A GUIDE TO RESTRUCTURING ISSUES FOR NOT-FOR-PROFIT COMPANIES AND THEIR DIRECTORS
An increasing number of not-for-profit (NFP) entities, including those in the education and healthcare industries, are facing financial challenges that may require restructuring of existing debt loads. The directors of NFPs are often not prepared to face these challenges, having usually agreed to serve on the board not for compensation or to monitor investments (as would be the case with directors of a for-profit entity) but rather because they believe in, and seek to support, the mission of the NFP entity. However, these directors are faced with the same issues, having the same complexity and presenting the same stakes, as are the boards of commercial entities when the companies they manage encounter financial distress.

In this handbook, we highlight the specific issues that NFP entities may confront when they find themselves in or near financial distress, and we address how NFP restructurings may differ from restructurings of for-profit entities.
WHAT DUTIES DO NFP DIRECTORS HAVE?

In general terms, all directors, regardless of the type of corporation they serve, owe three principal duties: (i) the duty of care, (ii) the duty of loyalty and (iii) the duty of good faith. The duty of care requires that the board act only after informing itself of all material information and that it exercise due care in discharging duties once informed. The duty of loyalty requires board members to put the best interests of the company ahead of those of directors, management or another person or organization. The duty of good faith requires that the board act with the good-faith honest belief that the actions it takes are in the best interests of the corporation.

Under most scenarios, the members of a board are entitled to the protections of the “business judgment rule,” which provides that, absent breach of fiduciary duty, lack of good faith or self-dealing, the action of the board is presumed to be in the best interests of the corporation. Where the transaction being considered/approved involves officers and/or directors, in their individual capacity, then the “fundamental fairness” standard is applied and the directors must affirmatively prove the “fairness” of their actions, both as to fair dealing and fair price.

In many instances, the potential liability of uncompensated directors of NFPs is more limited than that of the directors of moneyed corporations. Most states (and the federal government) have enacted “volunteer immunity” statutes which limit the liability of volunteers (including unpaid directors) for actions taken in furtherance of the NFP’s mission. These statutes generally afford unpaid directors immunity from liability except in the case of intentional acts, reckless behavior or gross negligence.

In the NFP context, at least one court has found potential board liability where red flags existed that should have given the board of an insolvent NFP corporation pause.1 The facts of the Lemington case, which are somewhat unique, involve allegations of a board abdicating its duties in the face of a known management failures which were continuing.2 The court found that allegations that the board members did not make due inquiry, exercise due care or properly investigate interested party transactions could give rise to claims in favor of the NFP’s creditors and against the board for breach of fiduciary duties and contributing to the debtor’s “deepening insolvency,” (i.e., the board’s unwillingness to confront issues, caused the loss suffered by creditors to be greater).3 The Lemington case stands for the proposition that boards must take affirmative action to remedy management conduct that endangers the interests of creditors when the corporation is insolvent.
WHAT IS A SUCCESSFUL RESTRUCTURING?

Before discussing the mechanics of a financial restructuring, it is important to consider what constitutes a successful restructuring and what methods and best practices may be considered to accomplish that goal. For an NFP, a successful restructuring should be considered one in which the recovery for all stakeholders is maximized while at the same time honoring the mission of the NFP thus enabling it to restore its financial health and continue its mission. At base, this is a balancing test, whereby the interests of creditors in getting paid, on the one hand, are balanced against the interests of the NFP, its mission and the constituency that depends on it, on the other hand.

In our experience, there are certain best practices or guiding principles that can lead an NFP board through the difficult process of a financial restructuring.

The first of these guiding principles is that the board must confront the problems as early as they appear. As soon as it becomes reasonably foreseeable that the corporation could face a liquidity shortfall or default on its debt obligations, or that debt burdens are impairing the health or viability of the NFP, the board should begin considering its options to face and resolve the issues head-on. The board needs to fully inform itself of all options while liquidity still permits those options to be explored. All too many entities, especially NFPs, fail to confront their financial issues, letting liquidity slip away, and then are only able to liquidate, not reorganize. This failure to confront issues early enough usually exacerbates already fragile situations.

