DEALING WITH PROBLEMS OF FINANCIALLY DISTRESSED EXEMPT ORGANIZATIONS

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Section 1. Introduction

1.1 Overview. Because of the changing economic conditions over the past few years and the numerous financial and public relation problems encountered by Exempt Organizations, there has been much interest by Exempt Organization practitioners and others regarding such issues as what happens when a charity is facing bankruptcy, and what to do with endowment funds. Many organizations are trying to determine whether they can make distributions from endowed funds to assist the organization during these difficult times. In addition to the legal issues involved, ethical issues may confront the lawyer advising the charity's board.

Section 2. Overview of Bankruptcy Law

2.1 Eligibility

2.1.1 Eligibility for relief under the Bankruptcy Code is limited to those entities or individuals identified as "persons" under §§ 109(a) and (d) of the Bankruptcy Code. Section 101(41) of the Act defines "person" to include an individual, partnership, corporation, and certain governmental units. A "corporation," as defined by the Bankruptcy Code, includes a business trust, but does not include a trust that is not engaged in a business. *See* 11 U.S.C. Section 101(9)(A)(v). *See, e.g.,* In re Hunt, 160 B.R. 131 (Bankr. 9th Cir. BAP (Cal. 1993)) ("Neither nonbusiness trust nor its trustee was 'person' eligible to file for Chapter 11 protection"). As a consequence, although trusts engaged in business are eligible for bankruptcy relief, trusts which are organized merely to hold passive assets are not.

2.2 Commencement of a Case

2.2.1 Voluntary Cases – 11 U.S.C. Section 301. A voluntary bankruptcy case is commenced by the filing with the bankruptcy court of a petition under one of the chapters of Title 11.

2.2.2 Involuntary Cases – 11 U.S.C. Section 303(a) provides that an involuntary Chapter 7 or 11 petition may be brought only against a person except a farmer, family farmer, or a corporation that is not a "moneyed, business, or commercial corporation." The phrase "moneyed, business, or commercial corporation" refers only to for-profit organizations. *See* In re Capitol Hill Healthcare Group, 242 B.R. 199, 202 (Bankr. D. D.C. 1999). A corporation, in other words, may not be the subject of an *involuntary* Chapter 7 or 11 debtor if it is a not-for profit corporation. In re Grace Christian Ministries, Inc., 287 B.R. 352, 355 (Bankr. W.D. Pa. 2002). The legislative history of this provision indicates that schools, churches, charitable organizations and foundations are protected from *involuntary* bankruptcy by §303(a), but such entities are permitted to file a *voluntary* petition. *See* H.R.

Rep. No. 95-595, 95th Cong., 1st. Sess.321 (1977); S. Rep. No. 95-595, 95th Cong. 2d Sess. 33 (1978).

2.3 The Bankruptcy Estate

2.3.1 Property of the Estate – Classified in §541 of the Bankruptcy Code, the bankruptcy estate is created automatically upon the filing of a bankruptcy petition and consists of a comprehensive range of rights and property interests, including all legal and equitable interests of the debtor at the time the petition is filed.

2.3.2 Debtor's Interest in Property – Applicable "non-bankruptcy" law generally defines the debtor's interest in property. Applicable "non-bankruptcy" law typically refers to state law, but can also include federal law as well. For example, property which is held by a debtor in a trust for the benefit of another, if recognized as such in state law, would not be deemed property of the estate and not be administered as part of the bankruptcy proceeding.

2.3.3 Property Interests as part of the Estate – Federal Bankruptcy law, not state law, determines what property interests of debtor are included in the bankruptcy estate.

2.4 The Automatic Stay and Executory Contracts [11 U.S.C. Sections 362 and 365]

2.4.1 Generally – The automatic stay, applicable to all entities, takes effect when the bankruptcy petition is filed and protects the debtor, his property, and the estate property from certain creditor's actions. It provides a reprieve for the debtor and promotes an orderly case administration and helps assure the uniform treatment of creditors similarly situated.

2.4.2 Acts Enjoined

2.4.2.1 Proceedings against debtor – The commencement or continuation of a judicial, administrative, or other action against the debtor is stayed if its purpose is to recover a pre-petition claim, or if the action was, or could have been, commenced before the filing of the bankruptcy petition.

2.4.2.2 Acts against estate property – Any act to obtain possession of property of the estate or in its possession, or to exert control over estate property, is prohibited. Any act to create, perfect, or enforce a lien against estate property is enjoined.

2.4.2.3 Liens against debtor's property – An act to create, perfect or enforce a lien against the debtor's property is barred to the extent the lien secures a pre-petition claim.

2.4.2.4 Collection Efforts – Acts to collect, recover, or assess a claim against the debtor that arose prior to the filing of the bankruptcy petition are forbidden.

2.4.3 Relief from Stay. Upon request, relief from the automatic stay may be granted to a party in interest after notice and a hearing. For "cause," the court will grant relief from the stay of any act enjoined, and the stay will also be lifted for allowing seizure of secured property where the debtor lacks equity in the property and the property is not necessary for an effective reorganization (that is, to assist a secured creditor whose financial position is eroding). The bankruptcy court has broad discretion to determine what constitutes cause for granting relief, which includes lack of adequate protection and the debtor's lack of good faith in filing the petition. Cause is generally determined on a case-by-case basis. As a practical matter, a party obtaining relief from stay must have demonstrated palpable injury to its position if it is not permitted to pursue its rights. Under these standards, relief from the stay may be granted to secured creditors whose position is eroding, or to allow claimants to pursue determination of their claims in another forum, with the collection of any judgment remaining with the bankruptcy court and part of its claims distribution process. Absent relief from the stay, if an individual debtor is injured by a willful violation of the stay, it may recover actual damages, costs, attorney's fees, and if warranted, punitive damages.

2.4.4 Executory Contracts. Consistent with its philosophy that enforcement of prepetition rights against a debtor are curtailed, so that all similarly situated creditors are to be treated similarly, the Bankruptcy Code also contains various provisions in Section 365 dealing with the treatment of unperformed prepetition contracts. In broad terms, a debtor which is a party to an unfavorable contract is permitted to "reject" the agreement, and the counterparty would assume the status of a prepetition creditor for its breach of contract damage claim. (Those damages are subject to certain limitations under 502(b)(6) and (7) in the case of nonresidential real estate leases and employment agreements.) On the other hand, if the debtor regards the contract as favorable, it has the right to "assume" the contract, if it can cure defaults (other than defaults related to the bankruptcy filing or financial condition) and show adequate assurance of future performance. Pending the debtor's decision of whether to assume or reject the contrast, the counterparty is obligated during the course of the bankruptcy case to perform it in accordance with its terms, although it has the right to seek relief from stay (in most jurisdictions), adequate assurance of interim performance, or an order compelling the debtor to assume or reject the agreement by a specified time. Typically, if the counterparty is not suffering undue risk in the interim, the debtor will be granted an extended period, often to the end of the case, to decide whether to assume or reject its contracts. This liberal attitude towards extensions applies even to nonresidential real estate leases, which absent extension are deemed under §365(d) to be rejected if not assumed within 60 days, or such longer period as the court may allow.

2.4.4.1 Practice Pointer – Due to the automatic stay and the rules as to executory contracts, the charitable organization must be aware that (i) any collection efforts or proceedings to enforce a gift taken against the debtor will be barred by the automatic stay, and (ii) to the extent there is an agreement as to the gift which is can be characterized as an executory contract (for example, where there is a gift balance due and the charity is obligated to engage in some performance in the interim), it will be subject to the rules outlined above as to executory contracts, and may require the charity to perform on an interim basis unless it obtains relief from the bankruptcy court.

2.4.5 Financial Accommodations. This is usually thought of as a subset of executory contracts (2.4.4 immediately above). Bankruptcy Code section 365(c)(2) provides that neither the trustee nor the debtor in possession may assume an executory contract to make a loan or to grant a financial accommodation. The term “financial accommodation” is not defined in the statute. The legislative history and judicial interpretations have narrowly construed that term to include executory contracts for the extension of money or credit to accommodate another, where the extension of money or credit is the primary purpose of the contract. Classic examples include bank loan commitments, and guaranty or surety contracts. *See In re Cole Bros.* 137 B.R. 647 (Bankr. W.D. Mich. 1992) at 652 “If the purpose of the executory contract is to provide financing, then the debtor should not be allowed to assume it and force the creditor to continue its obligation to provide financial benefit at its own risk. But [when] the overall agreement establishes a contractual business relationship, of which financing is only a part, the debtor should be, and is allowed to exercise its right of assumption,” *and In re Thomas B. Hamilton*, 969 F2d 1013 (11th Cir 1992) (bank agreement to extend credit under credit card processing contract with debtor is not a financial accommodation and contract is assumable by trustee). *See also*, In re Securities Group 1980, 124 Bankr. 875 (Bankr. M.D. Fla. 1991) (Limited partners' obligation to provide capital not a financial accommodation, because the contract was not executory, because it was for an equity investment without any expectation of repayment, and because the obligation to make equity contributions was also required by statute. No reported case has decided whether a charitable pledge enforceable under state law is characterized as a “financial accommodation” within the meaning of Bankruptcy Code section 365(c)(2). Characterizing a pledge as a financial accommodation would eviscerate the notion of enforceability of a pledge in bankruptcy.

2.5 Avoidance Powers

2.5.1 Generally. To further the bankruptcy policy of insuring equality of distribution among creditors, a bankrupt entity, acting through either a trustee or the debtor in possession, is empowered to "avoid" certain transactions (chiefly transfers of property) which occurred shortly before bankruptcy and which had the effect of allowing a single creditor or other party to be unfairly advantaged.

2.5.2 Preferences. Under section 547 of the Bankruptcy Code, a party which receives payment or other transfers on account of an antecedent debt within 90 days before the filing of a bankruptcy petition is required to return that payment to the estate, if the debtor was then insolvent and the payment resulted in the creditor being able to recover more than it would have received in a Chapter 7 liquidation. The "look back" period is extended from 90 days to one year if the recipient of the payment was an insider, and there is a rebuttable presumption of insolvency for payments made during the 90 day period. The preference recipient can assert various affirmative defenses. Among these are: (1) that the payment was made in the ordinary course of business, which typically requires that it be made in accordance with the "normal" prepetition payment pattern and without collection pressure: (2) that it be a contemporaneous exchange for new value; and (3) that after receiving the transfer, the creditor advanced additional new value to the debtor.

2.5.3 Fraudulent Conveyances. Section 548 of the Bankruptcy Code provides for a federal right of action for fraudulent conveyance, which examines transfers within one year before the filing of the petition. Under section 544, the trustee or debtor in possession may assert similar fraudulent conveyance rights which exist under state law, which can have as long as a six year statute of limitations. These rights encompass both "actual" and "constructive" fraudulent conveyances. "Actual" fraudulent conveyances are those done by an insolvent entity with an intention to hinder, defraud, or delay creditors. "Constructive" fraudulent conveyances, by contract, are not dependent on intent, but on the simple economic fact of an insolvent entity transferring assets for less than a reasonably equivalent value. Almost by definition, a charitable contribution, for which the donor receives no tangible economic benefit, would appear to be a transfer for less than reasonably equivalent value and thus subject to recovery under §§ 544 or 548. However, as noted below, these statutes provide a limited safe harbor for certain charitable contributions. Purchasers of assets from a debtor are also subject to fraudulent conveyance claims if their purchase price, in hindsight, is deemed inadequate or if the proceeds, for example, are paid to equityholders under circumstances that creditors will not be paid in full.

