BANKRUPTCY ISSUES
CONCERNING CALIFORNIA NONPROFITS AFFECTED BY THE ECONOMIC DOWNTURN

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This information sheet is published as part of Public Counsel's "Turning the Tide" program, a new initiative designed to meet the changing legal needs of our community in light of the economic downturn. You can access answers to other frequently asked questions ("FAQ") and updated resources for nonprofits & small businesses at www.publiccounsel.org/practice_areas/community_development.

> *Unrestricted donations have really dropped off and our 501c3 nonprofit is having difficulty in paying rent and business creditors. Our landlord is threatening eviction. Can a 501c3 organization voluntarily file for bankruptcy?*
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> *We don't think that our 501c3 nonprofit is financially viable. Rather than spend the time and money to file for bankruptcy, can we just dissolve under state law?*
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> *We ordered and paid a deposit on a very expensive piece of office equipment and just learned that the supplier has filed for bankruptcy. Now what?*

In these difficult economic times, nonprofit organizations are being challenged to consider a broad spectrum of strategies that may involve significant structural change. Collaborations and strategic partnerships, back office consolidations and mergers, bankruptcy reorganizations and even closure are all subjects that have become part of the required base of knowledge for nonprofit management and their boards of directors.

In this information sheet, the topic of bankruptcy is explored through a series of questions addressing many common concerns of nonprofit organizations from both the perspective of debtor and creditor. The answers offer a starting point for a nonprofit to evaluate whether the remedy of bankruptcy can help it achieve a more sustainable economic future through a reorganization, or whether the time has come to "close with honor." Also considered are the ramifications for a nonprofit when its landlord or a key supplier files for bankruptcy protection.

This information sheet is provided for informational purposes only and does not constitute legal advice. While this information can help you understand the options available during a period of financial distress, it is very important that you obtain the advice of a qualified attorney. Qualifying nonprofits may be eligible for free legal consultation or representation to assist with these matters. For an application for legal assistance for existing nonprofits, go to http://www.publiccounsel.org/tools/assets/files/Application-for-Existing-Nonprofits-2010.doc or call Public Counsel at (213) 385-2977 ext 200.

INTRODUCTION TO BANKRUPTCY LAW

What is Bankruptcy?

Bankruptcy law is a uniform body of federal law contained in the Bankruptcy Code[1] that provides an organized method for a financially distressed entity to either liquidate or reorganize its affairs. The Bankruptcy Code offers a potential debtor a number of helpful tools, including the ability to continue operations, sell assets, assume or reject contracts, and take out loans, all with a certain amount of court protection. While the Bankruptcy Code is available to a variety of entities, both for-profit and nonprofit alike, as well as individuals, this information sheet only addresses nonprofit corporations that may be considering filing for bankruptcy.

A voluntary bankruptcy case commences by filing a petition with a bankruptcy court.[2] Bankruptcy courts are associated with federal district courts, and have most bankruptcy matters automatically referred to them. The act of filing a petition automatically places the debtor in bankruptcy and creates the bankruptcy estate. The estate will contain the property interests of the debtor, subject to certain exceptions listed in the Bankruptcy Code. State law governs what constitutes a property interest, and the Bankruptcy Code merely specifies which of those interests are included in the estate.

<u>Chapter 7 vs. Chapter 11</u>

There are various "chapters" under the Bankruptcy Code, each available in different situations, and each with various tools and benefits. When a nonprofit organization files for bankruptcy, it typically will file for either a liquidation under Chapter 7 or a reorganization under Chapter 11 (although Chapter 11 can be used to allow for an orderly liquidation of a debtor). While only one chapter can be utilized at a given time, it is possible to convert from a Chapter 7 case to a Chapter 11 case, or *vice versa*.[3] While this

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[1] The Bankruptcy Code is contained in Title 11 of the United States Code.

[2] A nonprofit corporation cannot be forced into an involuntary bankruptcy.

