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REPRESENTING A NONPROFIT DEBTOR IN BANKRUPTCY

By Kavita Gupta[1]

I. Introduction

California's 150,000 registered nonprofit organizations,[2] like their for-profit cousins, have had their fair share of financial problems in recent years. In some instances, these problems have led to filings under the Bankruptcy Code. Notable nonprofit California Chapter 11 cases include the Roman Catholic Diocese of San Diego, and more recently, Crystal Cathedral Ministries, the owners of the landmark Crystal Cathedral in Orange County, California.

A nonprofit commences a bankruptcy case for many of the same reasons as a for-profit business—to obtain a stay of pending litigation or collection efforts, to reorganize its business, or to conduct an orderly liquidation of its assets. Although a bankruptcy case filed by a nonprofit is in many ways indistinguishable from that of a for-profit business, certain issues arise solely as a result of the debtor's nonprofit status. This article provides a general overview of some of those issues and their potential impact on a nonprofit's bankruptcy case.

II. Issues to Consider Before Commencing a Nonprofit's Bankruptcy Case

Below are four preliminary issues a practitioner may wish to consider before commencing a bankruptcy case in California on behalf of a nonprofit.

A. A Nonprofit Organized as a Corporation, Unincorporated Company or Business Trust May File a Bankruptcy Petition

Section 109(a)[3] sets forth the eligibility requirements a debtor must satisfy to file a petition under any chapter of the Bankruptcy Code. A debtor must be a "person," defined in the Bankruptcy Code as an individual, partnership or

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[1] Kavita Gupta is Of Counsel at Winthrop Couchot PC, Newport Beach, California. Ms. Gupta wishes to thank Marc J. Winthrop for his editorial comments on this article.

[2] National Center for Charitable Statistics, http://www.nccsdataweb.urban.org/PubApps/reports.php ?rid =34 (last visited Jan. 16, 2012).

[3] Unless stated otherwise, all chapter and section references are to title 11 of the United States Code, 11 U.S.C. §§ 101 *et seq.* (the "Bankruptcy Code").

corporation,[4] and must reside or have a domicile, a place of business or property in the United States. The term "corporation," in turn, is defined broadly to include: (i) an association having a power or privilege that a private corporation possesses; (ii) an unincorporated company or association; or (iii) a business trust.[5] So long as it is organized under state law as one of those types of entities, almost any nonprofit can file a bankruptcy petition under either Chapter 7 or Chapter 11.

B. Creditors Likely Cannot File an Involuntary Petition Against a Nonprofit

Section 303 provides in relevant part that creditors may commence an involuntary bankruptcy case ". . . only under Chapter 7 or 11 of this title, and only against a person, except a farmer, family farmer or a corporation that is not a moneyed, business or commercial corporation . . . ."[6] Although the Bankruptcy Code does not expressly define the phrase "corporation that is not a moneyed, business or commercial corporation," one interpretation of that phrase is that Section 303 prohibits creditors from filing an involuntary petition against a nonprofit,[7] since such an entity arguably falls within the description of a "corporation that is not a moneyed, business or commercial corporation."

Because Section 303 might not expressly prohibit creditors from filing an involuntary petition against a nonprofit, courts have developed several standards to determine whether a particular alleged debtor is "not a moneyed, business or commercial corporation."[8] For example, some courts apply the state

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[4] 11 U.S.C. § 101(41).

[5] 11 U.S.C. § 101(9)(A).

[6] 11 U.S.C. § 303(a).

[7] The legislative history of Section 303 provides that "schools, churches, charitable organizations and foundations are protected from involuntary bankruptcy." *See* H.R. REP. NO. 95-595, at 321 (1977); S. REP. NO. 95-989, at 33 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6277, 6278, 5787, 5819.

[8] James Lockhart, *What Constitutes "Moneyed, Business, or Commercial Corporation" Subject to Involuntary Bankruptcy or Reorganization Upon Creditors' Petition Under 11 U.S.C.A. § 303(a) and Predecessor Statutes*, 24 A.L.R. Fed. 2d 397 (2007). *See also In re* Dairy Mktg. Ass'n of Ft. Wayne, 8 F.2d 626, 628 (D. Ind. 1925) (holding that an involuntary petition could not be filed against a co-operative dairy market association because it was not a moneyed, business or commercial corporation, finding that the "character of a corporation or association must be determined from its articles of incorporation and the statute authorizing its formation."); *In re* Weeks Poultry Cmty., Inc., 51 F.2d 122 (D.C. Cal. 1931) (holding that a co-operative marketing association was not a moneyed, business or commercial corporation pursuant to the reasoning articulated in *Dairy Mktg. Ass'n.*).

