Reorganizing with Value but Without Profit (or Equity): Select Confirmation Issues for Nonprofit Entities

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I. Introduction

The reorganization of nonprofit entities often requires bankruptcy practitioners to consider several difficult questions arising from the qualitative differences between for-profit and nonprofit enterprises. Three such issues that arise in connection with confirmation of a plan of reorganization proposed by a nonprofit debtor are (i) the applicability of the "absolute priority rule," which generally prohibits distributions to current owners of an enterprise on account of that ownership interest unless a class of objecting unsecured creditors otherwise are paid in full; (ii) the application of the "best interests test," which requires that distributions under a plan be at least as generous as distributions projected to be available from a hypothetical liquidation of the debtor's assets; and (iii) whether the assets of nonprofit companies may be transferred under those provisions of the Bankruptcy Code frequently utilized by for-profit debtors.

These issues are at play in a nonprofit restructuring for a number of reasons. First, as discussed in detail below, no one "owns" the residual economic interests of a nonprofit, and thus many courts have determined that the "absolute priority rule," codified in section 1129(b) of the Bankruptcy Code,[1] does not preclude members of a nonprofit from controlling the entity postbankruptcy, even when dissenting classes of creditors are not paid in full under a plan of reorganization. Second,

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many states limit the ability of a nonprofit to liquidate its assets, thereby potentially depressing a nonprofit debtor's hypothetical liquidation value and complicating, or even rendering irrelevant, application of the best interests test. Finally, amendments to the Bankruptcy Code enacted under the Bankruptcy Abuse and Consumer Protection Act of 2005 (BAPCPA) require, among other things, that assets transfers by nonprofit corporations pursuant to a reorganization plan comply with applicable nonbankruptcy law.

This article addresses each of these issues in turn. As discussed below, the application of the absolute priority rule and best interest tests in nonprofit reorganizations appear dependent on the nature and function of the nonprofit debtor and the extent to which the debtor's plan reflects a good faith effort to provide to creditors with reasonable recoveries. In exploring this relationship, this article also compares the application of the absolute priority rule and best interest tests in nonprofit Chapter 11 cases to municipal reorganizations under Chapter 9 of the Bankruptcy Code. Municipalities and their enterprises, which are quintessential examples of enterprises that are not run to make a profit for their owners (even if they do not qualify as not-for-profit enterprises under state law), are not subject to Chapter 11's absolute priority rule when they reorganize, but they are required (among other things) to demonstrate that they have taken appropriate efforts to try to repay debt. This article then concludes by examining state law restrictions on transferring assets held by nonprofit corporations in light of the BAPCPA amendments.

II. Nonprofits and the Absolute Priority Rule: Retaining Control Without Payment in Full?

A. Understanding Nonprofit Entities

Although the Bankruptcy Code does not define "nonprofit,"[2] the term is generally recognized to encompass any corporate structure under which income cannot be distributed to members, directors, and officers.[3] Reference is often made to section 501(c)(3) of the Internal Revenue Code, which grants tax exempt status to companies organized and operated for certain enumerated purposes, which include the provision of health care, religious, educational, scientific or other charitable services,[4] although state statues often exclude towns, cities, boroughs and other municipal entities from state laws defining what constitutes a not-for-profit entity.[5]

Nonprofit entities can be organized as corporations, limited liability companies, unincorporated associations, or trusts. Although corporate structure dictates the parties responsible for corporate governance, many

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nonprofits are controlled at the ground level by "members" whose functions, including electing directors and voting on major decisions such as mergers or dissolution, resemble shareholders in a for-profit entity.[6] However, members of nonprofit entities, with certain limited exceptions explored in detail below, have no discernible ownership interest in the entity.[7] In addition to members, policy decisions and corporate direction are generally delegated to a board of directors, who in turn elect officers to handle the day-to-day functions of the nonprofit.[8]

B. The Absolute Priority Rule

Under specified circumstances, Bankruptcy Code section 1129(b) allows a debtor, or another party in interest that proposes a plan of reorganization, to "cramdown" the plan over the objection of an "impaired" class.[9] In order to do, the plan proponent must satisfy virtually all of the confirmation requirements present in Code section 1129(a), demonstrate that the plan does not discriminate unfairly against objecting parties, and show that "fair and equitable treatment" is afforded to each impaired objecting class.[10]

Commonly referred to as the "absolute priority" rule, section 1129(b)'s "fair and equitable" requirement prohibits distributions to any junior class of claims or interests over the objection of a senior class that has not been paid the allowed amount of its bankruptcy claim in full.[11] Specifically, as it relates to unsecured creditors, this provision mandates that "the holder of any… interest in a debtor may not receive or retain property on account of such an interest unless all creditors have been paid in full."[12] In light of the absolute priority rule, the ability to distinguish nonprofit membership (or sponsorship) from equity or other interest is vital for nonprofit debtors hoping to allow their existing members to retain control following approval of a plan or reorganization under which all creditors, particularly unsecured creditors, are not paid in full.

