

Can a non-profit organisation go bankrupt or be restructured?

Dávid Oršula and Filip Takáč discuss the issues of a non-profit organisation in Slovakia compared to other selected countries



DÁVID ORŠULA
bnt attorneys-at-law (Slovakia)



FILIP TAKÁČ
bnt attorneys-at-law (Slovakia)

It all started with a creditor's objection during a creditors' meeting as part of the restructuring of a non-profit organisation ("NPO").

The basis of the objection was simple: "A debtor non-profit organisation may not be the subject of restructuring proceedings, because an NPO is not established for the purpose of conducting business." Is the conducting of business activity a "conditio sine qua non"⁴¹ for the opening of insolvency or restructuring proceedings against a legal person (NPO)? This question raises more questions, and this specific case was even more interesting, because the NPO involved was the Slovak Basketball Association.

What does the EC insolvency regulation say?

Under Section 9 of the Preamble to Regulation No. 1346/2000 on Insolvency Proceedings (the "Regulation"), the Regulation "should apply to insolvency proceedings whether the debtor is a natural person or a legal person, a trader or an individual." Section 9 of the Regulation excludes certain economic sectors and business activities from insolvency proceedings.

Under Article 4(2)(a) of the Regulation "The law of the State of the opening of proceedings shall determine ... against which debtors insolvency proceedings may be brought on account of their capacity ..."

Article 4 Sec. 2 letter (a) of the Regulation clearly stipulates that the personal scope of the Regulation includes all legal persons regardless of their legal

status as determined by the local law of the State in which proceedings are opened.

Insolvency issues of NPOs in Slovakia

Slovak Act No. 7/2005 Coll. on Insolvency and Restructuring (the "IRA") does not distinguish between legal statuses of the debtor. The personal scope of the IRA includes (a) the treatment of a debtor in insolvency through the liquidation of the estate of the debtor and the collective settlement of the debts payable to its creditors, (b) the gradual settlement of debts payable to creditors in a manner agreed upon in a restructuring plan, or (c) the discharge of the debts of natural persons. In addition, the IRA identifies persons who may not be the subject of insolvency or restructuring, and NPOs are not included in this category.

The conducting of business activity as a Conditio sine qua non

As there are no restrictions on the economic (business) activities of an NPO, an NPO may be the subject of insolvency proceedings. Any person, either natural or legal, may be the subject of insolvency proceedings under the IRA, whether or not they conduct business activity.

When it comes to restructuring, the situation is not so clear. Under certain circumstances set forth in the IRA, the debtor or a creditor may instruct a trustee to prepare a restructuring report in order to determine whether the debtor qualifies for restructuring. The

criteria include particularly a detailed:

- description of the business conducted by the debtor;
- description of the financial and business status of the debtor; and an
- analysis of the conditions under which the business of the debtor or a material part thereof may be maintained.

These provisions of the IRA indicate that the conducting of business activity is a condition for the opening of restructuring proceedings, because the main purpose of restructuring proceedings is to maintain the business activity of the debtor. Therefore, an NPO that does not conduct any business cannot be the subject of restructuring proceedings under the IRA.

But what if an NPO does conduct business activity, but only within a certain scope of business (e.g. the renting of movable assets) which has nothing to do with the non-profit activities of the NPO? And, further, what if its debts arose only from activities other than its limited business activities? In such cases, the court probably should not open restructuring proceedings. The reality in Slovakia, however, is different, and the court opened the abovementioned restructuring proceedings even though the creditor objected to the restructuring of the NPO on the grounds that it was engaged in marketing business activities only, which did not generate debts. The court did not take the creditor's objections into account at all.

If an NPO conducts business and its debts arise from its business activities, it is understandable that restructuring

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proceedings are available to it. But isn't it then also understandable that only the business part of the NPO should be included in the proceedings?

