

BANKRUPTCY LAW

Restrictions on the Sale or Transfer of Assets of Not-for-Profit Debtors

Special issues arise when a charity becomes entwined in the bankruptcy process

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In 2012, a number of not-for-profit entities, including religious institutions, filed for bankruptcy relief in New Jersey. While unique and oftentimes altruistic in purpose, these special entities are not immune to the financial woes that plague for-profit enterprises. Not-for-profit entities often benefit from public funding and exemption from taxation and therefore must subscribe to additional state imposed requirements concerning formulation, governance and even dissolution. Special attention must be given when a not-for-profit entity becomes entwined in the bankruptcy process.

One issue that arises is the ability of not-for-profit debtors to sell or transfer assets under a confirmed plan of reorganization, pursuant to section 1123(b)(4) of

the Bankruptcy Code, or prior to the confirmation of a plan of reorganization pursuant to section 363(b) of the Bankruptcy Code, absent compliance with state law requirements governing the sale of assets by not-for-profit entities. Generally, not-for-profit entities are created and incorporated under state law for specified charitable purposes or to perform public missions that are typically enumerated in their charters and bylaws. Not-for-profit entities, including those that are exempt under section 501(c)(3) of the Internal Revenue Code, can file a voluntary petition for relief under the Bankruptcy Code if they are organized as corporations or "business trusts" within the meaning of section 101(9) of the Bankruptcy Code.

The Bankruptcy Code explicitly provides for the sale of some or all of a debtor's assets free and clear of claims, liens and other interests either as part of a confirmed Chapter 11 plan of reorganization, under section 1123(b)(4) of the code, or as a stand-alone non-"ordinary course" transaction under section 363(b). Courts typically determine whether to approve a proposed sale transaction by deciding

whether the transaction represents an exercise of the debtor's sound business judgment. Congress enacted several provisions related to the sale of assets by not-for-profit debtors as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA).

BAPCPA created a regime of compliance with applicable nonbankruptcy law. BAPCPA amended section 363 of the Bankruptcy Code to provide that the use, sale or lease of property by a not-for-profit debtor "that is a corporation or trust that is not a moneyed business, commercial corporation, or trust, [must be] in accordance with nonbankruptcy law applicable to the transfer of property by a debtor that is such a corporation or trust." 11 U.S.C. § 363(d). This amendment is applicable both in Chapter 7 and Chapter 11 cases. Moreover, this amendment is reinforced by subsection (f) of section 541 of the Bankruptcy Code, which requires that "property that is held by a debtor that is a corporation described in section 501(c)(3) of the Internal Revenue Code of 1986 and exempt from tax under section 501(a) of such Code may be transferred to an entity that is not such a corporation ..." if the transfer is in compliance with applicable nonbankruptcy law. 11 U.S.C. § 541(f). In addition, section 1129 of the Bankruptcy Code was amended to add a new subsec-

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tion providing that a not-for-profit debtor may only transfer assets pursuant to a confirmed Chapter 11 plan if state law governing such transfers is observed. *See* 11 U.S.C. § 1129(a)(16). Thus, prior to confirmation of a plan under Chapter 11 of the Bankruptcy Code, the bankruptcy court must find that all transfers of property under the plan will be made in accordance with applicable provisions of nonbankruptcy laws that govern the transfer of property by a not-for-profit entity.

Additionally, section 1221(d) of BAPCPA grants standing to the attorney general of the state in which the not-for-profit entity is incorporated, was formed or does business, such that it can be heard in the bankruptcy court on issues relating to the sale and transfer of assets. Finally, section 1221(e) of BAPCPA provides that section 363(d) of the Bankruptcy Code is not to be construed as requiring the bankruptcy court to remand or refer any proceeding under section 363(d) to any other court, or to require the approval of any other court, prior to the transfer of any property. The legislative history regarding these amendments to the Bankruptcy Code suggest the intent of Congress was to give greater influence to state regulators and attorneys general and restrict the authority of a trustee or debtor-in-possession to use, sell or lease property by a nonprofit corporation or trust. Fittingly, there exists case law concerning the determination by courts as to whether proposed transactions comply with nonbankruptcy law.

