

## 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