including to avoid transfers, and so may also file suits to claw back fraudulent or preferential payments). The goal of chapter 11 is to develop a "Plan of Reorganization."

A chapter 11 Plan must propose, in good faith,[23] and in a clear and meaningful way, a feasible method of restructuring debtor's debts and paying back creditors over a period of time.[24] Usually the Plan is filed within about a year[25] of the bankruptcy petition (depending on the size and complexity of the case). The Plan must, among other things, list all of the creditors and organize them according to a "priority schedule" set by law. Similar to how a Chapter 7 Trustee organizes creditors, after administrative expenses (paying attorneys, court costs, etc.), creditors are generally paid in the following order: (i) secured creditors (debts to whom are secured by collateral, akin to mortgages),[26] (ii) priority creditors (who hold certain debts described by law, such as employee wages, debts to utilities, taxes owed to government entities, etc.),[27] and lastly (iii) general unsecured creditors (who hold debts that are unsecured and not deemed a priority; this may include vendors (with claims older than 20 days) for example, or credit cards, unsecured loans, etc.). Creditors are given the opportunity to vote on the

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[23] Case law has stepped in to define "good faith" but is still done with reference to statute. *E.g. In re Madison Hotel Assocs.*, 749 F.2d 410, 425 (7th Cir. 1994). Insolvency is generally not required. *Platinum Capital Inc. v. Sylmar Plaza L.P. (In re Sylmar Plaza L.P.)*, 314 F.3d 1070, 1074-75 (9th Cir. 2002).

[24] Technically it is also possible to file a Chapter 11 Plan of Liquidation; a decision to do so should be made based on particular circumstances and in consultation with an organization's attorney.

[25] The debtor-in-possession's management is given a 120-day "exclusive period" to propose a plan, which can be extended for cause. After this exclusivity period, however, other parties can propose their own plan, so a debtor-in-possession cannot simply "sit around and wait" during the pendency of the bankruptcy.

[26] Or rather, it may be more accurate to describe the situation as: a secured creditor's liens will generally survive a bankruptcy filing. *Farrey v. Sanderfoot*, 500 U.S. 291, 297 (1991) ("Ordinarily, liens and other secured interests survive bankruptcy."); *Johnson v. Home State Bank*, 501 U.S. 78, 84 (1991); 11 U.S.C. § 1129(b)(2)(A). Undersecured parties may be given both a secured and unsecured claim. Modification of secured claims may still be provided for in the chapter 11 Plan (but see 11 U.S.C. §§ 1123-24), but individual debtors should be aware that there are restrictions on modifying loans secured by a primary residence. 11 U.S.C. § 1123(b)(5).

[27] 11 U.S.C. §§ 503, 507.



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Plan, as well as object to it.[28] If the Plan is approved (over objections or not[29]), it will restructure the debts and the debtor must make payouts to creditors as dictated in the Plan. If the Plan is not approved, the debtor will often be given another chance, or the Bankruptcy Court can order the case converted to chapter 7 and have the assets liquidated by a trustee instead (or the case could be dismissed).

If the debtor is noncompliant, or engages in malfeasance, the OUST (or creditors) can seek a court order appointing a Chapter 11 Trustee to take over management of the estate. In addition to this prospect looming over debtors-in-possession, the OUST may sometimes (in larger cases) appoint a Committee comprised of some of the debtor's larger creditors to help oversee the debtor's actions (or lack thereof) and monitor case progress.[30]

## Nonprofit Organizations and Bankruptcy

With this background in mind, there are some issues particular to the nonprofit world that leaders should consider when discussing bankruptcy or financial issues with their counsel.

### *Filing for Bankruptcy*

Bankruptcy is not limited to individuals or certain types of organizations (though, as stated above, only certain chapters may be available to certain associations). The considerations for nonprofit entities when deciding to file for bankruptcy are similar to that of for-profit businesses.

First and foremost, nonprofit leaders must sit down with experienced counsel and decide if bankruptcy makes sense, or if some non-bankruptcy options would be better suited to the organization's goals and situation (for example, voluntary dissolution[31]). While bankruptcy is not necessarily the answer for every organization, it does offer important advantages such as the automatic stay, potential avoidance actions, and the

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[28] 11 U.S.C. §§ 1125-26.