The second guiding principle is that the fix must be permanent. In other words, the result of the restructuring process should not be likely to lead to a further restructuring at some future time. Inherent in this analysis is a process of making realistic, and not overly optimistic, assumptions about the entity’s future financial and business performance to avoid setting the NFP up for a future failure. The restructuring process is expensive, time-consuming and disruptive to management and those parties that support the NFP and those who rely on it. Thus, it is important to all involved that the NFP gets it right the first time. Too often, boards are willing to agree to an interim short-term fix which appeases creditors but does not address the underlying problems.

The third guiding principle is that a successful financial restructuring requires clear and honest communications with the constituents of the NFP: employees, creditors, donors, patients or residents, and regulators. It is important that the NFP develop a clear and consistent communication strategy or strategies to first introduce the problem in the correct manner to its constituents, and then thereafter to keep them apprised of developments. An NFP relies heavily on its credibility, which can be damaged easily by sloppy, inconsistent or inaccurate communications.

Finally, an NFP restructuring needs to be efficient with respect to costs and timing. Time spent in the restructuring process and attendant costs, especially professional fees, go hand in hand. Naturally, the quicker a solution can be identified and then implemented, the lower the costs will be. Moreover, the uncertainty of the process puts a strain on employees and the people whom the NFP serves. If it is at all possible, the fix should be determined before there is public knowledge of the issues requiring the restructuring so the good news (i.e., that a solution has been reached) can be shared at the same time as the bad (i.e., that a problem exists that needed to be addressed).
Following a determination by the NFP that a financial restructuring is needed, management (often with the assistance of its professional advisors) will need to choose the most effective and efficient path to achieve a successful resolution in a timely fashion. In making such a decision, the NFP will no doubt need to take into account the types and nature of the company’s various obligations, as well as the extent and nature of the company’s defaults in respect thereof. Deciding whether the company has sufficient time to pursue a consensual out-of-court restructuring or whether an in-court solution provides the best path will often be dictated (or at least significantly influenced) by (i) whether the NFP is currently in payment default on significant obligations (or anticipates a default in the relatively near term); (ii) the company’s near-term liquidity requirements; and (iii) the size of the creditor group affected by the defaults at issue. Particularly when a company has a relatively small creditor group whose interests are generally aligned (for example, when the overwhelming majority of its bonds and bank debt is held by a handful of creditors), a consensual out-of-court solution should, in theory, be easier to achieve.

There are several advantages to pursuing an out-of-court restructuring rather than a restructuring in bankruptcy. First, an out-of-court restructuring typically is less costly than a bankruptcy filing, primarily due to increased fees and expenses of the professionals for the NFP, secured lenders, the indenture trustee, the collateral agent and the administrative agent, as well as the cost of preparing the bankruptcy filing and related documents. Second, an out-of-court workout often takes less time to achieve than would be the case in bankruptcy, which requires various notice period and court hearings and may involve litigation with a number of interested parties. Third, the bankruptcy rules require substantial public disclosure from the company regarding its finances, operations and other items that may not be necessary in an out-of-court restructuring. Fourth, there will likely be less disruption to the day-to-day operation of the business during an out-of-court restructuring, whereas a bankruptcy filing may cause some agitation and uncertainty for the company’s employees, vendors, customers and other interested parties. In bankruptcy, court approvals will be required to accomplish certain things, such as to pay pre-bankruptcy claims of employees and key vendors that are essential to the operation of the business. In an out-of-court restructuring, a company remains free to pay its employees and vendors in the ordinary course of business.
Discussion of reorganization cases falls into three general categories: (i) “pre-packaged” cases; (ii) “pre-negotiated” cases; and (iii) “free fall” cases. To understand the differences, one needs a background in the chapter 11 plan process. The ultimate goal of a chapter 11 case is the confirmation of a plan of reorganization. The plan provides for the treatment of all creditor claims (including, in many cases, the adjustment of their contractual rights and entitlements) and determines the debt and ownership structure of the debtor once it emerges from chapter 11.

In order for a chapter 11 plan to meet the bankruptcy code confirmation requirements, among other things, it must receive the requisite support from creditors. Creditors vote on a plan after receipt of a “disclosure statement,” a document which is intended to provide a creditor with the information it needs to make a reasonably informed judgment about the plan. This document is circulated to voting creditors after a determination by the bankruptcy court that the disclosure statement provides adequate information for creditors to vote on the plan. Creditors vote in classes, which are groupings of similar creditors. A class of creditors is deemed to accept a plan if at least two-thirds in amount and more than one-half in number of those that actually vote, vote in favor of the plan. If the plan is approved by the bankruptcy court, it is binding on all creditors regardless of whether they voted in favor of or against the plan.