[3] Generally, the debtor has an absolute right to convert a Chapter 11 case to a Chapter 7 case. A creditor can also make a request to the court for conversion. Conversion will be allowed where the moving creditor has shown "cause" for the conversion (generally, mismanagement by the debtor or a failure to participate in the reorganization process). The debtor cannot prevent such conversion absent a specific showing that it would not be in the best interests of creditors. While conversion from Chapter 11 to Chapter 7 is probably the more common situation, the debtor can also convert a Chapter 7 case to a Chapter 11 case (or a case under another Chapter). Similarly, a creditor can petition the court to convert a Chapter 7 case to a Chapter 11 case, but as with a forced conversion to Chapter 7, cause must be shown. As with the initial decision of which chapter to file, your organization should consult a qualified attorney before it converts its case to a different chapter.

section explores some of the basic differences between the two chapters, it is important to consult with both legal and business advisors when choosing under which chapter to commence a case.

Chapter 7 Liquidations

In a liquidation proceeding under Chapter 7, a trustee is automatically appointed and is tasked with liquidating and subsequently distributing the cash value of the debtor's assets to creditors. Such distributions are made according to a creditor's priority. "Priority" is a concept under the Bankruptcy Code that establishes the order in which claims are paid from the bankruptcy estate. All claims with a higher priority must be paid in full before claims with a lower priority receive anything. For example, a creditor with a security interest in property of the estate such as a mortgage will be paid before an unsecured trade creditor. If there are insufficient funds in the estate to pay all creditors in full, claims are paid in order of priority. If sufficient funds are unavailable to pay claims in a given priority class in full, all claims with that priority share *pro rata*. In a Chapter 7 liquidation, a debtor's operations cease and management is removed from control. The trustee's involvement with the estate lasts only until liquidation and distribution have been completed.

To protect the estate, any business activity undertaken by the debtor requires notice and a hearing before it may proceed. The rationale is that because the debtor will go out of business at the close of the proceedings, any activities must be clearly shown to benefit the creditors.

Chapter 11 Reorganizations

In contrast to a proceeding under Chapter 7, an entity usually undertakes a Chapter 11 reorganization when it will be beneficial to remain a going concern, either indefinitely or until assets can be sold. While assets sold as a going concern may be worth more than assets sold through a liquidation, there are significant administrative costs associated with a Chapter 11 case. It is important to realize that such "administrative expenses" are usually paid before any unsecured claims. In some situations the administrative expenses (e.g., legal fees for the debtor's counsel, a broker's commission with respect to the sale of real estate after bankruptcy has been declared or the appraisal fee required to justify the price of an asset to be sold) could be so high as to render the estate "administratively insolvent," meaning that there is not enough value to satisfy even the administrative claimants, let alone the creditors who were owed money before the bankruptcy petition was filed. Such expenses are one factor an organization should consider with its advisors when determining under which chapter to file.

Once a debtor files for Chapter 11 protection, it can continue to operate its business or nonprofit enterprise within the confines of the Bankruptcy Code. Among other things, the debtor can borrow money (so called "debtor in possession" or "DIP" financing), sell assets to raise funds, continue to operate and pay employees, and continue to perform under its contracts. Because reorganizations focus on maintaining the business, ordinary operations of the debtor may continue without notice or a hearing. Activities outside of the ordinary course, however, will require court approval. Additionally, whereas Chapter 7 always involves the appointment of a trustee, in a Chapter 11 case the debtor's management remains in possession of the estate and acts in the capacity of the trustee, absent fraud, dishonesty, incompetence or gross mismanagement.

In order to exit Chapter 11 (absent conversion to a Chapter 7 liquidation), the court must approve a "plan." A plan for reorganization (1) designates classes and claims of interests, (2) specifies how each class will be treated (and which classes will be "impaired"), and (3) provides adequate means for implementing the plan's terms. All claims within a class must be treated equally. Except as discussed below, under the "absolute priority rule," each creditor holding an unsecured claim must receive 100% present value of their claim, or no claim or interest with a lower priority can receive or retain any interest on account of their previous interest.

Absent appointment of a trustee, the debtor's management has an exclusive right to submit a plan for the first 120 days of the case. As the case progresses, additional interested parties, including creditors, may also submit plans. The plan, or multiple plans in some cases, will then be voted on. Only those classes that are "impaired" are allowed to vote. For the most part, a class will be deemed impaired unless the plan leaves all of the claimants' legal and equitable rights unchanged. In general, in order for a plan to be approved, it must be shown that the value received by the debtor's creditors pursuant to the reorganization plan will be at least equal to what they would have received through liquidation. If the debtor cannot meet the reorganization requirements of the Bankruptcy Code, it may be forced to liquidate.

