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Applying the Absolute Priority Rule to Nonprofit Enterprises in Bankruptcy

Amelia Rawls

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COMMENT

Applying the Absolute Priority Rule to Nonprofit Enterprises in Bankruptcy

With the explosion of the nonprofit sector in recent years,[1] courts have struggled to adapt bankruptcy law—normally applied in the context of individuals and businesses[2]—to the context of nonprofit insolvency.[3] One area of confusion has been the absolute priority rule in section 1129[4] of the U.S. Bankruptcy Code.[5] The rule provides a way for courts to confirm a debtor's

1. For example, the real assets and revenues of the nonprofit sector have more than tripled since the 1970s. *See* Lester M. Salamon, *America's Nonprofit Sector: A Primer*, *reprinted in* JAMES J. FISHMAN & STEPHEN SCHWARZ, NONPROFIT ORGANIZATIONS: CASES AND MATERIALS 17, 17 (3d ed. 2006).

2. *See, e.g.*, *In re* Gen. Teamsters, 265 F.3d 869, 873 (9th Cir. 2001) ("The absolute priority rule is generally applied to for-profit corporations facing bankruptcy . . . .").

3. Despite the central role nonprofit organizations play in American economic, social, and religious life, even their basic characteristics are commonly misunderstood. For instance, the term "nonprofit" is deceptive because nonprofits are actually allowed by law to earn profits. *See* Jill R. Horwitz, *Does Nonprofit Ownership Matter?*, 24 YALE J. ON REG. 139, 144 (2007). What they may not do is engage in private inurement—that is, their earnings may not be passed along to individuals in their private capacity. This limitation, known as the "nondistribution constraint," is perhaps the most salient distinction between nonprofit and for-profit enterprise. *See* Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 838 (1980); *see also* I.R.C. § 501(c)(3) (2000) (granting federal income tax exemptions to "[c]orporations . . . organized and operated exclusively for religious, charitable, scientific . . . or educational purposes . . . 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 . . . and which does not participate in, or intervene in . . . any political campaign").

4. 11 U.S.C. § 1129(b)(2)(B)(ii) (2000). For an overview of the history and public policies associated with the absolute priority rule, see generally John D. Ayer, *Rethinking Absolute Priority After* Ahlers, 87 MICH. L. REV. 963 (1989).

5. 11 U.S.C. §§ 101-1532.

reorganization Plan over the objection of an impaired class of creditors,[6] thereby preserving the going-concern value of a firm in the face of creditor demands for liquidation.

Section 1129 states that in order for a Plan to be confirmed by cram down,[7] "the holder of any claim or interest that is junior to the claims of [the impaired] class [must] not receive or retain under the plan on account of such junior claim or interest any property."[8] In other words, not one cent may be received by a junior class of claimants until the class of creditors ahead of it has been repaid in full.[9] This provision furthers several related policy goals, including the maintenance of a hierarchy of claims to priority between the various classes of debt and equity interests,[10] the protection of each class of interests against collusion by the other classes,[11] and the safeguarding of public investors from insider dealing.[12]

Courts have puzzled over the bankruptcy implications of a certain subtle distinction between for-profit and nonprofit organizations. Namely, the typical residual claimant in a business is an equity holder, whereas a junior interest in

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6. A class of creditors is said to be impaired unless a debtor's Plan leaves unaltered the creditors' legal, equitable, and contractual rights (often meaning that the creditors are to be repaid the full amount of their allowed claims) or the Plan otherwise meets certain specific requirements. *See id.* § 1124.

7. The term "cram down" refers to a Plan that is being confirmed over the dissent of an impaired class—that is, the Plan is being "crammed down" the creditors' throats. *See* Richard I. Aaron, *Hooray for Gibberish! A Glossary of Bankruptcy Slang for the Occasional Practitioner or Bewildered Judge*, 3 DEPAUL BUS. & COM. L.J. 141, 150-51 (2005).

8. 11 U.S.C. § 1129(b)(2)(B)(ii).

