Health Care and Nonprofit Cases

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Selected Issues in Health Care Bankruptcy Cases: Medicare Provider Agreements – Executory Contracts – Regulatory Issues – Interfaith Medical Center Case Study

By

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I. MEDICARE PROVIDER AGREEMENTS AS EXECUTORY CONTRACTS

A. Regulatory Framework

Medicare's regulations, found at 42 C.F.R. § 489.18(c), govern the "Assignment of agreement" and provide that when "there is a change of ownership … the existing provider agreement will automatically be assigned to the new owner." Practically speaking, this "means that the new owner assumes the obligation to repay HHS [Health & Human Services] for any of the assignor's accrued Medicare overpayments," regardless of which entity owned the actual provider agreement "at the time the overpayments were made or discovered." Ted A. Berkowitz & Veronique A. Urban, *Intensive Care: Medicare Issues*, 31-7 Am. Bankr. Inst. J. 28 (Aug. 2012).

B. Bankruptcy's Rubric

Bankruptcy injects, however, a potential wrinkle into this equation. If a Medicare provider agreement is classified as an executory contract under 11 U.S.C. § 365, then "the trustee, subject to the court's approval, may assume or reject" the agreement under Section 365(a) of the Bankruptcy Code. However, as is true in all circumstances involving assumption of executory contracts, the trustee may not assume the contract if there is an existing default unless the debtor cures the default or offers adequate assurances that it will cure the defaults. 11 U.S.C. § 365(b). Similarly, if an executory contract is assigned, then the assignee would be

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liable for the obligations connected with the Medicare agreement. On the other hand, if it is not considered to be an executory agreement, then the potential exists for the Medicare provider agreement to be the subject of a Section 363 Sale, with the result being that liability is "washed away."

C. Is It an Executory Agreement?

Whether the Medicare agreement is deemed to be an executory contract is a question of judicial interpretation in light of the absence of statutory definition. Still, "courts have generally relied on the following definition: 'an executory contract is a contract under which the obligation of both the bankrupt and the other party are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.'" *Sharon Steel Corp. v. Nat'l Fuel Gas Distribution Corp.*, 872 F.2d 36, 39 (3d Cir. 1989). Against this backdrop, a divergence of opinions has emerged, with a majority of bankruptcy courts treating Medicare provider agreements as executory contracts. Still, to be sure, that view is not unanimously shared.

1. *Courts Treating Provider Agreements as Executory*

The rationale for treating the provider agreement as an executory contract flows from the mutual obligations arising under the contract, namely that the healthcare provider is obligated to provide patient services, while the government is obligated to reimburse the provider. As the District Court observed in *In re Monsoor Medical Center*, 11 B.R. 1014, 1018 (W.D. Pa. 1981), "Monsoor is obligated to provide services to Medicare patients without charge and HHS is obligated to reimburse Monsoor. These mutual obligations may be viewed as growing out of either an express contract … or an implied in fact contract …."

In *In re University Medical Center*, 973 F.3d 1065 (3d Cir. 1992), the Third Circuit rejected the contention that the "complexity of the Medicare scheme" excludes a provider agreement from the ambit of Section 365. Instead, it concluded that "a Medicare provider agreement easily" fit within the judicial definition of an executory contract.

More recently, in *In re Bayou Corp.*, 525 B.R. 160, 168 (Bankr. M.D. Fla. 2014), *aff'd*, 2015 U.S. Dist. LEXIS 83390 (M.D. Fla. June 26, 2015), the bankruptcy court held that the Medicare agreement was an executory contract. Citing a series of decisions, the Court observed that "the majority of courts have concluded that Medicare provider agreements are executory contracts …." 525 B.R. at 168. Significantly, in reaching its conclusion, the Court noted that there are two approaches in reaching the same conclusion that a provider agreement is executory in nature. The first approach examines whether a portion of the contract was unperformed, and whether a party could thus be deemed to be in breach. The other approach is more of a "functional approach," whereby a court examines the benefits that would run to the estate if the contract were accepted or rejected.

As but one example, in *Vitalsigns Homecare, Inc.*, 396 B.R. 232, 239 (Bankr. D. Mass. 2008), the Court observed that a "majority of bankruptcy courts considering the Medicare-provider relationship conclude that the Medicare provider agreement, with its attendant benefits and burdens is an executory contract." In reaching its determination, the bankruptcy court expressly rejected the holding of *In re BDK Health Mgmnt.*, 1998 Bankr. LEXIS 2031 (Bankr. M.D. Fla. Nov. 16, 1998), which held that the Medicare provider agreement is not executory, and observed that even *BDK Health Mgmnt.* acknowledged the conclusion reached by *Vitalsigns Homecare.* Similarly, in *University Medical Center v. Sullivan*, 125 B.R. 121 (E.D. Pa. 1991), the Court without discussion determined that a Medicare provider agreement constituted an executory contract.

2. *Not an Executory Agreement*

In *Hollander v. Brezenoff*, 787 F.2d 834 (2d Cir. 1986), the Second Circuit opened the door to characterizing the Medicare provider agreement as something other than a contract. Confronted with the issue of whether New York's six-year statute of limitations on contracts applied to a dispute between a disgraced nursing home operator, or whether its three-year statute of limitations applied, the Court ruled that the three-year statute pertained. Central to its determination was its characterization of the relationship as a "statutory business relationship." As for the agreement, the Court treated it as incidental to the broader relationship. *Hollander* did not address Section 365.

In keeping with this perspective, however, in *In re Barincoat*, 2014 Bankr. LEXIS 2752 (Bankr. D. Conn. June 23, 2014), the Bankruptcy Court expressly applied the rationale of *Hollander* and rejected the contention that a provider agreement was an executory contract. In *In re BDK Health Mgmt.*, 1998 Bankr. LEXIS 2031 (Bankr. M.D. Fla. Nov. 16, 1998), the Bankruptcy Court similarly relied upon *Hollander* and its progeny, and held that a Medicare provider agreement was not an executory contract, but instead was a statutory entitlement. The Court thus concluded that a seller did not have to comply with the terms of Section 365 to effectuate a sale. Consequently, the Court granted the debtors' motion for a Section 363 sale, and declared the Medicare provider agreement free and clear of the government's claims.

More recently, in *U.S. ex rel. Roberts v. Aging Care Home Health, Inc.*, 474 F. Supp. 2d 810 (W.D. La. 2007), the District Court determined that a breach of contract was not available to recoup losses for Medicare fraud because the Medicare statute did not create contractual rights.

Like *Hollander*, *Roberts* did not examine the tensions between Section 363 and Section 365. *Roberts* appears to have gained particular traction among the District Courts within the Fifth Circuit, at least in the context of *qui tam* litigation.

