

## Chapter 11 Reorganization and the Fair and Equitable Standard: How the Absolute Priority Rule Applies to All Nonprofit Entities

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# CHAPTER 11 REORGANIZATION AND THE FAIR AND EQUITABLE STANDARD: HOW THE ABSOLUTE PRIORITY RULE APPLIES TO ALL NONPROFIT ENTITIES

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## INTRODUCTION

Historically, very few nonprofit entities<sup>1</sup> sought bankruptcy protection; rather, when faced with insurmountable financial difficulties, they simply dissolved.<sup>2</sup> In the wake of the financial crisis and in response to calls to operate more like for-profit businesses,<sup>3</sup> however, nonprofits have increasingly turned to bankruptcy, filing petitions and planning to reorganize. Since 2008, charities, churches, dairy and utility cooperatives, hospitals, the largest non-profit guarantor of private education loans, a monorail, museums, performing arts groups, and retirement communities have filed Chapter 11 petitions.<sup>4</sup>

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<sup>1</sup> The nonprofit sector encompasses a large and diverse set of organizations, including churches, hospitals, schools, social organizations, museums, legal service providers, and community cooperatives. Taken together, nonprofits hold more than \$1 trillion in assets and generate revenues of approximately \$700 billion per year. See Gail A. Lasprogata & Marya N. Cotten, *Contemplating "Enterprise": The Business and Legal Challenges of Social Entrepreneurship*, 41 AM. BUS. L.J. 67, 67 (2003). No one definition of a nonprofit entity covers all nonprofit entities. See, e.g., *id.* at 69 (noting that some nonprofits are more "entrepreneurial"). For the purposes of this Article, the only pertinent characteristic of nonprofits is their lack of equity holders similar in nature to equity holders of for-profit entities. For example, Title 11 of the United States Code (the "Bankruptcy Code") does not define "nonprofit." The term, however, is generally understood to include any organizational structure under which members, directors, or officers are precluded from receiving distributions of income. In the context of bankruptcy, § 501(c)(3) of the Internal Revenue Code, which grants tax-exempt status to organizations formed for certain purposes, is often referenced to determine nonprofit status, and covers organizations providing charitable, educational, health care, literary, religious, scientific, and various other services. Many states statutorily exclude towns, cities, and similar municipal entities from the definition of "nonprofit." See Andrew M. Troop, et al., *Reorganizing with Value but Without Profit (or Equity): Select Confirmation Issues for Nonprofit Entities*, 19 NORTON J. BANKR. L. & PRAC. 147, 148 (2010) (citing BLACK'S LAW DICTIONARY 1057 (6th ed. 1990); CONN. GEN. STAT. § 33-1002 (2009)). The Bankruptcy Code similarly distinguishes municipalities, with Chapter 9 of the Bankruptcy Code providing for reorganization of municipalities. See 11 U.S.C.A. § 109(c)(1) (West 2011).

<sup>2</sup> Stephanie Strom, *Bankruptcy Now Touching Nonprofits*, N.Y. TIMES, Feb. 20, 2009, at A17.

<sup>3</sup> *Id.*

<sup>4</sup> See, e.g., Bankruptcy Petition, *In re* Archdiocese of Milwaukee, No. 11-20059-svk (Bankr. E.D. Wis. Jan. 4, 2011); Bankruptcy Petition, *In re* Crystal Cathedral Ministries, No. 8:10-bk-24771-RK (Bankr. C.D. Cal. Oct. 18, 2010); Bankruptcy Petition, *In re* Naknek Elec. Ass'n, Inc., No. A10-00824 (Bankr. D. Alaska Sept. 29, 2010); Bankruptcy Petition, *In re* Saint Vincents Catholic Med. Ctrs. of N.Y., No. 10-11963-cgm (Bankr. S.D.N.Y. Apr. 14, 2010); Bankruptcy Petition, *In re* Las Vegas Monorail Co., No. 10-10464-bam (Bankr. D. Nev. Jan. 13, 2010); Bankruptcy Petition, *In re* Erickson Ret. Cmtys., No. 09-37010-sgj11 (Bankr. N.D. Tex. Oct. 19, 2009); Bankruptcy Petition, *In re* Catholic Diocese of Wilmington, Inc., No. 09-13560

Though the Bankruptcy Code does not prevent nonprofit entities from filing Chapter 11 petitions,<sup>5</sup> Chapter 11 of the Bankruptcy Code was designed for and is predominately applied to for-profit entities' structure and business objectives.<sup>6</sup> This history and orientation often creates challenges for courts administering nonprofit bankruptcies, most acutely in regards to reviewing a nonprofit's proposed plan of reorganization. With nonprofit bankruptcy filings on the rise, courts will be presented with nonprofits' reorganization plans more and more often, and they will be required to hone how the less applicable provisions of Chapter 11 interact with a nonprofit's plan. Simply because Chapter 11 does not contemplate nonprofits' unique structures and operational goals does not mean that the guiding policies behind the requirements of Chapter 11 should not apply with the same force and intention to nonprofits. In an effort to bring courts one step closer to applying the same rigorous approval criteria to nonprofits' reorganization plans, this Article focuses on one crucial aspect of courts' evaluation of plans—the fair and equitable standard.

This standard, set forth in Section 1129 of the Bankruptcy Code, requires that a plan of reorganization be “fair and equitable” as to each class of creditors or interest holders that is not paid in full<sup>7</sup> and does not vote to accept the plan.<sup>8</sup> The fair

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(Bankr. D. Del. Oct. 18, 2009); Bankruptcy Petition, *In re* Humboldt Creamery, LLC, No. 09-11078 (Bankr. N.D. Cal. Apr. 21, 2009); Bankruptcy Petition, *In re* St. Mary's Hosp., No. 09-15619-MS (Bankr. D.N.J. Mar. 9, 2009); Bankruptcy Petition, *In re* Nat'l Heritage Found., Inc., No. 09-10525-BFK (Bankr. E.D. Va. Jan. 24, 2009); Bankruptcy Petition, *In re* Balt. Opera Co., Inc., No. 08-26265 (Bankr. D. Md. Dec. 9, 2008); Bankruptcy Petition, *In re* Copia, No. 08-12576 (Bankr. N.D. Cal. Dec. 1, 2008); Bankruptcy Petition, *In re* The Educ. Res. Inst., Inc., No. 08-12540 (Bankr. D. Mass. Apr. 7, 2008).

<sup>5</sup> Section 109 of the Bankruptcy Code governs what entities may file a bankruptcy petition. 11 U.S.C.A. § 109 (West 2011). It allows a “person” to be a debtor under the Bankruptcy Code. *Id.* § 109(a). “Person” includes individuals, partnerships, and corporations. 11 U.S.C.A. § 101(41) (West 2011).

<sup>6</sup> Section 77B was added to the Bankruptcy Act of 1898 (the “Bankruptcy Act”) specifically to regulate the reorganization of corporations. Section 77B was superseded by Chapter X of the Bankruptcy Act, which similarly applied to corporations, and which remained in effect until the enactment of the Bankruptcy Code. *See infra* notes 54 & 58 and accompanying text.

<sup>7</sup> Such classes are deemed “impaired.” A class of claims or interests is “impaired” under a plan of reorganization if the plan alters the legal, equitable, or contractual rights of the class. 11 U.S.C. § 1124 (2006).

and equitable standard operates among classes of creditors and interest holders with different priorities, providing a vertical limit on nonconsensual confirmation.<sup>9</sup> The standard is triggered when a debtor or other plan proponent wishes to “cramdown”<sup>10</sup> a plan of reorganization over the objection of an impaired or dissenting class.

Although the Bankruptcy Code does not define what it means for a plan to be “fair and equitable,” at a minimum, it explicitly requires that the plan satisfy the “absolute priority rule.” Of pertinence to nonprofit reorganizations, the absolute priority rule provides that only if a debtor pays its creditors in full can owners receive any of the reorganized entity’s going

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<sup>8</sup> Section 1129 states sixteen potentially applicable criteria that a plan must meet in order to be confirmed. 11 U.S.C.A. § 1129(a) (West 2011). Pursuant to 11 U.S.C.A. § 1129(b)(1),

if all of the applicable requirements of subsection (a) of [Section 1129] other than paragraph (8) are met with respect to a plan, the court, on request of the proponent of the plan, shall confirm the plan notwithstanding the requirements of such paragraph if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.

Paragraph 8 of 11 U.S.C.A. § 1129(a) provides: “With respect to each class of claims or interests—(A) such class has accepted the plan; or (B) such class is not impaired under the plan.”

<sup>9</sup> Bruce A. Markell, *A New Perspective on Unfair Discrimination in Chapter 11*, 72 AM. BANKR. L.J. 227, 227–28 (1998); see also *In re Simmons*, 288 B.R. 737, 747 (Bankr. N.D. Tex. 2003) (“[T]he term ‘fair and equitable’ establishes in chapter 11 a test of vertical fairness . . . .”); *In re Dow Corning Corp.*, 244 B.R. 696, 703–04 (Bankr. E.D. Mich. 1999).

<sup>10</sup> For an explanation of “cramdown,” see generally Kenneth N. Klee, *All You Ever Wanted To Know About Cram Down Under the New Bankruptcy Code*, 53 AM. BANKR. L.J. 133 (1979); Richard Maloy, *A Primer on Cramdown—How and Why it Works*, 16 ST. THOMAS L. REV. 1 (2003); Isaac M. Pachulski, *The Cram Down and Valuation Under Chapter 11 of the Bankruptcy Code*, 58 N.C. L. REV. 925 (1980).

concern value.<sup>11</sup> Thus, owners of a company cannot retain ownership of the reorganized company unless each class of creditors consents or is paid in full.

Satisfaction of the absolute priority rule, however, does not guarantee that a court will find a proposed plan “fair and equitable.”<sup>12</sup> In not defining “fair and equitable,” the Bankruptcy Code leaves the doctrine to be developed by case law and an analysis of the origins of the standard.<sup>13</sup> Nonetheless, because the absolute priority rule is viewed as “the cornerstone of

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<sup>11</sup> See, e.g., Bruce A. Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations*, 44 STAN. L. REV. 69, 70 (1991) [hereinafter *Absolute Priority*]; Elizabeth Warren, *A Theory of Absolute Priority*, 1991 ANN. SURV. AM. L. 9, 9 (1991). The absolute priority rule is codified in 11 U.S.C.A § 1129(b)(2) (West 2011). Of pertinence, § 1129(b)(2)(B) reads:

(2) For the purpose of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements:

....

(B) With respect to a class of unsecured claims—

(i) the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or

(ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property . . . .

*Id.* § 1129(b)(2)(B).

“Owners” are those individuals and entities entitled under non-bankruptcy law to any surplus in the value of a debtor, such as shareholders and partners. *Absolute Priority*, *supra* note 11, at 70 n.2; see also 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 n.8 (1988) (defining “owners” to include any individual or entity that has a claim to the income stream or assets of the debtor). Going concern value is the difference between the liquidation value of a debtor and the value of the business if it continues operating. See H.R. REP. NO. 95-595, at 223 (1977).

<sup>12</sup> See, e.g., *Fed. Sav. & Loan Ins. Corp. v. D & F Constr., Inc.* (*In re D & F Constr. Inc.*), 865 F.2d 673, 675 (5th Cir. 1989) (“Section 1129(b)(2) sets minimal standards plans must meet. However, it is not to be interpreted as requiring that every plan not prohibited be approved. A court must consider the entire plan in the context of the rights of the creditors under state law and the particular facts and circumstances when determining whether a plan is ‘fair and equitable.’”); *East West Bank v. Ravello Landing, LLC*, 2:09-CV-02224-PMP-LRL, 2010 U.S. Dist. LEXIS 101007, at \*28–29 (D. Nev. Sept. 7, 2010) (noting that courts have described § 1129(b)(2) as “alternative minimum requirements for finding a plan fair and equitable” and that although meeting the requirements of § 1129(b)(2) is necessary for a plan to be confirmed, “it may not be sufficient for a fairness finding”); *In re Dollar Assocs.*, 172 B.R. 945, 952–53 (Bankr. N.D. Cal. 1994) (holding that a plan was not fair and equitable despite satisfying § 1129(b)(2)); Kenneth N. Klee, *Cram Down II*, 64 AM. BANKR. L.J. 229, 229 (1990) [hereinafter *Cram Down II*] (discussing “the uncodified aspects of the fair and equitable rule”).

<sup>13</sup> *Absolute Priority*, *supra* note 11, at 71–72.

reorganization practice and theory,”<sup>14</sup> it has largely become synonymous with the fair and equitable standard.<sup>15</sup> Accordingly, when creditors of a nonprofit argue that a nonprofit’s proposed plan of reorganization does not meet the fair and equitable standard, they typically claim that the plan violates the absolute priority rule.

When confronted with absolute priority claims in nonprofit bankruptcies, courts have struggled with how to apply the rule to plans that propose to allow pre-petition interest holders of the nonprofit—such as directors, managers, or members—to retain control of the nonprofit, or which appear to allocate going concern value of the nonprofit to pre-petition interest holders or the nonprofit itself without providing for or paying the nonprofit’s creditors in full. Because the majority of nonprofits do not have residual claimants similar to for-profit entities’ owners, any management rights or going concern value retained by these pre-petition interest holders or the nonprofit itself, seemingly by definition, does not flow to the equity holders that the absolute priority rule fundamentally addresses.<sup>16</sup> Nevertheless, conceptually, when a nonprofit’s plan allows directors or managers to retain control or allocates going concern value to members or merely to the nonprofit itself, creditors may view

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<sup>14</sup> *Id.* at 123.

<sup>15</sup> See, e.g., Charles D. Booth, *The Cramdown on Secured Creditors: An Impetus Toward Settlement*, 60 AM. BANKR. L.J. 69, 78 (1986) (“Much of the Congressional debate [regarding the Bankruptcy Code of 1979] revolved around the ‘fair and equitable’ standards which had been cast in the form of the ‘absolute priority rule’ . . . .”); Paul B. Lewis, *Bankruptcy Thermodynamics*, 50 FLA. L. REV. 329, 342 (1998) (“For impaired dissenting unsecured creditors, a plan is deemed to be fair and equitable if it satisfies the terms of the absolute priority rule.”).

<sup>16</sup> The Bankruptcy Code does not define “interest.” Courts generally hold that “interest” is limited to an equity interest in the debtor. See, e.g., *Osborn v. Univ. Med. Assocs.*, 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, Warehousemen & Helpers Union Local 890*, 225 B.R. 719, 736 (Bankr. N.D. Cal. 1998) (“An ‘interest’ is that which is held by an ‘equity security holder,’ pursuant to 11 U.S.C. § 501(a); an ‘equity security holder’ is defined by 11 U.S.C. § 101(17) as the ‘holder of an equity security of the debtor’; an ‘equity security’ is defined by 11 U.S.C. § 101(16) as a share in a corporation ‘or similar security’ (or certain warrants or rights concerning the same), or the interest of a limited partner in a limited partnership (or certain warrants or rights concerning the same).”). As specifically applied to the absolute priority rule, courts hold that “interest” means “equity interest.” *In re Wabash Valley Power Ass’n (Wabash II)*, 72 F.3d 1305, 1313 (7th Cir. 1995); see also *infra* Part I (detailing the development of the absolute priority rule).

such a plan as tantamount to the nonprofit's "owners" receiving value. And if the plan does not pay creditors in full, creditors will object.

The few courts that have decided absolute priority claims in nonprofit bankruptcies overall hold that because the majority of nonprofits do not have "owners" who hold "equity interests" resembling for-profit businesses' equity holders, the absolute priority rule is categorically satisfied by—and, thus, categorically inapplicable to—nonprofit entities. These courts have engaged in a fact-specific analysis of the ownership structure of the nonprofit at issue,<sup>17</sup> focusing particularly on the retained "interest" or "control" in question and considering whether the nonprofit substantively is more akin to a for-profit entity for the purposes of the rule.<sup>18</sup>

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<sup>17</sup> Some courts seemingly have concluded that the structural limitations of nonprofits render the absolute priority rule categorically inapplicable without the need for a fact-specific analysis of the ownership structure at issue. *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 Independence Vill., Inc.*, 52 B.R. 715, 726 (Bankr. E.D. Mich. 1985) ("[The debtor] is a non-profit corporation. It has no shareholders, hence there are no interests inferior to the unsecured creditors. Thus there should be little difficulty with the absolute priority rule . . . .") (citations omitted); Amelia Rawls, Comment, *Applying the Absolute Priority Rule to Nonprofit Enterprises in Bankruptcy*, 118 YALE L.J. 1231, 1233–34 (2009) ("[Some courts] 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. On the other hand, [other courts] have not inferred any inevitability about nonprofit compliance with absolute priority, applying the rule on fact-specific grounds to reject reorganization Plans that allowed old interests to be preserved."). These courts, however, only considered the absolute priority rule secondarily to their main analyses. Those courts that fully addressed the rule in the context of a nonprofit reorganization engaged in a fact-specific analysis of the subject nonprofit even if the court's ultimate conclusion was that the absolute priority rule did not apply to the "interest" or "control" retained. *See infra* Part III.