A pre-packaged chapter 11 case is one in which the plan solicitation process is conducted prior to the filing. After receiving requisite acceptances of the plan, the debtor then files the chapter 11 petition, plan, ballots and other relevant documents. The bankruptcy court then conducts a hearing on the terms of the plan and the adequacy of the debtor’s prepetition solicitation of votes thereon.

In a pre-negotiated chapter 11 case, the debtor comes to agreement on the terms of the plan with its principal creditors but files prior to the solicitation of votes on the plan. Typically, the proposed restructuring set forth in the plan is agreed to by, and made binding on, major creditors through an pre-filing agreement known as a lock-up agreement. Pursuant to a lock-up agreement, the principal or majority creditors agree to support a plan which reflects their pre-filing negotiations with the debtor. While creditors are typically bound to such an agreement, most courts require that debtors maintain a “fiduciary out.” This means that the debtor maintains the ability to terminate the agreement in the due exercise of its fiduciary duties if a better deal thereafter emerges.

The third type of chapter 11 case is what is known as “free fall.” This is a case in which the debtor has not come to an understanding with its creditors on the terms of the restructuring prior to the bankruptcy filing and is required to file because of an external stimulus, such as pending litigation or lack of liquidity. In a free fall bankruptcy, the debtor is usually unable to state with any certainty what the result of the reorganization process will be.

In the authors’ experience, most NFP entities are engaged in operations which rely heavily on the confidence of their customers and vendors, such as providing healthcare or education. In these cases, it is essential that the debtor be able to articulate a viable exit strategy at the earliest stages of the bankruptcy case. In fact, most NFPs in these situations retain public relations firms or communications advisors who help to get the good news out. Of course, it is essential that full and honest communication be maintained throughout the process. The ability to deliver the message that the debtor has a clear and concise strategy to resolve its economic problems is absolutely essential and will facilitate the NFP’s successful financial rehabilitation.

Of course, pre-packaged or pre-negotiated plans require a great deal more planning than does a free-fall case, and a proactive attitude toward resolving the NFP’s financial problems is critical. In order to successfully negotiate and implement a restructuring, the board needs to act in advance and start the restructuring process well before external pressures force the NFP’s hand and/or limit its options.

For the most part, the restructuring process for an NFP is very similar to that of a for-profit corporation. But there are some significant differences. Since an NFP may not issue stock to creditors, the NFP does not have the option of de-levering its balance sheet through a debt for equity swap. Thus, the only ways to right-size an NFP’s balance sheet are through either the outright forgiveness of debt and/or through a series A/B note structure, in which the series A note is set at the amount of debt the entity can service on a current pay basis, with the balance of the debt being put into a series B note which is not payable on a current basis and is payable only under certain circumstances.
As discussed in more detail below, the NFP must be careful in formulating the new note structure so as to not run afoul of Internal Revenue Code restrictions on tax-free debt.

Another difference between a for-profit bankruptcy and an NFP bankruptcy is that NFP corporations cannot be forced into involuntary bankruptcy proceedings. Nor can an NFP’s chapter 11 case be converted to a chapter 7 liquidation case without the consent of the debtor NFP.

In contemplating a bankruptcy filing, an NFP should also consider the extent to which the “absolute priority rule” applies to the reorganization of an NFP entity. The absolute priority rule provides that equity cannot retain any interest in a reorganized entity or receive any distributions on account of its equity interest unless either the class of unsecured creditors consents to the plan or is paid in full. With respect to NFP entities, there are of course no equity interests. Thus, there is a question as to what extent the absolute priority rule applies in the context of an NFP chapter 11 case. While not many courts have addressed the absolute priority rule in the NFP context, most courts that have addressed this issue have suggested that because there are no equity interests, the absolute priority rule does not apply to NFPs. In In re Wabash Valley Power Association, the Seventh Circuit upheld the bankruptcy court’s determination that the absolute priority rule did not apply to an NFP electricity-generating cooperative’s chapter 11 case where the cooperative’s members would retain control of the NFP, noting that there was no “equity interest” to be retained. The Seventh Circuit identified three components of an equity interest — control, profit share and ownership of corporate assets — and held that control alone in an NFP that cannot be used to generate present or future profits is insufficient to constitute an “equity interest,” and therefore the absolute priority rule was inapplicable.