In *U.S. ex rel. Acad. Health Ctr., Inc. v. Hyperion Foundation, Inc.*, 2014 U.S. Dist. LEXIS 93185 (S.D. Miss., July 9, 2014), the Court sustained the government's claim for unjust enrichment because the remedy of breach of contract was not available in the context of Medicare recovery. Relying upon *Roberts*, the court held that Medicare provider agreements were not executory contracts, and instead were creatures of statute.

D. Medicare and Interfaith Medical Center, Inc. Chapter 11

In the *Interfaith Medical Center* Chapter 11 case, the government and the debtor entered into a Stipulation and Order, dated July 3, 2014, pursuant to which the debtor assumed the then-operative Medicare Provider Agreement. *See In re Interfaith Medical Center, et al.,* Case No. 12-48226 (CEC) (Bankr. E.D.N.Y). Under the terms of the agreement, the debtor also agreed to reimburse the government for certain overpayments.

It is worth noting that the debtor entered into the stipulation with little fanfare, and that there was no dispute that the Medicare provider agreement would be treated as an executory agreement. The text of the stipulation expressly referred to Section 365 and to the assumption of the agreement. The Stipulation and Order was executed by the U.S. Attorney's Office and by Hon. Melanie L. Cyganowski (Ret.), in her capacity as the Temporary Operator of the debtor hospital. To be sure, and with good reason, neither party raised the issue of whether Section 365 might be inapplicable.

II. INTERFAITH HOSPITAL CASE STUDY: OVERVIEW OF PATH TO BANKRUPTCY AND BEYOND

A. A Brief History

The arc of Interfaith Medical Center ("Interfaith") is directly tied to the changes in the post-World War II demographics of Central Brooklyn, which encompasses the neighborhoods of Bedford-Stuyvesant (153,000 residents) and Crown Heights (150,000 residents). After the war, many of Central Brooklyn's residents left New York City for its suburbs, causing a demographic shift in which non-Asian minorities became locally predominant.[1] Concurrently, the finances of St. John's Episcopal Hospital ("St. John's") and the Brooklyn Jewish Medical Center ("Brooklyn Jewish") -- two of the hospitals which served the community -- began to decline, as their patient rolls began to fill with indigent patients.[2]

Brooklyn Jewish was the first casualty, filing for bankruptcy in 1979. St. John's avoided bankruptcy with an infusion of government aid, until it merged with Brooklyn Jewish, and together became Interfaith in late 1982. Despite laying-off 800 workers as the result of the merger, Interfaith employed approximately 3,200 people, and was one of Central Brooklyn's largest employers at that time (which continues to be true as of today).[3] Nonetheless, it was also plagued by labor strife.

In 1985, Interfaith endured a two-week strike over wages and hours. Interfaith had entered into a decline, which also coincided with the emergent AIDS crisis, and the ever present scourges of drugs, deinstitutionalization, and violent crime. Fortunately for Interfaith, in 1997, the New York State Dormitory Authority ("DASNY") appropriated $148.5 million from a bond

[1] http://www.interfaithmedical.com/checksite/theDOCsPDFs/historyIMC.pdf
[2] Id.
[3] Id.

offering for construction and debt retirement.[4] Ultimately, the bond offering managed to stave off winter – but only for a while.

B. Prelude to Bankruptcy

Interfaith enjoyed some financial stability between 2005 and 2009, when its Medicaid reimbursement was among the five highest in New York City. But in October 2009, new Medicaid payment policies resulted in a 40% drop in Interfaith's Medicaid revenue.[5]

The Medicaid program covered 65% of Interfaith's patients, and with few commercial insurance contracts to make up for the losses, the hospital began to hemorrhage. By 2010, after ending with a $57 million loss, its net worth was a negative $126 million. Its long-term debt per hospital bed was $517,000 — more than double the $210,000 median for Brooklyn hospitals and three times the statewide median.[6]

In October 2011, Interfaith laid off some 200 workers as part of a plan to cut $10 million. The hospital ended that year with a $33 million loss and stopped making debt payments to DASNY.

By late 2011, Governor Andrew Cuomo's Medicaid Redesign Team issued a detailed 86-page report that focused on the short-comings of the hospitals located in Brooklyn. With regard to Interfaith, the report recommended that it should merge together with Brooklyn Hospital Center (which had just emerged from bankruptcy) and Wyckoff Heights Hospital.

In 2012, Interfaith entered into negotiations with Brooklyn Hospital, but its deteriorating financial condition made it clear it could not hang on long enough to execute the consolidation plan.

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[4] Id.
[5] http://www.modernhealthcare.com/article/20121203/INFO/312039993#
[6] Id.

C. State Involvement and Bankruptcy

After years of financial difficulty, including the inheritance of substantial legacy debt, on December 2, 2012, Interfaith filed a voluntary petition in the United States Bankruptcy Court for the Eastern District of New York commencing a Chapter 11 bankruptcy case. Cuts in Medicaid reimbursement and increases in costs of providing medical care, among other things, caused Interfaith to suffer significant financial and operational difficulties. The Chapter 11 filing was an opportunity for Interfaith to restructure its debts, address its financial instability, and reorganize.

Despite the bankruptcy, Interfaith faced the real possibility of closure because of lack of funding. Interfaith's financial difficulties, however, continued during the Chapter 11 case and in mid-2013, at the direction of the New York State Department of Health (the "DOH"), Interfaith prepared a plan of closure, which underwent several revisions. On December 20, 2013, fourteen local and state elected officials sent a letter to the Governor's office asking for a postponement of the planned closure, saying that hundreds of thousands of New Yorkers would lose their primary access to healthcare if Interfaith folded.[7] The following Sunday and Monday, the Governor announced that the State would fund Interfaith through early March 2014. No specific figure was announced at the time. "During this period, the State Health Department will continue its review of Interfaith's transition plan and work closely with the facility towards final approval . . . The State is committed to establishing a quality, accessible and sustainable health care delivery system to serve patients and community residents."[8]

The interested parties, including DASNY and the DOH, entered mediation at the end of 2013 to determine the future of the hospital. Due to changes in the healthcare environment, and recognizing the continued need for Interfaith as a safety-net hospital, the DOH ultimately

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[7] http://www.brooklyneagle.com/articles/breaking-last-minute-deal-postpones-closure-brooklyns-interfaith-medical-center-2013-12-23
[8] http://www.capitalnewyork.com/article/albany/2013/12/8537880/cuomo-buys-time-interfaith

decided to support and to subsidize Interfaith's continued operations. In addition to the $100 million that the DOH had committed to Interfaith during the bankruptcy proceeding, the DOH committed to funding up to an additional $40 million post-bankruptcy to sustain Interfaith's continued operations and needed capital expenses while it attempted to reorganize. Interfaith was required, however, to establish sustainable operations to avoid closure.

Interfaith exited its Chapter 11 case on June 19, 2014 when its Second Amended Plan of Reorganization became effective. The Bankruptcy Plan implemented the reorganization of Interfaith by transferring to DASNY -- Interfaith's secured creditor -- certain real estate and real property leases (which have been leased back to Interfaith), while Interfaith continues to retain its operating assets and to provide healthcare services to the Interfaith community.