<sup>18</sup> *See, e.g., Sec. Farms v. Gen. Teamsters, Warehousemen and Helpers Union, Local 890 (In re Gen. Teamsters, Warehousemen & Helpers Union, Local 890)*, 265 F.3d 869, 876 (9th Cir. 2001) (holding that the contractual right to escheatment of a labor union's parent did not create any immediate ownership in the union for the purposes of the absolute priority rule, and thus affirming the bankruptcy court's confirmation of the plan); *Wabash II*, 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."); *S. Pac. Transp. Co. v. Voluntary Purchasing Grps., Inc.*, 252 B.R. 373, 388–89 (E.D. Tex. 2000) (holding that patronage stock was property of the debtor's members that they could not retain through reorganization unless creditors were paid in full).



Moreover, in line with the common perception that the absolute priority rule is synonymous with the fair and equitable standard, despite the reach of the standard beyond the rule, only one of the courts addressing absolute priority claims in the context of a nonprofit reorganization seemed to consider whether the nonprofit debtor had demonstrated that the standard was otherwise satisfied before holding the challenged plan to be “fair and equitable.”<sup>19</sup> At best, certain statements in a few other opinions indicate that those courts understood the fair and equitable standard to encompass more than the absolute priority rule.<sup>20</sup> In the end, once courts dispense with the absolute priority rule, they uniformly hold the challenged plan to be “fair and equitable.”

These courts have missed an opportunity to develop a body of case law that explains what “fair and equitable” means in the non-profit reorganizations. Though the statutorily codified absolute priority rule may not apply to nonprofits, or only in certain circumstances, the theory underlying the rule does not

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<sup>19</sup> See *Wabash II*, 72 F.3d at 1318 (stating that “[t]he absolute priority rule is an aspect of the requirement that a plan be ‘fair and equitable’” and that “[t]here is some appearance of unfairness in the Wabash Plan,” but then concluding that those aspects of the plan were not as unfair as they may seem at first blush). In addition, after addressing the absolute priority rule, the court in *In re Whittaker Memorial Hospital Ass’n*, further held that “[t]he plan is fair and equitable to creditors.” 149 B.R. 812, 816 (Bankr. E.D. Va. 1993). In so holding, the court wrote one sentence: “A single creditor is objecting and its particular complaints addressed.” *Id.* The relevant “complaints” were (1) that the plan violated the absolute priority rule, (2) that the plan provided for disparate treatment of unsecured creditors, and (3) that, because the plan violated the absolute priority rule and treated unsecured creditors disparately, the plan was not fair and equitable. *Id.* at 815. Disparate treatment is addressed by the Bankruptcy Code’s “unfair discrimination” standard and is distinct from the fair and equitable standard. See 11 U.S.C.A. § 1129(b) (West 2011); Markell, *supra* note 9, at 227–28 (explaining that the “unfair discrimination” and fair and equitable standards provide separate horizontal and vertical protections to creditors). Thus, the only aspect of the fair and equitable standard that the court considered was the absolute priority rule.

<sup>20</sup> See, e.g., *In re Gen. Teamsters*, 265 F.3d at 877 (“[T]he plan represented the [union]’s honest effort to satisfy the demands of its creditors.”); *In re Whittaker Mem’l Hosp.*, 149 B.R. at 817 (noting, in dicta, that “the debtor must give priority, next to the care of its patients, to the position of [a certain creditor] . . . [The creditor] is financing all of this and the debtor must be dedicated and determined that for [the creditor]’s sake the plan is successfully consummated.”); *In re Wabash Valley Power Ass’n (Wabash I)*, No. 85-2238-RWV-11, 1991 WL 11004220, at \*60 (Bankr. S.D. Ind. Aug. 7, 1991) (“Wabash’s Plan satisfies the economic underpinnings of the absolute priority rule because it converts every piece of economic property in Wabash into cash to be paid to its creditors.”).

lose its vitality in the context of a nonprofit's reorganization plan. If a nonprofit debtor proposes a plan that would not satisfy the absolute priority rule if the nonprofit's interest holders were equity holders of a for-profit entity, merely because the debtor is a nonprofit and the retained "interest" at issue does not rise to the level of a for-profit "interest," it does not follow that the plan is magically fair and equitable. These courts' failure to examine the parallels between for-profit and nonprofit reorganization and the interconnectedness of the absolute priority rule and the fair and equitable standard has nurtured scholarship that proposes a limited view of the absolute priority rule's relevance to nonprofit reorganization, advises that the rule is easily circumvented, and merely expresses dismay that the rule cannot be used by creditors of nonprofits.<sup>21</sup>

Reorganization aims to restructure an ailing business's operations, preserving value that may be lost through liquidation.<sup>22</sup> The absolute priority rule prohibits equity holders from receiving this value ahead of creditors until all creditors are paid in full. The rule provides a powerful check on the ability of a debtor to propose a plan of reorganization that simply is too good a deal for its owners, and, thereby, itself. As evidenced by case law addressing absolute priority claims in the context of nonprofit reorganization, however, the rule does not apply cleanly to nonprofit entities because of their lack of equity holders. This has lead courts overall to hold that the absolute priority rule is inapplicable to nonprofits. In so holding, courts have removed an essential check in the reorganization process. This Article proposes a theory that will restore this check by linking the absolute priority rule with the fair and equitable standard, making the rule robust enough to handle the non-traditional structures of nonprofit entities.

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<sup>21</sup> See, e.g., David A. Skeel, Jr., "Sovereignty" Issues and the Church Bankruptcy Cases, 29 SETON HALL LEGIS. J. 345, 355-58 (2005) (discussing how the absolute priority rule may not apply in church bankruptcies); Troop, *supra* note 1, at 148-53 (advising how to "[r]etain[] [c]ontrol [w]ithout [p]ayment in [f]ull[]"); Rawls, *supra* note 17, at 1234-35 (distinguishing between nonprofit entities with an "entrepreneurial" structure and a "mutual" structure and suggesting that the absolute priority rule should apply to "mutual" nonprofits).

<sup>22</sup> See H.R. REP. NO. 95-595, at 220 (1977) ("The purpose of a business reorganization case, unlike a liquidation case, is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors . . . . It is more economically efficient to reorganize than to liquidate . . . .").

The remainder of this Article proceeds in two stages. First, Parts II, III, and IV provide the background necessary to develop the theory. Part II chronicles the development of the fair and equitable standard and the absolute priority rule. This history is important to understanding the interconnectedness of the rule with the standard. Part III details the key functions of the absolute priority rule and the rule's application to for-profit entities, with an emphasis on concerns regarding its compatibility with close corporations. This review highlights how courts' current application of the absolute priority rule to nonprofits contravenes the rule's purposes and deviates from the rule's application to functionally similar for-profit entities, thereby creating situations in which plans that courts otherwise may reject are confirmed simply because the reorganizing entities are nonprofits. Next, before the Article sets forth a theory that reconciles this deviation, Part IV overviews the limited body of case law analyzing the rule's operation in nonprofit bankruptcies. This overview provides one of the first compilations of cases dealing with nonprofit bankruptcies and begins to create a history of nonprofit reorganization.

The last three parts of the Article develop a theory of how the absolute priority rule, by way of its core tenets, applies to all nonprofit entities through the fair and equitable standard. Combining the insights of Parts II and III with current case law, Part V first sets forth the theory and then provides examples of the theory's application. Part VI suggests criticisms of the theory and, responding to those criticisms, explores the implications of applying Chapter 11 to nonprofits. Finally, Part VII offers concluding thoughts about the expanded utility of the absolute priority rule.

## I. HISTORY OF THE FAIR AND EQUITABLE STANDARD AND THE ABSOLUTE PRIORITY RULE

### A. *Foundational Case Law*

Both the term "fair and equitable" and the absolute priority rule originated with the railroad insolvencies and equity receiverships of the late nineteenth and early twentieth

centuries.<sup>23</sup> Railroads were expanding rapidly and investors were freely contributing capital, but many of the railroads could not generate revenue sufficient to meet their debts. With the help of a creditor, the railroad would become subject to an “equity receivership.”<sup>24</sup> The receiver would sell the railroad’s assets to a newly created entity, which usually was controlled by the stockholders of the old railroad. To acquire the old railroad, after negotiating with bondholders, the “new” investors would pay an amount less than the total due on the old railroad’s senior debt, either paying off or issuing new debt to the bondholders and completely eliminating the old railroad’s unsecured debt. Through this rearranging of ownership and payment scheme, the old railroad would become the new railroad absent any unsecured debt and a portion of senior debt. Most importantly, the old railroad’s management, bondholders, and investors—who often were the same—would remain in control.<sup>25</sup>

Understandably, this trick enraged unsecured creditors. The best way for them to protest that the “old” stockholders were being treated unjustifiably favorably to the unsecured creditors’ detriment was to sue the “new” railroad and/or stockholders<sup>26</sup> and, relying on fraudulent conveyance law, argue that the foreclosure defrauded unsecured creditors.<sup>27</sup> The first time the

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<sup>23</sup> The history of the absolute priority rule has been detailed repeatedly since the enactment of the Bankruptcy Code. See, e.g., John D. Ayer, *Rethinking Absolute Priority After Ahlers*, 87 MICH. L. REV. 963, 969–79 (1989); Douglas G. Baird & Robert K. Rasmussen, *Boyd’s Legacy and Blackstone’s Ghost*, 1999 SUP. CT. REV. 393, 397–425 (1999); *Absolute Priority*, *supra* note 11, at 74–90; Pachulski, *supra* note 10, at 938–45. This Article highlights those aspects of its history most pertinent to the rule’s application to nonprofits.

<sup>24</sup> The creditor would initiate a proceeding in federal court, claim that the railroad could not meet its debts as they became due, and request “the court to use its equity power to administer the property for the satisfaction of claims, and to appoint a receiver to keep the business going in the meantime: hence, ‘equity receivership.’” Ayer, *supra* note 21, at 970.

<sup>25</sup> See *id.*; see also *Dish Network Corp. v. DBSD N. Am., Inc. (In re DBSD N. Am., Inc.)*, 634 F.3d 79, 94 (2d Cir. 2010); *In re Wabash Valley Power Ass’n (Wabash II)*, 72 F.3d 1305, 1314 (7th Cir. 1995); *Absolute Priority*, *supra* note 11, at 76.

<sup>26</sup> Because foreclosure courts, where the old railroad’s assets were sold, typically believed themselves limited to deciding the sale price, unsecured creditors’ remaining recourse was to attack the new railroad and stockholders. See Randolph J. Haines, *The Unwarranted Attack on New Value*, 72 AM. BANKR. L.J. 387, 398 (1998).

<sup>27</sup> Under common law, a transfer was considered fraudulent if it was intended to hinder, delay, or defraud creditors. See *Absolute Priority*, *supra* note 11, at 76; Baird & Rasmussen, *supra* note 23, at 398.

Supreme Court was presented with such a trick, instead of selling the railroad back to its original owners, the railroad merely sought to pay stockholders ahead of unsecured creditors.

In *Railroad Co. v. Howard*,<sup>28</sup> the railroad owed \$7 million to secured bondholders. Upon insolvency, the railroad's stockholders negotiated with the bondholders to sell the railroad to a newly-formed entity and to distribute the proceeds to the bondholders and stockholders.<sup>29</sup> As agreed, the new entity purchased the railroad for \$5.5 million and distributed sixteen percent to the stockholders.<sup>30</sup> Thereby, the secured bondholders received approximately \$5 million on their \$7 million claim, unsecured creditors received nothing, and the stockholders received approximately \$500,000.

Unsecured creditors asserted that the stockholders could not be paid before all unsecured creditors were paid in full.<sup>31</sup> In response, the bondholders argued that the payment to the stockholders did not originate from the railroad, but, rather, was property of the bondholders that they gratuitously gave to the stockholders so as to expedite the foreclosure sale.<sup>32</sup>

The Supreme Court began its analysis with two fundamental principles: the railroad's assets were "held in trust for the payment of the debts of the [railroad],"<sup>33</sup> and "[c]reditors are preferred to stockholders on account of the peculiar trust in their favor."<sup>34</sup> Next, it rejected the bondholders' contention that money paid to the stockholders belonged to the bondholders.<sup>35</sup> From there, it held that the unsecured creditors were entitled to the money distributed to the stockholders.<sup>36</sup>

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<sup>28</sup> 74 U.S. 392 (1868).

<sup>29</sup> *Id.* at 408.

<sup>30</sup> *Id.* at 408–09.

<sup>31</sup> *Id.* at 413.

<sup>32</sup> *R.R. Co. v. Howard*, 74 U.S. 392, 411 (1868).

<sup>33</sup> *Howard*, 74 U.S. at 409.

<sup>34</sup> *Id.* at 411.

<sup>35</sup> "Holders of bonds secured by mortgage as in this case, may exact the whole amount of the bonds, principal and interest, or they may, if they see fit, accept a percentage as a compromise in full discharge of their respective claims, but whenever their lien is legally discharged, the property embraced in the mortgage, or whatever remains of it, belongs to the corporation . . . Prompt payment was secured by the bondholders, and it is highly probable that they received under that arrangement a larger portion of their claims than they could have obtained in any other way."

*Id.* at 414–15.

<sup>36</sup> *Id.* at 410.

Perhaps the most pressing unanswered questions of *Howard* were whether the Court would have found for the unsecured creditors if the stockholders received ownership in the acquiring entity rather than cash<sup>37</sup> and whether unsecured creditors could agree to allow stockholders to receive payment or ownership.<sup>38</sup> Despite the outstanding issues coupled with the Court's clear statement of creditors' rights, railroad reorganizations continued in the same manner for the next forty-five years,<sup>39</sup> unabated even after the Supreme Court's first encounter with a fully manipulative equity receivership scheme.

In *Louisville Trust Co. v. Louisville, New Albany & Chicago Railway Co.*,<sup>40</sup> after entering into receivership, the railroad sold itself to the existing bondholders and stockholders, thereby ridding itself of troublesome unsecured debt.<sup>41</sup> Before striking down the scheme, the Supreme Court noted that the "peculiar character and conditions of" railroads as "[i]nstrument[s] of public service" justified the elevation of unsecured creditors as against "contract and recorded liens"<sup>42</sup> and then held that any sale "which attempts to preserve any interest or right of [the stockholders] in the [railroad] after the sale must necessarily secure and preserve the prior rights of general creditors thereof."<sup>43</sup> Following this statement, the Court announced what evolved into the absolute priority rule:

[S]tockholder's interest in the property is subordinate to the rights of creditors. First, of secured, and then of unsecured, creditors. And any arrangement of the parties by which the subordinate rights and interests of the stockholders are attempted to be secured at the expense of the prior rights of either class of creditors comes within judicial denunciation.<sup>44</sup>

Not until 1913 did the Supreme Court have a chance to bolster its position in *Howard*. When it did, it rendered an opinion that ushered in "[t]he modern law of corporate

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<sup>37</sup> See Haines, *supra* note 26, at 400; *Absolute Priority*, *supra* note 11, at 77 n.47.

<sup>38</sup> This question is most often linked with subsequent cases decided by the Supreme Court. See, e.g., Booth, *supra* note 15, at 72–74. Regardless, the question is equally applicable to *Howard*.

<sup>39</sup> Haines, *supra* note 26, at 400.

<sup>40</sup> 174 U.S. 674 (1899).

<sup>41</sup> *Id.* at 679–81.

<sup>42</sup> *Id.* at 682.

<sup>43</sup> *Id.* at 684.

<sup>44</sup> *Id.*

reorganizations”<sup>45</sup> and lead to the death of railroad receivership schemes that violated the fully articulated “absolute priority rule.”<sup>46</sup> As in *Howard and Louisville Trust, Northern Pacific Railway Co. v. Boyd*<sup>47</sup> involved a railroad selling itself to bondholders and stockholders without providing payment or property to unsecured creditors. Relying on fraudulent conveyance law, Boyd, an unsecured creditor, alleged that the old railroad’s debts to Boyd and other unsecured creditors became liabilities of the new entity upon transfer and that unsecured creditors must be paid before stockholders could receive property from the new entity.<sup>48</sup> The Court further noted that the property received by the new company was “property out of which the creditors were entitled to be paid before the stockholders could retain it for any purpose whatever.”<sup>49</sup> Thereby, *Boyd* announced a “fixed principle”<sup>50</sup> that

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<sup>45</sup> Baird & Rasmussen, *supra* note 23, at 397.

