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Reorganizing With Value But Without Profit (Or Equity):

Select Confirmation Issues for Nonprofit Entities

**Andrew M. Troop
Megan Cummins
Joseph Zujkowski
Cadwalader, Wickersham & Taft LLP
One World Financing Center
New York, New York 10281
(212) 504-6000**

Introduction

The reorganization of nonprofit corporations 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 for a nonprofit are (a) the applicability of the “absolute priority rule,” which generally prohibits distributions to current owners of an enterprise on account of that ownership interest, (b) 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 and (c) the ability to transfer assets as part of a plan, where, generally speaking, assets can be transferred free of pre-approval or consent rights. These issues are at play in a nonprofit case because (x) no one owns the residual economic interests of a nonprofit, and thus many courts have determined that the “absolute priority rule” does not preclude members of a nonprofit from controlling the post-reorganization organization, even when its creditors are not paid in full under a plan of reorganization, (y) many states limit the ability of a nonprofit to liquidate its assets, thereby potentially depressing a nonprofit debtor’s hypothetical liquidation value and (z) amendments 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 non-bankruptcy law. This paper briefly addresses each of these issues in turn.

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

The Absolute Priority Rule

Section 1129(b) of the Bankruptcy Code¹ generally allows a debtor to “cramdown” a plan of reorganization over the objection of an impaired class, provided, among other requirements, that “fair and equitable treatment” is afforded to each “class of claims or interests that is impaired under, and has not accepted” the plan.² Commonly referred to as the absolute priority rule, this “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 in full. Specifically, section 1129(b) 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.”³ In light of the absolute priority rule, the ability to distinguish nonprofit membership (or sponsorship) from an 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.

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 been required 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 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 nonprofit corporations generally have no right to dividends or to distributions of corporate assets.⁴

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 even where there are no rights to dividends or other distributions of corporate assets. In these cases, courts have required full payment to dissenting creditor classes as a prerequisite for the retention of nonprofit member interests.

No Economic Benefit: No Absolute Priority Concern

Courts which have confirmed a nonprofit's reorganization plan that leaves the prepetition parties in control of a reorganized debtor over the dissent of an impaired class of creditors have based their decisions on the lack of value being distributed, or capable of being distributed, to those parties in control. Thus, in In re Whittaker Memorial Hospital Association ("Whittaker"), the United State Bankruptcy Court for the Eastern District of Virginia confirmed the plan of reorganization of a nonprofit hospital association, even though certain unsecured creditors were not paid in full, because nothing "beyond control" was retained by the "Virginia nonstock, membership corporation," which controlled the hospital. The court recognized that the nonprofit debtor's structure "places it in a unique status apart from private enterprise."⁵ Similarly, the bankruptcy court in In re Independence Village Inc. ("Independence Village") allowed members of a nonprofit debtor to retain control over 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 with the absolute priority rule."⁶

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 the section 1129(b) when the interest is retained and creditors are not paid in full. In In re Wabash Valley Power Association ("Wabash"), the United States 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.⁷ 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. Furthermore, citing to Whittaker the court stressed that the absolute priority rule did not prevent the continued control of the cooperative by its members because the members could not manipulate such control to afford themselves potential future profits.⁸ Finally, the court held that the absolute priority rule was inapplicable

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notwithstanding the member's 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."⁹

Economic Benefit: Absolute Priority Concern

Other courts, however, have looked at nonprofits and determined that the retention of 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 United States Bankruptcy Court for the District of Maine in In re Eastern Maine Electric Cooperative Inc. found that the rights of members of an agricultural cooperative to recover from patronage capital accounts were more accurately described as equity interests rather than as claims for the repayment of debt and thus the retention of such interests violated section 1129(b). 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.¹⁰ In addition, the United States Bankruptcy Court for the Middle District of Florida found that membership in a nonprofit homeowners association, given to each owner of a residential unit in a particular development, could not be retained under a reorganization plan if a significant judgment creditor was not paid in full. The court concluded that being a member of a homeowner's association provided significant "value in use" to individual unit owners, even if the land owned by the association had little fair market value. As a result of this value, the members of the homeowner's association could not retain those interests where all creditors did not receive the full value of their claims.¹¹

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 an economic benefit to its members or serves some other, more public purpose. In the former case, 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.¹²

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

Section 1129(a)(7) of the Bankruptcy Code mandates that a plan of reorganization serve the "best interests" of creditors and has been interpreted to require that each creditor receive, at a minimum, the liquidation value that it would have received in 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 for each individual creditor and cannot be waived. 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, heightens 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 even prohibited by both the Bankruptcy Code and applicable nonprofit law.¹³ If liquidation requires approval from a non-bankruptcy court authority and approval is not assured because a chapter 7 trustee could not sell 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 presumably 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 reorganization value with creditors. If the latter, however, liquidation value may create a strong incentive for nonprofits to share reorganization value with creditors for fear that liquidation truly would create a better return.

