Protecting Endowment and Restricted Funds to Further Donor Intent

Richard L. Fox, Esquire and Josh D. Headley, Esquire
Buchanan Ingersoll & Rooney PC

2018 Planned Giving Day Conference
Philadelphia
October 25, 2018

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Enclosure 1

Talking Points Outline

Protecting Endowment and Restricted Funds to Further Donor Intent

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Talking Points Outline

- **Introduction** (RLF)
  - Facing creditors they are unable to pay, it is not unusual for charities to seek bankruptcy protection under federal bankruptcy laws.
  - Invariably, creditors will seek restricted/endowment/trust funds of a charity:
    - Philadelphia Orchestra / Annenberg Foundation (2011): $50 million endowment (for educational programming, touring, special artistic endeavors).
    - National Heritage Foundation (2009): $25 million in donor-advised funds.
  - Clash: State law protection of charitable assets / donor intent versus bankruptcy law maximization of assets for creditors.
  - Ultimate determination as to whether funds are available to creditors depends on nature of restriction: specific charitable uses or general use of charity – are they sufficiently restricted to survive bankruptcy? Does charity have "absolute control" over use of funds?
- **Nature of Restrictions** (RLF)
  - Large unrestricted gifts for the general use of a charity are rare.
  - The norm: restrictions on use -- scholarship funds, chair for a professor, medical research, educational programs, etc. –

        - Restricted funds not available for the general charitable uses.

        - Restrictions should be set upon making of contribution – no continuing control to donor.

    - How restrictions may arise:

        - Grant agreement.
        - Endowment agreement.
        - Trust agreement.
        - Testamentary documents – Will or Revocable Trust.
        - In response to solicitation of charity for specified funds.
        - Evidence of donor intent.

    - Donor concerns about bankruptcy – ongoing client matter:

        - Testamentary bequest of 75% of estate small liberals arts college facing financial difficulties: "to be used for the scholarship fund **in memory of my mother** …"

        - Issues:

            - Is it an endowment?
            - College says "no"
            - Use of "in memory" or "as a memorial to" has been construed to mean to "keep remembrance alive" and, therefore, to evidence "permanent endowment."
            - What happens if college goes bankrupt and ceases operations?

- **Effect of Bankruptcy on Restricted/Endowment Funds** (JDH)

    - Eligibility of charities to file bankruptcy.

    - Recent examples of bankruptcies.

    - "Bankruptcy estate."

        - The only property that is subject to claims of creditors.
        - Charitable trust doctrine: bare legal title versus equitable interest.
        - Exclusion of assets where charity only holds legal interest.
        - Endowments treated as charitable trusts.

- Applicable provisions under Bankruptcy Code: Sections 541(d) and 541(c)(2).
- How courts have made their determination as to whether restricted/endowment funds are excluded from "bankruptcy estate."
- Donor-advised funds subject to claims of creditors?

- **Effect of Closure of Charity on Restricted/Endowment Fund** (JDH)
  - Charity ceases operations and seeks to liquidate under Chapter 7.
  - Can funds be used to pay creditors?
  - If not, what happens to funds?

- **Strategies to Protect Charitable Restricted/Endowment Assets from Claims of Creditors** (RLF)
  - Use gift agreement or other written instrument:
    - Should specify restrictions and indicate that funds are not to be used for general purposes of charity.
    - Indicate that funds are to be held as an endowment, whether temporary or permanent.
    - Indicate that funds can't be used as collateral or to make loans, including loans to the charity's general funds.
  - Indicate who the "real beneficiaries" are and that charity is holding bare legal title. Example: In the case of a scholarship fund, indicate the beneficiaries are students seeking to obtain a collection education and that school holds legal title to funds.
  - State that fund shall be deemed to be a trust fund impressed with an obligation to be expended for specific purposes.
  - Include "spendthrift provision" – specific provision indicating that creditors or trustees in bankruptcy shall not have an interest in the funds.

- Specify “triggering events” that will cause funds to be transferred to continue their intended purposes. Examples:
  - The charity becomes insolvent or files for bankruptcy.
  - Charity no longer carries out specified purposes of contribution.
  - Charity ceases to exist, discontinues its operation, or changes it mission.
  - It becomes impracticable or impossible for charity to adhere to restrictions or operate the endowment.
  - Loss of tax-exempt status.
- Indicates what happens upon a “triggering event” – examples:
  - Name alternative charities to receive funds (i.e., charity waiting in the wings).
  - Include provision to revoke grant, and receive funds back or to direct to another charity. (Annenberg Foundation/Philadelphia Orchestra)

Enclosure 2

Speaker Bios;

Selected Publications and Speeches

SPEAKER BIOS

Richard L. Fox, Esq. is a shareholder in the Philadelphia office of the law firm of Buchanan Ingersoll & Rooney PC. He concentrates his practice in the areas of charitable giving, private foundations, tax-exempt organizations, estate planning, trusts and estates, and family planning. Mr. Fox is the author of the treatise, Charitable Giving; Taxation, Planning and Strategies, a Warren, Gorham and Lamont publication, writes a national quarterly bulletin on charitable giving, and writes and speaks frequently on issues pertaining to nonprofit organizations, estate planning and philanthropy. He is a Fellow of the American College of Trust and Estate Counsel. He is a member of the advisory board of the Estate Planning Journal and BNA Tax Management and is a commentator for Leimberg Information Services, Inc. He is also a member of the American College Chartered Advisor in Philanthropy Board of Advisors, where he previously headed the Chartered Advisor in Philanthropy Program as the Sallie B. and William B. Wallace Chair in Philanthropy. Mr. Fox, who holds an LL.M. degree in taxation from New York University School of Law, is a frequent contributor to the Estate Planning Journal the Journal of Taxation. He was has been named by Worth Magazine as one of the Top 100 Attorneys in the country representing affluent families and individuals, including in the areas of estate planning, private foundations and philanthropy, as well as a Pennsylvania Super Lawyer in these areas.

Josh D. Headley, Esq. is an associate in the Washington, DC office of the law firm of Buchanan Ingersoll & Rooney PC. He concentrates his practice in the areas of tax, wealth and succession planning and nonprofit organizations. Josh also regularly works with fiduciaries on estate and trust administration matters. On the nonprofit side, Josh works closely with donors and exempt organizations in structuring planned giving vehicles to achieve both charitable and tax planning objectives. Josh holds a J.D. degree with a concentration in taxation from Antonin Scalia Law School and is a member of the Washington D.C. Estate Planning Council. Josh is also a member of the bars of the U.S. Bankruptcy Courts for the Eastern District of Virginia and the Western District of Virginia.

Richard L. Fox
Buchanan Ingersoll & Rooney PC
50 S. 16th Street, Suite 3200
Philadelphia, PA 19102
(215) 665-3811
richard.fox@bipc.com

Richard L. Fox, Esq. is a shareholder with the law firm of Buchanan Ingersoll & Rooney PC. He concentrates his practice in the areas of charitable giving, private foundations, tax-exempt organizations, estate planning, trusts and estates, and family planning. Mr. Fox is the author of the treatise, *Charitable Giving; Taxation, Planning and Strategies,* a Warren, Gorham and Lamont publication, writes a national quarterly bulletin on charitable giving, and writes and speaks frequently on issues pertaining to nonprofit organizations, estate planning and philanthropy. He is a Fellow of the American College of Trust and Estate Counsel. He is a member of the advisory board of the *Estate Planning Journal* and is a commentator for Leimberg Information Services, Inc. He previously headed the Chartered Advisor in Philanthropy Program at the American College as the Sallie B. and William B. Wallace Chair in Philanthropy. Mr. Fox, who holds an LL.M. degree in taxation from New York University School of Law, is a frequent contributor to the periodicals *Estate Planning* and the *Journal of Taxation.* He has been named by *Worth Magazine* as one of the Top 100 Attorneys in the country representing affluent families and individuals, including in the areas of estate planning, private foundations and philanthropy, as well as a *Pennsylvania Super Lawyer* in these areas. Mr. Fox has also been selected for inclusion in *The Best Lawyers in America.*

Publications by Richard L. Fox

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- *'Newman's Own' Exception to Excess Business Holdings Rule Allows Private Foundations to Own 100% of a Business Enterprise*, Bloomberg Tax, Daily Tax Report, September 17, 2018; Tax Management Memorandum, October 1, 2018.
- *Is the Charitable Deduction a Double-Edged Sword for a Nonexempt Trust?,* Bloomberg Tax, Tax Management, Estates, Gifts and Trusts Journal, July 12, 2018
- *Proposals by States to Recast SALT Payments as Charitable Contributions, Are These a Valid End-Run Around the New $10,000 Limitation*?, Trusts & Estates, June 2018.
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- *Plan Now to Avoid the Private Foundation Excise Tax Rules,* Estate Planning, February 2018.

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- *Practical Charitable Planning for Employee Stock Options*, Estate Planning, May 2005.
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Speeches by Richard L. Fox

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- *New Models in Philanthropy,* Neumann University, The Center for Leadership, December 6, 2017.
- *Not-for-Profits and Investments: Doing Well While Doing Good*, Bryn Mawr Trust Company, Merion Cricket Club, November 15, 2016.
- *The Creation of the Institute for Journalism in New Media*, Financial Planners Association of Philadelphia's 29th Annual Spring Symposium, St. Joseph's University, May 11, 2016.
- *Grantmaking and Fundraising in the Digital Age,* Neumann University, The Center for Leadership, April 9, 2016.

- *Charitable Giving and Tax-Exempt Organization Changes Under the PATH Act of 2015*, Webinar, Advisors in Philanthropy, February 16, 2016.
- *Charitable Contribution of Philadelphia Newspapers to Newly Formed Institute for Journalism in New Media,* Temple University Beasley School of Law Media & Communications Law Society, February 9, 2016.
- *The Nuts and Bolts of Charitable Remainder and Charitable Lead Trusts: Tax Rules, Drafting Guidelines, and Creative Planning Ideas*, The 50th Annual Heckerling Institute on Estate Planning (University of Miami Law School), January 14, 2016.
- *Charities in Distress, Bankruptcy and Impact on Restricted Gifts*, Mid-Atlantic Regional Meeting of the American College of Trust and Estate Counsel (ACTEC), September 12, 2015.
- *Selected Topics in Philanthropic Planning*, Princeton Area Community Foundation, May 7, 2015.
- *Private Foundations: Tools to Add to Your Planning Arsenal to Achieve Your Clients' Goals*, The International Association of Advisors in Philanthropy, April 28, 2015.
- *Tax Law: Issues Relating to Memberships, Donations and Benefits and Other Nonprofit Concerns*, Independence Foundation, March 24, 2015.
- *Gifts of Property - Do You Know What You Don't Know?*, The Univest Foundation, May 1, 2014.
- *2014 Charitable Giving in America: The Tax Update*, The Community Foundation of South Jersey, March 4, 2014.
- *The Top Ten Ways Private and Family Foundations Get into Trouble*, The Philadelphia Foundation, Private and Family Foundation Seminar, October 1, 2013.
- *Nonprofit and Philanthropic Tax Issues,* Pennsylvania Institute of Certified Public Accountants, Annual Tax Form, November 8, 2012.
- *Selected Topics in Philanthropy & Tax-Exempt Organizations*, Philadelphia Bar Association - Probate and Trust Section, Tax Committee, September 24, 2012.
- *What Every Estate Planner Needs to Know About Tax-Exempt Organizations and Charitable Gift Planning,* The 46th Annual Heckerling Institute on Estate Planning (University of Miami Law School), January 11, 2012.
- *Private Foundations: Perpetual or Limited Lifespan,* The Philadelphia Foundation, November 4, 2011.
- *Creating Nonprofit Organizations, Daytime With Donna Radio Show, TOGINET Radio,* July 15, 2011.
- *The Power of Charitable Trusts in Planned Giving*, Univest Foundation – 6th Annual Planned Giving and Development Seminar, May 5, 2011.
- *Question and Answer Panel, Ethics and Law Course Presentation*, New York University Heyman Center for Philanthropy and Fundraising, April 26, 2011.
- *Charitable Planning in a Time of Low Interest Rates*, ALI-ABA Seminar, December 2010.
- *Doing Well By Doing Good*, Or Hadash Synagogue, March 2010.