9. *See* Omer Tene, *Revisiting the Creditors' Bargain: The Entitlement to the Going-Concern Surplus in Corporate Bankruptcy Reorganizations*, 19 BANKR. DEV. J. 287, 320 (2003). Notice, however, that this priority rule is an "absolute" requirement only if the Plan has not already obtained the approval of all classes in the reorganization. Ralph A. Peeples, *Staying In: Chapter 11, Close Corporations and the Absolute Priority Rule*, 63 AM. BANKR. L.J. 65, 75 (1989).

10. G. Eric Brunstad, Jr. & Mike Sigal, *Competitive Choice Theory and the Broader Implications of the Supreme Court's Analysis in* Bank of America v. 203 North LaSalle Street Partnership, 54 BUS. LAW. 1475, 1488 (1999).

11. *See id.*

12. For example, managers may have firm-specific skills or other forms of leverage that allow them to extract special concessions from senior creditors, such as better equity positions in the reorganized firm than they would be entitled to according to their preexisting interests. Meanwhile, public investors whose preexisting interests were comparable to those of the insiders might see their claims completely extinguished. *See* Douglas G. Baird & Thomas H. Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. CHI. L. REV. 738, 740-41 (1988).

a nonprofit usually is not regarded as "equity."[13] This contrast raises the question of how to apply the absolute priority rule to Plans in which the pre-petition interest holders of a nonprofit (usually its directors or members) retain control of, and thus an interest in, the reorganized, post-petition debtor.[14] An equity holder of a similarly situated business debtor would not be permitted to retain such an interest.[15]

A doctrinal split has emerged, revealing two conflicting judicial approaches. Courts of the Fourth, Seventh, and Ninth Circuits have concluded that old interest holders of a nonprofit are permitted to control it throughout its reorganization process, reasoning that the operational limitations inherent to nonprofits render the absolute priority rule effectively irrelevant.[16] On the other hand, courts of the First, Fifth, and Eleventh Circuits have not inferred any inevitability about nonprofit compliance with absolute priority, applying

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13. *See, e.g.*, Osborn v. Univ. Med. Assocs. of the Med. Univ. of S.C., No. 2-01-4002-18, 2003 WL 25734356, at *1 (D.S.C. Sept. 11, 2003) ("[P]laintiff has conceded that a private individual may not possess an ownership interest in a nonprofit entity. . . ."); *In re* Gen. Teamsters, 225 B.R. 719, 736 (Bankr. N.D. Cal. 1998) ("Control alone, [such as occurs in the nonprofit context,] divorced from any right to share in corporate profits or assets, does not amount to an equity interest."); *see also* Knollwood Mem'l Gardens v. Comm'r, 46 T.C. 764, 786 (1966) (stating that the Internal Revenue Code's tax exemption for nonprofits should be denied to any organization in which the "individuals share in the corporate profits because of equity interests"); Semple Sch. for Girls v. Boyland, 126 N.E.2d 294, 297 (N.Y. 1955) (denying a tax exemption to a nonprofit on the basis that it had allowed an individual to assume "the position of the holder of an equity interest in the enterprise").

14. *See In re* Wabash Valley Power Ass'n, 72 F.3d 1305, 1313 (7th Cir. 1995) ("The difficulty in resolving the absolute priority problem in the case before us primarily reflects the unusual structure of the entities involved. . . . The corporation undergoing bankruptcy is a not-for-profit . . . .").

15. But this prohibition does not apply in very limited circumstances, such as when a new value contribution is offered. *See infra* note 45.

16. *See, e.g.*, *In re* Henry Mayo Newhall Mem'l Hosp., 282 B.R. 444, 453 (B.A.P. 9th Cir. 2002) ("[T]he Hospital's nonprofit status puts creditors in an unusually disadvantaged negotiating position because they are not able to assert the Bankruptcy Code's absolute priority rule to block unacceptable plans . . . ."); *In re Wabash*, 72 F.3d at 1320 ("Control of the cooperative provides no opportunity, either currently or in the future, for the Members to obtain profits or any equity in Wabash's assets and control itself is not an equity interest."); *In re* Whittaker Mem'l Hosp. Ass'n, 149 B.R. 812, 816 (Bankr. E.D. Va. 1993) ("The [board of trustees] retaining control over the debtor entity does not give them anything . . . . Clearly, there is no distribution to this group and nothing beyond control that passes to it. Being a Virginia nonstock corporation places it in a unique status apart from private enterprise.").