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 section 363 of the Bankruptcy Code (which generally allows debtors to sell assets outside the ordinary course of business provided 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 non-bankruptcy statutes.¹⁴ Anecdotally, the returns to creditors in courts where compliance with applicable non-bankruptcy

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law was not required was 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 non-bankruptcy 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.”¹⁵ This amendment was reinforced by the addition of subsection 541(f) to the Bankruptcy Code, which requires that corporations covered by section 501(c)(3) of the Internal Revenue Code may only be transferred to entities that are not covered by this section if the transfer would be permitted under applicable nonbankruptcy law.¹⁶ In addition, section 1129 was amended to provide that transfers under a plan of reorganization also must comply with applicable nonbankruptcy law. Finally, BAPCPA grants standing to the attorney general of the state where the debtor is located to be heard with respect to these issues.

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. The members/sponsors of the nonprofit may be 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. Moreover, transfers which otherwise are accomplished through a plan without the consent of any other party, remain subject to consents required under applicable nonbankruptcy law.

¹ 11 U.S.C. §§ 101 – 1532.

² 11 U.S.C. § 1129(b).

³ In re General Teamsters, Warehousemen and Helpers Union, 225 B.R. 719, 735-36 (Bankr. N.D. 1998).

⁴ Knollwood Mem'l Gardens v. Comm'r, 46 T.C. 764, 786 (1966); Gen. 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”).

⁵ In re Whittaker Memorial Hospital Ass'n, 149 B.R. 812, 816 (Bankr. E.D. Va. 1993).

⁶ In re Independence Village Inc., 52 B.R. 715, 726 (Bankr. E.D. Mich. 1985).

⁷ In re Wabash Valley Power Association, 72 F.3d 1305, 1317 (7th Cir. 1995)

⁸ Id. at 1319.

⁹ Id.

¹⁰ In re Eastern Maine Electric Cooperative Inc., 125 B.R. 329 (Bankr. D. Maine 1991).

¹¹ In re S.A.B.T.C. Townhouse Ass'n, Inc., 152 B.R. 1005, 1001 (Bankr. M.D.Fla. 1993).

¹² 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” and require payment in full of creditors as a prerequisite for members of the nonprofit to retain control. 188 Yale L.J. 1231, 1235 (2009).

¹³ See e.g. 11 U.S.C. § 1112(c); NY CLS N-PCL § 1101 (providing 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”).

¹⁴ 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).

¹⁵ 11 U.S.C. 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.

¹⁶ 11 U.S.C. 541(f).

**State Regulation of Charitable
Bequests in Nonprofit Bankruptcies**

**Robert J. Feinstein, Esq.
Pachulski Stang Ziehl & Jones LLP
780 Third Avenue, 36th Floor
New York, New York 10017**

Introduction

In most States, the use and disposition of assets of nonprofit organizations is subject to the oversight and approval of State regulators, exercising their *parens patriae* powers. When a not-for-profit entity becomes a debtor in a case under the Bankruptcy Code, questions arise as to whether endowment funds in the debtor's possession are property of the estate and the extent to which the State regulatory and jurisdictional scheme is affected by the automatic stay imposed upon the bankruptcy filing. These questions are considered below.

I. Are Donor Restricted Funds Property of the Bankruptcy Estate?

Frequently, charitable gifts and bequests are dedicated to a particular purpose, or are otherwise made with restrictions attached. Under State law, these restrictions are generally recognized and enforced. Those restrictions call into question whether donor-restricted funds are property of the charitable debtor's bankruptcy estate that can be used generally to conduct the debtor's operations.

Pursuant to the Bankruptcy Code, the filing of a bankruptcy petition creates an estate comprised of all the property enumerated under section 541, wherever located and by whomever held, including "all legal or equitable interests of the debtor in property as of the commencement of the case."¹ Although the Bankruptcy Code defines property of the estate in the broadest possible terms, the United States Supreme Court has held that any legal or equitable interest in any particular asset is determined pursuant to state law, notwithstanding the commencement of a bankruptcy proceeding.²

¹ 11 U.S.C. § 541(a)(1).