- *Private Foundations: Governance, Duration and Other Hot Topics,* Not for Profit Organization Symposium, Washington D.C., November 2008.
- *Nonprofit Governance and NFP Professionals Serving on Boards,* Not For Profit Organization Symposium, Washington D.C., November 2008.
- *The Art of Philanthropy - Do You Know What You and Your Clients Don't Know: Tools & Techniques for Advisors and Their Clients*, Central Indiana Community Foundation, March 2008.
- *Gifts of Property - Do You Know What You Don't Know?,* Current Topics: Private Foundations and Supporting Organizations, Planned Giving Council of Houston, September 2007.
- *Using Philanthropy to Add Value to Your Clients Relationships*, Presentation at the American College, Professional Advisors' Seminar, June 2007.
- *Luncheon Speech Regarding the Sallie B. and William B. Wallace Chair in Philanthropy at the American College, Advisors in Philanthropy Conference*, Chicago, Illinois, April 2007.
- *Private Foundation Workshop, The Annenberg Foundation*, Annual Retreat, November 2006.
- *Charitable Planning Ideas*, Temple University School of Medicine Reunion Day, October 2006.
- *Donor-Created Entities to Support Public Charities* Planned Giving Council of Greater Philadelphia, 2006 Planned Giving Day Conference, Greater Philadelphia Planned Giving Council, October 2006.
- *Gifts of Property - Do You Know What You Don't Know*, Planned Giving Council of Greater Philadelphia, September 2006.
- *Getting to the Heart of Charitable Giving*, Temple University Planned Giving Day, April 2006.
- *Donor-Created Entities to Support Public Charities*, Lorman Educational Services and Penn State University 60th Annual Tax Conference, March and May 2006.
- *Hot Topics for Academic and Nonprofit Institutions: Essential Issues in Executive Compensation*, Dilworth Paxson LLP Seminar, February 2005.

Joshua D. Headley
Buchanan Ingersoll & Rooney PC
1700 K Street, N.W., Suite 300
Washington, DC 20006-3807
(202) 452 6055
joshua.headley@bipc.com

Joshua D. Headley, Esq. is an associate in the Washington, DC office of the law firm of Buchanan Ingersoll & Rooney PC. He concentrates his practice in the areas of tax, wealth and succession planning and non-profit organizations. Josh also regularly works with fiduciaries on estate and trust administration matters. On the nonprofit side, Josh works closely with donors and exempt organizations in structuring planned giving vehicles to achieve both charitable and tax planning objectives. Josh is a member of the Washington D.C. Estate Planning Council.

Recent Speeches by Joshua D. Headley

- *New Models in Philanthropy – Recent Trends In Trusts, Charitable Giving, Online Giving, Grants, Funding, EITC*, Neumann University Center for Leadership, December 6, 2017.
- *Planning for Certainties: Death and Taxes*, CLE Presentation, November 29, 2017.

Recent Publications by Joshua D. Headley

- *'Newman's Own' Exception to Excess Business Holdings Rule Allows Private Foundations to Own 100% of a Business Enterprise*, Bloomberg BNA, September 17, 2018.
- *New Maryland Estate Tax Exemption for 2019, Signals Trend Following 2017 Tax Act*, Buchanan Ingersoll & Rooney PC Client Advisory, April 24, 2018.
- *The Tax Cuts and Jobs Act – What Nonprofits Need to Know*, Philanthropy Journal News, January 29, 2018.
- *With Great Power Comes Great Responsibility: A Trustee's Practical Guide to Investing Trust Assets*, Bloomberg BNA, November 9, 2017.
- *IRS Provides New Guidance to Simplify Foreign Grant Making by Private Foundations*, Bloomberg BNA, October 30, 2017.
- *Trustee's Failure to Administer Charitable Remainder Unitrust in Accordance with Governing Instrument Proves Costl*y, Bloomberg BNA, September 14, 2017.

Enclosure 3

General Outline

Protecting Endowment and Restricted Funds to Further Donor Intent

Richard L. Fox, Esquire and Josh D. Headley, Esquire
Buchanan Ingersoll & Rooney PC

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1. **Introduction.**

   a. Increasing number of charities declaring bankruptcy.
      i. Shepherd University in California (August 2017).
      ii. Archdiocese of San Juan (August 2018).
      iii. Verity Health System in California (September 2018).

   b. Major Issue: Must funds be used to pay creditors?
      i. Clash of two policy regimes: (i) state law protection of charitable assets/donor intent versus (ii) bankruptcy law maximization of assets for creditors.
      ii. Whether funds are subject to creditors' claims frequently depends on restrictions placed on contributions.

   c. Creditors claim restricted funds and courts must determine whether funds are protected because of the restrictions.

   d. Overview of Bankruptcy Process.
      i. Chapter 11 vs. Chapter 7.
      ii. Commencement of bankruptcy.
      iii. The "bankruptcy estate."
      iv. The importance of property rights under state law.
      v. Eligibility of charity to declare bankruptcy; considerations in deciding whether to declare.
      vi. The role of the Attorney General.

2. **Endowments and restricted gifts.**

   a. Large unrestricted gifts, *e.g.*, gifts that may be used by the organization for any purpose in any manner consistent with a general charitable purpose, are increasingly rare.

   b. Large donors typically create restrictions on use.
      i. Naming rights.

ii. Purpose, *e.g.*, support medical research, scholarship in specific field, chair for professorship, educational programs.

3. **Effect of bankruptcy on endowments and restricted funds.**

a. Courts may construe restrictions on use for charity or charitable purpose as creating an implied or resulting trust, even without a formal trust document.
 i. Treat charity as trustee; fiduciary with legal title but no beneficial interest.
 ii. Require compliance with trust "terms."
 iii. Trust can be created based upon solicitation used by charities.
 iv. Just because there is a deemed "trust" does not mean that funds will be protected from creditors; the terms of the trust are important (protection before or after bankruptcy).

b. Applicable provisions of the bankruptcy code.
 i. Bankruptcy Code Section 541(d): Property in which charity holds only legal title to property, but not an equitable interest in property, is excluded from bankruptcy estate.
 ii. Bankruptcy Code Section 541(c)(2): Restriction on transfer of beneficial interest in a trust that is enforceable under applicable nonbankruptcy law is enforceable under bankruptcy law.
 iii. *Parkview Hospital*.

c. Importance of spendthrift provision – If respected for state law purposes it will protect assets from creditors.

d. Is income considered to be used for a general or restricted purpose?

4. **Effect of close of charity operations on endowment and restricted funds.**

a. Charity ceases operations and seeks to liquidate under Chapter 7.

b. Charitable fund exists to provide income or principal for general charitable purposes.

c. Can funds be used to pay creditors?

d. Key determination – Does state law consider payments to creditors to be in furtherance of charitable purpose?

e. Creditor argument – debt incurred for charitable purposes while organization was operating as a charity.

f. *In re Breast Cancer Prevention Fund* (2017)*; Boston Regional Medical Center* (2005); *Ohio Chamber Ballet* (2010); *Winstead Memorial Hospital* (2000).

5. **Consequences when the purpose of an endowment or restricted fund cannot be fulfilled.**

a. Doctrines of *cy pres* and deviation.
b. Application of the doctrines during bankruptcy.
c. Role of the Attorney General.

6. **Donor advised funds as part of the bankruptcy estate of sponsoring organization.**

a. General discussion of donor-advised funds.
b. *In re National Heritage Foundation*.
c. Arguments for and against protecting donor-advised funds from creditors.

7. **Strategies to protect charitable donations from the claims of creditors and ensure that donor intent is followed.**

a. Grant agreement that contemplates bankruptcy or charity closing down.
   i. *Annenberg Foundation*.
   ii. Alternative beneficiary.
   iii. Specific charitable uses rather than general uses of charity.
   iv. Spendthrift provision.
   v. Confirm fund treated as trust.

b. Maintaining adequate books and other financial records.

c. Special considerations for donor-advised funds.

8. **Closing Remarks**.

Enclosure 4

Shield Donations From Bankrupt Charities Creditors,

Estate Planning Journal, January 2016

DONOR-RESTRICTED FUNDS

Shield Donations From Bankrupt Charity's Creditors

When a charity is in financial distress, donor-restricted funds may escape the reach of creditors-unlike general-purpose charitable contributions.

Author: RICHARD L. FOX, JONATHAN G. BLATTMACHR, AND BENJAMIN S. BOLAS, ATTORNEYS

RICHARD L. FOX, LL.M. (Taxation), is a partner in the Philadelphia office of the law firm of Dilworth Paxson LLP (www.dilworthlaw.com) where he heads the Philanthropic and Nonprofit practice. Mr. Fox is also the author of the treatise Charitable Giving: Taxation, Planning and Strategies (Thomson Reuters/WG&L) and a member of the editorial board of Estate Planning. JONATHAN G. BLATTMACHR is the Director of Estate Planning for the Alaska Trust Company, a principal of Pioneer Wealth Partners, LLC, and co-developer, with Michael L. Graham, Esq., of Dallas, Texas, of Wealth Transfer Planning, a computer system produced by Interactive Legal that provides artificial intelligence advice and automated document assembly systems for practitioners. BENJAMIN S. BOLAS, LL.M. (Taxation), is a tax associate in the Philadelphia office of the law firm of Dilworth Paxson LLP. *Copyright ©2015, Richard L. Fox, Jonathan G. Blattmachr, and Benjamin S. Bolas.*

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With the substantial growth of the charitable sector and nonprofit organizations operating more like

businesses, it is not unusual to find a charitable organization in financial distress. Facing creditors it is unable to pay, the charity may ultimately be left with no choice but to seek the protection of the federal bankruptcy laws. [1] Indeed, it is now more common than ever for charities-in the face of decreasing revenues, increasing expenses, mounting financial pressures, and weakness in the economy-to file for bankruptcy protection. [2] In recent years, a number of high-profile bankruptcy cases have involved charitable organizations, including the New York City Opera, the National Heritage Foundation, the Philadelphia Orchestra, Architecture for Humanity, Banner Health System, and San Diego's Orchestra Nova, as well as a host of other nonprofit organizations. [3]

Charitable sector difference

Unlike the for-profit sector, the charitable sector confers significant public benefits upon society and the community as a whole, unburdened by having to provide an economic return to shareholders or owners. In return, charitable organizations receive significant public support in the form of charitable contributions and grants, subsidized in part through the charitable tax deduction offered through the Internal Revenue Code [4] as well as an exemption from income taxation, in general, except for any unrelated business taxable income the charitable organization may receive. [5]

A substantial portion of the public support provided to charitable organizations is restricted by donors for specified charitable purposes or uses. [6] This includes donations, often in the millions of dollars, in the form of permanent endowment funds or charitable trusts, thereby making such funds unavailable to the recipient organization for its general charitable purposes. [7] Donations earmarked for specified charitable purposes should be distinguished from donations made for general charitable purposes, where the charity may use the gift as it determines in carrying out its general charitable mission.

When a charity enters bankruptcy, an issue arises as to whether its assets, which are otherwise committed to serving the public interest and the community, should be available for payment to unpaid

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creditors who generally seek to have their claims satisfied from any assets in which the charity has an interest, often including substantial endowment funds. [8] In essence, the bankruptcy of a charity represents the clash of two policy regimes: the aim of state law to protect donor intent with respect to assets contributed to charity for the public good versus the bankruptcy law goal of maximizing assets available for distribution to satisfy the claims of creditors. [9]

Although bankruptcy law itself does not exclude charitable assets from the claims of creditors, it protects the public interest in such assets from the claims of creditors by respecting property rights that are created under the applicable state law, thereby protecting the public interest in charitable assets. Therefore, when a charity declares bankruptcy, courts "will try to identify those charitable assets that are restricted in such a manner that they survive bankruptcy." [10] Those assets so identified will be excluded from the bankruptcy estate and, accordingly, will be insulated from the claims of creditors. This issue is not only relevant when a charity emerges from bankruptcy in a Chapter 11 reorganization and continues its operations, but also when a charity is forced to cease operations and close down its doors in a Chapter 7 liquidation.

This article discusses the applicable law and the analysis applied by the courts in determining whether donor-restricted funds become part of the bankruptcy estate of a charity and are therefore treated as an available resource for the payment of creditors, or whether they will be protected from the claims of creditors and used for the charitable purposes intended by the donor. The article also addresses how donors making restricted gifts to charity can protect those funds from creditors to ensure that, even in the event that the charity files for bankruptcy, the funds will remain available for use for their intended charitable purposes, whether by the charity emerging from bankruptcy or by another charitable organization.

Nonprofit's eligibility for bankruptcy protection

Charities organized as nonprofit corporations are generally eligible to file for bankruptcy protection under Chapter 7 and Chapter 11 of the Bankruptcy Code. [11]

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- A proceeding commenced under Chapter 11 seeks to reorganize the debtor's affairs and adjust its debts while generally continuing normal operations of the business. Therefore, Chapter 11 can often be used effectively to preserve a charity facing financial difficulties as a going concern and allow for the continuation of the charitable purposes of the charity. At the heart of a Chapter 11 case is the plan of reorganization, which sets forth how the debtor proposes to repay its creditors. Debtors may use various strategies in developing a plan, such as trying to reduce payments to some creditors and spread them out over a longer period.
- In a proceeding filed under Chapter 7, a trustee is appointed to control, collect, and liquidate a

debtor's assets to satisfy creditors. A Chapter 7 bankruptcy case does not involve the filing of a plan of repayment as it does in a Chapter 11 reorganization.

The Bankruptcy Code also contains provisions that protect charities from involuntary bankruptcy petitions against the charity. The Bankruptcy Code states that involuntary cases may be commenced by creditors "only against a person, except a farmer, family farmer, or a corporation that is not a moneyed, business, or commercial corporation." [12] Thus, an involuntary petition cannot be filed against a nonprofit or charitable corporation.