"classification" test, which provides that the debtor's registration with the state as a nonprofit is sufficient by itself to determine that the debtor is "a corporation that is not a moneyed, business or commercial corporation."[9] Other courts apply a more comprehensive "corporate activity" test, pursuant to which the courts review an entity's classification under state law and the nature of its activities.[10] The Ninth Circuit has not articulated which of these tests it will follow. As a result, counsel representing a nonprofit in a contested involuntary bankruptcy case should be prepared to meet both the state classification test (with evidence that the entity is formed or registered as a nonprofit in California),[11] and the corporate activity test (with evidence regarding the nature of the activities in which the alleged debtor nonprofit is engaged).

C. A Nonprofit's Chapter 11 Case Cannot Be Converted to a Chapter 7 Case Except on the Debtor's Motion or With Its Consent

A nonprofit, unlike a for-profit debtor, has sole control over the conversion of its Chapter 11 case to a Chapter 7 case. Section 1112(c) provides that a bankruptcy court cannot convert a debtor's Chapter 11 case to a Chapter 7 case, "if the debtor is . . . a corporation that is not a moneyed, business, or commercial corporation unless the debtor requests such conversion."[12] If a nonprofit is determined to be a "corporation that is not a moneyed, business or commercial corporation," then the nonprofit in a Chapter 11 case cannot be forced to liquidate its assets through a Chapter 7 case.[13] For a nonprofit to be in a Chapter 7 bankruptcy case, the nonprofit must either commence a Chapter 7 case itself, or request the conversion of its Chapter 11 case to a Chapter 7 case.[14]

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[9] *Lockhart*, *supra* note 8.

[10] *Id.*

[11] The three most common types of nonprofit corporations under California law are public benefit corporations, mutual benefit corporations, and religious corporations, the majority of which are registered as public benefit corporations. California Attorney General's Guide for Charities, *available at* http://www.ag.ca.gov/charities/publications/guide_for_charities.pdf (last visited Jan. 16, 2012).

[12] 11 U.S.C. § 1112(c).

[13] However, as discussed below in Section III(A), a creditor may be able to propose a plan that is funded by the sale of all or substantially all of the nonprofit debtor's property under Section 1123.

[14] It is an open question as to whether a Chapter 11 trustee would be able to convert a nonprofit's case without its consent under Section 1112(c). No court appears to have directly addressed this issue.

D. A Chapter 11 Trustee Can Be Appointed Even in a Case Involving a Nonprofit Debtor

Although a creditor of a nonprofit cannot force the nonprofit into an involuntary bankruptcy or request that the nonprofit's Chapter 11 case be converted to a Chapter 7, Section 1104 allows the creditor to seek the appointment of a Chapter 11 trustee. Section 1104 does not exempt a "corporation that is not moneyed, business or commercial corporation" from its reach. Accordingly, if "cause" exists for the appointment of a Chapter 11 trustee under Section 1104, the bankruptcy court may appoint a trustee to manage the nonprofit's bankruptcy estate, displacing existing management during the case.

III. Issues to Consider After Commencing a Nonprofit's Bankruptcy Case

The filing of a bankruptcy petition creates a bankruptcy estate that is comprised, with certain exceptions, of all of the debtor's prepetition property.[15] Often, the nature of a nonprofit's property and property rights will differ from those held by a for-profit entity. Therefore, counsel for a nonprofit should carefully consider these distinctions because they may well affect the ultimate plan structure or even the viability of the reorganization case.

For example, unlike a for-profit business, which typically generates income from the sale of products or services, the operations of many nonprofits are funded primarily from donations by individuals or other entities. In some instances, these incoming donations are subject to use restrictions. In other instances, a nonprofit may receive funds as a beneficiary of a trust. These attributes might determine whether the donations are property of the estate and how they can or cannot be used in the bankruptcy case.

Moreover, if certain assets are determined to be property of the bankruptcy estate, then a nonprofit that desires to sell or transfer those assets to pay its creditors or to fund a reorganization plan must comply with certain federal and state laws, provisions that would have no application to a for-profit business.

