Building Nonprofit Resilience: Dealing with Financial Distress

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In this multi-part series, we highlight strategic steps that nonprofits can take to build organizational resilience in three different phases of its life cycle—in times of health, when beginning to experience financial or other challenges, and in times of financial distress.

In our first installment, we discussed nonprofit strategy in times of financial and organizational health. In the second installment, we explored strategic steps an organization can take to build resilience when there are early signs of organizational stress. In this installment, we provide strategies for responding to financial distress.

We will define financial distress broadly as a situation where a nonprofit organization is faced with potentially existence-threatening financial problems, either imminently or in the foreseeable future. This could be the result of a sudden funding loss; upcoming maturity on debt with no viable options for paying off the debt or refinancing; fundraising, programmatic, or operational shifts that significantly increase expenses and/or reduce income; or some other cause.

For instance, the COVID-19 pandemic created a variety of still-evolving challenges for nonprofit organizations. Organizations that faced sudden forced layoffs at the beginning of the pandemic may now be facing labor shortages. As costs of labor and materials continue to rise as a result of inflation, philanthropic giving is still catching up to pre-pandemic levels and government relief programs are expiring.

The nonprofit sector has proved to be resilient through these challenges: even though recent surveys have indicated a significant percentage of nonprofits expressing concern about their ability to meet financial obligations or continue operations in the near future, there has to date not been a wave of nonprofit closures or bankruptcies. For organizations facing potentially existence-threatening challenges, however, the strategies that follow may help in determining the best course of action to be taken in the worst of circumstances.

In times of financial distress, a nonprofit's board will be tasked with making important decisions about the future of the organization. The first critical question the board will be forced to ask is whether the organization is salvageable. If it is, the board must make decisions about how to restructure the organization

and what the future of the organization will look like. If the organization is not able to continue, the board must decide how to wind down operations. Typically, the earlier the board begins this analysis the more likely it will be to successfully turn around the organization.

Can the Nonprofit Survive?

The first question a board should ask is whether the organization is likely able to continue operating. At this phase, the board should determine whether the organization is insolvent—whether the organization's liabilities exceed its assets and whether organization has enough cash flow to service its debt payments—and whether, taking a hard look at expenses and liabilities, it is possible to restructure to save the organization.

The board, in concert with key leadership staff, should consider possible avenues for cost savings, such as eliminating or trimming programs, downsizing staff, selling real estate, or terminating or renegotiating leases and contracts.

If these strategies can be deployed without impacting income streams, such as program- or staff-dependent grants, it may be possible to salvage the organization. In this case, restructuring options may include a formal restructuring process, such as a bankruptcy or receivership, or it may be possible to restructure without resorting to a formal process. Under any scenario, it may be helpful to engage outside experts, such as a restructuring specialist and restructuring counsel, to assist with evaluating the organization's financial condition and possible work-out solutions.

Under any form of restructuring plan, it will be critical to carefully manage internal and external communications about the organization's situation and plans. The communications plan should include thoughtfully crafted messaging and communications to specific groups such as employees, management, key donors, persons served, programming partners, and other community stakeholders.

Internal Restructuring and M&A Collaborations

In an internal restructuring, the organization's board and select staff leadership typically lead the restructuring efforts, potentially with the assistance of outside experts and counsel.

This internal restructuring team will be tasked with developing and implementing restructuring efforts, which may include closing non-performing locations or programs, laying off staff, negotiating with third parties such as grant funders, government funders, traditional lenders, landlords, and counter-parties to contracts, and managing communications both internally and with external stakeholders. An internal restructuring may include strategies such as selling assets to generate cash or transferring operational programs or divisions to another organization.

An internal restructuring may reduce the overall expenses the nonprofit will incur, and is a less public process than one overseen by a court. However, it will require a significant investment of time and energy on the part of board members and staff to negotiate with all the relevant parties. Also, an internal restructuring will only be successful if the critical parties consent to the organization's plans for restructuring and are willing to cooperate throughout the process. Thus, this type of restructuring may be ideal if the number of key creditors is relatively small and the creditors' interests are aligned with the organization's restructuring goals.