As you can see from this brief discussion, Chapter 11 reorganizations can be very complicated, often necessitating substantial advice from legal and financial professionals. The costs associated with such advice may make a reorganization impractical, or even impossible. Any organization contemplating a Chapter 11 reorganization should consult with a bankruptcy attorney to discuss the options available to your organization.

Special bankruptcy considerations for nonprofits with members[4]

One important difference for a nonprofit filing for bankruptcy, as opposed to a for-profit entity, is that the absolute priority rule may not apply to holders of membership interests in the nonprofit. As discussed above, the absolute priority rule requires that each creditor holding an unsecured claim receive 100% present value of its claim before any interest holder holding a lower priority claim receives

[4] This information sheet is aimed at nonprofit corporations, and to a limited extent, nonprofit limited liability companies. Additionally, certain information may vary depending on the jurisdiction. Furthermore, this sheet does not cover trusts. If your organization is a trust, or owns an interest in a trust, please consult an attorney who specializes in trusts.

or retains any interest on account of its previous claim or interest. In the for-profit situation, this means that unless all of the creditors receive 100% present value of their claims, the equity holders receive nothing (absent consent by the creditors). However, this rule does not generally apply to nonprofits because nonprofits do not have equity ownership interests. Although there is little court authority on this issue, the Ninth Circuit has stated that control in the absence of profit share and ownership of corporate assets, does not establish an equity interest. In the nonprofit scenario, the absolute priority rule doesn't apply to eliminate the member's interest. Thus, a nonprofit's members may be able to remain in control of the organization post-bankruptcy, despite a failure to satisfy the absolute priority rule. This is an important distinction and a beneficial one for nonprofits to be aware of. However, because there is little established guidance in this area, it is important for a nonprofit to consult a qualified attorney regarding this topic.

What might be some benefits of filing for bankruptcy?

In addition to the ability to continue operations, including borrowing money, paying employees and performing other everyday functions, filing for bankruptcy also provides the debtor with protection from creditors' collections efforts and various tools it can use to maximize the value of the estate and to protect its assets and operations. In particular, confirmation of a Chapter 11 plan, discussed above, may result in the discharge of certain debts.[5] Some of these tools are briefly described below.

<u>The Automatic Stay</u>

After a petition is filed, the Bankruptcy Code provides for an automatic stay of debt collection activities against the debtor. The stay is very broad, and is intended to protect estate property while also providing the debtor with a "breathing spell" from its creditors. Upon the filing of the petition, the stay *automatically* goes into effect, so that creditors have to cease their collection activities. Not only does this mean that formal proceedings, such as evictions and foreclosures, are stopped, but creditors are also prohibited from calling the debtor, sending letters, or otherwise demanding payment. There are, however, certain types of actions that will be allowed to proceed despite the stay. Specifically criminal actions against the debtor and certain other government actions to enforce police and regulatory powers will not be enjoined. In addition, the stay will not halt certain proceedings by creditors to perfect claims against the debtor. Finally, third parties can seek court relief allowing them to continue in their collection activities.

[5] The term "discharge" means that the debtor is no longer personally liable for the debt. Receiving a discharge order is often one of the principle reasons individuals file for bankruptcy. However, the discharge concept is more complicated with regards to entity filings, and a discharge order may not be available to your organization despite a successful reorganization. Furthermore, only individual debtors can be granted a discharge in a Chapter 7 case. A nonprofit should have a detailed discussion with a qualified attorney regarding the potential for the discharge of any of its debts.

Because of the nature of the stay and the ability of a third party to seek relief, a nonprofit should consult with an experienced attorney before assuming that filing for bankruptcy will enjoin specific actions against the organization.

Avoidance Powers

In addition to the automatic stay, a debtor's estate is also protected by its ability to unwind certain actions that were undertaken prior to filing for bankruptcy protection. The debtor's "avoidance powers" can be used to draw assets back into the estate, thereby maximizing the estate's value. One way this is accomplished is by unwinding "preferences." Bankruptcy law allows the debtor to set aside transactions entered into within the "preference period," typically ninety days before the filing of the petition (or one year in the case of insider-transferees).[6] If the conditions set forth in the Bankruptcy Code are met, the preferential transfers are avoided and the property is returned to the estate. The rationale behind this provision is that the debtor should not be allowed to prefer one creditor over others, and that instead funds should be returned to the estate and divided up evenly.