A. Donations that are not Restricted to a Particular Purpose or Held in Trust Qualify as Property of the Nonprofit's Bankruptcy Estate

Section 541(a) defines the property of a debtor's bankruptcy estate to include "all legal or equitable interests of the debtor in property as of the

[15] 11 U.S.C. § 541.

commencement of the case."[16] This language evinces the congressional intent to include a broad range of property.[17] However, property of the bankruptcy estate does not include "any power that the debtor may exercise solely for the benefit" of another under Section 541(b), nor does it include "[p]roperty in which the debtor holds . . . only legal title and not an equitable interest" under Section 541(d).[18]

In the context of a bankruptcy involving a nonprofit, courts have held that if the nonprofit receives donations designated for a specific purpose, then those types of donations are not property of the bankruptcy estate.[19] Moreover, if the nonprofit is holding property in trust for the benefit of a non-debtor, courts have held that the trust *res* is also not property of the bankruptcy estate.[20] On the other hand, if a nonprofit debtor receives donations that do not have specific use limitations, it should be able to use those donations in the ordinary course of its business under Section 363.

B. A Nonprofit Debtor Must Comply with State Law Prior to Transferring Substantially All of Its Assets

In a majority of states, including California, the state's attorney general is vested with broad authority to regulate nonprofits on behalf of the general public[21]

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[16] *Id.*

[17] United States v. Whiting Pools, Inc., 462 U.S. 198, 204-05 (1983) ("Both the congressional goal of encouraging reorganizations and Congress' choice of methods to protect secured creditors suggest that Congress intended a broad range of property to be included in the estate.").

[18] 11 U.S.C. § 541(b) and (d).

[19] *In re* Joliet-Will County Cmty. Action Agency, 847 F.2d 430, 432-33 (7th Cir. 1988) (federal and state agency grants to nonprofit community organizations that impose restrictions on grants' use were made to the organization as trustee and accordingly, the debtor lacked beneficial title to the funds and they were not property of the estate).

[20] Begier v. I.R.S., 496 U.S. 53, 58 (1990) ("Because the debtor does not own an equitable interest in property he holds for another, that interest is not 'property of the estate.'"); Mitsui Mfr. Bank v. Unicom Computer Corp. (*In re* Unicom Computer Corp.), 13 F.3d 321, 324-25 (9th Cir. 1994) (citing *Begier,* Ninth Circuit held that funds mistakenly deposited into debtor's account were held in constructive trust and, therefore, not property of the bankruptcy estate.).

[21] This oversight is critical for several reasons. First, an individual donor who makes a charitable donation to a nonprofit will likely not have the financial resources to file an action on his own behalf. Second, and more importantly, a nonprofit lacks shareholders, profit-incentives and other free market regulators that in the context of a for-profit business would generally ensure the efficiency and integrity of that business's operations. The lack of those regulators can lead to the inefficient operation of a nonprofit's operations and/or misconduct by its managers.

under the common law *parens patriae* doctrine,[22] and various state statutes.[23] Thus, in certain instances, a nonprofit must obtain consent of its state's attorney general before it can transfer or sell substantially all of its assets.

After a nonprofit files a bankruptcy petition, the Bankruptcy Code imposes an additional layer of regulation on the transfer or sale of property of the bankruptcy estate. In a Chapter 7 case, a Chapter 7 trustee is appointed to liquidate the assets of the bankruptcy estate.[24] In a Chapter 11 case, a Chapter 11 debtor-in-possession (or a Chapter 11 trustee if one is appointed) [25] may continue to operate the nonprofit, which could include selling or transferring some or all of the assets of the bankruptcy estate.

The interface between the regulations imposed on nonprofits by state law and the regulatory scheme in the Bankruptcy Code adds a layer of complexity to the nonprofit's bankruptcy case. Accordingly, regardless of whether the affairs of the nonprofit in bankruptcy are subject to the control of the nonprofit debtor (acting as debtor-in-possession), or a trustee under either Chapter 7 or Chapter 11, significant issues could arise as to: (i) whether the attorney general, bankruptcy trustee or debtor-in-possession should decide whether to sell property of the nonprofit debtor's bankruptcy estate; and (ii) whether state or federal law will govern the sale.