2.5.4 Setoff. Just as the preference statute seeks to prevent creditors from receiving prepetition payments which advantage them over other creditors, section 553 provides for recovery of amounts which a creditor set off during the 90 days before the petition date, if as a result, the creditor improved its position compared to what would have occurred had the setoff not occurred.

2.5.5 Potential Defendants. Under section 550, the above avoidance actions allow recovery from (i) the recipient of the transfer or the entity for whose benefit the transfer was made; and (ii) any of their immediate or mediate transferees. The ability to obtain recoveries from the parties in clause (ii) can avoid liability to the extent they can prove they took the property for value, in good faith, and without knowledge of the voidability of the transfer.

2.5.6 Lien Avoidance. Section 544(a), sometimes referred to as the "strong-arm clause", also empowers the trustee or debtor in possession to exercise any state-law avoidance rights which would be exercisable by a judicial lien creditor, an unsatisfied execution creditor, or a bona fide purchaser of real property. The effect of this provision is to set aside unperfected or improperly filed liens.

2.6. Chapter 7 – Liquidation

2.6.1 Overview. Chapter 7 allows for liquidation of the debtor's bankruptcy estate, payment of the creditors with the liquidation proceeds, and discharge of the debtor from debts.

2.6.2 Procedure. Immediately after the filing for Chapter 7 relief, a trustee is appointed. Typically the trustee is an individual registered on the Chapter 7 trustee list of the local bankruptcy court, but a replacement trustee may be elected by unsecured creditors. The trustee's duties are to locate and collect property of the estate, to convert the property to cash, to make distributions to claimants in the order established by the Bankruptcy Code, and to close the estate expeditiously. A Chapter 7 trustee may be authorized to operate the business for a limited period if in the best interest of the estate and consistent with orderly liquidation. 11 U.S.C. Section 721. Classically, the trustee acts for the benefit of unsecured general creditors, and where possible, will seek to challenge the purported security or priority claims of other creditors in order to create a pool of unencumbered assets which may be distributed to the class of unsecured general creditors.

2.6.3 Order of Payment

Claimants in a Chapter 7 proceeding receive distribution of the bankruptcy estate in the order prescribed by Bankruptcy Code sections 725 and 726.

2.6.3.1 Secured Creditors – Claims that have been allowed as secured are paid first from the collateral securing their claims.

2.6.3.2 Priority Claims – Unsecured creditors entitled to priority are paid in the following order as prescribed by §507 of the Bankruptcy Code:

2.6.3.2.1 Administrative Expenses (after notice and hearing) including:

2.6.3.2.1.1 Post-petition costs of preserving estate.

2.6.3.2.1.2 Post-petition taxes.

2.6.3.2.1.3 Compensation and reimbursement.

2.6.3.2.1.4 Expenses of involuntary petition.

2.6.3.2.1.5 Expenses of recovery of concealed or transferred property.

2.6.3.2.1.6 Expenses of criminal prosecution.

2.6.3.2.1.7 Expenses and compensation of pre-petition custodian.

2.6.3.2.1.8 Attorneys' or accountants' fees and expenses.

2.6.3.2.1.9 Witnesses' fees.

2.6.3.2.2 Involuntary case gap claims. ("Gap Claims" are those that arise in the ordinary course of the debtor's business after the commencement of the case but before the earlier of the appointment of a trustee or the order for relief);

2.6.3.2.3 Wages, salaries, or commissions earned by an individual within 90 days before either bankruptcy or "the cessation of the debtor's business," whichever is earlier;

2.6.3.2.4 Contributions to employee benefit plans for service rendered within 180 days before either bankruptcy or "the cessation of the debtor's business," whichever is earlier;

2.6.3.2.5 Claims of grain farmers and United States fisherman;

2.6.3.2.6 Consumer layaway claims;

2.6.3.2.7 Alimony, or spousal and child support;

2.6.3.2.8 Unsecured pre-petition taxes;

2.6.3.2.9 Capital requirements of insured depository institutions.

2.6.3.3 Unsecured general creditors.

2.7 Chapter 11 – Reorganization

2.7.1 Overview. Chapter 11 allows a business to reorganize under the supervision of the Bankruptcy Court and the Trustee, although the flexibility of Chapter 11 is often used for business which are being sold or otherwise liquidated as well. Generally, the debtor is allowed to remain in possession of its assets (referred to as a "Debtor in Possession") and to continue to operate in the normal course of business. Unless a trustee is appointed, the debtor's prepetition board and management remain in control of the property of the estate and continue to operate the business.

2.7.2 Procedure. If a trustee is appointed, he or she must account for all property received; examine proofs of claims and object to the allowance of any improper ones; provide information requested by parties in interest about the estate and its administration; file periodic financial reports, prepare and file a final report and account concerning the case; file any document required under Bankruptcy Code Section 521(1) that has not been filed by the debtor; investigate the debtor's conduct, financial condition, and business operations; file a report of investigation relating to any facts evidencing fraud, dishonesty, incompetence, misconduct or mismanagement; file a Chapter 11 plan as soon as is feasible or recommend conversion to another Chapter; provide available information to the taxing authorities; and after a plan is confirmed, file any required reports. Essentially, a trustee is appointed only by consent of the debtor, or under §1104 of the Bankruptcy Code, for "cause" such as fraud or mismanagement, or if otherwise in the best interests of the estate. This provision is not interpreted as permitting the ready appointment of trustees because of a general dissatisfaction with management, and appointment of trustees in the absence of fraud and the like, or in some cases, debilitating deadlock, is highly unlikely.

2.7.3 The Plan, Generally. The goal of the Chapter 11 process is the formulation and confirmation of a plan or reorganization, which defines the terms under which the debtor emerges from bankruptcy and how its asset values are to be distributed among the classes of its creditors and shareholders. As noted above, this plan can also be a plan of liquidation, as long as it otherwise complies with the provisions of Chapter 11. The debtor has the exclusive right under Section 1121 to propose a plan for the first 120 days of the case, and if so proposed, to seek confirmation for an additional 60 days, time periods which may be shortened but which typically are extended. This "exclusivity" right of the debtor makes for a more orderly process of plan negotiations, but will be terminated or not extended if the debtor is found to be using its exclusivity in a coercive way or if the delay in the plan process is deemed excessive.

2.7.4 Contents of Plan – Section 1123 of the Bankruptcy Code sets forth the contents for which a debtor must provide in its plan before it can be confirmed, including classifying all claims and interests, specifying any class that is not impaired, describing the treatment to be accorded any impaired class, and providing for the selection of officers and directors in a manner consistent with the interests of creditors and equity security holders and not in violation of public policy.

2.7.5 Acceptance of the Plan – Section 1126(a) of the Bankruptcy Code permits the holder of a claim or interest to accept or reject a proposed plan of reorganization. Subsection (c) specifies the required amount and number of acceptances for a class of creditors. A class of creditors has accepted a plan if at least two-thirds in amount and more than one-half in number of the allowed claims of the class that are voted are cast in favor of the plan. A class of equity or other interest holders, under Subsection (d), must accept a plan by two-thirds in amount of the shares or other interests which are voted.

2.7.6 Confirmation of Plan –Section 1129 of the Bankruptcy Code sets forth the complex requirements that must be met before a Chapter 11 plan is confirmed. One of the most critical, in terms of distributional priorities, is that the plan be "fair and equitable" – a term art specifies requires that unless a particular class accepts the plan by the requisite majorities, no holder of a claim or an interest that is junior to the class receives or retains any property on account of the junior claim or interest. A class of claims can agree to allow distributions to junior classes if a majority in number and 2/3 in amount of such class consents, or, in the case of shareholder classes, a 2/3 vote is achieved. Unless each class of creditors is receiving its full contractual rights or otherwise being is paid in full, the plan must also be accepted by at least one class of creditors, not including any insiders.

2.7.6.1 Absolute Priority Rule: The "fair and equitable" standard embodies the "absolute priority rule," which requires full payment to nonconsenting senior classes before any distribution can be made to junior classes. Where a debtor corporation is insolvent, the absolute priority rule prevents shareholders from retaining their interest in the business, absent the consent of all classes of unsecured creditors whose claims are not fully paid. However, some courts have held that Absolute Priority Rule does not apply to nonprofit organizations because Chapter 11 is "primarily designed" for profit-seeking enterprises. *See*, Matter of Wabash Valley Power Association, 72 F.3d 1305 (7th Cir. 1995), cert. denied, 519 U.S. 965, 136 L. Ed. 2d 305, 117 S. Ct. 389 (1996); In re Independence Village, Inc., 52 B.R. 715 (Bankr. E.D. Mich. 1985); In re Whittaker Memorial Hospital Association, 149 B.R. 812 (Bankr. E.D. Va. 1993). *But see*, In re Eastern Maine Electric Cooperative, Inc., 125 B.R. 329 (Bankr. D. Maine 1991).

2.7.6.2 A second important distributional requirement is embodied in another term of art, the "best interest of creditors" test. This principle requires that any nonconsenting creditors, whether or not it is a member of a consenting class, is entitled to receive as much as it would have received in a liquidation under Chapter 7. Typically, this requirement does not present an obstacle to confirmation of Chapter 11 plans, and even whether a plan of liquidation is at issue, plan proponents manage to present evidence that the additional costs of liquidation, such as trustees' fees, would result in a lesser distribution to the objecting claimant than in the proposed plan.

2.7.7 Conversion of Case – Section 1112(b) of the Bankruptcy Code sets forth various bases upon which a Chapter 11 case may be converted to a case under Chapter 7, including continuing losses and diminution of the estate and inability or prolonged delay to confirm a plan. However, Section 1112(c) of the Bankruptcy Code prohibits the *court* from converting a case under Chapter 11 to a case under Chapter 7 if the debtor is a not-for-profit corporation. However, the debtor organization can request a conversion from Chapter 11 to a Chapter 7 liquidation.

2.8 Chapter 13 – Individual with Regular Income

2.8.1 Overview and Procedure. Chapter 13 is designed for an individual debtor who has a regular source of income and chooses to repay all or a percentage of his or her debts pursuant to a plan, which the debtor has the exclusive right to propose. Chapter 13 is different from a Chapter 7 liquidation, in that the Chapter 13 debtor usually remains in possession of the property of the estate and makes payments to creditors (through the Chapter 13 trustee), based on the debtor's anticipated income over the life of the plan which is generally not less than three and not more than five years. Although this Chapter is specifically designed for wage earners and may not directly affect the typical nonprofit organization, the Chapter 13 plan can indirectly affect pledges that it has received from the donor/debtor.