Bankruptcy allowed Interfaith to extinguish approximately $161.5 million of secured debt through the transfer of assets to DASNY. As part of the Bankruptcy Plan, all liabilities estimated to be between $275 million and $380 million in unsecured pre-bankruptcy obligations owed by Interfaith were extinguished in exchange for cash transfers and non-liquid assets in full satisfaction of all general unsecured claims.

D. Appointment of Temporary Operator and Post-Emergence Reorganization

When Interfaith exited bankruptcy on June 19, 2014, as part of the plan confirmation process, former Chief Bankruptcy Judge for the Eastern District of New York, Melanie L. Cyganowski, was appointed by the DOH to serve as the Temporary Operator of Interfaith. The appointment of the Temporary Operator was made pursuant to N.Y. Pub. Health Law § 2806-a(2)(a), which provides as follows:

> In the event that: (i) a facility seeks extraordinary financial assistance and the commissioner finds that the facility is experiencing serious financial instability that is jeopardizing existing or continued access to essential services within the community, or (ii) the commissioner finds that there are conditions within the

> facility that seriously endanger the life, health or safety of residents or patients, the commissioner may appoint a temporary operator to assume sole control and sole responsibility for the operations of that facility. The appointment of the temporary operator shall be effectuated pursuant to this section and shall be in addition to any other remedies provided by law.

Ms. Cyganowski was the first Temporary Operator appointed by the DOH pursuant to the statute enacted in 2013. Ms. Cyganowski was tasked with continuing the work that she had begun as the CRO of Interfaith during the final three months of its bankruptcy case. Simultaneously with her appointment, the existing Board of Trustee resigned and a new Board of Trustees was also appointed so that they could seamlessly step into the governance role at the conclusion of the Temporary Operator's term.

In connection with her appointment as Temporary Operator, pursuant to N.Y. Pub. Health Law § 2806-a(3)(a), Ms. Cyganowski provided the Commissioner of the DOH with a work plan "to address the facility's deficiencies and serious financial instability and a schedule for implementation of such plan." Over the course of her appointment, the Temporary Operator worked with Interfaith's staff to "implement the work plan provided to the Commissioner and to correct or eliminate any deficiencies or financial instability in the facility and to promote the quality and accessibility of health care services in the community served by the facility." N.Y. Pub. Health Law § 2806-a(3)(b).

There were many issues to tackle upon emergence from bankruptcy, but certain key areas of initial focus by the Temporary Operator were as follows: (i) re-engage with the community through a multitude of community outreach efforts to enhance Interfaith's profile and overall image, which had deteriorated during the years leading up to and during the bankruptcy case; (ii) resolve legacy regulatory issues that were threatening the institution's continuing viability; (iii) institute measures to stabilize and improve Interfaith's leadership and financial health by actively recruiting top-notch management and clinical leaders; and (iv) identify opportunities for further growth. In addition to these broader goals, the Temporary Operator, together with the newly appointed CEO, was responsible for the day-to-day operations of the hospital.

The Temporary Operator's term ended pursuant to the statute approximately one-year following her initial appointment. While there is continuing work to be done to ensure that Interfaith can be a financially independent and viable institution for years to come, with the support of the State and community leaders, significant progress was made in a short period of time following emergence from bankruptcy. Interfaith has been able to come out from under the burden of its regulatory issues, put in place a strong leadership team to lead it into the future, and institute programs that will not only enable the hospital to stabilize operations, but to grow and provide enhanced and critical services to the surrounding community.

When Good Intentions Go Awry: Selected Issues in Nonprofit Bankruptcy Cases

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I. Introduction

The world of nonprofit organizations encompasses a wide variety of entities, including hospitals, nursing homes and other healthcare providers; churches and other religious organizations; colleges and other schools; orchestras, museums and other cultural organizations; cooperatives; and legal and social services providers. According to one source published back in 2003, nonprofits then held collectively more than $ 1 trillion in assets and generated revenues of approximately $ 700 billion per year.[1] It is not surprising that nonprofit organizations suffer from financial problems, just as for-profit businesses do. However, it may come as a surprise that Chapter 11 filings by nonprofits are not rare occurrences.[2] Other than cases involving healthcare providers, there is a dearth of case law discussing the unique issues facing a nonprofit debtor in Chapter 11. This article will provide a summary of the provisions of the Bankruptcy Code particularly applicable to nonprofit debtors and will discuss some of the more interesting issues presented when a nonprofit seeks to reorganize under Chapter 11 of the Bankruptcy Code.

[1] *See* Gail A. Lasprogata & Marya N. Cotton, *Contemplating "Enterprise": The Business and Legal Challenges of Social Entrepreneurship*, 41 AM. BUS. L. J. 67, 67 (2003).

[2] According to one study, approximately 90 religious organizations file for Chapter 11 relief every year. *See* Pamela. Foohey, *When Churches Reorganize*, 88 AM. BANKR. L. J. 277 (2014). This study counted only one subset of nonprofits, and there surely are a larger number of filings each year if all nonprofit filings were to be counted. Professor Foohey advised the authors that her research indicated that approximately 55 non-religious nonprofits file for bankruptcy relief each year.

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II. Nonprofit Entities and Examples of Recent Cases

A. Generally

Nonprofit entities generally are formed to be exempt from taxation under section 501(a) of the Internal Revenue Code of 1986 ("Tax Code").[3] The types of nonprofit entities entitled to tax exempt status are set forth in section 503(c)(3) of the Tax Code, and include those organized for religious, charitable, scientific, testing for public safety, literary or educational purposes, or to foster national or international sports competition.[4]

The corporate governance distinctions between a nonprofit entity and a for-profit entity are particularly important in the bankruptcy context. For example, nonprofit corporations do not have shareholders and are controlled by either their members or, for non-member corporations, by their officers, directors or trustees. This distinction is critical because, as described in detail below, the absolute priority rule set forth in section 1129 of the Bankruptcy Code, according to at least some courts, may not apply to membership interests in a nonprofit entity since they are not "equity" interests.[5] Additionally, even though directors of a nonprofit entity are subject to

[3] 26 U.S.C. § 501(a).

[4] *See id*. § 501(c)(3) (listing the following organizations as exempt from taxation: "Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.").

[5] *See* Section IV.C. herein.

breach of fiduciary duty claims in a bankruptcy case,[6] they generally have greater protections than their for-profit counterparts for such breaches.[7]

B. Examples of Nonprofit Bankruptcy Cases

Nonprofit entities have filed for bankruptcy protection in various industries and circumstances. Because many of these cases involve unique issues, a few representative examples are listed here for those who may wish to review their issues and outcomes.