Similarly, in In re General Teamsters, Warehousemen & Helpers Union, Local 890, the Ninth Circuit held that there were no equity interests in an NFP union debtor for purposes of the absolute priority rule. The court reasoned that the fact that the parent union would hold the local debtor union’s assets pursuant to a contractual provision while the debtor union reorganized with a conditional possibility of retention was not an “ownership interest” under the Wabash factors. Moreover, the parent union had no “control” because the debtor union was an independent financial and legal entity. Additionally, the debtor union’s members could not be considered owners, had minimal control, and did not share in any profits. Therefore, no equity interest was present for purposes of the absolute priority rule.

Clearly, whether or not the absolute priority rule is applicable to NFP cases has a significant impact on how plan negotiations play out. If an NFP entity can reduce its unsecured or undersecured debt without obtaining the consent of the unsecured creditors class, then the NFP will have considerable leverage in restructuring negotiations.
KEY ISSUES FOR OUT-OF-COURT RESTRUCTURING OF NFPs

BONDS: CREDITOR CONSENT REQUIREMENTS

A typical NFP will have one or more series of tax-free bonds outstanding that were issued on its behalf by a municipal entity or authority. Often, a significant portion of such bonds are held by a relatively small group of institutional lenders (e.g., hedge funds and insurance companies). The NFP may also have outstanding indebtedness pursuant to a working capital line of credit, letters of credit and/or interest rate swaps issued by one or more banks or other financial institutions. Thus, given the relatively limited nature of this creditor body, it is often very possible for an NFP to successfully restructure its bank and bond indebtedness outside of bankruptcy.

In connection with any out-of-court restructuring of an NFP’s bonds that would modify material terms or provide for an exchange of new bonds for the existing bonds, the consent of bondholders will need to be obtained in accordance with the terms of the bond indenture. Typically, pursuant to the indenture, certain non-material modifications thereto may be agreed to by the bond trustee without the consent of the bondholders. With respect to other more substantive amendments or modifications of the indenture, the prior written consent of the holders of a majority (or possibly a supermajority, such as 66-2/3 percent) of the bonds is often required. However, if the proposed restructuring involves a change in any terms of redemption or purchase of any bond, then the due date for the payment of the principal of or interest on any bond or any reduction in the principal, redemption price or purchase price of or interest on any bond, the consent of each bondholder is usually required. As a consequence, in an out-of-court restructuring, an NFP usually needs to obtain the consent of 100 percent of the bondholders to alter the principal amount, interest rate and/or time for payment of the bonds (as is also the case under most for-profit bond indentures). This leads to the “hold out” problem. That is, bondholders who refuse to accept a restructuring that requires 100 percent consent can hold out for par treatment (i.e., payment in full according to the original terms of the bond indenture).

Accordingly, an NFP will typically insist that any out-of-court restructuring agreement impacting these provisions require a high level of bondholder acceptance (95 percent is common) in order to be effective.

As discussed in more detail below, when a contemplated restructuring requires the consent of 100 percent of the bondholders but such consent is not achievable (and the NFP is not able and willing to leave the non-consenting bonds outstanding at their original terms without modification), the NFP may decide to file for bankruptcy in order to implement the restructuring.

In bankruptcy, an NFP can generally bind all bondholders to the restructuring by obtaining the consent of bondholders that hold at least 66-2/3 percent in amount and more than 50 percent in number of the claims held by bondholders that hold actual or potential claims that would hold out in an out-of-court restructuring (assuming all other confirmation requirements are satisfied).

FORBEARANCE/NO ACTION RULES

While the NFP is contemplating, and thereafter negotiating with its creditors, a financial restructuring, the NFP should consider what enforcement rights are available to its creditors as a result of an existing or impending default or event of default under the bond indenture, credit agreement or other financial instrument to which the NFP is a party. Often, an NFP will request that its bondholders or other lenders forbear for a limited period of time from taking any legal actions or otherwise seeking to enforce remedies that they may otherwise be entitled to pursue so as to allow the NFP sufficient time to complete a restructuring.

