For the Seton Hall Journal on Legislation
Bankruptcy in the Religious Non-Profit Context
Symposium Issue
ebrody@kentlaw.edu / March 30, 2005

The Charity in Bankruptcy and Ghosts of Donors Past, Present, and Future

Evelyn Brody*

The bankruptcy of a charity represents the clash of two policy regimes: Charity law's willingness to preserve assets for the public purpose determined by the donor as against bankruptcy law's desire to maximize assets for distribution to creditors. As a general rule, assets will be distributed to creditors; as the courts say, "a man must be just before he is generous."[1] However, when a charitable donee goes out of existence or otherwise becomes unable to perform a charitable trust or restricted gift, the courts will try to identify those charitable assets that are restricted in such a manner that they survive the bankruptcy proceeding.[2]

These assets excluded the bankruptcy estate are instead subject to the venerable doctrine of *cy pres* applies. Courts originally applied the *cy pres* doctrine to charitable trusts, but came to find the doctrine appropriate as well for restricted gifts made to corporate charities. These trusts and gifts, if they can no longer be performed as originally specified, are modified for another use by the same charity or are transferred to another charity, subject to the same or modified purpose. It is common for the *cy pres* proceeding to occur in state court, rather than in the federal bankruptcy proceeding.

This approach views any particular charity holding a restricted gift as distinct from the

---

* Professor of Law, Chicago-Kent College of Law. I am grateful for research support from the Marshall D. Ewell Research Fund at Chicago-Kent. I thank Angela Carmella for inviting me to participate in Seton Hall's symposium on Bankruptcy in the Religious Non-profit Context, and for discussing many of these ideas with me. I also appreciate comments from conference participants. Patrick Whaley's earlier work (cited below) proved invaluable. Jack Siegel, as always, was my first and last sounding board. While this Article draws from Comments and Reporter's Notes in American Law Institute, "Principles of the Law of Nonprofit Organizations," Council Draft No. 1 (October 2, 2003), which I drafted as Reporter for discussion by the ALI Council, it reflects my views only.

1 See, e.g., In re 375 Park Avenue Associates, Inc., 182 B.R. 690, 697 (Bankr. S.D.N.Y. 1995).

2 This can be a tedious, and not always successful, process. See, e.g., In re Parkview Hospital, 211 B.R. 619, 622 (Bankr. N.D. Ohio 1997) ("Because no records of periodic reconciliations with bank statements exist, either because they were lost or were never prepared in the first instance, it is not now possible to tie into the balance of the account at Mid-American with the records of the donated funds. What is available are records kept in spiral notebooks which memorialize, in individual handwritten entries, donations to the Fund from hundreds if not thousands of donors.").

contemplated beneficiaries of that gift.[3] Despite its benefits to society, such a policy also carries negative implications for the governance of individual nonprofit organizations. Sympathy for charitable beneficiaries in bankruptcy can make it harder for all charities – including those not in financial distress – to obtain needed financing. Less obviously, but perhaps more seriously, over-accommodating courts that wall off charity assets from bankruptcy creditors can further an already pervasive view that charitable property is "public" to an inappropriate degree.[4]

As explained in detail below, assets donated to or for the use of charity take a variety of forms.[5] Enough cases of nonprofit bankruptcy have been reported to allow for a general description of the legal consequences,[6] but uncertainty exists regarding certain types of restricted

---

[3] See *id.* at 638-39:

> Similarly, the Trustee argues that there was no separation of legal and beneficial title. This Court finds that there was. The purpose of the trust was to further osteopathic medicine in the northwest Ohio and southeast Michigan area. Thus, the beneficiaries are the people in this area. Though the furthering of such a goal would benefit the hospital, the purpose is nevertheless broader than just benefiting the hospital itself. Also, an underlying assumption in the Trustee's argument is that the increase in osteopathic medicine in the area would inure to the financial success of the hospital. Were Parkview a for-profit hospital, this argument would have weight. But Parkview's mission was not profit.

[4] See, e.g., Evelyn Brody, *Whose Public? Parochialism and Paternalism in State Charity Law Enforcement*, 79 IND. L.J. 937 (2004). See also Harold L. Kaplan, Patrick S. Coffey, & Rosemary Feit, *The "Charitable Trust" Doctrine: Lessons and Aftermath of Banner Health*, 23-4 AM. BANKRUPTCY INST. J. 28, at 62-63 (May 2004):

> Even more recently, state attorneys general have objected to specific expenditures by nonprofit corporations (including fees for hiring bankruptcy professionals) [footnote omitted citing to In re Nat'l Benevolent Ass'n of the Christian Church (Disciples of Christ), et al., Case No. 04-50948-RBK (Bankr. W.D. Tex.)] and have suggested that nonprofit corporation funds may need to be expended in accordance with charitable mission objectives rather than made available for creditor recoveries.

See also Texas Attorney General News Release, "Attorney General Abbott and Six States Persuade Judge to Appoint Auditor to Curb Fees of Bankrupt Charity," Oct. 14, 2004, *available at* http://www.oag.state.tx.us/oagnews/release.php?id=593 ("'To really save this charity we must get control of the hemorrhaging that is killing it by degree,' Abbott noted. 'This charity belongs to the public. It does not belong to lawyers and investment bankers.'").

[5] This Article does not address any specific results that might apply to a charity that is a church. See, e.g., 10 Penn. Statutes § 81.

[6] For a – hopefully unique – nonprofit bankruptcy proceeding in which charities were both the beneficiaries and the creditors, see Ponzi scheme carried out through the Foundation for New Era Philanthropy. See generally Evelyn Brody, *The Limits of Charity Fiduciary Law*, 57 MD. L. REV. 1400, 1490-1500 (1998). The court commented in approving the settlement:

> The Settlement is without question in everyone's best interests because it brings finality to this

gifts and pledges. This article, which generally focuses on federal bankruptcy,[7] considers in turn the treatment of gifts already made; the extent to which the bankruptcy trustee can compel the fulfillment of charitable pledges to the debtor; and the possible forms in which future donors might provide support to the surviving entity.

I. Introduction: The Legal Framework for a Charity in Bankruptcy

A. Assets of the Bankruptcy Estate

The filing of a petition for reorganization under Chapter 11 of the Bankruptcy Code creates an estate.[8] The bankruptcy estate comprises all the property listed in Code section 541, wherever located and by whomever held, including "all legal or equitable interests of the debtor in property as of the commencement of the case." Courts have ruled that the scope of the term "property of the estate" is very broad.[9] However, the estate has no rights in the property broader than the rights of the debtor. Property rights are generally determined by state law.[10]

> highly complex matter – to say nothing of affording charities who lost money an ultimate recovery of at least eighty-five cents on the dollar, perhaps an unprecedented result for victims of a Ponzi scheme. The agreement permits the settlement funds, and other recoveries, to be remitted quickly to these victims. This relatively prompt but thoroughly-considered settlement permits the members of the Settlement Class to turn their full attention to their charitable and other non-profit work for the communities they serve.

In re Foundation for New Era Philanthropy Litigation, 175 F.R.D. 202, 206 (E.D. Pa. 1997).

[7] For two excellent general discussions of the legal treatment of nonprofits in financial distress, see Jack A. Eiferman & Albert Rocha, "Nonprofits in Trouble: Receiverships and Bankruptcy," in 1998 Massachusetts Nonprofit Organizations, Vol. II, Chapter 22, Mass. CLE, Inc. Main Handbook (2d Supp. 2004 by Jack A. Eiferman & Christian J. Urbano); and J. Patrick Whaley, Shalom L. Kohn & Paul J. Dostart, "The End of the Road: When a Charity Goes Bankrupt," panel presentation, Exempt Organizations Committee, ABA Section of Taxation Fall Meeting (Chicago, Sept. 12, 2003), *available in* LEXIS, Legal Library, Secondary Legal, ABA, ABA Section of Taxation, ABA Section of Taxation Meeting Materials File. For a somewhat older source, see J.P. O'NEILL & S. BARNETT, COLLEGES AND CORPORATE CHANGE: MERGER, BANKRUPTCY, AND CLOSURE (1980).

[8] 11 U.S.C. § 541(a). A nonprofit organization is not subject to involuntary bankruptcy, a subject beyond the scope of this article.

[9] See, e.g., United States v. Whiting Pools, 462 U.S. 198, 205-06 (1983); Louisiana World Exposition, Inc., v. Federal Insurance Company, 858 F.2d 233, 245 (5th Cir.1988).

[10] Some states make statutory provision for determining the transfer of donated assets after certain extraordinary transactions. For example, Pennsylvania's Nonprofit Corporation Act provides:

> A devise, bequest or gift to be effective in the future, in trust or otherwise, to or for a nonprofit corporation which has:
> (1) changed its purposes;

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005,[11] currently under consideration in Congress, would (among other changes affecting a charitable bankruptcy) add a new paragraph (f) to Bankruptcy Code section 541, to read as follows:

> (f) Notwithstanding any other provision of this title, property that is held by a debtor that is a corporation described in section 501(c)(3) of the Internal Revenue Code of 1986 and exempt from tax under section 501(a) of such Code may be transferred to an entity that is not such a corporation, but only under the same conditions as would apply if the debtor had not filed a case under this title.[12]

The bill adds: "The parties who may appear and be heard in a proceeding under this section include the attorney general of the State in which the debtor is incorporated, was formed, or does business."[13]

> (2) sold, leased away or exchanged all or substantially all its property and assets;
> (3) been converted into a business corporation;
> (4) become a party to a consolidation or a division;
> (5) become a party to a merger which it did not survive; or
> (6) been dissolved;
>
> after the execution of the document containing such devise, bequest or gift shall be effective only as a court having jurisdiction over the assets may order under the Estates Act of 1947 or other applicable provision of law.

15 Pa. Stats. § 5550 (Devises, bequests and gifts after certain fundamental changes).

[11] S. 256 (Feb. 1, 2005); H.R. 685 (Feb. 9, 2005).

[12] *Id.* at § 1221 (Transfers Made by Nonprofit Charitable Corporations), subsection (c).

[13] *Id.* at subsection (d) (last sentence). This provision is apparently a response to the litigation initiated by the Pennsylvania attorney general in the bankruptcy proceeding of Allegheny Health, Education and Research Foundation ("AHERF"), also discussed below. The attorney general had sued in state probate court (called Orphans' Court) to preserve restricted charitable gifts made to AHERF from distribution to its creditors. The federal bankruptcy court voided the stay obtained by the attorney general in that proceeding, but the federal district court reversed the bankruptcy court. In re Bankruptcy Appeal of Allegheny Health, Education and Research Foundation ("AHERF"), 252 B.R. 332 (W.D. Pa. 1999); In re Bankruptcy Appeal of Allegheny Health, Education and Research Foundation ("AHERF"), 252 B.R. 309 (W.D. Pa. 1999). In this earlier proceeding, the district court set forth its reasoning at length. Notably, it described the public policy as follows:

> Obviously there is great public interest in having AHERF's and its debtor affiliates' Chapter 11 bankruptcy proceedings continue to an orderly, efficient resolution to maximize and preserve the estate's assets for the sake of the creditors. On the other hand, the non-profit charitable corporations involved in this case have incorporated under Pennsylvania's Non-Profit Corporation Law and submitted themselves, therefore, to the authority of Pennsylvania's Attorney General, in its *parens patriae* capacity, and to the jurisdiction of the Orphans' Court, as overseer of charitable trusts and foundations. The federal courts must give the Attorney General some deference in this regard as it presumptively acts in the public interest, and is, indeed, the only party that can really represent the "beneficiaries" of the charitable missions of these entities, that is, the

In the case of a restricted gift, several different treatments are possible. If the asset is kept out of the bankruptcy estate, the restriction will have to be modified if the debtor is being liquidated rather than reorganized, or is being reorganized but can no longer perform the restriction. If the gift instrument does not provide for the desired relief, the charity may obtain release of the restriction as provided in the widely-adopted Uniform Management of Institutional Funds Act ("UMIFA")[14] – following a release of the restriction, however, it would appear that the gift is treated as unrestricted and hence the asset comes back into the bankruptcy estate and is available to creditors. In any case, the charity may petition the court to modify the restriction, but the standards for relief might be more constrained.[15] Several federal bankruptcy courts have exercised their discretion to abstain from the ultimate application of *cy pres* to modify the restriction on a gift made to a failed charity,[16] with the result that this determination is made in a separate state court proceeding.[17]

> public. Moreover, the public interest may be served by abstaining from deciding the ultimate property of the estate issue, 11 U.S.C. § 541, while awaiting an expeditious resolution of the complicated issues of state law in matters of first impression by the specialized state court with the expertise to make such decisions.

252 B.R. at 331. See also discussion of federal abstention from *cy pres* determinations, below.

[14] [Insert from Feb. 2005 draft revision.]

[15] Specifically, two trust doctrines have developed for modifying a restriction: *cy pres* in a case where the charitable purpose has failed, and equitable deviation (or approximation) when the means to accomplish the purpose impede carrying out the purpose in a manner not anticipated by the settlor. See generally Restatement Third of Trusts, § 66 (Power of Court to Modify: Unanticipated Circumstances) and § 67 (Failure of Designated Charitable Purpose: The Doctrine of Cy Pres). Courts commonly apply these trust doctrines to restricted gifts made to charitable corporations.

[16] See, e.g., Salisbury v. Ameritrust Texas, N.A. (In re Bishop College), 151 B.R. 394, 397 (Bankr. N.D. Tex. 1993) ("Ameritrust recognizes that this Court is not the appropriate forum to reform the trusts pursuant to the cy pres doctrine. In the event the Court determines that the Trusts are not property of the estate, Ameritrust intends to petition the Probate Court in Wichita County, Texas to reform the Trusts to establish a minority student scholarship fund at Midwestern State University in Wichita Falls, Texas.") See also In re Stephen Smith Home for the Aged, Inc., 80 B.R. 678, 683 (Bankr. E.D. Pa. 1987) ("Allowing state courts to first decide unsettled cases of state law is but one aspect of comity and federalism. Another is the recognition of important state interests in the outcome of various disputes. [Citations.] Both aspects of comity are implicated by the matter at bench.").

[17] See, e.g., In re Stephen Smith Home for the Aged, Inc., 80 B.R. 678, 687 (Bankr. E.D. Pa. 1987):

> Having determined that discretionary abstention under § 1334(c)(1) is appropriate, I also conclude that any order to this effect should be entered by the district court. . . . [B]ankruptcy courts should not enter binding final orders granting abstention in noncore proceedings. First, orders granting abstention, even those under section 1334(c)(1), may not be reviewable. [Citations.] This matter, which is brought by the debtor against noncreditors seeking a determination of the debtor's property rights under state law, is probably a noncore proceeding. [Citation.] Congress intended, by virtue of 28 U.S.C. 157(c), to insure that the district court made all final determinations in noncore proceedings unless the parties consented

Cy pres is a trust law concept, and does not necessarily apply to the same extent to a corporate charity.[18] The law is unsettled about whether a corporate charity that amends its charitable purposes must obtain court approval to redirect its *unrestricted* donated assets. Indeed, *cy pres* might not even be necessary when restricted donations are restricted only as to time and not to use. Compare two cases, *In re Bishop College* and *Freme v. Maher*, which reached opposite conclusions on this issue. In both cases, the corporate debtor ceased its original operations but continued its corporate existence. In both cases, the court ruled that the restricted gifts stayed out of the bankruptcy estate. In *Bishop College*, the Texas bankruptcy court ruled that *cy pres* applied to modify an otherwise unrestricted income-only gift.[19] By contrast, in *Freme*, the Maine supreme court ruled that because there was no restriction on use (as distinct from the temporal restriction), *cy pres* does not apply, and the charity itself can decide on the new use.[20] In this latter case, the settlor's will bequeathed her residuary estate to –

> Ricker College, a corporation organized and existing under the laws of the State of Maine and maintaining an educational institution . . . [in the] State of Maine, to be accepted by . . . Ricker College and held by it in trust in a fund to be known as the "[Knox] Memorial Fund", the net income only to be used for such general purposes of . . . said Institution as the Board of Trustees of said Institution may determine.[21]

Ricker College subsequently filed for voluntary bankruptcy, although it would not dissolve as a corporate entity. The board determined to sell the campus and other physical assets, and to use the Knox Fund, which the bankruptcy court preserved from creditors, for scholarships. The bankruptcy court had declined to adjudicate the *cy pres* petition filed by the executor of the Knox Trust, and the issue was resolved in the Maine courts. The superior court upheld the referee's application of *cy pres*, and his determination that a transfer of the assets to three liberal arts colleges in Maine – Bates, Bowdoin and Colby Colleges – came closer to Mrs. Knox's intent than the board of trustees' proposal to provide scholarships. The trial court ruled that "Mrs. Knox intended an institutional beneficiary – a functional school," which would exclude the now-

---

otherwise. Here, these parties have not consented. Therefore, a recommendation to abstain will be sent to the district court.