2.8.2 Caveat to Nonprofits Regarding Pledges. Nonprofit organizations must be aware that pledges are executory contracts in nature, and of the power of the debtor in possession or trustee to confirm or reject certain contracts in a bankruptcy proceeding is not clear. (Refer to the discussion of "Financial Accommodations" at section 2.4.5 above.) The organization must also be aware of the possibility of having to return certain gifts made by Chapter 13 debtors that exceed fifteen percent of the debtor's gross income for the year in which the contribution was made. Specifically, Bankruptcy Code §§ 548(a)(2), (d)(3), (4) exclude certain charitable contributions from the rule that transfers for less than reasonably equivalent value are fraudulent. A transfer of cash or a financial instrument (*e.g.*, stocks or bonds) by a ***natural person*** to a qualified charitable or religious entity or organization (as defined by the Internal Revenue Code) will not be deemed fraudulent if the contribution: (i) does not exceed fifteen percent of the debtor’s gross annual income for the year of the contribution, or (ii) is consistent with the debtor’s normal practices concerning charitable contributions.

Section 3. Laws Governing Charitable Funds

3.1 Common Law Doctrine of Charitable Immunity From Tort Claims

3.1.1 Background.

This immunity has its origin in England in 1846, in Feoffees of Heriot’s Hospital v. Ross, 12 C& F. 507, 8 Eng.Rep. 1508, where it was held that trust funds in the hands of a charity could not be subjected to the payment of tort claims, since they would thus be diverted from the purpose for which they were intended by the donor. Although Feoffees was subsequently overruled by the English courts, the immunity continued to be accepted and recognized by the American courts, and at one time it prevailed in all but one or two states in which it had been considered. At the present time there are only a few jurisdictions still recognizing the rule of charitable immunity from tort liability.

3.1.2 Trust Fund Theory of Charitable Immunity

The trust fund theory maintains that a charitable corporation holds all of its funds in trust for the charity administered. Under this theory, it would be a breach of trust to apply charitable funds for any other purpose, and payment of damages for injuries resulting from the negligence of the corporation's servants is not a purpose contemplated by the charitable funds. Therefore these funds cannot be applied for the payment of damages. Many courts have severely criticized the trust fund doctrine and have rejected it on the ground that it does not stand the test of today's society. Several courts, in repudiating the trust fund doctrine, have stated that the donors are presumed to have given the trust property knowing that it might be required for the liquidation of claims in tort, incurred in carrying on the purposes of the corporation. Some courts have refined the trust fund theory so that although charities are not accorded immunity from suit for their torts, property devoted exclusively to charitable purposes may not be used to satisfy a judgment. However, recovery can be had out of property of the charity not devoted to charitable purposes in addition to liability insurance.

3.1.3 Abrogation of Charitable Immunity.

3.1.3.1 Other justifications for the grant of charitable immunity include: (1) assumption of risk, (2) that charities are performing functions analogous to those of municipal corporations and thus should enjoy the same protection, and (3) a public policy argument for the encouragement of charities and a mention of the fear that they may be stifled if donors are discouraged from making gifts because their money may go to pay tort claims. The development of liability insurance has made it quite unlikely that donors would fail to recognize it as a legitimate expense of operation. In fact, all of the supposed reasons for the immunity fail when the charity can insure against liability.

3.1.3.2 The great majority of jurisdictions has come to recognize that none of these justifications has validity, and have forthrightly abolished the immunity. The other jurisdictions have placed substantial restrictions upon it and may be regarded as in a transitional stage.

3.1.4 <u>Qualified immunity rule</u> – Rule as to liability to third persons or strangers.

Even those jurisdictions which hold that a charitable corporation is immune from liability to beneficiaries, such as patients in a charity hospital, usually hold that it is liable to strangers, that is, to persons other than hospital patients, for the torts of its employees committed within the scope of their employment. In these jurisdictions the determination of who is a beneficiary and who is a stranger can pose vexing questions for the courts. The test for determining whether an individual is a beneficiary of charitable work is whether the organization is engaged in the performance of its charitable objectives. From these cases it is apparent that the liability of a charitable corporation to servants and to third persons for negligence rests on the doctrine of respondeat superior. The majority of states in abolishing the doctrine have rejected any differences between paying and nonpaying entities or strangers and beneficiaries, thus holding the corporation liable to all.

3.1.5 <u>Research References</u>. For more information on the rise and fall of the common law doctrine of charitable annuity from tort claims, refer to: The American Law Institute, Restatement of the Law, Second, Torts, Chapter 45A Immunities; The Law of Trusts – Fourth Edition, Chapter 11 – Charitable Trusts; and Fletcher Cyclopedia of the Law of Private Corporations, William Meade Fletcher, Chapter 54 VI. Liability of Corporation for Torts, Charitable Corporations.

3.2 <u>Uniform Management of Institutional Funds Act (Endowment Funds)</u>

3.2.1 <u>Overview</u>. The Uniform Management of Institutional Funds Act ("UMIFA") was first promulgated in 1972 and governs endowment spending. Since then it has been adopted in whole or in part by 46 states. For a list of states that have adopted UMIFA, see http://www.law.cornell.edu/uniform/vol7.html#infnd. Furthermore, UMIFA defines an endowment fund as one that is "not wholly expendable by the institution on a current basis under the terms of the applicable gift instrument." Thus, if an organization is temporarily or permanently barred from spending all or some of the principal of a fund it qualifies as an endowment fund.

3.2.2 UMIFA Coverage. UMIFA includes every incorporated or unincorporated educational, religious, charitable, or other eleemosynary institution or governmental organization holding funds for such purposes.

3.2.3 No UMIFA if Held by Bank or other Non-Institution. UMIFA states that a fund is not an institutional fund if it is held for an institution by a Trustee that is not an institution, and therefore does not apply to organizations which exist in trust form, such as some community foundations.

3.2.4 Historic Dollar Value Concept. UMIFA essentially permits a charity to base spending on an endowment fund's realized and unrealized appreciation as well as on its natural income from dividends, interest and realized gains. However, UMIFA sets a floor entitled the "historic dollar value," on the charity's ability to spend the appreciation. Spending of the principal is prohibited. Furthermore, UMIFA requires the board of directors to exercise "ordinary business care and prudence under the facts and circumstances prevailing at the time the action is taken" in making decisions about investing and spending. The restrictions of an endowment instrument may be released by the board of directors following the written consent of the donor or by application to the proper court.

3.2.5 Release of Restrictions by Donor – Section 7(a) of UMIFA permits the governing board, with the consent of the donor, to release in whole or in part, a restriction imposed by the applicable gift instrument on the use or investment of an institutional fund.

3.2.6 Release of Restrictions by Court – If the donor is unavailable, Section 7(b) provides that a court may release restrictions that it finds to be "obsolete, inappropriate, or impracticable," but may not change an endowment fund into one that is not an endowment fund.

3.2.7 Trustees of Dartmouth College v. City of Quincy, 331 Mass. 219; 118 N.E.2d 89 (Ma. 1954). Pertinent provision in charitable trust stated that the principal was not to be expended until the designated time and purpose, and in the interim, only the income was to be used to pay expenses. In later years, the expenses exceeded income, and the trustee charged the balance against principal. The court found the trustee was not empowered by the will or by order of the court to use any part of the fund for current expenses which are properly charged to income, and the trustee owes to the fund the amount of the withdrawals with interest.

3.3 Uniform Prudent Investor Act (Charitable Funds)

The Uniform Prudent Investors Act ("UPIA") sets investment standards for endowment funds and provides that endowment funds must be invested and managed as a prudent investor would, by considering the purposes, terms, distribution requirement and other circumstances of the trust holding the endowment fund. In satisfying this standard, the trustees of the endowment fund shall exercise reasonable care, skill, and caution. While the UPIA governs endowment funds, it only covers funds held in trust, such as community funds. It essentially applies where the UMIFA does not. (But this may not be the result under UMIFA.)

3.4 State Corporations Law

Most states provide specific code sections governing the formation and operation of nonprofit corporations ranging from incorporation to dissolution. These statutes generally provide that an organization winding up and dissolving may, prior to the satisfaction of all creditors, transfer assets that are not subject to attachment, execution, or sale for the corporation's debts and liabilities. Except where the assets are held upon a condition requiring return, such distribution may only be made upon an order of the proper court or upon the state Attorney General's written waiver of objection.

3.5 Receivership Law

3.5.1 Generally

3.5.1.1 A receiver is a person appointed by the court to take possession and charge of designated assets or property and to administer them in accordance with court directives. Receivership can be an alternative to bankruptcy for the liquidation of a corporation, however, debt can only be discharged through bankruptcy. Receivership can be administered through both the federal and state courts. Receivership does not apply to individuals or general partnerships.

3.5.1.2 In a majority of states, receivership cannot be ordered unless a lawsuit (known as an adversarial proceeding) has already commenced and the court has determined that receivership is necessary and proper. A receivership is not only utilized to liquidate assets of corporations, but in certain cases where there are disputes between officers, directors or stockholders, courts may appoint receivers to serve as custodians.

3.5.2 Federal Receivership

3.5.2.1 The primary difference between a federal receivership and one conducted in state court is that federal receiverships are rare unless requested by a federal agency such as the IRS. Unlike state court receiverships that may or may not be prescribed by state statute, federal receiverships are governed by the Federal Rules of Civil Procedure. Under Rule 66, federal jurisdiction is limited to liquidating or operating the business for the benefit of a government agency that is owed fines or taxes. The receiver is generally not interested in, nor do the court instructions provide for, protecting the interests of trade creditors.

3.5.3 State Receivership

3.5.3.1 State receiverships vary from state to state depending on state laws. Receiverships under state law are typically allowed for the following reasons: (1) Insolvency; (2) Not paying debts in a timely manner; and (3) Disputes between internal factions.

3.5.3.2 The creditor upon receiving notification of receivership should determine whether the filing of a claim is necessary. Some states require claims to be filed and the creditor who fails to do so may be unable to share in the liquidation of assets or payments of bills in the case of a custodial receivership.

3.5.3.3 When receivers are authorized to continue the operation, they are usually authorized and empowered to pay debts in the ordinary course of business as they come due. However, there is no guarantee this will occur. A receiver is only the custodian of the assets and bound by the orders of the court that created the receivership. Creditors should not only try to work with the receiver but should also be cautious and not assume that because a receiver is in place all is going to be all right.

3.5.4 Involuntary proceedings against charity permitted

3.5.4.1 States such as California have legislation that not only allows for the involuntary dissolution of a nonprofit public benefit corporation, but also allows designated persons to petition the court for a receiver. California Corporations Code Section 6513 states that if, at the time of the filing of a complaint for involuntary dissolution or at any time thereafter, the court has reasonable grounds to believe that unless a receiver of the corporation is appointed the interests of the corporation, the public, or the charitable purpose of the corporation will suffer pending the hearing and determination of the complaint, the court may appoint a receiver to take over and manage the affairs of the corporation and to preserve its property pending the hearing and determination of the complaint for dissolution.