the rule on fact-specific grounds to reject reorganization Plans that allowed old interests to be preserved.[17]

This Comment proposes a framework that courts can utilize for systematically adjudicating absolute priority claims in nonprofit bankruptcies. Specifically, nonprofits may be classified along a continuum depending upon the particular type of interest they assign to directors and members: those that have an "entrepreneurial" structure mark one end of the continuum, and those that have a "mutual" structure mark the other end.[18] Part I of this Comment describes entrepreneurial nonprofits and explains why their directors and members should be able to conform with the absolute priority rule and yet maintain an interest in the nonprofit through a Plan confirmed by cram down. The second half of Part I elucidates the features of mutual nonprofits, whose directors and members enjoy equity-like interests that courts should not allow them to retain through cram down. Part II then provides guidance for courts faced with structurally ambiguous cases, highlighting additional contextual and policy factors that can be used to decide whether a bankrupt nonprofit's

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17. *See, e.g.*, S. Pac. Transp. Co. v. Voluntary Purchasing Groups, Inc., 252 B.R. 373, 386-89 (E.D. Tex. 2000) (holding that certain technical characteristics of patronage stock qualified it as property that the debtor's members could not retain through reorganization); *In re* E. Me. Elec. Coop., Inc., 125 B.R. 329, 338-40 (Bankr. D. Me. 1991) (same); *In re* S.A.B.T.C. Townhouse Ass'n, 152 B.R. 1005, 1011 (Bankr. M.D. Fla. 1993) (holding that a substantial asymmetry between the market value and the "value in use" of the debtor's real estate was insufficient to overcome the absolute priority conflict raised by the membership's post-petition retention of the property).

18. These nonprofit categories, defined in further detail in Part I, were first articulated by Henry Hansmann in his highly influential contribution to the scholarship on nonprofit organization. Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835 (1980). The distinction is part of what has been described as a "famous typology" of nonprofits, David E. Pozen, *Remapping the Charitable Deduction*, 39 CONN. L. REV. 531, 538 n.24 (2006), proposed in an article that constitutes a "cornerstone of the law of nonprofit organizations," Gail A. Lasprogata & Marya N. Cotten, *Contemplating "Enterprise": The Business and Legal Challenges of Social Entrepreneurship*, 41 AM. BUS. L.J. 67, 74 & n.34 (2003). Indeed, at least one Supreme Court Justice has credited Hansmann with providing the "leading theory" of nonprofit enterprise. Austin v. Mich. Chamber of Commerce, 494 U.S. 652, 675 n.6 (1990) (Brennan, J., concurring).

Critics of Hansmann's nonprofit law scholarship suggest that his conceptualization is inconsistent with the history of charitable exemptions. *See, e.g.*, Mark. A. Hall & John D. Colombo, *The Donative Theory of the Charitable Tax Exemption*, 52 OHIO ST. L.J. 1379, 1387 (1991). Others note that he fails to properly account for the role of altruism. *See, e.g.*, Rob Atkinson, *Altruism in Nonprofit Organizations*, 31 B.C. L. REV. 501, 519-66 (1990). And others suggest that he inaccurately treats as alike all customers, donors, and other actors in the nonprofit sector. *See, e.g.*, Ira Mark Ellman, *Another Theory of Nonprofit Corporations*, 80 MICH. L. REV. 999, 999-1001 (1982). The entrepreneurial-mutual distinction, however, has not been a focal point of these debates.

reorganization Plan should be prohibited. In summary, this Comment suggests a way for courts to assess whether a particular nonprofit is able to abuse the Chapter 11 process in the way that section 1129 was designed to prevent.

I. THE ENTREPRENEURIAL-MUTUAL CONTINUUM

Nonprofit entities can be categorized as having primarily an "entrepreneurial" or primarily a "mutual" structure.[19] By analogizing a nonprofit to one of the ideal types anchoring this continuum, courts can more readily identify violations of the absolute priority rule and thus better harmonize the charitable goals of nonprofits with the public policy goals of the bankruptcy system.

A. Entrepreneurial Nonprofits

The classic entrepreneurial nonprofit—such as a public hospital, museum, or national charity[20]—is controlled by a board of directors (or similar management group) whose members do not comprise the nonprofit's own patrons.[21] In other words, an entrepreneurial organization is characterized by the self-perpetuating nature and independence of its board; its directors do not substantially benefit from the charitable or social mission of the nonprofit that they operate.