The bond indenture will normally set forth enforcement rights of the bondholders. For example, the indenture may provide that following the occurrence and continuance of any event of default thereunder, the trustee may, and upon the written request of the holders of not less than 25 percent of the outstanding principal amount of the bonds is required to (unless the holders of 50 percent or more of the outstanding principal amount of the bonds object), enforce its rights and the rights of the bondholders under applicable law and the bond documents. The trustee, however, may be granted the right to decline to follow any direction given to it by the bondholders if, in the opinion of the trustee, doing so would be “unjustly prejudicial to holders of bonds that are not parties to such direction.” As a practical matter, a bond trustee will typically follow the direction of the required bondholders.

Bond indentures usually will place significant limitations on the ability of one or more bondholders to take independent actions to enforce remedies. For example, the indenture may provide that individual bondholders do not have the right to institute any suit, action or proceeding unless (i) the holders provided the trustee with notice of an event of default, (ii) the holders of not less than a majority of the bonds made a written request to the trustee and afforded the trustee a reasonable opportunity either to proceed to exercise
the powers granted by the indenture or to institute such action in its name, and (iii) the trustee was offered reasonable security and indemnity against the costs, expenses and liabilities to be incurred, and the trustee refused to comply with the request within a reasonable amount of time. Such a “no action” provision provides some comfort to the NFP that a single bondholder or relatively small group of bondholders will not disrupt the NFP’s restructuring strategy.

In addition, an NFP seeking to restructure its debt should be mindful of two recent decisions by the United States District Court for the Southern District of New York in a case involving the out-of-court restructuring of Education Management Corp. (EDC).18 In those decisions, the court ruled that the out-of-court restructuring, which would have converted the interests of one bondholder from a $14 million bond investment into a $5 million stock ownership, was impermissible by virtue of Section 316(b) of the Trust Indenture Act (TIA), which states that:

“Notwithstanding any other provision of the indenture to be qualified, the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture security, on or after the respective due dates expressed in such indenture security, or to institute suit for the enforcement of any such payment on or after such respective dates, shall not be impaired or affected without the consent of such holder.”

Although Section 316(b) has typically been interpreted to guarantee bondholders the ability to enforce their right to be paid principal and interest when due, the EDC decisions suggest that this section of the TIA can also be used to prevent an out-of-court restructuring where one or more bondholders have been forced by the majority, in accordance with the express terms of the indenture, to accept the restructuring.

SECURITY INTEREST IN NFP’S CASH FLOW

In a typical secured financing arrangement, the lender often seeks to be granted a security interest in the borrower’s accounts receivable and cash flow. The lender will want to perfect such a security interest in their borrower’s accounts receivable (and proceeds thereof) by filing financing statements under the Uniform Commercial Code (UCC) in the appropriate jurisdictions. The lender will also need to perfect its security interest in the borrower’s deposit accounts into which proceeds of such accounts receivable are deposited by obtaining “control” over the deposit accounts.19 The lender can obtain “control” over the borrower’s deposit accounts by means of a deposit account control agreement pursuant to which the borrower, lender and the depository bank agree that the depository bank will comply with instructions from the lender directing disposition of the funds in the deposit account, without the need for any further direction or consent by the borrower.20

Notwithstanding the above general secured loan arrangements, lenders to healthcare providers that receive Medicare and Medicaid payments have difficulty perfecting a security interest in the borrower’s deposit accounts as a result of certain Medicare/Medicaid regulations. These regulations provide that, generally, payments made under Medicare and Medicaid must be made directly to the provider of services and not to any assignee. Additionally, according to the Centers for Medicare and Medicaid Services (CMS),21 payments due to a Medicare provider may be sent to a bank for deposit in the provider’s account, but only if the account is in the name of the provider and the bank is bound by only the provider’s instructions.22 As a consequence, in order to be in compliance with the Medicare/
Medicaid anti-assignment regulations, the depositary bank can only be subject to the instructions of the borrower in respect of the disposition of funds in the deposit account and cannot be subject to the instructions of the lender. Therefore, the lender cannot be given “control” over the deposit accounts and, thus, is not able to perfect its security interest therein as required by the UCC. These facts provide an NFP with some flexibility when considering its liquidity and cash flow position and its ability to fund operations during a restructuring.

**TAX IMPLICATIONS OF BOND RESTRUCTURING**

Since bonds issued on behalf of a charitable organization such as an NFP are “qualified 501(c)(3) bonds,” it is a requirement that, subject to certain narrow exceptions, the bonds be tax-exempt during the entire term of the bonds and the user of the facilities be an organization described in Section 501(c)(3) of the Internal Revenue Code of 1986, as amended (Tax Code). State law may limit the types of transactions which can be entered into by the NFP. In addition to Tax Code requirements for eligibility as a Section 501(c)(3) organization, applicable state law may contain limitations (e.g., explicit restrictions on the issuance of equity) which should be reviewed.

