

NONPROFITS IN FINANCIAL DISTRESS

Exploring the alternatives for Illinois nonprofits facing financial pressures

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in cooperation with

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Nonprofits In Financial Distress

Exploring the alternatives for Illinois nonprofits facing financial pressures

Nothing contained in this manual shall constitute legal advice. Consultation with an attorney, accountant, and/or other advisors is recommended to ensure that the information discussed below is appropriately applied in the specific circumstances.

When a nonprofit is in financial trouble, there are usually a variety of alternatives to consider. The board of directors and management should work together to determine the best approach, often with assistance from outside advisors.

This manual provides an overview of the primary alternatives for a nonprofit when it finds itself in serious financial distress. The alternatives fall into three general categories, each of which will be discussed in more detail:

1. Restructure the organization
2. Wind down operations and liquidate
3. File for bankruptcy

If it becomes clear that the organization will not be able to survive, it may be tempting for those who run the organization to simply shut the doors, pay as many bills as possible, turn out the lights, and move on. The problem with abandoning an organization without following the proper legal procedures is that it could create **personal** liability for the officers and directors of the organization. *That's correct, personal liability!* If the proper steps are not taken, individuals involved with the organization could put their own **personal** bank accounts, homes, and other assets at risk.

Officers and directors can protect themselves from personal liability by following certain legal procedures, which vary depending on the alternative that is pursued. The manual highlights various alternatives and outlines the procedures that need to be followed to protect the directors and officers from personal liability.

It is strongly recommended that an organization get legal advice when winding down its operations, particularly if the organization does not have enough money to pay all of its debts. The last section of this manual provides contact information for resources in Chicago that may be helpful, and under certain circumstances, where it may be possible to get free legal assistance.

ABC Nonprofit, Inc.

For illustrative purposes, consider the alternatives and choices of ABC Nonprofit, Inc. (or "ABC"), a fictitious 501(c)(3) organization providing social services in Chicago.

For five years, ABC has prospered by receiving a mix of government grants, private foundation support, and personal donations. Two administrative employees (salaried) and 10 part-time counselors (paid hourly) support ABC's three different programs. ABC enjoys strong community support, which it has relied on for financial and volunteer assistance.

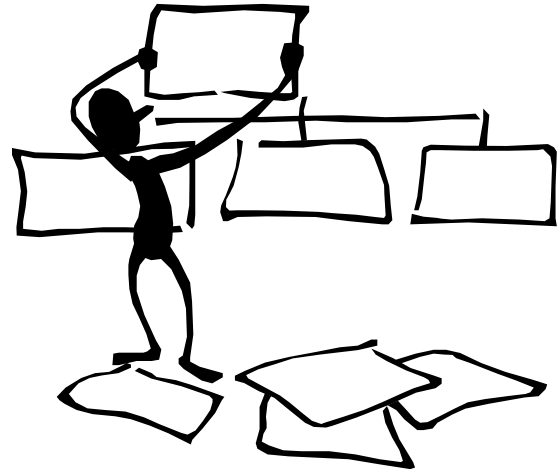
Recently, ABC has seen each of its sources of revenue decline and is now spending more money than it receives each month. Ms. Smith, the founder and Executive Director, has discussed the situation with the Board of Directors.

Read the boxes below to see how they analyzed their options...

Category #1: Restructure the Organization

There may be ways to restructure a nonprofit in financial distress so that it can continue in a modified or scaled back form. Among the options are:

1. Merge with another nonprofit
2. Drastically cut back operations/programs
3. Enact other cost-cutting measures



Option 1: Merging or consolidating

The merging of nonprofit entities requires careful planning and is not to be taken lightly. The key is finding the right organization to partner with and ensuring that the combined organization will be stronger and more financially stable than either organization was independently. A word of warning: there needs to be an excellent fit between the two organizations for a merger to be worth pursuing.

The benefits of a successful merger could include broader access to donors, the ability to leverage economies of scale, consolidating resources and information, the chance to offer expanded services, preservation of a strong reputation, and increased financial stability.