C. Retaining Control: Is It or Is It Not Receiving or Retaining Property (Value)

Because section 1129(b) prohibits the distribution of property to interest holders without the consent of those classes of creditors that are not being paid in full under a plan, courts have had to struggle with whether retaining control without also receiving a distribution of economic value constitutes a distribution of property to the prepetition members or sponsors of a nonprofit entity under a plan of reorganization in violation of the absolute priority rule. On the one hand, several jurisdictions have held that the retention of control by a nonprofit's members is not a violation of the absolute priority rule because the absolute priority rule is

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only about value distribution. In reaching this conclusion, these courts observe that nonprofit membership is different from holding equity in a for-profit corporation because, among other things, members of non-profit corporations generally have no right to dividends or to distributions of corporate assets.[13]

In contrast, other courts have found that the retention of control of a nonprofit can constitute the distribution of property prohibited by section 1129(b). These courts have concluded that, at least under some circumstances, control of a nonprofit in fact carries with it economic benefits personal to the members of the enterprise. One commentator has attributed these decisions to a rise in the number of "mutual nonprofits, such as cooperatives, homeowners' associations, and country clubs" under which members retain an "equity-like" interest in the entity and are "direct beneficiaries" of the nonprofit's mission.[14]

D. No Economic Benefit: No Absolute Priority Concern

Courts that have confirmed a nonprofit's reorganization plan which leaves the prepetition members in control of a reorganized debtor over the dissent of an impaired class of creditors have highlighted the lack of distributable tangible economic value possessed prepetition and retained postconfirmation by those parties in control of the nonprofit. For example, in *In re Whittaker Memorial Hospital Association*, the U.S. Bankruptcy Court for the Eastern District of Virginia permitted the members of the debtor, a "Virginia nonstock, membership corporation," to retain control of the debtor hospital following approval of a reorganization plan even though certain unsecured creditors were not paid in full. In reaching this conclusion, the court stressed that nothing "beyond control" was retained by the members and that the debtor's structure "places it in a unique status apart from private enterprise."[15] In an analogous decision also involving a healthcare facility, the bankruptcy court in *In re Independence Village Inc.* allowed members of a nonprofit "life-care" facility for the elderly to retain control of the nonprofit despite the objection of an indenture trustee, noting that the debtor has "no shareholders, hence… no interests inferior to the unsecured creditors" and, accordingly, that "there should be little difficulty [in confirming a plan that leaves pre-petition members in place, notwithstanding]… the absolute priority rule."[16]

In re General Teamsters, Warehousemen and Helpers Union Local 890 is also frequently cited in support of the proposition that the absolute priority rule does not bar members of a nonprofit from retaining control following confirmation of a reorganization plan under which unsecured creditors are not paid in full. In *General Teamsters*, the debt-

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or, a labor union organized as an unincorporated nonprofit association, proposed a plan under which it would borrow and distribute to creditors a sum of money totaling the equity in substantially all of its assets. Under this proposal, the debtor estimated that unsecured creditors would receive a 31% return on their claims.[17]

A creditor group objected, noting, among other arguments, that the debtor's continued existence and possession of property violated the absolute priority rule considering the proposed return to unsecured creditors.[18] In response, the court found that the absolute priority rule applies only to holders of an "interest in a debtor entity."[19] Citing to Bankruptcy Code section 501(a), the court added that "an 'interest' is that which is held by an 'equity security holder'" and distinguished "equity security," defined in section 101(16) as a share in a corporation or "similar security," from nonprofit membership.[20] In overruling the objection, the court concluded that "neither Debtor's members nor Debtor's affiliates nor anyone else holds any interest in Debtor, as that concept is defined by the Bankruptcy Code and case law" and later held that "the Absolute Priority Rule does not, by its terms, prohibit a debtor entity from retaining its own assets, and cannot, by its terms, apply to a situation such as this where the debtor has no equity security holders."[21]

Indeed, even where the members of a nonprofit do obtain some personal economic benefit from that relationship, at least one court has held that where the retained benefit does not include a right to share in profits, a right to ownership of the nonprofit's assets in the future, or the ability to manipulate the value of that personal economic benefit, there is no violation of section 1129(b) when the interest is retained and creditors are not paid in full. In *In re Wabash Valley Power Association*, the U.S. Court of Appeals for the Seventh Circuit held that even though a rural electric cooperative's members received lower utility rates as a result of their membership status and were entitled to occasional reimbursement payments from "patronage capital accounts" maintained by the cooperative to cover fluctuations in production costs and to fund necessary capital expenditures, they could retain their membership interest without paying a dissenting class of creditors in full.[22] In reaching this conclusion, the court noted that state law prohibited Wabash's cooperative members from owning any of its assets and that, as a result, the patronage accounts were more like no-interest loans to the cooperative by its members than equity interests held by those members. Additionally, the court drew an important distinction between "control" of nonprofit and equity ownership, observing that "control alone, divorced from any right to share in corporate profits or assets, does not amount to an equity interest."[23]