² See *Barnhill v. Johnson*, 503 U.S. 393, 398, 112 S.Ct. 1386, 1389 (1992) ("property' and 'interests in property' are creatures of state law."); *Butner v. United States*, 440 U.S. 48, 54-55, 99 S.Ct. 914, 918 (1979) ("Congress has generally left the determination of property rights in the assets of a bankrupt's estate to state law.").

Prepetition restrictions on property held by a debtor, such as a donor's restriction on the use of funds, are enforceable in bankruptcy. A long line of bankruptcy cases has held that the debtor's property interest is subject to those restrictions being enforced, thereby limiting their status as property of the estate.³ In particular, donor-restricted funds and property in the possession of a debtor that is held in trust by the debtor for a nondebtor have been held not to constitute property of the estate under section 541.⁴ The bankruptcy estate has no rights or interests in property broader than the rights and interests that the debtor had prior to the commencement of the case.⁵ Further, the bankruptcy court's jurisdiction over a debtor's property extends only as far as the debtor's particular interest in the property.⁶

Some courts have held that donor-restricted funds are held in actual or constructive trust by the debtor, and have therefore concluded that the trust funds are not property of the bankruptcy estate.⁷ In this regard, section 541(d) of the Bankruptcy Code provides that “[p]roperty in which the debtor holds, as of the commencement of the case, only legal title and

³ See, e.g., *Chicago Board of Trade v. Johnson*, 264 U.S. 1 (1924); *Salisbury v. Ameritrust Tex., N.A.*, 151 B.R. 394 (Bankr. N.D. Tex. 1993).

⁴ See e.g. *Farrell v. Sharon Steel Corp.*, 41 F.3d 92, 95 (3d Cir. 1994) (“debtors do ‘not own an equitable interest in property ... [they] hold[] in trust for another,’ and that therefore funds held in trust are not ‘property of the estate.’”) (citing *Begier v. IRS*, 496 U.S. 53, 59, 110 S.Ct. 2258, 2263 (1990)); *Universal Bonding Ins. Co. v. Gittens & Sprinkle Enters.*, 960 F.2d 366, 371 (3d Cir. 1992) (beneficiaries of trust may reclaim their equitable interest in the trust fund); *Indiana Lumbermens Mutual Insurance Co. Inc. v. Construction Alternatives Inc.*, 161 B.R. 949, 951 *aff'd*, 2 F.3d 670, rehearing and suggestion for rehearing denied (6th Cir. 1993) (“bankruptcy estate does not include property over which the debtor is a trustee.”); *Mitsui Mfr. Bank v. Unicom Computer Corp.*, 13 F.3d 321, 323 (9th Cir. 1994) (“something held in trust by a debtor for another is neither property of the bankruptcy estate under section 541(d), nor property of the debtor for purposes of section 547(b)”).

⁵ See, e.g., *Salisbury v. Ameritrust Tex., N.A.*, 151 B.R. at 398 (“the estate received [trust assets] subject to any restrictions imposed by state law, prepetition.”).

⁶ See, e.g., *Connecticut General Life Ins. Co. v. Universal Ins. Co.*, 838 F.2d 612, 618 (1st Cir. 1988) (“when a debtor is in possession of property impressed by a trust ... the bankrupt estate holds the property subject to the outstanding interest of the beneficiaries”).

⁷ See, e.g., *In re Joliet-Will County Community Action Agency*, 847 F.2d 430 (7th Cir. 1988) (holding that federal and state agency grants to nonprofit community organizations that impose restrictions on the grants' use were made to the organization as a trustee, such that the debtor lacked beneficial title to the funds and hence they were not property of the estate); *Parkview Hospital v. St. Vincent Medical Center*, 211 B.R. 619 (Bankr. N.D. Ohio) (debtor hospital's contributors manifested an intent that the hospital's development fund would be used for specific charitable purposes, supporting a finding of an express charitable trust that removed the funds from the chapter 11 estate).

not an equitable interest ... becomes property of the estate ... only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold." If the funds are not property of the estate, under applicable state law they can only be used for their dedicated purposes, and not used or administered for the benefit generally of creditors in the bankruptcy case.⁸

If a restricted gift of funds is kept out of the bankruptcy estate, the only way for the debtor to modify the restriction and use the funds for general purposes would be to petition the appropriate court under the doctrine of *cy pres*⁹ to modify the restriction. Query whether a bankruptcy court as a court of equity would be an appropriate court to adjudicate a request to modify the restriction in reliance on the *cy pres* doctrine or whether principles of comity mandate that such requests be directed to and resolved by the state courts. Since the trust funds are not property of the estate, the better view may be that the bankruptcy court has no jurisdiction over the funds and cannot entertain the *cy pres* request.