Mergers can also be time-consuming and expensive. A host of questions need to be answered prior to proceeding with a merger, which if not resolved early in the process will likely lead to conflict later. Those questions include:

- What will be the name of the organization?
- Who will be the officers and directors of the combined entity?
- Who will be employed by the organization? Will any positions be cut?
- Which programs will be offered and which are redundant?
- Where will the combined organization be located?
- Will the merger affect any funding sources (e.g., grants, donors, government agencies)?

Moreover, consideration needs to be given to which organization will be the surviving organization and what impact that decision will have on the tax exempt status of the surviving entity (e.g., will the surviving corporation need to apply for tax exempt status?).

An entire section of Illinois law deals with merging nonprofit corporations. Legal counsel should be engaged to ensure the merger is done correctly and outside consultants may be helpful in developing an operational

A Merger?

ABC has strong relationships with a variety of other organizations in Chicago. Ms. Smith thought that a similar nonprofit would be a good candidate for a merger.

After initial discussions, however, it was very clear that a merger would not work. The other nonprofit was facing the same financial pressure and combining the two organizations would not result in significant cost savings. And although the organizations provided similar services, a combined organization would not have resulted in increased funding opportunities.

strategy. If the legal process is adhered to and the operational challenges of merging two entities can be resolved prior to the merger, this may be a viable alternative for a troubled organization.

Option 2: Drastically cut back on operations/programs



An organization may explore cutting back its programs or reducing the size of its programs. If an organization needs to choose between shutting its doors and surviving in a scaled back form, the organization may be able to survive a financial crisis by scaling back.

Before deciding which programs to cut, the organization should clearly understand its financial position including its sources of revenue, the programs generating that revenue, restrictions on any funding source, and all of the organization's debts and obligations. The organization would want to focus on cutting costly programs and retaining those that generate income. There are a wide variety of factors to consider when making these cuts, which include:

- Which programs can and cannot be cut without disproportionately affecting revenue?
- Which programs can be scaled back and how much can be scaled back?
- Should the cuts be considered permanent or temporary?
- Are there any contractual obligations for future payments that may impact which programs or operations should be cut?

These decisions are never easy, but when faced with financial problems, a (hopefully) temporary scaling back is worth considering. If done right, scaling back can make the organization more efficient than ever and enable it to survive during leaner times.

Option 3: Other cost-cutting measures

A less drastic approach to cost cutting might be enough for an organization to make it through a period of financial distress. A variety of cost-cutting measures could add up to big savings. Potential areas for cost savings may include:

- “Going green” by reducing printing, printed

Cutting Programs – the only hope

ABC provides counseling in three different areas (domestic violence, addiction, and job placement). More than 60% of ABC's funding has traditionally come from government grants to its original program - domestic violence counseling. Addiction and job placement counseling were added after ABC received a private foundation grant (for 20% of its annual funding) supporting the integration of the three types of counseling. With this grant, ABC was able to add its second salaried administrative employee.

Ms. Smith and the Board agree that ABC's ability to provide an integrated counseling program has fueled its success in both patient outcomes and fundraising. While the addiction and job placement programs have been integral to ABC's success, these two programs are also significantly more costly than the domestic violence program.

Decision: Faced with no other option that would enable ABC to keep its doors open, the Board decided to suspend its addiction and job placement programs. ABC understood that it would lose its funding from the private foundation and would no longer need its second administrative employee. ABC confirmed that it would not lose its government grants because of the changes although the continued availability of those grants was in question. The ABC Board determined that it would assess the full financial impact of the program cuts after three months.

ABC Nonprofit, Inc. – Cost Cutting

ABC has been working on cutting its costs for several years and the income shortfall was too great to overcome with even the most aggressive cost-cutting measures.