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Citing *Whittaker,* the court also stressed that the absolute priority rule did not prevent the continued control of the cooperative by its members because the members could not manipulate that control to afford themselves potential future profits.[24] The court held that the absolute priority rule was inapplicable notwithstanding the members' continued right to discounted utility rates, describing this benefit as "an inescapable product of the cooperative form" and "not exploitation of insider status of the sort the absolute priority rule was designed to prevent."[25] It later noted that "the mere fact that the Members of [the debtor] are benefited by [the debtor]'s operation and might be disadvantaged by its demise also does not give them an 'interest' cognizable in bankruptcy."[26]

E. Economic Benefit: Absolute Priority Concern

Other courts, in contrast, have looked at nonprofits and determined that the retention of certain economic benefits available to their members can constitute a distribution of property, which in the absence of plan acceptance by all impaired classes of creditors violates the absolute priority rule. For example, in a case factually similar to *Wabash*, the U.S. Bankruptcy Court for the District of Maine in *In re Eastern Maine Electric Cooperative Inc.* found that the right of members of an agricultural cooperative to recover from patronage capital accounts were more accurately described as equity interests and not as claims for the repayment of debt as the court had in *Wabash*. Although the court considered many of the same factors discussed in *Wabash*, it noted that the cooperative itself had referred to patronage capital as representing "ownership" in the cooperative and had not generally recorded patronage capital as a liability.[27] The court in *Eastern Maine* thus held that the debtor's proposed plan violated the absolute priority rule.[28] Additionally, the court cited to applicable state law governing cooperatives and the debtor's by-laws in reaching the conclusion that the retention of interests in the nonprofit would render the plan unconformable if all unsecured creditors were not paid in full.[29]

The U.S. Bankruptcy Court for the Middle District of Florida reached a similar conclusion in *In re S.A.B.T.C. Townhouse Association, Inc.*[30] The debtor in *S.A.B.T.C. Townhouse* was a nonprofit homeowners association that held title to certain common areas and maintained "reserve accounts" to fund necessary capital expenditures.[31] Under its proposed plan of reorganization, the debtor offered unsecured creditors pro rata distributions from an account containing approximately $30,000, which represented two years of membership dues collected from the association's members and provided for the members of the association to retain ownership of the enterprise. A judgment creditor that held a $275,000

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claim objected to the plan, arguing that the absolute priority rule barred the retention of membership interests in the nonprofit considering the proposed return to unsecured creditors.[32]

In ruling in favor of the judgment creditor, the court first noted that the nonprofit debtor was required "to prove all of the elements necessary to meet the requirements of section 1129(b) by clear and convincing evidence" and determined that the debtor had failed to carry its burden with respect to the absolute priority rule.[33] The court concluded that the use of "public" areas owned and maintained by the association carried with it a real economic benefit for the individual property owners who were members of the debtor. In short, the ownership of and provision of services related to this property by the association augmented the value of the property owned by its members. The court found that this real and personal economic benefit constitutes the type of value retention that the absolute priority rule is intended to force "owners" to pay for or at least pay enough for to get the consent of every class of impaired creditors.[34]

F. The Mission of the Nonprofit Determines How Absolute the Absolute Priority Rule Is Applied

From these cases, it appears that whether the absolute priority rule applies to a nonprofit's Chapter 11 reorganization may well depend on whether the nonprofit corporate structure is being utilized primarily to provide a relatively direct economic benefit to its members or serves some other, more public purpose. In the former case (subject to the *Wabash* cases), members of nonprofit debtors will not be able to retain control and the benefits of their membership status without the consent of creditors unless those creditors are paid in full. In the latter case, members of nonprofit debtors will be able to retain control even if an impaired unsecured creditor class has not accepted the reorganization plan. This approach to section 1129(b), generally adopted in most jurisdictions, reflects both an accurate characterization of the value inherent to membership in nonprofit corporations and recognizes that the organizational structure of nonprofit debtors is often inextricably linked to their ability to carry out their missions.[35]

III. Nonprofits and the Best Interest Test: Keeping More For Less?

Section 1129(a)(7) of the Bankruptcy Code, often referred to as the "best interests test," mandates that each creditor receive, at a minimum, the liquidation value that it would have received in a Chapter 7 case. In contrast to the absolute priority rule which, in effect, can be waived by class acceptance of a plan of reorganization, the best interests test applies

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for each individual creditor and cannot be waived. [36] In tandem, therefore, the best interests test sets the floor for distributions to creditors, and the absolute priority rule maximizes the amount of value actually distributed to those creditors by assuring that equity holders who wish to retain or receive value under a plan do so only when distributable value in excess of liquidation value is sufficient (at least theoretically) to obtain class acceptance of a plan and the concurrent waiver of the absolute priority rule.

