

Transferring Assets of Nonprofit Entities in Bankruptcy

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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

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.