[18] See generally, ALI, Principles of the Law of Nonprofit Organizations, Council Draft No. 1, § 245 (Consequences of Change in Charitable Purpose) (Oct. 2, 2003). [UPDATE FOR P.D.3]

[19] Salisbury v. Ameritrust Texas, N.A. (In re Bishop College), 151 B.R. 394 (Bankr. N.D. Tex. 1993) (rejecting the creditors' argument that "the general charitable purpose of the trust has not failed, because the settlors' general intent can be met by making the trust resources available to the estate for the payment of creditors.").

[20] Freme v. Maher, 480 A.2d 783 (Me. 1984).

[21] *Id.* at 784-85.

bankrupt Ricker College. The high court of Maine reversed. Because "the Knox will does not suggest a clear attachment to Ricker, the college, as opposed to Ricker, the corporation," and because the corporate existence of Ricker College will continue, the court concluded "that the trust does not fail, and the doctrine of cy pres need not be applied, based upon any want of a qualified, existing beneficiary." Moreover, the court concluded that "Ricker, in its present form, is capable of carrying out the purpose of the bequest." The court upheld the trustees' scholarship proposal as "fully consistent with these general purposes." Concluded the court: "A resort to cy pres would tend to defeat, rather than further, the general charitable intent expressed in the Knox will."

A donor can preempt the need for a *cy pres* proceeding by specifying which is more important, the identity of the donee charity or the charitable purpose. One ambiguous gift did not reach trial on the merits because the Colorado supreme court upheld the application of collateral estoppel. In *Bennett College v. United Bank of Denver*,[22] Margaret Collbran, an alumna of Bennett College, established a trust with the United Bank of Denver as trustee, providing that on her death the trust would be divided and distributed outright to each of four designated charities (including Bennett College) that may be "in existence" at the time of her death. Bennett College went through bankruptcy in 1978, and its assets were distributed to creditors. However, as the dissent explains:

> Pace University subsequently assumed many of Bennett College's administrative obligations, including administering student loans and scholarship funds, maintaining Bennett College records and raising funds for the Bennett College Foundation. Pace accepted all of the Bennett College students and hired many of the faculty and staff formerly employed by Bennett. Pace also allowed Bennett's alumnae office to operate on its grounds. The Bennett College charter was never relinquished or revoked, and in 1986 Bennett College and Pace University were formally consolidated by the New York State Board of Regents.[23]

Collbran died in 1986, and the bank trustee petitioned for instruction on whether it should distribute Bennett College's share, by then worth $7 million, to Pace University or to the three other named charities.[24] The other charities succeeded in persuading the Colorado courts that a separate proceeding in New York state established that Bennett College was not "in existence" at the time of Collbran's death. The New York case had construed language in the trust of another Bennett College alumna, Margaret Gage; that trust provided that another charitable beneficiary could be named "[i]n the event that [Bennett College] cease[s] to exist, whether by reason of

---

[22] 799 P.2d 364 (Colo. 1990).

[23] *Id.* at 370 (Lohr, J., dissenting).

[24] *Id.* at 365.

dissolution, merger, consolidation or otherwise." The Colorado court found that Bennett College had notice of the New York proceeding, and had an opportunity and incentive to participate in it.[25] By contrast, the dissent would order a trial, at which "a court might find that Collbran intended to leave money to Bennett only if it continued to operate as it had when she was a student. On the other hand, a court might determine that Collbran merely wanted to leave a portion of her estate to an educational institution that was closely tied with her alma mater by corporate consolidation."[26]

As a separate matter, in appropriate cases, the bankruptcy trustee may abandon property of the estate.[27] The attorney general of Connecticut recently filed suit to compel the bankruptcy trustee of a bankrupt nonprofit hospital to abandon interests in certain charitable gifts;[28] as discussed below, the court instead examined each gift to ascertain whether it was restricted.

Contrariwise, in an extreme case, under its general equitable powers the bankruptcy court can order the involuntary substantive consolidation of the estate of a debtor with a non-debtor, "notably when the debtor and non-debtor are alter egos of one another and/or have totally

---

[25] *Id.* at 369.

[26] *Id.* at 371. Compare, e.g., Obermeyer v. Bank of America, 2004 Mo. LEXIS 104 (Mo. August 24, 2004) (ruling that a remainder interest that vested outright in Washington University "for the exclusive use and benefit of its Dental Alumni Development Fund" could be reformed for named chairs in research and practice in dental fields, in light of the intervening closure of the dental school).

[27] See 11 U.S.C. § 554. (Abandonment of property of the estate): "(a) After notice and a hearing, the trustee may abandon any property of the estate that is burdensome to the estate or that is of inconsequential value and benefit to the estate." See, e.g., In re Cult Awareness Network, Inc., 205 B.R. 575 (Bankr. N.D. Ill. 1997) (permitting the bankruptcy trustee to abandon files containing information about religious organizations that CAN viewed as cults, despite an offer from an adversary of CAN's to purchase those files). As the court summarized the facts:

> The files have value because they contain information about various religious organizations. The files are also a burden because they also contain the names of individuals who have threatened to sue the [Bankruptcy] Trustee if those names are disclosed. The Trustee determined that the financial burden outweighs the value of these assets to the estate and moved to abandon the files. The Court concluded that he was acting within the scope of his discretion and granted the motion.

The court described the policy of the abandonment provision: "Courts do not want to encourage a Trustee to keep burdensome or valueless property in an estate to increase the amount of fees paid to the Trustee and to the various administrative representatives of the Trustee." *Id.* at 579. Moreover, the court ruled: "In reviewing the Trustee's decision to abandon property of the estate, the court must only examine that decision to ensure it reflects a business judgment made in good faith." *Id.*

[28] In re Winsted Memorial Hospital, 249 B.R. 588 (Bankr. D. Conn. 2000).

commingled their assets."[29] It is possible that such a consolidation might be ordered between a bankruptcy charity and a trust or other vehicle supporting the charity, although the exemption from involuntary bankruptcy extended to nonprofits complicates this issue.[30]

B. Alternate Beneficiary Provided in Gift Instrument

When the gift instrument provides a mechanism for modifying a restriction, there is no need to resort to *cy pres*; rather, the charity must follow the specified procedure.[31] When the gift instrument provides for a "gift over" to another charity or other party in the event of breach, the alternate beneficiary is generally entitled to the gift.[32]

A "gift over" performs both a substantive and a procedural function. Substantively, at least in theory, the gift over is a declaration of intent by the donor that the specified purpose is more important to the donor than the identity of the charity carrying out the restriction. Procedurally, the technique is designed to induce the original donee to adhere to the restriction while providing an incentive to the alternate charity to exercise vigilance in monitoring the initial donee's use of the funds. In practice, though, a gift over might just reflect the donor's fear that the original recipient could fail or otherwise terminate existence;[33] in any event, many gifts over designate an established institution as the alternate beneficiary, and do not impose any restriction on the alternate beneficiary's use of the gift.

In *Winsted Memorial Hospital*, the Connecticut attorney general argued "that these gifts did not become property of the bankruptcy estate; that the court should compel the Trustee to abandon the gifts; and that the court should grant relief from stay to allow the gifts to be given to alternative beneficiaries, either by the operation of any applicable 'gift over' provisions or by cy

---

[29] In re Lease -A-Fleet, Inc., 141 B.R. 869 (Bankr. E.D. Pa. 1992).

[30] See Whaley, et al., *supra* note 7, at 28 (citing dicta in *id*. for the argument that such a substantive consolidation would result in an impermissible end run around the exemption of a nonprofit from involuntary bankruptcy).

[31] As described in commentary to the Restatement Third of Trusts: "A trust provision expressing the settlor's own choice of an alternative charitable purpose will be carried out, without need to apply the cy pres doctrine, assuming not only that the initially specified purpose cannot be given effect or continued but also that the alternative purpose is one that properly can be given effect." Restatement Third of Trusts, § 67, Comment *b*.

[32] Alternatively, the gift will revert to the donor if so provided in the gift instrument, or if the gift lacks a general charitable intent. The former is not commonly provided for, and the applicability of the latter has been reduced by modern reforms. Notably, a general charitable intent is presumed in the Restatement Third of Trusts, § 67, and is not even mentioned in Uniform Trust Code § 413 (Cy Pres) (see comments).

[33] See also the discussion of spendthrift trusts, below.

pres proceedings the Attorney General would commence in state court."[34] As a threshold matter, the bankruptcy trustee countered "that the debts she intends to pay with the gifts – debts incurred for goods and services acquired by the Hospital while it was still providing patient care – are within the permitted charitable uses of the gifts." (See further discussion of this case, below.) Moreover, it is not stated in the case whether the debtor actually held any gifts subject to a gift over.

C. Pre-Bankruptcy Judicial Deviation or *Cy Pres*: Borrowing from Restricted Gift

Even prior to filing bankruptcy (if ever), a charity suffering financial distress may seek *cy pres* or deviation relief to reach restricted assets. Courts have on occasion granted invasion of restricted corpus on the ground that the donor's primary charitable purpose is to help *this charity*, and would have consented to the modification if necessary to ensure the institution's survival.[35] However, if the financial exigency can instead be addressed by borrowing from the restricted gift or endowment, some courts have required this less-drastic avenue.[36] Many more of these cases

---

[34] In re Winsted Memorial Hospital, 249 B.R. 588, 591 (Bankr. D. Conn. 2000).

[35] See, e.g., Knickerbocker Hospital v. Goldstein, N.Y.S.2d 32, 35-36 (N.Y. Sup. Ct. 1943):

> The close association of the testator with the hospital, his activities in its behalf, and his generous benefactions and endowments for its support during his lifetime, evince his great interest in its maintenance as a hospital. . . . All those things establish the testator's general charitable purpose that the hospital shall endure. To one of his day a million dollars was calculated to produce an income which would ordinarily suffice to maintain forever an institution of the limited scope of the hospital of that time. He did not and could not foresee the vast changes that the passing years have produced. He could not predict the advent of a world war and of economic stress. Those changed conditions are the changed circumstances referred to in the statute which call for the intervention of a court of equity to direct an administration that "will most effectually accomplish the general purpose of the instrument, without regard to and free from any specific restriction, limitation or direction contained therein".

For a recent case, see In the Matter of the Estate of Donald F. Othmer, 710 N.Y.S.2d 848 (N.Y. Surr. Ct. 2000). The Reporter's Notes to the Restatement Third of Trust, § 67 (Failure of Designated Charitable Purpose: The Doctrine of Cy Pres), Notes on Comment *c*, observe of this case:

> Matter of Estate of Othmer, 185 Misc.2d 122, 710 N.Y.S.2d 848 (Sur. Ct. 2000), purportedly applied cy pres (should not it have been a nonprofit corporation counterpart of equitable deviation?) to allow a hospital to use enough principal of an income-only fund as security for a new multi-million dollar debt in order to carry out a strategic plan for capital projects and additional working capital, noting significant developments in the health-care industry and that the operating or financial failure of the hospital would frustrate the donors' charitable objectives.

[36] See, for example, the Trustees of the Alexander Linn Hospital Association, Inc. v. Richman, 135 A.2d 221 (N.J. Ch. 1957):

> Where, therefore, the very existence of the trust is in danger or its successful operation threatened, this

occur than appear in the court reports.[37]

There is disagreement over the ethical propriety, if not the legal availability, of using collections – that is, unique charitable assets – as collateral or credit enhancement for bond ratings.[38] There seems to be less hesitancy to using endowments (i.e., restricted investment

---

> court has the power to protect the public welfare by stepping in and modifying the settlor's intent to the extent necessary to preserve and continue the charitable trust. However, it is desirable that the trust fund remain intact if it is at all possible. The situation presented appears to be capable of solution by permitting the hospital to borrow from the trust sufficient funds to substantially reduce the hospital debt and complete the equipping and furnishing of the new main building. The sum borrowed from the trust is to be secured by a second mortgage on the hospital property. . . . . Since the hospital is entitled to the income from the trust, the mortgage will not bear any interest. Repayment of the principal is to be on such terms as the plaintiffs and the Attorney-General's office can agree on, subject to approval by this court.

See also Morristown School, Inc. v. Parsons, 92 A.2d 646 (N.J. Ch. 1952):

> Unless the gymnasium is completed it appears more than probable that the school must eventually close. If this should happen there will be no students to benefit from the fund and the beneficent purposes for which it was created will be frustrated. To prevent this it is desirable and proper that the sum of $40,000 be made available to the plaintiff to complete the construction of the gymnasium. If the school survives there appears to be little doubt that contributions will continue to be made to the fund. It also seems desirable that the principal of the fund, for the present, remain intact. These two objects can be realized by permitting the plaintiff to invest in a second mortgage.

[37] See, for example, John Pulley, *Unorthodox Strategy Saves Financially Strapped College, for Now*, CHRON. HIGHER ED., Sept. 19, 2003, at A29 ("Teetering on the edge of bankruptcy, Hood College backed away from the financial abyss this summer by tapping into restricted endowment funds that are generally considered untouchable. An unusual legal maneuver allowed the college to pry loose $10.5-million from its $50-million endowment, pay off defaulted loans, and continue operations this fall. ") This article explained: "Judge G. Edward Dwyer Jr., of the Frederick Circuit Court, granted approval of the loan from the endowment, at an annual interest rate of 6.25 percent over 10 years. During the term of the loan, Hood will continue to award scholarships stipulated by donors whose gifts are affected by the arrangement, college officials said."

[38] See the following excerpt from a lengthy discussion among museum experts, reprinted in *The Bond Buyer*:

> AR [Amy Resnick, *The Bond Buyer*]: One other question that has come up. Do you view the holdings in your collection as potential credit enhancement or assets that you can leverage when you approach the financial markets?
>
> JP [Jane Piasecki, Vice President of Finance, The Natural History Museum of Los Angeles]: How can you be asking that? It's just outrageous. Collections are held in the public trust. If an institution were to go bankrupt and out of building, the creditors don't stand on line for the collections to be sold so they can be paid. The collections are held in the public trust and the state attorney general would determine what would happen to those assets. It's unethical according to ethics codes of the American Association of Museums to do anything like that. If you sell something in your collection you're selling it because you have duplicates or maybe it doesn't fit into your collection. The proceeds from that sale would be used to

assets) for this purpose. If the charity's reason for borrowing is for its exempt purpose rather than to produce investment income,[39] then Congress permits the charity to issue subsidized tax-exempt bonds.[40] Generally, charities borrow only to acquire "bricks and mortar" assets, although they can bond for working capital. Revenue streams must generally be predictable enough to support an acceptable bond rating.[41] For example, a charity that borrows to construct a facility, such as a dormitory or parking garage, usually secures the bond with the income from that facility. The tax-exempt bond "antiarbitrage" rules require issuers to rebate to the government the difference between the amount of any investment income they earn on the proceeds and the interest rate they pay. Applying a tracing approach, however, these rules do not consider a charity possessing an endowment as "debt financing" its investments, so long as the bond proceeds are not secured by the endowment.[42] Even if charities cannot borrow directly against endowment, an endowment makes it easier to borrow, frees up other assets and revenue streams that might be used as security, and earns the charity a higher credit rating on its debt,

---

> acquire something that does fill a gap or does fit into your mission or to conserve objects in your collection. I was just astounded with that question.
>
> JW [Jack Wiant, Chief Financial Officer, Museum of Contemporary Art (MOCA)]: I do agree with Jane, but I know there are institutions that have financed debt with their collections and sold things for other purposes. In Los Angeles The Hamburg Museum sold their Leonardo DiVinci notebooks to pay off their widow. That was viewed as financial asset, so it does come up. We've certainly had board members push us on that issue.