[29] A full discussion of the chapter 11 "cramdown"—whereby plans are approved over dissenting creditors' objections—is beyond the scope of this paper, but experienced counsel will be familiar with this issue and the related "absolute priority rule" discussed below.

[30] The court also has other options to, for example, appoint examiners and consumer/patient ombudsmen (at the expense of the estate).

[31] Though nonprofits cannot be put into bankruptcy involuntarily, some states like California do offer non-creditors the option of an involuntary dissolution. Other options depending on the state may include an "Assignment for Benefit of Creditors" or even a "Deed in Lieu of Foreclosure," to say nothing of potential mergers.



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opportunity to reject certain pre-petition contracts.[32] Secondly, if bankruptcy is a viable option, a nonprofit organization will determine if it will proceed under a chapter 7 liquidation, or if it wants to maintain operations and rehabilitate itself under chapter 11 (despite the additional complexity and expense).

One advantage that nonprofit organizations have is that they cannot involuntarily be put into bankruptcy. Under relevant law, an involuntary case can only be commenced "against a person, except . . . a corporation that is not a moneyed, business, or commercial corporation." While that expression is not defined by the Bankruptcy Code, courts have held it to apply to nonprofit organizations. "Nonprofit" is broader than possessing tax-exempt status, and depending on the state in which the debtor is located, courts will either look to the debtor's state classification[33] as a nonprofit (the literature sometimes mentions an "eleemosynary organization") or will check its status and activities[34] to ensure it is a nonprofit.

And significantly, while normally a debtor has a right to convert a bankruptcy case between chapters 7 and 11, *and* creditors may also request such a conversion, a court cannot convert a nonprofit debtor's case from chapter 11 to 7 unless the debtor itself requests such a conversion.[35]

### *Estate Property & Restricted Gifts*

As mentioned above, the bankruptcy "estate" created upon the petition filing is understood *very* broadly to include all of the debtor's non-exempted assets and goes well beyond land holdings and cash-on-hand. On top of this, the trustee or debtor-in-possession is also charged with adding to the estate not only by effective management, but by seeking turnover or avoidance of certain pre-petition transfers. However, nonprofits present the additional issue of restricted endowments.

Nonprofit organizations may receive a combination of unrestricted gifts (those without limitations on how the funds are spend) and endowed restricted gifts or grants (those that go toward the stated purpose).[36] While well-crafted, restricted gifts are more properly the subject of their own whitepapers, they do present an interesting and

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[32] 11 U.S.C. § 365.

[33] *E.g. In Re Union Guarantee & Mortgage Co.,* 75 F.2d 984 (2d Cir. 1935).

[34] *In Re Capitol Hill Healthcare Group*, 242 B.R. 199 (D.D.C. 1999).

[35] 11 U.S.C. § 1112(c).

[36] A distinction will also be made between the gift *principal* (corpus) and gift *income* (such as interest). The principal is most likely to be untouchable, but *income* on that gift may go into the estate and become accessible by creditors.



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complex question for bankruptcy: are such restricted gifts available to satisfy the debts of creditors? Because bankruptcy laws still respect state property laws, in general the answer is no: courts tend to look for ways to avoid the transfer of charitably-intended gifts to private entities, at least where the donative intent is clear.

Thus, while a trustee or debtor-in-possession will likely be able to use unrestricted gifts to satisfy payments to creditors, they are probably still bound by the intent behind the restricted gifts. That does not mean a trustee, creditor, or interested party may not seek to challenge the gift's status, but nonprofits should note that in general, gift restrictions will survive the bankruptcy. More about this is said at the end of this article as to strategy. Further, since a nonprofit entity is generally deemed to hold assets in a charitable trust, other complications may arise that may even result in the participation of the state's Attorney General in the bankruptcy proceeding (yet another reason nonprofits must consult with an experienced bankruptcy attorney in both the planning and pending stages of a bankruptcy case).