3.5.4.2 Persons authorized to bring an Involuntary dissolution proceeding under California law:
Pursuant to California Corporations Code Section 6510, an involuntary dissolution proceeding can be brought by the following:

3.5.4.2.1 One-half or more of the directors in office;

3.5.4.2.2 A person or persons holding or authorized in writing by persons holding not less than 33 1/3 percent of the voting power, not counting as being in the voting power those who have committed fraud, waste, mismanagement or abuse of corporate office.

3.5.4.2.3 Any member if the ground for dissolution is that the period for which the corporation was formed has terminated without extension thereof;

3.5.4.2.4 Any other person expressly authorized to do so in the articles;

3.5.4.2.5 The Attorney General; or

3.5.4.2.6 The head organization under whose authority the corporation was created, where the corporation's articles include the provision authorized by California Corporations Code Section 5132(a)(2)(i).

3.5.4.3 California Corporations Code Section 6510(b) sets forth the grounds under which the permissible party may institute an involuntary dissolution.

3.5.4.4 Attorneys and board members must be aware that, even though the charity may not have an involuntary bankruptcy petition filed against the charity, state statutory authority likely permits the charity to be subject to an involuntary dissolution and receivership action, but creditors may not be permitted to initiate a receivership.

3.5.5 Practice Pointer.

The practitioner evaluating whether to proceed to federal bankruptcy court or under a state receivership statute will necessarily need to consider these points:

3.5.5.1 Only the charity itself can elect bankruptcy;

3.5.5.2 Only certain types of charities may file for bankruptcy (refer to Section 4 below);

3.5.5.3 A board faction likely is not able to file a bankruptcy but may qualify under the applicable state law to petition for a receiver;

3.5.5.4 A creditor of a charity (including, *e.g.*, a vendor or a labor union representing organized employees named in the articles with the power to do so) may qualify under applicable state law to petition for a receiver;

3.5.5.5 A lender named in the Articles of Incorporation.

Section 4. How do Creditors' Rights and Bankruptcy Law affect Exempt Organizations?

4.1 Inability of Creditor to Commence Involuntary Case against a Charity

4.1.1 Commercial Activity of a Charity – As previously mentioned, an involuntary case cannot be filed on behalf of a not-for-profit corporation. However, in determining whether a particular debtor is an eleemosynary organization against which a petition for involuntary Chapter 7 bankruptcy cannot be filed under Section 303 of the Act, the Bankruptcy Court must examine the alleged debtor's business activities in addition to the corporation's charter to determine whether its commercial endeavors are primary or ancillary activities of corporation.

4.1.2 The bankruptcy courts have not been consistent in their results. In the case of In re Elmsford Country Club, 50 F.2d 238 (DC NY, 1931), the court found a country club not to be subject to involuntary bankruptcy. In the case of In re Allen University, 497 F2d 346 (4th Cir. 1974), a university was found to be exempt, even though it carried on a number of commercial activities. In the case of In re Weeks Poultry Community, Inc., 51 F.2d 122 (DC Cal. 1931), a corporation organized on a co-operative basis for the purpose of packing and marketing agricultural products for members and others to facilitate profitable marketing, was held not to be a moneyed, business, or commercial corporation. In the case of In re Dairy Mktg. Assn., 8 F.2d 626 (DC Ind. 1925), a dairy marketing association was likewise held not to be a moneyed, business, or commercial corporation. However, in the case of In re American Grain and Cattle, Inc., 415 F.Supp. 270 (N.D. Tex. 1976), the court found that co-operative associations are within the intent of former 11 U.S.C. §22(b), and the court has jurisdiction over the bankrupt. The disparity in results seem to flow from a conflict among the courts as to whether the "state classification rule" should apply, or the "bankrupt rule." The former gives a corporation the same status under the bankruptcy laws as it has under state law. The latter permits the bankruptcy courts to examine both the corporation's character and its activities to determine whether it should enjoy the immunity afforded charitable institutions. See In re Grace Christian Ministries, Inc., supra. The 1978 Bankruptcy Code, as enacted, and its legislative history, does not appear to resolve this conflict. The court in In re United Kitchen Associates, Inc. 33 B.R. 214 (Bankr. W.D. La. 1983) concluded that accepting or not accepting contributions from the general public is not a determinative factor in the classification of a corporation as either a for-profit corporation or an eleemosynary corporation under either the "state classification rule" or the "bankruptcy rule."

4.2 Limitation on Avoidance Powers

4.2.1 Exemption for Recovery of Charitable Contributions. As noted above, fraudulent transfers are recoverable under both sections 544(b) (state law fraudulent transfers) and 548 (federal law), which requires the return to the bankruptcy estate of transfers which are less for reasonably equivalent value. Although charitable contributions are almost by definition not for reasonably equivalent value, each of these sections provides a safe harbor which prevents recovery of certain charitable contributions.

4.2.2 The Safe Harbor. Section 548(a)(2) provides that a charitable contribution is not subject to recovery as a constructive fraudulent conveyance under section 548(a)(1) if the charitable contribution does not exceed fifteen percent of the debtor's gross income for the year in which the contribution was made, or if, even above that amount, the transfer was "consistent with the practices of the debtor in making charitable contributions." There is no exemption for charitable contributions made as intentional fraudulent conveyances. Notably, this exemption only applies, per the definitions in section 548(d)(3), to contributions of cash or financial instruments by natural persons, and thus would not exempt gifts of other property or gifts by corporations, partnerships, or other entities. There is authority for the proposition that if the transfer exceeds fifteen percent of debtor's gross income and is otherwise avoidable under §548, the entire transfer is avoidable, not merely that portion of transfer exceeding fifteen percent of debtor's yearly income. *See* Murray v. Louisiana State Univ. Found. 234 B.R. 371 (Bankr. M.D. La 1999). In such a case, the charity may be required to return the transfers back to the bankruptcy estate subject to §548(a)(2).

4.2.3 Exemption as to State Law Fraudulent Conveyances. The right of the trustee or debtor in possession to assert state fraudulent conveyance claims under section 544(b)(1) is similarly constrained in the case of charitable contributions. Section 544(b)(2) effectively incorporates the provisions of section 548(a)(2). In addition, section 544(b)(2) also provides that the claim by any person to recover a transferred contribution described in the preceding sentence under Federal or State law in a Federal or State court is preempted by the commencement of the case, which would preclude all proceedings to recover such transfers, even if the cause of action were abandoned by the trustee.

4.3 What Assets can be reached by Creditors of a Bankrupt Charity and What Methods are available to protect the Charity's Endowment?

4.3.1 General (i.e., non-endowment) Assets of a Charity

4.3.1.1 Reachable by Creditors

The general assets of an exempt organization are subject to attachment and reachable by creditors to satisfy their claims subject to applicable state law.

4.3.2 Endowment Overview – Four Types of Endowments (Panel labels, not labels given by courts):

4.3.2.1 Held as "Rainy Day" Fund

4.3.2.2 Held as Quasi-Endowment

4.3.2.3 Held as segregated fund by Nonprofit Corporation Serving as its own Trustee

4.3.2.4 Held by Independent Third Party Trustee

4.3.3 Rainy Day Fund

4.3.3.1 General funds/assets of a Charity. As a legal matter, an endowment must be distinguishable from a surplus or 'rainy-day' fund. Reserves, unlike endowment, represent a cushion that can be drawn down at the discretion of the charity. These are considered part of the bankruptcy estate under §541 of the bankruptcy code and can thus be reached by creditors should a charity file for bankruptcy. *But see* In re Parkview, 211 B.R. 619 (Bankr. N.D. Ohio, 1997) (discussed, and criticized, below).

4.3.4 Quasi-Endowment

4.3.4.1 Quasi-Endowments can either be set up by an outside donor where the donor states that principal is available to be spent, or the organization has decided to retain income from an endowment fund as principal and utilize the earnings from these funds in a manner similar to that of a true endowment. The distinction between quasi-endowments and true endowments is that the organization may decide to expend the principal balance of the quasi-endowment at any time whereas the principal balance of the true endowment must remain intact in accordance with the donor's restrictions. Because the organization holds legal and equitable title to the unrestricted principal and income of a quasi-endowment, creditors will most likely be able to reach the Quasi-endowment.

4.3.4.1 In Hobbs et al., Trustees v. Bd. of Ed., 253 N.W. 627 (Neb. 1934), the court stated that it knew of no rule whereby the exempt organization could set aside a portion of its general assets, call it an endowment fund and thus create a charitable trust. When the funds were withdrawn, they were converted into property which cannot be separated from the general assets of the college to the prejudice of creditors. The court also went on to say that as to misapplications of the fund, if there is any remedy for these acts, it lies with the successor beneficiary in trust or the donors against the college trustees. *Hobbs* is an excellent case for study. The court identifies the factual background of many separate gifts made to the college, explaining the rationale for its holdings on each of the various gifts given the specific facts relating to each gift. Two gifts situations are particularly illuminating: (1) Of the about $85,000 in the donor-restricted and always-held-separate account labeled "endowment fund" on hand at the time of the college's closing, of which $52,000 was in cash and $27,000 in the form of a note from the college for funds that had been "borrowed" to construct a girl's dormitory, the court held the $52,000 was not subject to the college's creditors but would instead be transferred upon exercise of *cy pres* to another Baptist college under the oversight of the same denominational conference as it was a separate charitable trust, but as to the $27,000 withdrawn no such trust existed as it could not be separated from the college's other assets. (2) Mr. Webster had given the college $1,000 to be held "forever, as a trust fund [the annual income from which is] to be known as the Webster Scholarship." The college had supplemented this fund with $4,000 of its own unrestricted assets. The court, stating "We know of no rule whereby the college could set aside a portion of its general assets, call it an endowment fund and thus create a charitable trust," held the $4,000 must be returned to the college and made available to its creditors, but the $1,000 would be treated in accordance with the terms of the original gift instrument from Mr. Webster.

4.3.4.2 *But see* Hartford Hosp. v. Blumenthal, 1996 Conn. Super. LEXIS 994 where the Court found a fund was formed from income of endowment funds. The court held that the "income fund" fell within the meaning of Conn. General Statutes § 45a-533 and thus was subject to the same restrictions as the endowment fund itself. Because the nursing school was closed, the court applied the doctrine of *cy pres* to release the original restriction and allow the principal and/or income from the funds, as directed by the donors, to be used for similar charitable purposes.