II. The Disposition of Assets by a Charitable Debtor and New Sections 363(d)(1) and 503(f) of the Bankruptcy Code

The disposition of property of charitable entities in bankruptcy has been the subject of both litigation and recent legislation.

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 made two significant changes to the law that affect the disposition of property in nonprofit organization bankruptcies. First, new section 363(d)(1) of the Code was added to provide that a trustee (or

⁸ See, e.g., *In re Bishop College*, 151 B.R. 394 (Bankr. N.D. Tex. 1993). On the other hand, if the funds are property of the estate, presumably the charitable debtor would be allowed to use them in the ordinary course of business under section 363 of the Bankruptcy Code, but (i) using these assets inconsistently with their restrictions is not ordinary course of business and (ii) as discussed in the text, new section 363(d)(1) of the Code eliminates that possibility.

⁹ Under the doctrine of *cy pres*, where it is shown that a particular charitable purpose for which a trust was created becomes impossible of achievement or illogical or impracticable, the trust does not fail but rather the court can authorize that the property may be applied to some other charitable purposes falling within the general intention of the trust's settler. *Id.* at 400.

debtor in possession) may use, sell or lease property only “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.” Second, section 503(f) of the Code was added, likely in response to the litigation initiated by the Pennsylvania Attorney General in the bankruptcy proceeding of Allegheny Health, Education and Research Foundation¹⁰ (discussed below). New section 503(f) provides:

“[P]roperty that is held by a debtor that is a corporation described in section 501(c)(3) of the Internal Revenue Code of 1986 and exempt from tax under section 501(a) of such Code may be transferred to an entity that is not such a corporation, but only under the same conditions as would apply if the debtor had not filed a case under this title ... The parties who may appear and be heard in a proceeding under this section include the attorney general of the State in which the debtor is incorporated, was formed, or does business.”¹¹

Coupled with section 363(d)(1) of the Bankruptcy Code, section 503(f) dictates that nonprofit enterprises in bankruptcy, such as public hospitals, museums, or charities, cannot be sold to for-profit taxpaying entities without compliance with state-law regulatory provisions requiring approval for the sale of nonprofit enterprises to for-profit buyers.

III. State’s Exercise of Regulatory Powers

As stated above, a determination that donor-restricted funds constitute trust property that is not included in the bankruptcy estate removes the property from the jurisdiction of the bankruptcy court. As a result, the disposition of such property is subject to state regulators’ *parens patriae* powers. The question then becomes, to what extent, if any, is the State’s regulatory powers subject to restriction under the automatic stay provisions of section 362 of the Bankruptcy Code?

¹⁰ *In re Bankr. Appeal of Allegheny Health, Educ. & Research Found.*, 252 B.R. 332 (W.D. Pa. 1999); *In re Bankr. Appeal of Allegheny Health, Educ. & Research Found.*, 252 B.R. 309 (W.D. Pa. 1999).

¹¹ 11 U.S.C. § 503(f).

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Section 362 of the Bankruptcy Code provides for an automatic stay upon the filing of a bankruptcy petition to protect the debtor, property of the estate, and property of the debtor from certain actions by third-parties.¹² The general policy behind this section is to grant complete, immediate, and temporary relief to the debtor from creditors, and promote an orderly administration of the bankruptcy case.¹³ However, the commencement or continuation of a proceeding by a governmental unit to enforce its “police or regulatory power” is not stayed.¹⁴

Although “police or regulatory power” is not defined in the Bankruptcy Code, courts have held that the police and regulatory exception to the automatic stay should be broadly construed and that no “unnatural efforts [should] be made to limit its scope.”¹⁵ In support of its interpretation, the Third Circuit stated:

Given the general rule that preemption is not favored, and the fact that, in restoring power to the States, Congress intentionally used such a broad term as “police and regulatory powers,” we find that the exception to the automatic stay provision contained in 362(b)(4)-(5) should itself be construed broadly, and no unnatural efforts be made to limit its scope. The police power of the several States embodies the main bulwark of protection by which they carry out their responsibilities to the People; its abrogation is therefore a serious matter. Congress should not be assumed, therefore, to have been miserly in its refund of that power to the States. Where important state law[s] ... protect some public interest, they should not be overridden by federal legislation unless they are inconsistent with explicit congressional intent such that the supremacy clause mandates their suppression...¹⁶

¹² 11 U.S.C. § 362(a)(1).