2003 Cultural Institutions Forum, BOND BUYER, Supp. 2003 Cultural Institutions Forum, April 22, 2003, at A1. See, also, e.g., American Association of Museums, "Considerations for AAM Accredited Museums Facing Retrenchment or Downsizing (Aug. 28, 2003), at 2, *available at* http://www.aam-us.org/museumresources/accred/upload/Considerations%20for%20AAM%20Accredited%20Museums%20Undergoing%20Retrenchment.doc ("There is increasing pressure on museums to capitalize their collections and to use them as collateral for financial loans to the museum. The *AAM Code of Ethics for Museums* requires that collections be 'unencumbered,' which means that the collections cannot be used as collateral for a loan. ").

[39] Concerned that charities might unfairly grow simply by borrowing to produce investment income, Congress subjects debt-financed passive income to the unrelated business income tax (UBIT). See I.R.C. § 514 (1994), and the Treasury Department regulations thereunder. (An exception is provided for leveraged investments in real estate by colleges and universities. I.R.C. § 514(c)(9).) However, because Congress favors borrowing for charitable purposes, it looks the other way for all but the most blatant tax arbitrage. Under a generous tracing rule, a charity can continue to earn endowment income tax-free so long as it uses the debt proceeds to directly conduct a charitable activity.

[40] I.R.C. §§ 103, 145.

[41] See generally Evelyn Brody, *Charitable Endowments and the Democratization of Dynasty*, 39 ARIZ. L. REV. 873, 890-91 (1997).

[42] I.R.C. §§ 103(b)(2), 148. If the borrowing is secured by an investment fund, the charity would either have to restrict the yield to match the tax-exempt rate at which it is bonding, or rebate the difference to the federal government.

permitting it to borrow at a lower interest rate. The use of debt can thus be viewed as anticipating endowment corpus economically, even if not technically.

Leading practitioner and former charity regulatory Marion Fremont-Smith notes that state statutes do not address the availability of endowment funds as security for loans, and comments: "In a number of jurisdictions approval by the attorney general, and, in some instances, by the court is required. This requirement should be universal, particularly if no change is made in the liability provisions applicable in the case of breach of duty of care."[43]

D. Effect of Pre-Bankruptcy Breach of Restriction

It is not uncommon for a charity, intentionally or out of ignorance, to "borrow" against endowment without court approval. Newspaper reports about the Milwaukee Museum of Art's ambitious efforts to finance its Calatrava-designed expansion provide an eyebrow-raising example of a charity that entered into such a pledge without obtain consent from donors, the attorney general, or the court.[44] Withdrawing funds from a restricted gift probably converts them to assets reachable by creditors, even if the withdrawal was improper. For example, in an early case in which a college drew from donor-restricted endowment to build a building, the court held that the building was included in the bankruptcy estate.[45]

---

[43] MARION R. FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS: FEDERAL AND STATE LAW AND REGULATION 434 (Belknap Press of the Harvard University Press 2004). Fremont-Smith notes that the UMIFA revision project does not "address the question of whether a charity could pledge endowment assets." *Id.*

[44] See Bruce Murphy, *Art Museum Used Gifts for Collateral; Pledge of 14 Endowments Without Donors' Consent Rare but Not Illegal, Experts Say*, MILWAUKEE J. SENTINEL, July 7, 2002, at A1 ("Museum officials said they determined that pledging restricted endowments is legal, but national experts suggested that the move is at the frontier of legal and ethical practices and said there are few precedents to guide institutions."). Moreover, the museum reportedly considered pledging its collection. See Bruce Murphy & Mary Louise Schumacher, *Art Museum in a Cash Crunch; with Shortfall of at Least $20 Million, Collection May Be Used as Collateral for Loan*, MILWAUKEE J. SENTINEL, May 18, 2002. As mentioned in note 38, above, such a move would violate professional standards.

[45] Hobbs v. Board of Education of Northern Baptist Convention, 253 N.W. 627 (Neb. 1934). In *Hobbs* the court rejected the college's claim –

> to reimburse the endowment fund the sum of $26,726.41 which it withdrew from said fund many years ago with which to build a girls' dormitory. This cannot be allowed. When these 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 same is true of quite a number of other misapplications of the fund. If there is any remedy for these acts it lies with the successor in trust or the donors against the college trustees.

Id. at 636. Separately commenting on a claimed mechanic's lien, the court declared: "Our attention has not been called to any rule of law which would authorize this court to withdraw from the general assets a sum to reimburse the endowment fund under these circumstances, and as between the creditors and the college, the former have the

In such a situation, a separate question arises whether the members of the governing board have breached their fiduciary duties to the charity. In general, the Revised Model Nonprofit Corporation Act provides, individual members of the board of directors of a nonprofit corporation are not treated as trustees.[46] Even in states that do not treat directors as trustees, however, a breach of a gift restriction can, depending on the circumstances, reflect wrongdoing by the charity or by its fiduciaries or both. One recent commentary cautions fiduciaries:

> Directors/Trustees of non-profit corporations should not underestimate the untoward consequences that may result from ignoring trust/gift restrictions. These risks can be both institutional (loss of control of the restricted funds; injunctive relief to restrict corporate actions; restitution to the restricted fund, etc.) and personal (surcharge and/or removal of directors or, in worst case scenarios, criminal prosecution). As such, it is crucial to take care in dealing with such funds.[47]

Indeed, Pennsylvania recently treated this as a criminal matter. In the bankruptcy proceeding of the Allegheny Health, Education, and Research Foundation (AHERF), the court undertook a painstaking analysis of some 750 gifts instruments in order to determine which imposed restrictions on the expenditure or borrowing of corpus for current operations.[48]

---

stronger equity." *Id.* at 637.

[46] Section 8.30(e) of the Revised Model Nonprofit Corporation Act provides:

> A director shall not be deemed to be a trustee with respect to the corporation or with respect to any property held or administered by the corporation, including without limit, property that may be subject to restrictions imposed by the donor or transferor of such property.

Official Comment 1 explains that "the corporation, as distinguished from its director, may hold or be deemed to hold property in trust or subject to restrictions."

[47] Michael Peregrine & James Schwartz, *A General Counsel's Guide to Accessing Restricted Gifts,* 29 EXEMPT ORGANIZATION TAX REVIEW 27, at ¶ 52 (July 2000).

[48] This first known application of the criminal laws to a breach of a restricted charity gift involving no self-dealing concluded in 2002. On the civil side, the Pennsylvania attorney general obtained a $94 million settlement (funded largely by D&O insurance) of civil claims due to breaches of fiduciary duty by executives of the Allegheny Health, Education and Research Foundation ("AHERF"), the largest health care bankruptcy in the country. The attorney general prosecuted the chief executive officer, the chief financial officer, and the general counsel for hundreds of charges of "misapplication of entrusted funds" for spending endowment and restricted gifts on operations. A court dismissed the charges against the CFO and general counsel, but held CEO Abdelhak "for court on 354 counts of Theft by Failure to Make Required Disposition of Funds Received." See Preliminary Order, Commonwealth of Pennsylvania, Criminal Division v. Misc. Docket No 406 April 2000, Sherif S. Abdelhak, David W. Mcconnell, and OTN Nos: I119866-3; H191867-4; Nancy A. Wynstra; H191870-0 (Court of Common Pleas of Allegheny County, Judge Dauer, May 10, 2001) (on file with author). Ultimately, the court accepted a guilty plea from Abdelhak for a single count of misapplication, who served several months in a work-release program. Separately, in the settlement of the bankruptcy proceeding, the attorney general recovered over $22 million (with

II. Donors Past: Trusts and Gifts

We begin this part by examining the extremes: unrestricted gifts, which clearly constitute assets of the bankruptcy of the estate, and assets made in charitable trust, which do not. Our discussion of trusts examines express trusts, resulting and constructive trusts, and spendthrift trusts. We conclude with a discussion of restricted gifts made to a corporate charity.

The charity's bankruptcy trustee has the obligation to identify which of its assets are subject to donor-imposed restrictions. In general, –

> A nonprofit is often required to use some of its assets for one or more specific purposes determined by the person or entity conveying the asset to the nonprofit. For example, a contributor or grantor may limit the use of property given to the entity through its bequest, deed or by contract. Any such restricted funds or assets should be separately delineated in the debtor's books and on the schedules of assets and liabilities filed with the Bankruptcy Court.[49]

A. Unrestricted Gifts

Assume the simple case of an outright gift to the debtor charity, made without any conditions on the charity's use of the gift. The gift, to the extent it remains, is property of the bankruptcy estate.

The Connecticut bankruptcy court considered this situation in *In re Winsted Memorial Hospital*, a Chapter 7 proceeding involving a nonprofit hospital:

> With regard to restrictions on the use of the gifts, each of the gifts permit the Hospital to use the funds distributed to it for its general expenses or general charitable purposes, without further restriction. The Attorney General argues that when a charitable organization receives a charitable gift, the effect of the Connecticut charitable uses statutes is to impose a trust for the benefit of the community to be served. The Trustee does not dispute that all of the gifts at issue were given to the Hospital as charitable gifts to be used for the Hospital's general charitable purposes. The Trustee argues, however,

---

the possibility of several million dollars more) for the endowments; he had originally sought $78.5 million. See Pennsylvania Attorney General Press Release, "AG Fisher Files Distribution Petition in AHERF Bankruptcy; More Than $22 Million Recovered for Endowments," May 23, 2002, *available at* http://www.attorneygeneral.gov/press/release.cfm?p=5C8A294A-4399-4F4B-944A09C42DE871DE.

[49] Eiferman, Urbano & Rocha, *supra* note 7, at 22-13, discussing "Property Granted for Limited Purposes."

> that use of the gifts to pay for goods and services procured by the Hospital while it was actively engaged in providing health care is within the general charitable purposes of the Hospital.[50]

The court observed: "the Trustee (1) agrees to apply the gifts only to payment of debts incurred (a) prepetition while the Hospital was operating and (b) which would have been permitted uses of the gifts but for the closing and bankruptcy of the Hospital and (2) with regard to gifts of income only, seeks only the income earned by the trust during the pendency of the bankruptcy case, and makes no claim to the principal."[51] The court ruled:

> Whether the Trustee's use of the gifts at issue to pay debts incurred by the Hospital when it was still providing patient services is a valid charitable use depends on whether, in the absence of the bankruptcy filing, the Hospital would have been permitted to do so. There is no Connecticut case law on this issue, but the court is persuaded by, and will follow, the decisions in several other states to the effect that a charitable organization which retains its corporate existence may, even though it has ceased operating, continue to receive and use charitable gifts, provided it applies such gifts in accordance with the intent of the donor.[52]

See also *In re Boston Regional Medical Center, Inc.*, in which the district court approvingly summarized the ruling of the bankruptcy court that unrestricted gifts are available to pay debts:

> With respect to BRMC's turnover Complaint, Judge Kenner rejected the interveners' argument that BRMC's equitable interest in its share of the remainder was impressed by a

---

[50] In re Winsted Memorial Hospital, 249 B.R. 588, 592-93 (Bankr. D. Conn. 2000) (footnote omitted).

[51] *Id.* at 594.

[52] *Id.* at 594. The court then cited:

See Crisp Area Y.M.C.A. v. Nationsbank, N.A., 272 Ga. 182, 526 S.E.2d 63, 66 (Ga. 2000) ("The accepted rule in other jurisdictions is that a bequest to a charitable corporation is given effect if the named entity is still in existence when the time for vesting arrives, even though the corporation meanwhile has become has become entirely inactive. It may take the legacy but must devote it to some proper corporate purpose."); Montclair Nat'l Bank & Trust Co. v. Seton Hall College of Medicine and Dentistry, 96 N.J. Super. 428, 233 A.2d 195 (N.J. Super. Ct. App. Div. 1967) (college, operating when testator died but subsequently closed, was entitled to use gift to pay its debts.); Palms Clinic & Hospital, Inc. v. Arizona Soc. for Crippled Children & Adults, Inc. (In re Estate of Daley), 6 Ariz. App. 443, 433 P.2d 296 (Ariz. Ct. App. 1967) (clinic that was not operating, but retained its corporate existence could recive legacy.); Old Colony Trust Co. v. Third Universalist Soc. of Cambridge, 285 Mass. 146, 188 N.E. 711 (Mass. 1934) (religious corporation which had sold all property and ceased holding services, but did not dissolve, was entitled to receive legacy.)

quasi-trust and could therefore be used only for charitable purposes (and not for paying creditors). Instead, she adopted BRMC's argument that its interest in the trusts vested upon Ms. Krauss's death at a time when it was still functioning as a charitable hospital. She further concluded that there was no inconsistency between an entity's performance of its charitable mission and paying its creditors, as in a modern economy the one would be virtually impossible without the other.[53]

B. Charitable Trusts

1. Express, Resulting and Constructive Trusts

Assume instead a gift is made in trust for a specified charitable purpose of the debtor's. As a general rule, the trust will not be included in the bankruptcy estate.

Section 2 of the Restatement Third of Trusts defines a trust as follows:

> A trust, as the term is used in this Restatement when not qualified by the word "resulting" or "constructive," is a fiduciary relationship with respect to property, arising from a manifestation of intention to create that relationship and subjecting the person who holds title to the property to duties to deal with it for the benefit of charity or for one or more persons, at least one of whom is not the sole trustee.

In the absence of a state statute of frauds, an express trust may be created orally.[54]

A trust for charity can arise in the bankruptcy context in one of two ways:

1) A third party (such as a bank), as trustee, can hold property for the benefit of the charity. In such a case, the creditors *of the trustee* have no claim against the trust assets. As explained in commentary to the Restatement Third of Trusts: "If a trustee becomes insolvent or bankrupt, the trustee's personal creditors (ordinarily at least) may not reach the trust property (§ 42); the beneficiaries retain their equitable interests in that property if it can be identified, or in its product if the property can be traced into a product. (The trust beneficiaries are therefore entitled to that trust property as against the general creditors of the trustee.)"[55]

---

[53] In re Boston Regional Medical Center v. Reynolds, 328 F. Supp. 2d 130, __ (D. Mass. Aug. 9, 2004).

[54] See Restatement Third of Trusts, § 20 (Validity of Oral Inter Vivos Trusts) and commentary. See also *id.* at § 21 (The Parol-Evidence Rule).

[55] *Id*. at § 5 (Trusts and Other Relationships), Comment *k. Trusts and debt relationships, secured and unsecured.*

2) The charity itself can be a trustee of property for specified charitable purposes. Subsection (d) of Bankruptcy Code section 541 provides: "Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest . . . becomes property of the estate under subsection (a)(1) or (2) of this section only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold. "[56] However, the creditors *of the trust* (other than a spendthrift trust, discussed below) are entitled to be paid before distribution is made to beneficiaries.[57] The question that arises in these cases is when *the trust* has benefited from an extension of credit.

2. Constructive and Resulting Trusts

The Restatement Third of Trusts comments: "A property arrangement may constitute a trust, as that term is used in this Restatement, even though such terms as 'trust' or 'trustee' are not used . . . , or the parties to the arrangement are unfamiliar with the trust concept as such. Conversely, use of the word 'trust' or 'trustee' does not necessarily mean that a trust relationship is involved . . . ."[58] The Third Restatement distinguishes trusts from a variety of other relationships. Notably, in light of the discussion above regarding the use of a "gift over," Comment *h* explains how a trust differs from a transfer made subject to a condition:

> An owner of property may transfer it, inter vivos or by will, to another person and provide that, if the latter should commit or fail to perform a specified act, the transferred interest shall be forfeited. . . . On breach of the condition, the transferor, the successors in interest of the transferor, or some designated person will be entitled to recover the property from the transferee.
>
> In situations of these types, the interests of the transferees are subject to a condition subsequent and are not held in trust. The condition does not create a fiduciary relationship. Unlike a trust beneficiary's right to compel performance of a trustee's duties, neither the transferor nor a person to be benefited may compel or prevent performance of the act upon which a condition depends, nor can they have the transferee

---

[56] See, e.g., In re Parkview Hospital, 211 B.R. 619, 629 (Bankr. N.D. Ohio 1997) ("the Attorney General alleges that Parkview Hospital held only legal title as a trustee of a charitable trust established to aid in the furtherance of osteopathic medicine in the northwest Ohio and southeast Michigan area. If so, the Fund would be excluded from the bankruptcy estate, as indicated in § 541(d) of the Bankruptcy Code. In re Bishop College, 151 B.R. 394 (Bankr. N.D. Tex. 1993).").

