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Confirmation Issues Facing a Nonprofit Debtor

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Like their for-profit cousins, the 1.5 million registered nonprofit organizations in the U.S.[1] have had their share of financial problems in recent years. In certain cases, these problems have resulted in the filing of chapter 11 cases by such notable nonprofits as Crystal Cathedral Ministries and Nevada Cancer Institute. A debtor or creditor proposing a chapter 11 reorganization plan must, among other things, establish that its plan complies with the requirements in § 1129.[2] A nonprofit's compliance with certain § 1129 requirements such as § 1129(a)(7) (the best-interest test), § 1129(a)(11) (feasibility) and § 1129(b) (the absolute-priority rule) can differ significantly than a for-profit business's compliance with those same requirements.

The Best-Interest Test

Section 1129(a)(7) requires a plan proponent to establish that each creditor will receive at least as much under the proposed plan as it would receive if the debtor's assets were liquidated.[3] Under this requirement, known as the "best-interest test," a bankruptcy court must determine the probable distribution that the holders in each impaired class of claims and interests would receive if the debtor's assets were liquidated under chapter 7. The court first determines the liquidation value that a forced sale of the debtor's assets would generate and then applies the projected proceeds of such a sale to the distribution scheme set forth in § 1129(b). The best-interest test protects creditors by setting a baseline of distributions that a proposed plan must provide to them.

Unlike in the bankruptcy of a for-profit entity, the Bankruptcy Code and state law may preclude or restrict the forced sale of a nonprofit's assets.[4] For example, under § 1112(c), a nonprofit's creditors cannot force a nonprofit to convert its chapter 11 case to a chapter 7, nor under § 303 can they file an involuntary petition against a nonprofit. Similarly, state statutes may impose stringent requirements on the transfer or sale of a nonprofit debtor's assets[5] and the involuntary dissolution of a nonprofit.[6] Accordingly, a nonprofit debtor could argue that the best-interest test does not apply where the debtor is seeking to reorganize because of the above-described prohibitions on forcing a nonprofit to liquidate its assets. However, because no circuit court of appeals has directly addressed this issue, counsel may wish to raise this point while simultaneously demonstrating that the plan satisfies the best-interest test.

In a nonprofit's chapter 11 case, certain factors may work to substantially lower the barrier to confirmation set by the best-interest test. For example, a nonprofit debtor may have to comply with applicable state law before selling or transferring its assets under § 1129(a)(16), which could include notifying and obtaining consent from the state's attorney general.[7] The costs associated with this additional compliance burden, coupled with the delay and uncertainty associated with that compliance process, could well depress the forced liquidation value of the nonprofit's assets to a potential buyer. The lower liquidation value, in turn, could result in a lower minimum level of distribution to creditors for purposes of the best-interest test.

In addition, a nonprofit's assets, by their very nature, could yield a lower forced liquidation value. For example, a religious nonprofit

1 National Center for Charitable Statistics, www.nccsdataweb.urban.org/PubApps/reports.php?rid=34.
2 11 U.S.C. § 1129.
3 11 U.S.C. § 1129(a)(7).
4 11 U.S.C. §§ 1112(c), 303.
5 *See, e.g.*, Cal. Corp. Code §§ 5913, 7913 and 9633.
6 *See, e.g.*, Cal. Corp. Code §§ 6510-6519, 8510-8519, 9680 and N.Y. Not-for-Profit Corp. Law §§ 1001-1014.
7 *See, e.g.*, Cal. Corp. Code §§ 5913, 7913 and 9633.

may have unique real property, such as a church, temple or cemetery, for which the forced liquidation value could be lower because of the property's limited alternative-use potential, or the restrictive zoning associated with the site. Moreover, the intangible assets of some charitable or religious nonprofits, such as their ability to attract donations based on their "brand" or the "goodwill" associated with their charitable works (or unique intellectual property), may have a limited or nonexistent forced liquidation value due to the limited number of buyers and the asset's lack of market portability. The end result is that many of the assets owned by a nonprofit could have a very low forced liquidation value for the purposes of the best-interest test, which, in turn, would lower the minimum distribution level a plan proponent would have to satisfy to obtain confirmation. Thus, in a nonprofit's chapter 11 case, the best-interest test will likely be lowered due to the nature of the debtor and its assets.

The Feasibility of the Plan

Section 1129(a)(11) provides that a chapter 11 plan may be confirmed only if "[c]onfirmation of the plan is not likely to be followed by the debtor's liquidation, or the need for further financial reorganization of the debtor or any successor to the debtor under the plan."[8] This is known as the "feasibility" requirement.[9]

In the current economic climate and resulting steep decline of 11 to 13 percent in charitable donations nationwide from 2008 through 2010,[10] a nonprofit debtor whose plan is primarily funded by donations could face a significant feasibility challenge. Plan opponents could argue that the debtor's donors would be reluctant to make or continue making donations if they believe that their funds will be used to pay creditors instead of advancing the nonprofit's charitable purpose. Although the court could be receptive to this argument, counterarguments exist. A nonprofit with a supportive constituency of donors can use its financial crisis as a means to energize its donor base. Moreover, a nonprofit may have other assets and operational income that can be relied on to mitigate or offset a decline in donations.