Another tool is the debtor's power to avoid "fraudulent conveyances." While a fraudulent conveyance can be a transfer involving an attempt to hinder, delay or defraud creditors, it can also be one in which an insolvent entity receives less than reasonably equivalent value for the assets transferred. Thus, there need not be any deceit involved. As with the debtor's preference power, the law concerning fraudulent transfers allows the debtor to set aside certain transactions, recapturing property for the estate and the benefit of all creditors.

One issue which is important to be aware of is that in an avoidance action, the debtor may be able to recover from the transferee, any party for whose benefit the transfer was made, or any subsequent transferee of that property. Thus, while the estate can avoid preferential or fraudulent transfers made directly to a creditor, it can also recover the property *from a party for whose benefit the transfer was made*. For example, if the estate's debt is guaranteed by one of its directors, any transfer from the

[6] An illustrative, but by no means exhaustive, list of those who may qualify as an "insider" is provided in the Bankruptcy Code. With respect to debtor corporations (as opposed to individuals, which we do not cover here), insiders can generally be thought of as those persons or entities that are (1) able to or have exercised a measure of control over the debtor (including but not limited to directors, officers, general partners, major shareholders, other persons in control or the relatives of the foregoing); or (2) persons or entities in which the debtor itself has an interest, as such transfers are thought more likely to have been motivated by the personal relationship to the party involved. It is important to note that the person or entity alleged to have been an insider must have been an insider *at the time the transfer was made*. Generally speaking, transfers to those that were at one time insiders but were *not* insiders at the time of the transfer are not at risk of having such transfers avoided solely because of having been an insider. As noted, this definition is meant to apply generally, and because circumstances differ in every case any issues that may hinge on whether or not an individual or entity is deemed to have been an insider should be thoroughly discussed with a bankruptcy practitioner.

estate to the creditor could be recovered from the director since the director benefited by satisfaction of the guaranteed obligation.

Assuming or Rejecting Contracts

Another powerful tool available to a debtor is the ability to assume or reject executory contracts and unexpired leases. Generally speaking, an executory contract is one under which both parties still have material obligations to fulfill. Although there are certain limitations, this tool gives the debtor the power to reject an unfavorable contract (for example, a contract under which the debtor has to pay over-market for goods) or to assume a favorable one (for example, a below market lease). A debtor may assign an assumed contract to a third party as well. One limitation, however, is that the debtor must cure any defaults under the contract before it can be assumed and provide adequate assurance of its future performance. There are additional limitations on the debtor's power to assume or reject contracts, some of which are discussed below in the section on "Considerations for Nonprofits as Creditors in Bankruptcy."

What are the state law alternatives to a federal bankruptcy?

In addition to bankruptcy, California state law provides alternatives that may be preferable to nonprofit entities struggling to carry on their operations. These options are discussed in this section.

Voluntary Dissolutions in California

Voluntary dissolutions, as the name suggests, occur when the nonprofit itself makes the decision to dissolve. This can be done for any reason, and there is no requirement for court input when coming to the decision, though courts may be asked to supervise the process.

The approvals required to dissolve depend on the nature of the nonprofit. If the nonprofit has no members, is bankrupt or has disposed of its assets having not conducted business in a minimum of five years, it is likely that only the board of directors needs to approve the dissolution. If the nonprofit has members, a majority of such members must approve the dissolution, subject to other applicable laws or provisions in the entity's organizational documents. The Attorney General's waiver of any objection to the plan for distribution of assets will be required before dissolution can be completed.

Involuntary Dissolutions in California

In the same way a nonprofit cannot be involuntarily placed into bankruptcy by its creditors, creditors are similarly not allowed to cause the nonprofit to involuntarily dissolve. However, a petition for involuntary dissolution can be brought by other interested parties, specifically (a) one-third of the membership votes; (b) one-half of the directors; (c) the Attorney General; or (d) any other party authorized to do so by the entity's articles of incorporation. There are numerous grounds on which these parties can bring about an involuntary dissolution, and so a struggling nonprofit should consult an experienced bankruptcy attorney to determine whether any may exist.

