CHICAGO LAWYERS' COMMITTEE for Civil Rights
Community Law Project

Strengthening Communities through Legal Services

# A Guide for Nonprofit Organizations:
## Bankruptcy Issues

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This Nonprofit Bankruptcy Guide is published by the Community Law Project, a project of the Chicago Lawyers' Committee for Civil Rights, formed in 1985 and dedicated to assisting nonprofit groups and small business entrepreneurs with neighborhood revitalization efforts. The Community Law Project extends its appreciation to Mark S. Melickian with Sugar Felsenthal Grais & Hammer LLP; David L. Eaton, Justin R. Bernbrock and Peter A. Gutsche with Kirkland & Ellis LLP; Philip Martino and Sarah Baker with Quarles & Brady LLP; Gregory M. Gartland and Caitlin S. Barr with Winston & Strawn LLP; and Michael Mosher, Avery S. Buffa, and Alex Campbell with Mosher & Associates LLC for their assistance in the creation of this guide. The Community Law Project would also like to extend its gratitude to the American College of Bankruptcy, the American College of Bankruptcy Foundation, and The Chicago Community Trust for their generous support in helping make this Guide possible. This first edition was edited by Erica Spangler Raz, Staff Attorney with the Community Law Project and Kunal Malhotra, Public Interest Law Initiative Fellow with the Community Law Project.

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**GUIDE TO BANKRUPTCY ISSUES FOR ILLINOIS NONPROFIT CORPORATIONS**

The bankruptcy process is very complex. This Guide is intended for use by nonprofit board members, officers, executive staff and other non-lawyers who need to understand the implications of bankruptcy proceedings for Illinois nonprofit organizations. This Guide seeks to explain what is needed to prepare for bankruptcy, outline the bankruptcy process, identify key bankruptcy concepts, and highlight special considerations for nonprofits contemplating bankruptcy.

The Community Law Project recognizes that some organizations know they are close to liquidation, while others are still exploring the possibility of restructuring their organization's debt. While this Guide can be read from the beginning to end, its structure is meant to allow readers to pick chapters and subchapters that apply to their specific situation.

**Where possible, we recommend that a nonprofit board considering bankruptcy or involved in bankruptcy proceedings consult with an attorney, accountant and other advisors to ensure that the general rules and concepts discussed in this Guide are appropriately applied in the specific circumstances. The information provided in this publication should not be considered legal advice.**

# Chapter 1 – Preparing for Bankruptcy

## Importance of Financial Analysis of Nonprofit's Condition

Authored by: Mark S. Melickian, *Sugar Felsenthal Grais & Hammer LLP*

You are a senior marketing professional in Chicago. Over the past few years, at the behest of one of your best friends and business colleagues, you have attended fundraisers for The Golden Rule NFP, an Illinois nonprofit corporation. You have happily bid on Sox tickets at the live auctions, and volunteered your services as a marketing advisor to the entity. For your efforts, interest, and willingness to put your money up, you have been offered a seat on Golden Rule's board and have accepted. Prior to your first board meeting, you receive the agenda packet, and being a new board member, dutifully plunge in. Then your eye stops at agenda item 5 – "Restructuring Options" – and you wonder, just what have I gotten myself into?

If you are reading this sentence, chances are that you have more than a hypothetical interest in the concept that nonprofit organizations are as susceptible, perhaps more susceptible, to financial problems and insolvency than their for-profit counterparts. The smaller the nonprofit, the more likely that it has muddled along with less than adequate staff and resources to affirmatively address the daily, monthly, and annual financial and operational requirements of an operating company, much less an operating company with the additional compliance and reporting issues that burden nonprofits generally and certain nonprofit sectors in particular. Understandably, the board and staff of a nonprofit may focus intently on mission and vision while paying insufficient attention to financial and operational issues until a crisis looms – an inability to meet payroll, or a lease payment, or a loan payment.

The Golden Rule NFP has hit that point, and its board – with you, its newest member – has some work to do.

*Choices: Chapter 11, Chapter 7, or…*

When faced with a persevering liquidity crisis, the board may face the decision of whether to file for bankruptcy protection, or elect a bankruptcy alternative, such as dissolution under state law. Bankruptcy is an option for nonprofits, although one taken far less frequently by nonprofits than for-profits, for a variety of reasons. A nonprofit that determines that the best course is to close its doors may liquidate under Chapter 7 of the Bankruptcy Code. A nonprofit that determines that its mission remains valuable and its financial situation salvageable can attempt to reorganize and continue its mission under Chapter 11. Unlike their for-profit counterparts, creditors cannot force a nonprofit into bankruptcy involuntarily, so the decision to file, or not, lies entirely with the board.

*Mission – Does the World Still Need You, and Can You Still Serve?*

The threshold question for a nonprofit facing a possibly terminal liquidity crisis is one of mission, rather than finances. While you begin to collect, analyze, and understand the financial and operational aspects of the crisis, you should initiate a hard look at your mission and role. Are you still necessary? In your absence, will your target community be underserved? If you take a hard look at your mission and your role in serving your target community and constituents and determine that your mission is fulfilled or can be fulfilled by others, then the decision to shut your doors rather than incur the time, expense, risk, and turmoil of restructuring is an easier one. You will still have transition and wind-down issues to address, including identifying client constituents who will be hurt by the closure and exploring ways to minimize the disruption of services to them. For example, there may exist a community foundation or other donor who could donate funds to ensure that client transitions, if necessary, are as smooth as possible.

*Feasibility of a Restructuring – What to Look At.*

In this case, you have concluded that your mission remains vital. The next steps are critical. Your executive director and financial officer, and your board, must quickly become experts in understanding the operational and financial factors that have led you to a point of crisis, and must learn the language of restructuring and bankruptcy as you consider a path out of the woods.

You cannot presume that your entity's financial records are complete or accurate, even if you have dutifully reviewed and approved budgets and periodic Quickbook reports, received clean bills of health from your external auditor, and timely filed your Form 990 each year. Unfortunately, when a financial crisis strikes, the parties charged with untangling and solving the mess far too often find that the organization's financials, present and past, may be unreliable. Furthermore, in order to make decisions about and ultimately implement a restructuring, you will need to learn about cash flow models and other reports that are necessary to take your entity through a Chapter 11 restructuring, and engage a professional (on a paid or preferably pro bono basis) to assist in their preparation.

*Viability – Liquidity, Solvency, and Positive Cash Flow*

The viability of a potential turnaround of any operating company is based on the following factors – liquidity, solvency, and positive cash flow. Liquidity involves an analysis of existing cash and working capital. Solvency is a snapshot that is typically assessed through a balance sheet. Whether the organization can create and maintain positive cash flow going forward – the most critical analysis for determining whether the entity can be salvaged and restructured, rather than sold or shuttered – can be best assessed through what is commonly referred to in the turnaround and restructuring industry as the "13 week cash flow" model.

The 13 week cash flow is a method of forecasting liquidity at a granular level based on short, fixed periods of time (typically, 13 weeks, though in practice it can be longer or shorter) that allows the organization to assess its near-term "liquidity runway." You know you have a liquidity crisis, but your historically general approach to budgeting is woefully inadequate to allow you to see, analyze, and address the crisis. Once the model is built for your organization, it can be rolled forward on a weekly or monthly basis to allow for continual monitoring of cash flow and operations and liquidity projections going forward until the restructuring is completed.

A 13 week cash flow might start with the organization's existing budget model, but from that base, is built from scratch. The model is cash rather than accrual based, and acts somewhat as a very detailed checkbook in which revenue and expenditures – vendor by vendor, line item by line item, and category by category - can be compared, on a weekly basis, to projections. A typical 13 week cash flow is conservative, and will err on the side of caution for anticipated revenues and expenses. The concept is to build a cash flow model with enough specificity that the parties leading the organization through a restructuring can assess liquidity on a real-time basis, and project peak cash needs down to the week and day, as the entity moves toward a terminal restructuring event such as a significant sale of assets, or confirmation of a Chapter 11 plan that adjusts the entity's balance sheet.

There will be elements to a nonprofit's 13 week cash flow that are unique to its nonprofit status. Many nonprofits obtain a significant portion of their cash flow through service fees, which can be projected in a fashion similar to the sale of services or goods in the for-profit sector. Projecting unrestricted income from fundraisers or donations are another matter. As noted above, a typical 13-week cash flow model is conservative, and a restructuring advisor who is building the model will tend to discount, perhaps heavily, the projected availability of such funds compared to the organization's historical budgeted projections and assumptions. This should open a dialogue between the party or parties at the organization charged with overseeing the restructuring and the professional(s) assisting the organization in the restructuring about the appropriate way to value such assets. In turn, this may open up a useful discussion about the effectiveness of the organization's historical approach to fundraising, and ultimately lead the organization to re-formulate its fundraising strategy.

Building a 13 week cash flow model and learning to operate within its constraints is not something that an organization – profit as well as nonprofit - can or should do itself. Typically, a professional turnaround firm is engaged to undertake the financial and operational review necessary to build an accurate model that is unique to the entity and the industry in which it operates. Fortunately, for a struggling nonprofit, many larger restructuring professional firms are willing to undertake these projects on a reduced fee or even pro bono basis.

Whether you retain a professional to produce a 13 week cash flow and advise on the process going forward, or simply do a back of the envelope assessment of the entity's ability to service its obligations (near and long term) going forward, the calculus is simple: If the entity cannot service its near term obligations with its existing cash flow, the organization's ability to survive will require a wholesale revision of its business plan, including services, delivery methods, and financing, in addition to a hard look at mission.

*Balance Sheet, Assets, and Liabilities*

When contemplating a restructuring, the balance sheet model typically used for financial reports will continue to be used, but the assumptions about the value of the organization's assets will change and the existing booked values may require adjustment. A nonprofit's assets typically fall into the following buckets – unrestricted cash or investments (third party stock), restricted (partially or wholly) cash or investments, accounts receivable, personal property, and real property. The personal property typically owned by a nonprofit would be equipment, leases, licenses, and intellectual property. The good will of the entity, which also has value, may exist in its typical form – customer or constituent lists, for example – but also exists in connection with the organization's mission and community role.

When an organization goes down the public path of a bankruptcy restructuring, it faces the real risk that the value of at least some of its assets becomes impaired. One of a nonprofit's chief assets is its reputation, a form of good will that cannot easily be quantified but can be fairly said to be at risk when it becomes known that the entity is struggling. Just how much at risk is a question that is not easily answered.  Notable nonprofits, such as Helping Hand in California, have survived internal financial scandals by restructuring through Chapter 11 and survived these events with little impact on the support it received from its major institutional donors, reportedly because the organization chose to be open and frank about the crisis it faced and its plans for emerging from the fire.

A nonprofit generally cannot use endowed funds and other restricted donations to satisfy creditors' claims.  In liquidation, such funds must be returned to the donor unless the donor agrees otherwise.  Partially restricted funds, which are funds that have been donated to and retained by the nonprofit with the understanding that such funds will be used for certain purposes but without a formal endowment structure, are generally accessible to creditors and may be tapped to pay creditor claims in connection with insolvency or bankruptcy.

In addition to debts owed to vendors and other creditors, a board should include a nonprofit's tax obligations and other legal obligations such as existing judgments against the entity.  The board should also include the nonprofit's potential liability for any alleged fraud, embezzlement, or misuse of restricted funds within the entity.  This might lead the board to an analysis of the adequacy of the nonprofit's insurance coverage for such events.  Additionally, a board should consider any continuing obligations pursuant to contracts and leases, as a nonprofit may be able to modify or cap such obligations through the Bankruptcy Code.

*Realizing Value if there is Value to Realize*

Once a board evaluates its financial status, it needs to formulate a plan on realizing the value of those assets to satisfy debts and the feasibility of continued operations.  The plan to restructure the nonprofit's assets and liabilities may include a partial sale of assets or sale of operations. For example, if a nonprofit falls behind on tax liabilities, and owns its office building, the board may consider selling the property and switching to renting space in order to satisfy that debt. Note that this is a viable option only to the extent that the nonprofit has equity in its holdings.

A board of a section 501(c)(3) entity should take care in these situations to maintain tax-exempt status, which requires paying "unrelated business income tax" on income unrelated to the entity's mission.  Do not assume that the entity's tax-exempt status is a shield against capital gains tax on the sale of an investment asset or the taxes normally levied against the sale of personal or real property.  The organization will want a tax professional to advise on that issue before undertaking these one-time transactions as part of a larger restructuring.

The board may consider merging with another organization in an attempt to form an economically stronger entity, or explore other joint venture or partnership options.  While mergers can prove to be more complicated than a sale of operations, the choice between the sale of operations and a merger in the nonprofit sector may be more driven by regulatory or licensing concerns than would be typical in the for-profit sector.  In some cases, a straight sale or bankruptcy sale may not be a practical option because of the risk (or certainty) of loss of a key license or regulatory status.  The board will need to consider, and will need professional counsel regarding, the tax, regulatory, and licensing impact of each of these options.

*Reorganize, or Liquidate?*
After a thorough review the nonprofit's financials, including the preparation of a 13 week cash flow and a forecast that includes asset sales and/or mergers and/or other corporate transactions – and, of course, consideration of the organization's mission - the board may determine that the organization's continued existence is no longer possible, at which point a liquidation through Chapter 7 of the Bankruptcy Code, or dissolution under state law may be the only viable options. If a board elects to dissolve a nonprofit, some states, such as Illinois, do not allow for a consensual dissolution by the Board of a non-member entity unless it satisfies all outstanding debts. For more information, see Chapter 4 of this Guide and the Community Law Project's Guide for Nonprofit Organizations: Dissolution of Illinois Not For Profit Corporations.

## Board and Management Considerations

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*Role and Responsibility of the Board*
The board of directors of a nonprofit plays a significant role in the life of the entity – typically, a far more significant role than the board of a larger entity, particularly of public companies. Out of necessity, the board members of many nonprofits function as both an extension of management and of staff, or as a "free" analog to services that companies typically pay for, particularly in the areas of finance, marketing, and legal.

This can complicate the role played by a director in situations where the nonprofit is struggling with operational and financial issues. The board of a larger, for-profit company may be able to hire and rely on professionals to conduct an investigation into the trouble facing the company and the cause or causes of that trouble, and consult with the board on a variety of issues, including a path out of the financial desert. In a nonprofit, a director may find herself assuming an investigative role in the face of a financial crisis and can be pressured to take a significant role in determining the solution. For a nonprofit entity with a slim budget made slimmer, or nonexistent, by financial turmoil, this may be the only practical outcome, but it is far from ideal. To the extent possible, the board should seek outside help in navigating these waters. Large professional law firms and accounting firms can offer sophisticated pro bono assistance. The board should tap its own members and their connections first for contact with firms that may be willing to help.

Just as it does for the director of a for-profit entity, when a financial crisis hits, the fiduciary duty held by a nonprofit director expands to include not just the entity itself but the entity's creditors. As a director, you become charged with becoming more active and more intellectually engaged in the nuts and bolts of the entity's operations and finances.

The board cannot create the nonprofit's books and records. Keeping the books is the entity's responsibility. However, the board can require – and in a financial crisis, must insist – that those records are complete and current. If there is a silver lining to a financial crisis for a nonprofit, it is that the entity often comes out of the crisis – if it survives - with much tighter financial controls and with a far more financially literate staff and board.

In a financial crisis, the board must obtain and understand sufficient information to further direct the staff to produce additional information where the information presented to the board is insufficient to make well-considered decisions about the entity's present and future. Among the financial product that the board must obtain and review – as quickly as possible – are the entity's most recent annual budget, monthly and quarterly financial statements, and tax returns. The board will likely have seen and reviewed most of this, and perhaps all of it, on a regular basis, but absent a crisis, may have done so with a less-than-critical eye, relying heavily on management to note issues of concern. Now, the board is forced to look under the hood.

As mentioned previously, when taking a closer look, the board may find that the entity's financial records are not sufficiently detailed or sufficiently accurate to make a rational decision about the path to take. Furthermore, finding that the entity has been operating in an atmosphere of financial illiteracy raises significant issues with respect to its past and current financial reporting to taxing authorities, lenders, regulatory agencies, and donors. No board chair looks forward to that first conversation with his analog at the nonprofit largest institutional donor in which he conveys the message that "We are in financial trouble but we can't figure out why." Furthermore, the loans and grants made to a nonprofit typically come with reporting obligations not found in the for-profit sector. Governmental loan and major donor grant programs can require monthly reports that consume many hours of staff time to prepare. Discovery that past reporting may have been based on inaccurate data may lead to an obligation to file amended reports covering months or years. Prior years Form 990's may also have to be amended. Adding to these burdens, all of this will need to be reported to the state Attorney General's office, which can lead to a summary investigation aimed at determining whether the entity's charitable status should be revoked.

For all of these reasons, a nonprofit board faced with sudden knowledge that the financial situation is both grim and opaque must consider directing the entity to hire an independent financial consultant to rehabilitate the corporate financial records, and independent legal counsel to advise it in connection with its anticipated communications with constituents, lenders, donors, regulatory agencies, and the Attorney General.

*Existing Management*

It is the unfortunate lot of the board chair and the board to be faced with the possibility that the executive director that brought the news of crisis to you may be a part of the problem. Assume that the crisis is fueled by, or at least has exposed, the nonprofit's failure to adequately reserve for and pay its payroll tax obligations. The board must seriously consider whether the executive director and other existing management (e.g., chief financial officer and/or controller) should be retained at least while navigating through the crisis, or whether new management is necessary. To some degree, this decision may be driven by the outcome of the awkward communications that the board chair is about to have with its key grantors and stakeholders.

Where existing management may be an issue but removing them would prove operationally impractical in the near term, the board may consider engaging the services of a turnaround specialist as additional management (a "chief restructuring officer") who will function in part as an internal watchdog on the activities of existing management. The decision to remove any of existing management can then be deferred until the crisis has passed.

*Committees*

The existing committee structure should remain in place during a period of financial crisis. To the extent possible, the duties of the directors and members of those committees should continue "business as usual." However, recognize that business is not as usual. As mentioned previously, when a corporate entity is faced with actual or potential insolvency will expand a director's fiduciary duty beyond those owed to the entity and its mission to duties owed to the entity's financial stakeholders – creditors, grantors, and lenders. The existing financial and operational reports that the board has reviewed and, in some instances, approved will be revisited. For this reason, on top of the day to day responses that a financial crisis demands, there will be additional strain on the board's finance committee until the crisis is addressed and resolved. The audit committee, which in a typical year functions as a working group for mere weeks, may find itself called to bi-weekly or weekly conference calls to stay on top of due diligence and the potential need to address restatements of prior filings. The nonprofit's executive committee – if it has one – should be in daily communication.

The existing committee structure will not be enough, however, if the financial crisis is severe enough to send staff and board to the Internet searching for key term "bankruptcy." At the first meeting called by the board chair upon learning of the storm bearing down on the entity, an order of business should be the formation of a special restructuring committee. The restructuring committee should include key members of staff and the board – it will need both operational and financial expertise – and will be tasked specifically with advising the board on the causes of and potential cures for the crisis that threatens the entity's existence. The restructuring committee will request reports from other committees and engage directly with retained outside professionals to assist it in its tasks. Its role will be to synthesize the nonprofit's options and ultimately make recommendations to the board about the best path forward. This is, in effect, emergency strategic planning with a very short time horizon.

*Engagement of Board Members; Board Chair Role; Assignment of Tasks*

It is during a crisis that a nonprofit board often finds that it needs more members, while at the same time, the crisis makes it virtually impossible to recruit new members and heightens the risk that existing members will resign. Resignations may occur, and dealing with them is an issue if multiple resignations put the board at risk of insufficient membership to mount a quorum or otherwise function. That issue is addressed later in this section.

If there is a necessary time for board members to more fully engage, rather than disengage, it is during a financial crisis. The board chair – whose role includes that of board cheerleader – should undertake the following as soon she learns of the scope of the crisis:

- Call a special session of the board, inviting at least the nonprofit's executive director and, if appropriate, chief financial officer to report.
- Determine in advance of the meeting who should be on the special restructuring committee that will be proposed at the meeting, and reach out to those parties in advance of the meeting (if a member does not want to be put in that spot, best to know in advance).
- Draft and circulate an agenda for the meeting that includes the following elements:
    - Purpose of the meeting – Financial Matters
    - Report by the executive director on the issues facing the entity

- Formation of Special Restructuring Committee
    - Members
    - Charter
    - Assignments
- Schedule near term special and general meetings

The board chair should emphasize that this is an opportunity for the board to revisit the entity's role and mission, that the current board members should be energized by this opportunity, and that few things will make them feel as satisfied as if they can pull the entity successfully through the dark of the tunnel and out again into the light.