The bankruptcy estate

Under the Bankruptcy Code, the commencement of a bankruptcy case proceeding results in the determination of a "bankruptcy estate," which is set aside and used to pay the claims of creditors (as well as the costs of the proceeding). The bankruptcy estate includes "all legal or equitable interests of the debtor in property as of the commencement of the case." [13] While property of a bankruptcy estate has been broadly interpreted by the courts, [14] the estate can have no rights in property greater than the rights held by the debtor. Consistent with this principle, the Bankruptcy Code specifically provides that the bankruptcy estate does not include any "[p]roperty in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest." [15] Therefore, the bankruptcy estate does not include any property in which the debtor does not hold an equitable interest. [16]

For example, although a charity may have legal title to an endowment fund, it would be excluded from its bankruptcy estate if the corpus of the fund is not available for the charity's use. The nature and extent of a debtor's interest in property is determined by reference to applicable state law which creates and defines property interests, [17] such that the legal or equitable interest of a debtor in a particular fund is generally determined by state law. [18] Therefore, although the Bankruptcy Code is a federal law, the determination of a debtor's bankruptcy estate involves the application of the controlling state law.

Exclusion of donor-restricted assets from bankruptcy estate

Donations are not considered restricted where they can be used at any time, in any manner, and for any of the charitable purposes of the charity, including a charitable

purpose it did not have at the time of the gift. [19] Therefore, an outright gift to a charity, expressly or impliedly to be used for its general purposes, becomes the property of the charity which it can use as it determines in its sole and absolute discretion in carrying out its charitable mission. Donors to charity, however, increasingly do not want to make an unrestricted contribution of money or property to a charity, but instead desire to earmark the contribution for a specified use or purpose of the charity, such as to support medical research, perhaps on a particular disease, to establish a scholarship fund in a certain field of study, to endow a chair for a professor, or for the construction of a new building to be named after the donor. [20]

Terms of restrictions. Whether donor-restricted assets held by a charity in bankruptcy will be subject to the claims of creditors depends on the terms and conditions placed on the use of the assets by the donor and the applicable state law that determines a charity's underlying property interest in the assets. Therefore, if a charity's pre-bankruptcy interest in contributed assets is restricted under state law, those same restrictions apply upon the charity entering into bankruptcy.

When a charity declares bankruptcy, courts "will try to identify those charitable assets that are restricted in such a manner that they survive the bankruptcy proceeding," [21] so that they will be excluded from the bankruptcy estate that is otherwise subject to the claims of creditors. This approach tends to treat a donor-restricted asset held by a charity as being separate and distinct from the beneficiaries of the gift, whereby the charity is considered to hold only the bare legal title to the asset but not to have a beneficial interest. [22] This would be the case, for example, where funds given to a hospital are restricted to using income to further osteopathic medicine in a specified area. While the hospital holds the legal interest in the funds, the beneficiaries are considered the people in the area. Although furthering such a purpose would benefit the hospital, the purpose is nevertheless broader than just benefitting the hospital itself. [23]

Charitable trust doctrine. The exclusion of restricted assets from a charity's bankruptcy estate, often referred to as the "charitable trust doctrine," can be a potent weapon to insulate such assets from the claims of creditors. This doctrine, therefore, offers important asset protection to those charities holding substantial endowments restricted for specific purposes or uses, in many cases consisting of hundreds of millions of dollars.

If a restricted asset is excluded from the bankruptcy estate, the restriction will have to be modified, generally through the application of *cy pres* proceeding in a separate state court, if the charity is being liquidated in a Chapter 7 proceeding or is being reorganized under Chapter 11 but the charity is no longer

able to comply with the restriction. Of course, *cy pres* can be avoided if a donor agreement or trust instrument otherwise controls the disposition of the funds in the applicable situation, thereby preempting the need for the application of *cy pres.*

Are assets sufficiently restricted?

Although a bankruptcy estate is legally separate and distinct from the debtor, it "has no rights in the property broader than the rights of the debtor." [24] As indicated above, these rights are determined under state law, which permit donors to impose restrictions on the use of their contributions, [25] which may be as broad or narrow as the donor imposes subject, of course, to the charity's acceptance of such restrictions and potential limitations under the law. [26] The restrictions may also limit the donee charity's ability to expend the principal by limiting expenditures by the charity to the annual income generated by the principal or to an annual spending rule based upon a specified percentage of the value of the principal.

Written restrictions. The restrictions may be memorialized in different types of documents, such as an *inter vivos* gift agreement, the terms under a will, an endowment fund agreement, or the provisions of a charitable trust created by the donor. Restrictions may also arise even in the absence of a written document, such as where gifts are solicited from donors based on the charity making representations regarding the specific use or purpose to which contributions will be put and the donors contribute in reliance of such representations. [27]

Implied or resulting charitable trusts. Even in the absence of a formal document creating a separate

and distinct charitable trust whose trustees have legal ownership of the trust property, an implied or resulting charitable trust will generally arise under state law where property is contributed to a charitable organization and it is directed by the terms of the gift to devote the property to one or more specified purposes for which it is organized. [28] In the resulting or implied trust situation, the charity itself is considered to be the trustee, essentially holding legal, but not equitable, title to the property. [29]

Bankruptcy Code. If a charitable trust exists for state law purposes, the Bankruptcy Code contains two important provisions that are specifically applicable to such a trust:

(1) Under Bankruptcy Code section 541(d), "[p]roperty in which the debtor holds, as of the

commencement of the case, only legal title" is not included in the debtor's bankruptcy estate "to the extent of any equitable interest in such property that the debtor does not hold." Under this provision, even where a charity owns legal title to property that is considered to be a trust, the trust funds will not be part of the charity's estate if the purpose of the trust is to benefit a particular charitable purpose, not the charity itself, and the charity has no present right to use the corpus of the trust.
(2) Bankruptcy Code section 541(c)(2), provides that 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." Under this provision, a trust enforceable under state law as a spendthrift trust is excluded from the assets of a bankruptcy estate. [30] Even where a charity is entitled to receive a distribution from a charitable trust, because the bankruptcy estate of a charity can have no greater property rights than the charity itself, funds received by the bankruptcy estate will be subject to any applicable restrictions on the use of the funds in effect prior to the bankruptcy filing.

Contributed assets not subject to donor restrictions as to specified charitable uses. Assets held by a charity that are subject to donor restrictions as to their disposition are excluded from the bankruptcy estate where the restrictions are such that prior to the commencement of the bankruptcy case, the charity would not have been permitted to use the assets for its general purposes. Although a charity that receives a charitable donation has a duty under state law to apply it to one or more of its charitable purposes for which it was organized and cannot divert the donation for other purposes, this "charitable-use restriction" is not considered to impair the charity's right to use the donation for its general purposes, including for the payment of debts incurred while performing its charitable mission. [31] Consistent with this approach, although the charitable donee is obligated to use the funds only in furtherance of its charitable purposes and may not divert the funds from such purposes, a donation for the general purposes of a charity does not create a trust with respect to those funds. [32]

In *Crossroad Health*, [33] for example, the charity received a grant subject only to a "charitable use restriction." The court held that the funds remained an asset of the charity's bankruptcy estate available to satisfy claims of creditors. The court stated that the parties had not identified, and the court did not find, any support for the proposition that a charitable trust arose from a contribution to be used for general charitable purposes.

Treatment of charitable trusts in bankruptcy

Charitable benefactors often use a charitable endowment structure to provide long-term support for a charity, in most cases in perpetuity, which provides the charitable donee with a present right to the income or a specified spending rule percentage payout from the endowment, but no right to use principal. In the case of a spending rule distribution regime, an annual payout is made each year based on a specified percentage of a weighted average of the fair market value of the endowment, similar to a unitrust payout in the case of a charitable remainder unitrust.

Existence of trust. Such endowments may arise as a result of an express charitable trust document, whereby a donor creates a separate trust independent of the charitable beneficiary, which specifies the permissible distributions to the charity by the trustee, or by a donor creating or contributing to an endowment fund that is owned and maintained by the charity that generally limits spending to the income of the fund or a spending rule payout. Even where an endowment or other gift to a charity is not in the form of an express trust created pursuant to a formal trust document, it will generally be considered to be an implied or resulting trust under state law if the surrounding facts and circumstances evidence an intention of the donor to create a trust. Therefore, a charitable trust can arise even where a gift is not a charitable trust in a technical or formal sense, [34] including, in certain circumstances, in the absence of any gift instrument or other writings evidencing an intention of the donor to create a trust. [35]

One of the leading cases in this area, *Hobbs v. Board of Education of Northern Baptist Convention*, [36] involved Grand Island College which, due to its deteriorating financial condition, was unable to continue its operations and was forced to close, "with a large indebtedness staring it in the face." The question before the court was whether a donor-created endowment held by the college for educational purposes was subject to the claims of its creditors or should be preserved for educational purposes.

Although the endowment agreement was not in the form of an express trust, the court ruled that it was "in its very nature a charitable trust," stating that "[d]onations to the endowment fund of a college, conditioned that the principal sum shall be 'invested and preserved inviolable as endowment for said college,' constitute a charitable trust." In comparing the endowment to a charitable trust, the court emphasized that the donors indicated that the gifts were to be used as an endowment for educational purposes, with the corpus to be kept intact. In reaching its decision, the court examined each gift individually to determine the donor's intent.

In *In re Parkview Hospital*, [37] the court held that a charitable trust had been created based on the particular

actions taken by the charity in soliciting gifts. Here, the charity represented to donors that gifts made to a development fund would be for the purpose of promoting osteopathic medicine in the Toledo area and that only the income of the fund would be expended, with the principal "to perpetually remain untouched." The court held that notwithstanding the absence of a formal trust, the development fund was a charitable trust. In particular, the court noted that:

(1) The purpose of the fund was to further osteopathic medicine in the Toledo area.

(2) The use of the fund was intended to be restricted for that purpose.

(3) The principal was intended to never be invaded so that only the income generated by the principal could be used to further the fund's purpose.

The court found "ample proof" that the donors consistently manifested the intent that the contributions to the development fund would be restricted for osteopathic purposes, thereby supporting the characterization of the fund as a charitable trust. [38] The court noted that the "case at bar differs from the usual charitable trust case in that the purported trust property was not donated by one settlor at one time, but rather is the accumulation of numerous donations over a period nearing twenty-five years."

In *St. Joseph's Hospital v. Bennett*, [39] the donor made a bequest to a hospital, specifying that the income from the bequest be used for "ordinary expenses of maintenance" of the hospital. The hospital sought authorization to use principal from the bequest to pay certain debt or for objects within its corporate powers other than meeting the ordinary expenses of maintenance. The Attorney General opposed the hospital on the grounds that the bequest was a gift in trust, that the intention of the testator was to create a perpetual fund, the income from which was to be used for the ordinary expenses of maintaining the hospital, and that any use of the principal or any other use of the income would be a violation of the testator's intention and of the fiduciary duties of the hospital.

The Court of Appeals of New York (the state's highest court) acknowledged that such a gift was not held in trust in a technical sense and that the charity would not be bound by all of the laws applicable to technical trustees. Notwithstanding, in ruling against the hospital, the court determined that the gift had to be used for the purposes for which it was received and, accordingly, held that the principal of the gift and its income could not

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be used to satisfy debt of the hospital or for any other purpose. [40]

Alternatives for excluding charitable trust from bankruptcy estate. In various situations, assets held by a charitable trust, including an endowment fund treated as a charitable trust under state law, may be excluded from the bankruptcy estate of a charity. As discussed further below, these include situations where:

- The charity is not considered to hold the beneficial interest in the trust, but only the bare legal title.
- There is a valid spendthrift provision.
- The charity has ceased operations and applicable state law considers the use of charitable trust funds to repay debts incurred while the charity was operational as not furthering a charitable purpose.

Exclusion of corpus of charitable trusts from bankruptcy estate of charity because charity lacks beneficial interest in trust. When a charity holds only the bare legal title to charitable trust funds but not the beneficial interest, the trust funds will be excluded from the charity's bankruptcy estate and, therefore, will not be subject to the claims of its creditors. [41] In the case of *In re Parkview Hospital*, discussed above, the court, in excluding the charitable trust from the claims of creditors, determined that the hospital had no beneficial interest in the trust, stating that:

> 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 the area. Though the furthering of such a goal would benefit the hospital the purpose is nevertheless broader than just benefitting the hospital itself.

In *In re Roman Catholic Archbishop of Portland in Oregon*, [42] the debtor charity held title to the assets of a fund that was considered to be a charitable trust. Only the income of the trust could be expended each year and the charity was only one of multiple beneficiaries of the trust, with any distributions to the charity to be used for its "operating expenses." Therefore, although the charity held the legal title to the trust funds, it did not hold the entire equitable title to the fund. Accordingly, citing Bankruptcy Code section 541(d), the court held that the trust fund was not property of the bankruptcy estate.