1. Healthcare

In re Saint Michael's Medical Center, Inc.[8]

Saint Michael's Medical Center, Inc. and certain of its subsidiaries filed for bankruptcy on August 10, 2015 in the U.S. Bankruptcy Court for the District of New Jersey. In addition to facing liquidity issues, a stated reason for the debtors' filings was that a proposed sale of substantially all of their assets to Prime Healthcare Services, a for-profit entity, had been awaiting approval from the State of New Jersey for well over two years. As a result of the delay, the debtors filed a sale motion on the first day of the cases, seeking to consummate the sale to Prime pursuant to a "stalking horse" agreement, or to a different purchaser based on the results of an auction, by the end of the year.

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[6] *See, e.g.*, *Official Comm. of Unsecured Creditors v. Baldwin (In re Lemington Home for the Aged)*, 777 F.3d 620 (3d Cir. 2015), *denying reh'g and reh'g en banc*, 781 F.3d 675 (3d Cir. 2015) .

[7] *See* Thomas L. Hazen & Lisa L. Hazen, *Punctilios and Nonprofit Corporate Governance – A Comprehensive Look at Nonprofit Directors' Fiduciary Duties*, 14 U. PA. J. BUS. L. 347, 412 (2012) ("Although some states remain outliers, the law in most states is that volunteers for charitable organizations, including directors who are not compensated, are absolved from liability if they act in good faith and are not guilty of reckless, wanton, or intentional misconduct.").

[8] Case No. 15-24999 (VFP) (Bankr. D.N.J.). It should be noted that Cole Schotz P.C., the authors' law firm, represents the debtors in these cases.

In re Bayou Shores SNF LLC[9]

Bayou Shores SNF LLC, the operator of a skilled nursing facility in Florida known as the Rehabilitation Center of St. Petersburg, filed for bankruptcy on August 15, 2014 in the U.S. Bankruptcy Court for the Middle District of Florida. *Bayou Shores* has involved significant litigation over an attempt by the Centers for Medicare & Medicaid Services ("CMS") to terminate the debtor's Medicare and Medicaid provider agreements, notwithstanding the bankruptcy court's entry of a confirmation order providing for the assumption of the agreements. On June 29, 2015, the U.S. District Court for the Middle District of Florida issued an opinion in four related consolidated appeals that, among other things, vacated the bankruptcy court's order prohibiting CMS from terminating its provider agreements with the debtor and finding that the bankruptcy court lacks jurisdiction to review CMS's decision.[10]

2. Religious Organizations

In re Archdiocese of Milwaukee[11]

The Archdiocese of Milwaukee, like several Catholic archdioceses in recent years, filed for bankruptcy on January 4, 2011 in the U.S. Bankruptcy Court for the Eastern District of Wisconsin, as a result of tort claims of abuse. Although the court entered an order on May 28, 2014, approving the debtor's first amended disclosure statement, its proposed plan has yet to be confirmed.[12] The delay is a result of numerous contested matters, including the appropriateness of settlements with respect to, and the bankruptcy court's jurisdiction to enjoin continued prosecution of, claims of childhood sex abuse against the underlying parishes.[13]

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[9] Case No. 14-09521 (MGW) (Bankr. M.D. Fla.).

[10] *See id*., Docket No. 378.

[11] Case No. 11-20059 (SVK) (Bankr. E.D. Wis.).

[12] *See id*., Docket Nos. 2674, 3188.

[13] *See id*., Docket Nos. 3020, 3061, 3088.

3. Cultural Institutions

In re New York City Opera, Inc.[14]

New York City Opera, Inc. filed for bankruptcy on October 3, 2013 in the U.S. Bankruptcy Court for the Southern District of New York. The case has involved discovery and negotiations regarding the proposed sale of the Debtor's assets, including valuable intellectual property, to another nonprofit entity, NYCO Renaissance LTD.[15] On July 13, 2015 the debtor withdrew its sale motion due to, among other things, the anticipated bequest of approximately $5.5 million from a decedent's estate, which various parties in interest determined could be used to propose a plan that "fulfill[s] the mission of NYC Opera in the future."[16] On August 5, 2015 the court entered a consent order regarding the sale motion permitting any party to file a disclosure statement and plan of reorganization for the debtor.[17]

III. Bankruptcy Provisions Relating to Nonprofit Debtors[18]

A. 11 U.S.C. § 303(a) – Protection from Involuntary Petitions

Section 303(a) of the Bankruptcy Code provides that creditors may commence an involuntary bankruptcy case "only against a person, <u>except</u> a farmer, family farmer, or a corporation that is <u>not a moneyed, business, or commercial corporation</u>."[19] The determination of whether a corporation falls into this category requires an analysis of, among other things, the entity's charter, its corporate activities and its status under the laws of the state in which it was

[14] Case No. 13-13240 (SHL) (Bankr. S.D.N.Y.).

[15] *See id*., Docket Nos. 213, 273.

[16] *Id*., Docket No. 273.

[17] *See id*., Docket No. 281.

[18] The Bankruptcy Code sections discussed here are those that concern all nonprofits, and exclude those concerning only healthcare nonprofits. In particular, there are several provisions addressing issues of patient care and patient records, which are not included.

[19] 11 U.S.C. § 303(a) (emphasis added); *see also In re Allen Univ.*, 497 F.2d 346, 348 (4th Cir. 1974) ("By judicial interpretation, the phrase 'moneyed, business, or commercial corporation' has acquired a meaning which limits it to corporations organized for profit.").

organized.[20] In the case of *Capitol Hill*,[21] for example, a creditor filed an involuntary petition against a nonprofit corporation registered as such in the District of Columbia that operated a nursing home. Although many of the debtor's characteristics indicated that it was a nonprofit (*e.g.*, charter, mission, lack of stock), the creditor argued that the debtor should be considered the alter ago of a for-profit to which it made payments for providing services such as housekeeping, security and maintaining a cafeteria. To bolster its position, the creditor also noted that the debtor and the for-profit entity were operated as related entities and were owned by the same individual. Nonetheless, the court dismissed the case, "fail[ing] to see how any of these facts are relevant to whether the debtor is operated for pecuniary gain."[22]

B. 11 U.S.C. § 1112(c) – Bar against Conversion of a Nonprofit Debtor's Bankruptcy Case Absent Debtor Consent

Under the Bankruptcy Code, the Chapter 11 case of a nonprofit debtor may not be converted to a case under Chapter 7 unless the debtor consents. Specifically, section 1112(c) of the Bankruptcy Code sets forth that "[t]he court may not convert a case under this chapter to a case under chapter 7 of this title if the debtor is a farmer or a corporation that is <u>not a moneyed, business, or commercial corporation</u>, unless the debtor requests such conversion."[23] The application of this section of the Bankruptcy Code was litigated in the case of *In re Hyperion Foundation, Inc.*,[24] in which a lessor filed a motion to convert the Chapter 11 case of the debtor, a nonprofit corporation, to one under Chapter 7. The court directed the parties to file legal briefs addressing whether the debtor was an "eleemosynary" (*i.e.*, charitable) institution exempt from

[20] *See In re Capitol Hill Healthcare Grp.*, 242 B.R. 199, 202 (Bankr. D.D.C. 1999) ("*<u>Capitol Hill</u>*") ("State law organization or registration as a nonprofit corporation is not decisive. But such organization or registration is probative … .").