¹³ *Penn Terra Ltd. v. Dep't of Environmental Resources, Commonwealth of Pennsylvania*, 733 F.2d 267, 271 (3d Cir. 1984).

¹⁴ 11 U.S.C. § 362(a)(3); 11 U.S.C. § 362(b)(4) (the filing of a bankruptcy petition does not operate as a stay “under paragraph (1), (2), (3), or (6) of subsection (a) of this section, of the commencement or continuation of an action or proceeding by a governmental unit ... to enforce such governmental unit's or organization's police and regulatory power, including the enforcement of a judgment other than a money judgment, obtained in an action or proceeding by the governmental unit to enforce such governmental unit's or organization's police or regulatory power.”).

¹⁵ *Penn Terra Ltd. v. Dep't of Environmental Resources, Commonwealth of Pennsylvania*, 733 F.2d at 273.

¹⁶ *Id.*

According, the policy of this provision is to permit regulatory, police and criminal actions to proceed in spite of section 362(a)(1), and to permit enforcement of resulting judgments or orders, other than money judgments. To determine whether an action is excepted from the automatic stay as a police or regulatory power action, the courts have developed two tests to judge the government's action: the "pecuniary purpose test" and the "public policy test."

If either test is satisfied, then the exception applies. Under the pecuniary purpose test, the court must ask "whether the governmental proceeding relates primarily to the protection of the government's pecuniary interest in the debtor's property, and not to matters of public safety."¹⁷ Proceedings which relate primarily to matters of public safety are excepted from the stay. Pursuant to the public policy test, a court "distinguishes between proceedings that effectuate public policy and those that adjudicate private rights."¹⁸ Only government actions designed to effectuate public policy are exempted from the automatic stay.¹⁹

Using these tests, courts have applied the exception to a broad range of governmental actions.²⁰ Significantly, however, even when a governmental action is excepted from the stay, the bankruptcy court retains the power under section 105 of the Bankruptcy Code to enjoin an action by a governmental unit "where the exercise of State power, even for the protection of the

¹⁷ *In re James*, 112 B.R. 687, 704 (Bankr. E.D. Pa. 1990) (quoting *In re Commerce Oil Co.*, 847 F.2d 291, 295 (6th Cir. 1988)); see also *NLRB v. Continental Hagen Corp.*, 932 F.2d 828, 833 (9th Cir. 1991).

¹⁸ *Continental Hagen*, 932 F.2d at 833.

¹⁹ *Id.*

²⁰ See, e.g., *Universal Life Church, Inc. v. United States*, 128 F.2d 1294, 1297 (9th Cir. 1997) (IRS's revocation of church's tax exemption status falls with the police or regulatory exception); *NLRB v. 15th Avenue Iron Works, Inc.*, 964 F.2d 1336 (2d Cir. 1992) (NLRB unfair labor practice proceedings and enforcement proceedings are police or regulatory powers actions by a governmental unit, and therefore are exempt from automatic stay); *Brock v. Morysville Body Works, Inc.*, 829 F.2d 383 (3d Cir. 1987) (OSHA citation enforceable against debtor notwithstanding automatic stay, pursuant to police powers expectation).

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public health and safety, [is] so contrary to the policy of the Bankruptcy Code that it should not be permitted.”²¹

One case worthy of special mention in this area is *In re Bankruptcy Appeal of Allegheny Health, Education and Research Foundation* (“AHERF”), *supra*. There, the bankruptcy court had enjoined the Attorney General of the Commonwealth of Pennsylvania, pursuant to section 362(a) of the Bankruptcy Code, from proceeding in Pennsylvania Orphans’ Court to enjoin the Debtors’ disposition of donor-restricted funds. Appeals were taken by the Commonwealth’s attorney general and other interested parties. While the parties to the appeal pressed the district court to decide the underlying issue; *i.e.* the extent of AHERF’s estate property, the precise issue before the court was whether the 362 injunction was appropriate. In deciding the propriety of the injunction, the district court assumed *arguendo* that the interest which the Commonwealth sought to protect was property of the estate and that the Orphans’ Court proceedings were an attempt to exert control over such property. The district court concluded that such actions fell within the police and regulatory exemption of section 362(b). Initially, the district court noted that the 1998 amendment to section 362 broadened the police and regulatory powers exception to the automatic stay to include actions against property of the debtor’s estate. As a consequence, the district court stated:

if the police powers exception is otherwise applicable, the 1998 amendments make clear that it operates with regard to the Orphans’ Court litigation against Debtor AHERF ... even though that litigation might be deemed an action to exercise control over property of the debtor estate under section 362(a)(3) as well as an action against the debtor, section 362(a)(1).