The practical effect of dissolution is not altogether dissimilar from a bankruptcy liquidation. The structure is less rigid and for that reason may be more palatable if an entity can work amicably with its creditors. Once the process begins, the nonprofit must, to the extent possible, stop doing business and wind up its affairs to pay its debts and liabilities out of its remaining assets. Certain nonprofit property may be subject to distribution restrictions as outlined in "Treatment of Gifts and Donations in Bankruptcy" below. Finally, dissolution does not impair remedies available to or against the nonprofit for rights or liabilities existing prior to the dissolution (subject to applicable statutes of limitation).

Choosing Between State Dissolution and Bankruptcy

As noted, the end results of a state dissolution and a Chapter 7 liquidation may not appear to be very different. However, there are considerations that nonprofits should weigh before choosing one over the other. State laws lack the comprehensiveness of the Bankruptcy Code, and a number of the protections offered by the Bankruptcy Code (*see* "The Automatic Stay," "Avoidance Powers," and "Assuming or Rejecting Contracts," above) will be unavailable in dissolution. Dissolution thus imposes a greater need for the parties involved to cooperate in managing and distributing the entity's assets. In situations where cooperation seems unlikely, choosing dissolution may place unnecessary burdens on the nonprofit. On the other hand, bankruptcy proceedings are more complex and expensive undertakings, and a nonprofit may experience difficulty finding counsel willing to provide inexpensive representation over an extended period of time. Furthermore, there is an eligibility threshold for bankruptcy filings which must be met, though this requirement relates primarily to how the nonprofit is organized and should not pose a problem for entities that are corporations or "business trusts" as those terms are defined in the Bankruptcy Code. Finally, bankruptcy may carry with it a stigma the nonprofit would like to avoid. All of these concerns should be weighed by a nonprofit's management.

DUTIES OF THE BOARD OF DIRECTORS

Members of an organization's board of directors are considered to be in a fiduciary relationship with that organization.[7] A fiduciary relationship is one in which a party owes a duty to act primarily for the benefit of others. Nonprofit directors' fiduciary duties include the duty of care, the duty of inquiry, and the duty of loyalty.[8] Like the directors of for-profit corporations, directors of nonprofits owe these fiduciary duties to the nonprofit corporation. Because a fiduciary relationship gives rise to duties and responsibilities that may be enforced in a court of law, determining *who* is owed a fiduciary duty is of the utmost importance. As discussed below, the groups who may enforce the fiduciary duties of directors may change when a corporation files for bankruptcy, or otherwise finds itself in financial distress.

What should the Board's considerations be if our nonprofit becomes financially distressed?

As mentioned above, a director's fiduciary duties always run to the corporation. When an organization is in financial distress, however, its board of directors may face claims initiated by its creditors (including its donors), alleging breaches of fiduciary duties. Even though the duty remains the same (to maximize the corporation's value) the creditors may be able to enforce the duty in the event of financial distress.[9] Because of this, the creditors may institute litigation on behalf of the corporation, challenging the decisions of the board, or even seeking to impose personal liability on the directors.

One common means of insulating directors from personal liability is through directors' and officers' insurance policies (so-called "D & O insurance"). While typically the organization pays the premiums for

[7] This discussion is also applicable to officers of a nonprofit organization. "Officers" are generally those individuals who have high-level management responsibility for running the day-to-day operations of the organization.
[8] The fiduciary duties which a director may owe its organization are determined by non-bankruptcy law. Additionally, such duties may vary depending on the jurisdiction and type of entity. The fiduciary principles described in this information sheet are derived primarily from cases adjudicated under Delaware law, but are instructive in determining how comparable issues would be decided in California. Regardless of the specific circumstances, a qualified attorney should be consulted to provide advice on issues of fiduciary duties.
[9] Unfortunately there is no precise test to determine what counts as sufficient financial distress. However, courts have allowed creditors to challenge a directors' actions prior to an actual bankruptcy filing. Generally, an organization is nearing insolvency, and may be vulnerable to attack, when liabilities exceed assets, or when there is an inability to pay debts as they come due. Because nonprofit organizations frequently find themselves in this precarious financial position, it is important that the board consider the creditors' ability to enforce fiduciary duties at the first sign of financial distress. While individual circumstances may differ, determination of when a corporation is sufficiently close enough to insolvency will likely require complex financial and legal analysis.

such policies, the policies themselves generally do not become part of the bankruptcy estate. Instead, the proceeds of such policies are used for the purpose for which they were intended; paying for liabilities assessed against the insured directors and officers. Directors' and officers' policies may provide important protection for a nonprofit's officers and board of directors. Please consult an attorney or insurance expert to determine if it is appropriate for your nonprofit.