The crisis may (and likely will) identify that board member whose engagement is only skin-deep (at this point), and there is not much a board chair can do about that. A disengaged director is not someone you want around when the dust settles, and not a director on which much time should be spent when time and resources are precious. Identify and nurture the board members who respond to the call to arms, as their engagement will be redoubled when the entity lives to fight another day.

*Engagement of Professionals to Advise the Board*
The first step that the newly formed restructuring committee should take is to locate and interview professionals to advise the board in connection with the potential restructuring, and to recommend the hires to the board. These should be professionals familiar with principles of insolvency, bankruptcy, and restructuring, but their role will to advise the board generally on these issues. If and when the time comes to retain professionals to take the entity through a bankruptcy filing, the nonprofit itself will retain other professionals to accomplish this goal. The already constituted restructuring committee can be tasked with due diligence in connection with the entity's hire.

If your nonprofit functions in a heavily regulated environment, the board should retain, or at least consult with, attorneys with expertise in that regulated area to advise the board on the impact that insolvency or a bankruptcy filing may have on the entity. In many cases, the heavily regulated nonprofit already has attorneys with subject matter expertise in the regulatory area. These professionals should not be retained by the board – for a number of reasons, the entity should always retain different counsel than the board – but can be tapped with the nonprofit's blessing to make presentations on the relevant regulatory issues to the board.

*Ensuring a Clear Path to Resolution, Consent and Authority*
The entity is embarking on an unusual path. As stated before, this is not business as usual. The board will be faced with a number of decisions that must be well documented and formally approved. It will be involving itself in the operations and finances of the entity to a far greater degree than before. The board chair and board secretary must ensure that the board's internal recordkeeping throughout the crisis is solid and defensible. The board chair should call and conduct board and committee meetings with a renewed focus on protocol. It is not uncommon for board committees to get lax about their internal recordkeeping, particularly minutes. The bylaws may, in fact, require that board committees keep minutes, a requirement that is often ignored. This is the time to reacquaint and reinvest the board in its own governing rules.

*Commitment and Composition*

We talked previously about engagement, and the board chair's role as cheerleader and chief administrative organizer in bringing the board immediately and actively into the process. The board must be vested in the process itself, wherever the process takes it. The board must remain committed to determine the appropriate course and stay with the entity until the course is run. A bankruptcy that, by design, leads to liquidation, wind down and closure is complex and requires the same level of commitment and work as a bankruptcy filed to restructure the nonprofit and keep its mission alive.

Commitment can flourish when the board has the right composition in terms of skill, experience, energy, and means. Unfortunately, nonprofit boards, particularly smaller ones, often struggle to maintain a board composition with the requisite mix of skills sets and experience for the entity's ordinary course existence, much less during a financial/operational crisis.

In tasking "volunteers" to take on yet another assignment – e.g., restructuring committee – the board chair may discover that the board is missing some core competencies. Perhaps it has no accountant, or someone with a similar level of financial expertise (e.g, a banker). Perhaps the board currently has no attorneys – unlikely, but possible. The board will almost assuredly have no one with expertise or prior operational experience in their day jobs with bankruptcy or insolvency.

You are the board chair in this situation. What do you do?

What you do is work with what you have. Convene the board for an initial special meeting, as discussed previously. Poll the members on their experiences in this area, if any. Reinforce the concept that the board's existing role and the duties assigned to existing committees have not changed and must be fulfilled. Determine where you have gaps in expertise and experience and discuss how to fill the gaps. Assign directors to the restructuring committee who are the least likely to glaze over when discussing insolvency and restructuring issues with the board's retained professionals.

*Risks to Board Members*

When an entity finds itself unable to pay its daily obligations and short-term debts – the definition of a liquidity crisis – the board should immediately review the status and scope of the entity's directors and officers liability coverage.

State corporation laws generally offer substantial protections to independent board members and the bar on recovery for suits by creditors and stakeholders against independent directors remains high. Furthermore, the board of a nonprofit is far less likely to be hit with claims asserting breach of the duty of loyalty and similar claims related to self-dealing. Nevertheless, a nonprofit's insolvency invariably brings out the possibility of litigation by creditors and disgruntled stakeholders directed at directors and officers asserting other breaches of fiduciary duty, such as the breach of the duty of care, as well as claims for gross mismanagement and corporate waste, among others.

Unfortunately, when it has a reason to look, the board of a nonprofit may find that its directors and officers coverage is light, if not lapsed (a casualty of heretofore hidden cash flow, operational, and/or management issues). If the coverage appears to be substandard or has lapsed, direct the entity's executive director to immediately engage with its insurance broker to advise on options. Deal with any blame over the lapsed coverage at a later point; the immediate task is to get adequate coverage in place, review the status of past coverage, and determine the extent to which the inadequate or lapsed coverage puts the current board at risk.

There are other risks that may not be insurable. For example, recall the situation discussed previously in which the board discovers that the entity has not paid or reserved payment for certain payroll tax obligations. Under existing law, management and board members may be jointly and severally liable for such taxes if the deficiency is not addressed. Directors should not count on the availability of insurance coverage for that exposure.

*Board Disengagement: What then?*

During a financial crisis, a nonprofit board which has always struggled to find and hold productive board members – a common theme - invariably finds that it needs more members, while at the same time, the crisis makes it virtually impossible to recruit new members and heightens the risk that existing members will resign.

A resignation in this situation exacerbates an already skittish situation. The resigning board member takes away his or her expertise, board experience, resources, and vote. The latter can be critical. If the board is now an even number, the board runs the risk of deadlock on a key vote. Furthermore, if your board is small, the loss of a member increases the risk that a quorum will not be available for a vote at a critical point in the case.

In part due to the risk that board resignations may lead to issues finding a quorum, a nonprofit considering bankruptcy should immediately review its bylaws with an eye toward the following issues:

- Should the quorum requirements be loosened to account for the potential drop out of one or more board members, or to address the issue of disengagement by a sitting board member?
- Should the meeting and notice requirements be modified to ensure sufficient flexibility while in crisis?
- Do the bylaws unduly restrict the entity's ability to create and empower special committees to address the crisis?

The bylaws of a nonprofit with a membership structure present an additional layer of complexity, as they typically require that certain critical issues be addressed through official notice to and duly called meetings and votes by the membership. It is unlikely that the bylaws can be amended, absent membership approval, to allow the board more flexibility going forward in connection with decisions that otherwise require membership notice and approval, and there are constituent relationship risks to attempting to push through such changes in the first place. Better to engage the membership promptly and with candor, using the existing notice and consent protocols. It is critical that the board review, understand and comply with these requirements as it begins to address the concept of restructuring (or liquidation) through bankruptcy.

## Costs of Bankruptcy

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*Filing Fees and Professional Costs*

Bankruptcy is expensive. The bulk of the expense is in the fees and expenses paid to professionals retained by the debtor. The cost is also worth the price of admission, if the goals of a well-planned reorganization are met and the entity emerges from bankruptcy as a reorganized entity with its mission intact.

A nonprofit can often defray much of the cost of bankruptcy by seeking professionals to undertake the work on a pro bono or, at least, reduced fee basis. This is admittedly much easier to accomplish in urban areas where law and accounting firms are large enough to have formal pro bono programs willing and able to assist a struggling nonprofit on its path from struggle to success. Local and state bar associations can be a good resource for locating attorneys and willing to help. When seeking financial expertise – accounting and similar services – look to your local or regional chapter of the Turnaround Management Association, which may have a formal program in place for pairing member firms with nonprofits in need to sophisticated restructuring services. The American Bankruptcy Institute is another potential resource, although its network focuses heavily on consumers (individuals) seeking bankruptcy assistance. Finally, while the Community Law Project does not assist with bankruptcy litigation, the Community Law Project's pro bono attorneys may be able to assist with other legal needs related to an organization's financial distress prior to bankruptcy.

The following sections briefly describe the categories of costs that bankruptcy entails. Some of these costs – the filing fees and periodic statutory fees payable to the government – must be paid by all entities.

The costs of bankruptcy break down into the following categories:

(1) Chapter 7 (Liquidation)

Pre-bankruptcy preparation – costs of professionals hired to advise the company and prepare the bankruptcy petition and bankruptcy schedules listing creditors, contracts, and other pertinent information, and the statement of financial affairs, another substantial document required in bankruptcy cases.

Filing fee – $330 (the current statutory fee for filing a Chapter 7 petition).

Bankruptcy case costs – typically minimal for a nonprofit entity, because the entity is operated and wound down in the bankruptcy by an appointed Chapter 7 trustee, whose costs (including professionals) are paid out of the estate. In a typical case, the debtor entity would not be keeping its bankruptcy counsel busy during the course of the Chapter 7 case.

(2) Chapter 11 (Reorganization, though it can also be used for an orderly liquidation)

Pre-bankruptcy preparation – costs of professionals hired to advise the company and prepare the bankruptcy petition, bankruptcy schedules listing creditors, contracts, and other pertinent information, and the statement of financial affairs, another substantial document required in bankruptcy cases. In addition, in a Chapter 11, a number of substantive pleadings (called "first day motions") that address the entity's continued operation in bankruptcy are typically prepared and filed with the petition. An example is a motion to use cash collateral and obtain post-petition financing, as court approval is required before the debtor can use cash subject to a lien or to obtain additional financing.

Filing fee - $1717 (the current statutory fee for a Chapter 11 petition).

Bankruptcy case costs – substantially higher than the bankruptcy costs of a debtor in Chapter 7. In addition to its ordinary operating expenses, the debtor incurs the ongoing costs of its professionals (attorneys, accountants, and perhaps others) hired for the case, quarterly fees payable to the Office of the United States Trustee (an arm of the Department of Justice that oversees bankruptcy cases), and, if the case is large enough, the costs of professionals retained by an official committee of unsecured creditors appointed by the United States Trustee to represent the general interests of all creditors in the case. At a minimum, anticipate that a Chapter 11 case will cost the entity no less than $100,000 in legal and accounting fees (assuming that pro bono professionals cannot be found), for a small reorganization involving few if any hiccups along the path from petition to confirmation of a Chapter 11 plan of reorganization.

*Other Costs and Burdens of Administration of the Case*

A Chapter 11 debtor has significant ongoing reporting obligations. A debtor is required to file monthly operating reports – essentially, detailed reports of revenue, disbursements, and cash holdings. The books are opened to the public in bankruptcy. To some degree, the entity can leverage its existing monthly internal reporting – this is not reinventing the wheel – but there is an accepted format for the reports filed in bankruptcy cases to which the entity should adhere. Failure to promptly and consistently file these operating reports – staying no more than 2 months behind the close of each month – will lead to objection by the United States Trustee and, potentially, a motion to dismiss the case for failure to adhere to the reporting requirements. In addition, within 30 days of the close of each calendar quarter, a Chapter 11 debtor must file a quarterly summary report of that quarter's income and disbursements, and pay an administrative fee to the United States government based on that quarter's disbursements, on a sliding scale. The base amount payable is $325 per quarter, for every quarter the entity remains in bankruptcy. The costs can rise in to the thousands per quarter, however, if the entity's disbursements for that quarter are significant. Under the Bankruptcy Code, all disbursements are considered as part of the formula, including tax payments, payments to secured lenders and to the professionals hired to work in the case.

Other costs of bankruptcy include the potential cost of funding the fees and expenses of a committee of unsecured creditors appointed by the United States Trustee to represent the interests of creditors generally. Although Section 1102 of the Bankruptcy Code provides that the appointment of a committee is mandatory in Chapter 11 cases, as a rule, such appointments are made only in cases large enough to have a significant body of unsecured creditors, and requires a minimum of three such creditors willing to serve on the committee. If a committee is appointed, the committee is entitled to retain counsel and other professionals to assist it in its duties, and payment of those professionals is the responsibility of the bankruptcy estate rather than the creditors serving on the committee. In larger cases, a creditor's committee can play a very active role, and its professionals can incur significant fees and costs as a result.

## Understanding Bankruptcy Concepts

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The purpose of this section is to introduce you to some key fundamentals of bankruptcy law that will help you understand the latter sections and chapters in this Guide. By the end of this section, you should understand the basics regarding commencing a bankruptcy case, property of the bankruptcy estate, how a creditor's "claim" is defined, the "automatic stay," and other important bankruptcy concepts.

*Commencing a Bankruptcy Case*

The most fundamental questions of bankruptcy law relate to whom, when, and how a person or entity can commence a bankruptcy case. This section will answer those questions and address the related issues. Even before those questions can be answered, however, it is important to understand the different types of bankruptcy.

Bankruptcy law in the United States is governed by Title 11 of the United States Code, which is commonly referred to as the "Bankruptcy Code" or simply the "Code." The Bankruptcy Code is further divided into nine "chapters." The first three chapters—1, 3, and 5—contain general provisions that apply, with exceptions here and there, to the "substantive" chapters: Chapter 7 (liquidation), Chapter 9 (adjustment of debts for a municipality), Chapter 11 (reorganization), Chapter 12 (adjustment of debts of a family farmer or family fisherman), Chapter 13 (adjustment of debts of an individual), and Chapter 15 (ancillary and cross-border cases). These substantive chapters provide the Code's heavy lifting—they govern the "type" of bankruptcy case. Of these, only Chapter 7 and Chapter 11 are potentially relevant to distressed nonprofit organizations.

Although they will be discussed in more detail later in this Guide, it's important to understand the basics of these two chapters. Chapter 7, which is available to both individuals and businesses, dictates the procedures for a liquidation of a debtor's assets to satisfy creditors' claims. Fundamentally, the goal in any Chapter 7 case is to collect all of a debtor's assets (with certain exceptions for individuals), monetize those assets, and then distribute the proceeds to the debtor's creditors. Chapter 11, on the other hand, contemplates reorganization or restructuring of a debtor's financial affairs. Unlike Chapter 7, after which a business debtor ceases to continue operations, a Chapter 11 debtor emerges from the bankruptcy process as an "on-going concern." As discussed later, this fundamental difference between Chapter 7 and Chapter 11 gives rise to drastically different rules and procedures while in bankruptcy. At the outset, however, cases under either chapter start the same way: a petition for bankruptcy relief is filed.

Under the Bankruptcy Code, either a debtor or a debtor's creditors can file a bankruptcy petition. If the former, then the case is referred to as a "voluntary" one; if the latter, then it is an "involuntary" case. Significantly, an involuntary case cannot be commenced against a "corporation that is not a moneyed, business, or commercial corporation." As such, nonprofit organizations are not subject to involuntary bankruptcies—these organizations can only enter bankruptcy willingly. This Guide, therefore, only addresses voluntary cases.

Once a debtor files a voluntary petition, the "order for relief" is entered. This seemingly ministerial event gives rise to significant substantive ramifications by erecting a wall between the debtor's pre- and post-petition financial affairs. For example, in a Chapter 7 case, only debts that arose prior to entry of the order for relief can be discharged. Similarly, in a Chapter 11 case, debts incurred after the order for relief is entered are entitled to "administrative priority" claim, which enables a creditor with that type of claim to payment ahead of general unsecured creditors.

The answer to when a person or entity can commence a bankruptcy case is surprisingly simple: at any time, subject to certain exceptions related to serial filings that are not relevant here. Most importantly, the Bankruptcy Code does not impose affirmative requirements on prospective debtors. Indeed, no showing of insolvency is required nor showing of financial troubles or the necessity of the relief sought. Bankruptcy law policy in the United States, since at least 1898, has favored open access to the bankruptcy system.

As noted above, a debtor must file a "petition" to access the bankruptcy system. The petition itself, which must conform to Official Form 1, is straightforward and easy to complete. In addition to general, biographical information about the debtor, Official Form 1 contains several check boxes that present questions like: "type of debtor" (e.g., individual, corporation, etc.); "nature of business" (e.g., health care business, railroad, stockbroker, etc.); nature of debts (e.g., consumer debts versus business debts); and several others. A debtor must also submit a filing fee with the petition, and that fee is governed by 28 U.S.C. section 1930(a). That's it—indeed, the act of filing for bankruptcy relief is quite simple.

In sum, the answers to the questions posed at the outset of this section are:

- Who may commence a bankruptcy case? A debtor or its creditors, but in the case of a nonprofit organization only the organization can commence the case.

- When may a debtor commence a bankruptcy case? At any time—the Bankruptcy Code does not impose an affirmative insolvency requirement or initial showing of financial distress.

- How may a debtor commence a bankruptcy case? A debtor can commence a bankruptcy case by filing a petition, using Official Form 1, and by paying the required filing fee.

*Property of the Estate*
Once a debtor commences a bankruptcy case several important events occur, including the creation of an "estate." This bankruptcy estate contains all of the "legal and equitable interests of the debtor in property as of the commencement of the case." To understand this concept, it might be helpful to think of a fenced off open field into which all of a debtor's property is dumped. For example, immediately after filing a bankruptcy petition, all of the debtor's cash is transferred to our hypothetical open field. The same is true regarding any tangible personal or real property. At some point, the open field analogy breaks down because, as noted above, the Bankruptcy Code's concept of the bankruptcy estate also includes intangible property and property in which the debtor only has an "interest."

For some debtors, their intangible assets may be more valuable than their tangible ones. For example, a debtor may have a significant amount of accounts receivable outstanding as of the petition date. Although the debtor may not have collected on these accounts, they will be brought within the estate because the debtor has a contractual right to receive amounts that are or will become due and owing under the debtor's contracts. Similarly, a debtor may have commenced a lawsuit to recover damages, say for breach of contract, prior to filing bankruptcy. The debtor's right to collect those damages, if successful in the lawsuit, will also inure to the benefit of the estate.

Indeed, the Bankruptcy Code's definition of the estate is meant to be—and courts interpret it to be—as broad as possible. The rationale is simple: in order to effectively deal with the debtor's pre-petition financial affairs, the bankruptcy court must take constructive control of all of the debtor's assets that can be used to generate value for payment to creditors. Thus, when faced with questions regarding the corpus of the bankruptcy estate, the best rule of thumb is to consider whether: (a) the debtor has any legal or equitable interest in the subject property; and (b) whether the subject property can be used to satisfy payments to creditors. Of course, issues related to property of a bankruptcy estate can be hotly contested and there is a vast amount of case law interpreting Section 541 of the Bankruptcy Code. Accordingly, it is wise to seek assistance from a bankruptcy lawyer if thorny issues related to the bankruptcy estate arise.

All that said, a nonprofit organization generally would have a limited universe of property. Most commonly, a nonprofit debtor's estate will likely be made up of cash, real property, and personal property.

*"Claims" Under the Bankruptcy Code*
Now that you have a basic understanding of what makes up the property of a debtor's estate, it is important to understand the corollary to the estate: the pool of creditors' demands on estate property. Just like it defines estate property as broadly as possible, the Bankruptcy Code defines the term "claim" broadly, including any "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, mature, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured."

The purpose behind this broad definition is the fundamental goal of bankruptcy law to, once and for all, resolve a debtor's pre-bankruptcy financial affairs.

*The Automatic Stay*
Fundamentally, bankruptcy law is designed to collect all of a debtor's valuable assets, monetize those assets or restructure the debt associated with the assets, and then distribute proceeds to creditors or provide a mechanism for satisfaction of creditors' claims. In many ways, bankruptcy law is a complex procedural apparatus for the orderly payment of a debtor's debts. The alternative to a uniform bankruptcy law is a "race to the courthouse." That is, creditors would race to obtain judgments against the debtor and pick off, piece by piece, the debtor's assets to satisfy their claims. Of course, this alternative rewards speed and able navigation of state-law collection remedies—and it does not allow for an equitable, fair distribution of the debtor's assets to all creditors. In order to protect a debtor's assets from attack by its creditors, the Bankruptcy Code contains a powerful injunction against collection actions against a debtor in bankruptcy: the "automatic stay."

As its name implies, the automatic stay is self-effectuating and arises as soon as a debtor files a petition. Additionally, the automatic stay is effective against the entire world without the necessity of serving notice of the stay. Indeed, the existence of the automatic stay—and protections it provides—often delivers the reason for filing a bankruptcy petition. For example, a debtor facing an imminent foreclosure files a bankruptcy petition to avoid eviction; a debtor whose bank accounts are about to be swept files a petition to hold onto its remaining cash; or a debtor embroiled in taxing litigation files a petition to prevent imposition of a costly judgment.

Although broad and seemingly all-powerful, the Bankruptcy Code does place limitations upon the automatic stay.