An entrepreneurial structure, in light of statutory textual and contextual considerations, can be construed as a signal to courts that there is no conflict between the insolvent nonprofit's Plan and the requirements of absolute priority.[22] First, board members and trustees of entrepreneurial nonprofits control the organization but receive no "property" under section 1129 by virtue of that control.[23] The interest of any nonprofit director, whether entrepreneurial or mutual, is sharply limited by the nondistribution constraint[24] imposed upon all nonprofits; in an entrepreneurial structure, however, the successful fulfillment of the organization's mission provides no special benefit to its directors—that is, no more than it might provide to any

19. *See* Hansmann, *supra* note 18, at 841-42.

20. *Id.* at 842.

21. *Id.* at 841.

22. *See supra* note 8 and accompanying text.

23. For a discussion of the legislative history surrounding the use of the term "property" in section 1129, see *infra* notes 37-40 and accompanying text.

24. *See supra* note 3.

other outside party in the greater community. This is quite unlike the effect of a controlling interest in a business firm, which is valuable for its future economic potential even when the firm becomes insolvent.[25]

The trend, in fact, is for entrepreneurial nonprofits to select board members who they think might *contribute* resources to the organization, such as money or expertise.[26] This is not to suggest that there are no privileges arising from a board position; such position at a prominent charity may enhance one's managerial experience, generate publicity, and provide the opportunity to build a unique network of professional contacts. Nevertheless, these sorts of benefits are not easily valued, not transferable to creditors through liquidation, and thus not of the nature that Congress intended section 1129 to address.[27]

Second, allowing entrepreneurial debtors to enjoy post-confirmation control would not undermine the original purposes behind section 1129. For example, there is no real threat that the board members of an entrepreneurial nonprofit will collude with secured creditors to squeeze out a class of unsecured creditors.[28] Because there is no profit sharing or asset distribution that arises out of the control of an entrepreneurial nonprofit, the directors have little reason to arrange an unfair financial transaction that preserves their stake.[29]

Similarly, another purpose of the absolute priority rule is to protect public investors from "insider" managers who own large quantities of stock or who are otherwise inherently better positioned to advocate for their interests.[30] The risk of this insider dealing is mild in the context of an entrepreneurial nonprofit insolvency. A nonprofit, of course, has no public investors of the kind involved with a commercial firm, but even more relevantly, entrepreneurial directors do

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25. *See* Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 208 (1988).

26. *See* BOARDSOURCE, NONPROFIT GOVERNANCE INDEX 2007, at 6 (2007), http://www.boardsource.org/dl.asp?document_id=553 (finding in its survey of charitable organizations that 68% require board members to make a personal contribution to the charity and 74% of board members do indeed make such contributions).

27. *See infra* notes 37-40 and accompanying text.

28. *See* N. Pac. Ry. Co. v. Boyd, 228 U.S. 482 (1913) (determining that an equity receivership sale was an impermissible transfer of assets orchestrated by bondholders and stockholders to extinguish certain unsecured claims); *see also* Ayer, *supra* note 4, at 969-73 (explaining the historical background and policy rationales of the absolute priority rule).

29. *But see infra* note 31.

30. Management also has the exclusive right to propose a Plan for at least the first 120 days of reorganization. 11 U.S.C. § 1121(b) (2000). Outside shareholders and creditors may not propose competing Plans during that period. This advantage alone gives management a considerable amount of leverage over the other players in the reorganization process.

not share in the goods and services that their organizations are operated to provide. They therefore possess no incentive or natural medium through which to allocate those goods and services to themselves at the expense of outside patrons or creditors.[31]

B. Mutual Nonprofits

In recent years, the nonprofit sector has expanded rapidly and nonprofits have taken on more qualities of traditional commercial enterprises.[32] One aspect of this phenomenon is a rise in the number of mutual nonprofits, such as cooperatives,[33] homeowners' associations, and country clubs.[34] Mutual nonprofits are characterized by members or patrons who control the organization themselves.[35] The duties of the governing board, therefore, still run to the fulfillment of a charitable or social mission, but the board members, in turn, are direct beneficiaries of that mission.[36] They maintain what can be called an equity-like interest in the entity, the retention of which should be characterized as a receipt of property in violation of the Code's cram down regulations.