### *Retaining Control & the Plan of Reorganization*

As mentioned above, a chapter 11 Plan will classify, organize, and propose payments (either as they were pre-petition or in an "impaired" or modified way post-petition) to creditors organized in a way prescribed by federal law, as follows: (i) administrative creditors (attorneys, OUST, other professionals, court costs), (ii) secured creditors, (iii) priority creditors, and (iv) general unsecured creditors. Only after all creditors are paid does the court consider payments to equity holders. With for-profit businesses, there is a rule known in bankruptcy circles as the "Absolute Priority Rule" which provides that if a class of creditors cannot be paid in full, no "lower" class may receive anything. What this means in practice for businesses is that, if the general unsecured creditors are not paid in full, equity holders of the business cannot retain an interest absent contributing new value.

But here, nonprofit organizations are at an advantage. Nonprofits operate for a purpose beyond profit, so generally their members are not considered to possess an equity interest. Thus, members of a nonprofit organization are generally able to remain in control and possession post-bankruptcy, even if all creditors are not paid in full, as long as the members are not sharing in a profit akin to a traditional equity security holder.[37] This is a consequence of members not sharing in a "residual value" as they might in a for-profit enterprise. Nonprofits should be cautious however: not only is this a developing area of law, but some courts have held that certain *types* of nonprofits

[37] *In re General Teamsters, Warehousemen and Helpers Union Local 890*, 225 B.R. 719, 735-36 (Bankr. N.D. Cal. 1998).



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– mutual nonprofits like cooperatives – *could* still run afoul of the absolute priority rule because the members were working for their *own* benefits, similar to a profitable enterprise.

## Strategy: What Nonprofit Organizations Must Consider and What They Can Do

Understanding the mechanics and requirements of bankruptcy, together with its attendant advantages and disadvantages, and a few important exceptions for nonprofit organizations, is important for the last step: this whitepaper will now briefly look at some important questions and strategies to bear in mind in discussion with bankruptcy counsel.

### *Avoiding Bankruptcy: Cash Is Still King, But So Are Relationships & Proactivity*

While no whitepaper can advise as to what exactly must be done to avoid bankruptcy at all costs, common bits of advice for businesses are applicable to nonprofits as well.

(1) **Develop cash reserves** where possible. If the organization has not already, it needs to have that difficult internal conversation about the "rainy day" fund. Cash on hand will help the organization effectively leverage its assets on its own terms, present additional options, and is just sound operational practice.

(2) In finance as in other aspects of the business and nonprofit worlds, **relationships matter**. Whether it's a good, long-standing relationship with a bank, or staying up-to-date on the health of vendors or other partners, all organizations are best advised to stay current with interested parties. Staying on good terms, not just with donors, can go a long way in avoiding bankruptcy or dissolution. Creditors of a nonprofit in particular may be willing to work with them out-of-court to avoid bankruptcy altogether, where the prospect of repayment may be diminished.

(3) **Be proactive**. Paying bills and taxes in a timely manner, through an organized system, is critical (and will help have necessary records on hand if a bankruptcy filing is inevitable). But "proactivity" also means staying up on those relationships and committing to fiscal discipline. Get things in writing, and never underestimate the power of a follow-up email or phone call. Many a debtor has been "forced" to file for bankruptcy protection because a promissory note was coming due and there was not a good, healthy relationship with the creditor that could lead to an out-of-court workout.

(4) **Maintain books and records**. Along similar lines, it is not only smart and a best practice, but a federal requirement that a debtor turn over accurate and complete books or records if it files for bankruptcy. Recall that together with



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the petition or shortly thereafter, a bankrupt debtor must file a complete and accurate set of schedules and statements that list all assets, liabilities, income, expenses, and pending contracts, together with lists of payments made pre-petition. Having a clear sense of hierarchy and responsibility within the organization, as well as current and transparent management and accounting tools (together with good accountants and attorneys) will save the organization from many headaches.

### *Director & Officer Liability and Insurance*

Because a nonprofit board will likely be as involved—and more likely, more involved—than a for-profit entity's board of directors, the legal and operational (as well as practical and political) considerations of the board's involvement will also feature heavily in any pre-bankruptcy discussions.