Exclusion of trust corpus from bankruptcy estate because of spendthrift protection. Bankruptcy Code section 541(c)(2) provides that 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." As such,

"a trust enforceable under state law as a spendthrift trust is excluded from the assets of a bankruptcy estate." [43] The application of a spendthrift provision to exclude assets from the bankruptcy estate is consistent with the nature and extent of a debtor's interest in property being determined under bankruptcy law by reference to state law. [44]

In the case of *In re St. Joseph's Hospital*, [45] a nonprofit hospital that was liquidating under Chapter 7 of the Bankruptcy Code, the court excluded from the bankruptcy estate the hospital's beneficial interest in a testamentary trust under which the income was payable to the hospital, with the principal to be kept intact. The trust contained the following spendthrift provision:

> 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.

The court rejected the argument of the trustee in bankruptcy "that the spendthrift limitations of the testator's will are ineffective to exclude the debtor's interest from property of the estate because a corporation cannot be the beneficiary of a traditional spendthrift trust." The bankruptcy trustee, while noting that spendthrift limitations are normally imposed in the case of individual beneficiaries, cited no policy or rule of law that would be violated by enforcement of spendthrift provisions involving corporate beneficiaries.

In analyzing the issue, the court stated that "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." The court noted that the testator, rather than

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specifying that trust income was to be used for charitable purposes or providing for forfeiture or reversion if funds were not so used, effectively limited the extent to which his gift could be dissipated by creditors' claims by the inclusion of spendthrift language restricting access to future income and principal of the trust. Because of the debtor's status as a charitable corporation, the testator's gift is presumed to be for a

charitable purpose, and the spendthrift provision restricting alienation and encumbrances should be upheld as tantamount to the restrictions on gifts for a charitable purpose.

Accordingly, the court held that the hospital's beneficial interest in the trust was excluded from the hospital's bankruptcy estate, stating: "While assets of a not for profit corporation are to be distributed for the payment of debts upon dissolution, the debtor's interest in future trust income and principal is not an asset of the corporation to be distributed to creditors if the applicable spendthrift provision precludes the debtor's access to it."

In the bankruptcy case involving the Philadelphia Orchestra, a grant agreement creating a $50 million endowment, which was ultimately determined not to be subject to the claims of creditors, contained a spendthrift provision intended to prevent creditors from reaching the endowment. [46] Provided state law would recognize a spendthrift clause within the body of a grant agreement, including such a clause can only help maximize the asset protection otherwise accorded an endowment fund.

Exclusion where charity has ceased operations and payments to creditors not furthering a charitable purpose. Where a charity has ceased operations and, therefore, is no longer carrying out any charitable purposes, an issue arises in regard to whether the charity is ineligible to continue to receive funds from a charitable trust if the funds will only be used to repay debts that were incurred when the charity was operational. This issue is resolved based on whether applicable state law considers the repayment of those debts to further the charitable purposes of the organization. As discussed below, the state law on this issue is not uniform.

In *Boston Regional Medical Center*, [47] a hospital "closed its doors, halted operations, and filed for bankruptcy protection." The reorganization plan was strictly a liquidating plan, whose sole purpose was to liquidate the hospital's assets and distribute the proceeds to the hospital's creditors. Unbeknown to the hospital at the time it declared bankruptcy, approximately 11 months before the hospital closed, a testamentary trust was created as a result of the death of a hospital benefactor naming three equal charitable beneficiaries, one of which was the hospital, to be used for their general purposes. The issue in this case, as framed by the First Circuit Court of Appeals, was whether the hospital, "as a corporation whose sole purpose is to marshal its assets, liquidate them, and distribute the proceeds to creditors, is eligible to receive a charitable bequest."

The court stated that the applicable state law in this case "appears to require that a donee of a charitable bequest be able and willing, at a bare minimum, to direct the funds received to charitable purposes of the

same general type and kind that it historically had performed. Failing that, the courts will appoint a trustee to effectuate the testator's charitable intent."

The court noted that the bankruptcy court believed that because the hospital incurred its debts in the furtherance of its charitable mission, the payment of those debts could be deemed charitable in nature. The court stated that this reasoning "has some superficial appeal," as it would have been impossible for the hospital to function effectively as a hospital without credit and in that sense the provision of credit was vital to its ability to discharge its charitable function. Ultimately, however, the court held that the hospital's interest in the testamentary charitable trust was not part of the bankruptcy estate, stating:

> In the usual case, however, and in a real-world sense, the payment of debts after a hospital ceases operations does not further the hospital's ability to carry out its charitable mission. For that reason, we think it would be inconsistent with [the testator's] intent for a dead-as-a-doornail hospital to receive a portion of the trust corpus with the understanding that it would be spent solely to reimburse creditors for debts previously incurred.

A similar result was reached by an appellate court in *Revis v. Ohio Chamber Ballet*, [48] where the issue before the court was whether the defunct and inactive Ohio Chamber Ballet ("Ballet") was entitled to receive income distributions from an endowment for the sole purpose of repaying debts that it incurred while it was still operating. The endowment agreement provided that the Ballet was to receive income distributions from the endowment for "the Ballet's charitable and educational activities." The appellate court, affirming the judgment of the trial court, determined that "the Ballet was ineligible for continued disbursements because it was no longer actively

engaged in the pursuit of the charitable and educational activities that prompted the endowment." [49]

Other cases have held that even where a charity ceases operations, charitable trust funds that would otherwise be distributed to the charity may be used to repay debtors of the charity in bankruptcy. In *Winstead Memorial Hospital*, [50] for example, a hospital ceased operations and subsequently filed a Chapter 7 bankruptcy petition. There were a number of funds established for the benefit of the hospital in this case, which the court examined separately to determine their inclusion in the charity's bankruptcy estate. Among the various gifts at issue was one made under a donor's will and trust instrument, which provided for the distribution at her death of a portion of her residuary estate to the hospital "to be expended

both as to income and principal as the governing board [of the hospital] may determine." This gift was therefore essentially made without restriction, subject only to the requirement that the funds be used for the hospital's general expenses or general charitable purposes.

The Attorney General [51] asserted that the hospital's interest in the gift was restricted for the charitable purposes of the hospital and that the hospital's prepetition cessation of operations made such use impossible as a matter of law, notwithstanding that the expenses to which the bankruptcy trustee sought to apply the gifts would be a proper use of the gifts if the hospital had continued to operate. The Attorney General further asserted that when a charitable organization receives a charitable gift, the effect of the state charitable use statutes is to "impose a trust for the benefit of the community to be served." Thus, the Attorney General argued that the gift, as well as similar unrestricted gifts, "did not become property of the bankruptcy estate; and that the court should ... allow the gifts to be given to alternative beneficiaries, either by the operation of any applicable 'gift over' provisions or by *cy pres* proceedings the Attorney General would commence in state court."

The bankruptcy trustee objected to the position of the Attorney General, asserting that debts incurred by the hospital while it was still providing patient care and, therefore, were within the permitted charitable purposes of the gifts. The court, in accepting the trustee's position, held that although the hospital was no longer operating, the gift funds at issue were part of the bankruptcy estate of the charity and could be applied to the payment of debts incurred for the hospital's general charitable purposes while it was operating.

In the end, therefore, the debts to which the funds could be applied in this case were limited to those for which the hospital would have been permitted to expend had the hospital continued its operations and not filed its bankruptcy petition. Thus, as noted by the trustee in bankruptcy in this case, "[a]s to those gifts which grant the Hospital the use only of income, the Trustee makes no claim to the corpus of the gift."

Although not a bankruptcy case, *Montclair National Bank and Trust Company v. Seton Hall College of Medicine*, [52] further demonstrates that an outright gift to a charity, without restrictions, may be available for the payment of creditors even after the charity has ceased operations. In this case, a portion of the residuary estate of a decedent was to be distributed as an outright gift to Seton Hall College of Medicine and Dentistry ("Seton Medical"), without the imposition of any restrictions.

The decedent died on 5/21/1963. Seton Medical was incorporated in 1954 and continued as an active institution for medical training until 5/3/1965, when it sold its assets to the New Jersey College of Medicine and Dentistry and, thereafter, ceased operations. As of 5/3/1965, Seton Medical has not yet received

the residuary share under the decedent's will. Although Seton Medical was still in existence after 5/3/1965, it was thereafter primarily concerned with the payment of its debts which were substantially in excess of the distribution it would receive under the decedent's will. Seton Medical contended that, notwithstanding the fact that it had ceased its active educational program and, "it was entitled to its residuary share of the decedent's estate because the legacy vested at the testator's death and nothing had transpired to cause a divestiture."

The trial court disagreed and decided that "the intention of the testator would be most nearly approximated if the New Jersey College of Medicine and Dentistry became the cy pres successor beneficiary of the residuary portion in question." The determination of the trial court was predicated on the fact that the decedent's estate had not been completely administered, and the distribution to Seton Medical had not been made by 5/3/1965, stating as follows:

> Seton Hall (Medical) College may be regarded as having rejected its bequest from [the decedent] when, before payment, it gave up its function as an educational institution. The significant thing is not the bare existence of any entity to receive payment but the existence of a charitable corporation or association capable of carrying on the work.

The appellate court disagreed with the assessment of the trial court stating: "We conclude, however, that the effectiveness of an outright gift to a charitable institution should not thus turn on the amount of time it takes to administer an estate." Here, the court noted that the decedent's gift was absolute-"it was made outright"-and that the charity's interest in the gift vested at the time of the decedent's death and that interest was not lost by the subsequent termination of its program.

The court then stated that the gift was intended to promote medical education of Seton Medical, but nowhere is it alleged that Seton's Medical's debts were not contracted as a result of services and expenses related to that end. The court acknowledged that the doctrine of *cy pres* can be invoked where a charity is unwilling or unable to take a gift and apply it to the purposes intended, but a charity's right to a distribution cannot be made to depend on the actual date of distribution. The court concluded by stating: "We are of the opinion that the application of the funds here involved towards the diminution of the corporate debts would have the effect of furthering testator's intended charitable and testamentary purpose, i.e., the payment of expenses incurred in teaching medicine and dentistry."

Treatment of income on restricted endowment fund or charitable trust as part of bankruptcy estate. While the corpus of a charitable trust may be excluded from the bankruptcy estate of a charity, the courts have held that, once distributed to the charity, income from the trust becomes part of the bankruptcy estate. The charity takes such income, however, subject to whatever restrictions on the use of that income are enforceable under nonbankruptcy law. [53] Therefore, if income is distributed to the debtor charity subject to conditions on the use of the income in accordance with the charitable trust, and those conditions are enforceable under nonbankruptcy law, the bankruptcy estate takes the income subject to the conditions on use. In *Roman Catholic Archbishop of Portland in Oregon*, [54] for example, although the corpus of a trust was excluded from the bankruptcy estate, the court stated:

> [P]roperty of the estate includes debtor's beneficial interest in the income from the funds, subject to whatever restrictions on use of that income are enforceable under nonbankruptcy law. Thus, if income is distributed to debtor, subject to conditions on the use of the income in accordance with the Declaration of Trust, and those conditions are enforceable under nonbankrtupcy law, the estate takes that income subject to the conditions on use.

If the income distributed to the charity is not subject to any restriction and may be used for its general uses, the income can be used for any purpose, including the payment of debts. This is true even in the case of a spendthrift trust, which affects only the beneficiary's right to obtain trust benefits in the future, so that trust payments already received by the beneficiary may be transferred to creditors or seized for the collection of creditors' claims. [55]

Special bankruptcy law protections afforded charities

Bankruptcy Code section 363(d)(1) limits the right of trustees of certain nonprofit entities to use, sell, and convey the assets of the non-profit. This section was added in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, as was a companion provision, section 541(f). [56] The purpose was "'to restrict the use, sale or lease of a non-profit entity's property except in accordance with applicable nonbankruptcy law, so that a nonprofit entity cannot escape supervision by its state's Attorney General, who is given standing to appear and be heard on this issue.'" [57] Bankruptcy Code section 541(f) provides that "property that is held by a debtor that is a corporation described in section 501(c)(3) of the Internal Revenue Code of 1986 and exempt from tax under section 501(a) of such Code may be transferred to an entity that is not such a corporation, but

only under the same conditions as would apply if the debtor had not filed a case under this title."

DAFs as part of bankruptcy estate of sponsoring organization

As a result of losing a substantial lawsuit and in the face of a $6.2 million judgment against it, the National Heritage Foundation (NHF), a Virginia-based charity sponsoring thousands of donor-advised funds (DAFs) totaling millions of dollars, filed for Chapter 11 bankruptcy protection in January 2009. [58] The plan of reorganization stated that the NHF bankruptcy estate under Bankruptcy Code section 541 includes "all assets received from Donors (including without limitation all [DAFs])," thereby, in the view of the NHF, subjecting DAFs to the claims of its creditors. In support of its position that donors having DAFs are not claimants and have no rights in connection with NHF bankruptcy, the plan of reorganization stated that the agreement to establish the DAF "clearly provides that all ownership and custody in the donated funds are relinquished to the [NHF]," "the Donors took or were entitled to claim a tax deduction ... confirming that the Donor transferred to the [NHF] full control over all interest and rights to the property," and "any rights that the Donors have with respect to [DAFs] are merely 'advisory.'"