[21] *Id.*

[22] *Id.*

[23] 11 U.S.C. § 1112(c) (emphasis added).

[24] No. 08-51288-NPO, 2009 WL 2477392 (Bankr. S.D. Miss. Aug. 11, 2009).

involuntary conversion under section 1112(c) of the Bankruptcy Code. Similar to the court's analysis in the *Capital Hill* case described above, the court explained that whether an entity is a "moneyed, business, or commercial corporation" requires an examination of the powers and characteristics imposed on it by the law of the state of its incorporation. In ruling that the debtor's Chapter 11 case could not be involuntarily converted to one under Chapter 7, the court observed that, in addition to the debtor's organization as a nonprofit entity under Georgia law and a tax-exempt organization under the Tax Code, the debtor was organized for the charitable purpose of operating nursing homes and related health care facilities, and organized to serve the housing and other related needs of the elderly.

C. 11 U.S.C. §§ 363(d)(1), 541(f) and 1129(a)(16) – Compliance with Applicable Nonbankruptcy Law

Several sections of the Bankruptcy Code require compliance with "applicable nonbankruptcy law." These provisions may have an enormous impact on the case of a nonprofit debtor and, in some cases, may prevent the debtor from successfully reorganizing if a federal or state authority with regulatory powers over the debtor opposes the debtor's proposed plan or other actions. Clashes between the debtor and regulatory authorities may arise in a variety of circumstances, ranging from state approval being required to proceed with a desired sale transaction to federal and state health regulatory authorities being able to terminate the debtor's ability to continue in business.

1. Section 363(d)(1) of the Bankruptcy Code provides that "[t]he trustee may use, sell, or lease property under subsection (b) or (c) of this section … [i]n the case of a debtor that is a corporation or trust that is not a moneyed business, commercial corporation, or trust, only in

accordance with nonbankruptcy law applicable to the transfer of property by a debtor that is such a corporation or trust."[25]

2. Section 541(f) of the Bankruptcy Code restricts the transfer of property held by a nonprofit debtor. Specifically, that section provides: "Notwithstanding any other provision of this title, property 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."[26] In short, to the extent applicable nonbankruptcy law governs the transfer of assets from a nonprofit debtor to a for-profit entity, the transfer must comply with those laws.

3. Section 1129(a)(16) of the Bankruptcy Code provides: "All transfers of property under 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."[27] This provision thus bars the transfer of property of a nonprofit debtor under a Chapter 11 plan unless the transfer complies with applicable nonbankruptcy law.

4. In addition to the Bankruptcy Code sections discussed above, which apply expressly to nonprofits, 28 U.S.C. § 959(b), which applies to all debtors and trustees, provides that a trustee or debtor in possession "shall manage and operate the property in his possession as such trustee, receiver or manager according to the requirements of the valid laws of the State in

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[25] 11 U.S.C. § 363(d)(1). This provision was added to the Bankruptcy Code in 2005 as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. 109-8, 119 Stat. 23.

[26] *Id.* § 541(f).

[27] *Id.* § 1129(a)(16).

which such property is situated, in the same manner that the owner or possessor thereof would be bound to do if in possession thereof."[28]

IV. Selected Confirmation Issues in Nonprofit Chapter 11 Cases

A. Best Interest Test

Section 1129(a)(7) of the Bankruptcy Code provides:

> With respect to each impaired class of claims or interests—
>
> (A) Each holder of a claim or interest of such class—
>
> (i) has accepted the plan; or
>
> (ii) will receive or retain under the plan on account of such claim or interest property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under chapter 7 of this title on such date; or
>
> (B) if section 1111(b)(2) of this title applies to the claims of such class, each holder of a claim of such class will receive or retain under the plan on account of such claim property of a value, as of the effective date of the plan, that is not less than the value of such holder's interest in the estate's interest in the property that secures such claims.[29]

This requirement, known as the "best interest" test, requires the bankruptcy court to determine the estimated distribution that the holders of each impaired class of claims and interests would receive under Chapter 7, and to confirm that each such class will do no worse under the proposed Chapter 11 plan.

Section 1129(a)(7), by its terms, contains no exception for nonprofit debtors. However, a nonprofit debtor may point to the prohibitions in the Bankruptcy Code against the forced liquidation of assets of a nonprofit organization,[30] and argue that the best interest test does not

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[28] 28 U.S.C. § 959(b).

[29] 11 U.S.C.§ 1129(a)(7).

[30] *See* Sections III.A. and III.B. herein (discussing Sections 303 and 1112(c) of the Bankruptcy Code).

apply where the debtor seeks to reorganize under Chapter 11. Without supporting case law for such an argument, a nonprofit debtor should expect to be required to meet the best interest test and to present the necessary evidence to do so.

Depending on the nature of the nonprofit debtor's assets and organization, and the regulatory scheme to which it is subject, there will likely be a number of unique factors that must or can be considered when attempting to estimate what the nonprofit's assets would generate upon a liquidation. Under federal or state law, there are likely a number of restrictions that would impact how the sale would need to occur and limits on the type of organizations that may be a purchaser and what assets may be sold.[31]

Unlike a for-profit business that may be sold as a going concern based on projected revenues, a nonprofit's revenues may largely if not entirely depend on charitable donations, which would cease upon a shut-down and liquidation, and thereby limit the liquidation value of the debtor's assets to forced sale valuation of the debtor's assets. As a consequence, in the reported cases involving nonprofit debtors, the debtors appear to be successful in meeting the best interest test, and this requirement does not seem to be a basis for denying confirmation of a nonprofit's Chapter 11 plan.[32]

B. Feasibility

Section 1129(a)(11) requires, as an element of confirmation, that:

> confirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under

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[31] *See, e.g.*, *Sec. Farms v. Gen. Teamsters, Warehousemen & Helpers Union, Local 890* (*In re Gen. Teamsters, Warehousemen & Helpers Union, Local 890*), 265 F.3d 869 (9th Cir. 2001) (affirming confirmation of the union's plan and noting that the best interest test was met in view of the National Labor Relations Act bar against the sale of the debtor union's most significant asset, its collective bargaining agreement and its right to collect future member dues, without the members' consent).

[32] *See, e.g.*, *id.* at 876.

the plan, unless such liquidation or reorganization is proposed in the plan.[33]

This test, generally known as the "feasibility" test, is designed to ensure that the plan has a reasonable prospect of being consummated. Depending on the nature of the nonprofit debtor's plan, if it is a plan contemplating a reorganization and continuing the debtor's mission, this requirement could present a genuine challenge.

