



Legal Minute

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Surviving a Recession Legally

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During the current economic environment, directors, executive directors and other members of non-profit management have enough to worry about as they try to keep their expenses in line with their (declining) income. Unfortunately, these efforts are likely complicated by related legal issues. By recognizing some of the potential pitfalls concerning contractual obligations to vendors, suppliers and landlords, non-profit organizations will be better able to develop a plan that can be effectively and efficiently implemented. This article attempts to anticipate some of those issues and to provide general guidance. In all cases, though, the organization is well advised to consult with its attorney when making these decisions.

How does an organization amend or terminate contracts with its suppliers and vendors?

Undoubtedly, one of the first steps that any organization will take when facing a cash shortage is to identify expenses that it believes can be reduced or eliminated. The organization must consider both the amount of the monthly payments being made to each of these suppliers and vendors and any additional cost of amending or terminating these arrangements.

A contract will require the consent of both parties in order to be amended to reduce services and/or payment amounts. If the organization is able to terminate the arrangement and take its business elsewhere, then it will be better positioned to negotiate an amendment. Key items that affect the cost or ability to terminate the contract include:

- Term - does the contract provide for a set period of time, e.g. six months or a year? If so, how much time is remaining?
- Early termination fee - if the contract has a set term, does it allow the organization to end the contract early by paying a fee?
- Notice - in order to terminate the contract, must the organization give a certain amount of advance notice to the vendor or supplier?

After reviewing the contract, the organization may discover that it would be less expensive to finish out the contract than to terminate it early.

If there is no easy or cost-effective manner to terminate the contract, the organization can still approach the supplier or vendor about changing the terms. A common approach is to offer to extend the contract further, but in exchange the organization would receive a lower price and/or reduced services, i.e. a blend between what the contract currently provides and what the market rate would be for buyers purchasing those goods and services today. If the vendor or supplier has not lived up to its obligations, then that fact could also provide a basis for amendment or modification.

Finally, be sure to put all communications in writing, including any notice of termination or amendment to any agreement. Later, it may be necessary to prove the terms of the new agreement or that the necessary steps to terminate or amend were followed.

What should an organization do if it cannot pay some or all of its bills or rent?

As soon as an organization senses that it could encounter financial difficulties, it is imperative that management immediately apprise the board of directors of the situation, contact legal counsel and develop an overall plan with the assistance and over-

sight of the board and legal counsel. The reason is that once an organization enters the “zone of insolvency,” loosely meaning the point at which the organization may become unable to meet its obligations or when its liabilities exceed its assets, then the board will have the duty to ensure that the organization is operating in a manner that reasonably protects the interests of its creditors and does not inappropriately favor one creditor over another. Further, though not common, it is possible for directors and officers to have personal liability to employees for wages and to creditors for amounts owed by the organization if appropriate measures are not taken.

If the organization were simply to stop paying its bills or rent, then the vendor likely will stop providing the related services or goods and the landlord may start the eviction process. Any contract between the organization and a creditor (i.e. a vendor or landlord) usually will discuss the consequences of the breach, though the creditor may have additional claims under law. At a minimum, the creditor will be able to sue the organization for any amounts not paid or at least for its lost profits, plus any other damages it sustained. If the creditor prevails and the organization still has not paid in full, then the creditor may be able to seize (and sell) assets of the organization to pay for these amounts. Finally, as discussed above, if the organization is only able to pay some of its bills, then it should make that decision with the guidance of its legal counsel.

How can an organization approach its landlord to amend its lease?

One of the largest expenses for most organizations is the rent payment. As a result, this expense is an obvious target for reduction, and one that will require a careful review of the existing lease.

A lease is likely to specify a term and notice period for termination. Some commercial leases may also let the tenant terminate the lease early by paying a termination fee; however, in most cases, the tenant must be prepared to pay the full remaining amount of the lease.

Many of the concepts described above for arrangements with vendors and suppliers also apply to leases. Prior to approaching the landlord, the organization should understand its rights under its lease as well as the obligations of the landlord. If the landlord has not complied with all of its obligations under the lease, then the organization may be able to offer settlement of those breaches as part of the justification for the rent reduction. The organization should also try to understand the state of the commercial rental market in its area. This type of knowledge can be invaluable when trying to negotiate a “blended” rental rate. For example, if the organization has one year left on its 5-year lease and pays \$5000/month in rent, but a new tenant would expect to receive three months rent free and then pay only \$4000/month for the same space for a three year lease, then the organization may offer to extend its lease for an additional two years but at a monthly rate that “blends” its current rent with the rent (including free months) that a new tenant would expect to receive. In this way, the arrangement can be seen as a “win” for both sides.

As with any other contract, it is important that any modifications be in writing.

Is it possible for an organization to sub-lease its office space to another company?

The short answer to this question is likely found in the lease, which should contain an explicit provision governing whether and under what conditions the space may be sublet. Some leases will prohibit this option outright or require landlord consent while other leases may provide a form of sublease agreement that must be used. In any event, it is important to realize that even if the organization sub-leases its space, the organization will remain primarily responsible for paying the rent. In other words, if the person or group to which the office space is sublet fails to pay, then the organization remains responsible for paying the rent to the landlord. Also, the organization will likely remain responsible to the landlord for any problems caused by the sub-lessee, though the organization will have the right to pursue the sub-lessee for any such claims.

Conclusion

During these difficult times, it is important to keep in mind the legal implications that management’s decisions may have on the organization. Other parties may be facing similar struggles and will be willing to work (within reason) to reach a compromise that benefits all parties. Of course, it is important to always consult with an attorney when trying to assess these legal obligations. Texas C-BAR (www.texasbar.org) can provide additional assistance.