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Board Talking Points: Chapter 11 Bankruptcy Filings

As nonprofit corporations expend their cash reserves to preserve programs during a time of limited resources, many organizations will find it difficult to continue to pay expenses as they become due. Mounting debt will jeopardize the ability of nonprofit corporations to continue to deliver program services and some will consider filing for bankruptcy protection to restructure their debts.

Questions Regarding Chapter 11 Bankruptcy Filings:

1. What does it mean for a corporation to file for bankruptcy?
2. Can a not-for-profit corporation file for bankruptcy?
3. What is Chapter 11?
4. What are the advantages of filing for Chapter 11?
5. What are the disadvantages of filing for Chapter 11?

More Detailed Information:

1. What does it mean for a corporation to file for bankruptcy?

The Bankruptcy Code is a federal statute that is designed to offer both corporations and individuals an opportunity to get some breathing room and to either reorganize or liquidate assets under the protection and supervision of the Bankruptcy Court. The entity that files the bankruptcy petition is called the debtor and the day on which a bankruptcy petition is filed is called the petition date. All debts that arise on or before the petition date are considered “pre-petition” claims. Debts that arise after the petition date are “post-petition” claims. Pre-petition claims will be paid by debtor according to a plan of reorganization that is approved by a vote of creditors and confirmed by the Bankruptcy Court. Post-petition claims that arise in the ordinary course of business can be paid without court approval. However, expenses that are incurred to preserve the value of the estate will be considered administrative expenses and may require Court approval before payment.

2. Can a nonprofit corporation file for bankruptcy?

Nonprofit corporations, including those that are exempt under section 501(c)(3) of the Internal Revenue Code, can file a voluntary petition for bankruptcy protection. A person can file for bankruptcy protection. A corporation is considered a person within the meaning of the Bankruptcy Code. Courts have interpreted the Bankruptcy Code as barring the filing of an involuntary petition against an exempt organization. An involuntary petition is when

creditors file a bankruptcy petition on behalf of a debtor. Involuntary proceeding cannot be filed against a corporation that is not moneyed, business or commercial corporation. The term “not moneyed, business or commercial corporation: has been interpreted by Courts as to apply to not-for-profit corporations.

3. What is Chapter 11?

Chapter 11 is the reorganization provision of the Bankruptcy Code that is available to both corporations and individuals. Typically when a corporation files for Chapter 11 protection its management continues to operate the corporation. A trustee can be appointed by the Court for cause, such as fraud or gross mismanagement. The debtor is responsible for filing comprehensive schedules and statement of financial affairs that detail its assets and liabilities and identify all of its creditors. Copies of the bankruptcy petition and bankruptcy schedules and statement of financial affairs are available at http://www.uscourts.gov/bkforms/bankruptcy_forms.html#official. Creditors will receive notice of the filing and information about how to file a claim in the bankruptcy case. A copy of Official Form 10, the form that is used to file a proof of claim, is available at <http://www.uscourts.gov/query.html?qt=official+form+10&pw=798&ws=0&col=uscourts&r f=1&IMAGE.x=0&IMAGE.y=0>.

For 120 days from the petition date, the debtor usually has the exclusive right to file a plan of reorganization detailing how the debtor can reduce its debts by repaying a portion of its obligations and discharging others. Many tax exempt organizations considering a bankruptcy filing might be able to take advantage of the provisions of the Bankruptcy Code that relate to small business debtors including the provisions that extends the exclusivity period to 180 days. A small business debtor is a debtor whose total liability on the petition date does not exceed \$2,190,006¹. Creditors claims are paid in accordance with the priority established by the Bankruptcy Code. The minimum threshold for the confirmation of a chapter 11 plan of reorganization is that creditors receive at least the same payment as they would were the debtor’s assets liquidated under Chapter 7 of the Bankruptcy Code. Additionally, a plan cannot be confirmed unless all classes of creditors accept – a class of creditors is deemed to have accepted the plan if creditors that represent 2/3 in dollar amount and ½ the number of creditors in the class (excluding insiders) vote to accept the plan. There are circumstances under a plan of reorganization will be confirmed without the consent of more junior classes of creditors.

Through the bankruptcy process the debtor has the ability to assume or reject contracts, including commercial leases, and to sell assets. Under section 365 of the Bankruptcy Code a debtor can either assume or reject executory contracts and leases on nonresidential real property. An executory contract is essentially a contract under which both parties still must perform in some way. The obligation to pay money is not considered in and of itself performance. When the debtor controls a lease on nonresidential real property it has two options: either assume the contract (which means they agree to be bound by its terms) or reject it, in which case the landlord is deemed to have a pre-petition claim against the debtor in the amount of their breach of contract claim. If a debtor chooses to assume a contract they must first cure any default amount. While a Debtor can assume or reject an executory contract or unexpired nonresidential real property lease at any time prior to the confirmation of a plan of reorganization a creditor can move to set a date certain for the assumption or rejection of a particular agreement. If debtor is not current in lease payments post-petition it will be very difficult to extend the time to assume or reject.

¹ This amount will be adjusted annual in accordance with formula established in the Bankruptcy Code.

4. What are the advantages of filing for Chapter 11?

There are several advantages for debtors filing for protection under Chapter 11 of the Bankruptcy Code. Immediately upon the filing of a bankruptcy petition, the automatic stay takes effect and stops lawsuits, foreclosures, garnishments, and all collection activity against the debtor related to a pre-petition debt. Pre-petition creditors receive notice of the bankruptcy filing and they have opportunity to file claim. During a Chapter 11 case, the debtor's management usually continues to operate the corporation on a day-to-day basis. Subject to court approval, the debtor can assume and reject contracts and leases and sell assets outside of the ordinary course of business. The greatest advantage of a bankruptcy filing, however, is the ability to propose a plan of reorganization that establishes how and when pre-petition claims will be paid. The terms of a bankruptcy plan can “compromise” a claim, i.e. allow the debtor to pay the creditor less than what they were originally owed. Once a debtor has substantially complied (i.e. made payments and distributed assets) with its plan of reorganization, the bankruptcy case will be closed and the debtor will receive a discharge. A discharge is a release from all claims that arose prior to the petition date.

5. What are the disadvantages of filing for Chapter 11?

Bankruptcy filings by nonprofit corporations are less common than bankruptcy filings by for-profit business and, therefore, there is still a stigma attached to filing for bankruptcy. A nonprofit corporation considering a bankruptcy filing should engage its stakeholders in discussions about what it means for the organization to file for bankruptcy protection. Bankruptcy is a complex, time-consuming process that will consume the time and energy of the organization's board and management staff. Nonprofit corporations filing for bankruptcy will require legal representation and will have to operate under scrutiny of court. Even attorneys representing a debtor on a pro bono basis will have to seek court approval to be retained. While the debtor can develop a plan to pay its pre-petition debt it must stay current with expenses. Bankruptcy cases can be very expensive and may require the payment of professional fees including those of attorneys and accountants not only for the debtor but for any committees that might be formed. For example, creditors may be allowed to form a creditors committee represented by counsel that is paid by the debtor's estate.

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