That is why ABC determined its only chance to survive was to cut two of its three programs.

marketing materials, and mailers

- Scaling back operating hours and/or reducing staffing
- Relying on volunteers rather than paid staff for non-specialized tasks
- Reducing utility expenses by managing gas, electricity, and phone expenses
- Selling or leasing unused or unnecessary assets (e.g., sub-leasing extra office space or equipment)
- Reducing benefits to employees (such as retirement contributions)
- Shopping around for less expensive payroll service and/or switching to monthly payroll
- Renegotiating leases
- Sharing employees or services with other not for profit organizations

Category #2: Wind Down Operations and Liquidate (also known as “Dissolution”)

When it becomes clear that a nonprofit organization is going to have to shut its doors, the organization needs to follow the appropriate legal steps to fully protect the directors and officers from personal liability. The decision to wind down and dissolve an organization is difficult for everyone who has invested in the organization, but it is important for organizations to take all the necessary steps of properly winding down before “turning out the lights.”

The directors and officers of an organization have certain duties that do not go away when the organization is insolvent or decides to dissolve. This is particularly important to remember when the organization does not have enough money to pay all its debts. A breach of these duties or a failure to follow the proper procedures of dissolution can result in personal liability for each of the directors and officers for any and all of those unpaid debts.

In Illinois, Article 12 of the General Not For Profit Corporation Act of 1986 lays out the process for dissolving a nonprofit corporation in a way that protects the directors and officers from personal liability. It can get a bit complicated and it is strongly recommended that the organization seek out the advice of legal counsel.

The Decision to Dissolve

Two months after suspending its addiction and job placement programs, Mrs. Smith was notified that its most significant government grant had been canceled immediately due to a government financial crisis. Mrs. Smith immediately notified the Board of Directors and an emergency meeting of the Board was called.

Although ABC was covering its costs after dropping two of its programs, it was clear that there would be a significant cash shortfall the following month without the government grant. ABC had used up its cash reserves and all potential funding sources (individuals, corporations, and government agencies) had been solicited, to no avail.

Decision: The Board determined that it was financially unsustainable for ABC to pursue its mission and directed Ms. Smith to immediately cease operations.

Ms. Smith and the Board reviewed all of the assets and liabilities of the organization. ABC had sufficient assets to pay all its current debts, including its next quarterly payroll tax payment to the IRS. Ms. Smith contacted the landlord for its office space regarding the five months left on the lease. ABC was fortunate that their space was in high demand and the landlord agreed to waive all its rights under the lease in exchange for whatever payment ABC could make after all other debts were paid.

The Board determined that all of its debts, including contractual obligations, were satisfied and voted to formally “dissolve” ABC.

Dissolution Procedures – When All Debts Can Be Paid

When there are sufficient funds and assets to pay off all of the organization's debts, the dissolution process is fairly straightforward. Note that when an organization is set to dissolve, the debts as well as the future obligations of the company need to be taken into consideration. Ideally, future obligations (e.g., future lease payments) can be negotiated away by speaking directly with the lessor (e.g., landlord) about the situation and the organization's plans. If the organization can pay all its debts, there are three steps:

Step 1: Vote to dissolve. To formally “dissolve” as a legal entity, the organization needs to take the proper vote to approve dissolution and then file articles of dissolution with the state. The manner of voting will depend on whether the organization has “members”. If the organization does not have members, then the board of directors can approve the dissolution by a majority vote at a meeting or by the written consent of two-thirds of the directors without a meeting. If the organization does have members with voting rights, then an affirmative vote of two-thirds of the members present at a member meeting is needed.

Once the decision to dissolve is made and the simple dissolution form is submitted to the Secretary of State, the organization may not conduct any affairs other than those necessary to wind down its affairs, pay off debts, and distribute any remaining assets. Doing more than simply winding down the affairs of the organization (e.g., providing any services) can also result in personal liability for the officers and directors.

Step 2: Liquidate Assets and Pay Debts. All of the obligations and debts of the organization must be satisfied, including all tax obligations. Some obligations, such as future lease or rental payments, may require a discussion with the landlord or lessor such that the organization gets a full release from any obligations under the relevant contract. If there are any cash or assets left after all obligations have been satisfied, the remaining assets should be distributed in accordance with the articles and bylaws of the organization.