In the case of a nonprofit where the absolute priority rule does not apply, however, there would appear to be no Bankruptcy-Code-based incentive for members of a nonprofit to propose a plan of reorganization that shares value in excess of liquidation value with the enterprise's unsecured creditors as these members do not need to purchase a waiver of the absolute priority rule in order to confirm a plan, retain control over the enterprise, and keep "reorganization value" imbedded in the enterprise. The absence of the absolute priority rule from the confirmation equation for certain nonprofits thus appears to heighten the importance of the best interests test in determining the amount of distributions to be made to creditors of these nonprofits. Indeed, hypothetical liquidation value might, from a technical legal perspective, represent both the floor and ceiling on distributions to unsecured creditors in some nonprofit cases, although we are not aware of any cases addressing this issue.

This observation raises the following question, though: how effective is the best interests test in ensuring a fair distribution to unsecured creditors? Liquidating a nonprofit enterprise is complicated and, in some instances, arguably prohibited by both the Bankruptcy Code and applicable nonprofit law. For example, Bankruptcy Code section 1112(c) provides that a case filed by a corporation that "is not a moneyed, business, or commercial corporation" may only be converted to Chapter 7 liquidation if the debtor consents to such a conversion.[37] Additionally, as an example of state law restrictions on nonprofit liquidation, New York law provides that the New York State Attorney General may only bring an action for involuntary dissolution if it can establish either (a) that the nonprofit was formed through fraudulent misrepresentation or concealment of a material fact or (b) that the nonprofit "exceeded the authority conferred upon it by law, or has violated any provision of law whereby it has forfeited its charter, or carried on, conducted or transacted its business in a persistently fraudulent or illegal manner, or by the abuse of its powers contrary to public policy of the state has become liable to be dissolved."[38]

If liquidation requires approval from a nonbankruptcy court authority and approval is not assured because a Chapter 7 trustee could not sell

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a nonprofit without complying with applicable nonbankruptcy law (as discussed below), what impact does this have on a debtor's liquidation analysis? Specifically, would liquidation value reflect the hypothetical best price that could be achieved through a forced sale to any willing buyer that would use the acquired assets for their highest economic return, or must liquidation value reflect only the hypothetical best price that could be achieved through a forced sale of a nonprofit debtor to a buyer who would continue to operate the nonprofit? For example, is the hypothetical liquidation value of a hospital the value that someone would pay in a forced sale to continue to operate that distressed facility or the possibly higher value that someone might pay for the opportunity to develop the hospital property into condominiums? If the former, the best interests test may not create much of an incentive for members of nonprofits to share imbedded debtor value with creditors. If the latter, however, liquidation value may create a strong incentive for nonprofits to share more value with creditors for fear that liquidation truly would create a better return for creditors and effectively bar a plan of reorganization that seeks to retain that value for the enterprise.

Only a few of the cases cited above discuss liquidation value in considering the plan proposed by the nonprofit debtor. The court in *Whittaker* briefly observed that the debtor had an "orderly liquidation value" of $5.75 million and a forced sale liquidation value of $3.85 million, noting later that an objecting creditor stood to receive more under the proposed plan than it would receive following a forced sale.[39] The court in *General Teamsters* provided a liquidation value for the debtor's real estate but declined to provide a more detailed analysis in light of the debtor's expressed reluctance to consider the possibility of conversion to a Chapter 7 liquidation.[40] The *Wabash* court also noted that the liquidation value of the debtor's "tangible, useful assets" was approximately $175,000. None of these cases, however, directly addressed the role of the best interests test as the only limit on creditor recovery in nonprofit cases where the absolute priority rule has not been applied. That said, in each case, the court does appear to have taken comfort from the fact that the reorganization plan for which confirmation was sought indeed provided creditors with more than simply liquidation value.

IV. Turning to Chapter 9

Although nonprofit debtors are reorganized along with their for-profit counterparts under Chapter 11, the Bankruptcy Code contains a separate chapter for the reorganization of municipalities: Chapter 9, which provides for the adjustment and refinancing of debts incurred by municipal debtors. In light of the scarcity of case law addressing the

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liquidation value of nonprofit entities and the related application of the best interests test, as well as the dispute over the extent to which the absolute priority rule applies in nonprofit Chapter 11 cases, Chapter 9 may provide some guidance for courts as they try to balance the inherent lack of an economic owner in nonprofit cases with fair treatment for creditors.[41] As noted above, like nonprofits, municipalities are not operated to provide their "owners" with a return on their "investment."