For example, in *In re Save Our Springs (S.O.S.) Alliance Inc.*, the Fifth Circuit found that the plan proposed by the debtor, Save Our Springs Alliance (SOS), which was to be funded solely by donations to a creditor settlement fund, was not feasible.[11] SOS had limited assets and relied almost exclusively on a handful of donors to fund its ongoing operations. After it commenced its bankruptcy case, SOS proposed a plan that provided that distributions would be paid from a $60,000 creditor settlement fund, which would be generated solely by charitable contributions from SOS's donors within 60 days of the plan's effective date. At the confirmation hearing, SOS asserted that it had already obtained $20,000 in pledges and expressed confidence that it could raise the balance of the creditor settlement fund through donations within the requisite 60-day period.[12] The bankruptcy court disagreed, ruling that the plan was not feasible because, among other things, the evidence established that SOS had secured only $12,500 in donations and that SOS's established donors had expressly declined to contribute to the plan, despite its repeated requests.[13] The Fifth Circuit affirmed the bankruptcy court's decision, finding that SOS had failed to meet its burden of proving feasibility.[14]

In contrast, the bankruptcy court in *In re Indian National Finals Rodeo Inc.* came to a different conclusion on feasibility where the debtor had operational income to fund a plan despite declining donations (in the form of sponsorship agreements). In this case, the nonprofit debtor, Indian National Finals Rodeo Inc. (INFR) commenced a chapter 11 case to reorganize its debts, including a judgment debt owed to a creditor. It proposed a reorganization plan that was funded by regional fees paid by its 11 regional members, membership fees and entry fees paid by contestants who participated in INFR's rodeos, sponsorship agreements and ticket sales. At confirmation, the judgment creditor argued that INFR's plan was not feasible because sponsorships had declined. The bankruptcy court disagreed and confirmed the plan, finding that the plan was feasible because the evidence established that INFR had a positive cash flow for 2010, its ticket sales had consistently increased since 2005 and INFR could likely reduce its expenses as projected in its plan. The court further found that the decline in sponsorships was the result of the judgment creditor's own aggressive collection attempts and that sponsorships would in all likelihood increase once those efforts were barred by the confirmed plan.[15]

Therefore, a nonprofit debtor can satisfy its burden of proving feasibility by presenting evidence of an adequate income stream from donations, operating income or a combination of both. However, if the nonprofit's plan relies solely or primarily on a declining stream of donations as its funding source, compliance with the feasibility requirement may prove difficult in today's economic environment.

The Absolute-Priority Rule

Section 1129(b)(1) provides that a debtor may "cram down" a reorganization plan over the objection of an impaired class of creditors provided that the plan provides, among other things, "fair and equitable" treatment to each class of impaired claims or interests that have rejected the plan.[16] The fair-and-equitable requirement codifies what is known as the "absolute-priority rule." Under the absolute-priority rule, a plan cannot be confirmed over the objection of a non-accepting class of unsecured creditors unless the holders of junior claims and interests will not "receive or retain under the plan on account of such junior claim or interest any property."[17] In for-profit chapter 11 cases, the absolute-priority rule generally comes into play when a class of unsecured creditors rejects the plan and the equity-holders in the debtor corporation seek to retain some or all of their equity.[18] Under these conditions, confirmation of the plan will be denied, unless equityholders seeking to retain their

8 11 U.S.C. § 1129(a)(11).

9 *See generally Bank of Am. Nat'l Trust and Savs. Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434, 439, fn 4.

10 *Giving USA 2011: The Annual Report on Philanthropy for the Year 2010*, www.givingusareports.org/products/GivingUSA_2011_ExecSummary_Print.pdf.

11 *In re Save Our Springs (S.O.S.) Alliance Inc.*, 632 F.3d 168, 172-73 (5th Cir. 2011).

12 *Save Our Springs*, 632 F.3d at 171.

13 *In re Save Our Springs (S.O.S.) Alliance Inc.*, 388 B.R. 202, 242 (Bankr. W.D. Tex. 2008); affirmed, *In re Save Our Springs (S.O.S.) Alliance Inc.*, 632 F.3d 168 (5th Cir. 2011).

14 *Save Our Springs*, 632 F.3d at 172-73.

15 *In re Indian National Finals Rodeo Inc.*, 453 B.R. 387, 402-3 (Bankr. D. Mont. 2011).

16 11 U.S.C. § 1129(b)(1).

17 11 U.S.C. § 1129(b)(2)(B)(ii).