[57] See generally Restatement Third of Trusts, § 56 (Rights of Beneficiaries' Creditors): "Except as stated in Chapter 12 [relating to spendthrift trusts], creditors of a trust beneficiary . . . can subject the interest of the beneficiary to the satisfaction of their claims, except insofar as a corresponding legal interest is exempt from creditors' claims." Comments that follow address the bankruptcy regime.

[58] *Id*. at § 5, Comment *a. Trusts in general.*

removed and replaced by another. . . .[59]

In the absence of an express trust, arguments are sometimes made that the debtor holds assets in a resulting trust or in constructive trust.

The Restatement Third of Trusts defines a resulting trust as follows: "A resulting trust is a reversionary, equitable interest implied by law in property that is held by a transferee, in whole or in part, as trustee for the transferor or the transferor's successors in interest."[60] It "arises when a person (the 'transferor') makes or causes to be made a disposition of property under circumstances (i) in which some or all of the transferor's beneficial interest is not effectively transferred to others (and yet not *expressly* retained by the transferor) and (ii) which raise an unrebutted presumption that the transferor does not intend the one who receives the property (the 'transferee') to have the remaining beneficial interest."[61] A resulting trust can arise when an express charitable trust fails for some reason,[62] but ordinarily the doctrine of *cy pres* would instead be applied to save the trust.[63]

By contrast, a constructive trust arises by operation of law rather than by the intent of the parties. As explained in commentary to the Restatement Third of Trusts: "A constructive trust is imposed not because of the legally inferred intention of the parties but because the court concludes that the person holding the title to the property, if permitted to keep it, would profit by a wrong or would be unjustly enriched. Thus, unlike either a resulting trust or an express trust, a

---

[59] *Id.* at Comment *h. Trusts compared to conditions and equitable charges.*

[60] *Id.* § 7 (Nature and Definition of Resulting Trusts).

[61] *Id.* at Comment *a. In general.*

[62] See generally *id.*, § 8 (When Express Trust Fails in Whole or In Part).

[63] *See id.* at Comment *b. Situations to which the rule of this Section applies: in general*:

> On the other hand, an express trust has not failed or been fully performed, and therefore resort to a resulting trust is not called for, as long as the beneficiary, interest, or need for funds that appears to be lacking can be supplied through interpretation, by application of rules of construction or an anti-lapse statute, or through some form of reformation based, for example, on curable mistake (see § 62), the doctrine of cy pres (see § 67), or equitable approximation under modern perpetuities legislation or decisions (see § 29, Comment g, and Restatement Second, Property (Donative Transfers) § 1.5).

However, "if the settlor has provided no other purpose and has directed that cy pres not be applied, the trustee holds the trust estate, or an appropriate portion thereof or interests therein, upon resulting trust for the settlor or the settlor's successors in interest. (This assumes, of course, that the settlor has manifested no intention that the trustee should hold the property beneficially and free of trust. . . .)" *Id.* at Comment *g. Application to charitable trusts*.

constructive trust is remedial in character. See generally Restatement of Restitution § 160."[64]

Recently, the Sixth Circuit – declaring the constructive trust to be a remedy rather than a trust – refused to allow the claimed beneficiary of a constructive trust (which had not been reduced to judgment) to jump the queue of unsecured creditors in a bankruptcy proceeding.[65] In a subsequent nonprofit-hospital bankruptcy case arising under Ohio law, the bankruptcy judge preserved the endowment for charity, but felt compelled by this Sixth Circuit decision to base its holding other than on the doctrine of constructive trust.[66] The bankruptcy court, however, distinguished the Sixth Circuit decision:

---

[64] Restatement Third of Trusts, § 7 (Nature and Definition of Resulting Trusts), *d. Resulting trust distinguished from constructive trust.*

[65] In re Omegas Group, Inc., 16 F.3d 1443, 1451 (6th Cir. 1994):

> We cannot find a more succinct manner of making our point than did Judge Aspen of the Northern District of Illinois: "[A] constructive trust is fundamentally at odds with the general goals of the Bankruptcy Code." The Oxford Organisation, Ltd. v. Peterson (In re Stotler and Co.), 144 Bankr. 385, 388 (1992). Quoting a Texas opinion, the judge explained:
>
>> The reluctance of Bankruptcy Courts to impose constructive trusts without a substantial reason to do so stems from the recognition that each unsecured creditor desires to have his particular claim elevated above the others. Imposition of a constructive trust clearly thwarts the policy of ratable distribution and should not be impressed cavalierly.
>
> [Citation.] We now see and raise Judge Aspen. We think that § 541(d) simply does not permit a claimant in the position of Datacomp to persuade the bankruptcy court to impose the remedy of constructive trust for alleged fraud committed against it by the debtor in the course of their business dealings, and thus to take ahead of all creditors, and indeed, ahead of the trustee. Because a constructive trust, unlike an express trust, is a remedy, it does not exist until a plaintiff obtains a judicial decision finding him to be entitled to a judgment "impressing" defendant's property or assets with a constructive trust. Therefore, a creditor's claim of entitlement to a constructive trust is not an "equitable interest" in the debtor's estate existing prepetition, excluded from the estate under § 541(d).

[66] In re Parkview, at 632 ("Due to a recent bankruptcy case from the Sixth Circuit, In re Omegas Group, Inc., 16 F.3d 1443 (6th Cir. 1994), the doctrine of constructive trust does not appear available in this case."). Nevertheless, the judge noted approvingly the concurring opinion in that Sixth Circuit case:

> It pointed out that under § 541, the state law should determine when a constructive trust comes into being. [Citation.] The concurrence then applied the appropriate state's law, that of Kentucky, and found that a constructive trust arises upon a judicial determination of the same. [Citation.] In the present case the Attorney General cites Bender v. Cleveland Trust Co., 123 Ohio St. 588, 176 N.E. 452 (1931), for the proposition that under Ohio law a constructive trust attaches at the time that the deeds or misdeeds arose. Thus, under the rationale of the concurrence, a charitable trust could exist in this case. Giving the facts of the present case, this Court would have little difficulty finding a constructive charitable trust.

Id. at 632 n.4.

> Much of the focus of the Court's analysis concerned the fact that the doctrine of constructive trust is remedial in nature, as for unjust enrichment. This Court is not certain that such a rationale is appropriate regarding constructive charitable trusts, as neither the donors nor the beneficiaries are not [sic] in a position to file claims and participate in the bankruptcy as do other creditors. Nevertheless, this Court believes it is bound to follow controlling precedent and so will not apply the constructive trust doctrine in this case.[67]

3. Spendthrift Trust and Spending "Income" from Endowment

The Bankruptcy Code includes in the bankruptcy estate certain property interests of the debtor despite a provision conditioning the debtor's rights on continued financial good health.[68] This policy is designed to protect the debtor's fresh start.[69] The only exception is for "spendthrift trusts" – because they are also enforceable under non-bankruptcy law.[70] At least one court has

---

[67] *Id.* at 633 n.5.

[68] Specifically, section 541(c)(1) provides:

> (c) (1) Except as provided in paragraph (2) of this subsection, an interest of the debtor in property becomes property of the estate under subsection (a)(1), (a)(2), or (a)(5) of this section notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law –
>
> > (A) that restricts or conditions transfer of such interest by the debtor; or
> >
> > (B) that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title, or on the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement, and that effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property.

Compare 5 COLLIER ON BANKRUPTCY ¶ 541.24. (Restrictions on Transfer Invalid; "Bankruptcy Clauses;" § 541(c)(1)) (15th ed. 2004) ("11 U.S.C. § 365 provides for the assumption or rejection by the trustee of any executory contract or unexpired lease of the debtor. Section 365(e) provides similar protection against contract termination based on the debtor's financial condition. In other words, the contract becomes property of the estate regardless of restrictions dependent on the debtor's financial condition pursuant to section 541(c) and may then be assumed and not terminated by virtue of section 365(e).").

[69] See Whaley, et al., *supra* note 7, at 24:

> "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."

[70] Section 541(c)(2) provides:

held that the spendthrift trust exception is not limited to individual debtors.[71] In *In re St. Joseph's Hospital*, an Illinois bankruptcy court excluded from the bankruptcy estate a liquidating nonprofit hospital's interest in the spendthrift trust, finding: "While assets of a not for profit corporation are to be distributed for the payment of debts upon dissolution [citations], the debtor's interest in future trust income and principal is not an asset of the corporation to be distributed to creditors if the spendthrift provision precludes the debtor's access to it."[72] Rather, "it is the policy of Illinois courts to give effect to a testator's intent where possible, and if it appears from a consideration of the will that the testator intended to place his gift beyond the reach of creditors and restrict alienation of the beneficial interest, this limitation will be enforced to the extent permitted by law. "[73] The bank trustee had sought relief from the automatic stay "so that it might obtain direction in state court under the doctrine of cy pres concerning the proper disposition of the debtor's interest in the trust now that the debtor is no longer operated as a charitable institution."[74]

What if a donor had made a gift to a charity conditioned on the requirement that the gift not be used to satisfy tort settlements or judgments – will that be viewed as a valid spendthrift trust? There do not appear to be any cases answering this question. Notably, the Restatement Third of Trusts comments: "The nature or a pattern of tortious conduct by a beneficiary, for example, may on policy grounds justify a court's refusal to allow spendthrift immunity to protect the trust interest and the lifestyle of that beneficiary, especially one whose willful or fraudulent

---

> (2) A restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable in a case under this title.

See generally Restatement Third of Trusts, § 57 (Forfeiture for Voluntary or Involuntary Alienation): "Except with respect to an interest retained by the settlor, the terms of a trust may validly provide that an interest shall terminate or become discretionary upon an attempt by the beneficiary to transfer it or by the beneficiary's creditors to reach it, or upon the bankruptcy of the beneficiary." Comment *d. Interest becoming discretionary on alienation* reads, in part: "These arrangements are particularly common in England and in states that reject or severely restrict spendthrift trusts, but they are also used elsewhere to prevent creditors from seizing spendthrift trusts following distribution (§ 58, Comment *d*)."

[71] In re St. Joseph's Hospital, 133 B.R. 453 (Bankr. S.D. Ill. 1991) (chapter 7 proceeding). The spendthrift trust provision in this case read:

> Neither the principal nor the income of any trust estate herein created shall be liable for the debts of any beneficiary thereof, nor shall the same be subject to seizure by any creditor of any beneficiary under any writ or proceeding at law or in equity, and no beneficiary shall have any power to sell, assign, transfer, encumber or in any other manner dispose of any interest in said trust estate.

[72] *Id.* at 458-59.

[73] *Id.* at 547.

[74] *Id.* at 456 (footnote omitted).

conduct or persistently reckless behavior causes serious harm to others."[75] (While this Section seems drafted with private trusts in mind, the policy could apply equally to a charitable trust.) The Reporter's Notes under this Section 59 of the Third Restatement observes that a tort exception is controversial, and that one does not appear in the new Uniform Trust Code.[76] But the Reporter quotes Professor Adam Hirsch's proposal, who wrote:

> I would permit involuntary creditors in general to reach spendthrift trusts, but at the same time permit benefactors to name in the instrument of trust specific involuntary creditors who are nonetheless barred from tapping into it. The "exception to the exception" would apply where the benefactor is aware of an existing claim or anticipates a claim by an individual creditor whom she specifically desires not to satisfy. . . . I hasten to add that not a single jurisdiction follows this approach today, but a pervasive analogy can be found in a close relative of the spendthrift trust, known as the "supplemental needs trust."[77]

According to a leading treatise, "Rulings diverge on what happens to distributions from spendthrift trusts after they are received by the debtor."[78] However, comments to the Restatement Third of Trusts (2003) provide:

> *d(2). Rights of beneficiary's creditors*. A spendthrift trust protects the income and principal interests of its beneficiaries from the claims of their creditors as long as the income or principal in question is properly held in trust. Thus, a beneficial interest that is subject to a valid spendthrift restraint cannot be attached by judgment creditors of the beneficiary, nor does it become an asset of the beneficiary's bankruptcy estate under § 541 of the Bankruptcy Code.
>
> After the income or principal of a spendthrift trust has been distributed to a beneficiary, however, it can be reached by creditors through the same procedures and in

---

[75] Restatement Third of Trusts, § 59 (Spendthrift Trusts: Exceptions for Particular Types of Claims), General Comment, *a(2) Other exceptions*, at 396.

[76] *Id.* at Reporter's Notes on § 59, *Exception for some tort claims*, at 400 (citing to Uniform Trust Code § 503).

[77] Adam Hirsch, *Spendthrift Trusts and Public Policy: Economic and Cognitive Perspectives*, 73 WASH. U. L.Q. 1, 82 (1995).

[78] 5 COLLIER ON BANKRUPTCY, ch. 541 (Property of the Estate), ¶ 541.11. Property Held in Trust, at [6][b] (15th ed. 2004) (footnotes omitted).

accordance with the same rules that apply generally to property of the beneficiary. . . .[79]

As described below, courts generally treat donor-restricted endowment as includible in the bankruptcy estate, if not otherwise restricted as to purpose, only to the extent of what used to be called "income." Modern common law and statutory reformulations of prudent investing have moved from distinguishing principal and income to a focus on total return.[80] For a perpetual charitable trust – subject to a prudence requirement in general and the state's version of UMIFA in particular – spending policy is generally left to the discretion of the trustee.[81] Specifically, the current version of UMIFA permits trustees to spend a "prudent" portion of appreciation over the historic value of endowment property when contributed. Some state versions of UMIFA condition what constitutes prudence.[82] By contrast, UMIFA is silent about fiduciary obligations

---

[79] Restatement Third of Trusts, § 58 (Spendthrift Trusts: Validity and General Effect), Comment on Subsection (1), at 361. See also, e.g., In re St. Joseph's Hospital, 133 B.R. 453, 458 n.6 (Bankr. S.D. Ill. 1991) ("The Court notes that trust income, once distributed to the debtor beneficiary under the terms of the trust, could be used for any purpose including the payment of debts. Spendthrift trust provisions affect only the beneficiary's right to obtain trust benefits in the future, and trust payments already received by the beneficiary may be transferred to creditors or seized for the collection of creditors' claims.")

[80] To counter the perceived conservatism of charity fiduciaries who focused on "income"-paying investments, the Uniform Management of Institutional Funds Act (UMIFA), adopted by the National Conference of Commissioners on Uniform State Laws in 1972, permits charity fiduciaries to make such any investment as "deemed advisable by the governing board, whether or not it produces a current return." Most states have adopted a version of UMIFA, allowing the charity to make decisions not in isolation but in the context of the organization's portfolio of investments as a whole and as a part of an overall investment strategy having appropriate risk and return objectives. About the same time, the U.S. Treasury Department's regulations on "jeopardizing investments" by private foundations also blessed such a "total-return" approach, as well as a policy of examining investment decisions in the context of the entire portfolio. Congress adopted this flexible approach in the 1974 federal legislation governing pension trustees. Similar reforms later appeared in the American Law Institute's Restatement Third of Trusts: The Prudent Investor (1992), devoted exclusively to this topic, and in the Uniform Prudent Investor Act (adopted by the National Conference on Commissioners of Uniform State Laws in 1994 and approved by the American Bar Association in 1995), enacted in 44 States.

[81] UMIFA is in the process of revision. See the February 2005 draft, available at <http://www.nccusl.org>.

[82] For example, Massachusetts provides that "the appropriation of net appreciation for expenditure in any year in an amount greater than seven percent of the fair market value of the institution's endowment funds . . . shall create a rebuttable presumption of imprudence on the part of the governing board.." Mass. ch. 180A, § 2. New York law distinguishes between unrealized gains on marketable securities from unrealized gains on non-marketable assets:

> The governing board may appropriate for expenditure for the uses and purposes for which an endowment fund is established so much of the net appreciation, realized (with respect to all assets) and unrealized (with respect only to readily marketable assets), in the fair value of the assets of an endowment fund over the historic dollar value of the fund as is prudent under the standard established by section 717 (Duty of directors and officers). This section is not intended to restrict the authority of the governing board to expend funds as permitted under other law, the terms of the applicable gift instrument or the certificate of

in cases where the current value of the fund falls below the historical dollar value of the gift.