Step 3: Reporting Requirements. Articles of Dissolution must be filed with the Illinois Secretary of State. Articles of Dissolution must be signed by the corporation's president or vice president, and the corporation's secretary or assistant secretary, and must contain the following information:

- The corporation's name
- The date dissolution was authorized by the members or directors, as appropriate
- A mailing address for documents relating to any lawsuits against the corporation that may be served on the Secretary of State after the corporation's dissolution
- A statement that the dissolution was authorized by the directors or the members at a meeting or by written consent.

Final Steps for Dissolution

After the Board determined that all of its debts could be paid, the Board voted to dissolve. The Board prepared and signed the Articles of Dissolution for the Illinois Secretary of State.

All of the assets were sold, including furniture, phones, and the copy machine. In accordance with the agreement with the landlord, a small final payment was made to the landlord in exchange for the waiver of the lease.

At the end of this process there was \$2,000 remaining in ABC's account. ABC transferred this money to the Do Good organization which runs similar programs.

The IRS Form 990 and a final form AG990-IL were filed after the sale of all the assets and payment was made to the landlord.

Generally, tax-exempt organizations that dissolve must inform the IRS by filing a final Form 990, 990-EZ, or e-Postcard (990-N), depending on the organization's gross receipts and assets. A final form is necessary whether the organization is dissolving on its own or effectively going out of business by merging with another organization.

Moreover, if the organization files an annual report with the Attorney General, a form AG990-IL (the "Illinois Charitable Organization Annual Report") marked "final" must be filed with the Attorney General's office in a timely manner. The form lists a summary of all revenue and expenditures of the organization during the year, a summary of all paid fundraiser and consultant activities, and the amount of compensation paid to the three highest-paid persons during the year among other things.

Dissolution Procedures – When All Debts Cannot Be Paid

As soon as it is even a question as to whether the organization can pay all of its debts, dissolving the organization properly, in a way that protects the directors and officers from personal liability, becomes much more complex. It is highly advisable under these circumstances to seek the advice of legal counsel.

Illinois law defines certain procedures that, if followed, protect the directors and officers from personal liability from known debts (other than taxes) that cannot be repaid from the assets of the organization. If these procedures are followed, a creditor cannot come after the directors and officers personally to recover money for any known debts. Taxes, penalties, and interest on taxes or penalties are not subject to these protections.

One complication in Illinois law is that when an organization cannot pay its debts, the board of directors is prohibited from voting for dissolution. If the board does vote for dissolution when all debts cannot be paid, the individual directors may become personally liable for the organization's debts. The "members" of an organization can approve the dissolution, but many organizations do not have members. One alternative in this situation would be to amend the organization's structure so that there are "members" who could vote for dissolution, but this should only be done with the advice of legal counsel.

If the members vote to dissolve a corporation that cannot pay its debts, Illinois law dictates a specific procedure whereby all known creditors are notified that the organization has dissolved and each creditor has the opportunity to state their claim for the organization's remaining assets. All known creditors must be notified within 60 days of the dissolution date and each creditor has 120 days to respond to the notice.



If ABC could not pay its debts...

If ABC were not able to pay all of its debts, then pursuant to Illinois law, the Board of Directors would not be allowed to vote to dissolve the organization. If ABC had "members," however, then the members could vote to dissolve the organization, even if it had outstanding debts.

ABC, like most nonprofits, however, does not have members, so it needs to follow the specific procedures set forth under Illinois law, describing how a not for profit with debts can be dissolved. In this situation, ABC would want to get legal advice on how to proceed. It may be possible to amend the bylaws to create "members" of the organization who can vote to dissolve.