The plan of reorganization further indicated that the assets of the NHF, "which include Assets originating from a Donor's [DAF]," may be used "for its reasonable and necessary operational and overhead costs and expenses ... including establishing sufficient reserves as it determines in its discretion." Thus, under its plan of reorganization, the DAFs maintained by the NHF, which were otherwise dedicated to making distributions to charities recommended by its donors, would, by virtue of being included in its bankruptcy estate under Bankruptcy Code section 541, be used by the NHF to satisfy claims of creditors, pay expenses, and create reserves for future operations, a clearly distressful outcome for donors having DAFs with the NHF. Ultimately, the plan of reorganization was confirmed by the bankruptcy court, [59] wiping out nearly 9,000 DAFs totaling approximately $25 million.

Notwithstanding the use of DAFs to pay creditors in the NHF case discussed above, there would still appear to be an argument that DAFs should be excluded from the bankruptcy estate of a sponsoring organization. [60] In the context of a DAF, a donor clearly gives up ownership and control of the contributed funds. The same is true, however, for a donor-restricted contribution to an endowment or charitable trust, but the relinquishment of ownership and control by a donor does not, in and of itself, mean that the funds will be included in the bankruptcy estate of the sponsoring organization and used to satisfy its creditors.

Under a DAF agreement, a contribution is subject to the donor's legal right to make nonbinding recommendations from the DAF to bona fide charities.

Although the donor's legal right is merely to make nonbinding recommendations with respect to a DAF, it is nonetheless a legal right, so that the sponsoring organization could not choose simply to ignore a donor or a donor's recommendation. To the contrary, a sponsoring organization is free to simply ignore a third-party non-donor and a recommendation made by such third party on the grounds that he or she has no right even to make a recommendation regarding distributions from a DAF, nonbinding or otherwise. The donor, however, has a clear and bona fide expectation, based on the language of the DAF agreement and the accompanying guidelines, policies, or promotional literature, that those recommendations will be honored by the sponsoring organization.

This arrangement, as specifically prescribed by the DAF agreement and related program materials, clearly contemplates that the DAFs will not be used by the sponsoring organization for its general support, including the payment of creditors, but will be restricted to making grants to other charities based only on the recommendations of its donors, subject only to the final authority of the sponsoring organization to approve or reject such

recommendations. Indeed, at least one case has held that when a supporting organization of a DAF ignores a bona fide recommendation by a donor, the organization has "breached the implied covenant of good faith and fair dealing." [61]

The only indication in a DAF agreement, or related program materials, that a DAF will ever be used for anything other than donor-recommended grants is the imposition of a fee in connection with the administration of the DAF, which the sponsoring organization generally indicates will be used for its general support. This is further evidence that a DAF is not intended to be used for the general support of the sponsoring organization, with the limited exception of administrative fees charged against the DAF. [62] A sponsoring organization of a DAF is also arguably a mere trustee of the DAF funds and the use of such funds to pay its creditors could, as a result, arguably be a breach of trust.

Protecting charitable assets from claims of creditors

When a donor is contemplating making a large donation for the benefit of a charity to be held over a long

period, consideration should be given to the impact of the charity's bankruptcy on the use of those funds and steps that might be taken to ensure their continued use for charitable purposes, rather than the loss of the funds to the claims of creditors. Maximum protection can be achieved by the donor creating an express trust with an independent trustee, which limits distributions for specified charitable purposes of the charity. Including a spendthrift provision in the trust will provide even further asset protection.

If funds are to be given directly to the charity, a written gift agreement should be used, containing appropriate restrictions and conditions on the use of the funds. [63] If the funds are sufficiently restricted for specified charitable purposes, the charitable purposes of the funds should be protected and the funds should be kept outside the bankruptcy estate of charity, notwithstanding that the legal title to the funds are held by the charity.

A charitable trust or gift agreement should also contain provisions that anticipate the possibility of the donee charity facing financial distress, closing down, declaring bankruptcy or other events that could impair the effectiveness of the charitable funds provided by the donor. Donors have enjoyed success in protecting charitable assets by using covenant-like restrictions in a grant agreement and including provisions that make the donation expressly revocable upon the deterioration of a charity's financial conditions, the charity becoming insolvent or filing for bankruptcy, the loss of its tax-exempt status, or other triggering events. [64]

In the bankruptcy case involving the Philadelphia Orchestra, for example, a private foundation made a grant to establish a $50 million endowment fund to provide the Orchestra with annual income (but not principal) for educational programming, domestic and international touring, special artistic endeavors and disseminating the Orchestra's performances through electronic media. The grant agreement included a variety of conditions which, if violated, made the grant revocable, as determined by the foundation in its sole discretion, in which case the funds would revert to the foundation. These included the insolvency of the Orchestra, failure of the Orchestra to meet it debt obligations on a current basis, and the filing of a bankruptcy petition by the Orchestra.

The grant agreement also included a spendthrift provision. The foundation intervened in the Orchestra's bankruptcy proceeding in order to protect its endowment funds, and ultimately the funds were transferred to a third-party trustee to be used for the same purposes as originally intended by the foundation and the funds were kept outside the reach of creditors. Donors can impose these and other restrictions and, upon a breach, can require the funds to be transferred to an alternative charity waiting in the wings, to be held for the charitable purposes as originally intended by the donor.

Conclusion

It is now more common than ever for charities, in the face financial distress, to file for bankruptcy protection, thereby potentially exposing to the claims of creditors contributions made by donors that were intended to be used for charitable purposes. The determination of whether the principal or income of donor-restricted assets should be included in the bankruptcy estate in the event of a charity's bankruptcy is a complex and difficult endeavor, often turning on a multitude of factors and the application of both federal and state law. When donors give substantial funds to a charity, particularly funds to be held over a long period or in perpetuity, consideration should be given to the possibility of the charity eventually ceasing operations, changing its purpose, becoming insolvent, or declaring bankruptcy. To ensure that the funds will continue to be used according to the charitable intention of the donors, rather than lost to the claims of creditors, appropriate conditions and restrictions should be imposed on any donation that will not be immediately expended by the charitable recipient of the contribution.

[1] See, e.g., Strom, "Charities Now Seek Bankruptcy Protection," N.Y. Times (2/20/2009) (stating that "experts in the field say that [charities filing for bankruptcy protection] has become more common as nonprofits have been pressured by donors to operate more like businesses."). In this same article, Diana Aviv, president and chief executive of Independent Sector, is quoted as stating: "Our expectation is that this is just the tip of the iceberg," pointing to a decline in donations and the difficulty such groups are having in getting loans. See also Hall and Kean, "Bracing for Tough Times-Many Charities Feel Vulnerable As Economy Slips," Chron. Philanthropy (2/7/2008); Wilhelm, "Some Small Groups Fail in Recession," Chron. Philanthropy (9/17/2009).

[2] In Campana and Allerding, "Health Care Insolvencies: Are Charitable Trusts to be Trusted?," 33-JUL Am. Bankr. Inst. J. 28 (July 2014), the authors stated that "*Standard & Poor's* has foreshadowed the financial hardships facing those in the nonprofit health care industry: 'The sector is at a tipping point, and increasingly organizations will find that the negative load weighing down credit quality will outstrip their ability to implement sufficiently robust positive countermeasures.'"

[3] Other recent examples of charities filing for bankruptcy include: New York's Federation and

Employment Guidance Services, Architecture for Humanity, and Liberace Foundation for Creative Performing Arts. Among the hospitals filing for bankruptcy protection in 2014 alone were the following: Archer City Nursing Center, Casa Grande Regional Medical Center, Craig General Hospital, C.W. Williams Health Care Center, Gilbert Hospital, Hutcheson Medical Center, Key Rehabilitation Company, Long Beach Medical Center, Monroe Hospital, Natchez Regional Medical Center, Nicholas County Hospital, North Adams Regional Hospital, Palm Drive Hospital Specialty Hospitals of America, St. Francis Hospital, and St. Anthony's Hospital.

[4] Bliss, 13 AFTR 615 68 F2d 890 (CA-2, 1934), *aff'd* 14 AFTR 668 293 US 144 79 L Ed 246 35-1 USTC ¶9001 1934-2 CB 191 (1934) (addressing the charitable deduction introduced into the income tax law by section 1201(2) of the War Revenue Act of 1917, the court stated that the "obvious purpose was to encourage gifts for charity, education, and science"); White v. Atkins, 13 AFTR 904 69 F2d 960 (CA-1, 1934); Estate of Sternberger, 46 AFTR 976 348 US 187 99 L Ed 246 55-1 USTC ¶11504 1955-1 CB 450 (1955); Benedict, 38 AFTR 1208 338 US 692 94 L Ed 478 50-1 USTC ¶9179 1950-1 CB 70 (1950).

[5] See Section 512 . The investment income, even if it is not unrelated business taxable income, of a charitable organization that is private foundation as defined in Section 509 is subject to a 1% or 2% excise tax imposed under Section 4940 .

[6] For articles discussing the tax consequences of placing restrictions and conditions on charitable contributions, see Fox, "Restrictions on Charitable Bequests of Art: Recent Ltr. Rul. Paints a Picture," 29 ETPL 452 (September 2002) , and Fox, "Planning for Donor Control and Other Strings Attached to Charitable Contributions," 30 ETPL 441 (September 2003) . A charity should carefully consider accepting gifts subject to restrictions to ensure that such restrictions are consistent with its mission and will not be unduly burdensome or costly. The gift of the Reves Collection to the Dallas Museum of Art, for example, required that the museum build an exact replica of a French villa owned by the donor and that the collection be displayed as it appeared in that villa. According to one newspaper article, the $6 million that the museum spent to build the villa could arguably have bought better paintings in the open market. See Sokolov, "Art: Wendy's Villa in Dallas," Wall St. J. (1/29/1986).

[7] A study commissioned by Forbes magazine and Credit Suisse found that at higher wealth levels, donors are more likely to give restricted gifts. The study found that nearly 70% of donors with $1 million to $5 million in investable assets said they preferred to give unrestricted gifts to charity, while among those donors with assets of $50 million or more, 45% said they preferred to make restricted gifts. See "Next-Generation Philanthropy: Changing the World," Forbes (September 2012) (hereinafter "Next Generation Philanthropy"); see also Blum, "Ties That Bind," Chron. Philanthropy (3/21/2002) ("More donors specify terms for their gifts to charity.").

[8] See, e.g., "College's Bankruptcy Lawyers Target Endowment Money," Wall St. J. (11/26/2012). The article notes that the "request for endowment money touched a nerve within the nonprofit community, which has struggled as much as any industry in recent years." See Weisbord, "Charitable Insolvency and Corporate Governance in Bankruptcy Reorganization," 10 Berkeley Bus. L.J. 305 (2013) ("[I]n its recent bankruptcy proceeding, the Philadelphia Orchestra protected its restricted endowment fund worth $116 million over vigorous objection by unsecured creditors.").

[9] Brody, "The Charity in Bankruptcy and Ghosts of Donors Past, Present, and Future," 29 Seton Hall Legis. J. 471, 472 (2005) (hereinafter "Brody").

[10] *Id.*

[11] 11 U.S.C. section 101 11 U.S.C. section 101 et seq. At one time, nonprofit corporations were exempt from bankruptcy proceedings, but the bankruptcy laws are now applicable to nonprofit corporations. See Bankruptcy Act of Mar. 2, 1867, ch. 176, 14 Stat. 517; Bankruptcy Act of 1947, ch. 39, 61 Stat. 652, codified at 11 U.S.C. section 303(a) (1988) 11 U.S.C. section 303(a) (1988). An involuntary petition cannot, however, be filed against a charitable corporation. 11 U.S.C. section 303(a) 11 U.S.C. section 303(a).

[12] 11 U.S.C. section 303(a) 11 U.S.C. section 303(a).

[13] 11 U.S.C. section 541(a)(1) 11 U.S.C. section 541(a)(1).

[14] See, e.g., United States v. Whiting Pools, Inc., 52 AFTR 2d 83-5121 462 US 198 76 L Ed 2d 515 83-1 USTC ¶9394 1983-2 CB 239 (1983) ("The House and Senate Reports on the Bankruptcy Code indicated that § 541(a)(1)'s scope is broad."). Section 541(a)(1) includes both tangible and intangible property, causes of action, and "all other forms of property specified in section 70a of the Bankruptcy Act." *Id.* n.9 (citing H.R. Rep. No. 95-595, at 367 (1977); S. Rep. No. 95-989, at 82 (1978), U.S. Code Cong. & Admin. News 1978, at 5868, 6323).

[15] 11 U.S.C. sections 541(b)(1) 11 U.S.C. sections 541(b)(1) and (d).

[16] 11 U.S.C. section 541(d) 11 U.S.C. section 541(d).

[17] See, e.g., Krystal Cadillac Oldsmobile GMC Truck, Inc. v. General Motors Corp., 142 F3d 631 (CA-3, 1998); Commerce Bank v. Mountain View Village, Inc., 5 F3d 34 (CA-3, 1993).

[18] See Butner v. United States, 440 US 48 59 L Ed 2d 136 (1979) (determination of property rights in assets of bankruptcy estate are governed by state law).