As a result, the discussed difficulties in liquidating a nonprofit have been compared to those difficulties faced by creditors negotiating with a Chapter 9 debtor, whose sole remedy in opposing a plan is to pursue dismissal of the case (as opposed to moving for conversion to Chapter 7 or proposing an alternative plan) because, among other things, the absolute priority rule does not apply to compel the municipality to pay creditors in full to retain control over its property. If successful in seeking dismissal, such creditors would be forced, along with all other creditors, to pursue state law claims which "often have little possibility of being repaid, especially where the municipality's debt burden is too high to be retired by taxes."[42]

Although both Chapter 9 and Chapter 11 require that a court determine that the proposed plan of reorganization "is in the best interests of creditors," Chapter 9 does not require that creditors receive at least as much as they would receive in a Chapter 7 liquidation.[43] In explaining this distinction, courts have observed that "the same interpretation [imposition of the Chapter 7 liquidation floor] does not work for a chapter 9 case" because one cannot compel the sale of municipal property for some other, more valuable use.[44] Still, in applying the "best interests" test to Chapter 9 plans, courts have found that a plan which makes "little or no effort to repay creditors over a reasonable period of time" is not in the best interests of creditors, but they also have held that "interpretation of the best interest of creditors test that required the municipality to devote all resources available to the repayment of creditors equals or exceeds the fair and equitable standard."[45] Additionally, at least one court has cited Collier on Bankruptcy in concluding that the correct application of section 943(b)(7) should direct courts to "require a reasonable effort by the municipal debtor that is a better alternative to the creditors than dismissal of the case."[46]

Approval of a Chapter 9 plan is also conditioned on a determination that the plan is proposed in good faith as sections 901 and 943(b)(1) expressly incorporate the good faith requirement present in section 1129(a)(3).[47] While section 1129(a)(3)'s good faith mandate is often overshadowed in Chapter 11 decisions by a discussion of the other confirmation requirements such as the absolute priority rule, the test appears to play a

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more central role in Chapter 9 cases. Indeed, while courts have emphasized that the question of whether a Chapter 9 plan is proposed in good faith is fact specific and determined on a case-by-case basis, confirmation has been consistently denied where a Chapter 9 plans disproportionally benefits certain creditors or fails to disclose certain material information.[48] This formulation of "good faith," when coupled with the best interest test, reads much like a variant of the "absolute priority" formulation in section 1129(b): in the absence of class consent, plan treatment of the dissenting class must be "fair and equitable" (provide a fair value above liquidation) and may not "discriminate unfairly."[49]

From the cases discussed above, it appears that the nature of a nonprofit debtor is central to applicability of the absolute priority rule. These cases suggest that members of "entrepreneurial" nonprofits who do not benefit economically from membership should be allowed to retain control following confirmation of a reorganization plan that does not pay all creditors in full, while members of "mutual" nonprofits possess an "interest" in the entity, similar to equity in a for-profit corporation, that should not be retained unless the proposed plan complies in all respects with the absolute priority rule.[50]

In making these distinctions and not applying the absolute priority rule in certain nonprofit contexts, courts nonetheless appear to be cognizant the same principles reflected in Chapter 9 decisions, namely whether a debtor has shown a reasonable effort to provide creditors with a competitive recovery and that the plan is proposed in good faith. In other words, courts do not appear to have given debtors free rein to retain value from distribution to creditors as part of their reorganizations, even where the court has concluded that the absolute priority rule does not apply. Thus, for example, in General Teamsters, the bankruptcy court offered a detailed discussion of why the debtor's plan, under which union membership dues did not increase even though unsecured creditors were not paid in full, was still proposed in good faith. The court concluded both that the debtor could not compel an increase in membership dues to fund additional payments to creditors and that the debtor had leveraged the entire equity value of its tangible assets to support payments to those creditors.[51] Similarly, in Whittaker, the court observed that the objecting creditor stood to receive "far more" under the debtor's plan that it would following liquidation at a forced sale, given the debtor's commitment of future resources to support distributions to prepetition creditors .[52] The Seventh Circuit in Wabash also noted that control by nonmembers could not "squeeze as much out of Wabash as a going concern and considerably less could be realized by liquidation."[53]

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From these cases, bankruptcy practitioners should be cognizant not only of the nature of any interest retained by prepetition members but also of the extent to which the plan comports with those fundamental principles underlying both Chapter 9 and Chapter 11 of the Bankruptcy Code in proposing plans of reorganization for nonprofit debtors.

V. BAPCPA and Nonprofit Debtors: Selling More for Less?

Prior to the enactment of BAPCPA, there was a serious question about the ability of nonprofit debtors to transfer assets under a plan of reorganization or pursuant to Bankruptcy Code section 363 (which generally allows debtors to sell assets outside the ordinary course of business provided that the sale is consistent with the exercise of sound business judgment), without having to comply with state law procedures and approvals. Some bankruptcy courts allowed nonprofit debtors to sell assets without having to go through state court processes and over the objection of state attorney generals and regulators that their consent was required for any transfer, while other courts required compliance with all applicable nonbankruptcy statues.[54] Anecdotally, the returns to creditors in courts where compliance with applicable nonbankruptcy law was not required were higher than in courts where compliance was required because nonprofits could be converted to for-profit enterprises or their assets sold without the uncertainty, and often time delay, that attends state-law compliance.