4.3.5 Held by Nonprofit Corporation Serving as its own Trustee

4.3.5.1 Generally. Although gift or donation to a charity may appear to be safe, litigation is still foreseeable. Property transferred to a non-profit organization without any restrictions is subject to the charity's limitations defined by the organization's purposes and bylaws. A charity can then use the gift as it sees fit in accordance with its bylaws or purpose. If a charity uses the gift to purchase assets or put into a commingled common fund, then such gift may become available to its creditors. *See* Freme v. Maher, 480 A.2d 783 (Me. 1984) (decedent's will provided for Ricker College to receive bequest "in trust … to be used for such general purposes … as the Board of Trustees … may determine." Ricker filed Chapter 11 bankruptcy shortly after decedent's death, closing its physical plant but remaining in corporate existence. Decedent's trustee proposed to use the bequest for scholarships at other nearby colleges. The court ordered instead that the surviving Ricker entity receive and use the trust fund for a proper "corporate purpose" of that surviving corporate entity, namely, "to promote the cause of education.")

4.3.5.2 Doctrine of Merger under laws applicable to Trusts

4.3.5.2.1 The trust doctrine of "merger" generally provides that a trust ceases to exist when the trustee and the beneficiary are identical. The question has been asked whether the doctrine applies when a charity holding its own segregated endowment, thus rendering the supposed endowment a part of the general assets of the charity.

4.3.5.2.2 The general proposition is that no trust is created where property is conveyed or donated to a charitable corporation, although the donor adds that it is to be used for certain purposes, when those purposes are among those for which the charitable corporation was incorporated. One cannot be a trustee of property and a beneficiary at the same time and the legal and equitable title is in the corporation where gifts are made directly to it. Another view is that the beneficiary is the public rather than the corporation and therefore legal and equitable title do not merge. Courts will try to preserve charitable gifts and bequests, and in some instances say that "If there is a reason for keeping the estates separate, or if it is necessary to do so to carry out the purposes and intentions of the donors, equity will prevent a merger." Hobbs et al. v. Bd. of Ed., 253 N.W. 627 (Neb. 1934) *citing* Sherlock v. Thompson, 148 N.W. 1035 (Iowa, 1914).

4.3.5.2.3 Practice Pointer. When a charity serves as its own trustee, it is essential that it scrupulously observe the separate existence of its endowment. A failure to do so may result in the endowment being characterized by a court as a quasi-endowment and potentially subject to attachment

4.3.6 Held by Independent Third Party Trustee

4.3.6.1 This is the safest way for an organization to prevent creditors from reaching endowment funds should a charity file for bankruptcy. Legal title is held by the independent third party trustee, and thus will not constitute property of the estate pursuant to §541 of the Bankruptcy Act. The scope of the debtor's estate as defined by §541 limits the estate to property interests held by the debtor at the time the bankruptcy petition was filed. Typically the nature and extent of a debtor's property rights existing as of the petition date are defined by non-bankruptcy law.

4.3.6.2 Note: If a charity's endowment is held by a for-profit financial institution, UMIFA might not apply because the banks and other financial institutions that act as trustees are not "institutions." An institution is an incorporated or unincorporated organization organized and operated exclusively for educational, religious, charitable, or other eleemosynary purposes, or a governmental organization to the extent that it holds funds exclusively for any of these purposes. However, at least four state legislatures, Hawaii, Indiana, North Carolina and West Virginia have amended Section 1 of UMIFA in order to make UMIFA applicable to trust-form community foundations.

4.4 Endowment Income Available to Creditors During Administration of the Bankruptcy Estate

4.4.1 If a Charity Holds its own Endowment

4.4.1.1 General Rule. Based on current case law, it appears that the principal of the restricted endowment will not become part of the bankruptcy estate available to creditors. However, income from endowment has been considered as part of the bankruptcy estate available to pay of obligations owing to creditors.

4.4.1.2 In re Winsted Memorial Hospital, 249 B.R. 588 (Bankr. D. Conn. 2000). The court concluded that certain endowment funds were part of the bankruptcy estate, but were subject to the donor restrictions that only the income be applied to payment of debts incurred for the hospital's general charitable purposes while it was operating. Thus, the income from the funds were used to pay general expenses of the hospital.

4.4.2 <u>If Independent Third Party Holds Endowment</u>

4.4.2.1 <u>General Rule</u>. Case law provides that when an independent third party holds the endowment as trustee, neither the income nor the principal becomes part of the bankruptcy estate and therefore unavailable to creditors.

4.4.2.2 <u>In re Bishop College</u>, 151 B.R. 394 (Bankr. N.D. Tex. 1993). Pursuant to the testators' wills, Ameritrust, the independent trustee was directed to liquidate the decedents' estates, invest the proceeds in stocks and bonds set up in a Foundation for the benefit of the beneficiaries, and pay the annual income to Bishop College. Bishop College subsequently filed for bankruptcy, and the Chapter 7 Trustee made a demand that the trusts be liquidated and their entire corpus and income be turned over to the bankruptcy estate for the payment of the college's creditors. The court held there was no basis for finding that the trustee has an interest in the trust property subject to turnover pursuant to section 542 and 543 of the Bankruptcy Act, that the trust income and the trust corpus of the Foundation are not property of the Debtor's estate, and therefore also not subject to turnover. The court also held that the trustee was authorized to take all actions necessary to institute a proceeding in the District Court to reform the trusts, in accordance with the doctrine of *cy pres*.

4.5 <u>Case law disfavoring invasion of Endowment Principal</u>

4.5.1 <u>Parkview v. St. Vincent Medical Center,</u> 211 B.R. 619 (Bankr. N.D. Ohio, 1997). A nonprofit hospital had a "Fund" that received charitable gifts, some with the restriction that only the income be used by the hospital for the purposes stated. Also, in a few years the hospital operated at a surplus and, sometimes, a part of the hospital's surpluses was added to the endowment. The hospital also decided to put unrestricted gifts in the Fund as well, thus commingling restricted and non-restricted gifts and operating surplus. Hospital operations declined, and the hospital filed for bankruptcy. In questionable reasoning, the Bankruptcy Court, citing Ohio state law authorizing non-profit corporations to make charitable contributions (Ohio Rev. Code § 1702.12(D)), while acknowledging that that Parkview "placed its own funds, or funds donated to it, into this account," held: (1) the Fund was in fact a charitable trust, (2) the bankruptcy estate holds only legal title and not an equitable interest, (3) the funds are not assets of the bankruptcy estate, (4) the bankruptcy estate holds the funds in trust as the trustee of a charitable trust, and (5) by the terms of the trust, only the income generated on the principal of the fund may be used. After the bankruptcy estate is closed, the fund principal will be used for charitable hospital purposes.

Cases like In re Parkview, 211 B.R. 619 (Bankr. N.D. Ohio, 1997) allow bankruptcy protection for “self-settled” monies. See also In re The Brunswick Hosp. Ctr., Inc., 156 B.R. 896, 899 (E.D.N.Y. 1993).

In re Brunswick Hospital Center, Inc., 156 B.R. 896 (E.D.N.Y. 1993), illustrates the application of the well-established legal principles in this area. In that case, the debtor corporation operated a hospital as well as health care facilities in New York and had transferred assets to a third party trustee to hold in trust to provide for self-insurance for malpractice claims against it. Several malpractice claimants, who had obtained prepetition judgments and sought to levy on the trust funds, contended the trust was not property of the estate because the debtor held no equitable interest in the trust. Other malpractice claimants, who had not obtained judgements, opposed this by asserting that the debtor held an equitable interest in the trust because the corporation created the trust to benefit itself.

In deferring to the bankruptcy court's holding that the equitable interest in the assets had been transferred to the trust for the benefit of the claimants, the Brunswick District Court cited the "surrounding circumstances and extrinsic evidence [which] indicate an intent by the parties to designate the medical malpractice claimants as beneficiaries of the trust." Id. at 902. Specifically, the court noted that: (a) the malpractice claimants, not the grantor, were to receive all of the trust proceeds; (b) the grantor designed the trust to comply with the Medicare eligibility option of self-insuring against malpractice losses; (c) the trustee received the trust funds for the purpose of meeting "patient liability losses" and related expenses; (d) even upon termination of the trust, the trust was obligated to retain sufficient assets to satisfy claims (the prepetition claims of $4.4 million exceeded the $3.2 million trust fund); and (e) the trustee was prohibited from loaning or advancing funds to the grantor or anyone else "by reason of common ownership or control." Id. at 901-02. In reaching this conclusion, the court overlooked contrary indications of the settlor's intent, and the trust's character, including that: (1) the trust's preamble said the trust was created "solely for the *benefit* of the Provider as a 'Grantor Trust'...."; (2) the trust specified that only the grantor had any "right, claim, or interest" in the fund; (3) the grantor retained the exclusive right to determine whether to make distributions from the trust; and (4) the grantor retained the right to terminate the trust. Brunswick, 156 B.R. at 901.

4.5.2 In re Winsted Memorial Hospital, 249 B.R. 588 (Bankr. D. Conn. 2000). The endowment funds established by certain donors provided for the hospital to receive the income earned on the endowment fund, the principal of which is to remain intact. All of the gifts provided that they were to be used for the hospital's general expenses. The hospital subsequently filed for bankruptcy relief, and the court concluded that the gifts, subject to the restriction that they only be applied to payment of debts incurred for the hospital's general charitable purposes while it was operating, were part of the bankruptcy estate, the endowment principal should not be abandoned, and the trustee was only to use the income to pay general expenses.

4.6 Case Law Favoring Invasion of Expected Gifts.

4.6.1 In Re Boston Regional Medical Center, Inc., 298 BR 1 (Bankr. D. Mass 2003). Declining to distinguish Bishop College, and without citation to either Parkview v. St. Vincent or In re Winsted Memorial Hospital, the Massachusetts bankruptcy court held that Boston Regional Medical Center (BRMC) became entitled to a distribution of its share of a decedent's trust's assets immediately upon her death, even though BRMC filed bankruptcy and commenced dissolution prior to any distribution from the trust. "The delay attendant upon administration and distribution of the trust corpus should not be a determinative factor in a charitable beneficiary's qualification." In Re Boston Regional Medical Center, Inc., 298 BR 1, 28 (Bankr. D. Mass 2003). More importantly, the BRMC court found that "*even if the validity of the gifts to BRMC were to be determined as of the date of actual distribution, after BRMC had ceased to function as a hospital, the gifts would still serve the hospital's charitable mission*." The court bottomed its conclusion on the basis that "a hospital provides medical services by paying its [doctors and nurses, and other] suppliers, administrators, lenders, utilities … all of whom make it possible for the hospital to exist and function. [V]irtually all … are paid in arrears. [Para.] In a credit economy [insistence] on payment in advance would hobble charities in the performance of their charitable functions." *Accord*, Montclair Nat. Bank & Tr. Co. v. Seton Hall College, 233 A.2d 195, 96 N.J. Super. 428 (1967); *contra*, In re Kruetzer, 119 Misc.2d 436, 462 N.Y.S.2d 1009 (1983).

4.7 Application of the Cy Pres Doctrine

4.7.1 Failure of Trusts

4.7.1.1 Where the owner of a property gratuitously transfers it upon trust for a charitable purpose and the purpose cannot be accomplished, the transferee holds the trust estate upon a resulting trust for the transferor or his estate, unless (1) the doctrine of *cy pres* is applicable, or (2) the transferor properly manifested an intention that no resulting trust should arise.