²¹ *Penn Terra*, 733 F.2d at 273; *United States v. Commonwealth Cos. (In re Commonwealth Cos.)*, 913 F.2d 518, 527 (8th Cir. 1990); *Brennan v. Poritz*, 198 B.R. 445, 450 (D.N.J. 1996) (“[t]he plain language of § 105 restrains the bankruptcy court’s discretionary authority to issue § 105 injunctive relief, as the statute specifically states that any action taken under § 105 must be designed to carry out the provisions of the bankruptcy code. Because the bankruptcy code expressly exempts state actions brought under state police or regulatory powers from the automatic stay, it is only in rare cases that a § 105 injunction of a police power exercise will ‘carry out’ the code’s provision.”).

252 B.R. at 325.

The district court acknowledged that no reported decision could be found regarding relief from an automatic stay in bankruptcy for proceedings wherein the state is exercising its *parens patriae* powers to protect the assets and/or charitable mission of a charitable trust or other non-profit charitable corporation. Nevertheless, upon examination of case law interpreting a state's exercise of its *parens patriae* powers, the court concluded that the police powers exception includes the traditional parental powers of the Commonwealth of Pennsylvania and; therefore, "the police power exception of section 362(b)(4), as amended, clearly applied and exempted the Commonwealth from automatic stay of the Orphans' Court litigation ..." *Id.* at 36.

The district court left open the possibility that the bankruptcy court could consider an order pursuant to section 105 of the Bankruptcy Code to enjoin the Orphans' Court action. However, the district court cautioned the bankruptcy court as to the exercise of its discretionary powers under section 105.

Transferring Assets of Nonprofit Entities in Bankruptcy

By: Matthew W. Levin

Alston & Bird LLP

For most bankruptcy practitioners, the sale of a debtor's assets under Section 363 of the Bankruptcy Code, or under a confirmed plan of reorganization, is a common occurrence. Very few would question whether a bankruptcy court has jurisdiction to order the debtor's assets sold in an effort to maximize the value of the estate for creditors. However, when the assets involved belong to a nonprofit entity, basic assumptions may not necessarily apply.

A. A Brief History

In particular, various states have long taken the position that so-called "conversion statutes", which regulate the sale of nonprofit companies (usually, healthcare related businesses) to for-profit enterprises, apply even inside of a bankruptcy case. For example, in Georgia, as in many states,¹ the legislature has adopted a statute governing the sale of non-profit hospitals, known as the Georgia Hospital Acquisition Act (the "GHAA"). Under the GHAA, the seller of a nonprofit hospital and a potential purchaser thereof may not enter into any agreement to dispose of hospital assets without first providing the Attorney General with at least ninety days notice of the proposed transaction prior to its consummation. O.C.G.A. § 31-7-407. Under the GHAA, the

¹ Arizona, California, Colorado, Connecticut, Georgia, Hawaii, Idaho, Indiana, Louisiana, Maryland, Nebraska, New Hampshire, New Jersey, Ohio, Oregon, Pennsylvania, Rhode Island, South Dakota, and Virginia have all adopted conversion statutes. In addition, in many states, common law allows the state attorney general to exercise such oversight even in the absence of a specific state statute.

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Attorney General is required to conduct a public hearing to inquire into certain issues as more fully set forth in O.C.G.A. § 31-7-406 and subsequently issue a report of his/her findings. Finally, if the Attorney General finds that any disposition or acquisition of assets violates the GHAA, then any such agreements shall be deemed “null and void” and each nonprofit entity and acquiring entity shall be subject to a fine of up to \$50,000. O.C.G.A. § 31-7-412. In Sparks v. Hospital Authority of the City of Bremen, 241 Ga. App. 485, 526 S.E.2d 593 (1999), the Georgia Court of Appeals interpreted the scope of the GHAA and held, among other things, that under the GHAA, the Attorney General is authorized to “approve or reject” any proposed sale of a non-profit hospital. No exception is made in the GHAA for hospitals owned by nonprofit sellers in bankruptcy.