18 *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 202 (1988).

interests can satisfy the "new value exception" (or corollary) to the absolute-priority rule.[19]

Unlike a for-profit corporation, a nonprofit does not have holders of equity interests. However, if a nonprofit has members that exercise control over the nonprofit by electing directors and voting on major decisions affecting the nonprofit, an issue arises as to whether the absolute-priority rule applies to that nonprofit's plan notwithstanding the member's lack of equity interest. The two circuit courts of appeals that have considered this issue have ruled that the absolute-priority rule does not apply if the nonprofit's members or affiliated entities do not hold an equity interest in the nonprofit, which is defined as control of the nonprofit's operations and either the right to share in profits or the ownership of assets.[20]

For example, in *In re Wabash Valley Power Association Incorporated*, the Wabash Valley Power Association was a nonprofit, electricity-generating cooperative governed by a board of directors that, in turn, consisted of members that were also electric utility cooperatives. Under state law, Wabash was precluded from paying its members any earnings or dividends, and if Wabash were dissolved or liquidated, all of its assets remaining after the payment of its debts would escheat to the state.[21]

Wabash filed a chapter 11 petition after an unsuccessful investment in nuclear power. A creditor objected to Wabash's reorganization plan, asserting that, among other things, the plan violated the absolute-priority rule because Wabash's members would retain control over the reorganized nonprofit debtor by their continued board representation.[22] The Seventh Circuit disagreed, finding that there were three components of an equity interest—control, the right to share in profits and ownership of corporate assets—and that control alone could not constitute an equity interest. It further found that the members could not use whatever limited control they had over Wabash to generate profits, nor did they have the right to share in profits or in the ownership of corporate assets upon Wabash's dissolution.[23] Thus, the court ruled that because Wabash's members did not have an equity interest in Wabash, the plan did not violate the absolute-priority rule.

Similarly, the Ninth Circuit, citing *Wabash Valley Power*, concluded in *Security Farms v. General Teamsters, Warehousemen and Helpers Union, Local 890 (In re General Teamsters, Warehousemen and Helpers Union Local 890)* that the international parent union (the "international") of an affiliated local labor union (the "local") did not have an equity interest in the local as a result of a contract between the two that provided that upon the local's liquidation, its assets would escheat to the international for a two-year period.[24] The Ninth Circuit found that the international's right to the local's assets upon liquidation was a "highly conditional future interest" rather than an equity interest in the local because those assets would be segregated for a period of two years, during which the local could conceivably reorganize. It further found that the two other indicia of an equity interest—control and the right to share in profits—did not exist because the international did not have any control over the local's operations or any type of profit-share because the local was financially and legally independent of the international.[25]

Given the limited case law and particular facts of each of these cases, it is difficult to predict the circumstances under which a bankruptcy court would apply the absolute-priority rule to a nonprofit. Therefore, in formulating and presenting a reorganization plan for a nonprofit debtor, counsel should carefully analyze the type and purpose of the nonprofit debtor, whether it has members and, if so, whether those members have any of the indicia of an equity interest in the nonprofit—*i.e.*, control, a right to profits or ownership in the nonprofit's assets.

Conclusion

Like a for-profit entity, a nonprofit debtor will have to comply with the requirements in § 1129 to confirm its plan. However, there are nuances to that compliance that are specific to a nonprofit. For example, under certain conditions, the nature of a nonprofit's assets, its business model and the additional regulatory burdens applicable to a nonprofit's sale of assets may well justify a lower liquidation value, making it easier for the nonprofit to satisfy the best-interest test in § 1129(a)(7). In the feasibility context, a nonprofit with both operating income and a stable donation revenue stream will be more likely to meet its burden of proof than a nonprofit relying solely upon the strength of future donations, particularly in today's difficult economic times. Finally, if a class of unsecured creditors declines to accept the nonprofit's plan, the nonprofit may have to comply with the absolute-priority rule if its members are entitled to a distribution or payment during the nonprofit's existence, or upon its dissolution and if their interests have certain indicia of typical equity—*i.e.*, control, right to profits and ownership of assets would likely all be present. abi

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19 *See generally Bank of Am. Nat'l Trust and Savs. Ass'n. v. 203 N. LaSalle St. P'ship*, 526 U.S. 434, 441-58 (1999).

20 *In re Wabash Valley Power Assoc. Inc.*, 72 F.3d 1305, 1318-19 (7th Cir. 1996); *Security Farmers, et al., v. General Teamsters, Warehousemen and Helpers Union, Local 890 (In re General Teamsters, Warehousemen and Helpers Union, Local 890)*, 265 F.3d 869, 873-77 (9th Cir. 2001).

21 *Wabash*, 72 F.3d 1309.

22 *Wabash*, 72 F.3d 1317.

23 *Wabash*, 72 F.3d 1318-21.

24 *General Teamsters*, 265 F.3d 873-76.

25 *Id.*