Specifically, the Code first lists eight exclusive actions that are stayed:

1. The commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the bankruptcy petition;
2. The enforcement, against the debtor or against property of the estate, of a judgment obtained before the bankruptcy petition;
3. Any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;
4. Any act to create, perfect, or enforce any lien against property of the estate;
5. Any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the bankruptcy petition;
6. Any act to collect, assess, or recover a claim against the debtor that arose before the bankruptcy petition;
7. The setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor; and
8. The commencement or continuation of a proceeding before the United States Tax Court concerning a tax liability of a debtor that is a corporation for a taxable period the bankruptcy court may determine or concerning the tax liability of a debtor who is an individual for a taxable period ending before the bankruptcy petition.

Next, the Bankruptcy Code lists a number of actions that are not stayed, or put on hold, by the automatic stay. By and large, these exemptions have their roots in public policy and most would not apply to a nonprofit organization as debtor. (For example, the automatic stay does not prevent the commencement or continuation of a criminal proceeding against the debtor. And the automatic stay does not stay an action against the debtor regarding the debtor's obligations to pay domestic support obligations.) There are a number of other exceptions to the stay, and the exceptions generally arise from congressional decisions to allow actions against a debtor in bankruptcy because the alternative would allow a debtor to unfairly evade the law.

Despite its breadth and scope, including the limited exceptions mentioned above, the automatic stay is limited. First, the stay is limited in time. Second, it is limited because the bankruptcy court can terminate or modify the stay.

Bankruptcy Code Section 362(c) establishes temporal limits on the stay. Specifically, the stay will terminate if and when the debtor's bankruptcy case is closed, dismissed, or (in the case of an individual debtor, rather than a business) the debtor's discharge is either granted or denied. Additionally, with respect to specific property, the stay terminates when property is transferred out of the debtor's bankruptcy estate. For example, if property is abandoned by a debtor, then the stay ceases to apply to the abandoned property. This rule makes sense: if property is valueless or not able to be used to satisfy creditors' claims, the purpose behind the stay ceases to exist.

In addition to the exceptions to and limitations on the automatic stay, the bankruptcy court can grant "relief" from the automatic stay. The Bankruptcy Code provides that a bankruptcy court may terminate, annul, modify, or condition the automatic stay under specific circumstances. Most commonly, relief from the stay is granted: (a) "for cause, including the lack of adequate protection of an interest in property"; and (b) if the party seeking relief from the stay is seeking to obtain control over or possession of certain property, and if the debtor does not have equity in such property, which is not necessary to effectuate a reorganization. As to the former, the term "cause" is not defined. Nevertheless, courts generally evaluate whether specific property, to which the creditor moving for relief has specific recourse, is declining in value on account of the bankruptcy case. If so, a court may determine that cause exists, and thus allow the moving party to recover its specific property. Relatedly, if a party has a specific claim to a piece of the debtor's property, and that property is not necessary to the debtor's reorganization, then the court is authorized to permit that party to recover its property.

The automatic stay, therefore, provides significant protection and leverage to a debtor in bankruptcy. It does, however, have certain limits. As with most things in bankruptcy, automatic stay issues can become very complicated very quickly.

*Parties in Interest in a Bankruptcy Case*

Armed with the knowledge of how to commence a bankruptcy case and an understanding of the property of the estate and the automatic stay, a prospective debtor must next understand the players and the roles they play in a bankruptcy case.

(1) Pre-bankruptcy Preparation

Costs of professionals hired to advise the company and prepare the bankruptcy petition and bankruptcy schedules listing creditors, contracts, and other pertinent information, and the statement of financial affairs, another substantial document required in bankruptcy cases.

(2) The Trustee or Debtor In Possession

As discussed above, the world changes upon the filing of a petition for bankruptcy relief. In the case of a Chapter 7 bankruptcy, a trustee is immediately appointed to safeguard the debtor's estate. This person, usually a bankruptcy lawyer, will oversee the maximization and liquidation of the estate. Chapter 11 is a bit different. In Chapter 11, there is a presumption that a business debtor's management will continue to operate and control the business. In this manner, the "debtor in possession" supplants and fulfills the role of a trustee. Sometimes, even in Chapter 11, a bankruptcy court will appoint a trustee if the debtor's management is unwilling or incapable of successfully running the business.

(3) The United States Trustee

Most federal judicial districts throughout the United States participate in the United States Trustee Program. That program—a component of the U.S. Department of Justice—seeks to promote efficiency and the integrity of the bankruptcy system. In essence, the United States Trustees in each judicial district serve in a watch-dog capacity to ensure that parties to a bankruptcy proceeding comply with applicable law and procedural rules.

(4) Official Committees of Creditors

The Bankruptcy Code provides for the creation and appointment of official committees of creditors in Chapter 11 cases. The general theory behind this provision is that, while a single creditor may not have the resources or incentive to actively participate in a bankruptcy case, a group of creditors who band together will be able to protect and advance the interests of all creditors similarly situated—in essence, what's good for the goose is good for the gander. The Bankruptcy Code empowers official committees by enabling them to: (a) actively participate in a debtor's bankruptcy case; (b) retain counsel—usually at the expense of the debtor's estate; (c) conduct investigations into the debtor's prepetition financial affairs; and (d) participate in the formulation of a Chapter 11 plan. As suggested above, official committees of creditors are not appointed in cases under Chapter 7.

(5) Parties in Interests

The Bankruptcy Code provides broad standing for any party in interest to "appear and be heard" in any Chapter 11 case. While the provision does have its limitations, the Bankruptcy Code's aim—consistent with the notion that bankruptcy is primarily a procedural mechanism—is to allow maximum participation by a party that could suffer an adverse economic impact as a result of a proceeding within a bankruptcy case.

*Executory Contracts and Unexpired Leases*

The next important concept to understand is the treatment of "executory" contracts and unexpired leases of the debtor. To fully grasp this area of bankruptcy law, it is important to recall that a fundamental tenant of bankruptcy law is the maximization of value for the debtor's estate.

For most business debtors, considerable value is tied up in contractual relationships with other parties. For instance, a debtor may be party to a contract under which the non-debtor counterparty is obliged to pay the debtor in exchange for the debtor's services or products. Conversely, a debtor may be obliged to pay a vendor for its services rendered or products delivered to the debtor. Indeed, these simple examples form the building blocks for nearly all economic activity in the United States. Of course, things change when a debtor enters bankruptcy.

Before delving into the specific changes to contractual relationships after a bankruptcy filing by one of the parties, it is important to understand the term "executory contract." The term is not defined in the Bankruptcy Code—and yet the term is used extensively in the Bankruptcy Code. Accordingly, bankruptcy courts have developed their own understanding of the term. By and large, most bankruptcy courts follow the "Countryman test," which is derived from a law article written by Professor Vern Countryman.

Under the Countryman test, a contract is "executory" if the parties to the contract still owe obligations under the contract that, if not performed, would give rise to a claim for material breach of the contract.

Here is an explanation by way of examples:

- John agrees to mow Sam's entire lawn, and Sam agrees to pay John $20 in exchange—$10 before John mows the lawn and the remaining $10 once he has finished. Assume that Sam pays John the initial $10 and John begins to mow Sam's lawn. Half-way through, however, John decides that he can no longer tolerate the smell of fresh-cut grass, and he walks off the job. At that moment, Sam could sue John for material breach of their agreement.

- Same facts as above, except Sam pays John the entire $20 before John starts the job. Here, the Sam has fully performed his end of the contract—all that remains is for John to perform his end. Of course, Sam could sue John for material breach. But John could not sue Sam, because Sam has fully performed.

- Now, keeping in mind the principals of bankruptcy law, assume in the first example that Sam files bankruptcy immediately after paying the first $10 installment and before John begins the job. At that point, the contract would be "executory" because both parties still owe each other obligations under the agreement. To preserve value for Sam's estate, bankruptcy law imposes changes on the parties' contractual relationship.

First, assume that John—notwithstanding Sam's bankruptcy filing—mows the entire lawn and then makes a demand on Sam for payment of the remaining $10. Here, John's demand for payment would violate the automatic stay. Thus, John is precluded from seeking payment from Sam because it could deplete Sam's bankruptcy estate.

Second, the Bankruptcy Code provides several options to a debtor regarding executory contracts. The debtor can "assume" the contract, thus obligating the postpetition entity to perform under the agreement. Debtors chose this option for various reasons, but do so primarily when the benefits to the debtor are important or necessary to the debtor's business. Conversely, the debtor can "reject" the contract. This action is akin to affirmatively breaching the agreement. Under this option, the non-debtor counter party is no longer obligated to perform and is entitled to assert a general unsecured claim against the debtor's estate for damages it has suffered. A debtor may also "assign" its rights under a contract. By choosing to assign rights under a contract, a debtor may be able to more efficiently monetize a contract.

The above discussion has focused on executory contracts, but the analysis and rationale is the same for a debtor's unexpired leases. Like many things in bankruptcy, the nuances and intricacies of executory contract and unexpired lease law are limitless. Generally, however, a party can predict the outcome of any dispute by determining what will benefit the debtor's estate and pursuing that goal.

*Avoidance Actions*

Keeping with the "maximization of value" theme, the Bankruptcy Code gives a debtor two powerful weapons—fraudulent transfer actions and preference actions—to "avoid" certain transfers of the debtor's property made prior to the bankruptcy petition. In common parlance, bankruptcy professionals refer to these weapons as "avoidance actions" because the result is generally the same for both types: a prepetition transfer of the debtor's property to a third party is avoided—i.e., annulled—such that the property or its value is returned to the debtor's estate.

The first type of avoidance action—a fraudulent transfer action—can take one of two forms under the Bankruptcy Code. First, a debtor or trustee can assert a fraudulent transfer action against a third party where the debtor or trustee can show that the transfer was effectuated with the actual intent to hinder or defraud the debtor's creditors. For example, a business debtor's management team—just before a bankruptcy filing—authorizes payment of non-standard bonuses to the company's executives. If the elements of a fraudulent transfer are satisfied, the Bankruptcy Code allows the postpetition debtor or trustee to recover the bonus payments because the money should be used to pay creditors—not gratuitous payments to executives.

In addition to a fraudulent transfer action based on actual fraud, the Bankruptcy Code provides a cause of action for "constructive fraud." Constructive fraud is shown when a transfer is made from the prepetition debtor to a third party, and in return for the transfer the third party gives less than "reasonably equivalent value" for the transferred property. For example, a debtor transfers title to real property worth $1 million to a third party the day before the debtor files bankruptcy, and the third party pays $500 for the property. Again, the purpose behind this rule is clear: bankruptcy seeks to maximize the value of the debtor's property so that creditors can recover as much as possible.

The second type of avoidance action—a preference action—is built upon the same rationale; however, for a preference action, the law is not concerned about the motivation behind the transfer. Instead, under preference law, a postpetition debtor or trustee may avoid any transfer of estate property made to or for the benefit of a creditor within 90 days prior to the bankruptcy filing, when the transfer would allow a creditor to recover more than it would recover under a hypothetical liquidation of the debtor's assets. Basically, preference law can be summed up as a rule against allowing a creditor to skip ahead of other creditors—that is, the Bankruptcy Code does not allow a debtor to "prefer" one, favored creditor above others.

In sum, avoidance actions give a postpetition debtor or trustee other options for maximizing the value of property available for distribution to creditors. As you might expect, fraudulent transfer and preference actions are hotly contested—indeed, no one likes to give up money—and the Bankruptcy Code does provide for specific defenses to avoidance actions. Nevertheless, avoidance actions should and do scare most creditors.

*Federal Rules of Bankruptcy Procedure*

By way of brief mention, it is important to note that, in addition to the Bankruptcy Code, the bankruptcy process is governed by the Federal Rules of Bankruptcy Procedure. These rules, as their name gives away, govern the nuts and bolts of bankruptcy cases. For example, Bankruptcy Rule 2002 governs the types of notices that must be provided throughout a bankruptcy case. In fact, a fair number of the Bankruptcy Rules address things like notice to creditors, the mechanics of filing a claim, certain duties to be performed by the bankruptcy court clerk, and other administrative and procedural issues.

*Conclusion*

As you can tell, bankruptcy law is complex. Nevertheless, the topics and principals discussed above are basic themes that underpin most of the complexity. Once you have a firm understanding of these basics, you will be able to understand the more advanced topics covered in the next sections of this Guide.

# Chapter 2 – Petitioning for Bankruptcy

## Chapter 7 Liquidation

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The current Bankruptcy Code, codified at 11 U.S.C. section 101 et seq. (the "Code"), was enacted in 1978 and is divided into nine Chapters, eight odd-numbered and one even-numbered. While the provisions of Chapters 1, 3 and 5 apply to all bankruptcy cases, they do not offer a Debtor any form of substantive bankruptcy relief. Only Chapters 7, 9 (for municipalities), 11, 12 (family farmers), 13 (wage earners), and 15 (international ancillary proceedings) offer substantive bankruptcy relief to a Debtor. As the parentheticals in the prior sentence show, many of those Chapters are wholly irrelevant to nonprofit entities.

This part of the Guide will discuss Chapter 7, which is a liquidation proceeding available to business entities as well as individuals. In a Chapter 7 proceeding, all of the Debtor's non-exempt assets are accumulated by the bankruptcy trustee and sold or otherwise reduced to cash. In simple terms, exempt assets are assets that an individual Debtor is allowed to retain, free from the claims of creditors who do not have liens on the property.

For instance, the Bankruptcy Code allows an individual Debtor to exempt up to $3,675 in the value of a motor vehicle. Assume that a Debtor owns a car free and clear of any liens of creditors. If the Debtor's car is worth less than $3,675, the Chapter 7 trustee may not sell the car. If the car is worth more than $3,675, the trustee may sell it, but would have to pay the Debtor the value of his $3,675 exemption from the sale proceeds. Exemptions generally are irrelevant to nonprofit bankruptcies, as they apply only in bankruptcy cases filed by individuals.

The Debtor's assets are liquidated, with the net proceeds (that is, after satisfying secured claims, paying the costs of administration, and recognizing statutory exemptions afforded individuals) distributed among the Debtor's creditors that filed proofs of claim. Chapter 7 relief is available to any: (i) individual; (ii) partnership; or (iii) corporation, except for railroads, insurance companies, banks, savings and loan associations, credit unions, or other similar institutions which are insured under the Federal Deposit Insurance Act.

*Commencement of the Bankruptcy Case*

A bankruptcy case is commenced by the filing of a petition with the Bankruptcy Court. The petition must clearly indicate under which Chapter of the Code the case is to proceed. If the Debtor files the petition, the case is considered "voluntary" and the filing of the petition serves as the "order for relief." Section 303 permits creditors to file an "involuntary" bankruptcy proceeding against certain entities. An involuntary bankruptcy is a bankruptcy case that is filed by creditors, and not by the person or business who owes the debts to those creditors. Involuntary bankruptcies are rare. They are usually filed against businesses. Bankruptcy Code Section 303(a) expressly prohibits the filing of an involuntary bankruptcy proceeding against a nonprofit corporation. Additionally, Section 1112(c) provides that in the event a nonprofit corporation files a Chapter 11 bankruptcy petition, the bankruptcy case cannot be converted to a Chapter 7 liquidation case unless the nonprofit corporation debtor requests such conversion.

In addition to the bankruptcy petition, all Debtors are required to submit to the court various lists and schedules, including: (i) a list of all creditors; (ii) a schedule of assets and liabilities; (iii) a schedule of current income and expenditures; (iv) a statement of financial affairs; (v) copies of payments received within 60 days before the date of the filing from any employer of the Debtor; (vi) a statement of monthly net income; (vii) a statement disclosing expectation of increased income or expenditures for the year following the filing of the bankruptcy; and (viii) a statement of executory contracts and unexpired leases. An experienced bankruptcy attorney will be able to advise a nonprofit business on how to correctly fill out and file these forms with the Bankruptcy Court.

*Parties To a Bankruptcy Proceeding*

<u>The United States Trustee</u>

The Attorney General of the United States appoints one United States Trustee to serve in each of 21 statutorily-defined regions. The primary purposes of the United States Trustees are to assist the Bankruptcy Courts of the region in the efficient administration of bankruptcy cases, and to police fraud and dishonesty in the bankruptcy arena. The United States Trustee's duties include: (i) establishing, maintaining, and supervising a panel of private trustees eligible and available to serve in Chapter 7 cases; (ii) appointing an interim trustee from that panel to serve in a Chapter 7 case until the 341 Meeting; (iii) serving as trustee in cases under Chapters 7, 11, and 13 when so required by the Code; (iv) supervising the administration of bankruptcy cases and the individual trustees serving in those cases; and (v) convening and presiding over the first general meeting of creditors, pursuant to Section 341 (the "341 Meeting"). The United States Trustee has standing to raise, appear, and be heard on any issue in any case or proceeding under any Chapter of the Code.

With limited exceptions, a 341 Meeting must be held in every Chapter 7 and 11 bankruptcy case. The meeting must be held between 20 and 40 days after the order for relief is entered in a Chapter 7 or Chapter 11 case. The United States Trustee may convene the meeting anywhere in the district that is convenient for the parties in interest. The primary purpose of the 341 Meeting is to examine the Debtor and/or the Debtor's controlling persons, under oath, regarding the Debtor's history, financial situation, assets, and liabilities. At the 341 Meeting, the creditors also decide whether to elect a trustee to replace the interim trustee initially appointed by the United States Trustee. The bankruptcy judge may not attend the 341 Meeting.

<u>The Chapter 7 Bankruptcy Trustee</u>

Chapter 7 requires that a trustee oversee the Debtor's affairs and administer the case. The United States Trustee appoints an interim trustee, normally at random, when the case is filed. If the creditors do not elect a trustee, the interim trustee becomes the permanent trustee for the case. At the 341 Meeting in a Chapter 7 case, the creditors decide whether to elect a trustee for the case to replace the interim trustee named by the United States Trustee. The individual selected to act as trustee must be competent, must meet residency requirements, and must post a bond in an amount determined by the United States Trustee. Only the Debtor's unsecured creditors may vote to replace the interim trustee and select a different person as permanent trustee.

The duties of a Chapter 7 trustee are described in Section 704. Those duties include: (i) collecting and liquidating the property of the estate, distributing it according to the scheme provided by the Code, and closing the case; (ii) investigating the financial affairs of the Debtor; (iii) examining proofs of claim and objecting to the allowance of claims, where appropriate; (iv) assuming or rejecting executory contracts of the Debtor; (v) pursuing preference, fraudulent conveyance or other avoidance actions; (vi) continuing to perform the obligations of the administrator of an employee benefit plan, if the Debtor served as such an administrator; and (vii) if Debtor is a health care business that is being closed, using reasonable and best efforts to transfer patients to a facility in the vicinity providing substantially similar services at a reasonable quality of care. Section 704 also provides that if the trustee operates the Debtor's business, the trustee must provide certain information concerning that operation to the court, to the United States Trustee, and to governmental taxing authorities. In all Chapter 7 cases, the trustee must file a final report and a final account of the administration of the estate with the court and with the United States Trustee. These reports will provide the Bankruptcy Court with an overview of the liquidation and disposition of the Debtor's assets, as well as the proposed cash distributions, if any, to eligible creditors.

Generally a Chapter 7 trustee will not operate a Debtor's pre-petition business during the bankruptcy proceeding. There are a number of reasons for this. Primarily, the Debtor's bankruptcy estate may not contain sufficient funds to operate the business. Moreover, the purpose of Chapter 7 is to liquidate the Debtor's assets to cash for distribution to creditors, not to reorganize the Debtor's business so that it will emerge from the bankruptcy proceeding as a going concern. With respect to small nonprofit businesses, it is not uncommon that strained finances will have forced the business to terminate employees and shut down business operations in the weeks or days before the filing of the bankruptcy petition. In such cases, there is no business to operate in Chapter 7.

The trustee may determine that running the Debtor's business operations for a limited period of time during the bankruptcy case is in the best interest of the Debtor's creditors. This may occur if it is determined that the continued operation of the business would increase the sale price of the business to a third party during the bankruptcy proceedings. If the trustee determines that continued operation of the Debtor's business for a limited period of time during the bankruptcy case is in the best interest of creditors, the trustee must file a motion seeking the Bankruptcy Court's authorization to run the business. A Chapter 7 trustee is extremely unlikely to seek Court authorization to operate a nonprofit business during the bankruptcy proceedings.

The Chapter 7 trustee is compensated by a formula set forth in Section 326(a). Imprecisely, that compensation is 5% of the first million dollars disbursed to creditors, and 3% of the balance.

<u>Estate Professionals</u>
Bankruptcy Code Section 327 requires prior Court approval for the trustee's employment of any "professional person." The term professional is not defined in the Code. Professionals include, but are not limited to, attorneys, accountants, appraisers, auctioneers, consultants, investment bankers, and real estate brokers. Professionals are compensated with funds from the Debtor's estate. The professionals' fees become administrative expenses of the bankruptcy estate, which are paid before distributions are made to Debtor's pre-petition general unsecured creditors.