<sup>46</sup> See, e.g., *Dish Network Corp. v. DBSD N. Am., Inc. (In re DBSD N. Am., Inc.)*, 634 F.3d 79, 99 (2d Cir. 2010) (noting that the Supreme Court “finally set down the ‘fixed principle’ that we now call the absolute priority rule” in *N. Pac. Ry. Co. v. Boyd*, 228 U.S. 482, 507 (1913).); *Absolute Priority*, *supra* note 11, at 78 (“After *Boyd*, reorganizations would never be the same.”). The term “absolute priority rule” originated in the article *Two Rival Theories of Priority Rights of Security Holders in a Corporate Reorganization* by James C. Bonbright and Milton M. Bergerman, 28 COLUM. L. REV. 127 (1928). As discussed below, *Boyd* did not adopt the absolute priority rule, but, rather, what is termed the “fair offer” standard. See *infra* note 53 and accompanying text. Thereby, *Boyd* engendered debate as to whether its articulated standards required a senior class be paid in full before any value could be distributed to a junior class—that is, an “absolute priority rule”—or merely required that a senior class receive payment or property of greater value than that received by a junior class—that is, a “relative priority rule.” See Haines, *supra* note 26, at 401–02; *Absolute Priority*, *supra* note 11, at 82. This debate was resolved in *Case v. Los Angeles Lumber Products Co.*, with the Supreme Court’s statement that “fair and equitable” are “words of art which . . . had acquired a fixed meaning through judicial interpretations”: “the absolute or full priority doctrine of the *Boyd* case . . .” 308 U.S. 106, 115, 123 (1939). The Court confirmed its upholding of the absolute priority rule two years later in *Consolidated Rock Products Co. v. Du Bois*, 312 U.S. 510 (1941). Nevertheless, the standard adopted in *Boyd* substantively mirrors the absolute priority rule codified in 11 U.S.C.A. § 1129(b)(2) (West 2011). See Edward S. Adams, *Toward a New Conceptualization of the Absolute Priority Rule and Its New Value Exception*, 1993 DET. C.L. REV. 1445, 1455–56 (1993).

<sup>47</sup> 228 U.S. 482 (1913).

<sup>48</sup> *Id.* at 501; see also *Absolute Priority*, *supra* note 11, at 79 n.62 (“The arguments of counsel for the [new entity] make clear that Boyd alleged that the sale of the [r]ailroad’s assets to the [new entity] was fraudulent as to his claim against the [r]ailroad.”).

<sup>49</sup> *Boyd*, 228 U.S. at 508. The Court concluded that it did not matter that the sale price of the railroad was less than the debt owed to bondholders:

[T]he question must be decided according to a fixed principle, not leaving the rights of the creditors to depend upon the balancing of evidence as to

creditors must receive property or payment on account of their interests before equity can receive anything on account of its interests.<sup>51</sup> Under *Boyd*, this requirement translated to creditors receiving a “fair offer.”<sup>52</sup> Congress codified *Boyd*’s concepts of a “fair offer” and a “fixed principle” as the fair and equitable standard and the absolute priority rule.

### B. Statutory Codification

The rule announced in *Boyd* and subsequently honed in several Supreme Court cases<sup>53</sup> was first included in the 1933 and 1934 amendments to the Bankruptcy Act, which added Sections 77 and 77B.<sup>54</sup> Sections 77 and 77B each required that a court find a plan “fair and equitable”<sup>55</sup> before confirming it, thereby codifying *Boyd*’s “fair offer” concept.<sup>56</sup> In addition, the

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whether, on the day of sale, the property was insufficient to pay prior encumbrances . . . . If the value of the [rail]road justified the issuance of stock in exchange for old shares, the creditors were entitled to the benefit of that value, whether it was present or prospective, for dividends or only for purposes of control.

*Id.* at 507–08.

<sup>50</sup> *Case*, 308 U.S. at 116.

<sup>51</sup> See Haines, *supra* note 26, at 401; *Absolute Priority*, *supra* note 11, at 80–81.

<sup>52</sup> See Haines, *supra* note 26, at 402; *Absolute Priority*, *supra* note 11, at 81; see also Baird & Jackson, *supra* note 11, at 744 (“The basic lesson of *Boyd* . . . is that leaping over an intermediate class triggers special scrutiny.”).

<sup>53</sup> See, e.g., *Ecker v. W. Pac. R.R. Corp.*, 318 U.S. 448, 452–53 (1943) (discussing valuation); *Marine Harbor Props., Inc. v. Mfrs. Trust Co.*, 317 U.S. 78, 85 (1942) (“Under the rule of [*Boyd*] and [*Case*], a plan of reorganization would not be fair and equitable which in such circumstances admitted the stockholders to participation, unless the stockholders made a fresh contribution in money or in money’s worth in return for ‘a participation reasonably equivalent to their contribution.’” (quoting *Case*, 308 U.S. at 121)); *Consol. Rock Prods. Co. v. Du Bois*, 312 U.S. 510, 520 (1941) (discussing valuation); *Case*, 308 U.S. at 122 (confirming that *Boyd* adopted the absolute priority rule); *Kan. City Terminal Ry. Co. v. Cent. Union Trust Co.*, 271 U.S. 445, 454–55 (1926) (articulating what has become known as the “new value exception” to the absolute priority rule).

<sup>54</sup> Section 77 applied to railroad corporations and Section 77B applied to other corporations. Act of Mar. 3, 1933, ch. 204, § 77, 47 Stat. 1467, 1474; Act of June 7, 1934, ch. 424, § 77B, 48 Stat. 911, 912. The original Bankruptcy Act contained no provisions for reorganization, and, consequently, no “fair and equitable” principle.

<sup>55</sup> As originally enacted, Section 77 only required that a plan be “equitable.” Act of Mar. 3, 1933 § 77(g). After the adoption of Section 77B, in 1935, the words “fair and” were added before “equitable.” Act of Aug. 27, 1935, ch. 774, § 77(e)(1), 49 Stat. 911, 918.

<sup>56</sup> Neither Section 77 nor Section 77B state that claims must be paid according to an “absolute priority rule.” Rather, in *Case*, the Supreme Court held that “fair and



Bankruptcy Act's "fair and equitable" requirement was stricter than the Bankruptcy Code's: it applied to each individual creditor regardless of whether the plan was accepted by all classes of creditors.<sup>57</sup>

Chapter X superseded Section 77B of the Bankruptcy Act in 1938 and remained in effect until the enactment of the Bankruptcy Code in 1978.<sup>58</sup> It similarly required that a plan be "fair and equitable" regardless of whether the plan was accepted by all classes of creditors.<sup>59</sup> And the Supreme Court subsequently confirmed that the absolute priority rule equally applied to Chapter X.<sup>60</sup> In 1938, Congress also added Chapter XI to the Bankruptcy Act. Chapter XI dealt with the reorganization of unsecured debt and initially contained the same "fair and equitable" requirement as Chapter X. Reflecting Chapter XI's aim to encourage settlement, Congress deleted the "fair and equitable" standard in 1952.<sup>61</sup>

The Bankruptcy Code brought sweeping reforms to the field of bankruptcy. It made two significant changes to the application of "fair and equitable" and the absolute priority rule. First, drawing upon Chapter XI of the Bankruptcy Act, the fair and equitable standard allows for consensual plans that are not "fair and equitable" and only applies to classes of creditors.<sup>62</sup> This

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equitable" as used in these Sections are "words of art" that include the absolute priority rule. *Case*, 308 U.S. at 115, 123.

<sup>57</sup> Section 77 provided that unsecured debts were discharged if "two-thirds in amount of such creditors shall have accepted the plan in writing." Act of Mar. 3, 1933 § 77(h)(6). Section 77B provided that confirmation required two-thirds of each creditor class vote to confirm a plan. Act of June 7, 1934, § 77B(e)(1) (repealed 1938). Courts, however, could ignore the creditors' vote and confirm the plan. *See Absolute Priority*, *supra* note 11, at 83 n.94. Confirmation discharged "all creditors, secured or unsecured." Act of June 7, 1934, ch. 424, § 77B(g)(3), 48 Stat. 911, 920 (repealed 1938); *see also Absolute Priority*, *supra* note 11, at 88 n.124 (noting that individual creditors could challenge a plan based on the "fair and equitable" requirement, allowing individual creditors to "bargain for every last dollar of going concern value"); Pachulski, *supra* note 10, at 938.

<sup>58</sup> The Chandler Act was adopted on June 22, 1938. Chandler Act, ch. 575, 52 Stat. 883 (1938). Chapter X was codified at 11 U.S.C. §§ 501-676 (1976) (repealed 1978).

<sup>59</sup> 11 U.S.C. § 621(2) (1976) (repealed 1978).

<sup>60</sup> *Consol. Rock Prods. Co. v. Du Bois*, 312 U.S. 510, 530-31 (1941).

<sup>61</sup> Act of July 7, 1952, ch. 579, § 35, 66 Stat. 420, 433.

<sup>62</sup> Pursuant to 11 U.S.C. § 1129(a), § 1129(b) only applies if a class of impaired creditors or interest holders does not accept a plan. 11 U.S.C.A § 1129(a)(8) (West 2011); *see also Booth*, *supra* note 15, at 79 ("[S]ection 1129(a) harks back to Chapter XI . . .").

relaxation of the strict requirement of Chapter X that a plan must be “fair and equitable” as to each individual creditor stemmed from a desire to encourage deal making and settlement with debtors.<sup>63</sup> In place of the absolute priority rule, individual creditors receive the “best interests of creditors” test, thus ensuring that each creditor recovers at least the liquidation value of its claim, but allowing excess going concern value to be distributed to classes of creditors based on negotiations amongst themselves and with the debtor.<sup>64</sup>

Second, drawing upon Chapter X of the Bankruptcy Act, Section 1129(b) formally articulates the absolute priority rule.<sup>65</sup> Section 1129(b)(2) provides three distinct, but substantively similar requirements of what is “fair and equitable”: one for secured classes, one for unsecured classes, and one for classes of interest.<sup>66</sup> Moreover, the text of Section 1129(b)(2) makes the absolute priority rule a mandatory, but not sufficient, condition to finding that a plan is “fair and equitable.”<sup>67</sup> The term “includes,” which the Bankruptcy Code specifically states is open-ended,<sup>68</sup> grants courts the ability to and almost demands that they continue to develop what constitutes *Boyd’s* “fair offer.”

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<sup>63</sup> See, e.g., Richard F. Broude, *Cramdown and Chapter 11 of the Bankruptcy Code: The Settlement Imperative*, 39 BUS. LAW. 441, 443 (1984) (“Early in the process, most of the knowledgeable commentators on bankruptcy concluded that, if not abandoned completely, the absolute priority rule should be modified in major respects. The importance of deal-making in the reorganization process was recognized.”).

<sup>64</sup> 11 U.S.C.A. § 1129(a)(7); see also *Absolute Priority*, *supra* note 11, at 88 (“Once the creditor received its liquidation value, the [Bankruptcy] Code allocated the surplus of going concern value over liquidation value by democratic vote within and among *classes* of creditors.”).

<sup>65</sup> See Booth, *supra* note 15, at 79 (“[S]ection 1129(b) [harkens back] to Chapter X.”).

<sup>66</sup> 11 U.S.C.A. § 1129(b)(2).

<sup>67</sup> *Id.* at § 1129(b)(2) (“[T]he condition that a plan be fair and equitable with respect to a class *includes* the following requirements . . .” (emphasis added)); see, e.g., Baird & Rasmussen, *supra* note 23, at 417–18 (“The structure of the clause invites us to see the specific requirement that equityholders receive nothing on account of their prior interest as an integral component of a ‘fair and equitable’ plan . . . . However much judges continue to refine the ‘fair and equitable’ standard, they cannot return to a regime of relative priority.”); *Cram Down II*, *supra* note 12, at 230.

<sup>68</sup> 11 U.S.C. § 102(3) (2006) (noting that “includes” is “not limiting”); see also *supra* note 12.

Legislative history further makes clear that Section 1129(b) requires that a court consider more than the absolute priority rule when determining if a plan is “fair and equitable.”

Overall, Congress crafted Section 1129(b) with the aim to moderate the effects of Chapter X's strict application of the absolute priority rule, but still retain the core insights of the “fair offer” concept that led to the “fair and equitable” principle. The *Report of the Bankruptcy Commission* (“*Report*”), delivered in 1973, significantly influenced Congress's initial draft of the bill that would become the Bankruptcy Code.<sup>69</sup> The *Report* essentially proposed to gut the absolute priority rule. It recommended that broad discretion be given to bankruptcy courts to allow equity to receive a portion of the debtor's going concern value even if creditors were not paid in full,<sup>70</sup> and that individual shareholders be permitted to participate in the reorganized company if the court determined they would make an “essential” contribution.<sup>71</sup> The *Report* engendered strong criticism and heated debate.<sup>72</sup> Taking this criticism and the compromises reached among the business, academic, and government sectors into account,<sup>73</sup> Congress considerably tempered the *Report's* recommendation.

The House submitted the first draft of what would become Section 1129(b). The House's initial attempt contained the simple statement that a court could confirm a plan “if such plan is fair and equitable with respect to all classes except any class that has accepted the plan.”<sup>74</sup> Before being sent to the Senate,

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<sup>69</sup> COMM'N. ON THE BANKR. LAWS OF THE U.S., REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 93-137, pt. 1 (1973). Part II contains the Commission's proposed bill. *Id.* pt. 2.

<sup>70</sup> *Id.* pt. 2, at 242.

<sup>71</sup> *Id.* at 258; see also *Absolute Priority*, *supra* note 11, at 87 n.117 (discussing the H.R. DOC. NO. 93-137).

<sup>72</sup> See, e.g., Walter J. Blum & Stanley A. Kaplan, *The Absolute Priority Doctrine in Corporate Reorganizations*, 41 U. CHI. L. REV. 651, 651–52 (1974); Victor Brudney, *The Bankruptcy Commission's Proposed “Modifications” of the Absolute Priority Rule*, 48 AM. BANKR. L.J. 305, 308 (1974) (“[T]he Commission both proclaims its attachment to the absolute priority rule and proposes effectively to abolish the rule.”); *Absolute Priority*, *supra* note 11, at 87–88 nn.118–120 (citing statements of representatives from the business, academic, and government sectors); Note, *The Proposed Bankruptcy Act: Changes in the Absolute Priority Rule for Corporate Reorganizations*, 87 HARV. L. REV. 1786, 1786–87 (1974).

<sup>73</sup> See *Absolute Priority*, *supra* note 11, at 88.

<sup>74</sup> As initially introduced, § 1129(b) of H.R. 6 read:

the House revised its draft to define “fair and equitable” treatment without using the words “fair and equitable” but, rather, by listing multiple examples of what constituted a “fair and equitable” plan, including that a plan must satisfy the absolute priority rule.<sup>75</sup> The House described its final submission as a “partial codification” of the absolute priority rule and as focused on allocating the going concern value of a debtor to creditors.<sup>76</sup>

The Senate’s input led to important changes to the House’s bill, which were included in the enacted Section 1129(b). The final version effectively combined the initial and final version of the House’s bill. The first subsection explicitly incorporated the words “fair and equitable,” harkening back to the House’s initial draft, and the second subsection provided three examples of what is “fair and equitable,” adopting a portion of the House’s definitions of “fair and equitable.”<sup>77</sup> Congress made clear that the second subsection’s examples were not an exhaustive list of what constituted “fair and equitable” treatment: “[M]any of the factors interpreting ‘fair and equitable’ . . . , which were explicated in the description of section 1129(b) in the House report, were omitted from the House amendment . . . [T]he

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(b) If all of the requirements of subsection (a) of this section other than paragraph (8) are met with respect to a plan, the court, on request of the proponent of such plan, shall confirm such plan notwithstanding such paragraph if such plan is fair and equitable with respect to all classes except any class that has accepted the plan and that is comprised of claims or interests on account of which the holders of such claims or interests will receive or retain under the plan not more than would be so received or retained under a plan that is fair and equitable with respect to all classes. H.R. 6, 95th Cong. § 1129(b) (as initially introduced Jan. 4, 1977).

<sup>75</sup> H.R. 6, 95th Cong. § 1129(b) (as introduced in Mar. 21, 1977); H.R. 7330, 95th Cong., § 1129(b) (as introduced in May 23, 1977); H.R. 8200, 95th Cong. § 1129(b) (as introduced in July 11, 1977); and H.R. 8200, 95th Cong. § 1129(b) (as introduced in Sept. 8, 1977).

<sup>76</sup> HOUSE COMM. ON THE JUDICIARY, BANKRUPTCY LAW REVISION, H.R. REP. NO. 95-595, at 223, 414 (1977) (“[C]reditors are entitled to be paid according to the going-concern value of the business.”).