In addition, when all of the debts cannot be paid, Illinois law explains how and in what order assets of the corporation should be distributed. It also explains how a nonprofit corporation can go about formulating a plan of redistribution and when it may and when it must approve such a plan. Even where a plan of distribution is not mandatory, it may be helpful to specify a plan for the smooth distribution of assets. The plan of distribution is a detailed description of how corporate debts and obligations will be paid or satisfied, and how and to whom any remaining assets will be distributed.

When a plan of distribution is necessary, it must follow the conditions set forth under Illinois law, specifically, Section 112.16 of the Illinois General Not For Profit Corporation Act of 1986. If the organization holds funds that constitute a charitable trust, it must follow the conditions set forth by the Charitable Trust Act.

It is important to note that if a plan is required under Illinois law, (i) all liabilities and obligations of the corporation must be paid, satisfied, and/or discharged, or (ii) adequate provision must be made to pay the liabilities and obligations prior to any assets being distributed. In addition, specific assets that are required to be returned, transferred, or conveyed to a specific party in the event of the corporation's dissolution must be so conveyed. Moreover, if the corporation holds some or all assets for a charitable, religious, eleemosynary, benevolent, educational or similar use, such assets must be transferred or conveyed to an organization engaged in activities that are substantially similar to those of the dissolving corporation. These procedures must be strictly followed to protect directors and officers from personal liability, which is why legal counsel is recommended.



Involuntary Dissolution

The process outlined above is often referred to as “voluntary dissolution.” There are also two processes in which an organization may be forced to dissolve, which can be called “involuntary dissolution.”

Administrative Dissolution: The Secretary of State may dissolve a corporation, called “administrative dissolution,” for various reasons including if the corporation fails to file its annual corporate report with the Secretary of State, fails to pay any fees or charges required by Illinois law, or fails to appoint and maintain a registered agent in Illinois.

The first step in an administrative dissolution is for the Secretary of State to send a Notice of

Delinquency to the registered office of the organization when the organization has failed to meet one or more of its legal obligations. The corporation is given a specified period of time to correct whatever problem led to the Notice of Delinquency. If the organization does not comply, the organization will be dissolved. It is also possible for a dissolved organization to be reinstated

after an administrative dissolution by filing an application for reinstatement with the Secretary of State and by filing the organization's current and past due reports.

Judicial Dissolution: Through a process called “judicial dissolution,” an Illinois circuit court may dissolve a corporation where appropriate grounds exist. Grounds for judicial dissolution include when the corporation obtained its certificate of incorporation through fraud or if the corporation has continued to exceed or abuse its legal authority.

Category #3: File for Bankruptcy

For larger organizations, filing for bankruptcy may be an option. Bankruptcy is a legal, court-supervised process that can be used to either wind down a business or significantly restructure it. It can be an expensive and time-consuming process. Bankruptcy may be worth considering if:

- The organization is large (e.g., more than \$50,000 in assets which are still insufficient to cover all debts)
- The organization is complex (e.g., various creditors of \$25,000 or more that would be willing to fight over any remaining assets)
- The organization has the resources to pay for legal representation



Bankruptcy necessitates the organization hire a lawyer to prepare the necessary filings, represent the organization at hearings, negotiate with creditors, and guide the organization through the process. If a not for profit organization is considering bankruptcy, it is likely because a restructuring (Category #1 described above) or simple winding down of operations (Category #2 described above) would be impractical or too complex for the directors and officers to conduct themselves.

Assignment for the Benefit of Creditors: An alternative to bankruptcy that is similar to a liquidation described in Category #2 above is called “assignment for the benefit of creditors.” This process is not governed by bankruptcy law; but, instead, general Illinois law allows the voluntary transfer of property to another person in trust so that he or she can sell the property and apply the money to the payment of debts. Legal advice is necessary.

Corporations have two main options when considering filing for bankruptcy. The first is referred to as “liquidation” or chapter 7 bankruptcy. The second is called “reorganization” or chapter 11 bankruptcy. The differences between the two are significant and need to be well understood prior to filing.