The National Conference of Commissioners on Uniform State Laws is in the process of revising UMIFA – in large part to reform the rules for endowments that have fallen below their historic dollar value, and to address spending policy during economic downturns, when the charity may need to make expenditures even if income and appreciation is limited or nonexistent.[83] Confusion was compounded by the accounting rules issued by the Financial Accounting Standards Board; some accountants have read these rules to suggest that the charity has a legal liability to make up a decline in value in an endowment fund with other, unrestricted funds.[84] The February 2005 draft of UMIFA § 4 replaces the historic dollar value approach with an expenditure approach providing, generally, that "[s]ubject to the terms of the gift instrument, an institution may expend or accumulate so much of an endowment fund as the institution determines to be prudent for the uses, benefits, purposes, and duration for which the endowment

---

incorporation of the corporation.

N.Y. Not-for-Profit Corporation Act § 513(c), discussed in Antonia Grumbach and William Gaske, "What Can We Spend? The Use of Appreciation on Endowment Funds in New York," EXEMPT ORGANIZATIONS (Patterson, Belnap, Webb & Tyler, Winter/Spring 2002), available at <http://www.pbwt.com/Resources/newsletters/eo02a006.html>.

[83] See, for example, the following news story regarding the events involved in Matter of Estate of Othmer, 185 Misc.2d 122, 710 N.Y.S.2d 848 (Sur. Ct. 2000), discussed in note 35, above:

> Donald Othmer gave about $54-million to the university, asking only that $5-million be set aside to endow a chair in chemistry and for scholarships. The rest was unrestricted. The university has spent about $30-million of it simply covering operating deficits. The remaining $19-million could conceivably be spent, but Polytechnic cannot touch it because its bondholders require that the university maintain at least $15-million in a bank account.
>
> The university is in a box: It cannot spend its restricted endowment without negotiating with the Othmers' heirs. As it is, Polytechnic is still tied up in probate court over several details of the couple's wills.
>
> The trustees have maintained a policy of spending 5 percent of the endowment and its income, but that may not be legal, according to the New York Attorney General's Office. Eliot Spitzer, who heads that office, put out an advisory in October, saying that the "historic dollar value" of an endowment must be preserved, meaning that all spending from an endowment must be stopped if it means eating into the permanently restricted part.

Martin Van Der Werf, *From Rags to Rag: One of the Largest Gifts in the History of Higher Education Couldn't Stop the Decline of Polytechnic University*, CHRON. HIGHER ED., April 11, 2003.

[84] *See, e.g.,* Erin McCormick, *SFMOMA to Cut Back on Exhibits; Endowments Frozen After Losses on Market*, SAN FRAN. CHRON., Feb. 26, 2003, at A1 (the finance committee chair of the board of the San Francisco Museum of Modern Art – which had been drawing $2-3 million from the endowment annually – characterized the endowment as essentially frozen; SFMOMA has asked several donors reclassify $15 million in prior contributions as no longer permanent endowment).

fund is established." In comments, ... [INSERT WHEN DRAFT IS AVAILABLE].

In cases where the spending policy is determined by the exercise of discretion, **[may the bankruptcy trustee determine that a larger portion of total return (compared with what had been determined prior to bankruptcy) is available to the creditors of the estate?]**.

C. Restricted Gifts to Corporate Charities

Gifts to a corporate charity may be unrestricted, or they may be restricted in a wide variety of ways. A purpose restriction might be as broad or narrow as the donor wishes, subject to the desires of the donor and the acceptance of the charity. Thus, a gift may be for nursing school scholarships, autism research, or the construction of a new building. The gift might also be conditioned on the actions of others, such as in the case of a matching-money gift. A temporal restriction may restrict the expenditure of corpus in perpetuity or over a specified period. A temporal restriction may be combined with a purpose restriction or stand alone (for example, "income only, in perpetuity, for such charitable purposes as the donee charity determines" or "to endowment"). A charity that accepts restricted gifts (or that raises funds for specific, identified purposes) should ensure that its staff and advisors are aware of their obligations and adhere to specified requirements.[85]

Caveat: Terminology is not determinative. Only a donor may create a binding restriction on a gift. (Responding to the charity's solicitation to make a contribution for a specific purpose can also create a restriction – even a solicitation to endowment.) A charity's unilateral action, however, has no legal significance: Surplus is just surplus, even if the board "transfers" it to board-designated endowment (called "quasi-endowment" by the Financial Accounting Standards Board[86]) or a rainy-day fund. The board is always free, subject to its general fiduciary duty of

---

[85] New York's Not-for-Profit Corporation Law, section 513(b), provides, in relevant part: "The governing board shall cause accurate accounts to be kept of such assets separate and apart from the accounts of other assets of the corporation. Unless the terms of the particular gift instrument provide otherwise, the treasurer shall make an annual report to the members (if there be members) or to the governing board (if there be no members) concerning the assets held under this section and the use made of such assets and of the income thereof." *See generally* Peregrine & Schwartz, *supra* note 47.

[86] Charities might want to classify free assets as endowment in order to look more needy to potential donors. In 1993, the Financial Accounting Standards Board adopted the controversial Statement No. 117, requiring charities to catagorize their assets as "endowment," "quasi-endowment" (self-imposed), or "current fund" (freely spendable or restricted); as a separate matter, funds can be "restricted" or "unrestricted." Notably, FASB 117 states:

> An organization's governing board may earmark a portion of its unrestricted net assets as a board-designated endowment (sometimes called funds functioning as endowment or quasi-endowment funds) to be invested to provide income for a long but unspecified period. The principal of a board-designated endowment, which results from an internal designation, is not donor restricted and is classified as unrestricted net assets.

care, to draw down reserves.[87]

States vary on whether they treat a restricted gift to a corporate charity as a trust. The Restatement Third of Trusts continues the approach in the Restatement Second of Trusts that a restricted gift to a corporate charity creates a trust.[88] By contrast, the Third Restatement comments, "[a]n outright devise[] or donation to a nonproprietary hospital or university or other charitable institution, expressly or impliedly to be used for its general charitable purposes, is charitable but does not create a trust as that term is used in this Restatement."[89] Applying trust doctrine to corporate charities runs up against the venerable trust doctrine of merger, in which the trust vanishes if the beneficiary and trustee are the same person.[90] In any case, the courts uniformly hold that a corporate charity must honor the restriction even when the charity is not technically a trustee.[91]

An influential case from Delaware explains the law that applies to assets held by a

---

[87] But see In re Parkview Hospital, 211 B.R. 619 (Bankr. N.D. Ohio 1997), discussed below, in which the court treated reserves transferred to endowment as excluded from the bankruptcy estate.

[88] A comment in the Restatement Third of Trusts declares: "A disposition to such an institution for a specific purpose, however, such as to support medical research, perhaps on a particular disease, or to establish a scholarship fund in a certain field of study, creates a charitable trust of which the institution is the trustee for purposes of the terminology and rules of this Restatement." Section 28, General Comment *a*.

[89] *Id.*

[90] The Restatement Third of Trusts, § 69 (Merger), provides: "If the legal title to the trust property and the entire beneficial interest become united in one person, the trust terminates."

[91] Notably, in New York, at a time when charitable trusts were illegal, the high court saved the charitable corporation by ruling: "The corporation uses the property, in accordance with the law of its creation, for its own purposes; and the dictation of the manner of its use, within the law by the donor, does not affect its ownership or make it a trustee. A person . . . cannot be a trustee for himself." St. Joseph's Hospital v. Bennett, 22 N.E.2d 305, 307 (N.Y. 1939). Nevertheless, the court held:

> No authority has been brought to our attention that a gift to a charitable corporation with the express direction that it be applied to a specific corporate purpose in a specific manner may be accepted by the corporation, and then used for a different corporate purpose in a different manner. No trust arises, it is true, in a technical sense, . . . for the trustee and beneficiary are one. . . . [The charitable corporation] may not, however, receive a gift made for one purpose and use it for another, unless the court applying the cy pres doctrine so commands.

Id. at 308. New York has codified this result in section 513 of the Not-for-Profit Corporation Law. See generally Trustees of Dartmouth College v. Woodward, 17 U.S. (4 Wheat.) 518, 647 (1819) (philanthropy was founded on the hope that the funds would "flow forever in the channel which the givers have marked out for it"). Wrote Justice Marshall: "a great inducement to charitable gifts is the conviction felt by the donor that the disposition is immutable and that the corporation constitutes the security for such gifts." 17 U.S. at 647.

corporate charity. In *Denckla v. Independence Foundation*,[92] the chancery court considered a challenge to a transfer of assets made by a charitable corporate foundation to another foundation. In discussing the challenger's argument that the corporate foundation was governed by the same rules as a charitable trust, the court said:

> It is sometimes important to determine whether or not a gift to a charitable corporation is an absolute gift to be used by the corporation for one or more of its corporate purposes, or whether it is a gift of such nature as to make the charitable corporation trustee of a charitable trust. If the gift is outright to the corporation to be used for its corporate purposes no trust is involved in a technical sense. The resulting duty on the part of the corporation is to use the property solely for its corporate purposes and not to do an ultra vires act. 2 Bogert, Trusts and Trustees, §§ 324; 3 Scott on Trusts, §§ 348.1. In a loose sense, therefore, the assets of a charitable corporation are trust funds, but the extent and measure of that trust with respect to assets given outright to it are to be determined by the Certificate of Incorporation and By-Laws of the charitable corporation. Unless assets are given it upon express limitations and conditions, no charitable trust has been created in the technical sense.[93]

The leading case determining the extent to which assets of an insolvent corporate charity are preserved from distribution to creditors is *Hobbs v. Board of Education of Northern Baptist Convention*, decided by the Nebraska supreme court in 1934.[94] The trustees of Grand Island College, a corporation, sought court instruction "for a decree finding whether the funds or properties in their control, or any part thereof, are subject to the payment of the indebtedness of the college, and, if so, determining the priorities, if any, as between such creditors, determining the rights and equities, if any, of the several donors and contributors to said endowment fund and the holders of agreements for the payment of annuities, a decree approving and confirming the contract [of merger] between Grand Island College and Sioux Falls University and appointing trustees as successors of plaintiffs of the endowment funds and properties of the college, and for an order allowing payment of plaintiffs' attorneys for legal services in this action."[95] For our purposes, the primary question was the legal status of the endowment fund. As the court described:

---

[92] 193 A.2d 538 (Del. Ch. 1963).

[93] *Id.* at 541. See also Persan v. Life Concepts, Inc., 738 So.2d 1008, 1010 (Fla. App. 1999) ("Making a gift to a charity for a specific project or purpose does not create a charitable trust. For this court to suggest that it does would create havoc for charitable institutions. A charity has to be able to know when a donation is a gift and when it is merely an offer to fund a trust for which the charity is taking on fiduciary responsibilities. The creation of such a trust must be express.").

[94] Hobbs v. Board of Education of Northern Baptist Convention, 253 N.W. 627 (Neb. 1934).

[95] *Id.* at 629.

> During the existence of the college as an educational institution numerous donations and contributions were made to the college for the purpose of establishing an endowment fund, in the aggregate about $85,000, of which there remained in the hands of the so-called "treasurer of the endowment fund" $52,400 at the time the college was closed, the remainder having been borrowed by the college for the erection of buildings to the amount of $26,726.41, and some used by the college as collateral security for loans, generally with the consent of the donors.[96]

Thus, as articulated by the court:

> Does this endowment fund constitute a charitable trust? If so, it is not subject to the claims of creditors, and, if not, it belongs to the general assets of the college. Charitable trusts do not differ from numerous other kinds of trusts, except that they are generally affected by a public interest and are looked upon with peculiar favor, it being the policy of the law to sustain them if possible. At common law a trust in the nature of a public charity was looked upon with such favor that it was not permitted to fail even by reason of the impossibility of carrying it out according to the conditions prescribed by the donor; but in such case, and to meet such contingency, there arose the doctrine of *cy pres,* in accordance with which the subject-matter of the trust came under the protection of the King as *parens patriae,* whose duty and prerogative it was to administer the trust, as nearly as might be, in accordance with the declared wishes of the donor.[97]

The court rejected the creditors' argument that a formal trust is required to preserve the charitable purpose of gifts to a corporate charity:

> We think that all these cases [argued by the creditors] are distinguishable from the one under consideration by the fact that the absolute control of the corpus of the estate conveyed was transferred to the grantee, while here the body of the gifts and contributions were distinctly stated to be for the endowment of the college, the corpus to be kept intact and inviolable, and the income only to be used for the general purposes of the college. While the legal title or estate may be said to be in the college, it is not an absolute estate. The college is given no control over anything but the income arising therefrom. The college has no beneficial interest in the body of the gift, and the real beneficiaries of the trust are the students who may attend the college for the purpose of education. If the gifts in this case had been unconditionally to the college for the purpose of purchasing a site, building necessary buildings, and maintaining a school for the

---

[96] *Id.* at 630.

[97] *Id.* at 631. The court explained that this type of *cy pres* (known as prerogative cy pres) was not generally adopted in the United States, but that its general equity powers, rather than any specific *cy pres* authority, permitted resolution of this case. *Id.* at 638.

> education of the young, doubtless the cases cited would be applicable. But, as elsewhere intimated, the intent of the contributors to the endowment fund was clearly to preserve it from mistakes and mismanagement of the trustees, and to provide a permanent fund, the income of which should be used for educational purposes. This is in its very nature a charitable trust, and to put any other construction upon the instruments evidencing the donations would destroy and render nugatory the benevolent intentions of the donors.[98]

The court then examined each gift individually to ascertain whether the evidence showed donor intent to contribute to endowment, and preserved the endowment fund for transfer to the successor college "to be held by it upon the same trusts and conditions as it was theretofore held by Grand Island College. . . ."[99] But self-designated endowment does not enjoy the same protection. "We know of no rule," the court declared, "whereby the college could set aside a portion of its general assets, call it an endowment fund and thus create a charitable trust."[100]

More generally, the court considered "whether the property of the college, other than the endowment funds, is liable for the debts of the college. There is no real contest here. It seems well settled that where donations are made for the general purpose of carrying on a business of any kind, though in the form of a trust, the absolute control of the *res* being bestowed upon the donee, the property is liable for debts incurred for the purpose intended."[101]

Despite its age, *Hobbs* continues to be the leading authority for the preservation of donor charitable intent as against distribution to creditors.[102] Two subsequent legal developments, however, are worth noting. First, as mentioned above, in nearly every state, by either common law or statute, the judicial power of *cy pres* is available to modify the terms of the restriction

---

[98] *Id.* at 634.

[99] *Id.* at 640.

[100] *Id.* at 636. For example, the court rejected trust treatment for the "Library Fund": "It appears that certain securities were set aside by the college trustees and placed in the control of the endowment treasurer for the maintenance of the library, but the evidence entirely fails establish any gift or donation for such purpose." *Id.* at 635.

[101] *Id.* at 638.

[102] See also Crane v. Morristown School Foundation, 187 A. 632 (N.J. 1936) ("[T]here was a charitable trust in both the Crane stock and in the other donations given and received for the endowment fund. Since it has become impracticable to execute the terms of the trust, since the school has become insolvent, the income from the fund accruing since that event should be devoted to a cognate purpose. There was quite properly found to be such a purpose – the new school organized by Alumni.")

when the particular charitable donee fails.[103] Second, while debate exists over whether restricted gifts to nonprofit corporations are trusts for all purposes, courts will preserve the charitable purpose of restricted gifts made to corporate entities.

In the recent case *In re Parkview Hospital*, the bankruptcy court ruled that binding restrictions on a fund resulted from particular actions taken by the charity itself in soliciting gifts, and thus the entire fund fell outside the bankruptcy estate.[104] As the court explained:

> When a non-profit organization seeks donations for a charitable purpose, an understanding can be found between the donors and the non-profit corporation that the donations are to be used for the charitable purpose. The issue is whether such an understanding manifests an intent to legally bind the non-profit corporation to so use the funds, or was simply a hopeful desire or suggestion for the ultimate use. Were the donations simply solicited for a charitable purpose, this Court would probably conclude that the intention was precatory and not mandatory. That is, a charitable trust would not exist. However, when the fund is held out as being "restricted," and that only the income generated from the principal could be used for this purpose, this shows that the intent was mandatory.[105]

Moreover, in part because of poor record-keeping, the court also treated as restricted those unrestricted gifts that the charity had deposited into the fund.[106]

---

[103] See generally the 50-state (plus District of Columbia) table in FREMONT-SMITH, *supra* note 43, at 512-13 (appendix, table 2 (Cy pres doctrine applicable to outright transfers and trusts)).