<sup>77</sup> H.R. 8200, 95th Cong., 2d Sess., 124 CONG. REC. 32,350 (1978). Despite these changes, the statements in the House’s committee report retain their vitality: “[I]n lieu of a Conference Report, [Congress] read virtually identical statements into both the House and Senate records on the bill. As noted at the time, Congress believed that this procedure imbued such remarks with ‘the effect of being a conference report.’” *Absolute Priority*, *supra* note 11, at 89 n.131 (citations omitted) (quoting 124 CONG. REC. 32,391 (1978) (statement of Rep. Rousselot)).

deletion is intended to be one of style and not one of substance.”<sup>78</sup> Omitted concepts include the requirements that no creditor receive more than its non-bankruptcy entitlement, that no senior class receive more than 100 percent of its claims if there is a dissenting class, that a senior dissenting class be compensated if it loses priority relative to a junior class, and that no “worthless securities” be issued.<sup>79</sup> Most importantly, this list demonstrates “the open texture of the statute,”<sup>80</sup> inviting courts to extrapolate from legislative history and case law what amounts to a “fair and equitable” plan.

## II. FUNCTION AND TRADITIONAL APPLICATION OF THE ABSOLUTE PRIORITY RULE

As evident by its historical and legislative underpinnings, at its core, the absolute priority rule is about fraudulent conveyance.<sup>81</sup> It protects creditors by guaranteeing that a court will not confirm a plan that subordinates their claims to the benefit of the debtor’s equity holders without the creditors’ consent. Consequently, it reassures creditors that they will receive all available going concern value up to the amount of their claims unless they agree otherwise. Only once all creditors’ claims are satisfied in full can a plan allocate any remaining going concern value elsewhere.<sup>82</sup> The absolute priority rule thereby prevents equity holders from taking advantage of any insider status or colluding with senior creditors to get rid of intermediate claimants. If such a rule did not exist, as manifested by the railroad reorganizations that gave rise to the rule, senior creditors and equity holders—who also may be management—or other junior claimants seemingly could agree to give intermediate creditors’ property to equity holders or other

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<sup>78</sup> 124 CONG. REC. 34,006 (1978) (statement of Sen. DeConcini); *see also id.* at 32,407 (statement of Rep. Edwards); *Absolute Priority*, *supra* note 11, at 89 (“[C]ourts were not to exclude other components and interpretations.”).

<sup>79</sup> *Cram Down II*, *supra* note 12, at 231–44; *Absolute Priority*, *supra* note 11, at 90; Pachulski, *supra* note 10, at 944.

<sup>80</sup> *Absolute Priority*, *supra* note 11, at 90.

<sup>81</sup> *See, e.g.*, Baird & Jackson, *supra* note 11, at 746 (noting that the type of transaction that gave rise to the absolute priority rule “is viewed as a conveyance that, by preferring holders of equity interests over creditors, violates the payout norms implicit in the debtor-creditor relation”).

<sup>82</sup> *See supra* note 11.

junior claimants without these creditors' consent.<sup>83</sup> By prohibiting such conveyances, the absolute priority rule "vindicate[s] the reasonable expectations formed by claimants when their investments or loans were made"<sup>84</sup> and mitigates "the danger inherent in any reorganization plan proposed by a debtor . . . that the plan will simply turn out to be too good a deal for the debtor's owners."<sup>85</sup> It likewise upholds the Bankruptcy Code's fundamental goal of ensuring that debtors provide for creditors as much as possible through payment or other property.<sup>86</sup>

The absolute priority rule also grants creditors, particularly unsecured creditors,<sup>87</sup> a crucial negotiation tool. Stripped of the ability to demand that debtors treat them "fair and equitable" via the absolute priority rule, unsecured creditors lose one of their only and perhaps most valuable bargaining chips.<sup>88</sup> Unsecured

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<sup>83</sup> *But see* Baird & Jackson, *supra* note 11, at 788–89 (arguing that "[o]ne of the attractions of the *Boyd* rule at first meeting is that it appears to respond to a freeze-out problem that neither non-bankruptcy law nor market sales can prevent," but that "the presence of owners junior to the residual owner [i.e., creditors] who would have a right to assets of the firm in absence of default . . . does not require a special set of rules").

<sup>84</sup> *Falcon Capital Corp. S'holders v. Osborne (In re THC Fin. Corp.)*, 679 F.2d 784, 785 (9th Cir. 1982) (quoting *In re U.S. Fin., Inc.*, 648 F.2d 515, 519 (9th Cir. 1980)).

<sup>85</sup> *Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434, 444 (1999).

<sup>86</sup> *See, e.g., Ransom v. FIA Card Servs., N.A.*, 131 S. Ct. 716, 725 (2011) (noting that one of the purposes of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 was "to ensure that [debtors] repay creditors the maximum they can afford" (quoting H.R. Rep. No. 109-31, pt. 1, p. 2 (2005) (internal quotation marks omitted)); *United Savs. Assoc. of Texas v. Timbers of Inwood Forest Assocs., Ltd. (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."); Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97, 103 (1984) (theorizing that the foremost goal of bankruptcy is to enhance creditors' collection efforts); Warren, *supra* note 11, at 12–13 (articulating "the principal reason for a reorganization" as "to enhance return to the creditors and to increase the opportunity for reorganization of the business").

<sup>87</sup> Secured creditors have other negotiation tools at their disposal, such as the § 1111(b) election. 11 U.S.C.A. § 1111(b) (West 2011).

<sup>88</sup> *Official Comm. of Unsecured Creditors v. Henry Mayo Newhall Mem'l Hosp. (In re Henry Mayo Newhall Mem'l Hosp.)*, 282 B.R. 444, 453 (B.A.P. 9th Cir. 2002) (noting that creditors who are unable to assert the absolute priority rule are "in an unusually disadvantaged negotiating position"); Raymond T. Nimmer, *Negotiated*

creditors are less able to object to valuation of the debtor as a going concern and to argue that going concern value is being allocated—either explicitly or covertly—away from the unsecured creditors to whom it belongs.<sup>89</sup> This has the potential to skew the loss allocation system embodied in the Bankruptcy Code and to disrupt the baseline from which negotiations start and return during a bankruptcy proceeding.<sup>90</sup> Though this baseline affects public companies and close corporations differently, it uniformly thwarts attempts to divert value from senior claimants to junior claimants—most typically owners—without the senior claimants' consent.

#### A. *General Application to For-Profit Companies*

As an initial matter, it is important to understand that the going concern value of a reorganizing company is available for distribution to creditors before equity holders.<sup>91</sup> If the reorganizing company instead were liquidated either through a Chapter 7 or Chapter 11 proceeding, the debtor-in-possession or trustee would sell the bankruptcy estate more or less piece-meal and disburse any recovery according to the Bankruptcy Code's priority scheme.<sup>92</sup> One of the main benefits of reorganization is that reconstituting a company as a whole through a bankruptcy proceeding plan may preserve value that likely would be lost during a liquidation.<sup>93</sup> As theorized by Professor Elizabeth

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*Bankruptcy Reorganization Plans: Absolute Priority and New Value Contributions*, 36 EMORY L.J. 1009, 1038 (1987).

<sup>89</sup> See Nimmer, *supra* note 88, at 1038 (“[T]he [fair and equitable] standard permits the debtor to confirm a plan of reorganization and the owners to retain control despite dissent of a class of creditors so long as the plan meets the applicable financial test.”).

<sup>90</sup> See *id.* at 1038–39 (noting that the fair and equitable standard “involve[s] loss allocation” and that it “create[s] a baseline below which the debtor’s reorganization plan cannot be taken”); Omer Tene, *Revisiting the Creditors’ Bargain: The Entitlement to the Going-Concern Surplus in Corporate Bankruptcy Reorganizations*, 19 BANKR. DEV. J. 287, 354 (2003) (“Bankruptcy is a legal forum for bargaining and negotiation among various classes of investors in a financially distressed firm under the auspices of a federal court.”).

<sup>91</sup> The filing of a bankruptcy petition creates a bankruptcy estate. This estate becomes the legal and equitable owner of all property of the pre-bankruptcy company, including “control and ownership of the business and its going-concern value.” Warren, *supra* note 11, at 11.

<sup>92</sup> See 11 U.S.C.A. § 507 (West 2011).

<sup>93</sup> See *supra* note 86 and accompanying text (discussing the fundamental goals of bankruptcy); COLLIER ON BANKRUPTCY ¶ 1100.01 (16th ed. 2010) (“[C]ontinued

Warren, when a court confirms the reorganizing debtor's bankruptcy plan, the entirety of the bankruptcy estate effectively is "sold" to the post-reorganization company.<sup>94</sup> This sale includes the going concern value of the reorganized company, which remains available for distribution to creditors prior to equity holders.<sup>95</sup>

Three distinct entities take part in a reorganization: the pre-bankruptcy company, the bankruptcy estate, and the post-reorganization company.<sup>96</sup> These separate entities necessarily are overseen by discrete management teams, even if the actual individuals do not differ. As supervisors of the bankruptcy estate, during the pendency of a Chapter 11 reorganization case, management works to maximize the sale price of the reorganizing company and then offers the resulting bundle of real, personal, and intangible property held by the bankruptcy estate to the owners of the post-reorganization company.<sup>97</sup> The price paid may take the form of debt satisfaction and other contributions, but it nonetheless results in the post-reorganization company's purchasing the bankruptcy estate, which includes control and ownership of the reorganized company and the business's going concern value.<sup>98</sup> Because the sale of the bankruptcy estate is governed by the Bankruptcy

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operation can save the jobs of employees, the tax base of communities, and generally reduce the upheaval that can result from termination of a business.").

<sup>94</sup> See Warren, *supra* note 11, at 11.

<sup>95</sup> See *id.* at 11–12; Baird & Jackson, *supra* note 11, at 745 ("Where the firm continues, the general creditors, but for the restructuring, might have something of value that the restructuring takes away and gives to the shareholder. Even though the firm will likely not be able to pay off the [creditors], the possibility that the firm will do much better than expected makes the general creditors' right to reach the assets of the firm before the shareholders worth something.").

<sup>96</sup> The concept of three entities being involved in a reorganization is proposed by Professor Warren: "The debtor gives way to the bankruptcy estate at the time of the initial filing, the estate gives way to the post-bankruptcy entity on confirmation of a plan, and the post-bankruptcy business survives the confirmation." Warren, *supra* note 11, at 12.

<sup>97</sup> See *id.* at 12 ("The [debtor-in-possession] reshapes the business through assumption and rejection of contracts, setting aside voidable preferences, dropping unprofitable ventures and pursuing new business plans.").

<sup>98</sup> See *id.*; 11 U.S.C. § 1123 (2006).



Code's priority scheme, unless the relevant parties agree otherwise, distribution of the purchase price should go to creditors ahead of equity holders and other junior claimants.<sup>99</sup>

Against this backdrop stands the absolute priority rule. Because Chapter 11 and the absolute priority rule were designed for larger companies with equity,<sup>100</sup> in the typical for-profit company case, the rule's application is easily summarized:

A rule that prohibits old equity from retaining any interest in the post-bankruptcy business on account of its earlier interest in the pre-bankruptcy debtor simply restates the rules creating the estate: upon filing, the bankruptcy estate owns *all* interests, legal and equitable, of the pre-bankruptcy debtor. No one retains any interest in property of the estate—not the secured creditors, not the unsecured creditors, and not the old owners of the estate. Creditors may file claims for payment and payout from the estate which will be determined according to detailed statutory provisions. Old owners may come back to claim control only with the consent of creditors or if the creditors are paid in full. No legal rights carry through from any relationships with the pre-bankruptcy debtor to relationships with the post-bankruptcy company.<sup>101</sup>

Indeed, the absolute priority rule mirrors and thereby supports the structure and principles of reorganization outlined above. Given the unambiguous statutory mandate that senior claimants be paid in full before junior claimants receive any payment or property on account of their claims,<sup>102</sup> combined with courts' interpretation of the term "interest" as specifically referencing equity,<sup>103</sup> courts universally apply the absolute priority rule to for-profit companies and reject reorganization plans which propose to allocate property to equity holders without paying creditors in full.<sup>104</sup> Questions as to the rule's

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<sup>99</sup> See 11 U.S.C.A. §§ 507, 1129(a) (West 2011); Baird & Jackson, *supra* note 11, at 745 ("[The general creditors'] objection . . . goes to the shareholder's recapture of an interest in the firm . . . [T]he general creditors should be able to object if the old shareholder recovers something over which the general creditors have a prior claim and does so by means of a transaction in which the general creditors have no voice.").

<sup>100</sup> See Nimmer, *supra* note 88, at 1056.

<sup>101</sup> Warren, *supra* note 11, at 13.

<sup>102</sup> See *supra* note 11; 11 U.S.C.A. § 1129(b) (West 2011).

<sup>103</sup> See *supra* note 16.

<sup>104</sup> See, e.g., *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 202 (1988) ("Under current law, no Chapter 11 reorganization plan can be confirmed over the

application predominantly arise when old equity holders seek to retain an interest in the reorganized company without paying creditors in full, but offer to contribute new capital to the reorganized company. If old equity holders supply a “new” and “substantial” contribution that is “necessary for an effective reorganization,” “reasonably equivalent” in value to their retained interest, and in the form of “money or money’s worth,” courts generally will allow old equity holders to receive ownership in the reorganized company.<sup>105</sup> This scenario has become known as the “new value exception” or “new value corollary” to the absolute priority rule and has generated scholarly debate principally around the existence of a true “exception” and valuation of the contributed capital.<sup>106</sup>

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creditors’ legitimate objections . . . if it fails to comply with the absolute priority rule.”); *In re Armstrong World Indus.*, 432 F.3d 507, 508–09 (3d Cir. 2005) (upholding denial of plan confirmation where plan proposed to distribute warrants to equity holders over the objection of a class of unsecured creditors not paid in full pursuant to the plan); *Coltex Loop Cent. Three Partners v. BT/SAP Pool C Assocs.* (*In re Coltex Loop Cent. Three Partners*), 138 F.3d 39, 40 (2d Cir. 1998) (upholding denial of plan confirmation where plan proposed to allow equity to retain interests in the reorganized limited partnership and to pay unsecured creditors ten percent on their claims); *Liberty Nat’l Enters. v. Ambanc La Mesa Ltd. P’ship.* (*In re Ambanc La Mesa Ltd. P’ship.*), 115 F.3d 650, 652 (9th Cir. 1997) (holding that partnership’s proposed plan violated absolute priority rule where creditors were not paid in full and equity holders retained interests in excess of contributions these holders made to the reorganized partnership); *In re Woodbrook Assocs.*, 19 F.3d 312, 316, 322 (7th Cir. 1994) (upholding finding that real estate limited partnership’s proposed plan violated the absolute priority rule).

<sup>105</sup> For a discussion of these criteria, see Ralph A. Peeples, *Staying In: Chapter 11, Close Corporations and the Absolute Priority Rule*, 63 AM. BANKR. L.J. 65, 78–99 (1989) and Warren, *supra* note 11, at 43–44. For a discussion of the minority of courts holding that this “exception” or “corollary” to the absolute priority rule did not survive the enactment of the Bankruptcy Code, see Warren, *supra* note 11, at 36, 39–40. Most recently, in *Bank of America National Trust & Savings Ass’n v. 203 North LaSalle Street Partnership*, the Supreme Court assumed that the “exception” or “corollary” did survive the enactment of the Bankruptcy Code, though the Supreme Court declined to rule on the precise question. 526 U.S. 434, 435 (1999).

<sup>106</sup> See, e.g., Adams, *supra* note 46, at 1450 (discussing how to ensure that equity holders “contribute the fair market price for the interests they are retaining”); *Absolute Priority*, *supra* note 11, at 124 (concluding that “a new value exception to the absolute priority rule simply does not exist”); Warren, *supra* note 11, at 41 (arguing that the Bankruptcy Code allows equity to participate in a reorganized debtor even if creditors have not been paid in full based upon the “bargain . . . old equity proposes to purchase control of the post-reorganization business”); see also 203 N. LaSalle, 526 U.S. at 444–49 (discussing the history of the “new value corollary” (or ‘exception’)).

### B. *Specific Application to Close Corporations*

Owners of close corporations often encounter problems with the absolute priority rule and retaining interests in the reorganized entity.<sup>107</sup> Their interaction with the rule highlights one side of the issues that arise when courts confront the absolute priority rule in non-traditional contexts. As developed in Part V of this Article, contrasting these dilemmas with the impediments courts have found in applying the absolute priority rule to nonprofits helps illustrate how the core tenets of the rule are relevant to all nonprofit reorganizations.