Chapter 7: Known as the liquidation chapter, under chapter 7, a company’s assets are sold piecemeal to provide payment to creditors as the organization goes out of business. ***After the chapter 7 bankruptcy process is complete, the organization no longer exists.***

Chapter 11: Under chapter 11, charities can get relief from creditors, shed unwanted assets, obtain emergency financing, renegotiate and even reject unwanted contracts and leases, and draw up a plan of reorganization to let them emerge as financially viable. If successful, an organization can emerge from bankruptcy stronger than ever. But while some chapter 11 reorganizations can happen quickly, many take many months or years and that can mean the need for a lot of money in legal fees. ***After the chapter 11 bankruptcy process is complete, the organization may emerge from bankruptcy and continue to operate after the reorganization.***

Should ABC file for Bankruptcy?

It is highly unlikely that an organization like ABC would want to file for bankruptcy. It is not large or complex enough that it would be cost effective to hire a bankruptcy lawyer and pay the fees necessary to file for bankruptcy. ABC's creditors, and the claims those creditors would have, are straightforward enough that bankruptcy would not be a cost-effective option.

There are similarities to both kinds of bankruptcies. For example, the filing of a petition in either a chapter 7 liquidation or a chapter 11 reorganization triggers the automatic stay, which is designed to give "breathing space" to the company by preventing creditors from going after its assets for a certain time period. If your organization has a large number of creditors, this could be an enormous benefit while you figure things out.

Conclusion

This manual sets forth the options available to nonprofits facing financial difficulties. The decision to pursue one or more of these options may have legal implications and/or require legal action. The executives and board of directors for any organization in financial distress should review this information, analyze alternatives, and proactively address the challenges before it is too late. Legal and other outside professionals will be crucial to meeting the organization's needs.

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Additional Resources

Legal Services

Community Economic Development Law Project ("CEDLP")

Phone: (312) 939-3638

Internet: www.clccrul.org/projects/community_economic_development_law_project.html

Chicago Volunteer Legal Services ("CVLS")

Phone: (312) 332-1624

Internet: www.cvls.org

Lawyers for the Creative Arts ("LCA")

Phone: (312) 649-4111

Internet: www.law-arts.org

Many local law schools offer legal clinics. Contact the law school directly to find a clinic that can serve your needs.

Financial Services

Chicago Community Loan Fund ("CCLF") -- A community development financial institution, provides links to helpful resources at: <http://cclfcchicago.org/assistance/lookingfor.html>

Donors Forum -- "Advances philanthropy by serving its members and by promoting an effective and informed nonprofit sector."

Internet: http://www.donorsforum.org/Dealing_With_an_Uncertain_Economy.html

Lumity -- Provides consulting in financial planning, accounting and budgeting, and strategic financial management.

Phone: (312) 372-4872

Internet: www.lumity.org

ShoreBank's Nonprofit Service Center -- Provides full-service banking tailored to the needs of nonprofit organizations.

Phone: (773) 420-5135

Address: The DePaul Center at 333 South State Street, Chicago, IL 60604

General Information

Merger

Bridgespan article on mergers of nonprofits, available online at:

http://www.bridgespan.org/uploadedFiles/Homepage/Articles/Mergers_and_Acquisitions/091702-Nonprofit%20Mergers%20and%20Acquisitions.pdf

Dissolution

Illinois General Not For Profit Corporation Act, 805 ILCS 105 et seq., available online at:

<http://www.ilga.gov/legislation/ilcs/ilcs5.asp?ActID=2280&ChapAct=805%26nbsp%3BILCS%26nbsp%3B105%2F&ChapterID=65&ChapterName=BUSINESS+ORGANIZATIONS&ActName=General+Not+For+Profit+Corporation+Act+of+1986>

Bankruptcy

The American Bar Association Business Bankruptcy Primer, available online at:

<http://www.lsc.gov/lscgov4/RevisedABABusinessBankruptcyPrimer.pdf>

Miscellaneous

The Illinois Attorney General, available online at:

<http://www.illinoisattorneygeneral.gov/charities/index.html>