[104] In re Parkview Hospital, 211 B.R. 619, 627-28 (Bankr. N.D. Ohio 1997). The court concluded:

> Though it is without question that Parkview should have kept more detailed accounting records and memorializations of the activities of the Fund (or that these records should not have been lost), this Court nevertheless finds that the following conclusions are supported by the record taken as a whole, and that little in the record is inconsistent with these factual findings. This Court finds that the Fund was a restricted fund, whose interest income was to be used for the purpose of promoting osteopathic medicine in the Toledo area. The principal was to perpetually remain untouched.

[105] *Id.* at 634.

[106] See *id.* at 634:

> What makes the case at hand more difficult is that the source of much of the funds appears to have come from unrestricted donations made to the non-profit corporation itself which 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. Further, due to the lack of documentation of accounting records reconciling the Fund's donations with the bank statements, it is now impossible to separate the amount of unrestricted donations designated to go into the Fund by the hospital from the donations restricted by other donors.

III. Donors Present: Post-Petition Bequests and Unfulfilled Pledges

A. Post-Petition Bequests

Bankruptcy Code section 541(a)(5)(A) includes in the bankruptcy estate "(5) Any interest in property that would have been property of the estate if such interest had been an interest of the debtor on the date of the filing of the petition, and that the debtor acquires or becomes entitled to acquire within 180 days after such date – (A) by bequest, device, or inheritance. . . ." In a recent case involving the bankruptcy of a nonprofit hospital, the Connecticut bankruptcy court excluded from the estate unrestricted bequests from two decedents who died more than 180 after the filing of the bankruptcy petition.[107]

B. Causes of Action

In determining "property of the estate," the reference in Bankruptcy Code section 541(a)(1) to "all legal or equitable interests of the debtor in property" includes causes of action belonging to the debtor at the time the case is commenced.

1. Suits for Breach of Fiduciary Duty

The Fifth Circuit ruled that a nonprofit corporation's cause of action against its officers and directors for gross negligence, mismanagement, and breach of fiduciary duty is "property of

---

However, the court concluded:

> Finally, even were some improper use of funds to be shown, this Court would be reluctant to abrogate the intent of the donors (who understood that this Fund was restricted for a charitable purpose) due only to the improprieties of the Fund's trustee. Were Parkview still in existence and not in bankruptcy, and were the Attorney General seeking to impose a charitable trust on the Fund in order to deny the hospital the use of the monies in the Fund in a manner inconsistent with the Fund's restrictions, this Court believes that an Ohio court would have little difficulty imposing the charitable trust against the hospital.

Id. at 638.

[107] In re Winsted Memorial Hospital, at 592 ("For each of the gifts involved, the court must first determine whether the Hospital attained a property interest in the gift on the date of the bankruptcy petition (or within 180 days thereafter for subsequent bequests) . . . .") (footnote omitted). See also *id.* at 595 ("Section 541(a)(5)(A) provides for inclusion in the bankruptcy estate of postpetition bequests, but is limited to those to which the debtor becomes entitled within 180 days after the petition. Because the Hospital had no right to the gift until the death of Ms. Spiotta more than 180 days postpetition, the gift is not included in the bankruptcy estate."); and *id.* ("The will of Helen Kozlick gave a share in her residuary estate to the Hospital without imposing a restriction on its use. Ms. Kozlick died on July 26, 1997, more than 180 days postpetition. Accordingly, her gift is also excluded from the bankruptcy estate.").

the estate."[108] A possible claim by the bankruptcy trustee for a suit against wrongdoing charity fiduciaries is beyond the scope of this Article. It should be mentioned, however, that in a later proceeding, the Fifth Circuit adopted the cost-benefit approach used by the Second Circuit for determining when a creditors' committee would be permitted to go forward with such a derivative claim.[109]

2. Unfulfilled Pledges

a. Extent Binding

Applying traditional contract law to a charitable pledge would ordinarily result in a finding that the pledge does result in an enforceable contract, because the charity has provided no

---

[108] Louisiana World Exposition, Inc. v. Federal Insurance Company, 858 F.2d 223, 236 & 245 (5th Cir. 1988). The complaint, filed derivatively by the creditors committee, asserted: "(1) conflicts of interest on the part of officers and directors which, in many cases, were resolved against the interests of LWE and in favor of outside interests; (2) grossly inadequate formulation, implementation and monitoring of budgetary constraints which led to expenditures far in excess of reasonable expectations of income; (3) insufficient oversight of personnel; (4) inadequate marketing and planning of the fair itself; and (5) unreasonable failure to enforce the terms and conditions of LWE's contracts and agreements." *Id.* at 236. "Due to a conflict of interest on the part of its officers and directors, however, the debtor-in-possession [the corporation itself], in effect, refused to assert the cause of action. As a result, the [Creditors'] Committee sought to bring the action on the corporation's behalf." *Id.* at 246-47.

[109] Louisiana World Exposition, v. Federal Insurance Company, 864 F.2d 1147, 1153 (5th Cir. 1989) (ruling, in a "Postscript re: Cost-Benefit Analysis," that it approved of In re STN, 779 F.2d 901 (2d Cir.1985)). The Second Circuit had ruled:

> If the committee presents a colorable claim or claims for relief that on appropriate proof would support a recovery, the district (or bankruptcy) court's threshold inquiry will still not be at an end. In order to decide whether the debtor unjustifiably failed to bring suit so as to give the creditors' committee standing to bring an action, the court must also examine, on affidavit and other submission, by evidentiary hearing or otherwise, whether an action asserting such claim(s) is likely to benefit the reorganization estate. See Toledo Equipment Co., 35 Bankr. [315] at 320 (Bankr. N.D. Ohio 1983).
>
> The court's inquiries will involve in the first instance not only a determination of probabilities of legal success and financial recovery in event of success, but also a determination as to whether it would be preferable to appoint a trustee in lieu of the creditors' committee to bring suit (bearing in mind any fees imposed on the estate by such an appointment, the wishes of the parties, and other relevant factors) and the terms relative to attorneys' fees on which suit might be brought. The creditors who compose the committee may agree themselves to be responsible for all attorneys' fees, but if they would seek to impose such fees on other creditors or the chapter 11 estate, whether by contingent fee arrangement or otherwise, that would obviously affect the cost-benefit analysis the court must make in determining whether to grant leave to sue. Hence fee arrangements should not only be made a matter of record but should be carefully examined by the court as it makes that determination.

779 F. 2d at 905 (footnote omitted).

reciprocal "consideration" to the donor.[110] Nevertheless, courts in most states will enforce a pledge or installment gift if the charity has relied on the donor's promise to its detriment, or if the promise induced others to give.[111] (Assume that none of the other contract defenses apply – that is, assume the donor had the mental capacity to make the gift, and the charity did not apply fraud, undue influence, or duress.) Charities seem increasingly willing to sue donors who default on their (major) pledges – often when the donor dies, and the will makes no mention of the promise.[112]

Cases sometimes examine whether the parties intended the pledge to be binding. In an attempt to synthesize various authorities, a draft I prepared for the American Law Institute's project on "Principles of the Law of Nonprofit Organizations" comments that –

> A donor is presumed to intend that a promise to give is binding when –
>
> (1) The promise is in writing and does not negate intent of enforceability;
>
> (2) The donor, at the time of the promise, served in a fiduciary position with the charity;
>
> (3) The charity reasonably relied on the donor's promise; or
>
> (4) The promise induced one or more others to give to the charity.[113]

Going further, § 90 of the Restatement Second of Contracts provides that all charitable subscriptions are enforceable, without any required showing of detrimental reliance, "if justice can be avoided only by enforcement of the promise."[114] Commentary to § 90 observes: "Where

---

[110] Pledges have been upheld under standard contract doctrine, even if courts have sometimes stretched to find consideration. See Allegheny College v. National Chautauqua County Bank, 159 N.E. 173 (N.Y. 1927), in which Justice Cardozo found: "The longing for posthumous remembrance is an emotion not so weak as to justify us in saying that its gratification is a negligible good."

[111] *See generally* Mary Frances Butig, Gordon T. Butler, & Lynne M. Murphy, *Pledges to Nonprofit Organizations: Are They Enforceable and Must They Be Enforced?*, 27 U.S.F. L. REV. 47 (1992).

[112] See, e.g., Salsbury v. Northwestern Bell Telephone Co., 221 N.W.2d 609 (Iowa 1974) (enforcing a promise to give to a college that failed before the first payment was made).

[113] ALI, Principles of the Law of Nonprofit Organizations, Council Draft No. 1, § 480 (Donor's Failure to Perform), Comments on Subsection (a), at 180 (Oct. 2, 2003). [UPDATE FOR P.D. 3]

[114] Section 90 reads in full:

> (1) A promise which the promisor should reasonably expect to induce action or forbearance on

recovery is rested on reliance in [charitable subscription] cases, a probability of reliance is enough, and no effort is made to sort out mixed motives or to consider whether partial enforcement would be enough."[115] The Restatement provides the following example:

> A promises to donate to B University $100,000 in five annual installments for the purposes of its fund-raising campaign then in progress. The promise is confirmed in writing by A's agent, and two annual installments are paid before A dies, but A has made no provision for the remainder of the gift in his will. The continuance of the fund-raising campaign by B is sufficient reliance to make the promise binding on A and his estate.[116]

The position enunciated in Restatement Second of Contracts § 90(2) that charitable subscriptions are enforceable without proof of consideration or reliance may be the more enlightened view, as de facto recognition of courts' creative efforts to find such promises binding, but at present it remains a minority view.[117]

For example, the Massachusetts Supreme Judicial Court refused to find that public policy supported enforcing a pledge made under the following circumstances: The decedent, while suffering a long illness, was visited throughout by his hospital stay by his congregation's

---

> the part of the promisee or a third person and which does induce such action or forbearance is binding if injustice can be avoided only by enforcement of the promise. The remedy granted for breach may be limited as justice requires.
>
> (2) A charitable subscription or a marriage settlement is binding under Subsection (1) without proof that the promise induced action or forbearance.

[115] Restatement Second of Contracts, § 90, Comment *f* (Charitable subscriptions, marriage settlements, and other gifts).

[116] *Id.*, Illustration 17.

[117] See the compilation of cases at Russell G. Donaldson, *Lack of Consideration as Barring Enforcement of Promise to Make Charitable Contribution or Subscription – Modern Cases*, 86 A.L.R.4th 241 (1991). Only two jurisdictions, Iowa and New Jersey, appear to follow subsection (2) of § 90, notwithstanding dicta in cases from a few other jurisdictions (Georgia, which codified § 90 verbatim, has produced no case law). Even in Iowa, though, enforceability might have grounded on reliance. See Salsbury v. Northwestern Bell Telephone Co., 221 N.W.2d 609 (Iowa 1974) (soliciting charity used subscription pledges to secure credit from a supplier); P.H.C.C.C., Inc. v. Johnston, 340 N.W.2d 774 (Iowa 1983) ("although not necessary under the standard adopted in *Salsbury*, the present case does contain strong evidence of reliance on the part of the grantee of the subscription"). However, in a pre-Restatement Second case, the New Jersey supreme court unequivocally declared the same absolute policy: "A careful study of the cited decisions and many others to like effect, together with opinions of text writers on the subject, impels the conclusion that public policy forms the basis upon which consideration is spelled out in order to impose liability on charitable subscriptions." More Game Birds in America, Inc. v. Boettger, 125 N.J.L. 97, 100-101 (E.&A. 1942); see also Jewish Federation v. Barondess, 560 A.2d 1353 (N.J. Super. 1989) ("It would be absurd . . . to permit the Statute of Frauds to be used as a defense to an admitted charitable pledge which the Court has only characterized as a contract in order to insure that it is enforced.").

spiritual leader. During several of these visits, and in the presence of witnesses, he made an oral promise to give the congregation $25,000. The congregation contemplated using the $25,000 to transform a storage room in its synagogue into a library named after the decedent. However, the congregation took no steps to construct a library. The oral promise was never reduced to writing, and the decedent died intestate. He had no children, but was survived by his wife. The court found that these facts indicated a mere expectation, not a binding agreement.[118]

The Maryland high court does not enforce, in the absence of consideration or reliance, a pledge made for a general charitable purpose.[119] Courts in other jurisdictions consider the public policy reasons for enforcing charitable pledges, but, where they do so, they go to sometimes great lengths to base their decisions on traditional grounds of consideration or reliance sufficient to make a charitable promise binding.[120] As the Reporter for the Restatement Second of

---

[118] Congregation Kadimah Toras-moshe v. DeLeo, 540 N.E.2d 691, 693 (Mass.1989). The court held:

> As to the lack of reliance, the judge stated that the Congregation's "allocation of $25,000 in its budget[,] for the purpose of renovating a storage room, is insufficient to find reliance or an enforceable obligation." We agree. The inclusion of the promised $25,000 in the budget, by itself, merely reduced to writing the Congregation's expectation that it would have additional funds. A hope or expectation, even though well founded, is not equivalent to either legal detriment or reliance.

The court further stated:

> Although § 90 dispenses with the absolute requirement of consideration or reliance, the official comments illustrate that these are relevant considerations. *Restatement (Second) of Contracts*, supra at § 90 comment *f*. . . . . Furthermore, [the promise here] is an oral promise sought to be enforced against an estate. To enforce such a promise would be against public policy.

Id. at at 693-94.

[119] Maryland National Bank v. United Jewish Appeal Federation, 407 A.2d 1130 (Md. 1979) ("The pledge was not for a specific enterprise; it was to the UJA generally and to the Israel Emergency Fund," and the UJA "made due allowance for the fact that a certain percentage of the pledges would not be paid"); *see also* Arrowsmith v. Mercantile-Safe Deposit & Trust Co., 545 A.2d 674 (Md. 1988) ("this Court would not carve out an exception to the established law of contracts in order to give a privileged position to promises made to charities"; "the legislative process is more finely and continuously attuned for the societal fact-finding and evaluating required for resolution of this exclusively public policy-based argument."). The *Arrowsmith* court worried particularly that "One principal effect of the requested change [to adopt § 90(2)] would be to subject Maryland citizens who make a generous pledge but who then face a change for the worse in economic circumstances to suits by charities on unfulfilled subscriptions." *Id.* at 685.

[120] The following recent cases dealing with charitable pledges supplement the 1991 A.L.R. annotation, *supra* note 117; they are all from jurisdictions that appear to require consideration or reliance to render a pledge enforceable: King v. Trustees of Boston University, 647 N.E.2d 1196 (Mass. 1995) (holding that evidence was sufficient for a jury to find that Martin Luther King, Jr. made a promise, supported by consideration or reliance, to transfer title to papers to the university with which they had been deposited before his death); In re 375 Park Ave. Associates, Inc., 182 B.R. 690 (Bankr. S.D.N.Y.1995) (upon the challenge of the bankruptcy trustee of the promisor

Contracts conceded a few years ago: "The exception for charitable subscriptions has played to mixed reviews. Courts have been less than pellucid in assessing such important factors as whether the promise was written or oral and whether the promisor reneged before death or simply died. Scholarly efforts to justify the exception have been varied."[121]

Pennsylvania has adopted the Uniform Written Obligations Act, which provides:

> A written release or promise, hereafter made and signed by the person releasing or promising, shall not be invalid or unenforceable for lack of consideration, if the writing also contains an additional express statement, in any form of language, that the signer intends to be legally bound.[122]

By a three-to-two vote, a New York appeals court recently upheld the application of this statute

---

to a $3 million pledge to U.S. Holocaust Museum, reiterating New York law that charitable pledge becomes a binding obligation when the charity incurs liability in reliance thereon, but denying summary judgment based on questions of fact regarding extent of reliance, among other issues); Matter of Versailles Foundation, Inc., 610 N.Y.S.2d 2 (N.Y. App. Div. 1994) (holding that New York law makes charitable pledges enforceable as an offer for unilateral contract that becomes binding when accepted by the charity by incurring liability in reliance thereon, but in this case deeming decedent's letter too equivocal to constitute a charitable pledge); Friends of Lubavitch/Landow Yeshivah v. Northern Trust Bank of Florida, 685 So.2d 951 (Fla. App.1996) (in holding that venue was proper in the forum where the charitable pledge was made, the court noted that a charitable pledge is enforceable if estoppel element is established to supplant missing element of contractual consideration); Dorrance Estate, 14 Fiduc. Rep.2d 72 (Pa. Com. Pl. 1994) (allowing balance due on charitable pledges without interest where others made pledges in reliance on decedent's pledges); Virginia School of the Arts, Inc. v. Eichelbaum, 493 S.E.2d 510 (Va. 1997) (holding that a school's fund-raising efforts in reliance on the donor's "matching grant" constituted consideration, but that the contract was unenforceable because the school failed to meet the condition of raising sufficient funds; without reference to the Restatement, court then held that the doctrine of promissory estoppel should not be adopted in Virginia).