To satisfy the absolute priority rule, either a reorganization plan can give claimholders of the objecting class “property of a value, as of the effective date of the plan, equal to the allowed amount of such claim,”<sup>108</sup> or the plan proponent can demonstrate

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<sup>107</sup> Prior to the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”), owners of sole proprietorships who filed Chapter 11 petitions as individual debtors also anticipated encountering similar problems with the absolute priority rule as outlined in this sub-part. In BAPCPA, Congress amended § 1129(b)(2)(B)(ii) of the Bankruptcy Code—the absolute priority rule as applicable to unsecured creditors—to provide that a plan of reorganization is fair and equitable if “the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property, *except that in a case in which the debtor is an individual, the debtor may retain property included in the estate under section 1115.*” Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 321(c)(2), 119 Stat. 23, 95 (codified as amended at 11 U.S.C.A. § 1129(b)(2)(B)(ii) (West 2011)) (emphasis added). As stated by one commentator: “it appears that Congress intended the § 1129(b)(2) exception to ameliorate the harsh effects that the absolute priority rule had on individual Chapter 11 debtors [, such as sole proprietors,] by permitting the retention of certain property of the estate in exchange for satisfying the § 1129(a)(15) requirement to pay future disposable income or ‘sweat equity’ into the plan.” Michael P. Coury, *Sweat Equity Redux: Does the Absolute Priority Rule Survive for Individual Chapter 11 Cases?*, NORTON BANKR. L. ADVISER, Feb. 2011, at 1, 3.

Since the enactment of BAPCPA, courts addressing absolute priority claims in the context of plans proposed by Chapter 11 individual debtors have produced split decisions regarding whether Congress intended the complete abrogation of the absolute priority rule for Chapter 11 individual debtors by way of this amendment. Some courts hold that the rule does not apply to these debtors. *See, e.g., In re Shat*, 424 B.R. 854, 856 (Bankr. D. Nev. 2010); *In re Roedemeier*, 374 B.R. 264, 276 (Bankr. D. Kan. 2007); *In re Tegeder*, 369 B.R. 477, 478 (Bankr. D. Neb. 2007). Other courts hold that § 1129(b)(2)(B)(ii)’s exception only includes property added to the bankruptcy estate by § 1115 and, thus, the absolute priority rule applies to pre-petition property. *See, e.g., In re Mullins*, 435 B.R. 352, 359–60 (Bankr. W.D. Va. 2010); *In re Gelin*, 437 B.R. 435, 442–43 (Bankr. M.D. Fla. 2010); *In re Gbadebo*, 431 B.R. 222, 229–30 (Bankr. N.D. Cal. 2010).

<sup>108</sup> 11 U.S.C.A. § 1129(b)(2)(B)(i) (West 2011).

that holders of junior claims or interests will not receive anything under the plan.<sup>109</sup> If a public company does not have enough cash to pay the claims of an objecting class in full, the company's plan can provide that the debtor will issue and distribute securities, such as stock, in the reorganized company to fulfill the remainder of the claims. Equity holders can then receive the same or other securities, thereby retaining interest in the reorganized company.<sup>110</sup>

This distribution method, however, is unavailable to close corporations, which cannot offer creditors a liquid ownership stake in the reorganized company. Instead, owners of troubled close corporations, who often are the directors and key employees of these entities, must find a new source of "money or money's worth" to contribute to the reorganized entity if they want to retain ownership of their business. The absolute priority rule, notwithstanding the "new value exception," prevents owners of close corporations from reorganizing their businesses without the consent of creditors more often than owners of public companies.<sup>111</sup>

Courts and commentators have long lamented the divergent results of the application of the same rule to different for-profit entities.<sup>112</sup> In particular, they point to the unique role owners serve in close corporations, particularly limited partnerships and other similar entities, and to the problems these owners face in attracting investors.<sup>113</sup> Taken together, they suggest that the

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<sup>109</sup> *Id.* § 1129(b)(2)(B)(ii).

<sup>110</sup> *See* Peeples, *supra* note 105, at 76 ("Although difficult to value in advance, the securities can at least be sold or traded by the holders of the claims. Thus, the managers of a public company can avoid having to confront the danger of eliminating the old equity owners.").

<sup>111</sup> Perhaps because of this result, empirical research demonstrates "that in small business cases, the owner/operator tends to retain control through a consensual plan while discharging some debt." Warren, *supra* note 11, at 17.

<sup>112</sup> Decades before the enactment of the Bankruptcy Code, the Supreme Court noted that the absolute priority rule had the potential to preclude reorganizing close corporations from retaining the owners and managers best equipped to run the reorganized entity. *See* *Case v. L.A. Lumber Prods. Co.*, 308 U.S. 106, 117 (1939); *In re Wabash Valley Power Ass'n (Wabash II)*, 72 F.3d 1305, 1314 (7th Cir. 1995) ("[I]n recognition of the fact that prior owners may sometimes be the best 'buyers' of a reorganized corporation, courts are reluctant to squeeze the old owners out entirely."); *see also* Nimmer, *supra* note 88, at 1068–81; Peeples, *supra* note 105, at 77.

<sup>113</sup> *See supra* note 112; Warren, *supra* note 11, at 15–16.

absolute priority rule be relaxed in these instances to allow owners to retain an interest in—and thereby control of—the reorganized entity even if creditors are not paid in full.<sup>114</sup>

For instance, commentators recommend that a “best efforts” standard similar to that applicable to Chapter 12 and Chapter 13 proceedings be applied to close corporations and similar entities.<sup>115</sup> Owners could remain in control, but they would need to use their “best efforts” to allocate all available funds to repaying creditors. As with Chapter 12 and Chapter 13 plans, this standard would balance the rights of creditors to payment with the benefit of allowing those individuals best able to increase payment to creditors to manage the reorganized business.<sup>116</sup> Moreover, application of the “best efforts” standard seemingly would comport with the underlying tenets of the absolute priority rule. Though old owners may retain an interest in the reorganized business in order to maintain management control, creditors would receive all going concern value of the reorganized entity until they were paid in full before the old owners could be allocated any value.<sup>117</sup>

Regardless, at present, unless the owners of close corporations reach a consensual agreement with creditors, the absolute priority rule operates and the owners may not retain an interest in their reorganized businesses unless creditors are paid in full or the owners contribute “money or money’s worth” equal to their retained interest.<sup>118</sup> As detailed in the next Part of this Article, because nonprofit entities typically lack “owners” akin to

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<sup>114</sup> See, e.g., Nimmer, *supra* note 88, at 1050–51; Peeples, *supra* note 105, at 95.

<sup>115</sup> See, e.g., Nimmer, *supra* note 88, at 1070–81; Peeples, *supra* note 105, at 103–07.

<sup>116</sup> See Nimmer, *supra* note 88, at 1070 (“The ‘best effort’ model is a rule of debtor protection based on equitable and financial effects. The rule benefits the individual who makes an effort, but ensures that the creditors receive what is realistically available from the debtor. It converts the creditor’s contract right to full payment into a right to a best effort from the debtor to repay.”).

<sup>117</sup> The main concerns with allowing owners to provide “value” to their reorganized companies other than “money or money’s worth” are (1) that other types of “value,” such as labor and managerial skills, are difficult to quantify; (2) that if creditors wanted the owners to remain in control, they would strike a deal with them, and courts should not upset the creditors’ decision; and (3) that the unique position and insider status of owners of close corporations and similar entities afford them too great an ability to depress or skew the going concern value of the reorganized entity. See, e.g., *Wabash II*, 72 F.3d at 1314; Warren, *supra* note 11, at 17–18.

<sup>118</sup> See *supra* note 111.

for-profit entities' equity holders, the few courts that have addressed how the absolute priority rule applies to nonprofits hold that the rule generally is presumptively satisfied, or in the limited circumstances in which it is not, that it applies only when the nonprofit's structure essentially transforms the nonprofit into a for-profit for purposes of the rule.<sup>119</sup> Consequently, in contrast to a close corporation's owners, who direct and manage the business, current case law potentially allows a nonprofit's directors, managers, and members to retain control of the nonprofit post-reorganization without a clear requirement that a nonprofit's plan provide as much payment as possible to creditors until creditors are paid in full.

### III. THE ABSOLUTE PRIORITY RULE'S CURRENT APPLICATION TO NONPROFIT ENTITIES

The few courts that have decided absolute priority claims in nonprofit bankruptcies overall hold that the absolute priority rule is categorically satisfied by nonprofit entities, except in limited circumstances, even if the nonprofit had members and those members, along with the nonprofit's managers and directors, retained control of the reorganized nonprofit. In arriving at this conclusion, these courts engaged in a fact-specific analysis of the membership and control structure of the nonprofit at issue, often trying to squeeze the nonprofit into the inapposite framework of Chapter 11's plan confirmation provisions, and sometimes criticizing their inability to apply a key creditor protection to the plan at hand. Many of these cases lack an analysis of the retention of going-concern value by managers, directors, members, or the nonprofit itself, value which owners and the entity would not be allowed to retain if the nonprofit was structured more like a for-profit entity.

There are three main cases addressing absolute priority claims in nonprofit bankruptcies. The first court to opine on the issue was the Bankruptcy Court for the District of Maine in 1991.<sup>120</sup> A rural electric cooperative filed a Chapter 11 petition

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<sup>119</sup> Courts often find that the absolute priority rule is categorically satisfied in nonprofit reorganizations, which is another way of saying that analysis of the rule is unnecessary and that the rule does not apply.

<sup>120</sup> *In re E. Me. Electric Coop., Inc.*, 125 B.R. 329 (Bankr. D. Me. 1991). The first court to mention the issue was the Bankruptcy Court for the Eastern District of Michigan in 1985. A life-care facility for the elderly filed a Chapter 11 petition and

after making a financially burdensome investment.<sup>121</sup> Similar to other utility cooperatives, the cooperative allocated “patronage stock” to its members.<sup>122</sup> The cooperative’s proposed plan sought to pay those members holding patronage stock a pro rata share of approximately \$200,000 on account of the stock and a percentage return on their membership fees, and to pay unsecured creditors less than the full amount of their claims.<sup>123</sup> Certain unsecured creditors objected to the accompanying disclosure statement, arguing that payment on account of the stock and fees violated the absolute priority rule.<sup>124</sup>

After reviewing the statute under which the cooperative was organized and the function of patronage stock, the court concluded that the stock constituted the equivalent of an ownership interest in the cooperative substantively distinct from, and thus junior to, debt and unsecured claims.<sup>125</sup> Accordingly,

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certain bondholders moved to lift the automatic stay. *In re Independence Vill., Inc.*, 52 B.R. 715 (Bankr. E.D. Mich. 1985). In support of their motion, the bondholders argued that the facility was so insolvent that it could not reorganize. *Id.* at 726. The court found the argument “unpersuasive”: “[The debtor] is a non-profit corporation. It has no shareholders, hence there are no interests inferior to the unsecured creditors. Thus there should be little difficulty with the absolute priority rule . . . . Thus a severe cramdown of unsecured debt may not be an insurmountable problem in a plan of reorganization.” *Id.* (citations omitted).

<sup>121</sup> *In re E. Me. Electric Coop.*, 125 B.R. at 331.

<sup>122</sup> *Id.* at 332. Patronage stock—also called “patronage capital”—refers to a portion of excess revenues of a utility that is collected by the cooperative to smooth fluctuations in its expenses: “Because of the difficulty of anticipating exactly what the costs of producing power will be, utilities sometimes collect excess revenues . . . . Patronage capital . . . refers to a portion of this excess revenue which [the cooperative’s bylaws] allow it to retain in order to cover fluctuations in production costs and to make capital expenditures without having first to raise rates and accumulate the necessary funds.” *Wabash II*, 72 F.3d at 1315–16. The cooperative eventually must repay these excess revenues to members. Thus, the cooperative’s bylaws provide that members are allocated patronage stock according to their respective purchases of energy. The cooperative’s board determines the timing of repayment on the patronage stock at their discretion, similar to the payment of dividends in a for-profit corporation. *See id.* at 1316; *In re E. Me. Electric Coop.*, 125 B.R. at 332.

<sup>123</sup> *In re E. Me. Electric Coop.*, 125 B.R. at 331–32.

<sup>124</sup> *Id.* at 334.

<sup>125</sup> *Id.* at 339. The court predominately focused on the fact that repayment of the patronage stock was at the discretion of the cooperative’s directors, which made the patronage stock distinct from “claims [that] have one feature in common: there exists or may come to exist a set of facts, capable of proof, that will require the debtor to encounter liability, whether it chooses to do so or not.” *Id.* at 338 n.42. In contrast, “allocated patronage capital the directors have not voted to retire remains an ownership interest.” *Id.* at 339.

the court held that the absolute priority rule precluded members from receiving property or payment on account of the stock unless creditors were satisfied in full,<sup>126</sup> declared the proposed plan unconfirmable, and disapproved the disclosure statement.<sup>127</sup> Though a nonprofit, the cooperative's governing statute and documents allowed the court to transform the cooperative's members into the equivalent of for-profit equity holders for the purposes of the absolute priority rule, creating one of the limited circumstances in which the rule is not categorically satisfied by—or inapplicable to—a nonprofit. The proposed plan sought to pay the cooperative's equivalent of equity holders ahead of unsecured creditors, giving them money that belonged to unsecured creditors, and the court appropriately rejected the scheme.

Several months later, the Bankruptcy Court for the Southern District of Indiana found that the absolute priority rule was satisfied, via its inapplicability,<sup>128</sup> by a plan put forth by another struggling electric cooperative with similar “patronage capital.”<sup>129</sup> The plan provided that unsecured claims would not be paid in full and that the cooperative's members would retain control of the reorganized nonprofit.<sup>130</sup> Certain creditors objected, citing the absolute priority rule. The court rejected their argument, finding that an “equity interest” necessary for the rule's application included two attributes—control and sharing in profits—the second of which was not inherent in members' patronage capital because applicable state law required any surplus upon liquidation to be escheated to the state. This escheatment precluded members from “any profiteering at the creditors' expense.”<sup>131</sup> The court further noted that the plan “satisfies the economic underpinnings of the

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<sup>126</sup> *Id.* at 339.

<sup>127</sup> *Id.* at 339–40. The court also held that members did not have any interest in their membership fees and, thus, no claim for repayment: “Again, proposing any distribution on account of such claims with neither consent nor full payment of senior claims creates an unconfirmable plan.” *Id.* at 339.

<sup>128</sup> *See infra* note 133.

<sup>129</sup> *In re Wabash Valley Power Ass'n (Wabash I)*, No. 85-2238-RWV-11, 1991 WL 11004220, at \*5 (Bankr. S.D. Ind. Aug. 7, 1991).

<sup>130</sup> *Id.* at \*3.

<sup>131</sup> *Id.* at \*60.



absolute priority rule because it converts every piece of economic property in [the cooperative] into cash to be paid to its creditors.”<sup>132</sup>

On appeal,<sup>133</sup> the Seventh Circuit upheld the bankruptcy court's ruling, identifying three components of an “equity interest”—control, profit share, and ownership of corporate assets—and similarly highlighting the cooperative's inability to pay profits to members in finding that the plan did not violate the absolute priority rule.<sup>134</sup> Focusing also on the control component of an “equity interest,” the Seventh Circuit analyzed the effect of members' retention of control of the reorganized cooperative both on the application of the absolute priority rule and, more cursorily, on the fairness of the proposed plan. It concluded that control alone did not amount to an “equity interest”<sup>135</sup> and that members' control was necessary and

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<sup>132</sup> *Id.* This statement demonstrates that though the court technically found the absolute priority rule satisfied, it substantively found the rule inapplicable to the cooperative: if the absolute priority rule operated, the court would have had no need to state explicitly that its core tenets were satisfied. Also, as discussed below, on appeal, the Seventh Circuit upheld the bankruptcy court's conclusion. *See infra* notes 135–138 and accompanying text. Later, in confirming a labor union's reorganization plan, the Bankruptcy Court for the Northern District of California characterized the Seventh Circuit's ruling as holding “that the Absolute Priority Rule did not apply under such circumstances.” *In re Gen. Teamsters, Warehousemen & Helpers Union Local 890*, 225 B.R. 719, 736 (Bankr. N.D. Cal. 1998).

<sup>133</sup> During the interim years, two more bankruptcy courts encountered absolute priority objections in the context of nonprofit reorganization. First, in *In re Whittaker Memorial Hospital Ass'n*, the debtor hospital nonstock, membership corporation proposed to pay certain creditors less than the full amount of their claims while allowing “a junior class of creditors” to remain in control without contributing new value. 149 B.R. 812, 815 (Bankr. E.D. Va. 1993). The court held that the plan did not violate the absolute priority rule because “retaining control over the debtor entity” did not give the junior class “anything” and “nothing beyond control . . . passe[d] to it.” *Id.* at 816.

Second, and in contrast, in *In re S.A.B.T.C. Townhouse Ass'n*, the debtor nonprofit corporation homeowners' association proposed to pay unsecured creditors a portion of the full amount of their claims and to allow association members to retain their interests in the reorganized nonprofit. 152 B.R. 1005, 1008 (Bankr. M.D. Fla. 1993). Without any analysis, the court assumed that the members' interests were “interests” subject to the absolute priority rule and then proceeded to analyze whether the members had contributed “new value.” *Id.* at 1008–11. Because the court found that the members had not contributed “new value,” it held that the plan violated the absolute priority rule. *Id.* at 1011.

<sup>134</sup> *In re Wabash Valley Power Ass'n (Wabash II)*, 72 F.3d 1305, 1315–18 (7th Cir. 1995).