When a nonprofit corporation is under financial stress, the fiduciary responsibilities of the board may be enforced by a number of interested parties, including creditors, donors, and customers. Maximizing the nonprofit's total value, however, must remain the focus and may necessarily involve difficult decisions that require weighing the interests of several disparate groups. It is important that the board not make decisions that favor one of these constituents over another without careful consideration of its obligations, and full information. It is also important that the Board not make decisions at the expense of ongoing statutory obligations relating to its employees. An employer should continue to pay all employee obligations, including salaries, wages and related taxes, until it has consulted with an attorney. As both bankruptcy and nonbankruptcy law may be applicable in the case of layoffs, the employer should make sure to obtain adequate legal advice on all employment related issues.

Finally, the board should assume that its actions during this time will be scrutinized and second-guessed. Primarily, the board must be wary of actions or inactions which may involve conflicts of interest, insider issues, or preferential treatment of certain parties. The board should work with outside experts to obtain all necessary information prior to making important decisions. Furthermore, the board should take special care to document the decision-making process, including the alternatives that were considered, and the information that was relied on in making each decision. It is essential that this process include consultation with a bankruptcy attorney.

TREATMENT OF GIFTS AND DONATIONS IN BANKRUPTCY

How are restricted and unrestricted gifts treated in bankruptcy? If our nonprofit becomes financially distressed, can we access the principal of endowed or restricted funds in order to continue as a going concern?

Endowed Funds in Bankruptcy

Funds that nonprofits consider to be "endowments" come in two forms: endowed funds and quasi-endowed funds. In an endowed fund, the principal must be preserved in perpetuity due to conditions imposed by the fund's donor. In addition to these restrictions, the donor may choose whether to impose restrictions on the income. A quasi-endowed fund is a fund that would otherwise be unrestricted, save for the fact that the nonprofit has decided to treat the particular fund like an endowed fund. In bankruptcy, the principal from an endowed fund is very unlikely to become part of the bankruptcy estate, however income from the endowment can be included. If the endowed fund is held by an independent third party trustee, neither principal nor income will be included in the estate. Because nonprofits have unlimited access to the principal and income of quasi-endowed funds, such funds will likely be included in the bankruptcy estate. In sum, where the nonprofit has control over a portion of a fund, it is more likely to be included. An experienced attorney should always be consulted before assuming funds will fall into one category or another.

Endowed funds in most cases will fall under the Uniform Prudent Management of Institutional Funds Act ("UPMIFA"). The UPMIFA provides the opportunity to alter restrictions on endowed funds in order to access the principal. First, a donor can provide his or her consent to the release of any restrictions. If the donor is deceased or otherwise unavailable, the restriction may only be changed with court permission. The court may amend the restriction on the fund through the doctrine of *cy pres*. The legal doctrine of *cy pres* is used when the donor can be shown to have held a general charitable intent, and the specific intent for the gift has subsequently become permanently impossible, impracticable or illegal. The court may then revise the specific charitable purpose in a way that is still related to the original purpose. The fund, however, will remain an endowed fund, as the court can only change the fund's purpose, not its character.

<u>Non-Endowed Funds in Bankruptcy</u>

Non-endowed funds unrestricted by donors as to use are subject to attachment and are reachable by creditors. A nonprofit's reserve funds are considered separate from its endowments, and because the nonprofit may draw them down at any time, the reserves will be included in the bankruptcy estate. Any remaining non-endowed funds left after payments have been made to creditors are still held in charitable trust by virtue of the express declaration of the nonprofit's purposes in its articles of incorporation. Thus, a nonprofit undergoing a liquidation must distribute those funds to another charity with a similar purpose. Other unrestricted gifts similarly remain subject to the limitations in the nonprofit's charter. If the gift has been used to purchase assets or has been commingled with general assets, it will become a part of the estate in bankruptcy.