To resolve the foregoing issues, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") added three new subsections governing such transfers—Sections 363(d)(1), 541(f) and 1129(a)(16). Section 363(d)(1) provides that a trustee may sell or lease property under subsection (b) or (c) of this section only in accordance with applicable non-bankruptcy law that governs the transfer of property by a nonprofit. Section 541(f) provides that a tax-exempt nonprofit organization under 26 U.S.C. § 501(c) may transfer its assets to a corporation that is not such a corporation, but only under the same conditions that would apply if the debtor had not filed a bankruptcy case. The

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[22] Holt v. College of Osteopathic Physicians & Surgeons, 394 P.2d 932 (Cal. 1964) ("Since there is usually no one willing to assume the burdens of legal action, or who could properly represent the interests of the trust or the public, the Attorney General has been empowered to oversee charities as the representative of the public, a practice having its origins in the early common law.").

[23] *See, e.g.,* CAL. CORP. CODE §§ 5250, 5223; CAL. GOV. CODE §§ 12588, 12598 (public benefit corporation and mutual benefit corporation); CAL. CORP. CODE § 9230 (religious corporation).

[24] 11 U.S.C. §§ 701, 704.

[25] 11 U.S.C. § 1108.

legislative history of BAPCPA indicates that Congress was trying to give greater influence to state regulators and attorneys general and "restrict the authority of a trustee to use, sell, or lease property by a nonprofit corporation or a trust."[26] Finally, Section 1129(a)(16) requires a bankruptcy court, in confirming a Chapter 11 plan, to find that all transfers of property under the plan are made in accordance with applicable non-bankruptcy law that governs the transfer of property by a nonprofit entity.

Therefore, to comply with the requirements of Sections 363(d)(1), 541(f) and 1129(a)(16), a corporate nonprofit debtor intending to sell or transfer substantially all of its assets must give written advance notice to the attorney general's office prior to such a sale or transfer unless: (i) the transaction is in the usual and normal course of its activities, or (ii) it obtains a written waiver from the attorney general's office.[27] The nonprofit must also obtain approval for these transactions from its board of directors.[28] Moreover, certain types of nonprofits, such as hospitals, must comply with even more stringent requirements to obtain approval of a proposed sale due to the critical nature of their business.[29] In summary, a practitioner representing a nonprofit debtor must thoroughly research and comply with applicable state law requirements before attempting a transfer of property of the bankruptcy estate.

C. Whether a Creditor Seeking to Transfer Property of the Estate in a Chapter 11 Case Without the Nonprofit's Consent Must Comply with State Law is Unsettled

Although a nonprofit debtor is subject to state laws regulating the transfer of its assets, a creditor seeking to sell property of the bankruptcy estate through its plan without the consent of the nonprofit debtor may not have to comply with Section 1129(a)(16) or applicable state laws. For example, in *In re Machne Menachem*,[30] the bankruptcy court held that Section 1129(a)(16) and the relevant New York state statutes governing sales of assets of nonprofits only applied to voluntary transfers of assets by a debtor. Therefore, if a creditor (in this case, the

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[26] H.R. REP. NO. 109-31, pt. 1, at 145 (2005).

[27] CAL. CORP. CODE § 5913 (public benefit corporation), CAL. CORP. CODE § 7913 (mutual benefit corporation) and CAL. CORP. CODE § 9633 (religious corporation).

[28] CAL. CORP. CODE § 5911 (public benefit corporation), CAL. CORP. CODE § 7911 (mutual benefit corporation) and CAL. CORP. CODE § 9631(religious corporation).

[29] CAL. CORP. CODE §§ 5914-30.

[30] *In re* Menachem, 371 B.R. 63, 68 (Bankr. M.D. Penn. 2006).

debtor's former director) proposed a plan that provided for the sale of the assets to a for-profit entity, New York state law would not restrict such sale. The bankruptcy court reasoned that requiring a creditor to comply with applicable state law, including obtaining a majority vote from the debtor's board of directors, would lead to an "absurd" result.[31]

California statutes governing the transfers of assets of a nonprofit are analogous to those in New York. However, because neither the Ninth Circuit nor the California Supreme Court has addressed this issue, it remains an open issue whether a creditor in a nonprofit's bankruptcy case filed in California could similarly argue against the need to comply with California state law prior to the transfer or sale of assets of the nonprofit's bankruptcy estate. Given this lack of clarity, a practitioner representing a creditor holding a claim against the bankruptcy estate of a nonprofit debtor should research state law requirements prior to seeking a transfer of property of the estate through a plan. Complying with these requirements, if feasible, could prove more cost efficient than risking the failure of the creditor's plan effort under Section 1129(a)(16), or worse, risking a future and unnecessary title contest that pits the powers of the state against those of the bankruptcy court.