Compensation and reimbursement of professional persons may be approved only after notice to all parties in interest (including the United States Trustee) and a hearing. Each professional must file and present a fee application, which is a detailed listing of all of the services the professional provided to the estate. The Bankruptcy Court, after reviewing the fee application, will award reasonable compensation for actual, necessary services rendered to the estate by the professional person and reimbursement for the actual, necessary expenses incurred by the professional person. Section 330(a)(3) sets out a non-exclusive list of factors for the Court to consider in awarding compensation. These factors include: (i) the total time spent; (ii) the reasonableness of the time spent given the complexity, importance, and nature of the tasks addressed; (iii) the rates charged; (iv) the necessity of the services to the administration of the case; (v) the compensation customarily charged by comparably-skilled professionals in non-bankruptcy cases; and (vi) whether the professional is board certified or has otherwise demonstrated skill and experience in bankruptcy practice.

The Court may not allow compensation for unnecessary duplication of services, services that were not reasonably likely to benefit the estate, or were not necessary to the administration of the case. Failure to obtain judicial approval of the professional's retention may result in the denial of the professional's request for fees.

<u>Committees</u>
After the commencement of a bankruptcy case, Section 521 mandates that the Debtor file a list of all of its creditors.

Creditors' committees are optional, and exceedingly rare, in a Chapter 7 case. Such a committee is chosen at the 341 Meeting by the unsecured creditors who are qualified to vote for a trustee. The committee may have a minimum of three and a maximum of 11 members. In a Chapter 7 case, the committee's powers are limited to consulting with the trustee or the United States Trustee on the administration of the case. A Chapter 7 committee may not employ professionals at the estate's expense. Committee members are not compensated for their services.

*Avoiding Powers*
The Code allows a Chapter 7 trustee to "avoid" certain transfers even if they were or would have been valid under state law. Any transaction that the Chapter 7 trustee avoids or any property that the Chapter 7 trustee recovers is preserved for the benefit of the bankruptcy estate. The avoiding powers are codified in Bankruptcy Code Sections 542-553.

The trustee's "Strong Arm" power, codified in Section 544, is one of the trustee's most important tools in a Chapter 7 bankruptcy case. The "Strong Arm" power provides that transfers of the Debtor's assets or interests in the Debtor's property that are unperfected at the time the petition is filed are generally not effective against the Debtor's estate or its creditors. As such, Section 544(a) gives the Chapter 7 trustee the power to invalidate certain transfers of the Debtor's property. If a lien creditor or bona fide purchaser of real property, assuming one existed, could avoid a Debtor's prepetition transfer of assets under state law, the Chapter 7 trustee also can. The most common use of the "hypothetical lien creditor" power is to invalidate security interests that were not properly perfected as of the date of the filing of the bankruptcy petition.

Invalidating improperly perfected security interests frees up assets for liquidation and distribution to general unsecured creditors.

Section 544(b) allows the Chapter 7 trustee to pursue, against a transferee of the Debtor's property, remedies that any unsecured creditor could have pursued if bankruptcy had not intervened. The practical consequence is that it incorporates state fraudulent transfer law, under which the "reach back" period may be greater than the two-year "reach back" of Section 548 (for example, under Illinois state fraudulent transfer law, the reach-back period is generally 4 years). Applicable state limitations periods govern, in addition to a separate limitation period set forth in Section 546.

In furtherance of the Code's goal of equality of treatment among similarly-situated creditors, Section 547 empowers a Chapter 7 trustee to avoid a "preferential" prepetition transfer of the Debtor's property, and the property or interest transferred may be recovered for the benefit of the estate. In order to prove that a transfer was an avoidable preference, the Debtor or trustee must demonstrate that: (i) a transfer of the Debtor's property occurred; (ii) the transfer was to or for the benefit of a creditor; (iii) the transfer was for, or on account of, an antecedent (i.e., pre-existing) debt; (iv) the transfer occurred while the Debtor was insolvent; (v) the transfer occurred: (1) within 90 days prior to the date of the filing of the bankruptcy petition, or, (2) if the transferee is an "insider" (as defined at Section 101(31)), the transfer was made within 1 year prior to the filing of the petition; and (vi) the transfer resulted in the creditor's receiving more than it would have received in a Chapter 7 liquidation had the transfer not been made. The requirement that the Debtor be insolvent when the transfer occurred is simplified by application of a statutory presumption. Section 547(f) provides for a rebuttable presumption that the Debtor was insolvent for the 90 days immediately preceding the filing of the bankruptcy petition.

To illustrate this point, imagine a nonprofit business that operates a telephone hotline as part of its charitable services. Because fund raising has substantially decreased in the past year, the business is in financial distress, and cannot pay all of its bills. In the 90-day period before the business filed bankruptcy, the business paid its telephone bills because maintaining its telephone hotline was vital to its charitable mission. The nonprofit business did not pay any of its other creditors during that same time period. Once the nonprofit business files for Chapter 7 bankruptcy, the trustee would seek to recover the amount of the payments made to the telephone company within the 90-day period before the bankruptcy case was filed.

Within the 90-day period, the telephone company (i) received transfers of the Debtor's property (payment on the telephone bills); (ii) the transfers were to or for the benefit of a creditor (the bill payments benefitted the telephone company); (iii) the transfers were for, or on account of, an antecedent debt (the transfers paid the telephone bills, which were pre-existing debts); and (iv) the transfers resulted in the creditor receiving more than it would have received in a Chapter 7 liquidation had the transfers not been made (telephone company received 100% of the money owed to it in the 90 days before the bankruptcy case was filed, it is extremely unlikely that telephone company would have received 100% of its claim during the Chapter 7 bankruptcy case). The trustee will receive the benefit of the presumption that the Debtor was insolvent for the 90 days immediately preceding the filing of the bankruptcy petition. Consequently, the payments to the telephone company are avoidable preferences. This simplified example ignores defenses that the phone company would raise, like ordinary course and new value.

Bankruptcy Code Section 548 enables a Chapter 7 trustee to recover fraudulent transfers that have occurred within two years prior to the filing of the bankruptcy petition. Section 548 is modeled after the Uniform Fraudulent Conveyance Act and contains various grounds for avoiding fraudulent transfers. The trustee may avoid transfers that the Debtor made with actual fraud under Section 548(a)(1). An actual fraudulent conveyance exists where the trustee can demonstrate that the Debtor made the transfer, or incurred an obligation, with the actual intent to "hinder, delay, or defraud" its creditors. The focus is on the intent of the Debtor. The recipient's intent or knowledge is irrelevant. For instance, assume that a creditor obtained a judgment against a Debtor. Further assume that the relationship between the Debtor and creditor is extremely antagonistic. The Debtor does not want to pay the creditor one cent of the judgment owed to it. To avoid paying the judgment, the Debtor sells all of its assets to another business for 10% of what the assets are actually worth. The Debtor then files for bankruptcy. The company buying the assets did not know about the judgment against the Debtor or the Debtor's sour relationship with the creditor. The sale is a fraudulent transfer because the Debtor intended to get rid of its assets so that the judgment creditor would not be able to collect on its judgment.

Because intent may be difficult to prove, the Debtor's intent may be inferred by the facts and circumstances surrounding the transaction. Some fact patterns or "badges of fraud" that the Court may consider in determining the Debtor's actual intent include: (i) secretiveness of the transaction; (ii) whether there was an agreement not to record the transfer; (iii) whether the transfer was made at a price far below fair value; or (iv) whether the transfer occurred at a time when the Debtor was being pursued by its creditors. While transactions involving a family member are not fraudulent per se, they will be subjected to closer scrutiny than other transactions.

The trustee may also avoid constructively fraudulent transfers under Section 548(a)(2). A constructively fraudulent transfer is one where the Debtor received less than reasonably equivalent value for the transfer; and at least one of the following is true: (i) the Debtor was insolvent at the time of the transfer or was rendered insolvent as a result; (ii) the Debtor was left with an unreasonably small amount of capital for conducting its business; or (iii) the Debtor intended to incur, or believed that it would incur, debts beyond its ability to pay. The trustee does not have to prove that the Debtor intended to "hinder, delay, or defraud" its creditors under this section of the Code. With respect to constructively fraudulent transfers, insolvency means balance-sheet insolvency: the Debtor's total assets are less than the Debtor's total liabilities.

*Executory Contracts and Unexpired Leases*

As part of its business operations, the Debtor will likely be party to a number of executory contracts. While the term "executory contract" is not defined in the Code, the focus is on whether the Debtor and the other party to the contract still have significant obligations to perform prior to the filing of the bankruptcy petition. If all that remains to be done under the contract is for the Debtor to pay the creditor money (e.g., under a promissory note), the contract is not executory. Examples of executory contracts include employment agreements, provider agreements, and leases.

Pursuant to Section 365, a Chapter 7 trustee has the power to: (i) reject an unexpired lease or executory contract; (ii) assume and retain an unexpired lease or executory contract; or (iii) assume and assign an unexpired lease or executory contract even though such lease or contract prohibits assignment.

For a lease of nonresidential real property where the Debtor is the lessee (tenant), the Code deems the lease rejected unless the Chapter 7 trustee assumes the lease within 120 days after the order for relief. This deadline may be extended under certain circumstances. The Chapter 7 trustee would ordinarily only assume a lease for nonresidential real property in connection with a sale of the Debtor's assets so that he could immediately assign it to a third party purchaser. Pending assumption or rejection of nonresidential real property leases, the Chapter 7 trustee must stay current on all of the obligations that arise thereunder from and after the date of the entry of the order for relief. If the Chapter 7 trustee does not stay current on all of the lease obligations, the lessor receives an administrative claim for the full amount due postpetition under the lease.

*Use, Sale, or Lease of Property of the Estate*
The Chapter 7 trustee may use, sell, lease, or enter into other transactions involving estate property in the ordinary course of business without a court order or notice to affected creditors. Section 363(c)(1). If the trustee wants to use, sell, or lease property other than in the ordinary course of business, generally 21 days' notice and a court hearing are required.

The trustee may sell property free and clear of the interest of a third party in that same property – including liens, covenants, claims of ownership, and leaseholds – only if: (i) applicable non-bankruptcy law permits the sale of the property free and clear of such an interest; (ii) the holder of the interest consents; (iii) the interest at issue is a lien, and the price at which the property is to be sold is greater than the aggregate value of all liens on that property; (iv) the interest is in bona fide dispute; or (v) the third party could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of its interest (for example, under the Uniform Commercial Code, a secured creditor's collateral may be sold in the ordinary course of the Debtor's business free and clear of liens, with the secured party limited to a monetary recovery).

At any sale free and clear of liens, the holder of the lien may bid in the amount of its debt unless the Court, for cause, orders otherwise. Section 363(k). Moreover, a sale of property pursuant to a court order that is subsequently reversed on appeal will remain valid even if the party purchasing the property knew of the appeal, assuming that the purchaser acted in "good faith". However, if the order was stayed pending appeal, the sale may be invalidated.

Under Section 363(d), the Chapter 7 trustee may sell, use or lease property of a nonprofit Debtor outside of the ordinary course of business. Any such sale, however, is expressly conditioned upon compliance with "applicable non-bankruptcy law that governs the transfer of property by a corporation or trust that is not a moneyed, business, or commercial corporation or trust". Accordingly, a sale of nonprofit Debtor's assets must comply with any state or federal laws, rules or regulations that would otherwise govern such a sale outside of bankruptcy. This provision of the Code may require the Chapter 7 trustee to obtain the permission of a state attorney general, or a regulatory arm of the state, such as the department of health, before selling assets. See, e.g., In re Peninsula Hospital Center, et al., Case No. 11-47056 (Bankr. E.D.N.Y.).

*Claims And Interests*

Section 501(a) provides that creditors may file proofs of claim and equity holders may file proofs of interest. A proof of claim or interest serves notice that the creditor or equity holder is asserting a right to payment from the Debtor's estate. In Chapter 7, proofs of claim or interest must be filed with the Court within 90 days after the first date set for the 341 Meeting of the Debtor's creditors. This deadline is known as the "bar date". A governmental unit has 180 days from the date the case is filed to file a claim.

In the typical no asset Chapter 7 case, there is no need for creditors to file proofs of claim because there will be no distribution. If the trustee later recovers assets for distribution to unsecured creditors, the Bankruptcy Court will provide notice to creditors and will allow additional time to file proofs of claim.

Only creditors or equity security holders who file proofs of claim or interest before the bar date will be entitled to participate in a distribution upon the Debtor's liquidation. Proofs of claim or interest must be filed with the Clerk of the Bankruptcy Court in the district in which the case is pending unless the Bankruptcy Court permits the proofs to be filed elsewhere (such as with a third-party claims processor or claims agent).

Bankruptcy Code Section 502 provides that a proof of claim or interest filed pursuant to Code Section 501 is deemed allowed (that is, valid and entitled to payment) unless a party in interest objects. While the claimant will ultimately bear the burden of proving the validity of a challenged claim, the filing of a proof of claim serves as *prima facie* evidence that the claim is valid. (*Prima facie* evidence is evidence that would be sufficient to prove a given point on its face or on its own.) In addition to claims that have been successfully challenged, Code section 502 disallows or limits certain creditor's claims, even though they may otherwise be valid. These include: (i) most late claims; (ii) claims that are unenforceable against the Debtor pursuant to applicable law or mutual agreement; (iii) claims for unmatured interest; (iv) claims for property taxes to the extent that the tax due exceeds the value of the property; (v) claims by an insider or attorney for the Debtor which exceed the reasonable value of the services provided; and (vi) claims for unmatured alimony, maintenance, or support. In addition to the above categories of claims, the following types of general unsecured claims are or may be limited: (i) those asserted by landlords for unpaid rent; (ii) those based upon breached employment contracts; or (iii) those based upon tax credit reductions.

<u>Secured and Unsecured Claims</u>

A secured creditor has a "secured claim" if the creditor holds collateral (e.g., a lien on or security interest in property of the Debtor) that gives that creditor the right to be paid from that property before creditors who do not have collateral. Secured claims generally arise from a voluntary agreement between the borrower and the lender. There are examples of involuntary liens arising, however.

If the Debtor obtained a bank loan to purchase the real estate from which its nonprofit business operates, and in connection with that loan, the Debtor executed a mortgage in favor of the bank, the bank would be a secured creditor (that is, it can liquidate the real estate to satisfy its claim) under the Bankruptcy Code. If, instead of a mortgage, the bank took security interests in all of the Debtor's personal property (office equipment, machines, furnishings, etc.), and the bank filed a financing statement under the Uniform Commercial Code, the bank would also be secured creditor and could liquidate the personal property to satisfy its claim. If the Debtor owns vehicles for use in its nonprofit business operations, as is common for programs providing transportation for seniors or people with disabilities, and financed the purchase of those vehicles with a loan, the bank extending the loan likely has a security interest in the vehicles. In many states, the failure to pay real or personal property taxes to the appropriate government entity may result in a tax lien against the Debtor's real or personal property. If it possesses a valid tax lien, the government entity (city, county, or state) could be a secured creditor of the Debtor. Similarly, a judgment creditor can obtain perfected status by recording its judgment or in some states by lodging its judgment with the Secretary of State, which then becomes a lien against certain classes of personal property. These issues are very fact and state specific, and this simplified overview is for illustrative purposes only.

A secured creditor does not need to file a proof of claim in a Chapter 7 case to preserve its security interest or lien in specific property. A secured creditor of a Debtor (e.g., a mortgagee lender of Debtor's real property) must protect the value of its interest in the Debtor's property. To the extent that value diminishes during the case (while the creditor is prevented from foreclosing by the automatic stay), the mortgagee may be entitled to periodic cash payments, additional liens, or additional collateral as compensation – this compensation is referred to as adequate protection of the mortgagee's interest in the Debtor's property. The creditor may also investigate the possibility of (i) lifting the automatic stay in the bankruptcy court and, then, proceeding against the collateral, via state-law foreclosure proceedings or (ii) filing a motion in the bankruptcy court that the Debtor has abandoned the property.

An unsecured creditor is a claimant whose claim is not secured by collateral. Examples of unsecured creditors in bankruptcy proceedings are credit card companies, utility providers (unless government regulations grant those providers a lien against real property for failure to pay utility charges), and business vendors (unless agreements between the Debtor and its vendor expressly state otherwise). Of course, to the extent that the Debtor posted a security deposit with the company, provider or vendor, the claim is secured to the extent of that deposit, and unsecured to the extent of any balance due.

An undersecured creditor is a claimant who holds a claim in excess of the value of the collateral securing the debt. An oversecured creditor is one whose collateral is worth more than its claim. An oversecured creditor is entitled to interest on its claim to the extent the value of its collateral exceeds its claim. To that same extent, the oversecured creditor may also add to its claim any reasonable fees, costs, or charges (including attorneys' fees) expressly provided for in the underlying agreement creating the security interest.

Priority claims

Each "priority" unsecured claim must be paid in full before general unsecured claims may receive any distribution. Code section 507 sets forth the types of unsecured claims that are entitled to priority over other unsecured claims. These include, in order of their priority: (i) expenses incurred in the administration of the Debtor's estate and any fees and charges assessed against the estate under Chapter 123 of title 28; (ii) wage claims including vacation, severance, and sick leave pay (and sales commissions for some independent contractors) which were earned by the claimant within 180 days before the filing of the bankruptcy petition or the cessation of the Debtor's business, whichever occurred first, up to $10,000 per employee; (iii) certain contributions to employee benefit plans; (iv) certain claims of grain producers and United States fishermen; (v) unsecured claims of individuals arising from the deposit of money, up to $2,225, before the commencement of the case, with respect to a contemplated purchase of property or services for personal use; and (vi) certain taxes.

*Discharge*

Corporations, both for profit and nonprofit corporations, do not receive a discharge at the conclusion of a Chapter 7 bankruptcy proceeding. Technically, after the company's bankruptcy case is closed, general unsecured creditors could pursue their state court rights to collect on their unpaid debts. However, because the Chapter 7 trustee would have liquidated all unencumbered assets of the Debtor during the bankruptcy proceeding, it is extremely unlikely that the Debtor would retain any assets from which the creditors could collect on their debts.

## Chapter 11 Reorganization

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The general goal of a Chapter 11 case is to allow the financially troubled business debtor the breathing room necessary to restructure its affairs and negotiate with creditors and other parties in interest in order to reorganize the company and move forward successfully. This process also allows the business to continue to operate as a "debtor-in-possession" of its assets after filing Chapter 11. In other words, subject to court approval for certain activities, operations of the business may continue in the ordinary course after filing for Chapter 11. Thus, Chapter 11 is an option available to an entity that believes reorganization, rather than an immediate liquidation, is a realistic and viable option.

While Chapter 11 filing provides the insolvent entity with powerful tools to aid its reorganization and reemergence as a healthy entity after confirmation of a plan of reorganization, it cannot be emphasized enough that successful Chapter 11 reorganization requires the support of senior creditors, long and often tense negotiations with multiple constituents and access to capital.

*Commencement of the Case*

Typically, there are two ways an entity can be subject to Chapter 11 of the Bankruptcy Code as a debtor: (1) by filing a voluntary petition for bankruptcy or (2) three or more creditors join together to petition to file an involuntary petition against the entity.

Voluntary Proceedings
Section 109 of the Bankruptcy Code dictates the eligibility requirement for bankruptcy filings. The code initially provides that voluntary bankruptcy filing under Chapter 11 is only available to "a person that resides in or has a domicile, a place of business, or property in the United States, or a municipality…" The statute defines "person" to include any "individual, partnership or corporation." Thus, any nonprofit corporation qualifying under Illinois state law is eligible to voluntarily file for bankruptcy under Chapter 11 of the Bankruptcy Code.

Involuntary Proceeding
Section 303 of the Bankruptcy Code provides that an involuntary case may be filed by three or more creditors (or, if there are fewer than 12 creditors in total, one creditor) holding claims of at least $15,325 in the aggregate "against a person, except a farmer, family farmer, or a corporation that is not a moneyed, business, or commercial corporation." Thus, any corporation that does not qualify as "moneyed, business or commercial corporation" cannot be subject to an involuntary Chapter 7 or 11 case.

An involuntary filing usually requires multiple creditors with significant claims who know of each other's existence and who each believe that causing an involuntary filing – a very aggressive strategy -- is their best path to recover their owed debts.