Prior to 2005, the interplay between Bankruptcy Code provisions relating to the sale of assets (specifically, Sections 363 and 1123(a)(5)(D) of the Bankruptcy Code), and non-bankruptcy law governing the sale of assets by nonprofit entities (such as the GHAA) presented courts with a problem. As noted above, state law sometimes provided for various procedures which had to be followed prior to effectuating a sale of a nonprofit’s assets, and indeed, state law often contained a requirement of approval of such a sale from the state. All of this directly conflicted with the Bankruptcy Code, which placed approval of a sale of nonprofit debtor in bankruptcy’s assets squarely and exclusively within the control of the Bankruptcy Court. Some Courts resolved the conflict by finding that the Bankruptcy Code preempted conflicting provisions of state law, and permitted nonprofit entities in bankruptcy to transfer assets through a Section 363 sale without complying with state laws and regulations. Other Courts attempted to

harmonize the bankruptcy and non-bankruptcy law by requiring that nonprofit entities comply with both sets of rules.

B. Congress Changes the Rules

Against this backdrop, in 2005, Congress enacted certain provisions related to the sale of assets by nonprofit entities as part of The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”). BAPCPA changed the Bankruptcy Code in the following ways:

1. Section 363(d)(1). BAPCPA amended Section 363(d)(1) of the Code to provide that any sale under Section 363 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.” Thus, in order for a nonprofit entity to sell assets pursuant to Section 363 (prior to confirmation of a plan of reorganization), that entity must comply with state law that speaks to such sales.

2. Section 1129(a)(16). BAPCPA also amended Section 1129 of the Code to add a new subsection (subsection (a)(16)), which provides that a Chapter 11 plan of reorganization may be confirmed only if: “[a]ll transfers of property of the plan shall be made in accordance with any applicable provisions of nonbankruptcy law that govern the transfer of property by a corporation or trust that is not a moneyed, business, or commercial corporation or trust.” Accordingly, a nonprofit entity may only transfer assets pursuant to a confirmed plan if state law governing such transfers is observed.

3. Section 541(f). Finally, lest there have been any doubt about what Congress intended, BAPCPA amended Section 541 of the Code to add a new subsection (subsection (f)) which states: Notwithstanding any other provision of this title, property

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that is held by a debtor that is a corporation described in section 501(c)(3) of the Internal Revenue Code of 1986 and exempt from tax under section 501(a) of such code may be transferred to an entity that is not such a corporation, but only under the same conditions as would apply if the debtor had not filed a case under this title.” In other words, non-bankruptcy law will govern the transfer of assets from a nonprofit to a for-profit entity.

The legislative history regarding these various amendments to the Code suggest that the intent of Congress was to give greater influence to state regulators and attorneys general and “restrict the authority of a trustee to use, sell, or lease property by a nonprofit corporation or trust.” H.R. Rep. No. 109-31, pt. 1, at 145 (2005).

C. **So Now What?**

Given these changes to the Code, it is apparent that any attempt to transfer the assets of a nonprofit entity to a for profit entity has become more challenging. However, such transfers are not impossible – just more cumbersome. For example, in In re Machne Menachem, Inc., 371 B.R. 63 (Bankr. M.D. Pa. 2006), the bankruptcy court construed new Section 1129(a)(16) and relevant provisions of New York State law governing sales of not-for-profits to restrict only voluntary transfers of assets by the debtor. Thus, where a plan of reorganization was proposed by a creditor of the debtor (in this case, the debtor’s former director), as opposed to the debtor itself, and which plan provided for the transfer of assets of the estate to a for profit entity, New York State law did not restrict such transfer. Id. at 66-68. New York law normally requires that a supermajority of a nonprofit’s board of directors approve any transfer of assets to a for profit entity before such transfer can be effectuated. Id. However, the bankruptcy court opined that requiring such approval in the case of an involuntary transfer of assets (such as a

foreclosure), would lead to an “absurd” result, as it would require the board to approve any such involuntary transfer, which would, in essence, render such transfer voluntary. Id. at 68. Accordingly, the bankruptcy court held the New York statute only applied to voluntary transfers.

Although the situation described in the above-discussed case may be limited, by its nature, to cases involving New York nonprofits, legal counsel would be well advised to review their state’s laws governing the transfer of assets of a nonprofit to see if a similar argument could be made. Absent a legal solution, however, a practical solution is required, and prior experience may provide some pointers.