BAPCPA, however, resolved these different approaches in favor of compliance with applicable nonbankruptcy law. BAPCPA amended section 363 to provide that asset sales must be "in accordance with applicable nonbankruptcy law that governs the transfer of property by a corporation or trust that is not a moneyed, business, or commercial corporation or trust."[55] This amendment was reinforced by the addition of Bankruptcy Code subsection 541(f), which requires that corporations covered by Internal Revenue Code section 501(c)(3) may only be transferred to entities that are not covered by this section if the transfer would be permitted under applicable nonbankruptcy law.[56] In addition, section 1129(a)(16), which as noted above governs confirmation of a Chapter 11 plan, was amended to provide that transfers under a plan of reorganization also must comply with applicable nonbankruptcy law. Finally, BAPCPA granted standing to the attorney general of the state where the debtor is located to be heard with respect to these issues.

Although these additions to the Bankruptcy Code will clearly impact future nonprofit bankruptcy cases, there appears to be only one decision to date examining these provisions in significant detail. In *In re Machne Menachem, Inc.*, the U.S. Bankruptcy Court for the Eastern District of

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Pennsylvania considered whether a section of the New York Not-for-Profit Corporation Law, made applicable by Bankruptcy Code section 1129(a)(16), applied to the transfer of assets of a nonprofit debtor under a plan of reorganization proposed by one of the debtor's former directors.[57] Under the proposed plan, all of the debtor's "right, title, and interest" in its real and personal property would be transferred to a new entity created by the former director.

The debtor objected to the plan, arguing that the New York statute required "the sale, lease, exchange or other disposition of all, or substantially all, the assets" of a nonprofit be approved by at least two-thirds of its board of directors.[58] In finding the statute was inapplicable, the court relied heavily on its observation that the proposed asset transfer was "involuntary."[59] It therefore concluded that to find that the statute applied to involuntary transfers would lead to a "absurd result" as a nonprofit's board of directors could never be expected to approve an asset transfer the nonprofit did not propose and support.[60] Although this decision is highly fact-specific, it suggests that despite the recent amendments, certain state law provisions governing the transfer of assets on nonprofit entities may not apply in light of the unique circumstances presented by a bankruptcy proceeding.[61]

VI. Conclusion

Notwithstanding the fact that they are reorganized under Chapter 11, the reorganization of a nonprofit can differ markedly from the reorganization of for-profit enterprises. Basic tenets of the confirmation lexicon are turned on their head in a nonprofit case. Specifically, the members of certain nonprofits are able to retain their control over the enterprise over the dissenting vote of a class of impaired creditors because the absolute priority rule does not apply. Liquidation value may set the only bar for distributions to creditors, and because the liquidation of the nonprofit remains subject to compliance with applicable nonbankruptcy law (including any required governmental consents), the amount received in any liquidation could be limited. That said, as a practical matter, courts do not appear to have not allowed nonprofits to treat their creditors unfairly. Similar to Chapter 9, courts in nonprofit Chapter 11 cases seem to provide leeway from the more strict provisions of section 1129(b) only where the debtor has devoted substantial value (or at least as much as it could) to repaying prepetition debt. Moreover, in light of recent amendments to the Bankruptcy Code, transfers which otherwise are accomplished through a plan without the consent of any other party, remain subject to consents required under applicable nonbankruptcy law.

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NOTES

1. 11 U.S.C.A. § 1129(b).

2. It should be noted that BAPCPA added "health care business" as a defined term under section 101 of the Bankruptcy Code, which includes any public or private entity "primarily engaged in offering to the general public facilities and services for (i) the diagnosis or treatment of injury, deformity, or disease; and (ii) surgical, drug treatment, psychiatric or obstetric care." A "health care business" can be either a nonprofit or a for profit entity depending on the nature of the business and local law requirements.

3. Black's Law Dictionary 1057 (6th ed. 1990).

4. Black's Law Dictionary 1057 (6th ed. 1990).

5. See e.g., Con. Gen. Stat. § 33-1002 (2009).

6. Lisa A. Runquist, The ABCs on Nonprofit Membership 16 (A.B.A. 2005).

7. Lisa A. Runquist, The ABCs on Nonprofit Membership 16 (A.B.A. 2005).

8. Lisa A. Runquist, The ABCs on Nonprofit Membership 16 (A.B.A. 2005) at 15.

9. Pursuant to section 1124 of the Bankruptcy Code, any party whose legal, contractual, or equitable rights are altered under a plan of reorganization is deemed "impaired." 11 U.S.C.A. § 1124(a).

10. 11 U.S.C.A. § 1129(b).