Thus, involuntary filings are fairly rare and virtually unheard of in the realm of nonprofit entities. This is because it is generally accepted that nonprofit entities are not eligible to be involuntary debtors. Churches, school foundations and charitable organization are almost certainly not eligible. Some courts have struggled with the determination of whether or not a nonprofit entity is actually a "moneyed, business, or commercial corporation," regardless of its official designation. If a court were to take up the task of determining whether the target of an involuntary petition is a "moneyed, business or commercial corporation", the court would likely examine the entity's charter, business activities and the powers and characteristics imposed on the entity by the laws of the state of its incorporation, such as tax laws.

*Preparing for a Chapter 11 Case*
An emergency Chapter 11 filing is rarely successful. Most Chapter 11 cases (and virtually every successful Chapter 11 case) begin in negotiations long before they are publicly filed. If a company is unable to pay its debts as they come due, they should consult appropriate professionals to assess the problem, the company's rights and obligations and the rights and remedies available to the company's creditors. After such a consultation, a company may decide Chapter 11 is a realistic option.

Once a strategy is developed, the company should approach its key creditors to explain the issues and seek the support of those creditors to the company's restructuring strategy. It is likely that the company will first be requesting a forbearance from the creditor exercising remedies (think foreclosure), a waiver of existing defaults, an amendment to the company's credit documents or possibly all three actions. This initial step will provide the company the time necessary to prepare for and commence a Chapter 11 filing in order to resolve their corporate issues.

This discussion will also involve the company's financing needs and the goal of the Chapter 11 case. Depending on the company's financial situation and operations, it may need post-petition loans (with the alternative being using only cash on hand – known as "cash collateral", i.e., the cash proceeds of their lender's collateral). Negotiating terms of a loan or consensual use of cash collateral with the company's lenders can take weeks and sometimes months, and will often require the company to prepare a budget showing the company's cash needs and uses on a line item basis.

The goal of a Chapter 11 case is also a key point for discussion. Chapter 11 cases are expensive and time consuming, and filing without an end goal is highly ill-advised. Certain nonprofit entities (or their creditors) may see a sale of their assets (a "363 sale") in bankruptcy as the goal of the Chapter 11 case. Others may seek to commence a Chapter 11 case in order to fully reorganize the company through a plan of reorganization. Either way, gaining the support of key creditors is advisable for a successful Chapter 11 process.

Involving company professionals early on in the Chapter 11 planning process is advantageous. The company's professionals will need a full understanding of the company and its business in order to best prepare the motions and other documents that must be filed at the commencement of the case. The initial petitions themselves set forth the debtor's corporate structure, top creditors and summarize the debtor's assets and liabilities. The petition must adhere to the format prescribed by the Judicial Conference of the United States. The filed voluntary petition will contain standard information for each filing debtor, including: name, social security or tax identification number, residence and the location of principal assets.

Other filings, commonly referred to as the "first day pleadings," will include, among other items, various requests to continue the company's normal operations. The list of such requests is specific to each business, but may include the use of bank accounts, employee benefits plans, use of cash or financing and the payment of certain prepetition debts. If the goal of the case is a 363 sale, a sale motion may be filed at the commencement of the case as well.

Each motion filed with the court, and the case itself, will be supported by a declaration (the "first day declaration") by an insider of the company with knowledge of the company's operations and the goal of the case. This declaration will provide the evidence necessary for the bankruptcy court judge to grant the preliminary relief requested by the debtor.

Why does one "goal" of a case rise up over others? It is situational and every situation is different. A debtor with ample assets or creditor support may seek to approve a reorganization plan. A debtor with one dominant secured creditor who is driving the case may pressure the debtor to commence a "363 sale", if that creditor believes the sale will maximize value. Alternatively, the debtor may be aware of a buyer that will continue the debtor's charitable mission but only if that buyer is able to purchase the debtor's assets "free and clear" of liens – i.e., through a bankruptcy sale.

*Commencing the Chapter 11 Case*

Once a deal with creditors is struck and (ideally) the company is prepared, the Chapter 11 case is technically commenced by electronically filing the petition with the bankruptcy court, followed immediately thereafter by the first day pleadings and the first day declaration. Bankruptcy courts charge a filing fee of $1,717 to file a bankruptcy case. This fee must be paid to the clerk upon filing of the petition. If the entity that is filing bankruptcy is also filing bankruptcy for additional related entities (subsidiaries or affiliates), the filing entity can file a joint petition which joins all entities into one bankruptcy case and may streamline the bankruptcy for both debtors and creditors. In such a case, the filing fees charged are per debtor.

Venue will be the place where the company is domiciled, their principal place of business or the location of their principal assets for the 180-day period prior to commencing the case. For Chicago area nonprofit corporations, the most likely venue is the Bankruptcy Court for the Northern District of Illinois, located in Chicago.

A debtor must also file (1) schedules of debtor's assets and liabilities; (2) a schedule of current income and expenditures; (3) a schedule of executory contracts and unexpired leases of which the debtor is currently a party to; and (4) a statement of the debtor's financial affairs. These schedules are required to be filed within fourteen days after commencement of the case, though courts routinely grant reasonable extensions of time to file these schedules.

Once the petition is filed, the debtor takes on the name of "debtor in possession." This term is Chapter 11 vernacular that indicates that the debtor is in control and possession of its assets while undergoing a Chapter 11 reorganization of its business without the appointment of a case trustee. The debtor will remain a debtor in possession until the debtor's plan of reorganization is confirmed by the bankruptcy court, the debtor's case is dismissed or converted to a Chapter 7 bankruptcy case, or a Chapter 11 trustee is appointed in the case.

As a debtor in possession, the company and its petition date management will retain control of the company's assets and operations and continue many of its normal business activities unless otherwise ordered by the court. The debtor in possession has fiduciary obligations to creditors and must maximize the value of its assets.

This requires that the debtor perform trustee functions, including accounting for property, examining and objecting to claims, and filing informational reports as required by the court and the U.S. Trustee. Furthermore, a debtor in possession has the power, with court approval to employ attorneys, accountants, appraisers, auctioneers and additional professionals to assist the debtor in its bankruptcy case. Often, on matters within the ordinary course of business, the debtor's management has discretion to exercise its reasonable business judgment in good faith. Courts are typically reluctant to impose their business judgment over that of management absent a clear showing of cause; however some actions will require court approval.

*Estate Assets*

Upon commencing a bankruptcy case, the debtors' assets become estate assets, subject to the jurisdiction of the bankruptcy court and bankruptcy law. While a debtor is allowed to operate in the ordinary course, non-ordinary course transactions require bankruptcy court approval. Therefore, an entity may sell its inventory as it did pre-petition. However, if a debtor desires to liquidate slow moving inventory or an entire business line, bankruptcy court approval is required for this more extreme action. This ensures the debtor is meeting its fiduciary duty to creditors to maximize the value of its assets.

What are an estate's assets? Almost everything. Real property, personal property, intellectual property, insurance recoveries, contracts and litigation claims are all estate assets. The debtor has a fiduciary duty to maximize value of its assets for the benefit of all creditors.

While "fiduciary duty to maximize value of its assets for the benefit of all creditors" is a mouthful, what it basically means is that the debtor should not waste its assets and instead needs to use its judgment to ensure it is seeking the highest price for those assets. The bankruptcy court serves as a referee to help. For example, in the 363-sale context, the debtor makes an evidentiary showing to the court that the price it is receiving is the highest and best for its assets. In a plan context, the court will hear evidence that the plan has been properly solicited and confirmed in accordance with the law. In such cases, the court will enter an order confirming the debtor's actions. And along the way, the debtor's professionals (i.e., its lawyers) will assist the debtor in such actions.

One area of potential assets unique to nonprofit debtors are restricted (or designated) funds. Restricted funds are funds donated to a nonprofit entity for an express, specific purpose. The purpose set forth in the grant is akin to a contractual requirement binding the nonprofit entity, including in bankruptcy. Restricted funds could be made for scholarships, to build or refurbish a building, develop a new program or support an existing one. Because restricted funds are only available to a nonprofit for a specific purpose (as set forth in the granting documents), many courts have found them to not be estate assets and therefore unavailable to creditors. The debtor should instead seek court approval to use such funds for the express purpose stated or, if the purpose of such funds is frustrated due to the filing, to consider returning the funds to the grantor or to ask the grantor to lift or alter the restriction.

*Bankruptcy Powers*

Upon filing for bankruptcy, a period known as the "automatic stay" comes into effect. From the debtors' perspective, the automatic stay is one of the most powerful and important features of a Chapter 11 filing.

The automatic stay provides for a period of time in which all judgments, collection activities, foreclosures, and repossession of property are suspended and may not be pursued by creditors of the debtor with regards to any debt or claim that arose prior to the filing of the debtor's bankruptcy petition. Essentially, any rights a creditor has are immediately cut off upon the commencement of a case. The breathing room provided by the automatic stay allows the debtor time to negotiate with creditors, effectuate its restructuring plan, conduct a sale of assets or otherwise take actions which are intended to maximize value or minimize or mitigate the damage that was occurring prior to filing of the Chapter 11 case.

Creditors can, under specific circumstances, obtain relief from the automatic stay. In order to seek relief from the stay and pursue their claim against the debtor, a creditor must file a motion with the court to lift the automatic stay and to permit the creditor to seek the request relief. Secured creditors, for example, can seek an order from the court to lift the automatic stay if certain covenants are not met or the debtors lack equity in the creditor's collateral. If the order is entered by the court, the secured creditor is permitted to enforce remedies, which typically means that the creditor may foreclose on the debtors' assets that are the creditor's collateral, sell the property and apply the proceeds to the debt owed by the debtor. Unsecured creditors are also able to seek relief from the automatic stay, for example, to continue state court litigation which was pending against the debtor prior to the filing of the Chapter 11 case.

<u>Assume or Reject Contracts</u>

A debtor has unique powers over its executory contracts – i.e., those contracts for which each party has performance obligations.

First, with respect to its leases, a debtor has a 60 day post-filing grace period during which a debtor need not perform its obligations. Thus, payments typically due under any real property or capital lease may cease until the 61st day after commencement of the bankruptcy case.

Second, contracts can be assumed by the debtor and assigned to a third party, so long as the counterparty to that contract receives adequate assurance of future performance and a cure of all pending defaults. Adequate assurance can take many forms, but unless the assignee is at tremendous risk of being unable to perform the contract, an assignment should be successful. Cure of pending defaults simply means if amounts are due on a contract, that amount due must be paid in full to effectuate the assignment.

Third, debtors can reject contracts. If a debtor has outsized or redundant leases or other onerous contracts, they can reject those contracts or leases in bankruptcy, thereby capping the liability due on them. This is especially valuable for debtors with numerous real property leases that are no longer needed in order to effectuate the reorganization. Each contract can be rejected, with the rejection damages due to the counterparty being capped per statutory limits.

*Creditors Committee*

A key element of a Chapter 11 case (at least cases of significant size) is the creditors' committee, a statutory committee of unsecured creditors whose job it is to represent the interest of all the debtors' unsecured creditors in the case. Creditors' committees are common in Chapter 11 cases of significant debtors with a large and diverse pool of unsecured creditors (committees are common in nonprofit health care cases, larger religious cases and educational cases, but less so in cases involving smaller nonprofits and charitable organizations with smaller creditor pools). The committee is entitled to retain its own counsel and, if necessary, its own financial advisors to assist the committee in its duties in the case.

The creditors' committee is appointed by the U.S. Trustee and typically consists of the unsecured creditors with large unsecured claims against the debtor who are willing to serve on the committee. In addition to other activities, the committee consults with the debtor in possession on administration of the bankruptcy case, investigates the debtor's conduct and operation of the business, investigates liens of secured creditors, and often participates in formulating a plan of reorganization. If the debtor proposes to sell its assets in the case, a committee will consult in that sale and may search for other potential bidders.

While the debtors and the committee are at odds, a cooperative and open relationship between the debtor and the committee is helpful to a successful Chapter 11 case. However, it cannot be discounted that the committee and the debtors will not see eye to eye on every issue and conflicts that will arise during the course of the Chapter 11 case.

*Formulation of a Plan*
Reorganization in Chapter 11 requires that the debtor first propose, then confirm, a Chapter 11 plan. Confirmation requires consent of certain creditors and court order. The debtor has a 120-day period after commencing its bankruptcy petition during which it has an exclusive right to file a plan of reorganization, which period can be extended by the court, up to 18 months. Once the exclusivity period has run, other parties in interest have the opportunity and right to file their own competing plan of reorganization (note that the debtor may file its own plan at any time, before and after exclusivity has run).

A Chapter 11 plan of reorganization should take into consideration the financial and operational outlook of the business as a practical matter, the legal rights of creditors and the requirements enforced by the Bankruptcy Code. All plans must contain: (1) the designation of classes of claims and interests; (2) identification and description of the treatment of any classes of claims or interests whose rights are impaired under the plan; and (3) adequate means for implementing the plan of reorganization. If the plan is a liquidating plan, it will provide the procedure for the sale of the business.

The plan itself will detail the proposed reorganization. It will describe the existing claims and put like claims into a class for voting purposes (each class of like claims votes on the plan together). A typical debtor will have separate classes for secured creditors, unsecured creditors, equity and a few other potential claimholders specific to the debtors' capital and equity structure. A nonprofit assisted living facility debtor, for example, may have a separate class of claims of residents. A debtor facing substantial litigation claims may have a class consisting of just those litigation claimants.

The plan will set forth what each class receives on account of its claim (if anything) and whether a class is deemed impaired (not receiving a full recovery) or unimpaired (receiving a full recovery) under the plan of reorganization. Classes typically receive a full or partial payment in cash of their claim or equity in the reorganized debtor (not realistic for a nonprofit debtor).

Along with its proposed reorganization plan, the debtor files a disclosure statement that "discloses" adequate information about a proposed plan for creditors, shareholders and other parties in interest in order to provide them with adequate information to allow them to make an informed decision on whether or not to vote in favor of the plan. The court must approve the form of disclosure statement. If the court approves the disclosure statement it will schedule the time period for soliciting votes on the plan and a date for a hearing to consider confirmation of the plan. Each creditor and interested party receives a copy of the plan, the disclosure statement and a voting ballot allowing them to vote in favor or against the plan of reorganization.

Once a plan is filed, the debtor has an additional 180 days after the petition date (or entry of the order for relief) to obtain acceptance of its plan of reorganization. The court may extend this period for up to 20 months or reduce this acceptance period for cause. In practice, extensions by debtors for both the plan filing and plan acceptance are often sought at the same time.

*Plan Confirmation*

The centerpiece of confirmation of a plan is voting by classes of creditors. A class of creditors is deemed to have accepted a proposed plan when there is acceptance by numerosity (more than 50% of the votes cast are voted in favor) and more than two thirds in dollar value vote to accept the plan. Naturally a plan is accepted by creditors if each class votes in favor or is deemed unimpaired. However, this is not the only way a plan can be accepted and confirmed. A plan can also be confirmed if an impaired, voting class supports the plan – something called "cram down" (meaning the plan has been "crammed down" on other creditors that have not voted in favor of the plan).

Beyond voting, a Chapter 11 plan can be confirmed by the court only if confirmation of the plan "is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan." In other words, the proposed plan must be feasible and not merely a slew of empty promises for the entity's creditors. It is important to note that this does not require a guarantee of the success of the plan of reorganization, but reasonable assurance of that success. The proponent of the plan of reorganization bears the burden of establishing that the proposed plan is feasible. Courts look to multiple factors in determining whether the proposed plan of reorganization is feasible and should be confirmed, including: the potential earning power of the business, the capital structure and working capital of the post-confirmation business, the debtor's ability to meet capital expenditure requirements, the relevant economic conditions, the ability of the management, in addition to any other factors that may affect implementation of the reorganization.

Multiple confirmation standards for a plan of reorganization must be met prior to confirmation of a plan. These confirmations include, but are not limited to, the finding that: the plan complies with the Bankruptcy Code; the plan has been proposed in good faith and not by any means forbidden by law; the plan discloses the identity of any individual to serve after confirmation as an officer or director of the debtor; the holder of each claim or interest in each class of impaired claims or interests has accepted the plan or will received not less than that holder would receive if the debtor were liquidated under Chapter 7; each class of claims or interests has either accepted the plan or is not impaired by the plan; at least one class that is impaired has accepted the plan after excluding the vote of insiders; and plan confirmation is not likely to be followed by liquidation or need for further financial reorganization.

As mentioned above, it is possible for a nonprofit debtor to be pushed into an involuntary liquidation. This scenario would occur where the debtor's exclusive period to file a plan has run out and the creditors of the nonprofit entity propose and confirm a liquidating Chapter 11 plan over the debtor's objection. Because this can only occur after the debtor's exclusivity period has run – something that is entirely predictable based on the bankruptcy law – it is a relatively rare and avoidable circumstance, unless the debtor's case has not gone according to plan at all. Therefore, nonprofit entities should be aware that although they most likely cannot be pushed into an involuntary Chapter 11 filing, they can still be involuntarily liquidated through the process described.

*Plan Modification*

After proposing a plan, a proponent may wish to amend that plan, possibly on account of a change in circumstances.  A significant creditor may have made an objection that makes amending a plan advisable.  New facts may have emerged.  New assets may have been located, changing the likely distributions initial set forth in the plan.

If an amendment is to be made prior to confirmation of the plan, the process is relatively simple.  Simply file and serve an amended plan and disclosure statement, and ensure creditors have proper notice of the revised plan so they have the opportunity to review and vote on the revised plan.

If a plan has already been confirmed, it may still be modified if the proponent files a motion and "circumstances warrant such modification and the court, after notice and a hearing, confirms such plan as modified."  Though courts prefer the finality of a confirmed plan, if good reason exists and others are not materially impacted, many courts will consider a post-confirmation modification of a reorganization plan.

*Employment Matters*

As previously stated, a Chapter 11 debtor in possession of its assets operates its business in the ordinary course – meaning that but for the additional tasks and obligations required by the Chapter 11 filing, the status quo remains unless it is intentionally changed.

However, many debtors are forced to file bankruptcy due to labor and employment issues.  A debtor's union employees may be subject to union contracts for above market pay, or perhaps, a debtor has pension obligations it simply cannot meet.  Therefore, a debtor may seek to reject those union contracts or terminate its pension once in bankruptcy.  Additional employment considerations are explored in Chapter 3 of this Guide.

It is important to note that great care must be taken in any action which impacts a debtor's employees, but in certain cases it must be done.  Any such action will require consulting labor and employment counsel, in addition to bankruptcy advisors.

*Conclusion*

Navigating a Chapter 11 case as the debtor in possession will often be harrowing, but the unique powers and rights held by a Chapter 11 debtor make it the best option for certain debtors.  Under the right circumstances, and with the support of the debtors' key creditors, the Chapter 11 filing can result in a healthy post-bankruptcy reorganized debtor, or the sale of the assets of the debtor in a way which ensures the debtors' charitable mission continues on.

## Chapter 3 – Special Considerations for Nonprofits

### Treatment of Unrestricted and Restricted Donations

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Once a nonprofit organization begins to consider bankruptcy or alternatives to bankruptcy, the organization should evaluate all its restricted and unrestricted donations and grants. The issue of restricted charitable endowments in the context of nonprofit bankruptcy is not fully explored in this section. But in general, bankruptcy law prevents unpaid creditors from receiving payment from the corpus of a restricted charitable endowment. (Corpus is a term used to refer to the principal of a trust, as distinguished from the interest earned on that principal.)

Nonprofit organizations often receive a combination of restricted and unrestricted donations, as well as grants from public or private entities that are program or event specific. For example, a nonprofit may run several different programs, such as youth afterschool programs, evening adult GED courses, and evening health and nutrition classes. Donors to the organization may request that their donation be restricted to support the afterschool program or the evening health and nutrition classes. Other donors to the organization may support the general operation of the organization without restricting how the nonprofit uses the donation.

Grants to nonprofits, whether from government or private sources are often restricted to specific programs—restricted grants are more often being used. Whether restricted or unrestricted, most grants may require the nonprofit to submit complete detailed and sometimes complex reports to the funder. Grant reporting requirements are particularly rigorous for government grants, some of which require the nonprofit to submit multiple reports each year. A nonprofit's failure to complete reporting requirements for government grants may result in grant funds being suspended, additional monitoring and oversight by the government, or cancellation of the grant. Finally, the government grantor can demand a refund of certain grant funds, which may adversely affect the personal standing of the directors responsible for the grant's administration.

As discussed in Chapter 1 of this Guide, when a nonprofit is considering bankruptcy or any form of dissolution, the nonprofit must conduct a thorough review of its assets and liabilities. (All the while, the nonprofit must be diligent in completing and submitting all required grant reports. Failure to submit a required grant report may cause a grant to be revoked, and result in a demand for grant funds to be returned to the grantor, which creates an unfortunate situation where a grantor becomes a creditor, and what was once an asset is now a liability. It should be noted that in some grant agreements, certain individuals are required to make a report irrespective of the fiscal status of the organization.)