Other strategies may include a full combination with another organization, whether in the form of a merger, asset transfer, member substitution, or another structure. See our discussions in the first installment of this series as to the "collaboration arrow" and a more complete discussion of integration models. Although the nonprofit in this instance is likely proceeding from a position of relative weakness as compared to its integration partner, it can still take strategic steps to attempt to leverage its unique assets and other "superpowers" in the context of a transaction to advocate for continuation of certain assets, services, activities, or programming, as described in our first installment.

If a nonjudicial route is not feasible to achieve the nonprofit's reorganization goals, the board may consider other options, such as filing bankruptcy or instituting a receivership, as described below.

Bankruptcy

Boards may be surprised that nonprofit organizations can seek financial protections under the federal bankruptcy code. In addition, the bankruptcy code offers other tools to nonprofits for restructuring or liquidating that can be helpful when creditors are not aligned with the nonprofit's restructuring plan, or when a creditor or other entity seeks protective assurances as a condition of its consent or voluntary participation in the proceedings.

The Bankruptcy Toolkit. One of the key benefits of filing for bankruptcy is that debtors receive the protection of the automatic stay, which prohibits creditors from taking enforcement action in many cases—this is meant to prevent a rush on the debtor's assets, preserving the organization's overall value and ensuring fair treatment of creditors, and to give the debtor "breathing room" to come up with a plan for repaying debts according to the priority rules set forth in the bankruptcy code.

Bankruptcy also offers an advantage for a nonprofit that would like to sell its assets, but would have difficulty transferring free and clear title. In appropriate circumstances a bankruptcy court may order that a transfer of previously encumbered property may be sold free and clear of competing interests in the property, even without the consent of interest holders. Another benefit of the bankruptcy process is the ability to assume or reject contracts and leases, again without requiring consent of the counter-parties to those agreements.

In short, the bankruptcy code offers a predictable set of rules for reorganization or liquidation of a nonprofit, even in complex situations, without need to negotiate consensual solutions with each creditor individually. The determination about whether bankruptcy is appropriate is complex and requires consultation with an attorney, but generally speaking, bankruptcy may be a good option if the nonprofit organization has a large number of creditors, property worth less than the debt owed on it, contracts or leases that must be terminated for successful reorganization, and/or the desire to restructure through an asset sale free and clear of encumbrances.

Downsides of Bankruptcy and Ancillary Risks. However, bankruptcy is costly, and numerous "neutral" or stakeholder representatives will have the legal right to be involved in the case. Bankruptcy may be futile if there is no prospect of reorganization or if there are no assets for administration.

And, it must be kept in mind that all cards are on the table for public view in a bankruptcy filing—at the commencement of the case a debtor must file detailed schedules that include information about the organization's assets, obligations, and operations, and the process is highly transparent at each step of the case. For many nonprofits, their organization's financial information is already subject to public disclosure on its annual IRS Form 990 filing so this may be less of a concern.

There can also be a reputational or community visibility risk involved in bankruptcy, both for the organization and potentially its board members and officers, by publicly acknowledging that the entity needs to enter a formal financial restructuring. Bankruptcy can also potentially draw the eye of regulators such as the state attorney general or other local oversight body for charitable assets. This is an additional reason for the board to carefully consider and document why it has determined that bankruptcy is the right fit for the organization at this time.

Finally, current and potential donors may be scared off by a nonprofit announcing that it is entering bankruptcy. This can have a deleterious effect on fundraising during and for a period of time after the bankruptcy process. Having a thoughtful communications plan to convey the nonprofit's future plans and strategy with branding that speaks to its "revisioning" or a similar growth mindset can help ease donors' concerns and bring them in as allies for the road to greater stability.