Whether a non-endowed gift restricted in some way by the donor as to use will be included in the bankruptcy estate and available for the payment of creditors depends on the application of state law and a determination about whether a charitable trust has been created. Legal analysis of the facts and circumstances surrounding the creation of the gift by an experienced bankruptcy practitioner will be required.

Treatment of Assets in Dissolution after Payment of Debts

In dissolution, assets held in trust or upon certain other conditions requiring return must be returned, transferred or conveyed in accordance with such conditions. Assets subject to restrictions under the nonprofit's articles, bylaws or a trust must be distributed for a use that is consistent with such restrictions. If the entity is exempt under Internal Revenue Code § 501(c)(3), any organization receiving its corporate assets must be similarly exempt. Additionally, a waiver from the Attorney General will be required for distribution of the assets of a public benefit corporation or for assets held in charitable trust (*see* "Voluntary Dissolutions in California" above). If the attorney general disagrees with the distribution plan, the matter will be resolved in court, which will be guided by the *cy pres* doctrine in determining how the assets are to be distributed.

Lastly, a nonprofit should be aware that if it does not observe the funds' restrictions, it could face legal action by donors and/or the Attorney General. Failure to observe such restrictions could also have tax consequences.

CONSIDERATIONS FOR NONPROFITS AS CREDITORS IN BANKRUPTCY

What if another business that owes us money files for bankruptcy?

As discussed above, upon the filing of a bankruptcy petition, a bankruptcy estate is created. Anyone with a claim against the debtor can only collect by asserting its claim against the bankruptcy estate. A nonprofit organization, like other individuals or business entities, may have a claim against the estate if it gave money to the bankrupt entity before it filed. A "claim" is defined broadly under the Bankruptcy Code and a claim could exist if an organization provided money to the debtor before it filed, whether for investment, payment on goods or services, or for another reason. A claim against the bankruptcy estate might be held to exist even if it is contingent or not yet liquidated. Because this is a complicated area of the law, an organization should seek guidance from a qualified attorney to assist it in ascertaining whether it has a claim.

Proofs of Claim and Bar Date

When the debtor files for bankruptcy it has to file a list or "schedule" of its creditors and their claims. In a Chapter 11 case, if a claim is listed on this schedule, no further action may be required to assert the claim against the estate. However, if a claim is not listed, or is listed as disputed, contingent or unliquidated, a creditor must file a "proof of claim" against the estate. A proof of claim must always be filed in cases not under Chapter 11. A proof of claim is a legal document that is filed with the bankruptcy court setting forth the amount the creditor claims it is owed by the debtor. The creditor must use a special form when filing a proof of claim and should seek legal assistance in filling out the form with the appropriate information.

In Chapter 11 cases, the bankruptcy court will set a “bar date,” or a deadline by which all of the proofs of claim must be filed. In Chapter 7 cases, the bar date is automatically set for 90 days after the date first set for the meeting of creditors (often very soon after commencement of the case). Furthermore, there are certain types of claims that a creditor must file even before the expiration of the general bar date. For example, a claim for reclamation of goods shipped to the debtor within the applicable time period must be filed within 20 days of the bankruptcy petition date. Additionally, if a creditor intends to make a motion to have its claim determined “non-dischargeable”[10], such a claim must be made on a shortened timeframe (generally, within 60 days of the date first set for the meeting of creditors). Therefore, as soon as your organization becomes aware of potentially having a claim against the debtor’s estate it should contact bankruptcy counsel and seek to (1) determine whether its claim is listed on the debtor’s schedule; (2) determine whether the claim is listed as contingent, disputed or unliquidated, and (3) ascertain when the bar date (or applicable deadline) is.

In some large bankruptcies, a website may be set up to facilitate the claims process and to provide further information to creditors. While these sites can be useful, creditors should be wary of any site purporting to provide advice and should recognize that for-profit sites also exist. Again, it is important that creditors and potential creditors obtain legal advice regarding potential claims.

What is the impact on our lease if our landlord files for bankruptcy?

