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ASSETS HELD BY CHARITABLE ORGANIZATIONS ARE SAFE FROM CLAIMS OF CREDITORS IN BANKRUPTCY CASES. . . OR ARE THEY?



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A charity, fulfilling its charitable mission, is successful in raising money for a variety of worthy projects - rebuilding after a natural disaster, medical education and care, summer camp experiences for disadvantaged children, or financial support for senior centers. Everyone agrees that these are worthwhile charitable endeavors — except perhaps some might suggest, the United States Bankruptcy Courts.

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This article examines how assets donated of charitable organizations may be treated if such organizations were ever to file a bankruptcy resulting from significant creditor claims. There is some, yet limited, legal authority determining what is ''property of the estate'' in a bankruptcy.

I. ''Property of the Estate'' in Recent Religious and Charitable Organization Bankruptcies

Recent bankruptcy cases filed by Catholic dioceses and archdioceses have raised issues regarding the extent to which the assets of non-bankrupt Catholic entities should be available for payment of creditor claims. Recent bankruptcy cases arise where abuse victims make monetary claims for damages arising out of alleged improper or illegal conduct. The decisions from these bankruptcy cases may have far-reaching implications for charitable institutions that hold donated assets or participate in pooled investment accounts.

In each of these cases, focused on religious institutions and their charitable assets, the bankruptcy courts have been asked to determine whether certain assets held by the debtor are considered ''property of the estate.'' Courts have consistently held that the scope of the term ''property of the estate'' is very broad. Property of the estate does not include ''any power that the debtor may exercise solely for the benefit of an entity other than the debtor,'' 11 U.S.C. § 541(b)(1), or ''[p]roperty in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest . . . .'' 11 U.S.C. § 541(d). Similarly, the estate does not include property containing ''[a] restric-

tion on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law. . . .'' 11 U.S.C. § 541(c)(2); *see In re Cutter*, 398 B.R. 6, 18-19 (9th Cir. BAP 2008). Although the Bankruptcy Code defines what is property of the estate, ''[p]roperty interests are created and defined by state law.'' *Butner v. U.S.*, 440 U.S. 48, 55; 99 S. Ct. 914, 918 (1979); *see also In re Mantle*, 153 F.3d 1082, 1084 (9th Cir. 1998) (bankruptcy courts must look to state property law to determine whether property is to be included in bankruptcy estate).

A. *Catholic Diocese of Wilmington*

1. Structure of the Pooled Investment Account

In 2009, the Catholic Diocese of Wilmington, Inc., which was the secular administrative arm of the Diocese of Wilmington, filed Chapter 11. Soon after, a committee of unsecured creditors (''committee'') was appointed and was composed of seven members, each of whom had filed a lawsuit against the debtor and other defendants asserting claims arising out of allegations of sexual abuse. *In re Catholic Diocese of Wilmington, Inc.*, 432 B.R. 135 (Bankr. D. Del. 2010).

For many years the debtor ran a pooled investment program that permitted multiple entities to share investment opportunities not otherwise available to them. As of December 2009, the diocese maintained a pooled investment account (''PIA'') of approximately $120 million. 432 B.R. at 142. The committee argued that all PIA funds were property of the debtor's estate that should be available for distribution to all creditors. The committee filed a complaint naming the debtor and a host of non-debtors as defendants, which included parishes with funds held in the PIA the Catholic Diocese Foundation , and various educational and service institutions.

The debtor held all of the PIA funds in a single account at BNY Mellon. The participants in the PIA believed that the funds remained their property and that they could withdraw funds at any time. In fact, most of the money was deposited by non-debtors (approximately $75 million), as evidenced by the fact that each nondebtor PIA participant treated its PIA funds as its own assets in its financial statements. The debtor's balance sheet described the funds of nondebtors as assets held for others.

With certain exceptions, when a PIA participant delivered funds to the debtor for deposit into the PIA, the funds were not deposited directly into the PIA. Instead, the debtor would immediately reallocate funds in the PIA to reflect an increase in the balance for the PIA participant making the deposit and reduce the debtor's balance in the PIA. After that adjustment, the debtor would deposit the funds into its general operating account.