As noted above, under the GHAA, the Attorney General must conduct a public hearing to inquire into the nature of a proposed transaction involving the sale of a nonprofit hospital to a for-profit entity. O.C.G.A. § 31-7-401. Under O.C.G.A. § 31-7-406, the Attorney General is required to address the following: (i) whether the disposition is permitted under the Georgia Nonprofit Corporation Code; (ii) whether the disposition is consistent with the directives of major donors who have contributed over \$100,000; (iii) whether the governing body of the nonprofit corporation exercised due diligence in deciding to dispose of Hospital assets; (iv) the procedures used by the nonprofit corporation in making its decision to dispose of its assets, including whether appropriate expert assistance was used; (v) whether any conflict of interest was disclosed, including, but not limited to conflicts of interest related to directors or officers of the nonprofit corporation and experts retained by the parties; (vi) whether the seller or lessor will receive fair value for its assets; (vii) whether charitable assets are placed at unreasonable risk if the transaction is financed in part by the seller or lessor;

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(viii) whether the terms of any management or services contract negotiated in conjunction with the transaction are reasonable; (ix) whether any disposition proceeds will be used for appropriate charitable health care purposes; (x) whether a meaningful right of first refusal to repurchase the assets by a successor nonprofit corporation or foundation has been retained, if the acquiring entity subsequently proposes to sell, lease, or transfer the Hospital to yet another entity; (xi) whether sufficient safeguards are included to assure the affected community continued access to affordable care and to the range of services historically provided by the nonprofit corporation; and (xii) whether the acquiring entity has made an enforceable commitment to provide health care to the disadvantaged, the uninsured, and the underinsured, and to provide benefits to the affected community to promote improved health care.

While the conclusion to be drawn from a review of the above-listed factors is by no means clear, it does not seem that the GHAA has as its chief purpose the protection of public health and safety. That is, whether a non-profit or a for-profit entity operates a particular health care facility would not seem to implicate public health concerns. Rather, the main purpose of the statute, as evidenced by the factors set forth above, seems to be for the protection of the public's pecuniary interest in ensuring that health care facilities owned by non-profit entities, which have received favorable tax and other benefits by virtue of their non-profit status generally in exchange for an increased commitment to charity care, continue the same mission for which the state's taxpayers have at least partially paid. This would seem to be pecuniary in nature.

Prior to the enactment of BAPCPA, the GHAA was challenged under a preemption argument in the case of Georgia International Health Alliance, Inc., et al.,

Case No. 00-66092 (Bankr. N.D. Ga.). In Georgia International, the Georgia Attorney General, as a compromise, ultimately did not oppose entry of a judgment in an adversary proceeding granting a declaratory judgment that the GHAA was preempted by federal bankruptcy law. The compromise reached with the Attorney General was to provide for a public hearing of the type contemplated by the GHAA, with the Attorney General given standing to file a report regarding the proposed transaction and to make a recommendation to the bankruptcy court subsequent to such public hearing. However, the Attorney General agreed to allow the bankruptcy court to make the final decision regarding the proposed sale of the non-profit hospital to a for-profit entity, and to be bound by such decision. Within the context of such structure, the for-profit buyer agreed to maintain certain levels of indigent care, and made other concessions to alleviate the concerns of the Attorney General. Ultimately, the bankruptcy court approved the sale. The result was that the bankruptcy court was able to accommodate at least some of the concerns which led to passage of the GHAA, without surrendering control over the bankruptcy process.

The key to the outcome in the Georgia International case was early contact with the Attorney General's office, and working with the Attorney General to devise a structure that satisfied the underlying goals of the GHAA. From the state's perspective, closing the hospital would not have benefitted the community, and thus the state had an incentive to see if the hospital could be saved, even if it meant its sale to a for-profit entity. From the debtor's perspective, had the preemption argument actually been tried, there was no guaranty as to the result. Obviously, given BAPCPA, the state may not have the same incentive to settle, although, as a practical matter there is no reason why

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the procedure utilized in the case described above could not be utilized if the same case were filed today. The challenge is to cause all parties (the debtor, the state and the creditors), to realize that even though BAPCPA has made the process of the sale of a nonprofit's assets more difficult, there are still often very good reasons to allow such sales to proceed.

D. Conclusion

BAPCPA has placed restrictions on the sale of the assets of a nonprofit debtor that did not exist prior to 2005. However, notwithstanding those restrictions, approval of such a sale is still possible. What is required is early attention to the state's laws regarding such sales, early outreach to the state regarding any proposed sale, and working with the state to achieve a result which fulfills the goals of non-bankruptcy restrictions on such sales, while at the same time maximizing value to the debtor's creditors.