<sup>135</sup>

important.<sup>136</sup> Moreover, the Seventh Circuit reiterated that the cooperative's plan, mainly because it allowed its members—for whom the cooperative was created and to whom the cooperative was most valuable—to remain in control, maximized the going concern value of the reorganized nonprofit and, most importantly, allocated that value to the cooperative's creditors.<sup>137</sup> Regardless of whether the absolute priority rule was categorically satisfied—or inapplicable—the plan still met the underlying goals of the rule and was “fair and equitable” to creditors who were saddled with the same “owners” despite not being paid in full.

Six years later,<sup>138</sup> in 2001, the Ninth Circuit published the next—and last—major decision regarding the absolute priority rule's application to nonprofit entities.<sup>139</sup> A local labor union affiliated with the International Brotherhood of Teamsters (“International”) and the Teamsters Joint Council No. 7 (“JC7”)

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The mere fact that the [members of the cooperative] are benefited by [the cooperative]'s operation and might be disadvantaged by its demise also does not give them an ‘interest’ cognizable in bankruptcy. Employees, managers and customers, among others, always have an interest, in the broadest sense, in a corporation. The factor which distinguishes these parties from stockholders is not ‘control’ per se (managers, after all, have at least a limited control) but the ability to make use of that control to generate profits or to increase their own share of profits.

*Id.* at 1318–19.

<sup>136</sup> *Id.* at 1318 (“[S]ince [the cooperative] was specifically designed to supply its own Members, their continuation as customers in control of [the cooperative] is a means of maximizing the value of the estate for the benefit of creditors.”).

<sup>137</sup> *Id.* at 1312–13 (“The value of [the cooperative] to its Members exceeds its value to any third-party buyer because [the cooperative] is tailored exactly to the Members’ requirements . . . . The bankruptcy court found that the [cooperative’s proposed plan] provided the maximum amount that [creditors] could possibly obtain. It met the requirements of 11 U.S.C. § 1129(b) and was confirmable.”).

<sup>138</sup> In the interim, one more court published an opinion addressing the absolute priority rule's application to nonprofit entities. In *Southern Pacific Transportation Co. v. Voluntary Purchasing Groups, Inc.*, a nonprofit agricultural cooperative proposed a plan that would pay holders of patronage stock while paying approximately 19% on unsecured claims. 252 B.R. 373, 385 (E.D. Tex. 2000). Relying on *Wabash II*, the cooperative argued that the patronage stock should be characterized as debt. The court held that the plan violated the absolute priority rule, finding that the patronage stock should be classified as equity based upon an analysis of governing state law. *Id.* at 388–89. Ultimately, the court remanded the case to the bankruptcy court to determine whether the new value exception was satisfied. *Id.* at 390.

<sup>139</sup> *Sec. Farms v. Gen. Teamsters, Warehousemen & Helpers Union, Local 890 (In re Gen. Teamsters, Warehousemen & Helpers Union, Local 890)*, 265 F.3d 869 (9th Cir. 2001).

submitted a plan of reorganization that proposed to distribute to creditors an amount equal to the equity in the debtor's real and tangible personal property financed through the reorganized union's borrowing against these assets.<sup>140</sup> The plan further provided that any gain from a sale or refinancing of these assets during the five years post-confirmation would be distributed to unsecured creditors.<sup>141</sup> Certain unsecured creditors objected to the plan, contending that the reorganized union should raise member dues and/or terminate the union's affiliations with International and JC7, thereby eliminating the cooperative's "per capita tax" obligations to them, in order to increase the amount paid to unsecured creditors.<sup>142</sup>

These creditors additionally argued that the plan violated the absolute priority rule because the union would continue to exist and own its property without paying unsecured creditors in full.<sup>143</sup> As clarified on appeal, they also maintained that International had an equity interest in the union by way of a provision in its contract with the union that escheated the union's assets to International upon the union's liquidation.<sup>144</sup> The union's plan distributed property to International on account of its secured and unsecured claims; if International received this property, the objecting creditors insisted that International provide new value.<sup>145</sup>

In addressing the absolute priority rule arguments, the bankruptcy court began by noting that

[i]n the case of a Chapter 11 debtor that is a corporation or partnership, the Absolute Priority Rule prevents the shareholders or partners from receiving anything on account of

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<sup>140</sup> *In re Gen. Teamsters, Warehousemen & Helpers Union Local 890*, 225 B.R. 719, 722 (Bankr. N.D. Cal. 1998).

<sup>141</sup> *Id.*

<sup>142</sup> *Id.* "Per capita tax" is the per-member portion of a local labor union's dues that it must remit to the national or international "parent" unions with which it affiliates. Severing ties with International and JC7 would have saved the cooperative \$6.50 per member per month. *Id.* at 724. The bankruptcy court, and later the Ninth Circuit, considered this an argument that the plan was not proposed in good faith in violation of 11 U.S.C. § 1129(a)(3). *In re Gen. Teamsters*, 265 F.3d at 877; *In re Gen. Teamsters*, 225 B.R. at 722.

<sup>143</sup> *In re Gen. Teamsters*, 225 B.R. at 735.

<sup>144</sup> *In re Gen. Teamsters*, 265 F.3d at 872; see also *In re Gen. Teamsters*, 225 B.R. at 736.

<sup>145</sup> *In re Gen. Teamsters*, 265 F.3d at 872.

their interests in the corporation or partnership, and from retaining the benefits of such interests, unless all creditors have been paid in full . . . .<sup>146</sup>

The bankruptcy court then confirmed that the union “is an unincorporated nonprofit association . . . whose members have no ownership interest in [the union] akin to that of shareholders of a corporation or partners of a partnership”<sup>147</sup> and that the plan did not provide that International would “receive or retain anything ‘on account of its escheat rights . . . .’”<sup>148</sup> After discussing the Seventh Circuit’s opinion, the bankruptcy court concluded that the absolute priority rule did not apply to the union’s plan.<sup>149</sup> In dicta, however, it lamented the uneasy fit of “traditional bankruptcy analysis” to nonprofit reorganizations, expressly noting that the absolute priority rule’s inapplicability to the union’s plan seemed to contradict the fact that the union’s members benefited most from the reorganization.<sup>150</sup>

On appeal, the Ninth Circuit upheld that bankruptcy court’s ruling. In addressing the dissenting creditors’ absolute priority rule arguments, similar to the bankruptcy court, the Ninth Circuit discussed the Seventh Circuit’s opinion, noting parallels and further distinguishing the union from for-profit entities based on the principles of local labor unions and their connection with their affiliates that made the local union financially independent from its affiliates.<sup>151</sup> The Ninth Circuit also found

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<sup>146</sup> *In re Gen. Teamsters*, 225 B.R. at 736.

<sup>147</sup> *Id.*

<sup>148</sup> *Id.* The bankruptcy court further found that the plan “provides for [International] merely to the extent that [International] holds a creditor’s claim.” *Id.*

<sup>149</sup> “In this case, neither [the union]’s members nor [the union]’s affiliates nor anyone else holds any interest in [the union], as that concept is defined by the Bankruptcy Code and case law. The Absolute Priority Rule does not, by its terms, prohibit a debtor entity from retaining its own assets, and cannot, by its terms, apply to a situation such as this where the debtor has no equity security holders.” *Id.* at 737.

<sup>150</sup> *Id.* Specifically, the bankruptcy court noted the union’s case “presents a somewhat anomalous situation whereby [the union]’s members are not the proponents of the Plan . . . yet the dues they pay are [the union]’s only source of income and the amount of such dues is determined solely by the members—thus, the Absolute Priority Rule cannot be applied . . . even though [the members] will reap the benefits of reorganization.” *Id.* The bankruptcy court also determined that the plan was proposed in good faith despite not seeking to raise member dues or terminate the union’s affiliations. *Id.* at 738.

<sup>151</sup> “If the International were to be regarded as an equity owner . . . then the International’s unwillingness or inability to contribute a sufficient value to ensure the [local union]’s reorganization would force the liquidation of the [local union].

that International's escheatment right was so uncertain and remote that it did not have any immediate ownership right in the union and, likewise, that the union's members did not have any ownership right in the union.<sup>152</sup> Accordingly, none of the three indices of an "equity interest" identified by the Seventh Circuit—control, profit share, and ownership of corporate assets—were present for either International or the union's members, and the absolute priority rule did not apply to the union's plan.<sup>153</sup>

In contrast to the Seventh Circuit's opinion, the closest the Ninth Circuit came to discussing whether the plan was "fair and equitable" notwithstanding the inapplicability of the absolute priority rule was its discussion of the dissenting creditors' argument that the plan should have raised member dues and/or terminated the local union's affiliations. In upholding the bankruptcy court's determination that the plan was filed in good faith despite these omissions, the Ninth Circuit noted that the bankruptcy court had found that "the plan represented the [union]'s honest effort to satisfy the demands of its creditors."<sup>154</sup> The Ninth Circuit, however, did not link this finding to a broader examination of the fair and equitable standard.

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This would in turn destroy the federally protected rights of the workers represented by the [local union] in the collective bargaining process . . . . As a consequence of this distinction between local and international unions, the [local union] is financially independent." *Sec. Farms v. Gen. Teamsters, Warehousemen & Helpers Union, Local 890 (In re Gen. Teamsters, Warehousemen & Helpers Union, Local 890)*, 265 F.3d 869, 874–75 (9th Cir. 2001).

<sup>152</sup> *Id.* at 876.

<sup>153</sup> *Id.* The Ninth Circuit did not explicitly state whether the absolute priority rule was inapplicable or satisfied. In discussing the Seventh Circuit's opinion, however, the Ninth Circuit did state that "[i]n the labor [union] context, the absolute priority rule makes even less sense than it did in the electric utility context . . ." *Id.* at 874. This statement suggests that the Ninth Circuit considered the rule to be inapplicable.

<sup>154</sup> *Id.* at 877.

Taken together, these three main cases<sup>155</sup> demonstrate courts' reasoning in holding the absolute priority rule generally inapplicable to nonprofit reorganizations. Given the express language of the absolute priority rule as codified in the Bankruptcy Code,<sup>156</sup> coupled with courts' narrow reading of the term "interest,"<sup>157</sup> this conclusion seems correct. The absolute priority rule, as written expressly and specifically into the Bankruptcy Code's fair and equitable standard, normally does not apply to nonprofits because nonprofits do not have "interest" holders with characteristics equivalent to for-profit's equity holders.

Notably missing by and large from these opinions, particularly the Ninth Circuit's opinion,<sup>158</sup> however, is the recognition that the absolute priority rule is only one facet of the fair and equitable standard. In not acknowledging the connection between the absolute priority rule and the fair and equitable standard, these courts have created case law that may be read to provide that a nonprofit's reorganization plan need not

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<sup>155</sup> Since the Ninth Circuit's decision, two more courts have addressed the absolute priority rule in the context of nonprofit reorganizations. First, in *In re Henry Mayo Newhall Memorial Hospital*, a "nonprofit public benefit corporation" that owned and operated a hospital sought a three-month extension of its exclusive period, as debtor-in-possession, to file a plan of reorganization. 282 B.R. 444, 446 (B.A.P. 9th Cir. 2002). The official committee of unsecured creditors objected, stating that "unsecured creditors should be allowed to protect themselves by proposing competing plans because the nonprofit status of the Hospital blunts the force of the absolute priority rule, which usually affords creditors leverage to block plans that give value to owners." *Id.* at 447. The court acknowledged the validity of the argument, stating that the hospital's unsecured creditors were in a "take-it-or-leave dilemma" that counseled against extending exclusivity because the unsecured creditors had the most incentive to propose a plan that increased the going concern value of the hospital as "every additional dollar is their money." *Id.* at 453. Second, in *In re Save Our Springs (S.O.S.) Alliance, Inc.*, a certain creditor argued that the debtor citizen action group non-profit charitable organization's reorganization plan should not be approved because it violated the absolute priority rule. 388 B.R. 202, 209, 244–45 (Bankr. W.D. Tex. 2008), *aff'd*, 632 F.3d 168 (5th Cir. 2011). The court disagreed, simply stating that the debtor's "Plan does not provide for equity holders to receive or retain an interest, because the Debtor, as a non-profit organization, has no equity holders." *Id.* at 245.

<sup>156</sup> See *supra* note 11.

<sup>157</sup> See *supra* note 16.

<sup>158</sup> For example, in discussing the Seventh Circuit's opinion, the Ninth Circuit stated that "[i]n the labor relations context, the absolute priority rule makes even less sense than it did in the electric utility context . . ." *Sec. Farms v. Gen. Teamsters, Warehousemen & Helpers Union, Local 890* (*In re Gen. Teamsters, Warehousemen & Helpers Union, Local 890*), 265 F.3d 869, 874 (9th Cir. 2001).

allocate going concern value of the debtor nonprofit to creditors until they are paid in full before that value is accessible to pre-petition interest holders who resemble a for-profit's owners—or the nonprofit itself—simply because the absolute priority rule, as explicitly codified, is inapplicable. Though justifiable reasons may exist for such deviations—as developed in Part VI—these courts offered no explanation for the potential departure. Moreover, the absolute priority rule has a fuller history than these courts have credited it—a history that directly links the fair and equitable standard and the absolute priority rule.<sup>159</sup> Those few courts able to transform the nonprofit's members into the equivalent of equity holders unintentionally take advantage of this history, grant creditors the baseline protections and bargaining position that Chapter 11 assumes them to have, and confirm reorganization plans that fully satisfy the requirements of Chapter 11. Indeed, all of the main cases dealing with absolute priority claims in the context of nonprofit reorganizations involved nonprofits with members. Not all nonprofits have members, which may appear to make the absolute priority rule even less applicable to such nonprofits. The next part of this Article develops a theory of how the absolute priority rule, by way of its history and core principles, applies to all reorganizing nonprofits, regardless of whether a nonprofit has members or whether those members resemble for-profit equity holders.

#### IV. EXTENDING THE ABSOLUTE PRIORITY RULE

##### A. *Theory*

As recognized in varying degrees by those courts addressing absolute priority rule objections in the context of nonprofit reorganizations, Chapter 11 of the Bankruptcy Code must be made to fit these reorganizations. One critical mandate of Chapter 11's plan confirmation requirements is that all distributable going concern value of the reorganizing debtor be allocated to creditors until they are paid in full. Because of the way in which the Bankruptcy Code codifies this mandate in the absolute priority rule, explicitly stating that only once creditors

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<sup>159</sup> See *supra* Part II.B (discussing the statutory codification of the fair and equitable standard and absolute priority rule).

are paid in full can the debtor's equity holders retain any value, courts overall have thought themselves forced to hold that the absolute priority rule—and, with it, possibly its mandate—does not apply to reorganizing nonprofits.

Nevertheless, the absolute priority rule is less about the debtor's equity holders retaining value and more about ensuring that a plan of reorganization provides for creditors to the greatest extent possible. What bankruptcy practitioners now know as the absolute priority rule originally was the directive developed in case law addressing a situation more analogous to nonprofit reorganizations than one would think. Railroads' owners attempted to rid their railroads of unsecured debt while retaining ownership and control.<sup>160</sup> Upon being presented with such schemes, the Supreme Court made three key holdings: (1) that all assets of a debtor railroad were held in trust first for the payment of the debtor's creditors;<sup>161</sup> (2) that, accordingly, property of the old railroad obtained by the new railroad was property from which creditors were entitled to be paid before owners "could retain it for any purpose whatever," including for the purpose of control;<sup>162</sup> and (3) that creditors of railroads in particular must not be passed over because railroads were "[in]strument[s] of public service."<sup>163</sup>

Two fundamental rules of reorganization emerge from these foundational cases: the going concern value of a reorganizing debtor belongs to the reorganized entity; and the reorganized entity must allocate as much of that value as possible to the debtor's creditors. These rules possibly gain additional vitality if the reorganizing entity serves the public in some capacity—such as in the context of nonprofits, which almost by definition predominately serve the public.<sup>164</sup> Just as the railroad's owners were not allowed to discharge their unsecured debt while retaining ownership and control, a nonprofit should not be able to

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<sup>160</sup> See *supra* notes 23–25 and accompanying text.

<sup>161</sup> See *supra* notes 32–34 and accompanying text.

<sup>162</sup> *N. Pac. Ry. Co. v. Boyd*, 228 U.S. 482, 508 (1913); see *supra* notes 48–49 and accompanying text (noting that the Supreme Court stated that if there was enough value in the railroad to justify issuing new stock, then the railroad's "creditors were entitled to the benefit of that value, whether it was present or prospective, for dividends or only for purposes of control," until creditors were paid in full).

<sup>163</sup> *Louisville Trust Co. v. Louisville, N.A. & C. Ry. Co.*, 174 U.S. 674, 682 (1899); see *supra* notes 41–43 and accompanying text.

