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Reorganizing With Value But Without Profit (Or Equity):

Select Confirmation Issues for Nonprofit Entities

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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).