IV. Issues Relating to the Confirmation of a Nonprofit's Chapter 11 Reorganization Plan

A debtor or creditor proposing a reorganization plan in a Chapter 11 case must, among other things, establish that its plan complies with the requirements in Section 1129. In the case of a nonprofit Chapter 11 case, compliance with those requirements could differ significantly from compliance with respect to a for-profit business.

A. Section 1129(a)(7)—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. Under this requirement, known as the "best interest test," the bankruptcy court must determine what the probable distribution to the holders in each impaired class of claims and interests would be if the debtor were liquidated under Chapter 7. The court first determines the liquidation value 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 Section 1129(b).

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[31] *Id.*

The best interest test protects creditors by setting a baseline of distributions a proposed plan must provide for creditors to be confirmed.

However, in a nonprofit Chapter 11 case, certain factors may work to substantially lower the barrier to confirmation set by the best interest test.[32] For example, a Chapter 11 trustee (or a debtor-in-possession) must comply with applicable state law before selling or transferring a nonprofit's assets under Section 1129(a)(16), which includes notifying and obtaining consent from the California Attorney General. The costs associated with this additional compliance burden, coupled with the delay and uncertainty associated with the compliance process, could well depress the forced liquidation value of the nonprofit's assets to a potential buyer. This lower liquidation value, in turn, could result in a lower minimum level of distribution to creditors for the purposes of the best interests test.

In addition, the assets of a nonprofit, by their very nature, could yield a lower forced liquidation value under the best interest test. For example, a religious nonprofit may have unique real property, such as a church, temple or cemetery, for which the forced liquidation value would be lower due to 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 upon their "brand," or

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[32] Unlike in the bankruptcy of a for-profit business, the Bankruptcy Code and state law may preclude or restrict the forced sale of a nonprofit's assets. For example, a nonprofit's creditors cannot force a nonprofit to convert its Chapter 11 case to a Chapter 7 case under Section 1112(c), nor can they file an involuntary petition against a nonprofit under Section 303. Similarly, California statutes impose stringent requirements on the involuntary dissolution of a nonprofit corporation. Accordingly, a nonprofit debtor might argue that the best interest test does not apply where the debtor is seeking to reorganize because of the foregoing prohibitions on forcing a nonprofit to liquidate its assets.

No Circuit Court of Appeals, including the Ninth Circuit, appears to have directly addressed this issue. However, both the Fifth and Eighth Circuits have held in cases involving family farmers (which are subject to the same limitations on forced liquidations as are nonprofit) that a creditor may file a liquidating plan over the objection of the debtor. *See* Jasik v. C.S. Conrad (*In re* Jasik), 727 F.2d 1379, 1381 (5th Cir. 1984) (ruling that a creditor could file a liquidating plan because, *inter alia*, neither Section 1121 nor its legislative history evidenced any congressional intent to give a family farmer both the offensive right to use a bankruptcy petition to stay the collection rights of its creditors and the defensive right to block the filing of a liquidating plan); Button Hook Cattle Co., Inc. v. Comm'l Nat'l Bank & Trust Co. (*In re* Button Hook Cattle Co.), 747 F.2d 483, 485-87 (8th Cir. 1984) (relying on the reasoning in *Jasik*, Court ruled that any party-in-interest can file a plan, including a liquidating plan, over the objection of the family farmer.). Thus, a practitioner may wish to consider arguing this point, while simultaneously demonstrating that the nonprofit debtor's plan satisfies the best interest test.

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 will have a very low forced liquidation value for the purposes of the best interest test which, in turn, lowers the minimum distribution level that a plan proponent must satisfy to obtain confirmation. In summary, in a nonprofit's Chapter 11 case, the proponent of a plan may well have solid grounds for arguing that the bar under the best interest test should be lowered due to the nature of the debtor and its assets.

B. Section 1129(a)(11)—The Feasibility of the Plan

Section 1129(a)(11) provides that a Chapter 11 plan may be confirmed only if the "[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."[33] This is commonly known as the "feasibility" requirement. Consistent with the plain language of the statute, the Ninth Circuit has ruled that the feasibility requirement does not require a guarantee of the Chapter 11 plan's success, but instead that the plan offer "a reasonable prospect" or "reasonable assurance" of success.[34] Section 1129(a)(11) conveys Congress' belief that the overall economic good would ultimately be served through the confirmation of a Chapter 11 plan as opposed to the destruction of a business.