Among other tax related issues of which an NFP must be mindful when contemplating a restructuring of its tax-exempt bonds is whether the proposed restructuring will cause a “reissuance” of such bonds to be deemed to have occurred. Generally, a reissuance of a tax-exempt bond triggers retesting of all the federal tax requirements that apply to a new issue. A reissuance occurs “when there are significant modifications to the terms of a bond so that the bond ceases to be the same bond for federal tax purposes. A reissuance is a deemed exchange of the modified bond for the original bond.” The IRS has specified seven specific types of modifications that are considered “significant” and, thus, can in certain situations give rise to a reissuance: (a) a change in annual yield by more than the greater of one-quarter of one percent or 5 percent of the annual yield of the unmodified instrument; (b) a change in timing of payments such as an extension of the final maturity or deferral of payments prior to maturity; (c) the substitution of a new obligor or the addition or deletion of a co-obligor; (d) a change in security or credit enhancement; (e) a change in priority of an obligation (e.g., the subordination of a tax-exempt bond to another obligation); (f) a change in the nature of a debt instrument (e.g., changing a tax-exempt bond from a non-recourse obligation to a recourse obligation); and (g) a change in payment expectations (e.g., a substantial enhancement or impairment of an NFP’s ability to meet its payment obligations).

Moreover, when evaluating the proposed restructuring, an NFP must be mindful that in order for the organization to maintain its tax-exempt status: “The organization must not be organized or operated for the benefit of private interests, and no part of a Section 501(c)(3) organization’s net earnings may inure to the benefit of any private shareholder or individual. If the organization engages in an excess benefit transaction with a person having substantial influence over the organization, an excise tax may be imposed on the person and any organization managers agreeing to the transaction.”

As a consequence of these restrictions, an NFP that seeks to restructure its bonds must evaluate very carefully the extent of any modifications being made to its existing bonds. The NFP should take into account the fact that granting bondholders additional rights and remedies (such as the payment of excess cash to bondholders), changing the amount and/or maturity of payment on the bonds, subordinating all or a portion of the bonds to other debt or adding or subtracting collateral securing the bonds, among other change to the bonds, may give rise to a retesting of the tax exempt nature of the bonds by the IRS.
OUT-OF-COURT SALES

Either as an alternative to a financial restructuring, or as a part thereof, an NFP may decide to pursue a sale of a portion or all of its assets. The sale of an NFP’s assets can occur outside of bankruptcy or in connection with the filing of a bankruptcy case. Outside of bankruptcy, asset sales, mergers, affiliations, and other similar transactions involving the assets of an NFP typically must be reviewed and/or approved by various governmental and regulatory bodies under applicable non-bankruptcy law. For example, under Pennsylvania law, when an NFP enters into a transaction effecting a fundamental corporate change involving a transfer of ownership or control of all or substantially all of its charitable assets, the Attorney General of Pennsylvania must review the transaction to ensure that the public interests are protected. Similarly, an NFP incorporated in New York must comply with New York’s Not-for-Profit Corporation Law in order to sell all or substantially all of its assets, which requires the NFP to provide prior notice to the New York Attorney General and make various disclosures. In addition, if the New York NFP is selling healthcare assets, then certain approvals will need to be obtained from the Commissioner of the Department of Health of the State of New York and, following the sale, the acquired assets must be operated in accordance with all applicable public health laws.

BANKRUPTCY SALES

To the extent that an out-of-court sale process is not feasible and/or is not the most advantageous way for the NFP to proceed, the NFP may decide to pursue a sale of its assets in bankruptcy, either pursuant to section 363 of the Bankruptcy Code or via a confirmed chapter 11 plan of reorganization. Doing so has become increasingly common in recent years and is generally viewed as an efficient and effective way to monetize a debtor’s assets and, under the appropriate circumstances, to maximize the value of the bankruptcy estate. An “inheriting” potential buyer who is concerned with liabilities from a distressed NFP will be comforted by a bankruptcy court’s ability to deliver assets free and clear of most liens, claims and interests.