4.7.2 "As near as possible." Where the particular charitable purpose for which the trust was created becomes impossible, illegal or impracticable, the trust does not fail if the settlor has shown a general intention that his property shall be used for charitable purposes. In such situations, the court will exercise its *cy pres* power and authorize that the property be applied to some other particular charitable purpose falling within the general intention of the settlor. In selecting the other particular charitable purpose, the court will choose the public charity which is as near as possible to the one designated by the settlor.

4.7.3 Reformation granted to permit invasion.

4.7.3.1 In the Matter of the Estate of Donald Othmer, 185 Misc.2c 122 (N.Y. 2000). Petitioner hospital brought an uncontested proceeding for *cy pres* relief. Hospital was the beneficiary of restricted gifts under the last wills and testaments of decedents. Petitioner found itself on the brink of bankruptcy. If the petitioner were forced to close, the intent and purpose of decedent's gifts to it would become impossible or impracticable to achieve. The court concluded that the decedent's would want petitioner to continue as a hospital, and therefore literal compliance with restrictive provisions of the fund established by the decedent were impracticable. However, modification of the restrictions of the fund would cure the impracticability and fulfill the decedents' general charitable intent. The court then granted petitioner *cy pres* relief.

4.7.3.2 Knickerbocker Hosp. v. Goldstein, 181 Misc. 540; 41 N.Y.S.2d 32 (N.Y. 1943). Under the terms of decedent's will, the principal of his bequest was to be kept invested and the income to be used for the general purposes of the hospital. Thereafter, the hospital suffered operating losses and sought the authority to invade the principal to keep the hospital in operation. The court granted the request, granting the hospital to use so much of the principal of the bequest to make possible the benefactor's purpose. The court found it appropriate to exercise *cy pres* powers to prevent the suspension of a valuable community service and the failure of a definite charitable purpose.

4.7.3..3 Matter of St. Charles Hospital, NYLJ, Aug. 4, 1995. The hospital petitioned for *cy pres* relief to permit it to pledge restricted funds gifted to it in order for the hospital to obtain the financing to implement a comprehensive restructuring plan. The will was silent as to the principal, and required that the income be expended for "charitable purposes." The court granted *cy pres* relief, finding that literal compliance with the "income only" provision of the gift, even when combined with the hospital's other sources of revenue, was insufficient to modernize the hospital, and without such modernization, the hospital would be forced to shut down.

4.8 Affect of Bankruptcy Law on Trusts

4.8.1 General Rule: Not Eligible. Generally, trusts are not eligible for relief in bankruptcy; trust can only obtain relief in bankruptcy if it qualifies as a corporation. In re John M. Cahill, M.D., 15 B.R. 639 (Bankr. E.D. Pa 1981).

4.8.2 Donative Trust Not Eligible. Donative trusts generally do not carry on the same (i.e., for-profit) activities as a business trust, and thus have traditionally been excluded by the Bankruptcy Code from the category of business trusts. In re Affiliated Food Stores, Inc., 134 B.R. 215, 218 (Bankr. N.D. Texas 1991). Neither nonbusiness trust nor its trustee was "person" eligible to file for Chapter 11 protection. In re Hunt, 160 B.R. 131 (9th Cir. BAP (Cal.) 1993).

4.8.3 Welfare Benefits Trust. Nonprofit trust fund that administered funds contributed by county under collective bargaining agreement with union to pay dental, optical, and legal expenses incurred by union members was not eligible to file petition for reorganization relief; the trust fund did not qualify as a "person" under statutory definition including individual, partnership, and corporation and was not a "business trust," as the trust fund was not engaged in any business activities and did not generate any business profits; accordingly, trust fund which filed Chapter 11 petition did not have standing to compel turnover of funds delivered to successor union by county. In re Westchester County, 111 B.R. 451, 456 (Bankr. S.D.N.Y 1990). *But see* In re Joliet-Will County Community Action Agency, 847 F.2d 430 (7th Cir. 1988). (Private nonprofit community service organization financed exclusively by federal and state grants was not statutorily precluded from declaring bankruptcy).

4.8.4 Other Passive Trusts. Generally, trust entities which are either passive or which do not engage in any business activities do not have a separate legal existence from the trustees and therefore, even if the trust is engaged in profit-sharing activities, it will not qualify as a business trust and will be ineligible for relief under Chapter 11 of the Bankruptcy Code. In re St. Augustine Trust, 109 B.R. 494 (Bankr. M.D. Fla. 1990).

4.8.5 Case law

4.8.5.1 Unincorporated companies or associations – A "common law" or "Massachusetts business trust" may be adjudicated a bankrupt as an unincorporated company. Krey Packing Co. v. Wildwood Springs Resort Ass'n, 4 F.2d 793 (8th Cir. 1925). See, also, Gallagher v. Hannigan, 5 F.2d 171 (1st Cir.), cert. denied, 1925, 269 U.S. 573 (1925); In re Sargent Lumber Co., 287 F.154 (D.C. Ark. 1923). Masonic Lodge, organized solely for fraternal purposes, which erected building and rented on large scale to general public rooms for divers purposes, was "unincorporated company" subject to adjudication as involuntary bankrupt. In re William McKinley Lodge No. 840, 4 F.Supp. 280 (S.D.N.Y. 1933). *See also* In re Miracle Church of God in Christ, 119 B.R. 308 (Bankr. M.D. Fla. 1990). (Unincorporated, not-for-profit religious association was eligible, as "unincorporated company or association," to file for Chapter 11 relief). Prior opinion in which Court of Appeals set out controlling legal standard for determining whether trust was "business trust" and thus qualified as debtor under Bankruptcy Code, under which trusts created with primary purpose of transacting business or carrying on commercial activity for the benefit of investors qualified as business trusts, while trusts designed merely to preserve trust res for beneficiaries generally were not business trusts, was not clearly erroneous decision that would work manifest injustice, so as to preclude application of the law of the case doctrine on appeal in which trust's residual beneficiaries challenged bankruptcy court's application of such standard on remand; standard was reasonably clear and workable and reflected intent of Congress. In re Kenneth Allen Knight Trust, 303 F.3d 671 (6th Cir. 2002).

4.8.5.2 Liquidating trust. Liquidating trust was a "business trust" and thus was a proper debtor under the Bankruptcy Code. In re Tru Block Concrete Products, Inc., 27 B.R. 486 (Bankr. S.D. Cal. 1983).

Section 5. Effect on Charitable Giving

5.1 Effectiveness of "Ipso Facto" Provisions in the Gift Instrument

5.1.1 Ipso Facto Clause Invalid. An ipso facto clause is a provision that declares a default of, or termination of, a contract in the event of insolvency or bankruptcy, or that would otherwise affect and/or waive the rights of a debtor in bankruptcy, such as the protections afforded by the automatic stay. Courts have found that to enforce ipso facto clauses would intrude upon the clear Congressional purpose to provide debtors a fresh start toward reorganizing their financial affairs, and thus have held such agreements unenforceable. *See* e.g., In re Atrium Highpoint Ltd. Partnership, 189 B.R. 599 (Bankr. M.D. Fla. 1985); In re Madison, 184 B.R. 686 (Bankr. E.D. Pa 1995); Matter of Pease, 195 B.R. 431 (Bankr. D. Neb. 1996); In re South East Financial Associates Inc., 212 B.R. 1003 (Bankr. M.D. Fla. 1997). Thus, section 365(b)(2) provides that in assuming an executory contract, the trustee or debtor in possession need not cure breaches of provisions relating to insolvency or financial condition of the debtor, the appointment of a trustee under Title 11 or a custodian for assets, or the commencement of a bankruptcy case, and section 365(e)(1) also prohibits termination of a contract based on these ipso facto clauses after commencement of the bankruptcy case. (*See* also Bankruptcy Code §541.)

5.1.2 Examples of an Invalid Ipso Facto Provision in the Charitable Setting

5.1.2.1 Provision in charitable remainder trust stating lease will automatically terminate if lessee goes bankrupt.

5.1.2.2 University licenses a patent with a provision in the license agreement that the license will terminate if the licensee becomes bankrupt (although generally the rights to assume or assign patent rights, if otherwise not assignable under the license, could be limited under the "applicable law" exclusion of section 365(c)).

5.1.2.3 Private foundation has made a contractual commitment to make annual contributions to a public charity for a period of years but the obligation will terminate upon the bankruptcy of the public charity. (But see Financial Accommodation discussion above.)

5.1.3 Method to Preserve Donor Intent Without Voluntary Ipso Facto Prohibition

Donor makes restricted gift to an independent trustee to be held as an endowment for a particular charitable *purpose*, specify a preferred charity, with a provision that the endowment is to be paid over to a different charity if the first charity goes bankrupt.

5.1.3.1 This has been upheld as a valid provision for a charitable contribution. *See*, Bennett College v. United Bank of Denver, 799 P.2d 364 (Colo. 1990). The trust provided that another charitable beneficiary could be named in the event that the College ceases to exist, whether by reason of dissolution, merger, consolidation, or otherwise. The trustee in that case sought a ruling that the College had ceased to exist by virtue of the prior bankruptcy and sale of its assets, and that the trustee was no longer obligated to disburse trust money to the College. The Colorado Supreme Court noted that the Supreme Court of New York, in a previous case, issued a memorandum decision finding that the College had "ceased to exist" and permitted the trustee in that case to substitute other beneficiaries to that trust in accordance with that trust's terms. The Colorado court held that collateral estoppel applied and that the other charities named in the Colorado trust would split the share of Bennett College.

5.1.3.2 Bennett College is a state court case. Note also that lack of privity of contract between donor and donee will likely yield same result in federal bankruptcy court.

5.1.4 Pre-petition Termination.

As noted above, there is an express provision in the Bankruptcy Code (§365(e)(1)) which prohibits termination or modification of any contract any time *after* commencement of case solely on account of insolvency. However, there is no provision which invalidates pre-petition termination of contract on the sole ground of insolvency. The explicit provision for assumption of *executory* contracts shows that there is no legislative intention to permit assumption or reinstatement of contracts which have expired or have been terminated before bankruptcy. Matter of Benrus Watch Co. Inc., 13 B.R. 331 (Bankr. S.D.N.Y. 1981).

See also the discussion on "Vicinity of Insolvency" possible fiduciary duty of trustees to not disclaim gift to charity at section 7.1.5 below.

5.1.5 Effect of Privity of Contract

5.1.5.1 Donor makes a restricted gift to an independent trustee to be held as an endowment to provide scholarships to students at Named University. The gift includes a provision that the trustee is to pay the income of the trust annually so long as Named University operates as an educational institution for higher learning with a direction to trustee to re-direct scholarships to students at other collegiate-grade schools if Named University ceases to so operate.

5.1.5.2 Donor offers to make a restricted gift to Named University if Named University constructs a building in donor's name. The gift is held by an independent third party trustee to be disbursed to Named University subject to the construction and signage of the building.