For example, if the debtor's funding primary funding source is donations, unless there are firm commitments from donors to provide funds to pay creditors under the plan, there could be a serious concern as to whether the debtor will be able to obtain donations to pay creditors as opposed to funding the actions of the organization to accomplish the debtor's mission. This was the problem that proved to be the debtor's downfall in the case of *Save Our Springs (S.O.S.) Alliance, Inc. v. WSI (II)-COS, L.L.C.* ("S.O.S.").[34] In that case, the debtor proposed a plan providing for distributions to unsecured creditors to be paid from a $ 60,000 settlement fund, with the funds to be generated by charitable donations within 60 days after the plan's effective date. At the confirmation hearing, the debtor advised the court that it had received $ 20,000 in pledges and represented that it would be able to raise the necessary funds within the time required by the plan. The bankruptcy court found, however, that the evidence indicated that the pledges were not firm commitments, and that the debtor had failed to show that it had reasonable prospects for successfully raising the funds required to fund the plan.

On appeal, the Fifth Circuit affirmed that the debtor had failed to meet its burden of proof of the feasibility requirement. In responding to the debtor's argument that its successful fundraising efforts in the past should have been enough to find feasibility, the Fifth Circuit noted: "raising funds during bankruptcy is more difficult than at other times. That is particularly true

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[33] 11 U.S.C. § 1129(a)(11).

[34] (*In re Save Our Springs (S.O.S.) Alliance, Inc.*), 632 F.3d 168 (5th Cir. 2011).

here, given that S.O.S.'s donors are hesitant to give for the purpose of paying off judgment creditors. The bankruptcy court's conclusion that past donations are not evidence of future fundraising ability is thus appropriate."[35]

The *S.O.S.* case appears to be the rare case, among reported cases, where the debtor could not meet the feasibility test.[36] In a number of other cases, feasibility was not an obstacle to confirmation of a nonprofit's Chapter 11 plan.[37]

C. Absolute Priority Rule

One of the most intriguing issues arising in nonprofit Chapter 11 cases is the proper application of the absolute priority rule. Section 1129(b)(1) of the Bankruptcy Code provides:

> Notwithstanding section 510(a) of [the Bankruptcy Code], if all of the applicable requirements of subsection (a) of this section other than paragraph (8) are met with respect to a plan, the court, on request of the proponent of the plan, shall confirm the plan notwithstanding the requirements of such paragraph if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.[38]

Section 1129(b)(2) provides, in relevant part, that the requirement that a plan be "fair and equitable" with respect to a class includes the following:

> (B) With respect to a class of unsecured claims--
>
> > (i) the plan provides that each holder of a claim of such class receive or retain on account of such claim

[35] *Id.* at 172-73.

[36] Even in *S.O.S.*, denial of confirmation of the debtor's plan was not based solely on failure to meet the feasibility test, as the bankruptcy court also held that the plan improperly classified the objecting creditor's claim in a manner that constituted impermissible gerrymandering. *Id.* at 174-75.

[37] *See, e.g., In re Indian Nat'l Finals Rodeo Inc.,* 453 B.R. 387 (Bankr. D Mont. 2011) (confirming nonprofit debtor's plan over creditor objection based on, among other grounds, feasibility, with the court accepting the debtor's projection that decline in revenues prior to bankruptcy, in the form of sponsorships of rodeos, was due to objecting creditor's collection efforts, which would no longer impact future sponsorships after confirmation).

[38] 11 U.S.C. § 1129(b)(1).

> property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or
>
> (ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property . . . .[39]

In the context of a for-profit business, application of the absolute priority rule is relatively straightforward. If, for example, the plan does not pay general unsecured claims in full, then the shareholders of a corporate debtor cannot retain their equity interests in the debtor without meeting the so-called "new value" exception to the absolute priority rule. In contrast, for a nonprofit debtor, a determination must be made as to whether the members of the debtor hold a claim or interest which is junior to those held by the general unsecured creditors.

In contrast to a for-profit business entity, which is to be managed for the benefit of its shareholders or equity holders, most nonprofit entities are devoted to a mission, with members or directors who are volunteers and who are entrusted with the responsibility and duties of carrying out the nonprofit's mission. Except for nonprofits like cooperatives, which are operated for the benefit of their members,[40] members of a nonprofit organization generally do not receive benefits from their member status, and in particular, and have no rights to receive any of the revenues or assets of the organization. Yet members and directors do have control of the organization, and however characterized, the rights that accompany membership of a nonprofit might arguably be portrayed as some kind of residual interest, junior to the rights of general unsecured creditors. In the context of confirmation of a Chapter 11 plan through cram-down of a dissenting class of creditors, the question that matters is whether the rights or interests of the debtor's members

[39] 11 U.S.C. § 1129(b)(2)(B).

[40] As reflected in the case law and as described herein, Chapter 11 cases involving cooperatives present the most challenging application of the absolute priority rule due to the very individualized attributes of membership rights and the fact that members do receive benefits.

constitute a "junior claim or interest" within the meaning of section 112((b)(2)(B) of the Bankruptcy Code.

An objecting creditor may argue that the plan violates the absolute priority rule by allowing members to retain control of the debtor by the debtor's members, who often may also be directors of the debtor. Consideration of this issue requires a case-by-case, fact-specific analysis of the nature of the interests of the members. Before drawing lessons from existing case law, it is worth confirming the framework by which to consider the cases. As expressed by the Seventh Circuit in *In re Wabash Valley Power Ass'n, Inc*.,[41] the absolute priority rule as three components: "(1) the identification of junior claims or interests, (2) the identification of any property retained by the holders of such claims or interests, and (3) the determination whether the property is retained "on account of" a junior claim or interest. The term 'interest' in this context means equity interest."[42]

The first reported case found by the authors that considered the issue was not a confirmation fight but provides commentary on the issue. In *In re Independence Village, Inc*.,[43] the debtor was a nonprofit corporation that operated a life-care facility for the elderly. The lender filed a motion for relief from stay two months into the case on , among other grounds, that the debtor was incapable of confirming a plan and that relief was warranted under section 362(d)(2) of the Bankruptcy Code. The motion was conditionally denied, subject to the debtor's meeting the court-imposed requirement for adequate protection, but what is of interest to this article is the court's reasoning in rejecting the lender's argument that the debtor had no hope of reorganization. As stated by the court:

[41] 72 F.3d 1305, 1313 (7th Cir. 1995).

[42] *Id.*

[43] 52 B.R. 715 (Bankr. E.D. Mich. 1985).