<sup>164</sup> See *supra* note 1 (defining nonprofit).



continue in existence without paying its creditors as much as possible purely by reorganizing. And just as with railroads, the "peculiar character"<sup>165</sup> of nonprofits, especially in relation to the Bankruptcy Code, demands that creditors receive the greatest possible amount of the nonprofit's going concern value.

Statutory codification of these rules did not alter them. Congress wrote the characterization of the Supreme Court's holdings as demanding that creditors receive a "fair offer" into the Bankruptcy Act as the requirement that a plan be "fair and equitable."<sup>166</sup> After codification, the Supreme Court confirmed that "fair and equitable" encompassed the absolute priority rule as it is thought of today,<sup>167</sup> evidencing that the fundamental rules developed by case law extend beyond the for-profit context of railroad reorganizations covered by the absolute priority rule. For example, in a case decided soon after "fair and equitable" was added to the Bankruptcy Act, the Supreme Court reaffirmed that a debtor's creditors have "full right of priority" to the debtor's assets.<sup>168</sup>

Then, in enacting the Bankruptcy Code, after protracted debate and numerous drafts, Congress specifically separated the absolute priority rule from "fair and equitable," making it a subpart of the standard.<sup>169</sup> Throughout all of Congress's drafts, the absolute priority rule remained an explicitly or implicitly necessary, but not sufficient, part of the standard.<sup>170</sup> And despite recommendations that a reorganizing debtor's going concern value be allocated away from creditors irrespective of whether they were paid in full,<sup>171</sup> Congress made certain that railroad reorganizations' fundamental rules survived. For example, in commenting on one of its drafts, the House identified the rule that all going concern value of a reorganizing debtor be allocated

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<sup>165</sup> *Louisville Trust Co.*, 174 U.S. at 682.

<sup>166</sup> *See supra* notes 52–59.

<sup>167</sup> *See supra* notes 56 & 60.

<sup>168</sup> *Case v. L.A. Lumber Prods. Co.*, 308 U.S. 106, 122 (1939) (quoting *Kan. City Terminal Ry. Co. v. Cent. Union Trust Co.*, 271 U.S. 445, 456 (1926)). The entire quotation reads: "Whenever assessments are demanded, they must be adjusted with the purpose of according to the creditor his full right of priority against the corporate assets, so far as possible in the existing circumstances." *Id.*

<sup>169</sup> *See supra* notes 66–68 and accompanying text.

<sup>170</sup> *See supra* notes 74–78 and accompanying text.

<sup>171</sup> *See supra* note 70 and accompanying text (discussing the COMM'N. ON THE BANKR. LAWS OF THE U.S., REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 93-137, pt. 2 (1973)).

first to creditors as one of its guiding principles.<sup>172</sup> Similarly, by not listing numerous examples of what satisfied the fair and equitable standard, Congress created a statute with an “open texture” that invites courts to rely on legislative history and case law to evaluate a reorganization plan,<sup>173</sup> necessarily leading courts to look to the fundamental rules that emerge from the railroad reorganization cases.<sup>174</sup>

The survival of the two fundamental rules through statutory codification makes sense. These rules comport with the primary structure and principles of reorganization. When compared to the railroads’ equity receiverships, Chapter 11 reorganization adds an intermediate party—the debtor-in-possession.<sup>175</sup> Chapter 11 delegates the responsibilities of the reorganized entity to the old entity’s creditors to the debtor-in-possession. First, as all going concern value of a debtor is available for distribution to creditors before equity holders during liquidation, when a debtor reorganizes, that going concern value must remain available for distribution to creditors before it can be accessed by equity holders.<sup>176</sup> Second, the reorganizing debtor—by way of the debtor-in-possession—thus has an obligation to propose a plan that provides for creditors to the greatest extent possible before allocating any going concern value elsewhere.<sup>177</sup>

The absolute priority rule mirrors this structure in the context of a for-profit reorganization and, accordingly, requires that creditors be paid in full before equity holders receive any property or payment. The rule frames the reorganizing debtor’s

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<sup>172</sup> See *supra* note 76 and accompanying text.

<sup>173</sup> See *supra* note 80 and accompanying text.

<sup>174</sup> For instance, in a recent decision addressing the absolute priority rule, the Second Circuit discussed and relied upon railroad reorganization cases in deciding that senior creditors’ “gifting” of shares and warrants to a junior class, although a more senior class did not approve the plan and were not paid in full, violated the absolute priority rule. *Dish Network Corp. v. DBSD N. Am., Inc.* (*In re* DBSD N. Am., Inc.), 634 F.3d 79 (2d Cir. 2011).

<sup>175</sup> See *supra* note 96 and accompanying text (discussing the three distinct entities that take part in a reorganization).

<sup>176</sup> See *supra* notes 91–93 and accompanying text.

<sup>177</sup> See *supra* notes 96–99 and accompanying text. The debtor-in-possession also must take into consideration other interested parties in the reorganization, such as employees. This obligation, however, most often should not require the diversion of going concern value otherwise available to creditors because a debtor-in-possession’s duty to other parties involves the same considerations implicated in reconstituting the debtor as a viable business post-reorganization. For example, in renewing an ailing business, the debtor-in-possession will preserve jobs.

obligation to creditors this way because the rule was crafted only considering for-profit entities. Even if Congress did not explicitly codify the absolute priority rule in the Bankruptcy Code, merely leaving the Bankruptcy Act's "fair and equitable" wording intact, none of the courts subsequently applying the rule to for-profit reorganizations should have arrived at different results than if the courts evaluated the instant plans for their fairness and equitableness.

Equity holders of for-profit entities are the residual owners of and ultimately control for-profit entities. They own all excess going concern value, and they rightly should not allow any of that value to be allocated elsewhere—such as to expand the operations of the reorganized entity—without their consent. Indeed, as identified by courts addressing the absolute priority rule as applicable to nonprofits, control is a critical hallmark of ownership.<sup>178</sup> Because of this control, when a for-profit entity reorganizes, the threat that equity holders will take too much for themselves looms. Given that creditors are entitled to a reorganizing debtor's assets before equity, absent the explicitly codified absolute priority rule, courts still would have been obligated to reject plans which proposed to allocate property to equity holders without paying creditors in full.

As concerns the absolute priority rule and fair and equitable standard, there is one relevant difference between for-profit and nonprofit entities: most nonprofits lack the equivalent of equity holders who ultimately direct management's and the board's business decisions and hold the for-profit accountable if management and the board attempts to allocate going concern value without the equity holders' approval. Instead, a nonprofit's managers, board, and, if applicable, members fill the role of the for-profit's owners, both directing the day-to-day business of the nonprofit and making larger decisions regarding its continued operation. In some cases, managers and board oversee the nonprofit at the discretion of state or municipal officials.<sup>179</sup> In other cases, even if a nonprofit has members, members have

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<sup>178</sup> See *supra* notes 131 & 153 and accompanying text.

<sup>179</sup> For example, the board of directors of the non-profit Las Vegas Monorail Corporation is appointed by the governor of the State of Nevada. *History*, LAS VEGAS MONORAIL, <http://www.lvmonorail.com/about/history> (last visited Mar. 11, 2012).

little control over the nonprofit.<sup>180</sup> Thus, in the case of some nonprofits, it can be argued that the state, municipality, or part of society that benefits from the continued operation of a nonprofit is the true “owner” of the nonprofit. Regardless of whether managers, directors, members, or the ultimate overseers of a nonprofit hold “interests” in the nonprofit, they become the “owners” for the purposes of the absolute priority rule and the fair and equitable standard. Any property that a reorganized nonprofit keeps for itself through its reorganization—and thus keeps for its managers, directors, members, or broadly for the benefit of society—is property that may be allocable to its creditors.

To determine whether a reorganizing nonprofit is assigning going concern value to itself that should go to creditors, a court merely needs to apply the two fundamental rules that animate the fair and equitable standard and the absolute priority rule. First, all going concern value of the reorganizing nonprofit not necessary to the restructuring is available, first and foremost, to its creditors.<sup>181</sup> As with for-profit reorganizations, the reorganized nonprofit essentially purchases the old nonprofit for its going concern value. The reorganized nonprofit consequently continues the operations of the old nonprofit. Second, if the going concern value is less than the amount the old nonprofit owed to creditors, the reorganized nonprofit must pay this value to those creditors. Unless a nonprofit has members equivalent to equity holders whose “interests” it wants to discharge through reorganization, the going concern value almost always should be less than creditors’ claims. Otherwise the nonprofit need not reorganize. Hence, stated generally, if the reorganizing nonprofit proposes to preserve going concern value for itself, the nonprofit’s proposed plan does not fulfill the underlying principles of the absolute priority rule and is not fair and equitable.

Such a scheme should be readily apparent. The plan may reserve a sum for capital expenditures in excess of the nonprofit’s historical major expenditures, provide for salary increases at a rate not at the level of previous increases, or decrease member dues. In these scenarios, not only does the reorganized nonprofit

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<sup>180</sup> For example, many private schools are nonprofit entities. Parents constitute the members and hold shares in the nonprofit, but a board of trustees ultimately oversees the school.

<sup>181</sup> See *supra* notes 131 & 153 and accompanying text.

survive, but it also benefits from the discharge of its debt, exactly as the railroads' owners attempted to benefit from equity receiverships. As dictated by the principles underlying the absolute priority rule, if the nonprofit decides to take advantage of reorganization pursuant to the Bankruptcy Code, the nonprofit's creditors must be paid in full before the nonprofit can better itself. If not, management and members will be allowed to take advantage of their insider status and usher through a plan that is simply too good a deal for the nonprofit and themselves.

The parallel between the application of the principles underlying the absolute priority rule to for-profit and nonprofit entities is most evident when nonprofits are compared to close corporations. Managers, directors, and members of nonprofits strongly resemble owners of close corporations. These owners direct the day-to-day business of their company and have the final say on larger decisions regarding its continued operation. Unlike managers, directors, and members of nonprofits, however, owners of close corporations who cannot find a source of new money to contribute to their reorganizing companies are unable to retain control of their companies absent creditor consent.<sup>182</sup> Despite the many benefits these owners may bring to their reorganized companies, courts strictly apply the absolute priority rule to their proposed plans, preventing owners who do not contribute new value from retaining any interest unless creditors are paid in full.<sup>183</sup>

This result starkly contrasts with nonprofit reorganizations. Because a nonprofit's managers, directors, and, if applicable, members do not hold traditional ownership stakes in the nonprofit, they may continue directing the nonprofit's operations post-reorganization without contributing to the reorganization in the same way owners of a close corporation are required to contribute. Indeed, in one of the three main cases dealing with nonprofit reorganization and the absolute priority rule, the Seventh Circuit even lauded the continued involvement of nonprofits' members in the reorganized nonprofit, stating that allowing members to stay in control maximized the going concern value of the nonprofit.<sup>184</sup> In the context of reorganization of close

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<sup>182</sup> See *supra* notes 108–111 and accompanying text.

<sup>183</sup> See *supra* note 118 and accompanying text.

<sup>184</sup> See *supra* note 137 and accompanying text.

corporations, a court would not credit this kind of intangible benefit accruing from management's involvement in the reorganized business to owners who also managed the business. If these owner-managers want to reorganize and remain in control, they must contribute new capital to the reorganized business.<sup>185</sup> Thus, if nonprofits were close corporations—which, given their size and management structure, many of them essentially are<sup>186</sup>—they would not be reorganizing at all.

If the directives of the absolute priority rule do not apply to reorganizing nonprofits, not only will a nonprofit's managers, directors, and members be allowed to retain control of their nonprofit despite not having to contribute new capital, creating even more division in how the fair and equitable standard is applied to different types of reorganizing entities,<sup>187</sup> but also they may be able to direct old capital and future revenues—that is, going concern value—to the reorganized nonprofit for them to use for the betterment of the nonprofit. Such a result contradicts the core of the absolute priority rule. Nonprofits cannot subordinate the claims of their creditors to the benefit of their continued operation.

In the end, it does not matter whether management or equity holders are viewed as the “owners” for the purposes of the principles underlying the absolute priority rule. If the reorganizing entity proposes a plan that violates the payment priority structure among creditors and interest holders, allocating going concern value away from senior claimants, to equity holders or simply to itself, the plan is not fair and equitable. This is the principle that courts addressing absolute priority claims in the context of nonprofit reorganizations only marginally acknowledged or completely overlooked. And this is the principle that animates the absolute priority rule and warrants its application to all nonprofit reorganizations. Regardless of case law that may be read to provide otherwise, unless creditors consent, a plan of reorganization, whether

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<sup>185</sup> See *supra* notes 113 & 118 and accompanying text.

<sup>186</sup> For example, Save Our Springs (S.O.S.) Alliance, Inc., a nonprofit that sues municipalities and developers regarding the use of an aquifer in Texas, filed its Chapter 11 petition as a small business debtor. *In re Save Our Springs (S.O.S.) Alliance, Inc.*, 632 F.3d 168, 171 (5th Cir. 2011).

<sup>187</sup> See *supra* note 112 and accompanying text (noting the divergent results of the application of the absolute priority rule to public companies and close corporations).

addressing a for-profit or nonprofit entity, is not fair and equitable unless creditors are provided for as much as possible until they are paid in full.

*B. Example Applications*

As an initial example, take a nonprofit without members.<sup>188</sup> Assume that the reorganizing nonprofit has one tier of secured debt and general unsecured creditors. Also assume that holders of the secured debt are undersecured. Further assume that the nonprofits' proposed reorganization plan provides that holders of the debt will receive a secured note that compensates them in full on account of the secured portion of their claim, and that the holders of the debt and general unsecured creditors will receive approximately 50% on account of their unsecured claims. Finally assume that the plan also allocates \$50 million to a general fund for expanding the nonprofits' operations to provide services encompassed by the nonprofit's mission and similar to services historically made available, but not previously offered by the nonprofit, and that this \$50 million would increase the distribution to unsecured creditors to approximately 55% on account of their unsecured claims.

This plan is not fair and equitable. It apportions funds to the reorganized nonprofit that allow the nonprofit to expand solely by way of the reorganization. In so allocating, it provides \$50 million to the nonprofits' management that they do not need to keep the nonprofit afloat post-reorganization. It is as if the managers, directors, and the portion of society that generally benefits from the nonprofit's existence are receiving \$50 million in dividends. These funds represent going concern value and belong to its unsecured creditors. Unless unsecured creditors consent to the expansion provided for by the plan, the plan cannot be confirmed. Even though the nonprofit has no members and, thus, the absolute priority rule as codified is categorically inapplicable as against the nonprofit itself retaining going concern value, the nonprofit must not be allowed to benefit from its reorganization simply because it does not have the equivalent

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<sup>188</sup> This example is inspired by the first plan of reorganization proposed by the Las Vegas Monorail Corporation ("LVMC"). Debtor's Plan of Reorganization, *In re* Las Vegas Monorail Co., No. 10-10464-bam (Bankr. D. Nev. Jan. 13, 2010), Doc. No. 516.

of equity holders. When presented with such a scheme, a court should read the core principles of the absolute priority rule into the open-ended fair and equitable standard and reject the plan. If the managers and directors of the reorganized nonprofit believe it advantageous to expand the nonprofit's operations, they must look outside the nonprofit for the necessary capital, such as taking out a loan that the nonprofit will be able to repay with anticipated future charitable gifts or revenues from the expansion.

The rule applies in the same way to nonprofits which courts deciding absolute priority claims have encountered: nonprofits with members. A court's initial inquiry should be into the nature of membership. But even if a court finds that the nonprofit's members are not the equivalent of a for-profit's equity holders, the court has not completed its inquiry into the fair and equitable standard. Take the labor union addressed by the Ninth Circuit.<sup>189</sup> Assume that the members are properly classified as unsecured creditors, as the Ninth Circuit found.<sup>190</sup> Also assume that in addition to continuing the labor union's current affiliations,<sup>191</sup> the plan contemplates affiliating with another "parent" union. Further assume that the reorganizing union believes the added affiliation will benefit the union and its members, but that the extra affiliation will require the union retain an extra \$5 per member per month to pay the "per capita tax" for the affiliation, thereby increasing its monthly operational expenses. Finally assume that all other provisions of the proposed plan remain the same, including that member dues are not raised.

In this example, it is slightly less obvious that the plan is not fair and equitable. The plan merely calls for the reorganized labor union affiliating with another "parent" union, which, upon initial consideration, seems to fall within the union's pre-reorganization operations.<sup>192</sup> But adding an affiliation materially

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<sup>189</sup> See *supra* notes 139–153 and accompanying text.

<sup>190</sup> See *supra* note 153 and accompanying text.

<sup>191</sup> See *supra* notes 140 and 142 and accompanying text.