5.1.5.3 Practitioner's Point: A key difference that may affect the outcome between situations 1 and 2 above is privity of contract between the donor and the nonprofit organization. In situation 1, there is no privity between the Donor and Named University; as long as Named University continues to operate, its students will receive the annual income of the trust, but if Named University ceases to operate, the trustee is required to disburse money to students attending a different college. Should Named University become bankrupt, the lack of privity will likely prevent the trust principal from becoming part of the bankruptcy estate. By contrast, in situation 2 an executory contract remains in force and privity of contract exists between Donor and Named University. If Named University becomes bankrupt, the trustee of the bankruptcy estate will likely claim detrimental reliance in commencing construction of the building, and attempt to bring the trust principal into the bankruptcy estate. The same result would likely occur if Named University itself held the building funds in a restricted account pending completion and signage of the building.

Section 6. Supporting Organizations

6.1 Generally

Pursuant to Internal Revenue Code § 509(a)(3), a supporting organization is a form of public charity (as opposed to a private foundation) that receives its charitable status because it is "operated, supervised, or controlled by," "supervised or controlled in connection with," or "operated in connection with," the charity it is organized exclusively to support. To be a supporting organization, the organization must itself qualify for tax-exemption and have one of three different relationships to the public charity that it supports.

6.2 Types of Relationships between Supporting Organization and Public Charity

6.2.1 The supporting organization must be operated, supervised, or controlled by the primary charity. This relationship looks like a parent and its subsidiary. The majority of the controlled supporting organization's board either must be filled by officers of the organization it supports or appointed by that charity.

6.2.2 The supporting organization must be supervised or controlled in connection with the primary charity. This test is met if the individuals controlling and managing the primary charity are the same individuals controlling and managing the supporting organization.

6.2.3 The supporting organization must be operated in connection with the charity. This test is both the most flexible and the most complicated to prove. It requires that the supporting organization be *responsive to* and *significantly involved in* the operation of the supported charity. Regulation § 1.509(a)-4(i)(2) provides that this test is met if: (1) the officers, directors, or trustees are elected or appointed by the officers or directors of the supported charity; (2) the supporting and supported charities share officers, directors, or trustees; or (3) there is a "close and continuous working relationship" between the officers, directors, or trustees of the two organizations. Alternatively, the responsiveness test can be met if the supporting organization is organized as a trust, the supported organization is the named beneficiary of the trust, and the supported organization has the power to compel an accounting of the trust.

6.3 Under what circumstances may the directors or trustees of Supporting Organization cease to support the Public Charity?

6.3.1 Bylaw Provisions. Add language in bylaws to support a successor to that supported organization in the event that operating organization no longer principally carries on the proscribed charitable activity. The bylaws should be written such that they allow the supporting organization to continue its charitable purposes without having to petition the court for *cy pres* relief in the event the operating organization goes bankrupt or ceases to fulfill its mission. The purpose of such language is to preserve the mission rather than the entity.

6.3.2 Restrictive Language in Dispositive Instrument. Language in the dispositive gift instrument that should the donee cease to exist (or become bankrupt), that the fund should then go to a similar organization that carries out the same mission as donee. *See e.g.*, Bennett College v. United Bank of Denver, 799 P.2d 364 (Colo. 1990).

6.4 Can Creditors of the Public Charity reach the assets of the Supporting Organization?

6.4.1 Alter Ego Theory

6.4.1.1 The Alter Ego Theory is a common law doctrine where one entity, usually a parent corporation, is held liable for the obligations of another entity, usually a subsidiary. This type of liability is difficult to establish if a charity and supporting organization observe corporate formalities, do not commingle funds, and carefully maintain the independence and separateness of each of the organizations. Because an alter-ego claim seeks an extreme remedy, the plaintiff bear the burden of proving that not holding the supporting organization liable would sanction a fraud or promote injustice. The remedy is more difficult to obtain in the charitable context as there is no “ownership” in the classic sense.

6.4.2 Substantive Consolidation under Federal Bankruptcy Law

6.4.2.1 Generally. The Bankruptcy Code nowhere specifically authorizes consolidation of separate bankruptcy estates, but courts might order consolidation by virtue of their general equitable powers under §105 of the Bankruptcy Code or by application, under §544, of state law causes of action of piercing the corporate veil. However, the courts have generally recognized that the power to consolidate should be used sparingly because of the possibility of unfair treatment of the creditors who had dealt solely with a particular debtor without knowledge of its interrelationship with other entities.

6.4.2.2 A bankruptcy trustee might pursue the endowment funds held by the supporting organization of a charity in bankruptcy by alleging that the operating charity and the supporting organization should be substantively consolidated, which is an equitable remedy whereby the bankruptcy court will consolidate the assets and liabilities of two or more entities into a single bankruptcy case. This remedy will likely only be ordered when the entities are so inter-related that it is difficult to segregate and ascertain individual liabilities and assets, and it is an equitable result for the creditors of both entities.

6.4.2.3 Supporting Organization as Non-Debtor

If the supporting organization has not filed a petition and is not seeking bankruptcy protection, it has been suggested that the bankruptcy court is prohibited from imposing substantive consolidation to involuntarily bring the supporting organization into bankruptcy. *See* e.g., In re Lease-A-Fleet, Inc., 141 B.R. 869 (Bankr. E.D. Pa. 1992). The court's rationale for its "no substantive consolidation" is even more applicable in the charitable entity context. Specifically, substantive consolidation is that an attempt to involuntarily consolidate end runs the legislative intent that eleemosynary institutions, such as churches, schools, and charitable organizations and foundations be exempt from involuntary bankruptcy. A caveat may be that if the supporting organization were set up for commercial activities, this would defeat the protection that §303 affords, thus allowing the supporting organization to be consolidated into bankruptcy.

6.4.2 Power to Avoid Transfers. The operating organization must be cautious when transferring assets to a supporting organization if it is contemplating filing for bankruptcy. If the purpose is to hinder, delay or defraud creditors, then the transfer can be avoided as an intentional fraudulent conveyance, and may also be scrutinized as a constructive fraudulent conveyance, under both §§ 544 and 548.

Section 7. Personal Liability of Directors and Others

7.1 Breach of Fiduciary Duty

7.1.1 Compliance with Trust Principles. Directors of a charitable trust should comply with strict trust principles in the performance of their duties, and while those directors are exempt from personal liability for the debts, liabilities, or obligations of the corporation, they are not immune from personal liability for their own fraud, bad faith, negligent acts, or other breaches of fiduciary duty. Good faith is no defense in an action against trustees based on negligence, and even where the fault rests with only one trustee, each trustee is liable for damages caused by the negligent acts of a co-trustee. See Lynch v. John M. Redfield Foundation, 9 Cal. App.3d 293 (1970), 88 Cal. Rptr. 86, 51 A.L.R.3d 1284. Since 1980, California statutory law establishes a standard of care for charitable corporation directors at California Corporations Code § 5231, and for trustees of a charitable trust at California Probate Code § 16402.

California law now insulates directors from personal liability if certain standards are met. (*See* California Corporations Code § 5047.5) Most states have similar legislation.

Likewise, the Federal Volunteer Protection Act of 1997 (42 USC §§ 14501-14505) applies throughout the United States.

7.1.2 Example Under State Law. The New York Not-for-Profit Laws provide that an aggrieved plaintiff may pursue the remedies of accounting, rescission, and an injunction in a misconduct action against an officer or director. A plaintiff may compel an accounting if an officer or director neglected, failed to perform, or otherwise violated his or her duties in the management of the not-for-profit corporation assets, or if such person acquired, transferred, lost, or wasted entity assets due to a derogation of duty. If the plaintiff demonstrates the officer or director knew of the unlawfulness of a conveyance, assignment, or other transfer of corporate assets, a court may set aside that unlawful act.

The New York Not-for-Profit Laws also provides immunity for officers and directors in certain circumstances. The purpose of this is to reduce the burden of expensive liability insurance by shielding persons serving qualifying not-for-profit corporations without compensation. Nonetheless, this immunity is not available if the officer or director acts in a manner that is grossly negligent or intended to cause the harm to the complaining party.

7.1.3 Statutory response to Liability Concerns. Concern in recent years has been that because nonprofit charitable organizations have had difficulty in obtaining adequate liability insurance, they could not attract and retain unpaid volunteers because of the risk of personal liability as directors, officers, agents or merely volunteer workers. As a result, a number of states such as California have enacted statutes (Cal. Corp. Code § 5239) that attempt to provide immunity from personal liability for ordinary negligence to officers and directors of nonprofit organizations and a few states extend such immunity to unpaid volunteers who are not directors or officers. See Colo.R.S. 13-21-116; Ill. R.S. c. 32 ¶108.70(c); R.I. Gen.L. §7-6-9(a); V.Tex., Civ. Prac. & Rem. Code §§84.003(2), 84.004(b). Some states have enacted legislation specifically authorizing a nonprofit corporation to indemnify its directors and officers against liability for breach of duty and to purchase and maintain liability insurance on behalf of its directors and officers. Practitioners are advised that state laws frequently change and to check the current applicable state statute. (California Corporations Code § 5047.5)

7.1.4 Potential Criminal Liability for Invasion of Endowment. Directors cannot simply rely on liability insurance to cover all indiscretions. A former Chief Executive Officer of Allegheny Health, Education and Research Foundation (AHERF) pled no contest to criminal charges of stripping funds from charitable endowments and using them to prop up the failing health care system. The CEO was sentenced to a prison term of 11½ to 23 months. He also pled to one count of misapplication of entrusted property, a second-degree misdemeanor that carries a maximum penalty of 24 months in prison. Felony theft charges against the CEO were dismissed because the court found he did not use the endowment money for his own personal gain. Additionally, the Pennsylvania Attorney General reached a settlement agreement with the parties in AHERF's bankruptcy proceedings that returned more than $22 million to the endowments.

7.1.5 Possible Personal Liability for Improper Disclaimer When in "Vicinity of Insolvency."

Is a disclaimer by the debtor a breach of fiduciary duty by the corporate debtor? (*See* Delaware Corporations Code § 141.2.12)

In Credit Lyonnais Bank Nederland v. Pathe Communications, C.A. No. 12150 (Del. Ch. Dec. 30, 1991) the Court of Chancery emphasized that "[a]t least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise." And in Geyer v. Ingersoll Publications Co., C.A. No. 12406 (De. Ch. June 18, 1992) the court stated that fiduciary duties to creditors arise when one is able to establish the fact of insolvency. The court also held that fiduciary duties arise at the moment of insolvency, rather than upon the initiation of statutory proceedings, noting that:

> The existence of fiduciary duties at the moment of insolvency may cause directors to choose a course of action that best serves the entire corporate enterprise rather than any single group interested in the corporation at a point in time when shareholders' wishes should not be the directors' only concern. Furthermore, the existence of the duties at the moment of insolvency rather than the institution of statutory proceedings prevents creditors from having to prophesy when directors are entering into transactions that would render the entity insolvent and improperly prejudice creditors' interest.

A bankruptcy court has held that the directors may be considered to have breached their fiduciary duties when they approve a transaction that maximizes shareholder value to the detriment of creditors.