> [The debtor] is a non-profit corporation. It has no shareholders, hence there are no interests inferior to the unsecured creditors. Thus there should be little difficulty with the absolute priority rule of § 1129(b)(2)(B)(ii) …. Thus a severe cramdown of unsecured debt may not be an insurmountable problem in a plan of reorganization.[44]

Not every nonprofit case even recognized the issue as to the applicability of the absolute priority rule in a nonprofit Chapter 11. In *In re S.A.B.T.C. Townhouse Association*, *Inc.*,[45] the debtor was a nonprofit homeowners' association that owned, managed and controlled the common areas, including roads, parking areas and a swimming pool complex, for the use and enjoyment of members who lived in the development. Each member had an easement over the common areas guaranteeing their use and enjoyment of the property, and paid monthly assessments to cover the costs of the debtor's operations. The debtor proposed a plan providing for members to retain their membership interests, which was opposed by an objecting creditor. In response to the argument that the plan violated the absolute priority rule, the debtor apparently did not argue that the members' interests were not subject to the rule, and instead argued that the new value exception applied. Based on its findings of fact, the bankruptcy court rejected the debtor's argument and found that the requirements of the new value exception were not met.[46]

The first reported case addressing this issue in the context of a nonprofit's confirmation proceedings appears to be *In re Eastern Maine Electric Cooperative, Inc*.[47] The debtor in that case was a rural electric cooperative that filed for bankruptcy relief due to the crush of debts incurred in connection with its involvement in a nuclear power project. The debtor was

[44] *Id.* at 726 (citation omitted).

[45] 152 B.R. 1005 (Bankr. M.D. Fl. 1993).

[46] *Id.* at 1009-1011.

[47] 125 B.R. 329 (Bankr. D. Me. 1991) ("*Maine Electric*").

organized under a state statute specifically addressing cooperative utilities, and its customers included over 9,000 members of the cooperative and some who were not-members. The largest unsecured creditor in the case objected to the debtor's disclosure statement on the ground that the proposed plan was not confirmable, in part based on a violation of the absolute priority rule.

Under the governing Maine statute, the debtor was required to apply its revenues to very specific uses and in order of priorities. After paying for expenses, debts, and other categories, any remaining revenues were to be distributed to its members as "patronage refunds", unless otherwise determined by a vote of the members. The debtor asserted that its obligations to pay patronage capital were equivalent to interest-free loans, and treated the members' rights to patronage capital as unsecured claims which were separately classified in the plan and were to receive a distribution of cash representing a pro rata share of the funds available to all general unsecured creditors in the event of a liquidation. After considering the evidence, the bankruptcy court found that members had no right to payment of their patronage capital and, therefore, that the member's rights were not entitled to be treated on par with general unsecured creditors and constituted a class of interests junior to such creditors.[48]

It is worth noting that the outcome of *Maine Electric*, that the proposed plan was held not to be confirmable, resulted from the court's finding that the members' rights to patronage capital were not entitled to treatment as claims. Perhaps if the debtor had eliminated the provision in the plan providing for distribution of cash to the members and just provided for the members to retain their interests, the outcome might have been different.

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[48] *Id.* at 339.

The first Circuit Court case on the application of the absolute priority rule to a nonprofit debtor is *In re Wabash Valley Power Assoc., Inc.*[49] The debtor in this case, like *Maine Electric*, involved a nonprofit electric power cooperative whose purpose was to provide a reliable and reasonably priced wholesale power supply to its members. The debtor was governed by a board, including one director from each of its 24 members, almost all of which themselves were nonprofit distribution cooperatives in Indiana. The debtor filed for relief in bankruptcy due to enormous debts incurred in connection with a failed nuclear power facility. Under the Indiana statute governing the organization, the debtor could not pay earnings or dividends to its members, and upon dissolution, any assets remaining after payment of debts would escheat to the state. Members thus have no right to receive any monies from the assets of the corporation.[50] The primary benefit to members of the debtor was received by them as customers of the debtor with access to electric power at favorable rates.[51] However, members also had certain rights with respect to "patronage capital," a factor that was the downfall of the *Maine Electric* plan.

The bankruptcy court confirmed the debtor's plan over the objection of its major creditor, and after the district court affirmed, the Seventh Circuit was presented with the issue of whether the plan violated the absolute priority rule. Before articulating its rationale for upholding confirmation, the Circuit Court noted that, in view of the membership structure of the debtor, "it is small wonder that the rules of Chapter 11 bankruptcy, primarily designed as they are for profit-seeking enterprises, are less than straightforward to apply here.[52]

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[49] 72 F.3d 1305 (7th Cir. 1995) ("*Wabash*").

[50] *Id.* at 1309.

[51] *Id*. at 1313.

[52] *Id.* at 1314.

The objecting creditor argued that the plan provision for the debtor's members to retain control over the reorganized debtor, and thus control over the rates paid by members, was property which the members retained "on account of" their prior interests in the debtor, and thus violated the absolute priority rule. The Seventh Circuit rejected that argument, finding that the members did not hold equity interests in the cooperative, and that it therefore was impossible for them to retain any property "on account of" such interests.[53] The court's analysis becomes more complex, however, when it considers the members' rights with respect to patronage capital. Under applicable state law, patronage capital was a means to reimburse or give members credit for prior excess billings for power, after the determination of the actual cost of generating the power sold was determined. The objecting creditor argued that the plan treatment of the patronage capital accounts the members' patronage capital accounts were equity interests junior to the creditor's unsecured claims. In considering this argument, the court correctly noted that the characterization of patronage capital for cooperatives in different states does not permit a uniform resolution, due to variances in the relevant state laws.[54] Under Indiana law, the patronage capital accounts were determined by the Seventh Circuit not to be equity interests and instead were "credits for overpayments for electric service", and thus were properly classified as unsecured claims.[55]

With respect to the members' interests in the debtor, the Seventh Circuit rejected the creditor's argument that control was a property interest for purposes of the absolute priority rule. As stated by the Seventh Circuit: "Control alone, divorced from any right to share in corporate

[53] *Id.* at 1315.

[54] *Id*. at 1317.

[55] *Wabash*, 72 F.3d at 1317.

profits or assets, does not amount to an equity interest."[56] The court thus distinguished the debtor's case from for-profit corporation cases, noting that "the prerogatives of equity ownership include not only the right to control corporate decisionmaking but also the right to a share in profits and in the ownership of corporate assets on dissolution.[57] In contrast, members of a nonprofit have no potential to realize value from their membership, as they have no right to share in profits or any possible distribution of the organization's assets. Accordingly, even though members of the debtor benefitted economically as customers of the debtor, their retention of their membership under the plan did not violate the absolute priority rule.[58]

The only other reported Circuit Court case considering the issue of the application of the absolute priority rule to a nonprofit is *In re General Teamsters, Warehousemen & Helpers Union, Local 890.*[59] After the bankruptcy court confirmed the debtor's plan over the objection of unsecured creditors, which the District Court affirmed, the Ninth Circuit was presented with the argument that the plan violated the absolute priority rule. The focal point of the issue in this case concerned the nature of the debtor's parent union's interest in the debtor. The contract between the debtor and the parent union provided that upon the debtor's liquidation, its assets would escheat to the parent for two years or until the debtor was reorganized. If the debtor did not reorganize within two years, then the parent was entitled to transfer the funds into the parent's general funds. If that conditional future interest constituted an equity interest within the meaning

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[56] *Id*. at 1318; *accord In re Whittaker Mem'l Hosp. Ass'n, Inc.,* 149 B.R. 812, 816 (Bankr. E.D. Va. 1993) ("The present group retaining control over the debtor entity does not give them anything …. It gives them problems and great anguish ahead…. Being a Virginia nonstock corporation places it in a unique status apart from private enterprise.").