[19] Principles of the Law of Nonprofit Orgs. § 400 cmt. a (Tentative Draft No. 2, 2009).

[20] For a study revealing high net worth donors' preference to give restricted, rather than unrestricted, gifts to charity, see "Next Generation Philanthropy," *supra* note 7 and accompanying text.

[21] Brody, *supra* note 9.

[22] See 11 U.S.C. section 541(d) 11 U.S.C. section 541(d).

[23] In re Parkview Hospital, 211 BR 619 (Bankr. N.D. Ohio, 1997).

[24] Brody, *supra* note 9.

[25] See Butner v. United States, *supra* note 18 ("Bankruptcy Act does include provisions invalidating certain security interests as fraudulent, or as improper preferences over general creditors. Apart from these provisions, however, Congress has generally left the determination of property rights in the assets of a bankrupt's estate to state law."). Generally, under state law, donor restrictions imposed on contributions are deemed to create a charitable trust (even absent a formal trust document) to be used only for the purposes delineated by the donor. See, Carter, "Donor Restricted Charitable Gifts: A Practical Overview," 18 Estates, Trusts & Pension Journal 139 (1998-1999); see Oberly v. Kirby, 592 A2d 445 (Del. 1991) ("the organization is legally bound by specific terms of the gift"); Gary, "The Problems with Donor Intent: Interpretation, Enforcement, and Doing the Right Thing," 85 Chicago-Kent L. Rev. 977 (2010) ("The law requires charities to comply with donors' restrictions."). See also section 4(a) of the Uniform Prudent Management of Institutional Funds Act (UPMIFA), specifically indicating that the use of the "income" from an endowment fund is "[s]ubject to the intent of a donor expressed in the gift instrument").

[26] See Brody, *supra* note 9. See also Eiferman and Yerby, "Nonprofits in Trouble: Receiverships and Bankruptcy," Mass. Nonprofit Orgs., MCLE, section 22.1(h) (2nd Supp. 2004, 2nd ed. 1998) ("Nonprofits should request that their donors ... draft appropriate restrictions in the relevant gift instrument. So long as the restriction is well written and binding under relevant state law, a bankruptcy

court will likely uphold it, forbidding the [bankruptcy] trustee from using such fund to pay creditors generally."). Note that in the absence of a specified definition of income, UPMIFA controls, whereby section 4(a) of UPMIFA allows a charity to adopt a spending rule that it deems prudent after considering the donor's intent that the endowment fund continue permanently, the purposes of the fund, and relevant economic factors. UPMIFA section 4(d) creates a rebuttable presumption of imprudence for spending more than 7% of the value of an endowment fund in one year. UPMIFA has been adopted in all of the states except Pennsylvania, although states adopt their own versions of UPMIA, which may vary from state to state.

[27] See, e.g., Adler v. Save, 74 A3d 41 (App. Div. 2013). In Adler the court held that the charity could not ignore or materially modify the express purpose of a gift, where donors made a gift to a New Jersey animal shelter in return for the shelter's verbal promise to build a new facility in the Princeton area, with rooms for large dogs and older cats, and naming rights for one of the new rooms. The animal shelter (1) relocated outside of the Princeton area, (2) did not provide designated rooms for large dogs and older cats, and (3) did not give the donors naming rights. Therefore, the court held that because the charity ignored and unilaterally disregarded the donors' expressed intent, basic fairness dictated that the donation be returned to the donors. For a more detailed discussion of this case, see Fox, "Adler v. Save: New Jersey Appeals Court Requires Refund of Contribution Where Charity Unilaterally Decides Not to Honor the Donors' Originally Expressed Purpose," Steve Leimberg's Charitable Planning Newsletter (December 2014).

[28] See Hobbs v. Board of Educ. of Northern Baptist Convention, 253 NW 627 (Neb. 1934) (finding that the endowment established by a donor, with income to be used in furtherance of the general purposes of the college, was "in its very nature a charitable trust," despite the fact that the donor did not create the endowment by a formal trust agreement).

[29] In re Parkview Hospital, 211 BR 619 (Bankr. N.D. Ohio, 1997).

[30] In re St. Joseph's Hospital, 133 BR 453 (Bankr. S.D. Ill. 1991); In re Morris, 144 BR 401 (Bankr. C.D.

Ill. 1992).

[31] See In re Winsted Mem'l Hosp., 249 BR 588 (Bankr. D. Conn. 2000) (holding that donations were property of the estate, subject to the restriction that the donations were used to pay debts incurred for hospital's general charitable purposes while it was still operating).

[32] Restatement (Third) of Trusts, § 28, cmt. a (2003).

[33] 319 BR 778 (Bankr. D. D.C. 2005).

[34] See St. Joseph's Hosp. v. Bennett, 22 NE2d 305 (N.Y. 1939); Hobbs v. Board of Education of Northern Baptist Convention, 253 NW 627 (Neb. 1934).

[35] See In re Parkview Hospital, *supra* note 29, where a charitable trust was determined to exist based on solicitations by the charity upon which donors relied in making gifts and the hospital's internal treatment of the gifts.

[36] 253 NW 627 (Neb. 1934).

[37] Note 29, *supra*.

[38] The court also cited some Ohio cases where a charitable trust had been formed upon solicited donations for a specified charitable purpose.

[39] 22 NE2d 305 (1939).

[40] *Id.* ("No trust arises, it is true, in a technical sense, from such a gift for trustee and beneficiary are one. The charitable corporation is not bound by all the limitations and rules which apply to a technical trustee. It 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.").

[41] 11 U.S.C. section 541(d) 11 U.S.C. section 541(d).

[42] 345 BR 686 (Bankr. D. Ore. 2006).

[43] In re Morris, 144 BR 401 (Bankr. C.D. Ill. 1992).

[44] Safanda v. Castellano, 2015 WL 1911130 (N.D. Ill. 2015) *rev'g* In re Castellano, 514 BR 555 (Bankr. N.D. Ill. 2014), *objections sustained*2015 WL 1911130 (N.D. Ill. 2015) (upholding the shifting interest trust-where the trust shifted from a spendthrift to a discretionary trust-after determining and analyzing applicable state law).

[45] Note 30, *supra*.

[46] The clause provided: "Without limitation, no third party nor any of the Orchestra's creditors or any trustee in bankruptcy shall have any right or claim to the Funds or the proceeds or any part thereof by any purported assignments or transfer at any time."

[47] 410 F3d 100 (CA-1, 2005).

[48] 2010-Ohio-2201 2010 WL 1986430 (2010).

[49] *Id.* See In re Bishop College, 151 BR 394 (Bankr. N.D. Tex. 1993), where a college was the beneficiary of two testamentary charitable trusts, the income from the trusts was payable to the college each year, and the principal was to remain intact. The trusts did not anticipate the possibility that the college might cease operating, as there was no provision addressing the use of the trust funds if the college was no longer operating. The college, however, did cease operations and filed a Chapter 7 petition. The bankruptcy trustee made demand that the trusts be liquidated and their entire corpus and income be turned over to the bankruptcy estate for the payment of creditors. Applying Texas law, the court stated that state law relating to charitable trusts militates against the termination of the charitable trusts and that Texas courts hold charitable trusts in such high regard that the rules of construction are more liberal. The court held that the charitable trusts were excluded from the college's bankruptcy estate and that the doctrine of *cy pres* should be applied so that the charitable assets are applied to some other particular charitable purpose falling within the general intention of the settlors.

[50] 249 BR 588 (Bankr. D. Conn. 2000).

[51] Under its *parens patriae* authority, the state Attorney General acts on behalf of the public's interest in charitable assets held by nonprofit corporations and charitable trusts, and will typically monitor a charity debtor's activities in a bankruptcy case and participate in the bankruptcy proceeding as necessary.

[52] 233 A2d 195 (1967).

[53] See, e.g., In re Roman Catholic Archbishop of Portland in Oregon, 345 BR 686 (Bankr. D. Ore. 2006), where although the corpus of a trust was excluded from the bankruptcy estate, the court stated that "property of the estate includes debtor's beneficial interest in the income from the funds, subject to

whatever restrictions on use of that income are enforceable under nonbankruptcy law.

[54] *Id.* Note that in In re Bishop College, *supra* note 49, involving the liquidation of a college, neither income nor principal of a charitable trust was included in the bankruptcy estate.

[55] In re St. Joseph's Hospital, *supra* note 30.

[56] See Ky. Emps. Ret. Sys. v. Seven Cntys. Servs., Inc. (In re Seven Cntys. Servs., Inc.), 511 BR 431 (Bankr. W.D. Ky. 2014); see also In re Save Our Springs (S.O.S.) Alliance, Inc., 388 BR 202 (Bankr. W.D. Tex. 2008) (citing to 11 U.S.C. section 541(f) 11 U.S.C. section 541(f) and stating, "Thus, as with most determinations of whether or not a particular asset is property of a bankruptcy estate, state law governs the determination of the debtor's interest in the property.").

[57] Citing 3 *Collier on Bankruptcy* ¶ 363.04 (Resnick and Sommers eds., 16th ed.).

[58] See Jacobs, "Charity Bankruptcy Leaves Many Donors in Distress," N.Y. Times (11/11/2009); Blum, "National Heritage Foundation Files for Bankruptcy After Court Orders Payout," Chron. Philanthropy" (2/12/2009). In connection with its bankruptcy filing, the NHF cited a $6.2 million court judgment in connection with a charitable split-dollar life insurance case as its largest single outstanding debt and numerous charitable gift annuitants as creditors. In September 2008, the NHF was found by a Texas District Court to have changed the beneficiaries of three multi-million dollar life insurance policies from the donors' children to the NHF itself without notifying the donors of the change, an action which resulted in the $6.2 million judgment.

[59] In re National Heritage Foundation, Inc., 510 BR 526 (E.D. Va. 2014).

[60] See Fox, "National Heritage Foundation Debacle Offers Lessons About Donor-Advised Funds," Chron. Philanthropy (2/21/2010).

[61] Styles v. Friends of Fiji, District Court, Clark County, Nevada, No. 51642 (12/11/2007), *aff'd* Nev. S.Ct., No 51642 (2/8/2011).

[62] For a further discussion of these issues, see Fox, "National Heritage Foundation Debacle Offers Lessons About Donor-Advised Funds," Chron. Philanthropy (2/21/2010); Fox, "Nevada Supreme Court Lets Donor-Advised Fund Ignore Donor's Advice," 38 ETPL 9 (May 2011) .

[63] See Eiferman and Yerby, *supra* note 26.

[64] See Weisbord, "Charitable Insolvency and Corporate Governance in Bankruptcy Reorganization," 10 Berkeley Bus. L.J. 305 (2013) (discussing the Philadelphia Orchestra bankruptcy proceedings and examining the treatment in the bankruptcy estate of the $50 million grant from the Annenberg Foundation to the Philadelphia Orchestra) (citing Grant Agreement, Limited Objection of the Annenberg Foundation, Ex. A, p.1, In re Philadelphia Orchestra Ass'n, Doc. No. 478, Case No. 11-13098 (E.D. Pa. Bank. 10/13/2011)).

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Enclosure 5

Recent DAF Cases Raise Issues of Charities Facing Financial Difficulties, Estate Planning Journal, January 2010

DONOR-ADVISED FUNDS

Recent DAF Cases Raise Issues of Charities Facing Financial Difficulties

Recent cases involving donor-advised funds raise issues of first impression where the sponsoring charitable organization declares bankruptcy or uses such funds for purposes other than furthering the donor's charitable purposes.

Author: RICHARD L. FOX, ATTORNEY

RICHARD L. FOX is an attorney and partner in the Philadelphia office of the law firm of Dilworth Paxson LLP (www.dilworthlaw.com) where he heads the Philanthropic and Nonprofit practice. He concentrates his practice in the areas of charitable giving, private foundations, tax-exempt organizations, estate planning, trusts and estates, and family planning. Mr. Fox is the author of the treatise, Charitable Giving; Taxation, Planning and Strategies, a Thomson Reuters/Warren, Gorham & Lamont publication (800-950-1216). He is also a member of the editorial board of Estate Planning and a member of the Board of Advisors of the American College Chartered Advisor in Philanthropy program (www.theamericancollege.edu). This article is based on an article by the author in Steve Leimberg's Charitable Planning Newsletter #150 (9/23/2009) ("LISI," www.leimbergservices.com).