11. "In full" is defined differently for secured and unsecured creditors under section 1129(b). For secured creditors, payment in full is defined as providing the secured creditor with either (a) the present value of its interest in its collateral in a deferred income stream secured by that collateral; (b) possession/ownership of the collateral; or (c) the indubitable equivalent of the value of its interest in its collateral. See 11 U.S.C.A. § 1129(b)(2)(A). There is some dispute over what constitutes the "indubitable equivalent" of an interest in collateral, though cash would definitely suffice. See In re Murel Holding Corp., 75 F.2d 941, 942 (C.C.A. 2d Cir. 1935); In re Pacific Lumber Co., 584 F.3d 229, 246-47, 52 Bankr. Ct. Dec. (CRR) 46, Bankr. L. Rep. (CCH) P 81642 (5th Cir. 2009) ("[w]hatever uncertainties exist about indubitable equivalent, paying off secured creditors in cash can hardly be improper if the plan accurately reflected the value of the collateral"). For unsecured creditors (which generally would include a secured creditor's deficiency claim), payment in full means payment equal to the allowed amount of the unsecured creditor's claim. See 11 U.S.C.A. § 1129(b)(2)(B).

12. The Bankruptcy Code does not directly define what constitutes an "interest." Generally, though, an interest is limited to an equity interest in a debtor. See In re General Teamsters, Warehousemen and Helpers Union Local 890, 225 B.R. 719, 735-36, 33 Bankr. Ct. Dec. (CRR) 403 (Bankr. N.D. Cal. 1998) ("An 'interest' is that which is held by an 'equity security holder', pursuant to 11 U.S.C. § 501(a); an 'equity security holder' is defined by 11 U.S.C. § 101(17) as the 'holder of an equity security of the debtor'; an 'equity security' is defined by 11 U.S.C. § 101(16) as a share in a corporation 'or similar security' (or certain warrants or rights concerning the same), or the interest of a limited partner in a limited partnership (or certain warrants or rights concerning the same").

13. Knollwood Memorial Gardens v. C. I. R., 46 T.C. 764, 786, 1966 WL 1208 (T.C. 1966); General Teamsters, 225 B.R. at 736 (finding that control of a nonprofit, "divorced from any right to share in corporate profits or assets, does not amount to an equity interest").

14. Amelia Rawls, Applying the Absolute Priority Rule to Nonprofit Enterprises in Bankruptcy, 118 Yale L.J. 1231, 1237 (Apr. 2009).

15. In re Whittaker Memorial Hosp. Ass'n, Inc., 149 B.R. 812 (Bankr. E.D. Va. 1993).

16. In re Independence Village, Inc., 52 B.R. 715, 726, 13 Bankr. Ct. Dec. (CRR) 637, 13 Collier Bankr. Cas. 2d (MB) 476 (Bankr. E.D. Mich. 1985).

17. General Teamsters, 225 B.R. at 722.

18. General Teamsters, 225 B.R. at 736-37.

19. General Teamsters, 225 B.R. at 735.

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20. General Teamsters, 225 B.R. at 736. Section 501(a) of the Bankruptcy Code provides that, rather than filing a proof of claim, holders of equity interests in a debtor should file a "proof of interest" to assert there interest in a debtor. 11 U.S.C.A. § 501(a).

21. General Teamsters, 225 B.R. at 737.

22. Matter of Wabash Valley Power Ass'n, Inc., 72 F.3d 1305, 1317, 34 Collier Bankr. Cas. 2d (MB) 877, Bankr. L. Rep. (CCH) P 76739 (7th Cir. 1995).

23. Wabash, 72 F.3d at 1318.

24. Wabash, 72 F.3d at 1318.

25. Wabash, 72 F.3d at 1318.

26. Wabash, 72 F.3d at 1318.

27. In re Eastern Maine Elec. Co-op., Inc., 125 B.R. 329, 339 (Bankr. D. Me. 1991).

28. Eastern Maine, 125 B.R. 329.

29. Eastern Maine, 125 B.R.at 338-39 (the debtor's by-laws provided that "In the event of dissolution or liquidation of the Cooperative, after all outstanding indebtedness of the Cooperative shall have been paid, outstanding capital credits shall be retired without priority on a pro rata basis before any payments are made on account of property rights of members").

30. In re S.A.B.T.C. Townhouse Ass'n, Inc., 152 B.R. 1005, 24 Bankr. Ct. Dec. (CRR) 126, 28 Collier Bankr. Cas. 2d (MB) 1081, Bankr. L. Rep. (CCH) P 75223 (Bankr. M.D. Fla. 1993).

