



Legal Minute

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Debt and Indebtedness Policies for Nonprofit Organizations*

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Nonprofit borrowing, even in times of economic prosperity, is a tricky endeavor; and that complexity is magnified during an economic downturn, such as the one currently facing our nation. Nonprofit organizations across the country are facing tough decisions, as fundraising efforts grind to a halt and operating expenses hold steady or increase. This Legal Minute explores some of the issues nonprofit organizations face when broaching the decision to borrow, or attempting to manage debt already amassed. This article is arranged into four parts: First, a discussion of the issues involved in deciding whether, and how, to borrow funds for use by a nonprofit organization; Second, an overview of some of the debt options available to nonprofit organizations; Third, tips for nonprofit organizations already facing significant indebtedness, on how to raise funds to help reduce those debts, and, alternatively, a glance at issues related to insolvent nonprofits. Finally, at the end of this article, the author has provided a list of sources used, and other resources which readers may find helpful.

When should a nonprofit borrow money?

As a general matter, individuals know from juggling their own budgets that it is never wise to borrow money one can never repay. But when a nonprofit organization faces the daunting task of deciding whether to borrow funds, many other factors come into play. As a preliminary step, it may help to expel the myth that borrowing, by any individual or organization, is a sure sign of financial trouble. Actually, properly managing cash flow, planning for stable operations, and making loan and interest payments are key components of successfully managing an organization.

So, once a nonprofit has come to terms with the benefits or, at least, the practicality of borrowing, the next step is to educate the decision makers on the issues an organization must address before borrowing. The decision makers within an organization are the resident experts on that organization's current financial situation and history. Therefore, as opposed to relying entirely on the generic opinions of loan officers, decision makers should address, at least, the following issues before determining whether to borrow funds:

- Does the organization have a recent cash flow projection?
- Does the organization have a recent analysis of its financial situation conducted using the appropriate financial ratios?
- Does the organization know how the funds will be used?
- Does the organization have a realistic plan for repayment?
- Does the organization have the support of the board of directors?
- The organization's inability to answer affirmatively any of these questions is a good indicator that now is not the right time to borrow.

What types of loans should a nonprofit consider?

Once the decision to borrow is made, the organization must determine what financing options are available to it, and which options best meet its needs. The simplest analysis focuses on the relationship between the funds' proposed use and the

* **DISCLAIMER:** Nothing contained in this article should be construed or relied upon as legal advice. Instead, this article is intended to serve as an introduction to the general subject of debt and indebtedness policies for nonprofit organizations, from which better informed requests for advice, legal and financial, can be formulated.

financing option chosen. Here are several possible reasons why an organization may borrow and some related financing options of which it may choose to avail itself:

- Evening out cash flow – A bridge loan or a line of credit may be helpful in this situation. But before this is a viable option, cash flow projections must be generated.
- Capital purchases – A term loan or a mortgage (for real estate projects) are options. These types of loans may be useful where they offer the borrower manageable monthly payments.
- Taking advantage of an opportunity – In this situation it is important to map out the timing of the event, such as an office move or a merger. This is because, the timing will dictate whether a loan with monthly payments or one with a lump sum balloon payment is the best option.
- Debt Consolidation – As with individuals, when there are several outstanding debts facing an organization, considerable stress and pressure can be placed on the decision makers. Sometimes borrowing in order to consolidate multiple debts into one monthly payment can help to relieve some of the pressure.

It is important, however, for organizations to note that the terms of the loan are just as significant as the reason for borrowing and the chosen financing option. A nonprofit, much like an individual, can turn a promising endeavor into a thorn in its side by binding itself to unfavorable loan terms—including fees and other associated loan costs.

Can and should a nonprofit borrow money from a Board Member or have a Board Member as a Guarantor?

While a Board Member may not borrow money from the nonprofit organization, nothing prohibits a nonprofit from borrowing money from members of its Board of Directors. However, borrowing money from a Board Member raises a number of concerns. First, the Director who lent the organization money may feel that their opinion now holds more weight than those of the other Directors, which can lead to more heated disagreements. Alternatively, Directors who have not lent money to the nonprofit may simply defer to the Directors who have lent money. Second, Board Members must also accept the possibility that the loan will not be repaid, or will not be repaid in full, which may lead to resentment. Also, if the organization were to enter bankruptcy or liquidate, Directors who lent money to the nonprofit would be considered “insiders” and their loans would be “subordinated,” or pushed down to the bottom of the line for repayment. Finally, borrowing money from a Board Member raises conflicts of interest issues, since the Board Member now has a personal financial interest in the organization.

If a nonprofit is going to borrow money from a Board Member, the organization should:

- Put all the terms of the loan in writing;
- Formally vote to accept the loan and the terms of the loan, with the lending Board Member abstaining from the vote; and
- Make sure the lending Board Member understands that their loan may be “subordinated” if the nonprofit liquidates or enters bankruptcy.

What nonprofits who have no realistic ability to pay liabilities could consider.

As a last result, under Chapter 11 of the Bankruptcy Code, nonprofits that become insolvent may be entitled to file a petition for reorganization. They, however, may avoid involuntary bankruptcy. Additionally, the Bankruptcy Code provides specific measures aimed at assisting nonprofits in the bankruptcy process. Like their for-profit counterparts, insolvent nonprofit organizations may be allowed to satisfy their creditors through workout plans. Bankruptcies for nonprofits, however, may take certain twists to businesses specifically where the Bankruptcy Code’s goal of marshalling assets for the benefit of creditors conflicts with the focus of the general law of charities—the preservation of assets for the public purpose determined by the donor. If an organization is facing insolvency, the decision makers would be wise to seek the help of experienced bankruptcy counsel to review its options.

Sources Used and Other Helpful Resources on Debt and Indebtedness:

1. *Using Loans: A Guide to Borrowing for Nonprofit Organizations*, NONPROFITS ASSISTANCE FUND, <http://www.nonprofitsassistancfund.org/files/MNAF/ArticlesPublications/UsingLoans2005.pdf> (last visited February 17, 2010).
2. Jan Masaoka, *Loans From Nonprofit Board Members*, March 8, 2009, <http://www.blueavocado.org/content/loans-nonprofit-board-members>.