Not All Bankruptcy is Created Equal. In considering bankruptcy options, a nonprofit board should consider what type of bankruptcy may be appropriate to meet the needs of the organization. In a "Chapter 7" case, a trustee will be appointed to take control of the organization and liquidate the organization's assets, distributing the proceeds to creditors in order of priority. The nonprofit will not be allowed to continue operations, except perhaps for a short period of time, because the goal is to close and sell off all remaining assets. A Chapter 7 case is essentially a public wind-down handled by a court-appointed third party, which may be beneficial if the organization is concerned that someone may question the integrity of a non-judicial

voluntary dissolution, or if the organization simply does not have the ability to manage a wind-down internally. However, a nonprofit is not entitled to obtain a discharge in a Chapter 7 case, which means that the now-defunct nonprofit will remain liable for unpaid debts. Further, the bankruptcy court may offer a convenient forum for claims against potentially responsible third parties if the liquidation does not satisfy all outstanding debts. Thus, the pros and cons of a Chapter 7 case must be carefully considered.

"Chapter 11" is the "reorganization" chapter of the bankruptcy code. Under a Chapter 11 case, a nonprofit, as a debtor-in-possession, may propose a plan to repay some of its debts over time while continuing to operate, and, upon court approval and completion of the plan, obtain a discharge of the balance of its dischargeable debts. The plan will include treatment of secured and unsecured creditors, and classes of creditors whose claims are impaired will have the opportunity to vote on the plan. Although the debtor-in-possession will normally drive the administration of the case, a number of other entities will likely be appointed to represent certain interests, including the United States Trustee (to protect the integrity of the bankruptcy process) a committee of unsecured creditors (to represent unsecured creditors as a whole), and potentially others depending on the particular circumstances of the case, such as a patient care ombudsman in a healthcare case, or a bondholder committee if there is bondholder debt. The nonprofit debtor will be responsible for the fees incurred by these third parties, which may be significant. Individual creditors and anyone deemed a "party in interest" may appear in a case as well.

Recently, Sub-Chapter 5 of Chapter 11 has emerged as a faster and cheaper method for small- or medium-sized nonprofits to reorganize. An organization must meet certain criteria to qualify for this process, including debt limits below a certain threshold (currently $7.5 million).

Receivership and Custodianship

If a nonprofit is in severe financial distress, another potential reorganization process involves the nonprofit's board, a secured creditor, or state attorney general bringing the nonprofit organization into a receivership. In a receivership, a state court appoints an officer of the court, known as a receiver, who is granted powers to control and/or sell the organization's assets according to the terms of the order appointing the receiver. The receiver's powers may be limited to defined tasks, or broad enough to gather, market, and sell all of the nonprofit's assets and wind down the organization. The receiver may also be able to set aside or undo certain actions taken by the nonprofit prior to the receiver's appointment, and creditors may be stayed from taking collection actions for a period of time while the receiver is in place. The receiver (and the receiver's counsel, if applicable) is entitled to compensation, which may be paid from the proceeds of a court-approved asset sale, with remaining proceeds distributed in accordance with the state's priority scheme for paying creditors.

Receiverships are typically faster and less expensive than a bankruptcy proceeding, while offering similar restructuring tools. In fact, depending on the state in which the receivership is filed, there may be a governing receivership statute that is structured much like the bankruptcy code. The nonprofit will be able to continue operating during the proceeding but will cede at least some authority over assets and/or operations to the receiver. If the receivership is initiated by the organization, the organization will be able to select the receiver of its choice, subject to court approval. In practice, receiverships are often initiated by a secured creditor, which allows the secured creditor to select the receiver and propose the scope of the receiver's duties and powers.

Similar to a receivership, in a custodianship, a state court appoints a custodian to manage the affairs of the organization in an attempt to make the organization's activities sustainable with the ultimate goal of handing back control to the organization's board. A custodianship, if available under applicable state law, may help the organization reorganize and continue to accomplish the organization's mission.

Winding Down

If restructuring is not viable, then the board will need to consider how to wind down the nonprofit organization, including options that may involve continuing or transferring all or some of the nonprofit's programming and/or assets to another organization. A wind-down can be conducted through a bankruptcy or receivership as discussed above, or through a voluntary dissolution or assignment for the benefit of creditors ("ABC").