When a PIA participant made a withdrawal, the funds came out of the debtor's general operating account, and corresponding adjustments were made to the withdrawing party's and the debtor's balances in the PIA. Therefore, when a withdrawal or deposit was made, the actual value of the PIA did not change. Only the amounts of the debtor's and non-debtors' balances in the PIA changed. The evidence demonstrated that the debtor's recordkeeping was meticulous and that at any time the PIA participants knew precisely what amounts in the PIA were attributable to their investments. Thomas M. Horan, ''Non-Debtor Funds in Pooled Investment Account Subject to Claims of Diocesan Creditors,'' XXX *ABI Journal* 1, 28-29, February 2011.

2. Basis for Court's Finding that Funds of the PIA Were Property of the Estate

The committee included in its complaint a request for a declaratory judgment that the contributions of non-debtors were not held in trust and were property of the estate subject to the claims of the creditors. The defendant parishes and other participants in the PIA opposed and objected, asserting that the debtor held the non-debtors' funds in trust, and that the funds were not property of the estate.

With one exception, there was no written trust agreement between the debtor and non-debtor participants in the PIA. The bankruptcy court, however, held that the PIA arrangement created a resulting trust under Delaware law. The court noted that the definition of a resulting trust encompasses those circumstances where a ''person makes or causes to be made a *disposition of property* under circumstances which raise an inference that he does not intend that the person taking or holding of property should have the beneficial interest therein. . . .''

Nevertheless, according to the court, the fact that there was a resulting trust was not sufficient to keep the PIA from the creditors' reach. Despite the debtor's meticulous recordkeeping, the court found the non-debtors' PIA funds that were deposited into the debtor's operating account were commingled with other property of the debtor. The court also found that the defendant parishes and other participants in the PIA could not identify and trace the trust funds.

The bankruptcy court found the defendant parishes and other participants in the PIA failed to meet their burden. Despite the excellent recordkeeping that demonstrated that the PIA ''balance never dropped below the amount of the trust funds on deposit,'' the defendant parishes and other participants in the PIA had no evidence to trace the funds to and from the operating account, or between the operating account and the PIA. Thus the defendant parishes and other participants in the PIA could not meet their burden and ''the entire balance of the PIA [was] property of the Debtor's estate under section 541(a) of the Bankruptcy Code.''

Significantly, the court found that the property of one of the non-debtor defendant parishes, St. Ann's Roman Catholic Church, was expressly excluded from the bankruptcy estate. Unlike the rest of the non-debtor defendant parishes and other participants in the PIA, St. Ann's had an express, written trust agreement with the debtor ''under which the Debtor [was] the trustee. St. Ann's [was] the beneficiary and the funds St. Ann's deposited into the pooled investment program [were] the trust *res*. In addition, St. Ann's made its only deposit under the pooled investment program directly into the PIA. As a result, St. Ann's [did] not share the other non-defendants' difficulties in tracing its trust funds. The balance in the PIA never remotely came close to dipping below the amount invested by St. Ann's. Thus, St. Ann's . . . met its burden of establishing that its funds in the PIA (including any gains or subject to any losses on its investment) [were] *not* property of the estate.''

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B. *Archdiocese of Milwaukee*

1. Structure of the Parish Deposit Fund

The Archdiocese of Milwaukee filed Chapter 11 in January 2011. The committee of unsecured creditors (''committee'') filed a motion in the bankruptcy court seeking derivative standing to prosecute an action to avoid and recover allegedly fraudulent transfers out of the debtor's Parish Deposit Fund (the ''PDF''). *In re Archdiocese of Milwaukee*, 483 B.R. 855, 857 (Bankr. E.D. Wis. 2012). The committee alleged that in 2005 the debtor transferred more than $35 million from the PDF to an entity called the Southeastern Wisconsin Catholic Parishes Investment Management Trust (the ''Trust'') and directly to certain parishes and other nondebtor entities. The committee sought derivative standing to prosecute an action to avoid and recover the transfer from the Trust and the parishes under §§ 544(a), 544(b), and 550(a) of the Bankruptcy Code.

The PDF was created as an optional pooled investment fund for Catholic entities within the Milwaukee Archdiocese, and the debtor and the parishes contributed funds. The PDF was attractive because of economies of scale allowing the PDF to offer higher interest rates. The PDF was held in a segregated account, and the funds invested by the parishes never passed through the debtor's general bank accounts. The debtor disclosed the PDF's existence in the debtor's audited financial statements, which had been posted on the debtor's website since 2002.