A thorough review should also be applied to the nonprofit's restricted and unrestricted donations or grants. More specifically, the nonprofit should isolate those liabilities associated with programs or services that have received restricted donations or grants, and then examine whether the restricted grants or donations can be used to cover those liabilities. In addition, the nonprofit must carefully examine the terms and conditions of the restricted donations and grants to assess whether or not the restricted funds may be used to pay liabilities tangential to the restricted nature of the donation or grant.

One example is whether or not restricted donations to a nonprofit's after-school program may be used to pay the nonprofit's liability for past due rent for the facility where the afterschool program, among many other programs, is run. Nonprofits often make the mistake of simply returning restricted donations before carefully analyzing where and how restricted funds can be used to pay outstanding liabilities or creditors. If a nonprofit has questions regarding the restricted nature of a donation or grant, it should examine the terms and conditions of the grant or donation, preferably with its legal counsel. Nonprofits should be aware that the intention of certain restricted donations and grants may be so narrowly focused that the nonprofit will have an obligation to expend those funds only for the specified activity or project.

A nonprofit considering bankruptcy should also discuss how it plans to handle on-going donations. If the bankruptcy discussions are in the early stages, a nonprofit may continue to receive and apply donations and grants, whether restricted or unrestricted, to cover current program and operating expenses. Once a nonprofit begins to seriously move towards Chapter 7 liquidation, it should consider sending its donors a letter informing them that the nonprofit is considering liquidation, which is the precursor to a nonprofit's dissolution. While such notice is not required under the Bankruptcy Code, it may bode well from a relationship standpoint to keep donors, especially significant and longstanding ones, informed of the nonprofit's fiscal health and future.

Further, by developing an effective communication plan for donors and funders, a nonprofit may receive direction on how it may use restricted and unrestricted donations or grants. When communicating to donors and funders, nonprofits should clearly articulate whether it is considering bankruptcy, moving towards bankruptcy, committed to filing a Chapter 11 reorganization with the court, or committed to liquidating under Chapter 7. Nonprofits may consider asking those donors permission to use restricted funds to pay creditors that are outside the restricted scope of the specific donation or grant. Of course, whether or not to ask any donors and grantors for permission to unchain their restrictions is a complicated question and may not be a suitable or preferred strategy for all situations, and nonprofits are wise to consult legal counsel before doing so. Regardless, it is essential that nonprofits have a clear understanding regarding when and for what unrestricted donations and grants may be used to cover its liabilities or pay creditors.

When a nonprofit decides to petition for liquidation under Chapter 7, the nonprofit must, in the very least, stop asking for donations and inform all of its funders of its plan to file for Chapter 7. In a Chapter 7 scenario, once a nonprofit has made its filing with the bankruptcy court, all received donations and grants received before the date of filing are considered assets of the bankruptcy estate. If there are unrestricted grants or donations, the Trustee can use those to pay any creditors. In regard to restricted donations and grants, the Trustee should review the terms and conditions of each and determine whether or not they can be used to pay outstanding creditors. Another complication can arise with bequests from the estates of deceased donors. For example, what happens if a nonprofit files for Chapter 7 and two weeks later it receives a $50,000.00 bequest from a donor who died three months before the Chapter 7 filing date. Is the bequest considered an asset of the estate? Does it make a difference if the donor died after the

Chapter 7 filing date, but the donative intent was written in a will or trust instrument years prior to the organization's Chapter 7 filing?

If there are restricted donations or grants that cannot be used to pay outstanding creditors, the Trustee may contact the donor to ask permission to use the restricted funds to pay outstanding creditors unrelated to the grant or donation's restriction. In some instances, the donor may be unable to be found or is nonresponsive. If that is the case, the Trustee, in consultation with the Attorney General's office, may redirect the restricted donation or grant to a similar charitable organization or activity. Any charitable donations received after the bankruptcy filing date, with the possible exception of donations or gifts that had been pledged pre-bankruptcy, are not included as assets of the estate, and the donee should send the donation back.

A complicated donation scenario arises when a nonprofit has received a pledge or commitment of a donation that is to be distributed over a period of time. For example, the donor may pledge $100,000.00 to a nonprofit and condition that the pledge is transferred in installments of $10,000.00 over ten months. Assume, as well, that the nonprofit has receipted the donation and placed the donation as an expected asset on its books. If, after the nonprofit has received seven installments, the nonprofit files a petition for bankruptcy, how does the Trustee handle the remaining three installments? This situation is akin to a commercial Chapter 7 filing, where a business has outstanding accounts receivable items that have not yet been paid but the service or product has delivered by the business before it filed for Chapter 7. In the commercial context, the Trustee may treat such payments received as an account receivable due prior to the Chapter 7 filing. In the context of a nonprofit, it is an open question as to whether the Trustee may treat the original pledge of $100,000.00 as an asset based on an obligation made prior to filing and use the final three payments to pay outstanding creditors.

A nonprofit's decision to undergo a Chapter 11 reorganization raises additional issues with respect to donations and grants. Though unrestricted donations may be used to assist the nonprofit's reorganization plan, all donors and grantors should be informed, for the same reasons set forth earlier, of the nonprofit's decision to undergo Chapter 11 reorganization. In the case of reorganization, the nonprofit's notice to donors will look like a fundraising letter expressing great optimism that the reorganization will be a positive step to preserving the charitable program. With respect to restricted donations and grants, the nonprofit needs to assess whether or not the programs supported by restricted donations and grants will remain intact or emerge in a different form when the nonprofit is reorganized.

As stated in Chapter 2, under Bankruptcy Rule 1007, a nonprofit will have to file a schedule of assets and liabilities, statement of financial affairs, statement of executory contracts, and a list of the twenty largest creditors. During a Chapter 11 reorganization the nonprofit, usually a debtor in possession, should inform the U.S. Trustee of its restricted donations and grants, and seek agreement that the U.S. Trustee will not object to the proposed restrictions on use in a confirmed plan. This will not guarantee that the court will approve the restriction, or that other creditors will not object, but at least it removes a significant obstacle. Before filing for Chapter 11, nonprofits are advised to communicate the plan to all donors and funders. In addition, the nonprofit should notify donors and grantors of unused restricted funds, and ask if the nonprofit can use those restricted funds in an unrestricted manner. More specifically, nonprofits may want to discuss plans with their grantors and donors if the restricted funds may be used to aid the nonprofit in completing its court approved reorganization plan. If, upon final court approval, the nonprofit's reorganization plan does not include previous programs that relied upon restricted donations or grants, those funders should be notified immediately that those program or programs no longer exist in the new, reorganized nonprofit.

In considering bankruptcy or its alternatives, nonprofits that hold charitable trust assets must consider how those charitable trusts are distributed or used in the bankruptcy process. The Attorney General's office in Illinois does have an interest in assets held for charitable purposes because those assets are ostensibly for the benefit of the public. In the bankruptcy context, the Attorney General may wish to appear in court to oversee or protect a nonprofit's charitable assets. In particular, the Attorney General's office will involve itself if questions are raised regarding the distribution of charitable assets to private creditors, especially if the distribution to private creditors falls outside the original intent of the charitable asset. As a general matter, courts and governments do not look favorably upon the diversion of charitable assets to unqualified private parties. For more information regarding the role of the Attorney General's office in protecting charitable assets see: Michael P. Mosher and Ryan K. Oberly, *Organizing an Illinois Not-for-Profit Corporation*, Not-for-Profit Corporations, Illinois Continuing Legal Education, Ch.1—12 (2013).

## Employment Considerations

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The purpose of this section is to introduce you to special considerations regarding employee treatment before and during a bankruptcy case. By the end of this section, you should understand how an employee's unpaid salary is treated before and during bankruptcy, how a company can alter certain employment agreements when it enters bankruptcy, and other employee-related bankruptcy concepts.

*Pre-Bankruptcy Employee Considerations*

A distressed company that is considering filing for Chapter 11 relief should take various measures to smoothly transition into Chapter 11, a number of which relate to employee issues and claims.

One issue the debtor should consider is the Worker Adjustment and Retraining Notification Act (the "WARN Act"), which requires employers to provide 60 days' notice in advance of facility closings and large-scale layoffs. Included in the WARN Act's purview are private employers—including nonprofits—with over 100 employees (excluding certain part-time employees).

Facility closings that trigger the WARN Act are employment site closings that result in 50 or more employees losing their jobs. Large-scale layoffs that trigger the WARN Act are layoffs that result in either 500 or more employee layoffs or, if the laid off employees make up at least 33% of the workforce, 50-499 employee layoffs. Failure to comply with the WARN Act results in back pay and benefits liability for each day of noncompliance within the 60 day window. In a Chapter 11 case, those liabilities could become priority claims — as such, distressed companies thinking about closing a worksite or laying off employees should consider WARN Act issues.

Another issue the debtor should consider is treatment of employee wages earned prior to the Chapter 11 case. Employee claims for "wages, salaries, or commissions, including vacation, severance, and sick leave pay" earned within 180 days before the bankruptcy filing have fourth priority status up to $12,475. Practically speaking, these wages will get paid, however, to the extent the debtor seeks to exceed the cap, it would be seeking to pay unsecured employee claims before general unsecured claims, which some courts may be reluctant to authorize. Additionally, if the debtor lacks unencumbered cash to pay employee claims, it will have to seek court permission to use cash collateral or obtain debtor-in-possession financing. Therefore, the debtor should attempt to pay these claims prepetition, or, if that is impracticable, seek court authorization to pay the prepetition amounts owing employees.

Finally, on a more granular, practical level, the debtor may pay its employees by check before the bankruptcy filing, but the check may not clear until after the filing. Assuming the debtor's financial institution puts a hold on the debtor's accounts in the early stages of a bankruptcy case (most do), the check will bounce and the employee will therefore be left with a claim in the bankruptcy case that cannot be paid absent court approval. In this case, in anticipation of a filing, the debtor could pay employees by direct deposit or wire transfer to ensure that the funds are received before the Chapter 11 filing.

*Collective Bargaining Agreements and Unions*

Consider a simple example of Company and Union, who have signed a collective bargaining agreement ("CBA") in the ordinary course of business providing for wages at $15/hour and substantial healthcare benefits. Now assume that, after the agreement is signed but has not expired by its terms, market wages in Company's industry have shrunk to $10/hour, benefits have been substantially reduced, and the market has forced Company into Chapter 11 protection. May Company start paying the employees $10/hour and cut benefits, now that Company is in bankruptcy?

The answer is no. Enacted after a Supreme Court holding widely seen as unfavorable to unions, Section 1113 establishes procedural and substantive hoops through which the debtor must jump before it can alter or reject a CBA.

Procedurally, Section 1113 commands the debtor to engage in extensive negotiations with the applicable union before it files a motion to reject the CBA between the debtor and said union. If the debtor jumps through the following nine hoops, it may file a motion to reject the CBA:

(1) The debtor must "make a proposal" to the union to modify the CBA;

(2) The proposal must be "based on the most complete and reliable information available at the time" of the proposal;

(3) The proposal must provide for modifications that are "necessary to permit the reorganization of the debtor;"

(4) The proposed modifications must assure that "all creditors, the debtor, and all of the affected parties are treated fairly and equitably;"

(5) The debtor must provide the union "such relevant information as is necessary to evaluate the proposal;"

(6) Between the time of making the proposal and the hearing on the rejection motion, the debtor must meet with the union at reasonable times;

(7) At those meetings, the debtor must "confer in good faith in attempting to reach mutually satisfactory modifications;"

(8) The union must refuse to accept the proposal "without good cause," and;

(9) The balance of equities must "clearly favor rejection" of the CBA.

These statutory negotiation procedures draw heavily on labor law policies of avoiding labor strife and encouraging collective bargaining. The process usually facilitates an agreement, as the parties seek to avoid the risks associated with rejection in court. Cognizant of this, debtors often use Section 1113 to extract cost-savings or other concessions from its union. If, however, the foregoing negotiations do not produce an agreement, the debtor may file a motion to reject the applicable CBA. The court must schedule a hearing within fourteen days of the motion's filing, although the date is often extended by agreement between the parties to prepare for litigation. The court must rule on the rejection application within 30 days of the hearing.

Substantively, the most heavily litigated requirements are the third, which requires that the proposal must provide for modifications "necessary to permit reorganization of the debtor," and the fourth, which requires the proposal to treat all affected parties "fairly and equitably." Regarding the third requirement, courts are split over what modifications to a CBA are "necessary to permit reorganization of the debtor." A majority of circuit courts, including the U.S. Court of Appeals for the Second Circuit, interpret "necessary" rather expansively. To the majority, a "necessary" modification is one that increases the likelihood of a successful reorganization. This expansive interpretation is, of course, debtor-friendly. It means that the debtor can propose modifications to the CBA that will help ensure the long-term viability of the debtor's business. Contrast this with the minority opinion, adhered to by the U.S. Court of Appeals for the Third Circuit, which narrowly interprets "necessary" to mean only bare minimum modifications that are required to stave off immediate liquidation. This narrow interpretation favors unions, as it makes it more difficult for the debtor to show that its modifications to the CBA are "necessary."

Unlike the third requirement, there is no major circuit split over what constitutes "fair and equitable." The point of this requirement is to spread the burden — that is, when a company files for Chapter 11 protection, the union workers should not bear the brunt of all the company's cutbacks. Rather, those cutbacks should be spread among all constituencies, including non-union creditors. Because it would be nearly impossible to precisely apportion the degree of sacrifice among the parties, courts do not require the debtor to treat all affected parties identically. Thus, if a debtor proposes to cut union wages by twenty percent, the debtor does not have to cut management and non-union salaries by twenty percent as well. It does, however, have to treat union and non-union employees “fairly and equitably,” so a court would heavily scrutinize a plan that cuts union wages by twenty percent and leaves management salaries untouched.

What happens after the bankruptcy court grants the debtor’s rejection motion and the debtor rejects the CBA — is the debtor out of the woods? Not exactly. The debtor must still comply with federal labor law, meaning that the debtor still has a duty to collectively bargain with the union and the union retains the right to strike. The union’s employees may have claims for damages upon rejection, which would be allowable in the same manner as for other executory contracts rejected under Section 365. Those claims would be subject to the Bankruptcy Code’s normal priority scheme. In a nutshell, claims on account of wages and benefits earned under the CBA after the bankruptcy petition is filed are entitled to administrative priority, claims on account of prepetition wages under the CBA are entitled to fourth priority, and prepetition claims on account of benefits under the CBA are entitled to fifth priority. Prospective claims of union employees for the post-rejection period will most likely be measured by the difference between the wages and benefits entitlements under pre-rejection CBA and the reduced wages and benefits entitlements that the union employee would receive under the debtor’s post-rejection CBA, if any.

Finally, note that the above discussion applies to permanent alterations of a CBA. What happens when a debtor faces a wages crisis so imminent that it will fail to pay its unionized employees as payment becomes due? The debtor can then turn to Section 1113(e). Section 1113(e) spells out the rules for interim alteration of a CBA. To alter a CBA on an interim basis, the debtor need not file an application to modify or reject the CBA, nor does it need to follow the statutory procedures discussed above. However, because Section 1113(e) relief is only considered on an emergency basis, the standard for obtaining interim modifications is difficult to satisfy: a debtor must show that, without the interim modifications, it is in danger of liquidating. Ordered changes can include wages and benefits reductions as well as work rules changes, and Section 1113(e) relief is usually granted only for the period of immediate crisis, which is often 60-120 days. After obtaining Section 1113(e) relief, the debtor can then continue the process discussed above to obtain permanent alteration of the applicable CBA.

*Employees’ Claims and Treatment in a Bankruptcy Case*
Before discussing employee claims and treatment in a bankruptcy case, it is useful to go back to the original definition of “claim.” In the 1978 amendments to the Bankruptcy Code, Congress decided to give “claim” the “broadest possible definition.” As defined in Section 101(5)(A) of the Bankruptcy Code, a “claim” is a “right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured.” This definition was meant to capture the idea “that all legal obligations of the debtor, no matter how remote or contingent, will be able to be dealt with in the bankruptcy case.”

A debtor’s employees have a “right to payment” of their wages and benefits from the debtor company. Thus, they have claims for such wages and benefits under the Bankruptcy Code. Claims for unpaid wages and benefits on account of services rendered during the bankruptcy case (that is, after the debtor files its petition in the bankruptcy court) are entitled to administrative expense priority. Functionally, this means that employee salaries and benefits during the bankruptcy period get paid in the ordinary course of business, as if the debtor never filed for bankruptcy.

More interesting is the case of wages and benefits on account of services rendered within 180 days of the first of (a) the bankruptcy filing and (b) the cessation of the debtor's business. Claims for "wages, salaries, or commissions," including "vacation, severance, and sick leave pay," are entitled to fourth priority, while claims for "contributions to an employee benefit plan" are entitled to fifth priority. These claims, moreover, are capped at $12,475 per employee, which is indexed every three years in accordance with changes in the Consumer Price Index.

The first interesting issue with prepetition employee claims is timing. Although the statutory timeline creates a hard cut-off, determining whether the claim falls within the 180-day window can be a matter of interpretation. Courts usually look to when the employee performed the services giving rise to the wage or the benefit claim rather than when the right to payment vested. The following illustration is instructive: suppose an employee had a vacation pay claim for $2,000, which was attributable to one year of service and vested at the beginning of the calendar year. Assume that the debtor-employer filed its bankruptcy petition on October 1, which is the beginning of the fourth quarter, and that the employee was still working on January 1, when the vacation pay claim vested. That employee's claim would be divided as follows: (a) the amount attributable to the employee's quarter-year of postpetition services ($500) would be entitled to administrative expense priority; (b) the amount attributable to services rendered during the 180-day prepetition period ($1,000) would be entitled to fourth (lower) priority; and (c) the balance would be a general unsecured, non-priority claim.

The second interesting issue with prepetition employee claims is the manner of computation. Recall that the fourth priority claim for wages is capped at $12,475 per employee. As it turns out, the fifth priority claim for benefits is capped at the same amount. At this point, you may be thinking that the employee claimant is entitled to a plus-$24,000 cap for the claims together. However, that is not the case. Instead, the claim for benefits must be reduced by (a) the aggregate amount paid to employees under the wages claim and (b) the aggregate amount paid to employees under any other benefit plan. In essence, the fifth priority claim is only available, if at all, to the extent of any unused amounts of the $12,475 maximum claim for unpaid wages.

*Recommendation Regarding Employee Issues*
For a distressed company contemplating bankruptcy, it is essential that the company get its "ducks in a row," so to speak. The company should think chronologically:

- If the company is large enough, consider WARN Act issues that would require it to warn employees of shutdowns and layoffs.

- Evaluate whether its employees have been paid, or, alternatively, whether it has some outstanding payments to make before the case begins. Prepare a first day "Wages" motion to pay ongoing employee salaries and benefits while the company is in bankruptcy.

- Upon entering bankruptcy, if the company has CBAs in place, consider modifying or terminating the CBAs, either on an interim or permanent basis. If the company decides to modify or terminate, it should begin negotiating with the applicable union(s) and, if negotiations are unfruitful, prepare a motion to alter or reject the CBA for filing with the court that argues persuasively why the company must modify or reject the CBA. If the court approves the rejection, be aware that labor laws require the debtor to nonetheless follow certain procedures and ensure compliance with such laws.

- If seeking to retain key executives, prepare a compensation package that has as its key purpose "incentivizing" rather than "retaining." Such package may (and probably should) include challenging financial and operational targets.

*Conclusion*

As you might imagine, a bankruptcy filing can drastically alter a company's treatment of its employees, both unionized and non-unionized. As a distressed company prepares for, and files, a bankruptcy petition, it should consider the foregoing issues, which address important employee-related bankruptcy concepts.

## Pension Considerations

Authored by: David L. Eaton, Justin R. Bernbrock and Peter A. Gutsche, *Kirkland & Ellis LLP*

The purpose of this section is to introduce you to the treatment of legacy liabilities, i.e., pension and healthcare plans, in a Chapter 11 bankruptcy case. By the end of this section, you should understand how a debtor in bankruptcy can treat its pension and healthcare plans.

*Legacy Liabilities*

The term "legacy liabilities" simply refers to a company's obligations to fund various benefit programs for active and retired employees. Alternatively referred to as "legacy costs," legacy liabilities are the present and future costs to a company of promises it made to its employees in the past. Generally speaking, there are two broad categories of legacy liabilities: (i) costs associated with pension plans on one hand; and (ii) costs associated with retiree medical and life insurance benefits, referred to as Other Post-Employment Benefits ("OPEB"), on the other. Legacy liabilities can, and often do, substantially burden a company.