Voluntary Dissolution

A voluntary legal dissolution process can be handled by the board without court involvement. The board must carefully review the organization's formation documents, bylaws, and applicable state law dissolution procedures to ensure compliance with all legal requirements. Typically, the board will adopt a plan of dissolution describing how the organization will distribute its assets and address its liabilities.

After adopting a plan of dissolution, the board will begin the winding down process. The state may provide for an optional or mandatory process of publishing notice to creditors along with a waiting period prior to final distribution of assets. During this period, the nonprofit will commonly accept claims of creditors and claimants and arrange for payment or other resolution of such claims.

The board should also ensure that it notifies all necessary state agencies of its decision to dissolve. Depending on the state where the organization was formed and in what states the organization may operate, it may need to notify a state's attorney general, charitable solicitation regulatory authority, state departments of labor, and any licensing authorities. Some of these regulatory bodies may require waiting periods following notice, before the nonprofit may file its final articles of dissolution.

Once the nonprofit has taken all required steps to resolve its known and unknown liabilities and give notice to the proper state regulatory bodies, the nonprofit may distribute the remainder of its assets in a manner consistent with its charitable mission and purposes and in accordance with state and federal law. Often, this process includes distributing the nonprofit's assets to an eligible 501(c)(3) organization either identified by the organization's Articles of Incorporation or Bylaws or determined by the board to be an organization that will further the organization's tax-exempt purposes.

Other important rules on distribution of assets are often identified in the state's nonprofit corporation act and guidance published by the state's regulatory authority for charitable assets. Any distribution must also comply with any restrictions in the nonprofit's governing documents and any donor purpose restrictions on such assets.

It may be helpful for the board to begin with an inventory of assets. Assets that the board should consider distributing to eligible organizations include cash, tangible property, intangible property, intellectual property, and real property. The organization's assets cannot be distributed to individuals. The organization could, however, sell any portion of its assets and distribute the proceeds to eligible recipients.

Once complete, the nonprofit will file articles of dissolution or a certificate of dissolution with the state's secretary of state, which is typically the step that formally dissolves the entity.

The organization will also need to file its final Form 990 tax return with the IRS by the 15th day of the 5th month after it is officially dissolved, as well as any state regulatory filings.

Assignment for the Benefit of Creditors (ABC)

Finally, liquidation may also be accomplished through a general assignment or an assignment for the benefit of creditors (an "ABC"). An ABC is a means of liquidating assets or transferring a company, in which the organization assigns all of its assets to a trust, exclusively for the purpose of paying off creditors. In this process, the trustee is selected by the organization, and the trustee then sells the assets and uses the money to pay creditors, halting the activities of the organization. The entire process occurs without judicial oversight. A board considering an ABC should determine if the state in which it is located approves of ABC's and if the state's attorney general will require that the organization obtain its permission prior to executing an ABC. Similar to an organization-initiated receivership, the organization will select the trustee and will be responsible for compensating the trustee. Thus, an ABC would only be appropriate if there are sufficient assets to compensate the trustee.

The Communications Plan

As noted throughout the above discussion, a solid communications plan that addresses relationships with a variety of stakeholders can be an invaluable tool as part of a nonprofit reorganization, wind-down, or rebirth. While an internal reorganization may require little outreach, a restructuring or dissolution often involves managing a variety of stakeholders and relational dynamics. The plan does not need to be complex, but content and timing are key. It can be helpful to be prepared—prior to public announcement, if possible—to share insight on the board's rationale at a high level for why the particular course of action is necessary and in the best interests (if possible) of the organization and its charitable mission. Some stakeholders such as employees may benefit from sharing a more detailed timeline of the process, while the public-facing statement can be more general. Share talking points with management and board members. Key donor and community partners may benefit from in-person meetings (use your board members!) to share the nonprofit's plan for the future. Fostering these relationships, while not achievable in every instance, can help build a community of support around the nonprofit and help the board, leadership, and others navigate through challenging times.

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Stay tuned for an upcoming final installment of our *Building Nonprofit Resilience Series*. If you have questions or would like to discuss these matters, please contact Catie Bitzan Amundsen at catie.bitzanamundsen@lathropgpm.com.