[121] E. Allen Farnsworth, *Promises and Paternalism*, 41 WM & MARY L. REV. 385, 404-05 (2000) (footnotes omitted). Professor Farnsworth identified a few dangers that attend enforcing promises to make charitable gifts. "[T]he exception for charitable subscriptions restores the promisor's power over such promises to what it was before the abolition of the seal, but it does so without the requirement of a signed writing to perform a cautionary function." *Id.* at 404. A promisor could "squander his future" even though "he had not so much as a penny." *Id.* at 398. (While the law recognizes a self-declared trust – without requiring delivery or anything in writing – a trust might be revocable and is limited to property owned by the donor at the time of declaration. *Id.* at 399.) One who makes a binding promise should "fashion explicit provisions that take account of the possibility of regret." *Id.* at 406. But what if "the promisee has at least some responsibility for the promisor's regret?" – "what if one is shocked at inefficient food distribution by one's chosen charity"? *Id.* at 408. Finally, "Should the law ignore even a devastating reversal of fortune?" *Id.* at 407 ("Courts might find contemporary inspiration in an Israeli statute that allows a promisor to retract a promise to make a gift, even after reliance, 'if the retraction is warranted . . . by a considerable deterioration in the [promisor's] economic situation.'"). In sum, "[i]t seems safe to hypothesize that the less tolerant a legal system is in excusing promisors from their promises, the more hesitant courts would be in finding promises to be binding." *Id.* at 405.

[122] 33 Pa. Stats. § 6.

to a pledge agreement executed two months before the decedent's death in favor of Drexel University.[123] The agreement declared that the signatory, who "intended to be legally bound,""irrevocably pledged and promised to pay" $150,000.[124] The dissent asserted:

> Despite the statute of frauds (33 PS § 6), under Pennsylvania law a charitable promise to pay money in the future is not enforceable unless there is consideration for the promise [citations]. In a charitable gift case, consideration is defined either as some type of detrimental reliance upon the promise by the promisee, or other donors who were induced to donate based on this promise [citations]. As the decedent died before the initial gift was transferred to Drexel, and before any acts were done by Drexel in reliance on the promise, the promise was merely an unenforceable promise to pay money in the future.[125]

As described above, a bankruptcy trustee may abandon a claim, including presumably an unfulfilled pledge, because it is subject to restrictions that render it "of inconsequential value and benefit to the estate."[126] The decision to sue a breaching donor "is governed by, among other considerations, the materiality of the breach, a change in the economic situation of the donor or related parties, concerns relating to other charity constituents (including the impact on others who gave or who promised to give), the purposes of the charity, and the chances of recovery and the costs of attempting to do so."[127] In the draft Principles of the Law of Nonprofit Organizations, I suggest that a charity might properly forbear to exercise its full rights in the following situations: (1) If the pledge was inter vivos and the donor is still alive, the charity may agree to modify the payment schedule or amount, or both, in order to accommodate a change in the donor's financial situation; (2) If the donor of an inter vivos pledge has died and the will makes no provision for the gift, the charity may agree to forgo all or part the gift if it determines that the donor's successors in interest were unaware of the promise and would suffer financial hardship if the gift were enforced; or (3) If the gift appears in the will, the charity may agree to forgo all or part of the bequest if full satisfaction would result in financial hardship to the donor's successors in interest. In general, the same considerations that permit a charity to agree to reduce a pledge would, if equity requires, support a court's modifying the agreement.[128] This approach is consistent with the Comments on § 90(1) of the Restatement Second of Contracts.

---

123 In the Matter of Wirth, 2005 N.Y. App. Div. LEXIS 424 (Jan. 18, 2005).

124 *Id.* at *2.

125 *Id.* at *5-*6 (dissent).

126 See note 19, above, and accompanying text, citing to 11 U.S.C. § 554, Abandonment of property of the estate.

127 ALI, Principles of the Law of Nonprofit Organizations, Council Draft No. 1, at 181-82. [UPDATE]

128 *Id.* at 182.

In contrast to an instrument that declares the donor's intent to create a legally binding obligation, some pledges explicitly state that they will not result in a binding obligation. A charity's gift acceptance policy might generally address the charity's intent regarding enforcement.[129] Where a binding commitment is lacking, the charity cannot be considered to have relied on the donor's promise. For example, a Missouri appeals court refused to enforce a pledge against the estate of a member of the board of trustees (and of the executive committee) of a college. She had signed a pledge card (for a campaign to raise funds for a new sports complex) promising to contribute $50,000 over five years, but the back of the card contained the statement: "It is understood that this pledge may be changed at the donor's request." The donor died after having paid $10,000, and her personal representative canceled the balance of the pledge. The court rejected the argument of the college that "a subscription to a charitable organization is an offer to contract which becomes irrevocable and enforceable if the promisee performs some act or incurs enforceable liabilities in reliance on such promise." Rather, the donor's retention of the power to cancel her promise prevents it from becoming binding.[130]

In some cases, the parties' intent can be difficult to determine because one or both parties want to keep the legal significance of the arrangement deliberately ambiguous.[131] Consider, for

---

[129] One association includes the following statement in its gift acceptance policy:

> Donors who make long term pledge commitments are encouraged to include the AAA in their estate or contingency plans to cover any unfulfilled commitment in the event of unexpected death or disability. The Association's policy is not to pursue any unfilled pledge commitment through legal means unless the AAA's Executive Board votes that special situations of circumstances involving any particular pledge would warrant such action.

American Anthropological Association Gift Acceptance of Policy (Sept. 28, 2001), *available at* <www.aaanet.org/rd/giftaccept.htm>.

[130] In the Estate of Buchanan, 840 S.W.2d 888 (Mo. App. 1992), which cited to In re Estate of Bacheller, 437 S.W.2d 132, 137 (Mo. App. 1968) (holding that an "unlimited right to change or cancel [a] pledge would prevent it from becoming a binding contract and thus, under no circumstances could it properly constitute a claim against the estate"), and to Fenberg v. Goggin, 800 S.W.2d 132, 136 (Mo. App. 1990) (by retaining a right to cancel, decedent effectively "promised nothing; therefore, [her] promise was an 'illusory promise,' neither enforceable against [her], nor operative as consideration. . . .").

[131] For example, a Texas jury was not sympathetic to a suit by a Pennsylvania college that in 1976 cajoled a major alumnus into pledging $4 million (seeking, over the next two decades, as much as $50 million); the donor had given only $2 million by time he died in 1995, prompting the college to sue to collect another $5 million. See Daniel Golden, *College Finally Got Alumnus To Pledge; Next Job: Collecting*, WALL ST. J., July 24, 2003, at 1 ("The case affords a rare look at the lengths to which a financially strapped college went to secure big gifts. Interviews and memos filed in a school lawsuit against [J. Howard Marshall II's] estate show that both Haverford and Mr. Marshall were less than candid with each other. Together, they created a cautionary tale for colleges about the hazards of pinning their hopes on reluctant angels."). This story reports: "In April [2003], a jury found that Haverford hadn't been injured because it hadn't relied on Mr. Marshall's pledges but instead had named already-funded projects after him." The story adds: "[One] juror says he didn't like the fact that Haverford kept an

example, the legal significance of pledges made to a college that subsequently went into receivership, a matter that went to the Iowa supreme court three times. In the case of one prospective donor, the court found that the pledge alone was ambiguous: "The receiver is correct that Hauser also stated at trial at the time he signed the pledge he intended to pay. We have no doubt Hauser did intend to pay; the pledge says so. But that conclusion does not answer the question before us. The question is, was that intention to pay to be obligatory?"[132] The court answered in the negative based on the parties' stipulation as to an oral conversation between the prospective donor and the college's professional fund-raiser:

> I asked Mr. Bruno, what if I should die, have a financial reversal or the College should fail?
>
> Mr. Bruno said, "this is only an intent and not binding and if anything like this should happen you just forget it."[133]

Moreover, the court ruled: "An estoppel did not arise in this case in favor of the creditors, in any event. Hauser's pledge was not assigned to them, nor did they extend credit on the strength of it."[134] By contrast, in the case of another donor who had simply signed the pledge form and only partially performed, the court stated: "Without extrinsic evidence bearing upon the intention of the participants, we must attempt to ascertain the meaning and legal effect of the pledge form by giving the language used in the instrument its common and ordinary meaning."[135] The form read:

> I/we intend to subscribe to the College Founder's Fund the sum of Five Thousand –

---

extensive file on Mr. Marshall, including details of his and his then-wife's drinking habits, confidential financial information and health."

In 1990, Paul Oliver-Hoffmann made a $5 million pledge to Chicago's Museum of Contemporary Art ("MCA"), to kick off its fund raising campaign for its new building on Chicago Avenue, near the Water Tower. At this time, Paul served as chairman of the Board of Trustees. During the next seven years, he and his wife, Camille, continued to support museum efforts, but in 1992 they moved to Virginia, and Paul resigned from the MCA Board. In their new home, they became active with the Hirschhorn Museum in Washington, D.C., whose board Camille joined in 1998. Paul never fulfilled his pledge to the MCA, based on his view that its management was fiscally imprudent. For a discussion of the settlement, see Alan G. Artner, *Museum Settles Suit over Reneged Pledge; Chairman's Widow Agrees to Donate 2 Paintings*, CHI. TRIB., July 10, 1998, at 1.

[132] Pappas v. Hauser, 197 N.W.2d 607, 611 (Iowa 1972).

[133] *Id.* at 608.

[134] *Id.* at 613.

[135] Pappas v. Bever, 219 N.W.2d 720 (Iowa 1974).

> no/100 Dollars.
>
> I intend to pay [] Monthly [] Quarterly [] Semi-Annually [/] Annually over [60] / [36] months beginning 1967 * * * *.[136]

The court concluded: "The language of the pledge form in this case, standing alone, shows nothing more than a statement of intention.. . . Even if the language were viewed as uncertain, the conclusion is the same. We are dealing with language printed on the pledge form by the fund-raiser in this case, and doubtful language in a written instrument is construed against the party who selected it."[137] The court rejected the receiver's argument that "the fact two payments were made proves the pledge was obligatory. This is a bootstrap argument. The mere fact a person carries out in part what he said he intended to do does not convert his statement of intention into a promise."[138] In the third case, however, the court held the promise to be enforceable when the (corporate) subscriber, in lieu of filling out the pledge form, wrote a letter stating, in part: "This is to advise you that the contribution from Northwestern Bell Telephone Co. to the Charles City College has been approved by . . . . The $15,000 contribution will be made over a three year period, in three equal payments. Our first $5000 payment will be made in 1968."[139] The court, after quoting approvingly § 90 of the Restatement Second of Contracts (then in draft form), concluded: "Charitable subscriptions often serve the public interest by making possible projects which otherwise could never come about. It is true some fund raising campaigns are not conducted on a plan which calls for subscriptions to be binding. In such cases we do not hesitate to hold them not binding. . . . However where a subscription is unequivocal the pledgor should be made to keep his word."[140]

b. Ipso Facto Bankruptcy Provision

What if a donor makes an otherwise unrestricted pledge to be paid over the next several years, and the pledge is explicitly conditioned on the charity's continued financial soundness? If the charity files for bankruptcy before the pledge is fulfilled, is the pledge an asset of the bankruptcy estate? If not, will the court enforce the pledge for the benefit of the charitable purpose under a *cy pres* proceeding, on the ground that the original gift has become impossible for the charity to perform? Or is the pledge nullified?

---

[136] *Id.* at 721.

[137] *Id.* at 722.

[138] *Id.*

[139] Salsbury v. Northwestern Bell Telephone Co., 221 N.W.2d 609, 610 (Iowa 1974). As mentioned in note 117, *supra*, this case could also have been decided on reliance).

[140] *Id.* at 613.

As described above, the Bankruptcy Code pulls into the estate certain entitlements of the debtor despite a contractual provision that terminates rights on bankruptcy.[141] As explained above, though, such provisions are enforceable if they would also apply outside of bankruptcy. It is not uncommon for a donor (particularly a major donor, whether an individual or a foundation) to condition a pledge or multiyear gift on the charity's continuing financial health and overall ability to perform the charitable purpose for which the gift is made.

Moreover, it might be appropriate for the law to excuse a pledgor, even in the absence of an explicit condition in the pledge document, if the charity itself fails to perform as it should.[142] Breach by the charity might include financial mismanagement or insolvency. I have been considering the appropriate legal treatment of this situation in my project for the American Law Institute. My Section 480 (Donor's Failure to Perform) of the October 2003 draft Principles of the Law of Nonprofit Organizations contains the following provision:

> (c) The donor may raise as a defense [to a suit for performance of a pledge] a bona fide material dispute with the charity over the charity's use of the gift, the charity's operations as they affect the use of the gift, or, in extraordinary circumstances, the general financial and managerial capacities of the charity.

Commentary adds: "This last ground embraces such problems as inadequate oversight responsibilities and refusal to obtain an outside audit in the face of bona fide, material allegations of financial improprieties. While the news media report many examples of the potential application of subsection (c), ordinary disagreements over charity management would not give rise to a defense for a suit on a charitable pledge."[143] The draft Principles provides the following two examples, one excusing the pledgor and the other not:

> **Illustrations:**
>
> 6. XYZ Corporation pledged $10 million to the Charity Federation of the City of W. Prior to [XYZ's] fulfilling this pledge, a front-page news story appears setting out reports of serious financial mismanagement at the Charity Federation, the demands of a minority of the trustees of the Federation to obtain an outside audit, and the refusal of the majority of the board to do so. If the Federation were to bring suit to enforce XYZ's pledge, XYZ could demand that these material, bona fide charges first must be

---

[141] See section 541(c), set forth in note 70, above.

[142] See, e.g., Farnsworth, *supra* note 121.

[143] ALI, Principles of the Law of Nonprofit Organizations, Council Draft No. 2, § 480 (Donor's Failure to Perform), Comments on Subsection (c), at 182-83 (Oct. 2, 2003). [UPDATE]

resolved.[144]

7. W Academy, a college preparatory school, began a fund-raising campaign to construct a school library building. S, whose children then attended the school and whose wife had been a member of its board of trustees, agreed to contribute $375,000. The pledge was in writing and recited that it was made "in consideration of the gifts of others." It specified that payments were to be made in three equal annual installments. Finally, the pledge required W to name the new building after S's wife. The document contained no other conditions or limitations. While S paid the first installment, a year later – when he no longer resided in the community where W was located and his children no longer attended its classes – he advised the academy that he would make no further payments. Upon W's suit for the balance of the pledge, S may not raise as a defense additional financial conditions precedent to satisfying his promise.[145]

IV. Donors Future: Donor Advised Funds and Other Forms of Giving

A. <u>Possible Effects of Bankruptcy Filings on Donative Support</u>

This final part briefly considers the effect that a bankruptcy filing or reorganization might have on future contributions to the charity. One possibility, of course, is a decline in the level of

---

[144] This illustration is based on news reports involving the United Way of the National Capital Area, although the suit is fictitious. See *id.*, Reporter's Note 13.

[145] This illustration is a simplified version of Woodmere Academy v. Steinberg, 363 N.E.2d 1169 (N.Y. 1977). The court recited Saul Steinberg's claims that –

> [H]is undertaking was conditioned upon (1) the collection of pledges from other contributors in a total amount equivalent to the sums the academy received from Steinberg, (2) the academy's earmarking of such matching funds solely for the construction of the library at a cost which was not to exceed $750,000, (3) its pursuit of a plan for merger with the neighboring Lawrence School and (4) the academy's agreement to manage its financial affairs "wisely and soundly" and disburse its funds "carefully". He goes on to allege, in rather broad and conclusory fashion, that the pledge was fraudulently induced because, among other things, the merger with the other school was not actively pursued and, despite verbal assurances he had received to the contrary, the school was not in sound financial condition because it had occasion to borrow money from a bank. For its part, the academy states that it undertook, dehors the writings, to obtain matching funds from others; on the motion for summary judgment, it submitted uncontroverted documentary proof that it had done so. It emphatically denies all the other items on which the defendant insists his pledge was conditioned.