Consider first the issue of pension liabilities. In a defined benefit pension plan, a portion of the funds needed to pay the projected benefit obligation comes from income from pension investments. Earnings on pension investments change the cash outflow the employer must contribute to the pension plan — when return on investment is high, the employer must contribute less cash, and when return on investment is low, the employer must contribute more. By tying pension fund earnings to the stock market, an employer is obviously left vulnerable to the cyclical performance of the global economy. A recession, therefore, can have calamitous effects on a business' legacy liabilities — while reducing profits, it simultaneously increases the employer's contribution to the applicable pension plan by devaluing the stocks and bonds that underlie the pension fund. The relevant data bears this out: at the end of 2012, only 18 of 335 companies in the S&P 500 maintaining defined pension benefit plans had fully funded those plans.

Next, consider OPEB liabilities. Historically, many employers have provided OPEB plans featuring a generous package of benefits, including medical, dental, vision, and prescription drug coverage. Some also provide life insurance and disability benefits as well. As you might expect, costs associated with OPEB plans go hand-in-hand with pension liabilities, as both are obligations promised primarily to retirees. While it affects both legacy liabilities, the United States' aging workforce has significantly contributed to OPEB liabilities by increasing the costs of providing such generous healthcare and other benefits. OPEB liabilities are particularly burdensome for state and local governments. In fact, the national total of unfunded OPEB liabilities was approaching $2 trillion in 2011, dwarfing public sector pension liabilities.

Legacy liabilities can be a driving force that plunges a distressed company into balance sheet insolvency, as claims on account of legacy liabilities can eclipse the billion dollar mark. As companies facing the strain associated with ballooning legacy liabilities look for ways to cut costs and increase liquidity, two general options emerge: (1) modify or terminate the company's pension contribution requirements and/or (2) modify or terminate OPEB benefits. Of course, a company can exercise these options in Chapter 11 as a debtor in possession.

*Treatment of Legacy Liabilities in a Bankruptcy Case*
Because legacy liabilities can substantially burden a troubled company, it is no surprise that when such a troubled company files for Chapter 11 protection, it targets legacy liabilities for termination or reduction. Indeed, legacy liabilities have been front and center in a variety of recent Chapter 11 cases, such as the GM, Chrysler, Hostess, and American Airlines cases. First, what happens to pension liabilities in bankruptcy? Recall that pensioners have claims for unpaid benefits. Thus, a debtor will often try to modify or terminate its pension plan in bankruptcy. The rules surrounding a debtor's termination of its pension plan in bankruptcy are quite complicated, but can be summarized as follows. If the debtor's collective bargaining agreement(s) ("CBA") requires the debtor to maintain a pension plan, then the debtor must reject the CBA by following the procedural and substantive requirements outlined in section 1113 of the Bankruptcy Code. Assuming the debtor meets the section 1113 requirements and rejects the CBA, it must then meet the standards for "distressed termination" of the pension plan, which are outlined in the Employee Retirement and Income Security Act ("ERISA").

To terminate a pension plan under the distressed termination standard, the debtor must meet the standard set forth in section 4041(c) of ERISA. This standard contains three requirements: (1) the plan administrator must provide sixty days' advance notice of its intent to terminate to the affected parties, i.e., the retirement plan participants and union representatives; (2) the plan administrator must provide certain information required under section 4041(c) of ERISA, e.g., the name of the plan and the contributing sponsor, statements as to guaranteed benefits, and statements as to whether plan assets are sufficient to pay benefit liabilities; (3) the Pension Benefit Guaranty Corporation ("PBGC"), a public agency that insures the payment of pension benefits under defined benefit plans at statutorily-specified benefit levels, must conclude that the "necessary distress criteria" exist. The distressed termination standard is extremely stringent, however — generally, a debtor can satisfy the distressed termination standard only if it shows that but for termination of the pension benefit plan, it would be unable to pay its debts as they come due and would be unable to continue in business.

In addition to debtor-driven procedures, the PBGC can initiate an involuntary termination of the pension plan under certain circumstances. Specifically, if the PBGC determines that one of the following grounds exist, it can initiate involuntary termination proceedings: (1) the plan sponsor has not made its required minimum funding contributions to the plan; (2) the plan has insufficient funds to pay benefits as benefits become due; (3) there has been a distribution to a substantial owner under ERISA section 4043(b)(7); or long-term loss to the PBGC can reasonably be expected to increase unreasonably if the pension plan is not terminated. When the PBGC involuntarily terminates a pension plan, it usually becomes the plan trustee and succeeds to terminate liability and other claims against the debtor under the plan. Subsequent to such termination, there is often litigation over the size and priority of PBGC's claims.

Second, what happens to OPEB liabilities in bankruptcy? Like pensioners, OPEB plan beneficiaries have claims under the Bankruptcy Code. The Bankruptcy Code addresses these claims in sections 1129(a)(13) and 1114. Section 1129(a)(13) is a threshold confirmation requirement, rather than an independently substantive statute — it requires the debtor to comply with section 1114 to obtain confirmation of its plan of reorganization. Under section 1129(a)(13), a debtor's plan must "provide for the continuance after its effective date of payment of all retiree benefits, as that term is defined in section 1114 of this Title, at the level established pursuant to subsection (e)(1)(B) or (g) of section 1114 of this Title, and at any time prior to confirmation of the plan, for the duration of the period the debtor has obligated itself to provide such benefits."

Section 1114, therefore, is the key statute vis-à-vis OPEB plan treatment in bankruptcy. The primary thrust of section 1114 is to prevent a Chapter 11 debtor from unilaterally terminating or modifying OPEB benefits. That goal is most clearly manifested in subsection (e) of the statute, which provides that a debtor "shall timely pay and shall not modify any retiree benefits." Like section 1113, section 1114 was passed in response to a famous Chapter 11 case that had employee treatment issues at its core. This time, though, it was LTV Steel's bankruptcy case that caught Congress' eye, as the debtor in that case sought on the first day of the case to terminate its medical benefits promised to 70,000 retired employees.

Section 1114 mirrors section 1113's procedural and substantive requirements for rejection of a labor contract. Of course, section 1114 applies to retiree benefits, not labor contracts, but the point is the same — the statute requires the debtor to jump through certain procedural and substantive hoops to modify or reject a retiree benefits program.

In most circuits, the threshold issue under section 1114 is whether the benefits under the applicable OPEB plan have "vested." If the plan is vested, the debtor must comply with section 1114, but if not, the debtor can unilaterally reject the OPEB plan. A plaintiff can show that his or her OPEB benefit has vested if he or she can show a contractual right to that benefit in perpetuity, which cannot be altered without the plaintiff's consent. Courts are split regarding the applicable test for determining whether benefits are contractually vested and, thus, the circumstances under which section 1114 applies. The leading case, Yard-Man, holds that if the benefits contract is ambiguous, there is an inference that the benefits are vested. Importantly, a right to payment under a benefits plan that has vested may not be altered without the consent of the benefit holder.

Assuming that the debtor seeks to modify vested benefits, it must negotiate in good faith with the authorized representative of the retirees, which can be a union or a special committee. Like section 1113, section 1114 requires the debtor to make a proposal based on the most complete and reliable information available, which provides only for modifications to benefits that are "necessary to permit the reorganization of the debtor" and assure that all parties are treated "fairly and equitably." Unlike section 1113, however, no reported decision has considered the "necessary" standard under section 1114. However, in the United Airlines case, the Bankruptcy Court articulated the following standard: "if there is such a significant possibility of a failure to reorganize [in the absence of the OPEB modifications], then I think the reductions can be said to be necessary for the [re]organization."

If the retiree representative "has refused to accept such proposal without good cause," the debtor may move to modify the benefits in court. The statute gives the bankruptcy court 90 days to rule on the motion; during this time, the parties usually negotiate to reach a consensual deal before the court issues its ruling. Assuming, however, that the debtor and retiree representative fail to reach agreement and the court approves the debtor's motion, the affected retirees have an unsecured claim for damages arising from the modification or termination.

*Recommendations Regarding Legacy Liabilities*
In the first instance, a distressed company should, of course, evaluate whether it has any legacy liabilities of note, and if so, whether those are liabilities it would like to curtail.

Assuming the company has pension and OPEB liabilities, it should (and has to) address the two differently:

- For pension treatment, first determine whether the pension plan benefits are granted as part of a CBA. If so, and the company desires to modify or terminate the CBA, it should begin negotiating with the applicable union(s) and, if negotiations are unfruitful, prepare a motion to alter or reject the CBA for filing with the court that argues persuasively why the company must modify or reject the CBA. Additionally, prepare ERISA notices to affected parties of the intent to terminate and develop arguments to meet the "distressed termination" standard.

- For OPEB treatment, look to the language of the contract providing for the benefits and analyze whether they would be considered "vested" benefits or not. If they are not vested, section 1114 will not apply at all (in the very large majority of circuits) and the debtor can drop OPEB from its benefits package offered to employees, leaving employee claims on account thereof as general unsecured claims that may potentially be paid for cents on the dollar. If, however, the benefits are vested, be prepared to negotiate with the retiree representative (either a union or a court appointed committee) in a nearly identical manner to the process in Section 1113, which is described earlier in the "Employment Considerations" section of this Guide. And, if negotiations are not fruitful, be prepared to file a motion with the court arguing persuasively why the company must cut OPEB. In the interim, continue to timely pay all retiree benefits unless and until they are modified under section 1114.

*Conclusion*
As you might imagine, a bankruptcy filing can drastically alter a company's treatment of its retirees, in addition to its employees. As a distressed company prepares for, and files, a bankruptcy petition, it should consider the foregoing issues, which address important legacy liability-related bankruptcy concerns.

## Treatment of Records

Authored by: Philip V. Martino and Sarah K. Baker, *Quarles & Brady LLP*

*Client and Donor Databases*
In the Bankruptcy Code, Section 363(b)(1) specifically restricts a Chapter 7 trustee's ability to sell assets that may contain or constitute Personally Identifiable Information ("PII"). Among a nonprofit business' most valuable assets are its client and donor databases. These databases are likely to contain the following types of information: (i) client and donor credit card and or bank account information; (ii) client and donor social security numbers; and (iii) client and donor names and addresses. These types of information are considered PII under the Code, and are afforded special protection in a bankruptcy sale.

The Bankruptcy Code defines PII as any of the following types of information, if provided by an individual to the Debtor in connection with obtaining a product or service from the Debtor primarily for personal, family, or household purposes: (i) first name (or initial) and last name; (ii) geographical address; (iii) electronic (e-mail) address; (iv) telephone number associated with physical place of residence; (v) social security number; and, (vi) credit card number.

PII also includes each of the following items of information, if such item is connected to any of items (i) through (vi) above: (a) a birth date; (b) birth or adoption certificate number; (c) place of birth, or (d) any other information regarding an identified individual that, if disclosed, will result in contacting or identifying that individual telephonically or electronically.

To the extent a nonprofit corporation's client and/or donor databases contain information constituting PII, the nonprofit corporation may not be able to sell that information during its bankruptcy proceedings. Section 363(b)(1) restricts the transfer of PII where: (i) Debtor had a privacy policy in effect on the petition date; (ii) the policy prohibited the transfer of PII to persons not affiliated with the Debtor, and (iii) the policy was communicated to individuals not affiliated with the Debtor. For instance, if the nonprofit company provided instructions for making donations or procuring services on its website, and the website also contained language stating that any information provided by the donor or client to the Debtor would not be communicated, sold, or otherwise transferred to a third party, that language may be sufficient to constitute a privacy policy for purposes of Section 363(b)(1).

If the nonprofit corporation did not have a privacy policy in effect prior to filing its bankruptcy petition, the information may be sold under the Code, so long as the sale complies with applicable non-bankruptcy law. The nonprofit business and its legal counsel should review state and federal privacy laws to determine whether any restrictions on the transfer of information in the client and donor databases applies.

If the privacy policy does not permit the transfer of PII, the transfer may still occur, but only after the Court orders the U.S. Trustee to appoint a consumer privacy ombudsman, and after notice and hearing, the Court must approve the sale. The consumer privacy ombudsman provides the court with information to assist the court in its consideration of the facts, circumstances, and conditions of the proposed sale of PII. Such information may include: (i) the privacy policy; (ii) the potential losses or gains of privacy to consumers if the sale is approved; (iii) the potential costs or benefits to consumers if such sale is approved; and (iv) the potential alternatives that would mitigate potential privacy losses or costs to consumers.

Consumer privacy ombudsmen appointed by Bankruptcy Courts have supported the sale of PII, provided that certain conditions were met, such as: (i) the purchaser must be in materially the same line of business as the seller; (ii) the purchaser must use the PII for the same purposes as are specified in the applicable privacy policy; (iii) the purchaser must agree to comply with the applicable privacy policy; (iv) the purchaser offers consumers the opportunity to "opt out" of any "material changes" it plans to make to the applicable privacy policy; (v) the purchaser must agree to employ appropriate information controls and procedures (technical, operational and managerial) to protect the PII; and (vi) the purchaser must agree to abide by any applicable state privacy and data breach laws. For more information on this topic, refer to Selling Customer Data in Bankruptcy Raises Privacy Concerns, Journal of Corporate Renewal (March 2012) by Lauren Nachinson.

*Special Rules for Educational Institutions*

The Code contains specific provisions for Debtors whose businesses function as accredited educational institutions. First are those relating to the automatic stay. These provisions can be found in Section 362(b)(14) to (16). Specifically, these subsections provide that filing a bankruptcy petition does not operate as a stay: (i) of any action by an accrediting agency regarding the accreditation status of the Debtor as an educational institution; (ii) of any action by a State licensing body regarding the licensure of the Debtor as an educational institution; or (iii) of any action by a guaranty agency, as defined in section 435(j) of the Higher Education Act of 1965 or the Secretary of Education regarding the eligibility of the accredited educational institution.

<u>Debtor to participate in programs authorized under such Act</u>

Pursuant to these sections, certain government agencies are permitted to continue monitoring educational institutions that have filed for bankruptcy. The government agencies may withdraw an educational institution's accreditation and/or licenses without violating the automatic stay. Moreover, if the Debtor is an educational institution that is participating in certain student loan guarantee programs with the government, the agency guaranteeing loans made by the Debtor can withdraw its participation in the guarantee program without violating the stay. In re Betty Owen Schools, Inc., 195 B.R. 23, 28 (Bankr. S.D.N.Y. 1996) (position taken by U.S. Department of Education in litigation with Debtor related to eligibility of Debtor to participate in programs under the HEA was exempted from the automatic stay under section 362(b)(16)).

The Code also contains special rules for accredited educational institutions relating to property of the estate. Pursuant to section 541(b)(3), the Debtor's eligibility to participate in programs authorized under the Higher Education Act of 1965 (20 U.S.C. 1001 et seq.; 42 U.S.C. section 2751 et seq.), or any accreditation status or state licensure of the Debtor as an educational institution are excluded from property of the estate. Consequently, educational institutions that file for bankruptcy cannot (i) assert that they have a property right in their accreditation status or a license issued by the state, or (ii) insist on the right to participate in programs authorized by the federal Higher Education Act of 1965. (Bankruptcy Law Manual § 5:23 (5th ed.)) The practical implication of these Code sections is that government agencies may be able to take actions affecting, and in some instances revoking, the Debtor's educational licenses, accreditation status, or right to participation in federal programs during the Debtor's bankruptcy proceeding.

*Rules For Medical Institutions*

The Code also contains special rules for health care businesses under the Bankruptcy Code. The term "health care business" is defined in Section 101(27A), and means any public or private entity (without regard to whether that entity is organized for profit or nonprofit) that is primarily engaged in offering to the general public facilities and services for—(i) the diagnosis or treatment of injury, deformity, or disease; and (ii) surgical, drug treatment, psychiatric, or obstetric care.

Health care businesses include any (a) general or specialized hospital; (b) ancillary ambulatory, emergency, or surgical treatment facility; (c) hospice; (d) home health agency; and (e) other health care institution that is similar to an entity referred to in (a), (b), (c), or (d). Health care businesses also include long-term care facilities, including any (i) skilled nursing facility; (ii) intermediate care facility; (iii) assisted living facility; (iv) home for the aged; and (v) domiciliary care facility.

<u>Patient Care Ombudsman</u>

If the Debtor qualifies as a health care business, the Bankruptcy Court may have to appoint a Patient Care Ombudsman ("PCO") pursuant to 11 U.S.C. section 333. This section provides that if the Debtor in a case under Chapter 7, 9, or 11 is a health care business, the court shall order, not later than 30 days after the commencement of the case, the appointment of an ombudsman to monitor the quality of patient care and to represent the interests of the patients of the health care business. The court can decline to appoint a PCO if it finds that a PCO is not necessary for the protection of patients under the specific facts of the case.

If the court orders the appointment of a PCO, the United States trustee shall appoint one disinterested person (other than the United States Trustee) to serve as the PCO. If the Debtor is a health care business that provides long-term care, then the United States Trustee may appoint the State Long-Term Care Ombudsman appointed under the Older Americans Act of 1965 for the State in which the case is pending to serve as the PCO.

A PCO monitors the quality of patient care provided to patients of the Debtor, to the extent necessary under the circumstances, including interviewing patients and physicians. The PCO is required to report to the court after notice to the parties in interest, at a hearing or in writing, regarding the quality of patient care provided to the Debtor's patients. This reporting obligation is ongoing throughout the Debtor's bankruptcy proceeding. If the PCO determines that the quality of patient care provided to the Debtor's patients is declining significantly or is otherwise being materially compromised, the PCO must immediately inform the Bankruptcy Court.

The PCO is required to maintain any information obtained relating to patients as confidential information. The PCO may not review confidential patient records unless the court approves such review in advance and imposes restrictions on the PCO to protect the confidentiality of the records.

To determine whether appointment of a PCO is necessary, courts will focus on: (i) whether Debtor has had a history of considerable patient care issues, or (ii) whether Debtor's reorganization plan poses risks to the quality of patient care. The PCO's fees, as well as its professionals' fees, likely become administrative expenses paid from the Debtor's bankruptcy estate. For more detailed information about PCO appointments in health care businesses bankruptcies, see Dalton Edgecomb, C. Daniel Motsinger, et al., The Next (Tidal) Wave of Cases: Health Care Restructurings and Insolvencies, American Bankruptcy Institute 127 (June 17, 2010).

Patient Records

The terms "patient" and "patient records" are defined in the Bankruptcy Code. The term "patient" means any individual who obtains or receives services from a health care business. The term "patient records" means any record relating to a patient, including a written document or a record recorded in a magnetic, optical, or other form of electronic medium.

Under section 351, if a health care business commences a case under Chapters 7, 9, or 11, and the trustee or Debtor does not have sufficient cash in the estate to pay for the storage of patient records in the manner required under applicable federal or state law, the Debtor or trustee is required to promptly publish notice, in one or more appropriate newspapers, that if the patient records are not claimed by the patient or an insurance provider (if applicable law permits the insurance provider to make that claim) within one year of the notice date, the patient records will be destroyed. The Debtor or trustee is required, during the first 180 days of that one year notice period, to attempt to directly notify each affected patient or insurance carrier of the impending destruction of the records.

If the patient records are not claimed by the patient or an insurance carrier during the one year notice period, the Debtor or trustee is required to write to any appropriate Federal agency, and request permission to deposit the records with that agency. The Code does not require any Federal agency to accept the patient records.

If the patient records are not claimed by a patient or insurance provider, and the Federal agencies decline to accept the records, the Debtor or trustee may destroy the patient records. If the records are written records, the Debtor or trustee may shred or burn the records. If the records are magnetic, optical, or other electronic records, the Debtor or trustee would destroy those records in any manner that would ensure that the record could not later be retrieved.

These protections are triggered only when federal or state law health care business recordkeeping requirements apply.

Transferring Patients

Under section 704(a)(12) a health care business Debtor, or the trustee appointed to administer a health care business's bankruptcy estate, has a duty to transfer patients from a health care business that is in the process of being closed. The Debtor or trustee must use all reasonable and best efforts to transfer patients to an appropriate health care business that (i) is in the vicinity of the health care business being closed, (ii) provides the patient with services that are substantially similar to those of the health care business being closed, and (iii) maintains a reasonable quality of care.

Sales of Health Care Business Assets

The Code provides that property that is held by a Debtor that is a corporation described in section 501(c)(3) of the Internal Revenue Code of 1986, and exempt from tax under section 501(a) of such Code, may be transferred to an entity that is not such a corporation, but only under the same conditions as would apply if the Debtor had not filed a bankruptcy case. This means that state and/or federal laws, rules, or regulations that would otherwise govern the sale or transfer of a nonprofit health care business's assets outside of bankruptcy, must still be complied with if the Debtor intends to sell or transfer its assets while in bankruptcy.