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31. Of course, this assumes that the directors are complying with their fiduciary duties. Nonprofit directors are constrained by fiduciary duties to the donors whose donations make their operations possible, by fiduciary duties of care and loyalty to the nonprofit itself, and by the various requirements of their corporate charter or the Internal Revenue Code. *See* Evelyn Brody, *The Limits of Charity Fiduciary Law*, 57 MD. L. REV. 1400 (1998). To the extent that directors violate their duties and inappropriately manage the nonprofit's resources for their own gain, even the directors of an entrepreneurial nonprofit may be seen to violate certain policy goals of section 1129. Nevertheless, these atypical situations are more appropriately addressed by enforcement of (or modifications to) corporate fiduciary law and nonprofit law than by indirect means through the Bankruptcy Code. *See, e.g.*, Frances R. Hill, *Targeting Exemption for Charitable Efficiency: Designing a Nondiversion Constraint*, 56 SMU L. REV. 675 (2003) (questioning the merits of continued tax exemption for organizations that appear to be diverting a high proportion of resources from activities that serve tax-exempt purposes to activities that have, at best, an attenuated relationship with such purposes).

32. *See* Horwitz, *supra* note 3, at 152-53; Jeff Kosseff, *Unclear Bankruptcy Rules Challenge Catholics and Disciples*, CHRISTIAN CENTURY, Aug. 10, 2004, at 12, 13.

33. Note that in some states, cooperatives are incorporated under statutes separate from the state's nonprofit or nonstock corporation statutes. *See, e.g.*, WIS. STAT. ANN. §§ 185.01-.996 (West 2002). As a result, those cooperatives do not receive the benefits of tax exemption under I.R.C. § 501(c)(3) and are not subject to the nondistribution constraint of nonprofit status. Only *nonprofit* cooperatives are the subject of the discussion here.

34. Hansmann, *supra* note 18, at 842.

35. *Id.* at 841.

36. *See id.* at 890-91.

Congress intended for the term "property" in section 1129 to be given a broad interpretation,[37] though its scope is not endless.[38] The legislative history of the Code states, "As used throughout this subsection, 'property' includes both tangible and intangible property . . . ."[39] This legislative history suggests that Congress did not want the word's interpretation to be limited only to real property and standard commercial instruments. At the same time, Congress did not want to prohibit the retention of even the most ancillary, personalized advantages only vaguely linked to a pre-petition interest, thereby creating an exception that effectively swallowed the cram down rule.[40] Accordingly, benefits such as the publicity and prestige that accrue to the director of an entrepreneurial nonprofit—benefits that cannot be easily monetized or transferred—need not be regulated by section 1129. On the other hand, post-reorganization control of a mutual nonprofit constitutes preservation of an equity-like interest that should not be enjoyed by directors at the expense of creditors.

The control of a mutual nonprofit is itself a "consumption item of value";[41] because of the way the organization is structured, control allows directors and members to enjoy concrete financial benefits. Although these benefits are not packaged as conventional equity instruments like stock dividends or capital gains, they include such opportunities as guaranteed discounts on purchased goods and services,[42] shares of appreciated patronage capital,[43] and interests in appreciated real estate.[44] Providing additional evidence that these privileges are, indeed, "property" of the sort the Code administers, interest holders in

37. *See* 124 CONG. REC. S17,421 (daily ed. Oct. 6, 1978) (statement of Sen. DeConcini) (noting that the term "property" should be "used in its broadest sense").

38. *See* H.R. REP. NO. 95-595, at 413-14 (1977) (implying through various statements that property must be monetizeable, including the statements that "property is to be valued as of the effective date of the [P]lan" and that "a valuation will almost always be required under section 1129(b) in order to determine the value of the consideration to be distributed under the [P]lan"); 124 CONG. REC. S17,420-21 (daily ed. Oct. 6, 1978) (implying that "property" under section 1129 must be of the nature that is alienable, or at least monetizeable).

39. H.R. REP. NO. 95-595, at 413.

40. *See supra* note 38.