A bankruptcy court has also held that the scope of directors' fiduciary duty to creditors upon insolvency is limited to protecting the contractual and priority rights of creditors, and does not necessarily include a duty to give those interests priority or require directors to liquidate and pay creditors when the corporation is near insolvency, provided that in the directors' informed, good-faith judgment there is an alternative. (*See* Steinberg v. Kendig (In re Ben Franklin Retail Stores), 225 B.R. 646, 655 (Bankr. N.D. Ill. 1998).)

7.2 Charities and the Business Judgment Rule

7.2.1 General Rule. Since Stern v. Lucy Webb Hayes National Training School for Deaconesses, 381 F. Supp. 1003 (D. D.C. 1974), the trend has been to hold directors of nonprofit corporations to a standard similar to the corporate standard. Courts have described this shift from a standard closer to a trust-law standard as a move to hold directors liable for gross negligence and not ordinary negligence. The concern may be in part to limit personal liability of directors, so that charitable institutions will not find themselves without directors altogether. Thus, business judgment standards (or "best judgment" standards) have been applied when determining director liability.

7.2.2 Requisites. The business judgment rule bars judicial inquiry into actions of corporate directors taken in good faith and in the exercise of honest judgment in the lawful and legitimate furtherance of corporate purposes. The policies underlying judicial creation of the common law rule derive from the realities of business in the corporate context. Directors should be given wide latitude in their handling of corporate affairs because the hindsight of the judicial process is an imperfect device for evaluating business decisions.

7.2.3 Limitations. The rule will only govern where such decision-making, although perhaps misguided, has been honest and disinterested, and the doctrine will not be enforced when the good faith or oppressive conduct of the offices and directors is in issue. Thus, the rule does not foreclose the courts from making an initial inquiry as to the status of those members of the board who are charged with misfeasance.

7.3 Replacement of Incumbent Directors

A case involving the interplay of public policy, bankruptcy, and state corporation law is In re Machne Menachem, Inc. (304 R.R. 140 (Bankruptcy M.D. Pa. 2003), a charity filed Chapter 11 bankruptcy. The plan of reorganization proposed by one of the current board members provided sufficient funds, contingent upon removal of the other incumbent directors. The bankruptcy court held that the plan could not be confirmed because it violated public policy with respect to "the manner of selection of any officer, director or trustee" as set forth in applicable (NY) state corporation law. Specifically, the court stated:

> "Unlike a traditional "take-over" involving the acquisition of a majority of the voting rights (stock) of a corporation in order to "vote the stock" and elect a new board pursuant to the corporation's bylaws, the same should not apply to a not-for-profit corporation organized under a statutory scheme permitting corporate control to vest in a board of directors and prohibiting the use of shareholders." Id.

Section 8. Ethical Considerations for Attorneys

8.1 <u>Invading Endowment Corpus</u>

8.1.1 If members of the board have exposed themselves to potential personal liability for actions such as misrepresentation or gross negligence, counsel for a charity should bear in mind that the invasion of corpus may be in the best interest of the members of the board of directors of a charity, and that the conflict of interest involved may require certain actions to be taken by counsel.

8.1.1.1 <u>Example</u>. Members of the charity's board of directors personally guarantee the charity's lease. The directors later seek to invade the corpus of the endowment to buy out the lease.

8.2 <u>Applicable ABA Model Rules of Professional Conduct</u>

8.2.1 <u>Model Rule 1.13(a)</u>. A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents.

8.2.2 <u>Model Rule 1.13(b)</u>. If a lawyer for an organization knows facts from which a reasonable lawyer, under the circumstances, would conclude that an officer, employee or other person associated with the organization is engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization, or a violation of law which reasonably might be imputed to the organization, and is likely to result in substantial injury to the organization, then the lawyer shall proceed as is reasonably necessary in the best interest of the organization. Unless the lawyer reasonably believes that it is not necessary in the best interest of the organization to do so, the lawyer shall refer the matter to higher authority in the organization, including, if warranted by the circumstances, to the highest authority that can act in behalf of the organization as determined by applicable law.

8.2.3 <u>Model Rule 1.13(c)</u>. Except as provided in paragraph (d), if (1) despite the lawyer's efforts in accordance with paragraph (b) the highest authority that can act on behalf of the organization insists upon or fails to address in a timely and appropriate manner an action or a refusal to act, that is clearly a violation of law, and (2) the lawyer reasonably believes that the violation is reasonably certain to result in substantial injury to the organization, *then the lawyer may reveal information relating to the representation whether or not Rule 1.6 permits such disclosure, but only if and to the extent the lawyer reasonably believes necessary to prevent substantial injury to the organization.[Emphasis added.]*

8.2.4 Model Rule 1.13(d). Paragraph (c) shall not apply with respect to information relating to a lawyer's representation of an organization to investigate an alleged violation of law, or to defend the organization or an officer, employee or other constituent associated with the organization against a claim arising out of an alleged violation of law.

8.2.5 Model Rule 1.13 (e). *A lawyer who reasonably believes that he or she has been discharged because the lawyer's actions taken pursuant to paragraphs (b) or (c), or who withdraws under circumstances that require or permit the lawyer to take action under either of those paragraphs, shall proceed as the lawyer reasonably believes necessary to assure that the organization's highest authority is informed of the lawyer's discharge or withdrawal. [Emphasis added.]*

> 8.2.5.1 Panel Query. Is the state Attorney General the organization's "highest authority" to whom the lawyer "shall" report?
>
> 8.2.5.2 "No," per California Supervising Deputy Attorney General, James M. Cordi (comments at California State Bar Business Section Luncheon, September 5, 2003, Anaheim.)

8.2.6 Model Rule 1.13(f). In dealing with an organization's directors, officers, employees, members, shareholders or other constituents, a lawyer shall explain the identity of the client when it is apparent that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing.

8.2.7 Model Rule 1.13(g). A lawyer representing an organization may also represent any of its directors, officers, employees, members, shareholders or other constituents, subject to the provisions of Rule 1.7. If the organization's consent to the dual representation is required by Rule 1.7, the consent shall be given by an appropriate official of the organization other than the individual who is to be represented, or by the shareholders.

8.2.8 Model Rule 1.16(a). Except as stated in paragraph (c), a lawyer shall not represent a client or, where representation has commenced, shall withdraw from the representation of a client if: (1) the representation will result in violation of the rules of professional conduct or other law; (2) the lawyer's physical or mental condition materially impairs the lawyer's ability to represent the client; or (3) the lawyer is discharged.

8.2.9 Model Rule 1.16(b). Except as stated in paragraph (c), a lawyer may withdraw from representing a client if: (1) withdrawal can be accomplished without material adverse effect on the interests of the client; (2) the client persists in a course of action involving the lawyer's services that the lawyer reasonably believes is criminal or fraudulent; (3) the client has used the lawyer's services to perpetrate a crime or fraud; (4) the client insists upon taking action that the lawyer considers repugnant or with which the lawyer has a fundamental disagreement; (5) the client fails substantially to fulfill an obligation to the lawyer regarding the lawyer's services and has been given reasonable warning that the lawyer will withdraw unless the obligation is fulfilled; (6) the representation will result in an unreasonable financial burden on the lawyer or has been rendered unreasonably difficult by the client; or (7) other good cause for withdrawal exists.

8.2.10 Model Rule 1.16(c). A lawyer must comply with applicable law requiring notice to or permission of a tribunal when terminating a representation. When ordered to do so by a tribunal, a lawyer shall continue representation notwithstanding good cause for terminating the representation.

8.2.11 Model Rule 1.16(d). Upon termination of representation, a lawyer shall take steps to the extent reasonably practicable to protect a client's interests, such as giving reasonable notice to the client, allowing time for employment of other counsel, surrendering papers and property to which the client is entitled and refunding any advance payment of fee or expense that has not been earned or incurred. The lawyer may retain papers relating to the client to the extent permitted by other law.

8.2.12 Model Rule 1.7(a). Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if: (1) the representation of one client will be directly adverse to another client; or (2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.

8.2.13 Model Rule 1.7(b). Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if: (1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client; (2) the representation is not prohibited by law; (3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and (4) each affected client gives informed consent, confirmed in writing.

8.3 Application of Ethical Rules

8.3.1 Attorney may be required to ask an officer to reconsider, or if possible, seek to have the matter reviewed by a higher authority in the organization.

8.3.2 Generally, the board of directors will be the highest authority in a nonprofit organization, but if there are "members" of the organization with the power to remove the directors, the attorney may be obligated to refer the matter to the membership. Note: Panel Query at Model Rule 1.13(e) regarding the Attorney General.

8.3.3 The attorney should take care to define his or her representation as that of the organization itself and not the individual members of the board of directors. The issue of dual representation is addressed Model Rule 1.7. Counsel must also be careful not to take actions that may be deemed by the directors as constituting representation of the directors individually.

8.3.4 Counsel should also advise any director whose interest the attorney finds adverse to that of the organization: (i) of the conflict or potential conflict of interest, (ii) that the attorney cannot represent such director, and (iii) that such person may wish to obtain independent representation.

Section 9. Hypothetical

Rachel's House is a nonprofit organization operating a shelter for abused women. It receives 80% of its budget from the state and has no endowment. Ms. Donor seeks to start an endowment for Rachel's House by writing a letter contained the following language:

> "This pledge is in consideration of the gifts of others and for the good work you have done in this community and must be used to enlarge your facility. I urge you to likewise expand your charitable work. I hereby pledge to Rachel's House a donation of $10 million, $4 million to be given upon acceptance of the terms of this pledge, and the remaining $6 million three years later. Only the income of these gifts is to be used. If Rachel's House ever files for bankruptcy, then the pledge is cancelled and Rachel's House must give back all amounts already paid under this pledge"

The board accepts the terms and Rachel's House receives the initial $4 million.

Due to a budget crisis, the state cuts its support to Rachel's House, leaving the organization without enough money to cover its operating expenses. The board members vote to enter into, and several directors personally guarantee, a 10-year sale-leaseback of its building, using the cash from the sale to pay off operating liabilities. The board also determines to lay off 52 of its 80 employees.

After results do not improve, the landlord is willing to accept a "buy-out" to terminate the lease if Rachel's House pay $3 million now and another $2 million in three years. The board votes to use the endowment principal to make the first payment to the landlord, and earmarks a third of the second disbursement for the remaining portion of the buy-out. The remainder of the endowment will be used to restart operations in a new, much smaller, facility.

Ms. Donor dies before the second disbursement becomes due. Ms. Donor's executor learns that the Rachel's House board of directors has voted to invade the principal of the endowment. The executor notifies the board that should the board actually invade the principal, Donor's estate will sue Rachel's House and its board members for return of the $4 million, and will not make the second disbursement of $6 million to Rachel's House but will instead pay that amount to Ms. Donor's heirs. One board member announces that if the charity cannot use the fund principal, it might be best to file for bankruptcy.

The board members, not having previously consulted counsel, now seek your advice.

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