

Closing the Doors: Strategies for CAAs Unable to Survive

CAPLAW Webinar

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Agenda

- Identifying the CAA in financial distress
- Termination of CSBG eligible entity status
- Practical concerns in closing down the CAA
- Dissolution
- Receivership
- Bankruptcy
- Board responsibilities and liability



Indicators of Serious Financial Problems

- A-133 Audit
 - “Going concern” comment
 - Significant disallowed costs
 - Large and ongoing deficits
 - Current liabilities exceed current assets
- Loss of government grant funding
- Late payment of vendors
- Can’t meet payroll
- Failure to pay withholding taxes to the government
- Bank funds frozen due to vendor claims
- Lenders calling loans and seizing funds

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Termination of Government Funding: CSBG

- CSBG Act provides CAAs with more due process rights than other grant programs
 - 42 USC §§ 9908(c)(2), 9914, 9915
- State may only terminate CAA as CSBG subgrantee for “cause”
 - Includes failure of CAA to comply with:
 - Agreement with State
 - State CSBG plan
 - A State requirement, including appropriate standards and goals established by State (including performance objectives)
- Otherwise, State must continue to fund CAA indefinitely

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Termination of Government Funding: CSBG, cont.

- State must continue CSBG funding to CAAs until:
 - State notifies CAA of deficiency after monitoring review
 - State requires CAA to correct deficiency
 - State offers T & TA, if appropriate, and submits report to HHS describing such assistance or why T & TA not appropriate
 - At discretion of State, CAA develops and implement, within 60 days, a quality improvement plan (QIP)
 - Within 30 days of receipt, State approves QIP, or disapproves or specify reasons why not
 - If deficiency not corrected, and after a hearing, state finds cause for termination
 - If CAA seeks review by HHS of termination decision, HHS either confirms State determination or doesn't act within 90 days

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Termination of Government Funding: CSBG, cont.

- CAA may voluntarily relinquish CSBG designation and status
- States will often request CAAs to do so, rather than go through the termination process
- Relinquishment of CAA status doesn't end status as a nonprofit entity under state law and tax-exempt organization under federal and state law
- But loss of CAA status typically does lead to loss of other funding and eventual shutdown of organization
- If voluntary, consider how much funding needed to close-out program and CAA and request payment of close-out costs

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Termination and Transfer of Other Grant Programs

- Focus on continuous services for clients
 - Early communications with funders
 - Working with neighboring CAAs and other nonprofits with capacity to carry out programs
 - Layoff and transfer of employees
 - Client files confidentiality issues
 - Residents living in CAA-owned housing
- Head Start
 - Interim grantees
 - Transfer of leases and facilities
 - Instructions from HHS on assets paid for with federal funds

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Practical Concerns in Closing Down

- Laying off employees consistent with CAA's policies
- Severance payments
- Funding of unused vacation pay
- Timing of layoffs
 - All at once or in stages?
 - Cutting losses sooner rather than later
 - Determining financial capacity to continue paying staff
 - Need for some staff to carry on close-out functions
 - Ability of board to take over some functions
- Record retention and transfer

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Garnishment and Seizure of Federal Grant Funds

- Creditors may attempt to seize or garnish CAA funds
- Several court decisions, including some involving CAAs and Head Start grantees, have held that federal grant funds may not be seized or garnished by third parties
 - Grant funds must be used for their intended purposes and are held in trust by the grantee for intended beneficiaries
 - May need to distinguish between funds paid as advances and funds paid as reimbursements
 - *Buchanan v. Alexander*, 45 U.S. 20 (1841); *In re Joliet-Will County Community Action Agency*, 847 F.2d 430 (7th Cir. 1985); *Palmiter v. Action, Inc.*, 733 F.2d 1244 (7th Cir. 1984) (community action agency); *Henry v. First Nat'l Bank of Clarksdale* (Head Start grantee), 595 F.2d 291 (5th Cir. 1979).

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Dissolution

- Each state has unique process
 - Secretary of State: corporate status
 - Attorney General and/or court: charitable nonprofit status
 - May require AG, or even court, approval for transfer of assets
 - Ensure that any remaining assets are used for charitable, and if appropriate, specific restricted purpose
- Watch out for “self-help” dissolution, i.e. transfer of assets prior to dissolution
- Review dissolution clause in Articles or bylaws
- Consider government interests in assets and seek instructions from funders
- Work in tandem with bankruptcy process

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Insolvency Options

- Receivership
 - Each state has its own process
 - Court-appointed fiduciary liquidates the assets
 - Sometimes, Receiver authorized to operate
 - Can be consensual or involuntary

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Insolvency Options

- Bankruptcy
 - Federal law
- Chapter 7
 - Trustee appointment automatic
 - Liquidation, no operations
- Chapter 11
 - 'Reorganization'
 - Management stays in place
 - Operations ongoing
 - Liquidation

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Bankruptcy

Bankruptcy and Nonprofits

- Involuntary not available against nonprofits
- 'Applicable nonbankruptcy law'
 - Dissolution
 - Merger / Conversion
 - Grant restrictions
 - Donative restrictions
 - *Cy pres*
 - Jurisdiction

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Bankruptcy

Key features of the bankruptcy process

- Automatic Stay
- Sale of Assets 'Free and Clear'
- 'Avoidance' Powers
- Pro rata distributions, by priority

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Bankruptcy

Automatic stay

- Automatic Federal court injunction
- Prohibited actions:
 - Realize on (collect) a claim
 - Commence or continue litigation
 - Obtain possession of debtor's property
 - Create or perfect lien

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Bankruptcy

Automatic Stay

- 'Relief from Stay'
- Police Power exception
 - Government oversight continues
 - Government 'collection' stayed
- Stay protects the debtor
 - Stay of actions against directors, officers not automatic
 - Court may enjoin actions against Ds/Os, but rare

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Bankruptcy

Asset Sales 'Free and Clear'

- Court can authorize asset sale
- Free and Clear of liens, claims, encumbrances
- Liens attach to the sale proceeds
- Avoid a disputed claim

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Bankruptcy

'Avoidance Powers'

- Preferences
 - 'Transfer' within 90 days pre-bankruptcy
 - 'Transfer' to insider within 1 year pre-bankruptcy
 - Includes liens, payments
 - Defenses:
 - Ordinary course
 - Fair value
 - Debtor may, and Trustee likely will, bring preference claims

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Bankruptcy

- Distributions in order of priority
 - Secured creditors
 - Grant / donor restrictions honored
 - Subject to *cy pres*
 - Unsecured creditors receive same percentage distribution
 - Will this satisfy your state AG?

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Board Responsibilities

- In times of financial stress and potential closure, active board role is critical
- Board may be faced with departure of Executive Director and appointment of Acting or Interim ED
 - Will require greater day-to-day involvement of Board
 - Need strong smaller group, such as Executive Committee, to lead and oversee staff
- Board needs to understand financial situation on a real-time basis
 - Obtaining accurate current financial information may be challenge
 - How much cash is left to operate? What funding is still coming in?
 - What restrictions are on funds?

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Board Liability

- Directors generally not personally liable for vendor or contract claims
- But may be liable for unpaid wages and unpaid taxes
- Also liable for breach of fiduciary duties to members, other directors, and the AG
 - Duty of care
 - Was Board paying attention, approving budget, reviewing financial information, overseeing ED, adopting strong internal controls, asking appropriate questions?
 - Duty of loyalty
 - Were any insiders inappropriately benefitting?
 - Excessive ED/CEO compensation?
 - Payments to Board members