41. *See* Hansmann, *supra* note 18, at 891.

42. *E.g.*, S. Pac. Transp. Co. v. Voluntary Purchasing Groups, Inc., 252 B.R. 373, 377 (E.D. Tex. 2000).

43. *E.g.*, *In re* E. Me. Elec. Coop., Inc., 125 B.R. 329, 339 (Bankr. D. Me. 1991).

44. *E.g.*, *In re* S.A.B.T.C. Townhouse Ass'n, 152 B.R. 1005 (Bankr. M.D. Fla. 1993).

mutual nonprofit debtors have been willing to offer cash contributions in exchange for their continued access to these financial opportunities.[45]

Finally, the incentive structure faced by the board members of a mutual nonprofit is akin to that of corporate executives or principal corporate shareholders: the directors have both an incentive and a medium through which to self-deal at the expense of creditors and other interest holders.[46] For these reasons, in a Plan confirmed by cram down, courts should determine whether the entity in question qualifies as a mutual nonprofit, and if so, forbid the pre-petition interest holders of the organization from retaining their interests unless the more senior classes of creditors are paid in full.

II. ADJUDICATING STRUCTURALLY AMBIGUOUS CASES

Some nonprofits may be particularly difficult to classify as predominantly entrepreneurial or mutual based solely on organizational features.[47] For instance, consider that a board of trustees of a university might be structured so that exactly half of its members are selected from students and alumni (who constitute the nonprofit's patrons) and half are independent and self-perpetuating.[48] Or, in other situations, courts might feel that a nonprofit's location along the entrepreneurial-mutual continuum inadequately reflects the actual gravity of absolute priority conflicts raised by its proposed Plan. This may arise when patron-directors exercise disproportionately more power over the organization than their representation on the board would suggest, or when an entrepreneurial nonprofit reveals future plans to transition toward a more mutual configuration. This Comment outlines other legal and policy considerations that should guide courts in applying absolute priority doctrine in such cases, in which structural factors are not dispositive. These

45. *See In re* Wabash Valley Power Ass'n, 72 F.3d 1305 (7th Cir. 1995). In fact, an entire legal doctrine, known as the "new value corollary" or the "new value exception" to the absolute priority rule, has been developed to deal with situations in which existing interest holders are willing to make new capital contributions in exchange for the right to retain an interest in the reorganized debtor through a Plan confirmed by cram down. This doctrine may be implicated in situations in which directors of mutual nonprofits attempt to confirm a Plan over the objection of a class of impaired creditors, but a full analysis of the subject is outside the scope of this Comment. For a more extensive explanation of the new value corollary and its application, see generally Brunstad & Sigal, *supra* note 10.

46. *See* DOUGLAS G. BAIRD & THOMAS H. JACKSON, CASES, PROBLEMS, AND MATERIALS ON BANKRUPTCY 967 (2d ed. 1990).

47. *See* Horwitz, *supra* note 3, at 145 (remarking that nonprofits can be "stubbornly resistant to classification").

48. *See* Hansmann, *supra* note 18, at 841-42.

considerations generally militate in favor of the debtor and indicate that courts ought to err on the side of accommodating an insolvent nonprofit's directors.

The issue of who manages a nonprofit debtor during its reorganization presents problems that management of a for-profit debtor does not. In the for-profit context, the interests of creditors and the interests of a company's directors are better aligned because successful management of the firm as a going concern means a higher likelihood that funds will be available to repay creditors.[49] Thus the creditors of an airline, for instance, have an interest in making sure that the individuals running the airline are competent in the airline business.

The interests of creditors and managers of a nonprofit overlap less.[50] Because the purpose of a nonprofit organization is not necessarily to generate earnings but rather to further a specific mission, the success of a nonprofit as a going concern may actually reduce the assets available to creditors. Thus creditors have an incentive to prevent control by even the most competent of administrators, because such competency may not result in a Plan most favorable to them.[51]

Due to these special conflicts of interest, courts that are initially unable to classify a nonprofit as either entrepreneurial or mutual face the task of balancing the importance of allowing a nonprofit's directors to remain in place against the importance of confirming a Plan that is consonant with the bankruptcy objective of maximizing repayment of debts. In this situation, a court might be tempted to defer to the general trend of societal support for

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49. *See In re* Timbers of Inwood Forest Assocs., Ltd., 808 F.2d 363, 373 (5th Cir. 1987) ("A principal goal of the reorganization provisions of the Bankruptcy Code is to benefit the creditors of the Chapter 11 debtor by preserving going-concern values and thereby enhancing the amounts recovered by all creditors."); Eric A. Posner, *The Political Economy of the Bankruptcy Reform Act of 1978*, 96 MICH. L. REV. 47, 53 (1997).