Against this backdrop of congressionally enacted restrictions on the sale or transfer of assets by not-for-profit entities, two of the handful of reported decisions to interpret these provisions distinguish between the voluntary and involuntary transfers or sales of assets by a not-for-profit entity. The first case, *In re Machne Menachem*, 371 B.R. 63, 65 (Bankr. E.D. Pa. 2006), reconsideration denied by *In re Machne Menachem*, Case No. 5-01-bk-04926 (JTT), 2006 Bankr. LEXIS 4295 (Bankr. E.D. Pa. Dec. 29, 2006), involved a not-for-profit corporation, formed and governed under the laws of the State of New York, that owned and operated a religious summer camp for Hasidic Jewish male children.

In *Machne*, a former director of the debtor, in his capacity as a creditor of the

debtor, proposed a Chapter 11 plan of reorganization over the opposition of the debtor. This Chapter 11 plan proposed, inter alia, to transfer the assets of the debtor to a new not-for-profit entity under his control without complying with a provision of New York Not-for-Profit Corp. Law that prevented the debtor from effectuating a transfer, sale or other disposition of its assets without either the vote of two-thirds or more of the board of directors of the debtor or leave of the appropriate state court. Since the Chapter 11 plan provided for an involuntary transfer of the debtor's assets that did not require board approval of the debtor, and was in fact opposed by the board of directors of the debtor, the bankruptcy court held that section 1129(a)(16) of the Bankruptcy Code and the applicable provisions of New York state law restricted only the voluntary transfer, sale or other disposition of assets of not-for-profit corporations. In sum, notwithstanding BAPCPA, applicable nonbankruptcy law was found not to apply to the involuntary transfer of assets of a not-for-profit debtor.

In a second case, *In re 51-53 West 129th Street HDFC*, 475 B.R. 391, 393 (Bankr. S.D.N.Y. 2012), the debtor was a Housing Development Finance Corporation (HDFC) created in 1984 for the purpose of providing low-income housing, pursuant to Article XI of the New York Private Housing Finance Law, at a certain property located in New York City. In that case, the city moved, inter alia, for relief from the automatic stay in the debtor's case, pursuant to section 362(d) of the Bankruptcy Code, to permit the city to transfer the property to another not-for-profit corporation that would oversee any necessary rehabilitation of the property, assure that the property remained part of the city's low-income housing supply, and permit the current tenants to remain in their apartments. In opposing the city's relief-from-stay request, the debtor proposed that it should be permitted to rehabilitate itself through a sale of the property to a for-profit purchaser.

The bankruptcy court granted the city's motion for relief from the automatic stay in the debtor's case on multiple grounds, including lack of adequate protection for the city's tax liens against the property. The bankruptcy court held that applicable state law forbid the debtor's proposed sale of the property. Sections 510

and 511 of New York Not-For-Profit Corp. Law required the debtor to obtain approval of the New York Supreme Court and to give notice to the attorney general of the state of New York, who was to review the sale application that was to be filed in New York State Supreme Court to ensure it complied with applicable not-for-profit law. Further, applicable state law required the terms of the proposed sale of the property to be "fair and reasonable to the corporation, and that the purposes of the corporation, or the interests of its members, will be promoted thereby" (quoting section 511(a)(6) of New York Not-For-Profit Corp. Law).

The bankruptcy court then noted that the New York State Supreme Court ruled in a decision prior to the bankruptcy filing of the debtor that these requirements were not met because "it appear[ed] the sale is much more for the benefits of the for-profit purchaser/developer ... and the outstanding corporate vendors of [the debtor] rather than promoting the interests of the [the debtor] or its members," (internal quotation marks and citations omitted) and "the sale of the building to an individual purchaser rather than a transfer of the premises by the City to a qualified HDFC is in contravention with the purpose of [the debtor's] creation." (Internal quotation marks and citations omitted). Since the New York State Supreme Court had already made the determinations that the proposed sale of the property to the purchaser/developer by the debtor contravened applicable New York state law, the debtor was unable to prosecute a motion for approval of such sale as a result of the bankruptcy court's application of section 363(d) of the Bankruptcy Code.

These cases illustrate the requirements imposed by BAPCPA on not-for-profit entities seeking to sell or transfer their assets through bankruptcy, and highlight the significance of nonbankruptcy law when not-for-profit entities are seeking to transfer or sell assets after filing for bankruptcy. The two cases had divergent outcomes that depended on whether the transfer of the assets of the not-for-profit entity was characterized as voluntary or involuntary. Notwithstanding these requirements, bankruptcy courts continue to approve the sale or transfer of assets of not-for-profit entities when parties are prepared to make the case that they have complied with applicable nonbankruptcy law. ■