The PDF closed in June 2005. The debtor advised the parishes of the option of (1) having their funds returned to them *or* (2) participating in the newly established Parish Trust. Most parishes opted to have their monies returned. The debtor's audited financial statement dated June 30, 2005, was posted on the debtor's website and disclosed the PDF's closure. 483 B.R. at 864; Thomas M. Horan, ''Property of the Estate in Church Bankruptcies: Archdiocese of Milwaukee,'' XLIV *ABI Journal* 1, 44-45, March 2013.

2. Basis for Court's Ruling that the Parish Deposit Fund Was Not Property of the Estate

On a motion for derivative standing, the court ruled that the committee failed to meet its burden and denied the motion.

In its analysis, the court addressed the decision in the *Diocese of Wilmington* case. The court noted that the PIA and the PDF featured many similarities, including the purpose, voluntary nature, ability of investors to withdraw their funds upon request, and belief by both the Diocese and the investors that all funds within the PIA remained the property of the investors. However, the Milwaukee Archdiocese did not commingle the fund in its operating account and transfer funds back and forth. Instead, all of the funds, like the funds in *Diocese of Wilmington*, were deposited into one segregated bank account and audited annually, and it was never found to have a shortfall. Therefore if every parish sought the return of its deposits, the PDF would have been able to return every deposit in full, which was not true in the *Diocese of Wilmington* case. For this reason, the bankruptcy court held that the committee failed to state a claim that the transfer of monies out of the PDF and to the parishes was a transfer of the property of the estate of the debtor.

C. Bankruptcy Case of the *Roman Catholic Archbishop of Portland in Oregon*

In the Chapter 11 case filed by the Archbishop of Portland, a committee of tort claimants (the ''committee'') filed an adversary proceeding to obtain a declaration of whether a Perpetual Endowment Fund (the ''PEF''), valued at $36 million, was property of the debtor's estate. In the alternative, the committee sought a determination that the debtor's beneficial interest in the PEF and certain powers it exercised were property of the estate. *In re Roman Catholic Archbishop of Portland in Oregon*, 345 B.R. 686 (Bankr. D. Oregon 2006).

The PEF was created in 1981 by a Declaration of Trust, which set forth the source of the endowment, its goals, objectives, management,investment objectives, inviolability of the principal, distribution, use of the PEF, procedure for withdrawal of income, and modification and amendment of the Declaration of Trust. The PEF was established by the non-profit Archdiocese of Portland in 1909. In 1991, the 1909 corporation merged with the debtor and the debtor was the surviving corporation. The PEF was originally comprised of land sale proceeds owned by the 1909 corporation. Additions included unrestricted gifts.

The debtor argued that the PEF was held in a charitable trust and therefore was not part of the estate and was not available to pay tort obligations. The committee argued that the PEF was not a valid trust, and therefore part of the debtor's estate and was subject to the claims of creditors. The bankruptcy court ruled that based on Oregon law, the Declaration of Trust created a valid, charitable trust. While the debtor was one of the beneficiaries of a charitable trust, it was not the sole beneficiary. The PEF's beneficiaries included the community that was served by these religious, charitable, and educational programs. Because the PEF was valid, the bankruptcy court held that the trust assets were not property of the estate. . The bankruptcy court further held that only the debtor's own beneficial interest in the income of the fund was included in the estate, subject to whatever restrictions on use of that income set forth in the Declaration of Trust.

D. *Parkview Hospital*

In the bankruptcy case of *Parkview Hospital*, 211 B.R. 619 (Bankr. N.D. Ohio 1997), a nonprofit hospital established a development fund for research and staff development. It solicited donations, which was held out as restricted and whose principal could not be invaded. Only the income could be used for the fund. The source of much of the funds appeared to have come from unrestricted donations made to the non-profit corporation that were designated by the hospital to go into the restricted fund, and from the gifts and donations of the staff and board of the hospital. Due to the lack of accounting records it was impossible to separate the amount of unrestricted donations designated to go into the fund by the hospital from the donations restricted by other donors.