Given the recent difficult economic climate, and the resulting steep decline of 11%-13% in charitable donations nationwide from 2008 through 2010,[35] a nonprofit debtor whose plan is primarily funded by donations could face a significant feasibility challenge. Opponents of the plan will likely assert that donors will 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 this argument may find favor with the court, counter-arguments 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 upon to mitigate or offset a decline in donations.

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[33] 11 U.S.C. § 1129(a)(11).

[34] Acquia Inc. v. Clinton, 787 F.2d 1352, 1364 (9th Cir. 1986) ("The Debtor has presented ample evidence to demonstrate that the Plan has a reasonable probability of success.").

[35] Giving USA 2011: The Annual Report on Philanthropy for the Year 2010, http://www.givingusareports.org/products/GivingUSA_2011_ExecSummary_Print.pdf (last visited Jan. 16, 2012).

For example, in *In re Indian National Finals Rodeo, Inc.,*[36] the bankruptcy court confirmed the nonprofit debtor's plan, finding that the plan was feasible because the debtor had stable donations and operating income. The nonprofit debtor in that case, Indian National Finals Rodeo, Inc. ("INFR"), was formed to promote Native American rodeos. It was comprised of 11 regions in the USA and Canada, each of which signed a contract with INFR to hold rodeos. INFR was funded by four sources: (i) membership fees and entry fees paid by contestants who participate in rodeos; (ii) sponsorship agreements; (iii) regional fees paid its 11 regional members; and (iv) ticket sales from guests attending the rodeos.

INFR filed a Chapter 11 petition to reorganize its debts, which included a judgment debt owed to Apache Gold Casino Resort ("Apache Gold"). At confirmation, Apache Gold argued, among other things, that INFR's plan was not feasible because the donations and sponsorships had declined. The bankruptcy court disagreed, finding that the evidence established that INFR had a positive cash flow for 2010, its ticket sales had consistently increased since 2005 and INFR had the ability to reduce its expenses as projected in its plan. It also found that the decline in sponsorships was the result of Apache Gold's aggressive collection attempts and that sponsorships would in all likelihood increase once those efforts were barred by the confirmed plan. Accordingly, the Court overruled Apache Gold's objection, finding that INFR's plan was feasible.

In contrast to *Indian National*, the Fifth Circuit in *In re Save Our Springs (S.O.S.) Alliance Inc.*[37] came to a different conclusion on feasibility when presented with a debtor whose plan was funded solely by donations to a creditor settlement fund. In that case, Save Our Springs Alliance ("SOS"), a nonprofit organization, had limited resources and assets and relied almost exclusively on a handful of donors to fund its ongoing operations. SOS filed a Chapter 11 petition when it could not satisfy a judgment debt. SOS' reorganization plan provided that distribution would be paid from a $60,000 creditor settlement fund. The plan further provided that this fund would be generated solely by charitable contributions from SOS' donors within 60 days of the effective date of the plan.

At the confirmation hearing, SOS maintained 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. The bankruptcy court disagreed, ruling that the plan was not feasible because, among other things, the evidence established that SOS had only secured donations

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[36] *In re* Indian Nat'l Finals Rodeo, Inc., 453 B.R. 387, 401 (Bankr. D. Mont. 2011).

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

in the amount of $12,500 and that SOS' established donors had expressly declined to contribute toward the plan, despite SOS' repeated requests. The Fifth Circuit affirmed the bankruptcy court's decision, finding that SOS had failed to meet its burden of proving feasibility.

In summary, a nonprofit debtor in bankruptcy, like a for-profit business, must satisfy the feasibility requirement in Section 1129(a)(11). It can satisfy this burden by presenting evidence of an adequate income stream from donations, operating income, or some 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.

C. Section 1129(b)(1)—The Absolute Priority Rule

Section 1129(b)(1) provides that a debtor may "cramdown" 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. The fair and equitable requirement codifies what is commonly 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."[38] 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. Under these conditions, confirmation of the plan will be denied, unless equity holders seeking to retain their interests can satisfy the "new value exception" (or corollary) to the absolute priority rule.[39]

Unlike a for-profit corporation, however, a nonprofit does not have holders of equity interests. In California, the most common types of nonprofits are public benefit corporations, religious corporations and mutual benefit corporations. Public benefit corporations and religious corporations may or may not have "members" and are formed for a public, charitable or religious purpose. These types of nonprofits are statutorily prohibited from making any distributions

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[38] 11 U.S.C. § 1129(b)(2)(B)(ii).