However, an NFP seeking to sell its assets in bankruptcy will typically want to consider factors other than simply maximizing value for creditors. For example, an NFP can and should consider, among other things, (a) whether the proposed purchaser (i) has the ability to obtain the necessary regulatory approvals under applicable state law, and (ii) is committed to continuing the NFP’s charitable mission, and (b) the extent to which the proposed sale transaction will serve the public interest. In addition, an NFP that provides healthcare (such as a hospital or long-term care facility) will want to consider the proposed purchaser’s ability to continue providing quality care (including indigent care) to its patients or residents after the sale is consummated.

ASSET SALES
Federal bankruptcy law typically overrides contrary state law and often allows certain transactions to occur in bankruptcy that would not be able to occur outside of bankruptcy. Despite this fact, the transfer of an NFP’s assets in bankruptcy is expressly subject to applicable non-bankruptcy law, including the laws of the relevant state(s) with jurisdiction over the NFP and its assets. As a consequence, an NFP seeking to sell its assets in bankruptcy must ensure that it complies with all non-bankruptcy requirements in addition to bankruptcy requirements. For example, in the chapter 11 bankruptcy cases of Saint Vincent’s Catholic Medical Centers of New York and various of its affiliates, in order to bid, potential purchasers were required to submit evidence of their ability to obtain all necessary regulatory approvals in a timely manner, and the ultimate purchaser was required to actually obtain such approvals before the sales could be consummated. Similarly, a potential purchaser seeking to submit a bid for an NFP’s assets should have a clear understanding of all required regulatory approvals and all licenses, permits, authorizations, accreditations and certificates needed to operate the business after the sale, and should be prepared to demonstrate its ability to obtain all of the foregoing when submitting its bid.

In a typical bankruptcy sale, the debtor seeks to obtain the “highest and best” offer for its assets, which often (but not always) involves selecting the offer that will provide the best recovery for the debtor’s estate and/or its creditors. In doing so, the amount of the purchase price is not the sole factor that a debtor usually considers in evaluating whether a bid is the highest and best offer for the debtor’s assets. Other factors include what contracts and/or liabilities the purchaser will be assuming (if any), the extent to which the purchaser is able to close the sale transaction in a timely manner, the purchaser’s financial wherewithal, and the purchaser’s commitment to preserving jobs and ongoing business relationships with suppliers and vendors.

In addition to the above factors to be evaluated by a typical debtor, an NFP often has some latitude to choose a purchaser dedicated to the mission and goals of the NFP and the public interest being served by its existence. In considering offers from prospective buyers, an NFP is charged with the fiduciary duties to act in furtherance of the organization’s charitable mission while also acting in the best interests of creditors. For example, under Pennsylvania law, the board of an NFP corporation, in discharging its duties, may consider, among other things, (i) the effects of the action on various constituencies and the communities where the NFP is located, (ii) the short-term and long-term interests of the NFP and (iii) the resources, intent and conduct (past, stated and potential) of the potential purchaser. Consequently, when considering competing offers to purchase its assets in bankruptcy, the NFP should consider how its charitable mission and the public interest will be served by each proposed purchaser. If a potential purchaser cannot adequately demonstrate that it will continue to pursue the NFP’s charitable mission and that the public interest will be served, it may not be deemed to have submitted the “highest and best” offer even if its bid contains the highest purchase price.

One bankruptcy case that addressed the factors an NFP should consider when selling assets involved a sale of the Children’s Hospital of New Jersey. The NFP’s board of trustees was advised by its financial advisor to consider several factors when analyzing bids, with price ranking last in importance. The NFP entity selected the winning bid based on, among other things, the purchaser’s (i) ability to further the hospital’s charitable mission, (ii) assurance that it would keep the hospital in one location, which was a concern for the Commissioner of Health and Senior Services of New Jersey and (iii) commitment to provide $5 million in future investments. However, the bankruptcy court rejected the NFP’s selection as the “highest and best” bid, finding that the NFP did not exercise sound business judgment in its selection when another bidder was offering a higher purchase price. On appeal, the district court reversed the bankruptcy court decision, stating: “When analyzing an articulated business reason for the sale, the bankruptcy court must also take into consideration the fact that a debtor is a charitable institution. The officers and directors of a nonprofit organization are charged with the fiduciary obligation to act in furtherance of the organization’s charitable mission.” The district court noted that purchase price alone should not be used to determine the best offer for an NFP’s assets, finding that the bankruptcy court was too focused on the monetary aspects of the competing bids. Rather, the district court continued, the “overriding consideration of public health” must be considered and the NFP’s board of trustees “had a fiduciary obligation to maintain the legacy of the Children’s Hospital.” Thus, the district court recognized that the
proposed purchaser’s ability to further the NFP’s charitable mission was an important consideration. Consequently, the district court determined that the NFP exercised sound business judgment in approving the original sale, notwithstanding the lower purchase price.