As in a for-profit enterprise, the directors and officers of a nonprofit organization owe a fiduciary duty to the organization. Claims by either complimentary or competing stakeholders notwithstanding, such higher-ups must always act pursuant to their state-mandated duties of due care and loyalty. While nonprofit board members may enjoy some more protections than their for-profit counterparts (not having "shareholders" in the sense of a for-profit organization), they must still follow relevant state and federal law in the fulfillment of their obligations.

The decision to not only file for bankruptcy, but make other related financial decisions, generally will require Board approval, and directors do not want to open themselves up to claims that they have not abided by the relevant operating agreements (mutual member benefit nonprofits only add additional layers of considerations). And further still, individual directors and officers can be found personally liable for certain violations (including, potentially, failure to pay payroll taxes).

Larger organizations will also have relevant insurance questions. While all the states offer many protections to board members, one of the first things the board of a nonprofit organization should do (besides retaining counsel) is immediately examine the state of its "Directors & Officers Insurance" (D&O Insurance) policy to doublecheck existing coverage (and ensure it has not lapsed) to make sure adequate protection is in place (or hire an insurance broker to evaluate and advise). Having this completed before the first sign of financial trouble is one of the most prudent choices a board of directors can make today.

### *Restricted Gifts & Grants*

The above discussion about assets and the bankruptcy estate also highlights the importance of good record-keeping: a nonprofit entity *must* have a detailed and accurate understanding of which of its gifts are unrestricted and which are restricted.



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This will directly impact the size of the estate and affect everyone from the trustee to creditors (beyond the organization itself).

Additionally, there are ample non-bankruptcy requirements when it comes to restricted grants, such as reporting requirements, with which the organization must keep up lest the grant-making body demand a return of funds (and now setting them in a potentially adversarial position to the debtor in the bankruptcy case). The terms of restricted gifts and grants will need to be scrutinized by the nonprofit organization and its counsel pre-petition, as well as the trustee or debtor-in-possession post-petition. A nonprofit entity must also consider, on an ongoing basis, its structure and how it is associating certain liabilities with certain programs that may in turn be associated with a particular gift. Just as a nonprofit would not want to use restricted gifts improperly, it also would not want to unnecessarily return or fail to consider funds that may otherwise be available to satisfy certain liabilities.

Other non-bankruptcy considerations to be made in discussion with counsel will include when to notify donors of the decision to file for bankruptcy. There are ethical and legal considerations to accepting donations after the decision has been made to file but before the petition is submitted to the Bankruptcy Court. All unrestricted prepetition donations are assets of the estate; a donor may not be happy if it makes a donation on Monday afternoon only to learn that the organization filed for bankruptcy on Tuesday morning, and now its donation will simply go to pay creditors. On the other hand, keeping the lines of communication open in good faith and maintaining good relationships may open the door to the debtor or trustee requesting that restricted-gift donors reconsider allowing their donations to become unrestricted. Keeping this in mind may also help in gift solicitation more generally.

Having a clear sense of what funds are open for broad operational use and which are unavailable due to their restrictive intent will help save time and resources to wrestle with the complex and open questions still being resolved by bankruptcy courts, for example: what if a nonprofit organizations files for bankruptcy, and only post-petition learns of a bequest? Or, what if a gift is paid in installments that span the pre- and post-petition months? Or what programs offered by the nonprofit entity can go forward in the plan of reorganization, and which may have to be lost in the shuffle of restructuring? Experienced counsel will also advise on the availability of any remedies or modifications under the Uniform Prudent Management of Institutional Funds Act (UPMIFA) or, for example, *cy pres* doctrine.[38]

[38] According to Nolo's Plain-English Law Dictionary, *cy pres* is "a doctrine used to give a gift to a similar beneficiary when the true beneficiary no longer exists or is not available."



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### *Other Bankruptcy-Related Considerations for Operating Nonprofits*

Bankruptcy is a surprisingly expensive endeavor: beyond the court costs, the bills for attorneys and other professionals add up quickly, especially in a chapter 11 case where it may take years for the debtor to exit the case. As nonprofits, however, such organizations should look to see if they will fall under the umbrella of any *pro bono* programs available at (generally larger) local law or accounting firms, to defray these costs.