For the record, in Slovakia, sports authorities² are legal persons formed under civil law. National sports federations are civic associations (a legal status similar to NPO) established under the Act on the Association of Citizens. Associations and NPOs are both part of third sector organisations, which must be established to fulfill a certain publicly beneficial purpose. These organisations may not be primarily established for the conducting of business activity, but they may operate a business activity as their secondary purpose. The profit gained by conducting business must be used solely for the primary purpose of the association or NPO, and not for the personal gain of its members or founders.

As the outcome of restructuring proceedings is a debt haircut, the situation of national sports federations with regard to their membership in international sports federations is quite interesting. International sports federations commonly require member organisations to meet their financial obligations. There are always a variety of possible sanctions, but above all is the suspension or exclusion from international competitions. No matter how legal the process is under local (Slovak) law, the debt haircut obtained through restructuring is definitely a breach of financial obligations, and once you are a member of an international sports federation, you have to fulfill your obligations under its policy.

Comparison of insolvency laws in Germany and selected CEE countries

The Slovak legislation described above is more or less similar to the Czech Act 182/2006 Coll. on Insolvency and its Remedies (the “**Czech Insolvency Act**”) and the relevant laws of other CEE

countries. In the **Czech Republic**, both natural and legal persons may be the subject of insolvency proceedings regardless of whether they conduct a business activity or not.

Under §316 Sec. 2 of the Czech Insolvency Act³, the insolvency of a debtor who is a business owner may be remedied through reorganisation (restructuring) proceedings. Therefore, in the Czech Republic, the debtor must conduct a business activity to qualify for reorganisation (restructuring) proceedings.

Germany

In Germany, the situation is different, and NPOs may be the subject of either insolvency or restructuring proceedings irrespective of their business activities. NPOs have the legal form of either a registered association (“*eingetragener Verein*”) or a foundation/trust (*Stiftung*). Both can be subject to restructuring/insolvency.

Poland

According to the Polish Bankruptcy and Reorganisation Law (the “**BRL**”) NPOs cannot be subjects of insolvency or reorganisation proceedings unless they conduct an economic (business) activity, which is allowed by the Polish Act on Associations. If an NPO that was not conducting any business activity becomes insolvent, it should be liquidated under the Act on Associations.

If an NPO conducts a business activity and becomes insolvent, the proceedings are conducted under the BRL.

Hungary

Under Hungarian law, the general rule is that NPOs can be subject both to restructuring (aimed at rescuing the debtor) and to bankruptcy (generally aimed at liquidation).

Estonia

In Estonia, insolvency proceedings may be opened on both legal and natural persons. Restructuring can only be carried out with regard to business entities, and a business activity may be conducted by NPOs and even by natural persons.

Slovakia

In Slovakia, the situation with regard to insolvency and restructuring proceedings is clear. NPOs can go bankrupt, but they cannot be restructured if they do not conduct a business activity.

Differences in the above-mentioned countries indicate that there is no unity of opinion on this issue. For the opening of insolvency proceedings, we are of the opinion that the conducting of a business activity is not a *Condition sine qua non*. More strict supervision would be helpful, though, because it is not normal for NPOs to generate enough debts to go bankrupt.

As for the opening of restructuring proceedings, we are of the opinion that the conducting of a business activity is a *Condition sine qua non*, and that only the business-conducting part of an NPO should qualify for restructuring. However, the Slovak courts have “ruled” once again, and this time the losers might be the basketball players and referees, who would not be allowed to represent their country in international competitions. ■

Footnotes

- 1 prep. Latin for “without which it could not be,” a necessary action or condition.
- 2 The organisation of professional sport in Slovakia is not regulated at all. There is no specific supervision or control of the State authorities over the sport authorities, so general rules as to other civil associations apply. The legislation provides only for a general clause on cooperation with the government upon agreement, and for the financing of sports activities from the state budget.
- 3 “Reorganizaci lze řešit úpadek nebo hrozící úpadek dlužníka, který je podnikatelem; reorganizace se týká jeho podniku.”



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