[39] *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).

to their directors, officers or members during their existence and upon dissolution.[40]

In contrast, a mutual benefit corporation has members and is formed for the benefit of those members. It may make distributions to its members both during its existence (by purchasing or redeeming memberships) and upon its dissolution after payment of its debts to creditors. If a nonprofit has members, or is affiliated with other entities which could have an equity interest in the nonprofit, an issue arises as to whether the absolute priority rule applies to that nonprofit's plan.

The two Circuit Courts of Appeal that have addressed this issue have both 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. An equity interest is evidenced by control of the nonprofit's operations and either the right to share in profits or the ownership of assets. For example, in *In re Wabash Valley Power Association, Incorporated*,[41] the Wabash Valley Power Association ("Wabash") 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.

Wabash filed a Chapter 11 bankruptcy petition after an unsuccessful investment in nuclear power. A creditor objected to Wabash's reorganization plan asserting, among other things, that the plan violated the absolute priority rule because Wabash's members would retain control over the reorganized nonprofit debtor by their continued board representation. 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. 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.

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[40] CAL. CORP. CODE § 5410 (public benefit corporation); CAL. CORP. CODE § 5410 (religious corporation).

[41] *In re* Wabash Valley Power Ass'n, Inc., 72 F.3d 1305, 1318-19 (7th Cir. 1996).

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)*,[42] 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 which provided that upon the Local's liquidation, its assets would escheat to the International for a period of two years. 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 in the Local because the Local was financially and legally independent of the International.[43]

Contrary to the appellate decisions discussed above, certain bankruptcy courts have applied the absolute priority rule in instances where a member of a nonprofit receives an economic benefit based on its membership interest. For example, in *In re Eastern Maine Electric Coop., Inc.*,[44] the bankruptcy court found that an electric cooperative members' interest in patronage accounts were ownership interests rather than claims under the cooperative's bylaws and applicable state law. It further found that the debtor itself had characterized patronage capital as representing "ownership" of the cooperative and that the debtor's accountant testified that patronage capital was classified as equity on the debtor's financial statement. Accordingly, the court ruled that the nonprofit debtor's proposed plan violated the absolute priority rule because it failed to pay a dissenting class of unsecured creditors in full while allowing its members to retain their interest in those patronage accounts. Given the limited case law and particular facts of each of the above-described cases, it is difficult to predict the

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[42] Security Farms 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).

[43] *Accord Indian Nat'l Finals*, 453 B.R. at 401 (the Court, citing *General Teamsters,* ruled that the absolute priority rule was inapplicable to a non-profit entity because the debtor had "no shareholders, and the board members and commissioners are paid no salaries and no members receive dividends."); *In re* Whittaker Mem'l Hosp. Assoc., Inc., 149 B.R. 812, 816 (Bankr. E.D. Va. 1993) (The plan does not violate the absolute priority rule because the "present group retaining control over the debtor entity does not give them anything . . . [c]learly, there is no distribution to this group and nothing beyond control that passes to it.").

[44] *In re* E. Maine Elec. Coop., Inc., 125 B.R. 329, 335-39 (Bankr. D. Me. 1991).

circumstances under which a bankruptcy court would apply the absolute priority rule to a nonprofit. However, 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.

V. Conclusion

A practitioner representing a financially ailing nonprofit debtor will need to weigh a number of specific factors when deciding whether to file a bankruptcy case. These include the creditors' inability to file an involuntary bankruptcy case against a nonprofit, whether there are facts extant that would provide cause for the appointment of a Chapter 11 trustee under Section 1104, and finally, the character or attributes of the nonprofit's assets and donations (i.e., whether the nonprofit's donations are subject to use restrictions or subject to a trust), since these factors will determine whether these assets are deemed property of the debtor's bankruptcy estate and can be used to pay creditors or fund a plan.

Upon the commencement of a Chapter 7 or Chapter 11 case, counsel should review applicable state law and take particular note of the fact that recent changes to the Bankruptcy Code mandate compliance with state laws governing the sale or transfer of a nonprofit's property.

A nonprofit that files a Chapter 11 case will have to comply with the requirements in Section 1129 to confirm its plan, although there are nuances 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 Section 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 typical indicia of equity—i.e., control, right to profits and ownership of assets.

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