The act of filing for bankruptcy, in and of itself, does not affect the validity of a lease. However, under the Bankruptcy Code, the landlord-debtor has the ability to “assume” or “reject” the unexpired lease. Generally, if the landlord-debtor assumes the lease, the tenant is obligated to keep performing, i.e. keep paying rent, under the lease. Because the automatic stay is in place, any failure by the tenant to pay rent could be viewed as a violation of the stay.

On the other hand, the landlord-debtor could choose to reject the lease. Depending on the terms of the lease agreement, such rejection could act to terminate the lease and the tenant could move out. Alternatively, despite rejection by the debtor, the Bankruptcy Code provides certain protections for tenants in this situation who want to remain in possession. In general, these protections allow the tenant to stay in possession of the real property for the remainder of the lease term (including any

[10] As mentioned above, individual debtors, and in some instances, organizational debtors, can have debts discharged. Under certain circumstances (often involving misdeeds by the debtor), a creditor can petition the court to determine its claim non-dischargeable. If the creditor is successful, the debtor will remain personally liable on the claim.

renewal options). However, the debtor may be able to avoid performing other affirmative obligations.[11] In such event, the remedy of "offset" may be available to the tenant, allowing the tenant to reduce its rent by the amount of any damages caused by the landlord-debtor's non-performance.[12] As mentioned above, because the automatic stay is in effect, and prohibits actions to offset prepetition claims against the debtor, the organization should consult an attorney before any action is taken to offset.

Finally, another principal concern when your organization's landlord goes bankrupt, is the status of its security deposit. Because this money remains the property of the tenant, not the landlord, it will generally not be accessible by creditors.

What are our rights if we have paid for expensive equipment, and before it was shipped, our supplier filed for bankruptcy?

As explained above, a debtor can file for Chapter 11 and attempt to reorganize, or it can file for Chapter 7, and liquidate. If the supplier filed for Chapter 11, it may continue to operate and may ship goods ordered in the ordinary course of business. Alternatively, it is possible that the debtor could either stop production (for example in a liquidation) or refuse to ship an item already ordered. An attempt to force the debtor to ship the equipment could be a violation of the "automatic stay," discussed above. Additionally, a customer's refusal to pay for goods ordered could also be a violation of the stay. Similarly, an attempt to "offset," as discussed above (in this case, subtracting the value of the property from other monies due to the supplier) could also be a violation of the automatic stay. An organization should refrain from taking any of these actions until it has sought the advice of counsel.

Finally, it is also worth noting that depending on the terms of the sales contract, the supplier might retain title to the property even though your organization has already paid for it. In the event your organization faces this problem, you should consult an attorney to determine your rights and remedies.

What should an organization do if one of its donors files for bankruptcy?

There can be several legal implications when a nonprofit's donor (whether an individual or an entity) files for bankruptcy. Because the automatic stay is in place, actions by the nonprofit to enforce a gift that was made could be a violation of bankruptcy law. Additionally, because of the debtor's power to "assume" or "reject" some types of contracts, the nonprofit organization could find itself forced to carry out a contract with the debtor. Finally, in some instances, bankruptcy law may allow for the recovery of

[11] Additional protections (with similar limitations) also exist for land sale contracts and intellectual property. If your organization has either asset, it should seek guidance from an attorney.
[12] The term "offset" in these circumstances simply means to withhold certain portions of the rent as compensation for damages incurred by the tenant due to the landlord's failure to perform in some respect.

property or funds which the debtor already donated to the nonprofit organization. As noted earlier, under such “avoidance powers” the bankruptcy estate can seek to avoid transfers that the debtor made before filing for bankruptcy. There are, however, important limitations on these powers with respect to the debtor’s ability to avoid transfers of charitable contributions. Generally, transfers to a qualified religious or charitable organization are not avoidable unless they exceed 15% of the debtor’s gross annual income for the donation year *and* were also inconsistent with the debtor’s practices of making charitable contributions. Note, however, that the above limitations only apply to “constructive” fraudulent conveyances. If the fraudulent conveyance involved an attempt by the debtor to hinder, delay or defraud creditors, these limitations will not apply. The nonprofit may also face liability on the basis of a preference. Thus, while a nonprofit organization could find itself as a defendant in a lawsuit brought by the bankruptcy trustee, it may have a viable defense and should consult an attorney.