50. *See, e.g.*, Evelyn Brody, *The Charity in Bankruptcy and Ghosts of Donors Past, Present, and Future*, 29 SETON HALL LEGIS. J. 471 (2005) (describing various charity law doctrines that restrict the ability of nonprofit managers to utilize donations for repayment of creditors); Jonathan C. Lipson, *When Churches Fail: The Diocesan Debtor Dilemmas*, 79 S. CAL. L. REV. 363, 400-01 (2006) (explaining that unlike for-profit debtors in possession, the leadership of a religious nonprofit must balance the duties of their religious mission against their duties to creditors).

51. This was precisely the frustration expressed by creditors in the case *In re United Healthcare System, Inc.*, No. 97-1159, 1997 WL 176574 (D.N.J. Mar. 26, 1997), in which the directors of a nonprofit debtor that operated a children's hospital decided to arrange a sale of the hospital. Over the objection of creditors, the district court permitted the directors to reject the bid of the buyer who offered the highest price, allowing them to accept instead the offer of the buyer whose bid was superior in its commitment to the hospital's healthcare goals. *Id.* at *5.

nonprofit enterprises, but this trend should not be construed to prevail over section 1129's protection of creditors. While it is true, for example, that statutory law[52] and common law[53] principles protect the charitable and social missions of nonprofits, these advantages apply to entrepreneurial and mutual nonprofits alike—yet mutual nonprofits can be found to violate the absolute priority rule.[54]

Instead, courts should use two independent factors to help determine the manner in which a seemingly hybrid organization ought to be treated. First, courts must consider whether refusing to allow the directors or members of a nonprofit debtor to manage its operations would trigger any secondary constitutional, federal, or state legal problems and, if so, should err on the side of the debtor. Church parishes, for instance, should be treated as entrepreneurial, despite the fact that many parishes are organized according to a "corporation sole"[55] structure that is unique to religious entities[56] and that defies clear classification.[57] This favorable treatment is preferable because appointment of a secular trustee to manage the affairs of a nonsecular organization risks violation of the Establishment or Free Exercise Clauses.[58]

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52. These statutory advantages include tax exemption, I.R.C. § 501(c)(3) (2000), and protection from involuntary bankruptcy, 11 U.S.C. § 303(a) (2000).

53. These common law protections include the enforcement of charitable subscriptions, *see* RESTATEMENT (SECOND) OF CONTRACTS § 90(2) (1981), and trust law doctrines that protect certain donations from encroachment by creditors, *see* Brody, *supra* note 31.

54. *See supra* Section I.B.

55. A corporation sole is a one-person corporation, usually with power vested in a religious leader, which provides for a corporation to be administered without a board of directors, ownership shares, or other diffusion of control. A corporation sole, however, has a fiduciary duty, and sometimes a canonical duty, not to operate the corporation for the benefit of the sole. It is hotly debated whether this arrangement results in an equity-like interest or whether the corporation sole merely holds property in trust for the benefit of the religious group's members. *See, e.g.*, *In re* Catholic Bishop of Spokane, 329 B.R. 304, 321 (Bankr. E.D. Wash. 2005); Felicia Anne Nadborny, Note, *"Leap of Faith" into Bankruptcy: An Examination of the Issues Surrounding the Valuation of a Catholic Diocese's Bankruptcy Estate*, 13 AM. BANKR. INST. L. REV. 839, 850-53 (2005); Allison Walsh Smith, Comment, *Chapter 11 Bankruptcy: A New Battleground in the Ongoing Conflict Between Catholic Dioceses and Sex-Abuse Claimants*, 84 N.C. L. REV. 282, 319-22 (2005).