When the hospital closed and filed Chapter 11 the trustee argued that the fund was property of the estate. The bankruptcy court disagreed. The court stated that ''[w]here property is given to a charitable corporation and is directed by the terms of the gift to devote the property to a particular one of its purposes, it is under a duty . . . to devote the property to that purpose.'' 211

B.R. at 630. The court found ample proof that the donors consistently manifested the intent that the contributions to a development fund would be restricted for osteopathic purposes, despite the absence of a formal trust. Accordingly, the court held that the ''funds were not assets of the bankruptcy estate which can be administered for the benefit of the creditors.'' 211 B.R. at 641; *see also In re Bishop College*, 151 B.R. 394 (Bankr. N.D. Tex. 1993) (holding that a bankruptcy estate of a defunct college had no enforceable property interest in charitable trusts established to support charitable educational mission of college and excluding charitable trust from college's estate); *Hobbs v. Board of Education of N. Baptist Convention*, 126 Neb. 416, 253 N.W. 627 (Neb. 1934) (donation to bankrupt college's endowment fund was not reachable by general creditors; donors indicated that the gifts were to be used as an endowment for educational purposes, with the corpus to be kept intact and income only to be used for the general purposes of the college); *In re Winsted Memorial Hospital*, 249 B.R. 588 (Bankr. D. Conn. 2000) (charitable gifts to Chapter 7 debtor hospital of portion of individual donor's residuary estates vested in debtor prepetition, when donor's died, and were thus included in ''property of the estate'' subject only to restriction that they be applied to payment of debts incurred for hospital's charitable purposes while it was still operating).

II. California Attorney General's Role in Protecting Charitable Assets

The California Attorney General has primary responsibility for regulating, enforcing and supervising organizations and individuals that administer and solicit charitable funds or assets in California. The Attorney General has the duty to protect donors to charities, charities themselves and the beneficiaries of charities. It has broad authority to regulate charitable organizations and trusts and to commence law enforcement investigations and legal actions to protect the public interest. *See* California Corporations Code §§ 5250 and 9230 and Government Code §§ 12588 and 12598.[1]

Because the Attorney General's oversight jurisdiction extends to charitable organizations, it is likely that the Attorney General may take legal steps to protect charitable funds and represent the intended ''beneficiaries'' of the charitable missions if the charitable funds are at risk of diversion. In a bankruptcy, for example, the Attorney General may likely become involved and take legal action if restricted funds held by a bankrupt charitable organization could be subjected to the claims of creditors.

III. Funds Held by Charitable Organizations and Potential Treatment in the Bankruptcy Context

Charitable organizations may receive and hold assets in various forms. An analysis as to how these assets may be treated in a bankruptcy case is limited to the few published bankruptcy cases that address whether certain assets maintained by charitable organizations would be subject to the claims of creditors and an understanding of the California Attorney General's policy of protecting charitable assets.

A. Funds That May Be Protected From the Claims of Creditors

Certain funds may be protected from the claims of creditors:

1. Funds Held on Behalf of Agencies

If the charitable organization holds funds on behalf of other agencies as an agent for that charity and not as a principal, and the charitable organization has no variance power over the funds, a bankruptcy court is more likely than not to conclude that such types of funds are not ''property of the bankruptcy estate'' because the charitable organization does not hold any equitable interest in the funds.

2. Agency Funds

Agency funds are assets held by the charitable organization on behalf of an agency. The assets of the agency funds belong to the charitable organization but are restricted in purpose such that they can only be spent on the agency. The charitable organization will have ''variance power'' over the funds. For example, if the agency goes out of business, the charitable organization may determine how to spend the assets keeping as close to the original purpose as possible.

Although it has control over agency funds, the charitable organization is restricted to use the assets for a specific purpose as identified by the agency. Similar to the ruling in the *Parkview Hospital* case, it would appear that a bankruptcy court is more likely than not to find that the agency funds are not ''property of the estate'' and thus not part of the bankruptcy estate.

3. Donor-Created Endowment Funds

A donor-created endowment fund is one that, under the terms of the applicable gift instrument, is not wholly expendable on a current basis. This characterization of non-expendability allows a gift to continue in perpetuity, with amounts appropriated for expenditure each year for the charitable organization's use only as are prudent for a fund of perpetual existence (the ''spend guideline''). Donor-created endowment funds may be further restricted as to the particular purpose for which the organization may spend distributions from such funds, and may also be held (whether or not restricted as to purpose) as endowed donor-advised funds, discussed below.