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Although donor-advised funds ("DAFs") have been in existence since the 1930s, [1] and have become one of the most popular forms of charitable giving, [2] recent cases raise issues of first impression involving these philanthropic vehicles. First, the Chapter 11 bankruptcy filing by the infamous and often controversial NationalHeritage Foundation ("NHF"), a sponsoring organization of thousands of DAFs, raises the issue of whether assets maintained in a DAF account are subject to the claims of creditors in the event of the bankruptcy of the sponsoring organization. Second, the NHF bankruptcy and a case now pending before the Nevada Supreme Court, *Styles v. Friends of Fiji ("Friends of Fiji")*, [3] raise the issue of whether a sponsoring organization facing financial difficulties or for any other reason (or for no reason at all) can, with absolute impunity, use DAFs for purposes other than making grants recommended by the donor. [4]

Because the vast majority of charities sponsoring DAFs, including the nation's approximately 700 community foundations, [5] are prudent and conservative and make their donors their number one priority, these issues are unlikely to go beyond the NHF bankruptcy and the *Friends of Fiji* case. Nevertheless, due to the recent rise in the number of charities declaring bankruptcy, [6] the increased pressure on sponsoring organizations of DAFs to meet ongoing expenses during the recent economic downturn, [7] and the increase in the variety of charities sponsoring DAFs, [8] these issues could possibly extend to other charities. This article explores the issues raised in the NHF bankruptcy and *Friends of Fiji*, where both charities have taken positions adverse to the interests of the donors, and sheds doubt on whether those positions should be ultimately upheld.

Background on NHF bankruptcy and *Friends of Fiji*

As a result of recently losing a substantial lawsuit and in the face of a $6.2 million judgment against it, the NHF, a Virginia-based charity, was forced to file for Chapter 11 bankruptcy protection in January 2009, [9] and filed a Third Amended and Restated Plan of Reorganization dated 9/4/2009. The plan of reorganization states that the NHF

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bankruptcy estate under section 541 of the Bankruptcy Code includes "all assets received from Donors (including without limitation all [DAFs])," [10] thereby, in the view of the NHF, subjecting DAFs to the claims of its creditors.

In support of its position that donors having DAFs are not claimants and have no rights in connection with the NHF bankruptcy, the plan of reorganization states that the agreement to establish the DAF "clearly

provides that all ownership and custody in the donated funds are relinquished to the [NHF]," "the Donors took or were entitled to claim a tax deduction ... confirming that the Donor transferred to the [NHF] full control over all interest and rights to the property," and "any rights that the Donors have with respect to [DAFs] are merely 'advisory'." [11] The plan of reorganization further indicates that the assets of the NHF, "which include Assets originating from a Donor's [DAF]," may be used "for its reasonable and necessary operational and overhead costs and expenses ... including establishing sufficient reserves as it determines in its discretion." [12] This is clearly a distressful outcome for donors having DAFs with the NHF. [13]

In *Friends of Fiji*, another case involving a distressful result for the donor, a Nevada nonprofit corporation based in Danville, CA, ignored the DAF agreement in its entirety. Instead of using the donor's $2.5 million contribution to make distributions to charities recommended by the donor, as contemplated under the DAF agreement, the directors of Friends of Fiji (who were also its officers), consisting of only two individuals, used the contribution as they determined in their sole discretion, including paying themselves substantial salaries, sponsoring celebrity golf tournaments at lavish resorts, transferring funds to another entity created and controlled by them, buying penny stocks, and paying in excess of $500,000 in legal fees to fight the donor who-in the end-was only trying to have his contribution to Friends of Fiji transferred to a DAF maintained at another charity.

After a two-day trial, the Nevada District Court held that Friends of Fiji had breached certain specific terms of the DAF agreement [14] and "that the failure [of Friends of Fiji] to attempt in any way to satisfy [the donor's] charitable goals is contrary to the intention and spirit of the [DAF] and thus in violation of the implied covenant of good faith and fair dealing." Despite this holding, the court awarded no remedy to the donor, thereby allowing Friends of Fiji to completely ignore the DAF agreement with impunity. The case has been appealed on the ground that a remedy should have been awarded, and is now pending before the Nevada Supreme Court.

Treatment of DAFs as part of sponsoring organization's bankruptcy estate

Treatment of restricted assets in bankruptcy. The filing of a petition for reorganization under Chapter 11 of the Bankruptcy Code creates a bankruptcy estate subject to the claims of creditors, which is composed of all property enumerated in section 541 of the Bankruptcy Code. [15] This includes "all legal or equitable interests of the debtor in property as of the commencement of the case." [16] When a charity

declares bankruptcy, courts "will try to identify those charitable assets that are restricted in such a manner that they survive the bankruptcy proceeding," [17] so that they will be excluded from the bankruptcy estate that is otherwise subject to the claims of creditors. This is the case even where the "restricted assets" do not constitute a charitable trust in a technical or formal sense. [18]

For example, in *In re Parkview Hospital*, [19] where the hospital closed shortly before it declared bankruptcy, the court stated that "Where property is given to a charitable corporation and is directed by the terms of the gift to devote the property to a particular one of its purposes, it is under a duty ... to devote the property to that purpose." The court found "ample proof" that the donors consistently manifested the intent that the contributions to a development fund would be restricted for osteopathic purposes, despite the absence of a formal trust. Accordingly, the court held that the "funds were not assets of the bankruptcy estate which can be administered for the benefit of the creditors."

One of the leading cases in this area, *Hobbs v. Board of Education of Northern Baptist Convention*, [20] involved Grand Island College which, due to its deteriorating financial condition, was unable to continue its operations and was forced to close, "with a large indebtedness staring it in the face." The question before the court was whether the donor-created endowment held by the college was subject to the claims of its creditors or should be preserved for educational purposes. Although the endowment did not technically constitute a formal trust, the court ruled that it was "in its very nature a charitable trust," and therefore not subject to the claims of creditors. In comparing the endowment to a charitable trust, the court emphasized that the donors indicated that the gifts were to be used as an endowment for educational purposes, with the corpus to be kept intact, "and the income only to be used for the general purposes of the college." Moreover, the court noted that "the intent of the contributors to the endowment fund was clearly to preserve it from mistakes and mismanagement of the trustees" of the college. Hence, in the court's view, the endowment was sufficiently restricted for educational purposes so that, in the face of the bankruptcy of the college, the endowment was not to be used to pay its creditors, but was to be preserved for educational purposes.

Interestingly, the court distinguished cases where a charity is given "absolute control" over a contribution, where the contribution may be used for its general charitable purposes, as opposed to a contribution made for restricted purposes. In the latter situation, although the charity has legal title to the contribution and control over the funds, as a result of the restriction placed on the contribution, the court indicated that it does not have "absolute control" over the funds and cannot use the contribution for its general purposes. Consequently, cases such as *Parkview Hospital* and *Hobbs,* where assets were protected from the claims of creditors, must be distinguished from cases where contributions are made for the general support of a

charity, in which case the charity has "absolute control" over the contributed funds, thereby subjecting the contributed assets to the claims of creditors.

Winstead Hospital, [21] for example, involved amounts held as an endowment under testamentary gifts by a closed hospital in bankruptcy. The gifts allowed the use of both principal and income for the general purposes of the hospital and so, in essence, provided "absolute control" of the funds to the hospital. The court denied the application of cy pres [22] to the endowment, holding that although the hospital was no longer operating, the endowment was nevertheless part of the debtor's estate because it was provided for the general purposes of the hospital, not for any particular purpose. Consequently, the court held that the endowment funds were part of the hospital's bankruptcy estate and could be used to pay creditors.

Impact of bankruptcy of sponsoring organizations on DAFs. As discussed earlier, the position of the NHF is that its DAFs are part of its bankruptcy estate and are subject to the claims of its creditors. [23] This is an issue that has never been

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addressed by the courts, but, ultimately, a court will have to determine whether the NHF's position is correct. This determination will rest upon whether a DAF is considered to be sufficiently restricted for a particular purpose so as to exclude it from the NHF bankruptcy estate.

For tax purposes, a DAF must be "owned and controlled" by the sponsoring organization and the donor may retain only "advisory privileges" with respect to the distribution of amounts held in the fund. [24] No charitable income tax deduction is allowed for a contribution to a DAF unless the donor obtains a contemporaneous written acknowledgement stating that the sponsoring organization "has exclusive legal control over the assets contributed." [25] Under the typical DAF agreement, the donor has the right to make nonbinding recommendations regarding distributions to other charities from the DAF, which the sponsoring organization has the final authority to approve or reject. [26] In some cases, the DAF agreement may also state that the contribution to establish the DAF is "unconditional" and "unrestricted."

It would appear, however, that despite the requisite exclusive ownership and control of a DAF by a sponsoring organization, the retention of mere advisory privileges by a donor, and even the existence of specific language indicating that the contribution is unconditional and unrestricted, a DAF should-contrary to the position of the NHF-be considered sufficiently restricted for a particular purpose so as to be excluded from the sponsoring organization's bankruptcy estate and the claims of its creditors. The fact that the sponsoring organization has exclusive ownership and control of the DAF should not cause the DAF to

be available for its general use, as such ownership and control is wholly consistent with every restricted fund maintained by a charity, including an endowment restricted for specific purposes where, although the charity owns and controls the endowment, it does not have "absolute control" in that the endowment must be used only for the purposes determined by the donor at the time of the contribution. [27]

Indeed, in cases holding that restricted funds are not part of a charity's bankruptcy estate, the funds were, in fact, under the exclusive control and ownership of the charity, rather than being controlled and owned, for example, by a third-party trustee. Further, the requirement that a DAF be "owned and controlled" by the sponsoring organization is not intended to allow the unfettered use of a DAF by the sponsoring organization for its general support or otherwise, but is aimed only at ensuring that a sponsoring organization is in a position to make certain that a grant recommendation by a donor is for bona fide charitable purposes. [28]

Under a DAF agreement, a contribution is clearly subject to the donor's legal right to make nonbinding recommendations from the DAF to bona fide charities. [29] There is a clear and bona fide expectation of the donor, based on the language of the DAF agreement and the accompanying guidelines, policies or promotional literature, that those recommendations will be honored by the sponsoring organization, even in the face of language indicating that the contribution is "unconditional" and "unrestricted." Further,

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in the typical DAF program, the sponsoring organization maintains a separate DAF account for each donor, which is identified by reference to the donor, reflects the balance available for distributions to charity, and indicates the income earned by the fund. Actual distributions to charities recommended by the donor are specifically identified as coming from the donor's DAF, and donors regularly receive reports reflecting the financial activity in their DAFs. This arrangement, as specifically prescribed by the DAF agreement and related program materials, clearly contemplates that DAFs will be not be used by the sponsoring organization for its general support, but will be restricted to making grants to other charities based on the recommendations of its donors, subject only to the final authority of the sponsoring organization to approve or reject such recommendations.

The only indication in the agreement establishing a DAF, or the related program materials, that a DAF will ever be used for anything other than donor-recommended grants is the imposition of a fee in connection with the administration of the DAF, which the sponsoring organization generally indicates will be used for its general support. [30] This is further evidence that a DAF is not intended to be used for the general support of the sponsoring organization, with the limited exception of administrative fees charged against the DAF.

Moreover, based on the pre-Pension Protection Act of 2006 DAF legal jurisprudence, the most that the "unconditional" or "unrestricted" language contained in any DAF agreement should mean is that there are no conditions or restrictions placed on the contribution that would prevent the DAF from being used in a manner consistent with the charitable purposes of the sponsoring organization's DAF program. [31] Even in the face of "unconditional" or "unrestricted" language within the body of a DAF agreement, therefore, a contribution by a donor to establish a DAF is clearly not intended to be used for the general support of the sponsoring organization. Rather, a DAF should be viewed as a restricted fund limited to being used only in connection with a sponsoring organization's DAF program. [32]

Moreover, consistent with restricted charitable funds that have been excluded from the claims of creditors in bankruptcy cases, it would clearly appear that the intent of donors in establishing DAFs is that the funds should be protected from the "mistakes and mismanagement" of the trustees of the sponsoring organization, so that, for example, the DAF accounts maintained by the NHF should not bear the economic burden caused by the actions of the board of directors that forced the NHF into bankruptcy. Lending further support to the restricted nature of a DAF is the recent holding in *Friends of Fiji.* There, despite language in the DAF that the contribution was "an unrestricted gift" to be used to further Friends of Fiji's charitable purposes, that Friends of Fiji had "complete ownership" of the contribution, and that Friends of Fiji had the "ultimate control, authority, and discretion" with respect to the contribution, the Nevada trial court determined that, in accordance with the "spirit and intention" of the DAF agreement, Friends of Fiji had an implied duty of good faith and fair dealing to use the donor's DAF account to further his charitable purposes and that such duty was breached where the charity

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failed to use the DAF to further such purposes.

In the end, therefore, because the clear intent is that a DAF should be limited to making grants to other charitable organizations in furtherance of the sponsoring organization's DAF program, rather than for its general support, a DAF should not be part of the bankruptcy estate of the sponsoring organization and should not be subject to the claims of its creditors. Thus, given NHF's bankruptcy, as a result of which it is apparently unable to continue to administer its DAFs in accordance with the intent of its donors, the doctrine of cy pres should be invoked, whereby the full amount of each of its DAFs should be transferred to another charity which can administer the DAFs in accordance with the intent of its donors. [33]

Use of DAFs other than based on donor recommendations

In its plan of reorganization, the NHF stated that funds in its DAF accounts may be used "for its reasonable and necessary operational and overhead costs and expenses (including establishing sufficient reserves as it determines in its discretion)," in which case the DAFs would be used other than for grants recommended by donors and such funds would, accordingly, be depleted. Similarly, in *Friends of Fiji,* the charity used the donor's DAF account solely for the purposes determined by its directors, without regard to the DAF agreement or any donor recommendation. Although the Nevada trial court found that this amounted to a breach of an implied covenant of good faith and fair dealing, no remedy was provided to the donor, an issue currently on appeal before the Nevada Supreme Court.