In considering the extent to which a proposed sale will impact the NFP’s mission and the public interest, the type of business being purchased will no doubt dictate what factors are most important. For example, if the NFP is selling a healthcare business such as a hospital or a long-term care facility, the extent to which a proposed sale will impact the NFP’s patients or residents will be a very important consideration. In that situation, the NFP and the bankruptcy court will want to be certain that the purchaser will continue to provide quality care and accommodations for patients or residents following the sale. Indeed, an emphasis on continued patient care is underscored in section 333 of the Bankruptcy Code, which provides for the appointment of a patient care ombudsman when the debtor’s business involves healthcare to monitor the quality of patient care and to represent the interests of patients during the debtor’s bankruptcy case. As a result, a potential purchaser will no doubt need to demonstrate that, following the sale, it will operate the business in a manner that will ensure quality care for and safety of the patients or residents. In addition, an NFP may want to specify what contracts or other liabilities are required to be assumed by any proposed purchaser so as to ensure that patients’/residents’ interests are protected (such as, in the case of a long-term care facility, the residency agreements).

The criteria that the NFP deems to be required for a bidder to be a “qualified” bidder should be reflected in a debtor’s bidding procedures. For example, in the chapter 11 case of The Clare at Water Tower, a continuing care retirement community in Illinois, the NFP conducted a section 363 bankruptcy sale process that, prior to being qualified to bid at the action, required potential bidders to describe in detail their intentions with respect to the NFP’s ongoing contractual obligations to its residents and satisfying all licensing and regulatory requirements for operating the retirement community. In addition, when the NFP operates a healthcare business, both the debtor and prospective purchasers should be mindful of issues and timing concerning the transfer of Medicare provider numbers and the potential for any Medicare chargebacks that may not be realized until well after the sale is consummated.
CONCLUSION

While the restructuring process can be difficult, unpleasant and time consuming, the board of an NFP which faces financial difficulties must confront the realities of the process early and in a fully informed fashion. Correctly pursued and managed, the restructuring process either in or out of court can provide an opportunity to revitalize a failing or floundering NFP. Board members must fully inform themselves of both the current condition of the NFP for which they serve and the options and pitfalls which it faces. Boards acting properly in distressed situations can preserve the organization’s mission at the same time as resolving its problems.
1. See In re Lemington Home for the Aged, 659 F.3d 282 (3rd Cir. 2011).
2. Id. at 291.
3. Id. at 291-94.
4. Outside of a chapter 11 case, the applicable bond indenture may prohibit a company from accessing reserves held by a trustee or obtaining additional financing absent unanimous bondholder consent.
5. 11 U.S.C. § 1126(c).
10. In re Wabash Valley Power Ass’n, Inc., 72 F.3d 1305, 1320 (7th Cir. 1995).
11. Id.
12. In re Gen. Teamsters, Warehousemen & Helpers Union, Local 890, 265 F.3d 869, 876 (9th Cir. 2001).
13. Id.
14. Id.
15. Id.
16. It should be noted that the application of the section 1111(b) election which permits an undersecured creditor (i.e., a creditor holding a claim exceeding the value of any collateral securing such claim) to have its entire claim treated as secured and the implications thereof are outside the scope of this article.
17. 11 U.S.C. § 1126(c).
19. UCC § 9-312(b)(1).
20. UCC §§ 9-104, 9-314(a).
21. 42 U.S.C. § 1395g(c).
23. Medicare Claims Processing Manual § 30.2.5. It is possible that the current policy regarding Medicare payments to banks would be deemed to apply to Medicaid payments as well.
24. The bank may provide financing to the provider, as long as the bank states in the loan agreement that it waives its right to offset.
25. UCC § 9-104.
27. Id.
28. Id.
31. See N.Y. Not-‐For-‐Profit Corp. Law §§ 510 and 511.
38. Id. at *5.
39. Id. at *6.
41. In re The Clare at Water Tower, Case No. 11-46151 (Bankr. N.D. Ill.).
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