<sup>192</sup> When a debtor reorganizes, it is assumed that the debtor-in-possession will reconstitute the ailing business primarily by selling and rearranging assets, not purchasing new assets. For example, a restaurant may change its fare—and interior and exterior decorations—from Mexican to Italian, but it will not reorganize from a restaurant into a clothing boutique. Thereby, a business's overall post-reorganization operations should reflect its pre-reorganization operations.



changes the benefits the union's members receive. And it does so without requiring that the union find financing for the additional affiliation. Instead, the \$5 per member per month must come from going concern value otherwise distributable to the union's creditors. If its members were found to be the equivalent of equity holders, it might be clearer that the extra affiliation amounts to a distribution to members. It is as if the union's members each are receiving \$5 per month in dividends that they are electing to reinvest in the union. Indeed, the plan provides the exact opposite of what creditors objected to—rather than increase member dues or terminate affiliations,<sup>193</sup> the plan effectively expands the pre-reorganization operations of the union while leaving dues unchanged, allowing the union's members to improve the union through reorganization. Unless unsecured creditors consent to the expansion, a court cannot confirm the plan. As with the previous example, a court should read the core principles of the absolute priority rule into the open-ended fair and equitable standard and reject the plan.

#### V. CRITICISMS AND IMPLICATIONS OF EXTENDING THE ABSOLUTE PRIORITY RULE

In crafting a theory that holds reorganizing nonprofits to the same standards applicable to reorganizing for-profits, this Article makes some key assumptions that may raise criticisms of the theory. This Part of the Article identifies and addresses three potential criticisms.<sup>194</sup> In responding to these criticisms, it begins to explore the implications of applying Chapter 11 to nonprofits.

Most notably, the theory assumes that the reorganizing nonprofit remains a nonprofit following reorganization. The theory also assumes that the reorganization plan allocates as much going concern value as possible to the nonprofit's creditors—that is, all going concern value not necessary for the nonprofit to operate post-reorganization is available first and foremost to creditors until they are paid in full.<sup>195</sup> As the above examples demonstrate, the nonprofit may pay its ordinary course of business expenses, but it may not significantly expand its operations, such as adding a hospital wing or purchasing cutting

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<sup>193</sup> See *supra* note 142 and accompanying text.

<sup>194</sup> Special thanks to Professor Lynn M. LoPucki for discussing these criticisms.

<sup>195</sup> See *supra* notes 131 & 153 and accompanying text.

edge medical equipment not available at similar hospitals. Unfortunately, in some instances, these two assumptions may clash.

In assuming that all going concern value of a reorganizing nonprofit is allocated first to creditors until they are paid in full, the theory necessarily affords creditors ownership of the reorganized nonprofit. The going concern value of an ongoing entity is the value of the assets of that entity as an operating whole;<sup>196</sup> thus, the creditors own the nonprofit. Through this ownership, creditors conceivably control the fundamental operations and structure of the reorganized nonprofit, which includes determining whether the nonprofit remains a nonprofit post-reorganization. Stated succinctly, if all going concern value of the reorganized nonprofit is the property of creditors until they are paid in full, the creditors should have the ability to reorganize the nonprofit into a for-profit.

This outcome obviously conflicts with the theory's assumption that the reorganizing nonprofit will remain a nonprofit post-reorganization. The question then becomes whether it is imperative that a reorganizing nonprofit remain a nonprofit. Part of the reason nonprofits increasingly are seeking to reorganize potentially is that their management is under pressure to operate nonprofits more like for-profits.<sup>197</sup> If so, and particularly if a nonprofit is financially unstable, then it might be most practical to convert into a for-profit. Reorganization may be the most efficient vehicle to realign a nonprofit's structure with the expectations of its stakeholders, such as donors and creditors. Accordingly, the assumption that a nonprofit will remain a nonprofit through reorganization may be dispensable.

Nevertheless, converting from a nonprofit to a for-profit represents a fundamental change that seemingly affects the core of a nonprofit's mission. If a nonprofit cannot survive without reorganizing, and if all going concern value must be allocated to the nonprofit's creditors in that reorganization to abide by the purposes underlying the Bankruptcy Code, perhaps that nonprofit should be ineligible for reorganization unless its

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<sup>196</sup> See Linda J. Oswald, *Goodwill and Going-Concern Value: Emerging Factors in the Just Compensation Equation*, 32 B.C. L. REV. 283, 289 (1991) (“[G]oing-concern value reflects the enhanced value of assets arising from their combination within an operating business.”).

<sup>197</sup> See *supra* note 3 and accompanying text.

creditors specifically agree that the nonprofit will reorganize as a nonprofit. This outcome resembles the absolute priority rule's application to close corporations. Unless creditors consent to a close corporation's owners retaining an interest in the reorganized business, the close corporation often cannot reorganize and the owners lose their business.<sup>198</sup> Similarly, unless creditors consent to the nonprofit remaining a nonprofit, the nonprofit cannot reorganize and most likely will dissolve. As with a close corporation, only if a nonprofit's creditors approve will the nonprofit survive. Both sets of creditors give up something they are entitled to in exchange for the debtor's survival. Creditors of a close corporation renounce a portion of their interest in the reorganized corporation, and creditors of a nonprofit forfeit their ability to transform the nonprofit into a for-profit.<sup>199</sup>

The theory also can be criticized for allocating all going concern value of the reorganized nonprofit first and foremost to creditors. Such allocation may not be feasible. Many nonprofits survive based on donations from individuals.<sup>200</sup> If a reorganized nonprofit's creditors are entitled to all going concern value until they are paid in full, they necessarily are entitled to donations

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<sup>198</sup> See *supra* notes 109–12 and accompanying text.

<sup>199</sup> The ability to transform the debtor nonprofit into a for-profit post-reorganization may be conceptualized as part of the going concern value of the debtor to which creditors are entitled. Unless they agree otherwise, the absolute priority rule requires that value be allocated to creditors. Because this value allows a nonprofit's creditors to initiate a change that fundamentally alters the nonprofit, the Bankruptcy Code would need to be amended to provide a special rule for nonprofits that prohibits their reorganization unless their creditors consent to their continuation as nonprofits post-reorganization. This rule will provide nonprofits' creditors with the same bargaining power they should be afforded by the absolute priority rule: They will be able to threaten to withhold their consent to the reorganization if they disapprove of the debtor's proposed plan. Though this bargaining power may seem to give a nonprofit's creditors too much leverage, the creditors of close corporations are provided with similar leverage.

Alternatively, the rule could provide that a nonprofit's creditors must consent to the reorganization of a nonprofit debtor as a nonprofit if the debtor's proposed plan allocates all going concern value first and foremost to creditors until they are paid in full. Logically, under this rule, creditors should realize that they are vulnerable if a nonprofit reorganizes, and they may adjust credit terms and other aspects of their business relationships with nonprofits accordingly.

<sup>200</sup> See GIVING USA 2011, THE ANNUAL REPORT ON PHILANTHROPY FOR THE YEAR 2010, EXECUTIVE SUMMARY 4 (2011) (stating that donations from individuals comprised 73% of the revenue from donations received by nonprofits in 2010), available at [http://www.givingusareports.org/products/GivingUSA\\_2011\\_ExecSummary\\_Print.pdf](http://www.givingusareports.org/products/GivingUSA_2011_ExecSummary_Print.pdf).

made to the nonprofit post-reorganization. But will a nonprofit continue to receive donations if individuals know that the nonprofit's creditors can access those donations—that they effectively are paying the nonprofit's creditors? Similarly, a sizable portion of nonprofits' operating budgets may derive from grants, either from private institutions or state and federal government agencies.<sup>201</sup> Like individual donors, will these institutions choose to give to a reorganized nonprofit when those grants will go to supporting the nonprofit's creditors? Will government agencies feel pressured to forego awarding grants to reorganized nonprofits because they anticipate that their constituents will disapprove of funds effectively going to the nonprofits' creditors?

Perhaps reorganized nonprofits will continue to receive funding because individual donors and grant-giving agencies will want to support nonprofits despite the consequences of their reorganization. For example, perhaps these individuals and agencies will continue giving because they historically supported a certain nonprofit and that nonprofit's goodwill and record—notwithstanding its reorganization—still will draw them to it. But there is a distinct chance that a reorganized nonprofit will be unable to attract funding because donors and grant-giving agencies will divert funds that otherwise would have gone to the reorganized nonprofit to another nonprofit with a similar mission, thereby ensuring that their money will be used to further the cause they want to support. This outcome seems especially likely given that if a nonprofit liquidates or dissolves, its directors and management are free to start a new nonprofit with the same mission. This new nonprofit effectively will be the same as the reorganized nonprofit except it will not be bound to its pre-reorganization creditors. Thus, all funding the new nonprofit receives will be available first and foremost for fulfilling its mission.

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<sup>201</sup> *See id.* (stating that donations from foundations and corporations comprised 19% of the revenue from donations received by nonprofits in 2010). According to the National Center for Charitable Statistics, in 2004, government grants made up about 9 percent of nonprofits' revenue. *See Frequently Asked Questions*, NATIONAL CENTER FOR CHARITABLE STATISTICS, <http://nccs.urban.org/FAQ/index.cfm> (last visited Mar. 11, 2012).

Accordingly, it may not be feasible to allocate all of the reorganized nonprofits' going concern first and foremost to creditors if a nonprofit is to survive post-reorganization. Rather, the nonprofit's creditors may need to accept the going concern value less donations and similar funding, either by agreement or by force. Though creditors may agree to such an arrangement because they understand that the alternative is liquidation, if creditors are forced to accept this arrangement, the objectives underlying the absolute priority rule will be violated. In effect, a version of the "best efforts" standard commentators recommend applying to close corporations and similar entities will be applied to nonprofits;<sup>202</sup> the reorganized nonprofit will be required to use its "best efforts" to allocate all available funds to repaying creditors, but if some of these funds, such as donations and grants, cannot be made available to creditors without the reorganized nonprofit failing, then the funds may be withheld. This solution, however, will create the same dichotomy between for-profit and nonprofit reorganization that exists now. Entities that otherwise would be unable to reorganize absent their nonprofit status will survive simply because they are nonprofits.

Alternatively, recognizing that certain nonprofits will be unable to survive post-reorganization if creditors are allocated all going concern value, perhaps these nonprofits simply should not be allowed to reorganize. Courts have rejected nonprofits' proposed reorganization plans upon determining that the plans were not feasible because they contemplated unrealistic levels of future funding.<sup>203</sup> Indeed, the result of applying the principles of the absolute priority rule to nonprofit reorganization may be to prevent confirmation of more proposed plans on the basis of anticipated future funding. As more nonprofits that rely on donations and grants reorganize and either succeed or fail post-reorganization, it will become clear whether funding ceases if nonprofits are required to abide by the absolute priority rule. If so, depending on the portion of nonprofits that rely on donations and grants to survive, this may prohibit a large percentage of

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<sup>202</sup> See *supra* notes 116–18 and accompanying text.

<sup>203</sup> See, e.g., *Save Our Springs (S.O.S.) Alliance, Inc. v. WSI (II)-COS, L.L.C. (In re Save Our Springs (S.O.S.) Alliance, Inc.)*, 632 F.3d 168 (5th Cir. 2011) (affirming bankruptcy court's denial of plan confirmation when the proposed plan was not feasible because the debtor had not demonstrated sufficient commitments from donors).

nonprofits from reorganizing. Those nonprofits that are unable to reorganize will liquidate or dissolve; if there is enough interest, they can re-emerge as new nonprofits.

Finally, the theory identifies a nonprofit's managers as one of the groups who are substantively akin to owners for the purposes of applying the absolute priority rule to reorganizing nonprofits. Managers, however, inhabit their own position in reorganizations. Debtors may offer managers incentive packages designed to entice them to remain with the debtor through its reorganization, debtors may eliminate managers it believes are ineffective or burdensome, creditors and other parties in interest may move to have certain managers removed and a chief restructuring officer appointed, and internal battles over post-reorganization management positions may erupt. Even so, the theory remains workable if managers are not deemed to stand-in for equity holders. The theory ultimately turns on whether a nonprofit preserves going concern value for itself—and, thereby, its founders, board, members, or, generally, the part of society that benefits from the nonprofit's continued operation—instead of allocating that value to creditors until they are paid in full.

Nonetheless, similar to managers of a close corporation, a nonprofit's managers may be the same individuals as the nonprofit's founders, directors, and members. In identifying managers as beneficiaries of an incongruously applied absolute priority rule, the theory recognizes and highlights the dichotomy created by courts' current application of the absolute priority rule and fair and equitable standard to for-profit and nonprofit entities. Overall, once courts clearly apply the absolute priority rule through the fair and equitable standard to reorganizing nonprofits, the viability of reorganization for different types of nonprofits may begin to become more apparent. As more information about the bankruptcies of nonprofits is gathered, the unique issues that arise when nonprofits seek to reorganize will become more perceptible, and the implication of applying Chapter 11 to nonprofits that this discussion has begun to explore will be better judged.

#### CONCLUSION

The absolute priority rule protects creditors from manipulation of their priority to going concern value of a reorganizing entity by guaranteeing that a court will not confirm

a plan that subordinates their claims to the benefit of the debtor's equity holders without the creditors' consent. It thereby prevents owners, who may be the same as management, from taking advantage of their insider status to the detriment of creditors or colluding with senior creditors to freeze out intermediate claimants. The absolute priority rule also affords creditors a critical negotiation tool by way of their ability to object to a plan that they suspect allocates going concern value away from the creditors to which it belongs. Without the rule, unsecured creditors in particular find themselves relatively defenseless against attempts by secured creditors and owners to use reorganization to discharge debt while retaining a stake in the reorganized entity.

In the context of reorganizations of for-profit entities, the absolute priority rule's application is straight-forward and well-established. Only if the reorganizing debtor provides for its creditors in full can equity holders receive any of the reorganized business's going concern value. Conversely, the few courts that have encountered absolute priority rule arguments in the context of nonprofit bankruptcies have struggled to apply the rule to the reorganizing nonprofit. Though the nonprofit's proposed plan may allow directors, managers, or members to retain control of the reorganized nonprofit, and though the plan may appear to allow the reorganized nonprofit to retain going concern value that most likely belong to creditors, courts have found the absolute priority rule categorically satisfied by or inapplicable to nonprofits except in limited circumstances.

Conceivably, courts could hold that such plans violate the Bankruptcy Code's mandate that plans be proposed in good faith.<sup>204</sup> To determine whether a plan meets the good faith requirement, courts examine whether the plan maximizes the value of the bankruptcy estate—that is, whether a plan allocates going concern value to creditors until they are paid in full.<sup>205</sup>

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<sup>204</sup> 11 U.S.C.A. § 1129(a)(3) (West 2011).

<sup>205</sup> See, e.g., *Sec. Farms v. Gen. Teamsters, Warehousemen & Helpers Union, Local 890* (*In re Gen. Teamsters, Warehousemen & Helpers Union, Local 890*), 265 F.3d 869, 877 (9th Cir. 2001) (noting that courts focus on whether a plan is consistent with the primary objectives of the Bankruptcy Code in evaluating good faith); *Crestar Bank v. Walker* (*In re Walker*), 165 B.R. 994, 1001 (E.D. Va. 1994) (noting that "the failure of a debtor to use the full reach of its disposable resources to repay creditors is evidence that a plan is not proposed in good faith because such

Nevertheless, the existence of the good faith requirement has not prompted courts to include detailed inquiries into the allocation of going concern value in their opinions addressing nonprofit reorganizations. With nonprofit reorganizations on the rise, courts will need to consider the history and principles underlying the absolute priority rule in order to hold nonprofits to the same standards that Chapter 11 imposes on other reorganizing entities.

Though courts have correctly held that the absolute priority rule, as explicitly codified in the Bankruptcy Code, may not apply to most nonprofits, the rule represents only one facet of the fair and equitable standard. The theory underlying the absolute priority rule remains relevant to nonprofit reorganizations and should be considered when deciding whether a nonprofit's reorganization plan is fair and equitable. The history of the rule demonstrates that it is less about equity holders retaining value in a reorganized entity, as it is written into the Bankruptcy Code, and more about ensuring that a proposed plan provides for creditors to the greatest extent possible. Accordingly, to determine whether a nonprofit's plan is not fair and equitable, a court merely needs to investigate whether the plan is too good a deal for the nonprofit. In short, does the plan assign going concern value to the nonprofit that should go to creditors? If so, the plan is not fair and equitable for the same reasons that a similar plan proposed for a for-profit entity should be found to violate the absolute priority rule.

Courts addressing absolute priority claims in the context of nonprofit reorganizations have overlooked or only marginally acknowledged the connection between the absolute priority rule and the fair and equitable standard. Recognizing that the core tenets of the absolute priority rule may be and should be considered when evaluating a nonprofit's plan will ensure that creditors benefit from one of the protections the Bankruptcy Code specifically affords them and will bring courts one step closer to applying all of Chapter 11's rigorous approval criteria to nonprofits. It also will elucidate some of the unique issues that arise when nonprofits seek to reorganize, laying the foundation to better evaluate the viability of nonprofit reorganization.

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conduct frustrates" one of the "primary objective[s] of a Chapter 11 reorganization," that is, "prompt payment of creditors").