[57] *Id*.

[58] *Id*. at 1320.

[59] 265 F.3d 869 (9th Cir. 2001) ("*General Teamsters*").

of section 1129(b)(2)(B), the plan would have violated the absolute priority rule since the parent union did not contribute to the funding of the plan.[60]

The Ninth Circuit, based upon its review of the facts, determined that the primary purpose of the escheat provision was to preserve the local union's assets in the event of a liquidation and to facilitate a reorganization, and agreed with the bankruptcy court that the parent union had no ownership interest in the assets of the debtor for purposes of the absolute priority rule, because the escheat provision did not create any immediate ownership by the parent in the debtor's assets and the parent had no other indicia of ownership.[61] The plan therefore was held not to violate the absolute priority rule and confirmation was affirmed.[62]

While the case law on the application of the absolute priority rule to nonprofits is thus limited, three conclusions may be drawn from prior cases about the issue. First, a proper consideration of the issue of whether members of a nonprofit may retain their membership interests without a new value contribution requires a case-by-case fact-based inquiry into the nature of the nonprofit's membership rights. Second, for a nonprofit that also is a non-member corporation, there should be no serious doubt about the rights of those in control of the organization by virtue of their status as directors or officers to retain their control under the plan without violating the absolute priority rule. Third, for a nonprofit with members, so long as the rights of members does not include, by virtue of their membership status, the right to receive any of the debtor's revenues or assets, the mere fact that members may receive benefits from the debtor's operations alone should not result in the membership rights being treated as a junior class of interests under section 1129(b)(2)(B) of the Bankruptcy Code.

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[60] *Id.* at 872.

[61] *Id*. at 876.

[62] *Id*.

V. Non-Monetary Considerations for Sales of Assets of a Nonprofit

A. General Standard for Sale Approval

Section 363(b) of the Bankruptcy Code provides that a debtor "after notice and a hearing, may use, sell or lease, other than in the ordinary course of business, property of the estate … ."[63] Courts generally use the "sound business purpose" standard for approving sales pursuant to section 363 of the Bankruptcy Code, which standard requires a debtor to establish: "(1) a sound business purpose exists; (2) the sale price is fair; (3) the debtor has provided adequate and reasonable notice; and (4) the purchaser has acted in good faith."[64] In connection with a proposed sale under section 363 of the Bankruptcy Code, a court will also analyze whether the sale is the highest and/or best offer, which generally means the highest dollar value.[65] In nonprofit health care cases, however, a higher dollar value bid may not be the most decisive factor in light of non-monetary considerations such as continuing the charitable mission of a health care facility and protecting the interests of its patients and employees.

B. Examples

In re United Healthcare System, Inc.[66]

In *In re United Healthcare System, Inc.*, prior to the petition date the Children's Hospital of New Jersey was marketed for sale. For purposes of analyzing the bids, United Healthcare's board members were instructed by their financial advisor to consider four factors, with price ranking last in importance. Bids were received by St. Barnabas Corporation ("SBC") for $13

[63] *Id.* § 363(b)(1).

[64] *In re Decora Indus., Inc.*, No. 00-4459, 2002 WL 32332749, at *2 (D. Del. May 20, 2002) (citing *Del. & Hudson Ry. Co.*, 124 B.R. 169, 176 (D. Del. 1991)).

[65] *See, e.g., Cadle Co. v. Mims (In re Moore)*, 608 F.3d 253, 263 (5th Cir. 2010) ("A trustee has the duty to maximize the value of the estate. As a general matter, the trustee must demonstrate that the proposed sale price is the highest and best offer, though a bankruptcy court may accept a lower bid in the presence of sound business reasons, such as substantial doubt that the higher bidder can raise the cash necessary to complete the deal.") (internal citations omitted).

[66] Case No. 97-1159 (Bankr. D.N.J.); *see also* Civ. Action No. 97-1159, 1997 WL 176574 (D.N.J. Mar. 26, 1997).

million in cash and UMDNJ/Cathedral Healthcare Systems, Inc. for $12 million plus the waiver of a $1.2 million unsecured claim. United Healthcare's board considered the bids and approved the sale to SBC. On March 5, 1997 United Healthcare filed for bankruptcy in the U.S. Bankruptcy Court for the District of New Jersey and moved for approval of the sale. The bankruptcy court refused to approve the sale, concluding among other things, that the board did not exercise sound business judgment and that a process to obtain a fair price for the assets pursuant to section 363 must be conducted. The district court, however, reversed, stating that mechanical application of highest and best offer principles was improper and that "the Court must not only weigh the financial aspects of the transaction but also look to the countervailing consideration of a public health emergency."[67] Moreover, the court noted that "[m]ere financial analysis of the two bids, with the clarity of hindsight, failed to examine the totality of the circumstances."[68]

In re Saint Vincent's Catholic Medical Centers of New York[69]

Saint Vincent's Catholic Medical Centers of New York ("Saint Vincent's") was the operator of Saint Vincent's Westchester Hospital, a behavioral health hospital located on approximately 66 acres of land in Harrison, NY (the "Harrison Facility"). During the course of their bankruptcy cases, Saint Vincent's engaged in a lengthy marketing process for the Harrison Facility. Only one viable purchaser emerged, however, that would commit to continue all of the debtors' fundamental inpatient and outpatient services and to consummate the sale transaction on an expedited timeline. Rather than seeking to sell the Harrison Facility in an open auction pursuant to section 363 of the Bankruptcy Code, which sale would be subject to higher and better

[67] *Id.* at *5.

[68] *Id.* at *6.

[69] Case No. 10-11963 (CGM) (Bankr. D.N.J.); *see also id.* Docket Nos. 799, 960 and 1011.

offers, the debtor sought approval through a private sale.[70] The court approved the sale after a consensual resolution, which provided for, among other things, maintenance of ongoing operations of the Harrison Facility and the preservation of jobs for over 900 employees.

[70] *See id.*, Docket No. 799 at ¶ 4 ("In the Debtors' business judgment there is virtually no chance that further marketing of the Behavioral Health Assets will lead to a higher or better offer. Further marketing of the Behavioral Health Assets will only waste estate assets and could possibly jeopardize the current transaction with [the proposed purchaser].").

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