The decision to file bankruptcy will also affect an organization's employees, and experienced counsel will be able to advise the debtor about the challenges of paying employees by check before the petition date (at the petition filing, the bank will put a hold on the debtor's bank accounts) and the application of state or federal employment law (such as the WARN Act mandating notice of large-operations closings) or pension protection laws.

Other complex bankruptcy issues will depend on the particulars of each case, including taxes borne by the bankruptcy estate. Each case will determine which bankruptcy strategies are right for a particular debtor. But other potential advantages of bankruptcy include finally having the "breathing room" (and leverage) to negotiate with creditors and landlords, or reject or accept pre-petition contracts. In a liquidation or reorganization, a trustee or debtor can still arrange for asset sales, and filing for bankruptcy also does not prevent a chapter 11 debtor from seeking post-petition financing (sometimes called "DIP financing"), but these processes will now be overseen by the Bankruptcy Court, soliciting input from the OUST and creditors. Most activity outside the "regular course of business" (but including executive compensation) in bankruptcy will require court oversight and approval (including attorney fees for debtors). Occasionally the prospect of having to operate "under a microscope" may deter some entities from filing, but that is the cost to the myriad benefits of an organized restructuring.

## One Last Thing: What If A Nonprofit Organization Is a *Creditor* of a Bankrupt Debtor?

A final note inspired by the economic prospects of the current climate: in a down economy, it is likely that nonprofit entities may encounter *other entities* that have filed for bankruptcy protection. Here are a couple things to consider keeping in mind in such a situation, which may also merit the retention of experienced counsel.

1. *The automatic stay and debtor's (or trustee's) ability to reject a contract or lease.* The organization should keep in mind that the same protections of bankruptcy available to it are also available to others. So, if a supplier or someone who owes money to a nonprofit files for bankruptcy, the organization must promptly ensure that all debt-collection activities have ceased, absent the



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organization obtaining court relief from the stay. The organization must also bear in mind that the trustee or debtor will have the ability to reject pre-petition contracts with the debtor, which is hopefully where the good working relationship will come in to salvage any potential outstanding obligations. Similarly, if a landlord declares bankruptcy, the tenant (subject to the Bankruptcy Code and some relevant limitations) may be faced with a rejected lease.

Further, the organization will want to be on the lookout for correspondence from the debtor or trustee about any pre-petition payments or transfers to the organization. If such payments were preferential (favoring the organization over other creditors) or fraudulent, the organization could find itself squaring off against a trustee in Bankruptcy Court. As always, do not ignore those correspondences (and never simply ignore a summons or subpoena). Bankruptcy attorneys are well-versed in defenses to such actions and can (and should) be consulted.

Conversely, the organization should hire an attorney if it wants to sue the debtor in Bankruptcy Court (for instance, to determine a debt is not dischargeable). There are strict deadlines by which such cases must be filed, so retaining an attorney right away is essential.

2. *Claims bar date.* If a debtor owes money *to* a creditor nonprofit, while all collection activity must cease, it does not mean the organization can rest on its laurels. The organization should be made aware of any "claims bar date," or deadline by which it must submit proof that the debtor owes it money (in other words, that it has a "claim" to payment). The organization should also review and calendar the deadline for any objections or votes on a Chapter 11 Plan.
3. *Vendor issues.* Finally, if a supplier files for bankruptcy, an organization will be limited in its ability to demand goods, or even stop payments or effectuate an "offset" (courts have held all these may violate the automatic stay). If an organization is a vendor to a bankrupt debtor, there may be instances for it to make a priority claim to payment, but this situation is likely very rare for nonprofits.

## Conclusion

Bankruptcy can be a complex but significant area of law which presents opportunities and obstacles for debtors and creditors alike, and on top of that presents questions particular to nonprofit organizations. For many, it is only a matter of time before an organization is faced with bankruptcy-related questions. As always, consulting earlier rather than later with experienced counsel is the organization's best bet moving forward to navigate this area of law.



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