31. S.A.B.T.C. Townhouse, 152 B.R. at 1007.

32. S.A.B.T.C. Townhouse, 152 B.R. at 1008.

33. S.A.B.T.C. Townhouse, 152 B.R. at 1008.

34. The court also rejected the debtor's efforts to avoid the application of the absolute priority rule by arguing that the plan fell within the "new value" exception to the absolute priority rule, which generally allows a debtor's equity holders to retain their interests when such interests are retained on account of sufficient new value provided to the entity. In doing so, the court stressed that the nonprofit's members had not made a "new contribution" and that the debtor merely collecting on certain accounts receivable from these members is insufficient to constitute new value. The court ultimately dismissed the case, noting that section 1112(c) bared conversion to Chapter 7 absent the consent of the debtor. S.A.B.T.C. Townhouse, 152 B.R. at 1009-11.

35. In a recent article published in the Yale Law Review, the author distinguishes "entrepreneurial nonprofits" (whose members do not substantially benefit from the charitable or social mission of the nonprofit that they operate) from "mutual nonprofits" (whose members "maintain an equity-like interest in the entity") but effectively reaches the same conclusion: the absolute priority rule should not apply to a reorganization of a "entrepreneurial nonprofit" to require payment in full of creditors as a prerequisite for members of the nonprofit to retain control. Rawls, 118 Yale L.J. at 1235.

36. The only exception to proving that each creditor is getting at least as much as it would on liquidation occurs in the highly unlikely circumstance that every holder of a claim agrees to take less than it would receive on liquidation. 11 U.S.C.A. § 1129(a)(7); In re Sentinel Management Group, Inc., 398 B.R. 281, 310 (Bankr. N.D. Ill. 2008) ("'Best interest' means that either (1) each holder of a claim or interest of each class has accepted the plan or (2) the nonaccepting class member will receive under the plan at least as much as it would receive upon liquidation").

37. See 11 U.S.C.A. § 1112(c).

38. See, e.g., 11 U.S.C.A. § 1112(c); NY CLS N-PCL § 1101.

39. Whittaker, 149 B.R. at 816.

40. General Teamsters, 225 B.R. at 728.

41. Indeed, at least one nonprofit hospital Chapter 11 debtor specifically suggested that Chapter 9 be used as a guidepost for confirming its Chapter 11 plan of reorganization. See

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Disclosure Statement Filed Pursuant to Section 1125 of the Bankruptcy Code For the Plan of Reorganization of St. Mary's Hospital, Passaic, N.J. at 70, In re St. Mary's Hospital, Passaic, N.J., No. 09-15619 (MS) (2009).

42. In re Mount Carbon Metropolitan Dist., 242 B.R. 18, 34 (Bankr. D. Colo. 1999); Newhouse v. Corcoran Irr. Dist., 114 F.2d 690 (C.C.A. 9th Cir. 1940).

43. Compare 11 U.S.C.A. § 943(b)(7) with § 1129(a)(7).

44. Collier on Bankruptcy § 943.03[7][a] (Alan N. Resnick et al. eds)(15th ed. Rev. 2009).

45. Collier on Bankruptcy § 943.03[7][a] (Alan N. Resnick et al. eds)(15th ed. Rev. 2009).

46. In re County of Orange, 191 B.R. 1005, 1020, 35 Collier Bankr. Cas. 2d (MB) 593 (Bankr. C.D. Cal. 1996).

47. See 11 U.S.C.A. §§ 901, 943(b)(1), 1129(a)(3).

48. In re Mount Carbon Metropolitan Dist., 242 B.R. 18, 41-42 (Bankr. D. Colo. 1999); Kaufman County Levee Imp. Dist. No. 4 v. Mitchell, 116 F.2d 959 (C.C.A. 5th Cir. 1941); In re Wolf Creek Valley Metropolitan Dist. No. IV, 138 B.R. 610, 618-19, 22 Bankr. Ct. Dec. (CRR) 1359 (D. Colo. 1992).

49. 11 U.S.C.A. § 1129(b).

50. See generally Rawls, 118 Yale L.J. at 1235.

51. General Teamsters, 225 B.R. at 730-31.

52. Whittaker, 149 B.R. at 816.

53. Wabash, 72 F.3d at 1320.

54. Compare In re Georgia International Healthcare Alliance Inc., Adv. Pro. No. 00-6196 (Bankr. N.D.Ga. 2001), with In re United Healthcare System, Inc., 1997 WL 176574 at *10 (D.N.J. 1997).

55. 11 U.S.C.A. § 363(d). This provision is applicable both in Chapter 7 and Chapter 11 cases, so even in liquidation, a trustee must comply with applicable nonbankruptcy law to be able to transfer the assets of a nonprofit debtor.

56. 11 U.S.C.A. § 541(f).

57. In re Machne Menachem, Inc., 371 B.R. 63 (Bankr. M.D. Pa. 2006).

58. Machne Menachem, 371 B.R. at 66.

59. Machne Menachem, 371 B.R. at 68.

60. Machne Menachem, 371 B.R. at 68.

61. See Matthew W. Levin, Transferring Assets of Nonprofit Entities in Bankruptcy (A.B.I. 2009).

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