Based on the rulings in both the *Archdiocese of Milwaukee* and the *Roman Catholic Archbishop of Port-*

[1] The California Attorney General's oversight role with respect to *religious* organizations is very restricted. The Attorney General's office does not have the same investigative or enforcement powers over religious corporations that it has over public benefit corporations and charitable trusts. California Corporations Code § 9230. With very limited exceptions, the Attorney General's enforcement powers may be used only if the directors of a religious corporation engage in criminal activity or conduct a public, fraudulent solicitation for ''secular'' purposes. As to most other harmful actions by directors of religious corporations, including self-dealing, improper distribution of a religious corporation's assets, and gross mismanagement, the Attorney General does not have the legal authority to file a derivative civil action on behalf of the religious corporation. Only the directors of the religious corporation or, in some cases, the corporation's statutory voting members may file a civil action to correct these types of abuses.

A religious corporation is required to obtain court or Attorney General approval for the distribution of its assets upon dissolution of the corporation. California Corporations Code § 9680.

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land in Oregon, it would appear that a bankruptcy court is more likely than not to find that the ''principal'' (or corpus) of a donor-restricted endowment fund that is restricted as to a particular purpose is not ''property of the estate'' and, therefore, not part of the bankruptcy estate. The bankruptcy court may determine that because the donor's intent, as set forth in a written instrument, is that such funds must be held in perpetuity for a specific charitable purpose, the charitable organization does not necessarily have control over the principal of the fund. However, donor-endowed funds that can be used by the charitable organization to make payments to support ***any*** of its charitable purposes (including those funds held in donor-advised funds) may be less protected from claims of creditors and are at a greater risk of being treated as ''property of the estate'' than donor-endowed funds that are restricted as to a particular charitable purpose.

B. Funds Likely Available to the Claims of Creditors

It appears that ***non-endowed funds unrestricted*** by donors as to use are subject to attachment and reachable by creditors.

C. Funds That *May or May Not* Be Subject to the Claims of Creditors

It is unclear at this time how the following funds held by a charitable organization will be treated by the California Attorney General or a bankruptcy court, but we believe that they may likely be subject to the claims of creditors.

1. Non-Endowed Donor-Advised Funds

A donor-advised fund is a separately identified fund that is maintained and operated by the charitable organization. Once the donor makes the contribution, the charitable organization has legal and ultimate control of the fund. However, the donor retains advisory privileges with respect to distributions and may retain investment advisory privileges. Because the charitable organization has complete control over the funds and no specific purpose has been provided by the donor as to how the money should be used, it would appear that such donor-advised funds will more likely than not be found by a bankruptcy court to be part of the bankruptcy estate. A bankruptcy court (and the California Attorney General) may find that such a fund is not sufficiently restricted for a particular purpose so as to exclude it from the bankruptcy estate.

2. Board-Created Endowment Funds (or Quasi-Endowments)

A board-created endowment fund is a fund that would otherwise be unrestricted but for the charitable organization's decision to treat the particular fund like an endowed fund. The fund is not considered a true endowment fund if the board of the charitable organization has the power to spend all of the fund but decides by board resolution to invest the fund and only spend the income or appreciation. Because the restricted use is board-imposed, that restriction may also be removed at any time by the charitable organization board.

The fact that the charitable organization has the legal authority to remove the endowment restriction, creating unlimited access to principal and income, likely means that the assets of a board-created endowment fund may be part of the bankruptcy estate.

3. Unrestricted Endowment Funds

An unrestricted endowment fund is a fund that is restricted as to how much an organization can spend but can be used for any charitable purpose permitted by the organization. The California Attorney General may argue that an endowment fund (even unrestricted) should be protected from the reach of creditors because the assets were provided to the charitable organization for charitable purposes in perpetuity and the charitable organization is restricted as to how much of the fund it can spend. However, creditors may be able to argue that all charitable organizations are set up for charitable purposes and that the charitable organization can spend the money for any general purpose. A bankruptcy court may find that such a fund is not sufficiently restricted for a particular purpose so as to exclude it from the bankruptcy estate.