56. One state, Arizona, technically permits the formation of a corporation sole for the secular purpose of administering the property of a nonprofit scientific research institution. ARIZ. REV. STAT. ANN. § 10-11901 (2001). But the vast majority of corporation soles in the United States are organized for religious purposes. *See* Patty Gerstenblith, *Associational Structures of Religious Organizations*, 1995 BYU L. REV. 439, 454-58 & n.65 (1995).

57. *See supra* note 55.

58. *See* Ryan J. Donohue, Comment, *Thou Shalt Not Reorganize: Sacraments for Sale*, 22 EMORY BANKR. DEV. J. 293, 323-24 (2005).

Labor union debtors, to provide another example, may deserve deference in cases where alternative unions or means of collective bargaining are unavailable to workers. A strict application of section 1129 of the Code can create complications under the National Labor Relations Act,[59] which states that employees must be permitted to bargain through the representatives of their choice—unsurprisingly, the representatives favored by creditors or a bankruptcy court may not be the same as those preferred by employees.[60]

A second factor that courts might weigh is whether the public policy benefits achievable through a hybrid nonprofit's mission will be more desirable from the perspective of overall equity than the policy benefits achieved through maximizing repayment to creditors. This is an admittedly vague standard, and the introduction of subjective value judgments to determine which nonprofit debtors qualify risks a retreat toward the legal uncertainty that marks previous absolute priority doctrine regarding nonprofit insolvency.[61] Perhaps, therefore, this factor should be utilized only in the most difficult of cases, to break the proverbial "tie" in the event that an examination of organizational structure and secondary legal conflicts has led a court to an impasse.

Nevertheless, there are many objective factors to which a court can look for guidance in conducting its policy analysis. For instance, courts might consider the role that a nonprofit has played in its target community, as measured by the amount of money that the nonprofit has spent on charitable services, both in absolute terms and as a percentage of its total operating costs.[62]

Similarly, a court might take into account the level of government and public support for the type of organization in question by considering metrics such as government funding and protective legislation.[63] Grants and protective legislation for objectives like improved education and healthcare services far outweigh similar support for, say, country club and fraternity activities.[64] On

59. 29 U.S.C. § 157 (2000).

60. *See, e.g.*, *In re* Gen. Teamsters, 265 F.3d 869, 874-75 (9th Cir. 2001).

61. *See supra* notes 16-17 and accompanying text.

62. *See, e.g.*, Jack Needleman, *The Role of Nonprofits in Health Care*, 26 J. HEALTH POL. POL'Y & L. 1113, 1122 (2001). *See generally* ELLISON RESEARCH, AMERICANS' PERCEPTIONS OF THE FINANCIAL EFFICIENCY OF NON-PROFIT ORGANIZATIONS (2008), http://www.ellisonresearch.com/releases/0208_ERWhitePaper.pdf (presenting empirical research that shows that most Americans think nonprofits spend an unreasonable amount of their funds on overhead costs).

63. This approach must be pursued with caution, as it may be misleading in some contexts; for example, government funding of certain religious activities is constitutionally prohibited.

64. Even when such education and healthcare entities become insolvent, it is not uncommon for communities to intervene to provide financial and political support. *E.g.*, *In re* Whittaker

this basis, if a court examines an institution of higher education with both entrepreneurial and mutual qualities, social welfare considerations may reinforce the need for deference to the institution's incumbent management. On the other hand, in the case of a structurally hybrid country club, a logical result would be to find that post-petition retention of control by the club's directors violates the absolute priority rule.

CONCLUSION

The application of absolute priority to nonprofit debtors has produced contradictory court opinions. Underlying these cases is a judicial perspective so distracted by the exoticism of nonprofit bankruptcies that it overlooks the potential for their efficient administration. A nuanced legal framework can be constructed by identifying a nonprofit's entrepreneurial or mutual qualities and then by using those structural qualities as guideposts for an appropriate application of section 1129 of the U.S. Bankruptcy Code. This approach produces results that align with social and charitable policies as well as with the bankruptcy system's overarching goal of preserving going concerns while maximizing repayment of debts.

AMELIA RAWLS

Mem'l Hosp. Ass'n, 149 B.R. 812, 814 (Bankr. E.D. Va. 1993) (noting that community leaders convinced a city government to forgive a $150,000 debt owed by the nonprofit hospital debtor).