Nevertheless, the court agreed with the donee that "even if defendant's allegations were true, they would not constitute a defense." *Id.* at 1172. "Even assuming the truth of the assertion that they were uttered, they turn out to have been mere expressions of opinion or of present or future expectations or, when promissory in nature, of conditions subsequent rather than precedent." *Id.* at 1173.

outright donations. However, I posit that the troubled charity's supporters rally around either the entity or what it stands for, and hence they might even want to increase donations.[146]

After all, many theories exist to explain why people give to charity in general and to specific charities in particular.[147] Much giving appears to be "expressive" (identifying with the donee charity and its supporters) rather than "instrumental" (seeking to fund a particular undertaking). Studies have found incomplete "crowd-out" of a particular donor's giving as charities obtain revenue from other sources, suggesting that donors give because of social forces (if not pressures) other than (only) to support an identifiable need.[148] James Andreoni posits a "warm glow altruist"[149] whose satisfaction increases with the value of the gift to the charity; others suggest that giving sends a social signal either that a certain level of giving to a particular charity is expected of those in the group,[150] or simply of one's wealth or income.[151] Under these models, giving may even be excessive.[152]

---

[146] See, e.g., Eric Gorski, *Catholics Vote With Wallets on Bishop's Communion Ban: One Prominent Donor Says He Will Withhold $100,000, but Others Double Their Contributions*, DENVER POST, May 19, 2004, at A1.

[147] This paragraph is drawn from Evelyn Brody, *Charities in Tax Reform: Threats to Subsidies Overt and Covert*, 66 TENN. L. REV. 687, 714-15 (1999).

[148] Christopher Jencks, *Who Gives to What?*, in THE NONPROFIT SECTOR: A RESEARCH HANDBOOK 321, 326-28 (Walter W. Powell, ed., 1987) (describing the noneconomic determinants of philanthropic giving); Richard Steinberg, *The Theory of Crowding Out: Donations, Local Government Spending, and the "New Federalism"*, in PHILANTHROPIC GIVING 143, 154 (Richard Magat ed., 1989) (crowding out is only partial).

[149] See, e.g., James Andreoni, *Giving With Impure Altruism: Applications to Charity and Ricardian Equivalence*, 97 J. POL. ECON. 1447, 1447 (1989); James Andreoni, *Impure Altruism and Donations to Public Goods: A Theory of Warm Glow Giving*, 100 ECON. J. 464, 469 (1990).

[150] See JERALD SCHIFF, CHARITABLE GIVING AND GOVERNMENT POLICY 9-10, 16 n.12 (1990) (describing the "demonstration effects" identified in Martin Feldstein & Charles T. Clotfelter, *Tax Incentives and Charitable Contributions in the United States*, 5 J. PUB. ECON. 1 (1976), and commenting that "as the level of giving by others increases, it may take larger donations to 'buy' prestige and the like via giving, and spending on such goods may rise").

[151] See Amihai Glazer & Kai A. Konrad, *A Signaling Explanation of Charity*, 86 AM. ECON. REV. 1019, 1019-20 (1996). Noting that "[i]mpressing former college roommates who may live in other parts of the world, may require a notice in the alma mater's alumni magazine," Glazer and Konrad describe the cliff effect of donations when the charity publicizes giving by dollar ranges. *Id.* at 1021 (stating that in "[t]he 1993-1994 report of the Harvard Law School Fund . . . 980 people contributed in the category of $500-$999. Contributions of exactly $500 would constitute 93 percent of the total raised in this category"). By contrast, these authors comment, a theory of giving in which the donor cares only about the charity's level of outputs would provide a smoother curve of donations. *Id.*

[152] See *id.* at 1019 ("[C]onspicuous consumption may be banned by social norms when charitable donations are not.") (footnotes omitted); see also LESTER M. SALAMON, PARTNERS IN PUBLIC SERVICE:

As a threshold matter, it is important to appreciate that techniques to keep financial support outside the direct control of the charity can have serious consequences for the overall governance of the charity. From the donor's perspective, this is the point – the charity, by having filed for bankruptcy, has demonstrated a serious inability to manage its financial affairs.[153] Where the financial troubles resulted from tort suits rather than voluntary credit transactions, donors will be equally concerned that the underlying cause has been remedied and will not recur.[154] From the charity's perspective, though, any control retained by the donors constrains the flexibility of the governing board or other authority. Depending on the charity, this shift in control might be the most significant result of the bankruptcy proceeding.

More systemically, donors, members, and other constituencies of a charity that emerges from bankruptcy might force long-term structural changes in the constitution and oversight of the charity. Donors might even be satisfied with making unrestricted donations if they succeed in making the charity's financial affairs more transparent and subject to their input. At the other extreme, a major donor might make demands for disclosure of information, a seat on the board, or the charity's waiver of the donor's lack of standing to sue for specific performance of a gift restriction.[155] Thus, more is at stake in a charity bankruptcy than the short-term financial health of the entity.

Already discussed in Parts II and III, above, are gifts made in trust held by a third-party trustee, staged gifts subject to conditions, and restricted gifts. A topic beyond the scope of this article is donors' general lack of standing to enforce the performance of restrictions.[156] This suggests that the surest way to maintain control over assets is not to transfer them to the charity

---

GOVERNMENT-NONPROFIT RELATIONS IN THE MODERN WELFARE STATE 46-48 (1995) (discussing "philanthropic particularism," "philanthropic paternalism," and "philanthropic amateurism").

[153] Even without concerns of financial distress, the trend at all levels of giving seems to be towards increased donor determination. Building on the donor-directed movement at the United Way, we now have "venture philanthropy," with its hands-on investment-like approach, and commercial donor-advised funds, such as the Fidelity Investments Charitable Gift Fund. In self-defense, community foundations and even individual public charities (such as universities) are beginning to offer donor-advised funds (described below); these arrangements usually require a portion of annual giving to go to the host institution.

[154] See, e.g., Nicole Wallace, *Boston Archdiocese Seeks to Offset Fund-Raising Fallout*, CHRON. PHILANTHROPY, Nov. 14, 2002 ("Some have held back donations out of fear that their contributions might be towards settling lawsuits brought by victims. Others have balked because they want to let church leaders know how upset they are about the scandal.").

[155] It is unclear whether this last demand, assuming it is accepted by the charity, would be enforceable in court. See generally ALI, Principles of the Law of Nonprofit Organizations, Council Draft No. 1, § 460 (Mechanisms to Address Charity's Breach of Restriction) (Oct. 2, 2003). [UPDATE]

[156] See generally ALI, Principles of the Law of Nonprofit Organizations, Chapter 4 (Gifts), especially § 450 (Role of the Donor and Relevance of Donor Intent) (Oct. 2, 2003). [UPDATE]

in the first place, or at least not until they will be expended. We thus will consider two remaining techniques: making gifts instead to a cognate charity; and employing a separate charity to make future gifts, whether that charity is a public charity, a private foundation, a supporting foundation, or a "donor-advised fund" (at a community foundation, commercially created fund, or a public charity).

B. Gifts to Cognate Charities

Gifts may be redirected, temporarily or permanently. When the Boston Archdiocese (which has not filed for bankruptcy) was engaged in negotiations with tort plaintiffs over charges of sexual abuse by priests, some supporters refused to contribute to the annual Cardinal's Appeal, and instead made an equivalent contribution to related entities.[157] One lay group seeking greater transparency in Church finances, Voice of the Faithful, made its $35,000 gift to the separately incorporated Catholic Charities – a move that prompted the Archbishop to order Catholic Charities to turn down the gift, an order the agency reluctantly refused.[158] One newspaper editorial commented: "An attempt by a lay group to dictate how the archdiocese spent donated money and Catholic Charities' defiance of the archdiocese directive would have been unthinkable just a few years ago. To all appearances, the shift is likely to continue in years to come."[159]

C. Use of Separate Organizations and Donor-Advised Funds

1. "Friends of" or similar public charity. A group of supporters can create a separate charity that will decide when and for what purposes to make gifts to the operating charity. (As long as this separate entity is widely supported, it will not be treated as a private foundation for federal tax purposes; see the next item.) This type of relationship has become common as a technique for alumni of public universities to raise funds for such a governmental institution;

---

[157] See, e.g., Wallace, *supra* note 154 ("While some parishioners have completely stopped giving to the archdiocese, . . . others have redirected gifts to their parishes or to specific archdiocesan programs supported by the Cardinal's Appeal.").

[158] See, e.g., Michael Paulson, *Church Refuses Group's Money: Voice of the Faithful Decries Decision*, BOSTON GLOBE, April 1, 2003, at A1; Michael Paulson, *Charity to Accept Donation Despite Lennon's Stance*, BOSTON GLOBE, April 9, 2003, at A1 ("Although some Catholic Charities officials had feared that [Bishop] Lennon might try to fire the charity's board, Lennon issued a statement after the vote saying that, at least for now, he would not punish the agency for accepting money from the Voice of Compassion, which is the name of the fund established by Voice of the Faithful."). See also Editorial, *Obedience and Charity*, PROVIDENCE JOURNAL-BULLETIN, April 15, 2003, at B4 ("Good Catholics, of course, don't want to disobey their bishop. But in this case, according to the Catholic Charities president, Dr. Joseph Doolin, 'We have a fiduciary obligation to the poor people of the Greater Boston area.'").

[159] Editorial, *Power Shift: Catholic Charities Decision Dramatizes Changes*, [WORCHESTER] TELEGRAM & GAZETTE, April 11, 2003, at A14.

increasingly, it is being used as a mechanism to express these supporters' views on university policy (with all the headaches for governance that suggests).[160]

2. Private foundations. A wealthy donor might create a private foundation to hold funds and make gifts as will be determined in the future. The private foundation will enjoy federal tax exemption under Internal Revenue Code section 501(c)(3) so long as it makes charitable distributes equal to at least five percent of the value of its investments.[161] However, private-foundation status carries certain disadvantages: notably, a one- (or two-) percent excise tax on investment income;[162] prohibitions on all transactions (other than payment of reasonable compensation) on dealings with the donor and related persons;[163] limits on excess business holdings, such as stock in the family business;[164] and lower percentage-of-income limits on donated cash and property.[165]

3. Supporting organizations. Congress deems certain types of 501(c)(3) organizations – churches, schools, and hospitals – as automatically public charities rather than private foundations. Moreover, entities that other would be classified as private foundations because of their narrow sources of support – the so-called "supporting organizations" – may piggyback on the public charity status of the organizations they are committed to support.[166] The flexible supporting-organization category offers a vehicle nearly equivalent to the private foundation while avoiding the excise taxes and other limitations that apply only to private foundations and gifts to them.

4. Community trusts. Component funds of a community trust enjoy non-private foundation status because of a rule in the Treasury regulations that allows the trust to aggregate separately endowed gifts in order to meet the "public support" test.[167] To ensure ongoing public benefit and freedom from the "dead hand" of the donors, the regulations require community trusts to have "variance power" over each of the separate donated funds. This power

---

[160] See, e.g., Julianne Basinger, *Private Sources Play More of a Role in Paying Public-University Chiefs: Does the Extra Money Keep Good Talent or Skew Priorities?*, CHRON. HIGHER ED., Nov. 30, 2001, at A24.

[161] I.R.C. § 4942 (Taxes on Failure to Distribute Income).

[162] I.R.C. § 4940 (Excise Tax Based on Investment Income).

[163] I.R.C. § 4941 (Taxes on Self-Dealing).

[164] I.R.C. § 4943 (Taxes on Excess Business Holdings).

[165] I.R.C. § 170(b) (Percentage Limitations).

[166] I.R.C. § 509(a)(3).

[167] Treas. Reg. § 1.170A-9(e)(11)(v)(B).

superficially resembles a contractual *cy pres* power – except that the community trust need not ascertain or adhere to the donor's intent once the trust's governing body "in [its] sole judgment" determines that the original restriction is "unnecessary, incapable of fulfillment, or inconsistent with the charitable needs of the community or area served. . . ."[168]

5. Other donor-advised funds. Today, donor-advised funds ("DAF"s) at community foundations face competition from commercially created DAFs (pioneered by Fidelity Investments Charitable Gift Fund) and by DAFs at public charities. Federal legislative proposals to conform the tax rules for all donor-advised funds failed to advance in prior years.[169] However, the topic is back on the table in light of the discussion draft on the governance of exempt organizations issued by the staff of the Senate Finance Committee in June 2004.[170] At the Finance Committee's request, the charity trade association Independent Sector provided some recommendations on DAFs on ________, 2005.[171]

Conclusion

Assets donated for specific charitable purposes are generally preserved from distribution to a bankrupt debtor's creditors. However, an overexpansive application of charitable trust policy can have serious operational repercussions for all charities, bankrupt or not. Indeed, if assets are held for narrow charitable purposes, redeployment within the charity can be impeded,

---

[168] This seeming broad discretion granted by the tax rules to the community trust's governing board was not recognized by the New York surrogate court in Matter of Laura Spelman Rockefeller Memorial, et al., reprinted in *New York Law Journal*, Oct. 21, 1999. The trial court ruled that the New York Community Trust acted too hastily when it decided that a change in circumstances had occurred that warranted the redirection of the Laura Spelman Rockefeller fund from the plaintiff beneficiary. Judge Preminger, in this first construction of "variance power," ruled that the use "must be grounded in a change of circumstance that negatively affects the designated charity to such a degree that it would be likely to prompt a donor of the fund to redirect it." This interpretation, however, takes the fiduciary power from the trustees and returns it to the donor. Nevertheless, the appellate division upheld the lower court's standard as "equitable and definable" (although it deprived the plaintiff of monetary satisfaction by ruling that it waited too long to sue). In re Application of the Community Service Society of New York, 713 N.Y.S.2d 712 (N.Y. App. Div. 2000).

[169] *See* U.S. Treas. Dept., *General Explanation of the Administration's Fiscal 2001 Revenue Proposals*, 105-06 (Feb. 2000); Joint Comm. Tax'n, *Description of Revenue Proposals Contained in the President's Fiscal Year 2001 Budget Proposal* 238-44 (JCS-2-00, March 6, 2000).

[170] Senate Finance Committee Staff Discussion Draft, Tax Exempt Governance Proposals, June 22, 2004, at 1-2 ("Donor advised fund reform"), *available at* <http://www.finance.senate.gov/hearings/testimony/2004test/062204stfdis.pdf>.

[171] See Panel on the Nonprofit Sector, "__" (________, 2005), *available at* www.nonprofitpanel.org.

perhaps even precipitating financial collapse. Moreover, even a healthy charity may find it more difficult to borrow necessary financing. As three health-care practitioners illustrate:

> Taken to its logical conclusion, the charitable-trust theory suggests that individual facilities within a multi-state nonprofit health care system should be treated as individual trust assets to be used solely for the benefit of the local community. Clearly, adoption of this view would imperil a nonprofit health care entity's ability to shift assets around interstate or intrastate – from well-performing assets (in metropolitan areas) to struggling ones (in rural, underserved areas) or from a sparsely populated state to a high-growth market. Likewise, the presence of trust obligations could hamper a system's access to inexpensive sources of capital: Facility assets that are covered by trust obligations could be unavailable as collateral to secure debt, including for use in cross-state mortgages, which could have the effect of driving up the cost of borrowing. . . . . Relatedly, in the insolvency context, application of the "charitable trust" theory could severely limit the ability of creditors, including tax-exempt bondholders, to recover against system assets that are encumbered by trust obligations – inasmuch as such assets could be deemed only available for designated charitable purposes and thereby even excluded from a bankruptcy estate.[172]

In connection with recent bankruptcy filings of several dioceses of the Catholic Church, some have suggested that assets donated to the dioceses are held in constructive (resulting?) trust for the benefit of the parishes.[173] Such an argument raises the risk that if a trust exists for bankruptcy purposes, it also exists prior to (any) bankruptcy – calling into question the authority of the bishop to reallocate donated assets by, for example, closing parish schools, without court approval.[174] The legal treatment of charitable assets, donated or otherwise, is ultimately a normative decision. What seems to have changed is the increased efforts of state attorneys general to assert the purported interested of charitable beneficiaries ahead of the interests of creditors.

---

[172] Kaplan, Coffey, & Feit, *supra* note 4, at 62-63.

[173] [Provide cross-references to appropriate other symposium contributions.]

[174] [Provide cross-reference to Catherine Wells' contribution.]