Many states require the attorney general to approve the sale of a health care business' assets. While the applicable guidelines may differ from state to state, state attorneys general commonly consider: (i) the fairness/reasonableness of the proposed sale terms and sale price; (ii) whether the sale benefits a private person or entity; (iii) whether the sale is an arms-length transaction; (iv) whether the proposed sale is consistent with a charitable trust or the mission of the nonprofit entity; (v) whether the sale will affect the availability or accessibility of health care services to the public; and (vi) whether the sale is in the public interest.

There are a number of issues that a nonprofit health care business should consider in connection with the sale of its assets in a bankruptcy proceeding. These issues include (i) possible successor liability for historical overpayments from Medicaid and/or Medicare, (ii) the ability to assign provider agreements, and (iii) continuing compliance with HIPAA requirements. A nonprofit health care business should also consider whether a proposed sale will result in any Hill Burton obligations.

The Hill Burton program provides federal loans and grants for the construction or modernization of nonprofit and public health care facilities. When health care facilities agree to participate in the program, they agree to (i) provide uncompensated care to the public for either 20 years or perpetually; (ii) provide community service, including participation in Medicare and Medicaid; and (iii) complete certain compliance reporting. Whether the Debtor participated in a Hill Burton program is an important consideration as part of any proposed bankruptcy sale because the government may seek to recover funds used for the construction or modernization of a facility if, within 20 years after project is completed, the health care facility is (i) sold to an entity that is not qualified for a grant or not approved as a transferee by the state agency; or (ii) "ceases to be a public or other nonprofit hospital, outpatient facility, facility for long term care, or rehabilitation facility." Id. A health care business considering a sale of its assets as part of a bankruptcy proceeding should consult with an experienced bankruptcy attorney to work through these issues.

For more thorough information regarding the sale of health care business assets, refer to Samuel R. Maizel & Mary D. Lane, The Sale of Nonprofit Hospitals Through Bankruptcy: What BAPCPA Wrought, Am. Bankr. Inst. J. 12 (June 30, 2011); and Dalton Edgecomb, C. Daniel Motsinger, et al., The Next (Tidal) Wave of Cases: Health Care Restructurings and Insolvencies, American Bankruptcy Institute 127 (June 17, 2010).

## Chapter 4 – Alternatives to Bankruptcy

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As explained in Chapter 1 of this Guide, a nonprofit experiencing financial distress has to make several difficult decisions, including whether or not filing for protection under the United States Bankruptcy Code (the "Code") makes financial and practical sense. Before addressing specific options, it is worth emphasizing the importance of obtaining and maintaining an accurate, up-to-date list of creditors. The nonprofit should also maintain a comprehensive balance sheet listing all of its assets and liabilities, including less obvious intangible assets such as intellectual property as well as depreciated fixed assets such as office equipment. The services of an accountant, either in-house or out, may be necessary. It is important for nonprofits to have a firm handle on their assets and liabilities and a complete list of their creditors because such information is essential to a determination of whether it is "balance sheet insolvent," meaning that its liabilities exceed its assets, and/or "cash flow insolvent," meaning that it cannot pay its debts when they come due. A nonprofit experiencing cash flow insolvency can also be said to be experiencing a "liquidity" problem, meaning that the nonprofit's revenues are insufficient to pay debts when they come due and, while it may have valuable assets, such assets cannot be easily converted to cash. Often, problems of liquidity and cash flow are temporary. Balance sheet insolvency, on the other hand, is more long-term.

For purposes of this discussion on alternatives to bankruptcy, it is assumed the nonprofit has already considered the possibility of trying to get out of its financial hole by cutting costs, eliminating programs, and other similar methods. It is also assumed that the nonprofit has considered reorganization under Chapter 11 of the Code but has determined that reorganization is not a viable option. Finally, it is assumed that the nonprofit does not wish to voluntarily pursue liquidation under Chapter 7 of the Code.

*Negotiating Settlement of Debts and/or Workouts with Creditors*

Simply being a nonprofit does not generally render an organization immune from collection activity by its creditors, which can range from friendly requests for payment to decidedly unfriendly litigation. It may be tempting for a distressed nonprofit's officers and directors to try to pay as many bills as possible and, once the bank account is empty, to simply cease operations. The officers and directors should not give in to this temptation. While this option may seem like an easy way out, it could actually create personal liability for the officers and directors. This will not only be a headache but could result in substantial risk to an individual's bank accounts, home, and other personal assets. Illinois and federal law set forth the proper procedures that must be followed in this situation. Generally, if the officers and directors follow those procedures, they will likely be able to avoid personal liability. With this in mind, we turn to the first alternative available to the nonprofit experiencing cash flow issues; that is, the negotiation of settlements and workouts.

A nonprofit experiencing cash flow problems should be aware that many creditors are willing to negotiate with nonprofit debtors, perhaps more so than with the typical for-profit entity. While an insolvent nonprofit should not assume that its creditors will "cut it a break" simply because of its charitable works, the fact is that many creditors will be members of the community served by the nonprofit and will possibly be more lenient as a result. Accordingly, the nonprofit should approach its creditors with a clear explanation of its financial position and be prepared to explain what kind of settlement/workout it proposes in light of its future plans. For example, an insolvent nonprofit could approach its landlord, with whom it has a multiyear commercial lease, and explain that it cannot continue to occupy the landlord's space after the end of the current calendar year. While not guaranteed, an offer to the landlord to make regular lease payments through the end of the year, with the understanding that the lease will be terminated at that time, may be a sufficient compromise for the landlord and provide it an opportunity to find a new tenant to fill the vacancy left by the nonprofit. If the landlord is amenable to the offer, the nonprofit should be sure to get the terms of the new agreement in writing. Another example of a creditor workout agreement would be the restructuring or financing of certain loan agreements with the various financial institutions with whom the nonprofit has a relationship. A restructuring or refinancing workout agreement can come in many forms, such as the extension of the maturity date on a loan, the reduction of the monthly repayment obligation, or, in the case of a lump sum debt, the creation of an installment payment agreement. The nonprofit can, and should, when contemplating ways to reduce its liabilities, think creatively about its debt obligations and not be shy about approaching creditors with workout proposals.

It is worth noting that this advice may not be appropriate for a distressed for-profit entity. The typical for-profit's board of directors does not enjoy the same limitation on personal liability that a nonprofit's board of directors does, so the nonprofit director may be able to take more risks. In addition, the nonprofit director's main fiduciary duties are to the nonprofit itself, while the for-profit director has to worry about keeping shareholders happy. Finally, unlike a for-profit entity, a nonprofit's finances are generally transparent, meaning the nonprofit can more easily have a conversation with creditors without divulging confidential information.

Before moving on from this discussion, one major caveat is worth repeating. A nonprofit debtor should avoid giving improper "preference" to one creditor over another. The decision to give preference to one creditor or group of creditors may result in an angry creditor who is more likely to sue and, in some cases, personal liability for the decision-maker. Because of the potential exposure to liability in complex workout negotiations, the nonprofit should strongly consider retaining the services of a competent attorney to assist with the process.

*Assignments for the Benefit of Creditors and Deeds in Lieu of Foreclosure*
Workout agreements can take many forms and, depending on the number and nature of the nonprofit's creditors, the workout process can either be relatively simple or extraordinarily complex. There are two specific workout arrangements that merit special attention.

The first, called an "assignment for the benefit of creditors," ("ABC") involves the nonprofit voluntarily transferring all of its property to another person or entity to hold in trust so that person/entity can sell the property and apply the proceeds to the payment of the nonprofit's debts. It is usually driven by an insecure creditor that wants to avoid precipitous litigation. An ABC is, essentially, the orderly liquidation of a nonprofit's assets without involving the federal bankruptcy court. (Indeed, the process is governed by Illinois state law.) ABCs can get quite complicated and may have various legal and tax implications, so it is essential that competent legal counsel be consulted before embarking down this road. Because of the complexity of this arrangement and the likelihood of expensive attorney's fees, most nonprofits of modest means would be better off attempting to work out their debts on their own.

The second specific kind of workout, called a "deed in lieu of foreclosure" ("DLF," or, occasionally, a "friendly foreclosure"), involves a nonprofit mortgagor (i.e., a borrower) using a deed instrument to convey all of its interest in a piece of real property to the mortgagee (i.e., a lender, usually a bank) to satisfy a secured debt. The driving force behind the DLF is the difference between the value of the security and the amount of the secured debt. In certain cases, the secured creditor/lender is willing to forgo collection of a part of the secured debt in exchange for the convenience and finality of the nonprofit signing away its rights to the property. Of course, as with any workout agreement, if the nonprofit is not able to work out its other debts, the fact it is able to resolve a debt with one lender might not be enough to avoid bankruptcy. In addition, while a DLF might be a financially viable option to the nonprofit, the lender may not always agree, especially if the property is encumbered by another mortgage or lien or the formal foreclosure process would be cheaper or more effective. Generally, the onus is on the nonprofit wishing to pursue this option, as the lender may not be permitted to do so due to various debt collection laws. As with the ABC, while a DLF is a potential alternative to bankruptcy, it can be quite complicated, so legal counsel is usually required.

*Merger and Consolidation*

Two more options to consider for a nonprofit experiencing cash flow issues are: (1) a merger with another organization, whereby two or more nonprofit corporations merge into one of the corporations, known as the "surviving corporation;" or (2) the consolidation of two or more nonprofits, whereby an entirely new corporation is formed for the purpose of acquiring the assets and liabilities of the consolidating corporations. While these changes are drastic, if the struggling nonprofit can find a willing and able partner that is fully prepared to take on the financial challenges associated with a merger or consolidation, the pooling of resources has the potential to make both organizations better. If, on the other hand, the struggling nonprofit is looking for a financial savior but has no intention of contributing to the union, it is very likely that both organizations will end up suffering and possibly even being forced to dissolve.

In fact, the greatest challenge to organizations planning to merge or consolidate is the management of the personal relationships and office politics between the key people involved. While the needs of the charitable organizations, and the communities they serve, should be paramount, even the best laid plans can be derailed if personal feelings are ignored, especially those belonging to the struggling nonprofit's employees who may feel they are losing control of their baby. Accordingly, there are numerous legal and personal questions that need to be resolved when contemplating a merger or consolidation, such as what the new organization will be called; how the newly formed organization will be governed; which, if any, programs will be cut and which, if any, will be expanded; whether the merger affects the continued viability of funding sources or the enforceability of any contracts; and what effect the merger or consolidation will have on the newly formed corporation's federal tax exempt status, the deductibility of contributions, and the way it is treated by various state agencies. In addition, special rules come into play when one of the parties to a merger or consolidation is not an Illinois corporation or a for-profit entity. Lastly, it is important to understand that a merger or consolidation does not necessarily resolve the struggling nonprofit's debts. Creditors can either continue to seek to recover those debts as if the merger never happened, or it can substitute the newly formed organization and seek recovery of those debts from the new entity. Even still, ensuring that the surviving corporation or consolidated corporation maintains a revenue stream is just as important as satisfying the organizations' creditors. As a result, mergers and consolidations often involve careful negotiations with significant creditors of both organizations as well as open communication with donors.

Mergers and consolidations are complex and time-consuming and can be expensive. While a detailed discussion of the technical requirements for a successful merger or consolidation, including the formation and adoption of a plan of merger or consolidation and the execution of articles of merger or consolidation, is outside the scope of this article, it is worth noting that the failure to carefully comply with the applicable law can result in a court finding an entire merger or consolidation to be invalid. As a result, competent legal counsel should be retained to assist in the merger/consolidation process. Depending on the complexity of the transaction, counsel may also be needed after the process is complete to ensure continued compliance with state and federal law.

*Corporate Dissolution*

The alternatives discussed thus far all apply to nonprofits experiencing cash flow problems, with each alternative offering a potential way for the nonprofit to correct the problem, restore liquidity, and move on. But what happens if none of the above options works, or none is even available in the first place? For a nonprofit experiencing balance sheet insolvency, with liabilities exceeding assets, one of the only alternatives to bankruptcy is to dissolve the corporation under state law. Illinois law provides for three different kinds of dissolution: (1) voluntary dissolution; (2) judicial dissolution; and (3) administrative, involuntary dissolution. Before addressing the specifics of each, it is important to note that corporate dissolution is not the same thing as the liquidation of the corporation's assets. Dissolution is a formal legal process that ends the nonprofit's legal existence. Liquidation, on the other hand, is the conversion of the nonprofit's assets to cash to pay the nonprofit's creditors (and, if anything is left over after all creditors are satisfied, to distribute such remaining assets to other nonprofits in accordance with the nonprofit's governing documents). Liquidation of a nonprofit's assets can occur either before or after it is formally dissolved.

*Voluntary Dissolution*

Illinois law provides, in the case of a nonprofit with no members entitled to vote on dissolution, that a majority of the nonprofit's board of directors can vote to voluntarily dissolve so long as "[n]o debts of the corporation remain unpaid" and proper notice is given. In the case of a financially distressed nonprofit, this restriction is troubling, as the source of the distress is almost always the nonprofit's inability to pay its debts. Nevertheless, the provision is valid and presents a significant issue that must be grappled with by a nonprofit considering its options.

In the case of a nonprofit with members entitled to vote on dissolution, on the other hand, such members are permitted to consent to or vote in favor of dissolution. In both of these situations, the organization's ability to pay its debts is not a prerequisite for the members to take such action. The tension created by these provisions is palpable. By creating a situation in which only the members of an insolvent nonprofit can voluntarily dissolve the corporation, the Illinois legislature seems to invite a last minute resolution by a desperate board of directors to change a nonprofit that never had members to one with members to avoid administrative or judicial dissolution. The authors do not necessarily recommend this course of action, but offer it as a potential loophole that can be exploited by a creative board of directors.

Finally, if the nonprofit's board or officers persist in an attempt to voluntarily dissolve the corporation without first ensuring that all debts are paid, the directors and officers could potentially be exposing themselves to personal liability for the nonprofit's debts.

The Illinois Not for Profit Corporation Act (NFPCA) provides, in the context of the distribution of the assets of a corporation in the process of dissolution, that the first priority is that "[a]ll liabilities and obligations of the corporation shall be paid, satisfied and discharged, or adequate provision shall be made therefor." 805 ILCS 105/112.16(a). Does this mean that a nonprofit can voluntarily dissolve if it can successfully work out all of its debts with all of its creditors? While the nonprofit's debts would not be immediately paid upon execution of the workout agreement, those debts would be adequately provided for, and it is likely that the nonprofit's creditors would be willing to say they are satisfied with this outcome. So, does "no debts remain unpaid" really mean "no debts un-provided for?" Or does the nonprofit really have to wait until the workout payment arrangements run their course before voluntarily dissolving? While there is no Illinois case law on this subject, if the NFPCA requires only that debts be provided for before voluntarily dissolving, a nonprofit that is able to reach workout agreements with all of its creditors should be able to voluntarily dissolve without needing to change the corporate structure to include members. The problem with venturing this guess, of course, is that the nonprofit's directors could potentially be held personally liable if it is later determined that the board was not authorized to dissolve the corporation with some debts remaining unpaid. And, because the law is unclear, the directors could have the specter of personal liability hanging over their heads for quite a while. It is also worth noting that if the nonprofit is able to work out some, but not all, of its debts, it would not be permitted to voluntarily dissolve, both because the holdout creditor could argue that the nonprofit gave preference to other creditors and also because the nonprofit would not be able to say all of its debts are either paid or provided for.

Because of this conundrum, the struggling nonprofit may need to consider judicial dissolution or administrative dissolution.

*Judicial Dissolution*
Another form of dissolution is judicial dissolution. Under Illinois law, there are a number of agencies and entities who may seek judicial dissolution of a nonprofit, including the Illinois Attorney General, a member of the nonprofit, and, under certain circumstances, the nonprofit itself. In addition, a creditor of the nonprofit may seek judicial dissolution of the nonprofit if "the creditor's claim has been reduced to judgment, the judgment has been returned unsatisfied, and the corporation is insolvent"; or "the corporation has admitted in writing that the creditor's claim is due and owing, and the corporation is insolvent." (Because of this statutory language, a nonprofit seeking to avoid a judicial dissolution action may wish to avoid admitting in writing that a creditor's claim is "due and owing" when attempting to work out its debts.)

Once a judicial dissolution action is initiated in an Illinois circuit court, the court has several options for dealing with the nonprofit, ranging from the appointment of a provisional director or custodian, in which case the court retains jurisdiction over the nonprofit's operations for a period of time, to the issuance of an order of dissolution, in which case the court dissolves the nonprofit, thus ending its corporate existence, and retains jurisdiction to oversee the winding up process.

In many ways, judicial dissolution is a cheaper, less complicated state law alternative to the federal bankruptcy process. The state law process is also less formal and less well known. Indeed, there is very little Illinois case law on judicial dissolution, leaving many critical issues unresolved, such as the enforceability of a state court dissolution plan against an out-of-state creditor. In any event, even though it is cheaper than bankruptcy, the judicial dissolution process will invariably be expensive and time-consuming for all parties. As a result, many nonprofits avoid judicial dissolution simply because their creditors and/or members lack motivation to pursue this option.

*Administrative Dissolution*

The final form of dissolution available under Illinois law is administrative dissolution. The power to administratively dissolve a nonprofit lies with the Illinois Secretary of State and can be exercised when a nonprofit fails to file its annual report, fails to pay a fee, and/or fails to appoint or maintain a registered agent in the state. If, after being notified of the Secretary of State's intent to seek administrative dissolution, the nonprofit fails to correct the problem, the Secretary of State will issue a certificate of dissolution which terminates the nonprofit's corporate existence.

Administrative dissolution presents an interesting option for the nonmember nonprofit that cannot pay its debts and, for whatever reason, is not subjected to judicial dissolution. Perhaps the nonprofit's creditors are not interested in pursuing an expensive, drawn-out court process, nor is the Attorney General's office. Perhaps the nonprofit's creditors and the nonprofit have all reached workout agreements, whereby the nonprofit has agreed to pay each creditor a portion of its debt. As explained above, the NFPCA does not allow the directors to voluntarily dissolve the nonprofit in this situation. The directors could, however, simply stop filing paperwork with the Secretary of State, thus allowing the nonprofit to be administratively dissolved. Once the certificate of dissolution is issued, the nonprofit can then bar claims against the corporation and its officers, directors, employees, etc. by following the process set forth in the NFPCA. Assuming the nonprofit's creditors are all satisfied with their workout agreements and thus do not file a claim during the window set forth in the NFPCA, once that window closes, the nonprofit will have achieved the same level closure associated with voluntary or judicial dissolution. Of course, allowing the nonprofit to be administratively dissolved is not a perfect option, and for it to be successful, the nonprofit's creditors have to be patient and the nonprofit's leadership has to be willing to risk a potential mismanagement claim during the months in which they are failing to comply with the state's filing requirements. In addition, the dissolution timeline is not entirely in the nonprofit's control, and the nonprofit cannot even begin the process of barring claims until the certificate of dissolution is issued. Finally, because purposefully allowing an administrative dissolution is tantamount to abandonment, the nonprofit may face criticism and inquiry from members of the community, government officials, or other interested parties.

*Effect of Dissolution*

While voluntary, judicial, and administrative dissolution are all accomplished by different means, they all lead to the same result: the termination of the nonprofit's corporate existence. Dissolution does not, however, transfer title to the corporation's assets, effect any change to the corporation's bylaws, or prevent the corporation from suing or being sued. Nor does dissolution terminate or suspend any proceeding pending by or against the corporation on the dissolution date. A dissolved nonprofit can only conduct those activities necessary to wind up and liquidate its affairs, such as the collection, distribution, and disposal of assets and giving notice to creditors and either discharging or providing for the nonprofit's liabilities. Doing anything else, such as continuing to provide services, may expose the directors and officers to personal liability.

Even still, if the nonprofit follows the notice to creditors procedure set forth in the NFPCA, its directors and officers are generally insulated from personal liability for "known claims." This protection does not extend to claims arising after the date of dissolution, nor does it apply to taxes, penalties, and/or interest on taxes or penalties. Also, while known claims can be barred, the nonprofit itself may still be sued for issues not known to the nonprofit at the time of dissolution. Of course, at that point, the dissolved corporation likely will be collection or judgment proof, and it is very unlikely a creditor would bother suing a non-existent entity that has no money.

For more detailed information on nonprofit dissolution, please refer to the Community Law Project's Guide for Nonprofit Organizations: Dissolution of Illinois Not For Profit Corporations.