Based on the treatment of a DAF as a restricted fund, it would appear that a sponsoring organization is not free to use DAF money for its own general support, but must restrict the use of such funds to making distributions to charities based on nonbinding donor recommendations, subject only to the sponsoring organization charging fees for its administration of its DAFs. This should be the case whether the sponsoring organization declares bankruptcy, runs into financial trouble, or even decides to shut down its DAF program.

Interestingly, in *Friends of Fiji*, the charity asserted that it was free to use the DAF account as it pleased (which it certainly did) because, under the terms of the DAF agreement, it had control over the DAF account and, in exercising such control, was free, without limitation, to reject any donor recommendation and could, therefore, use the DAF account solely as it determined. This position, however, is contrary to a multitude of cases in which the courts have held that even where a party to a contract has control over a particular aspect of the contract, such control must be exercised in good faith and, in the absence of the exercise of such good faith, a remedy should be provided. [34] Accordingly, despite Friends of Fiji's control of the contributed funds, it should not be permitted to exercise such control in a way that wrongfully and deliberately takes unfair advantage of its donor. Instead, it should be required to exercise its control in good faith, so as to be faithful to the purpose of the DAF agreement in a manner reasonably contemplated by the parties. And, what was contemplated by the parties was clearly spelled out in the DAF agreement, which was to use the donor's contribution to make distributions to other charities based on recommendations made by the donor.

Conclusion

The recent cases involving DAFs raise issues regarding the potential vulnerability of DAFs in situations where a sponsoring organization of DAFs declares bankruptcy, encounters financial difficulty, shuts down

its DAF program, or, even worse, simply seeks to take advantage of a donor. Although the positions taken by the charities in these cases, which are adverse to the interests of the donors, appear to be misplaced, these cases highlight the need for a donor considering establishing a DAF to know the prospective donee charity, its board of directors, its financial status, its investment policy and strategy, the nature of its activities, its DAF program history, and its reputation for dealing with donors.

PRACTICE NOTES

Although the adverse treatment of donors in these recent cases is questionable, the cases highlight the importance of a donor knowing the prospective donee charity, its board of directors, it program history, the nature of its activities, and its reputation for dealing with donors.

[1] IRS "Donor-Advised Funds Guide Sheet Explanation" (7/31/2008).

[2] In recent years, DAFs have been remarkably successful and the funds in the nation's DAFs have grown by the billions. See "A Surge in Assets," Chronicle of Philanthropy (5/3/2007). In a Chronicle of Philanthropy article entitled "Dwindling Reserves" (8/20/2009), assets in the nation's largest DAFs were reported to be $22.3 billion in 2008, slightly below the $23.7-billion level in 2007.

[3] District Court, Clark County, Nevada, No. 51642 (12/11/2007). As a matter of full disclosure, this author became professionally involved in the *Friends of Fiji* case when the plaintiff sought out his legal advice in December 2006 after reading an article by this author, entitled "Planning for Donor Control and Other Strings Attached to Charitable Contributions," 30 ETPL 441 (Sept. 2003) , later reprinted by the Nevada Lawyer in July 2004. This author had no involvement in the planning for the plaintiff's contribution to Friends of Fiji which occurred in 2002.

[4] A sponsoring organization declaring bankruptcy or using DAF funds other than based on donor recommendations would, of course, create a public relations nightmare and presumably put the charity out of the DAF business. See, e.g., McRay, "An Obituary for NationalHeritage Foundation?," Forbes (2/3/2009).

[5] "Key Facts on Community Foundations," Foundation Center (Sept. 2007).

[6] See Strom, "Charities Now Seek Bankruptcy Protection," New York Times (2/20/2009). See also Hall and Kean, "Bracing for Tough Times-Many Charities Feel Vulnerable as Economy Slips," Chronicle of Philanthropy (2/7/2008); Wilhelm, "Some Small Groups Fail in Recession," Chronicle of Philanthropy (9/17/2009).

[7] See "Dwindling Reserves-Declines in New Gifts Serve as Bleak Omens for Donor-Advised Funds in 2009," Chronicle of Philanthropy (8/20/2009).

[8] A publication issued in November 2008 by the National Philanthropic Trust, entitled "[DAF] Market," states: "A variety of organizations sponsor [DAFs]. These include national programs, which are made up of public charities ... and commercially-sponsored charities which are created by financial service firms. In addition, community foundations, faith-based institutions, universities and others sponsor donor advised funds."

[9] See Blum, "NationalHeritage Foundation Files for Bankruptcy After Court Orders Payout," Chronicle of Philanthropy" (2/12/2009).

[10] NHF's Third Amended and Restated Disclosure Statement, dated 9/4/2009, Article II, Par. 2.11, p. 3.

[11] *Id.*, at Article VI, Par. 6.1, p. 14.

[12] *Id.*

[13] In a letter dated 1/27/2009, the NHF advised its donors that "until the reorganization plan is established and approved, we cannot make any new disbursements from our foundation accounts until further notice," another distressing development for donors.

[14] See *supra* note 3, for the Nevada District Court's Findings of Fact and Conclusions of Law, describing the specific breaches of the DAF agreement.

[15] 11 U.S.C. §541 11 U.S.C. §541. Section 541 of the Bankruptcy Code Section 541 of the Bankruptcy Code, which defines the scope of "debtor's estate," limits the estate to property held by a debtor at the time the bankruptcy petition is filed. The nature and extent of a charity's interest in property, including property held for the benefit of the charity, such as a trust or endowment, is determined by reference to state law which creates and defines property interests. See, e.g. Krystal Cadillac Oldsmobile GMC Truck, Inc. v. General Motors Corp., 142 F3d 631 (CA-3, 1998); Commerce Bank v. Mountain View Village, Inc., 5 F3d 34 (CA-3,1993). Thus, although the Bankruptcy Code is a federal law, the determination of a debtor's estate typically involves the application of state law. Stephen Smith Home for the Aged, Inc. v. Mercy Douglass Center, Inc. 80 BR 678 (ED Pa., 1987).

[16] 11 U.S.C. §541(a)(1) 11 U.S.C. §541(a)(1).

[17] Brody (Chicago-Kent College of Law), "The Charity in Bankruptcy and Ghosts of Donors Past, Present, and Future," 29 Seton Hall Legislative J. 471 (2005). This article analyzes cases involving bankrupt charities and dealing with the issue of whether assets held by the charities are sufficiently restricted as to be excluded from the bankruptcy estate. See also Eiferman and Yerby, "Nonprofits in Trouble: Receiverships and Bankruptcy," Massachusetts Nonprofit Organizations, MCLE (2nd Supp 2004, 2nd Ed. 1998), section 22.1(h), where the authors observe: "Nonprofits should request that their donors ... draft appropriate restrictions in the relevant gift instrument. So long as the restriction is well written and binding under relevant state law, a bankruptcy court will likely uphold it, forbidding the

[bankruptcy] trustee from using such fund to pay creditors generally."

[18] *Id*. See also St. Joseph's Hosp. v. Bennett, 22 NE2d 305 (N.Y., 1930); Hobbs v. Board of Education of Northern Baptist Convention, 253 NW 627 (Neb., 1934).

[19] 211 BR 619 (Bankr. ND Ohio, 1997).

[20] 253 NW 627 (Neb., 1934).

[21] 249 B.R. 588 (U.S. Bkrtcy Ct. Conn., 2000).

[22] The term "cy pres" refers to the power that courts have to carry out a donor's intention as nearly as possible, when the donor's original intention becomes impossible to accomplish.

[23] According to the Third Amended and Restated NHF Disclosure Statement dated 9/4/2009, a number of donors, presumably those having previously established DAFs, have filed claims against the NHF bankruptcy estate (for approximately $11.4 million), which the [NHF] believes are not valid claims. Article II, p. 3. Footnote 7 of the disclosure statement provides that "Claims vary from certain Donors demanding return of donated funds to other Donors demanding that the [NHF] use their funds to make charitable donations."

[24] Section 4966(d)(2)(A) .

[25] Section 170(f)(18) . For more information on the tax treatment of DAFs, see Fox, "Charitable Provisions of the Pension Protection Act - Part 2," 33 ETPL 3 (Dec. 2006) . See also Fox, *Charitable*

Giving: Taxation, Planning, and Strategies, Chapter 31 (Second Edition Thomson Reuters/Warren, Gorham & Lamont 2009).

[26] See IRS "Donor-Advised Fund Guide Sheet Explanation," Part II, 6d (7/31/2008).

[27] The imposition of a restriction on a fund at the time of the contribution that is consistent with the tax-exempt purposes of the donee charity is quite common and does not affect the availability of an income tax charitable contribution deduction. See Fox, "Planning for Donor Control...," supra note 3.

[28] In Nat'l Foundation, Inc., 60 AFTR 2d 87-5926 13 Cl Ct 486 87-2 USTC ¶9602 (1987), the court held that an organization that raised funds and distributed funds to other charities and administered a wide variety of charitable projects, mostly recommended by its donors, qualified for exemption under Section 501(c)(3) . This holding is in contrast to New Dynamics Foundation, 97 AFTR 2d 2006-2134 70 Fed Cl 782 2006-1 USTC ¶50286 (2006), where the court determined that New Dynamics Foundation did not qualify for exemption because it permitted donors to use funds to serve their private interests. See also IRS "Donor-Advised Fund Guide Sheet Explanation," Part II, 6b (7/31/2008) (regarding the question of whether the sponsoring organization reviews all donor recommendations for distributions).

[29] Although the donor's legal right is merely to make nonbinding recommendations with respect to a DAF, it is a legal right, so that the sponsoring organization could not choose to ignore a donor or a donor's recommendation. To the contrary, sponsoring organizations would be free simply to ignore a third-party nondonor and a recommendation made by such third party on the grounds that he or she has no right even to make a recommendation regarding distributions from a DAF, nonbinding or otherwise.

[30] For example, the current information provided by the NHF (at www.nhf.org/costs.html) states that an administrative fee of 2.5% is charged on donations. There is also mention of other "Occasional Fees." By setting forth these fees, the clear indication is that the DAF will be restricted to grant recommendations made by donors, with the NHF being able to use only the administration fees for its

general purposes. Other sponsoring organizations of DAFs similarly indicate that other than the administrative fee, the DAF will be used only for charitable grants recommended by the donor. See, e.g., The Vanguard Charitable Endowment Program, www.vanguardcharitable.org.

[31] Prior to the Pension Protection Act of 2006 actually providing a definition of a DAF under Section 4966(d)(2) , the IRS, in determining whether a sponsoring organization of a DAF qualified for public charity treatment, relied on the rules applicable to community foundations under Reg. 1.170A-9(f)(11) . Under these rules, a contribution by the donor could not be subject to any "material restriction or condition (within the meaning of §1.507-2(a)(8))." Under Reg. 1.507-2(a)(8), the material restriction or condition applies only to one that prevents the organization "from freely and effectively employing the transferred assets, or the income derived therefrom, in furtherance of its exempt purposes." Thus, treating a DAF as a fund that is restricted to or conditioned upon being used solely to make grants to bona fide charities recommended by a donor would not be considered to create a "material restriction or condition" under these rules, as the purpose of the DAF program is to make grants to other charities. It was only because of this rule that certain DAF agreements provided specific language indicating that the contribution be "unrestricted" or "unconditional." This language was never intended, and should be not be relied upon, therefore, to permit the sponsoring organization to use a DAF for its general support.

[32] This conclusion is consistent with a report by the Joint Committee on Taxation, stating, with respect to DAFs, that "[s]ome charitable organizations (including community foundations) establish accounts to which donors may contribute and thereafter provide nonbinding advice or recommendations with regard to distributions from the fund or the investment of assets in the fund." Technical Explanation of H.R. 4, "Pension Protection Act of 2006," p. 340 (8/3/06). See also the IRS "Donor-Advised Fund Guide Sheet Explanation," Part II, 6a (7/31/2008).

[33] Although a donor's DAF would no longer be administered at the NHF, as originally contemplated by the donor, it would be administered at another charity, thereby carrying out the donor's intent as nearly as possible.

[34] It has been specifically recognized that contract damages are available where the party to a contract who has discretionary control over certain aspects of the contract wrongfully and deliberately takes advantage of the other dependent party. See Cal. Lettuce Growers v. Union Sugar Co, 289 P2d 785 (1955). Where one of the contracting parties is in a position either to approve or disapprove a request made by the other contracting party pursuant to the contract, "in deciding whether to exercise its approval or disapproval," the controlling party is "required to do so within the parameters of good faith." Mattel v. Hopper, 330 P2d 625 (1958); Rodriguez v. Barnett, 338 P2d 907 (1959).

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Enclosure 6

Nevada Supreme Court Lets Donor-Advised Fund Ignore Donor's Advice, Estate Planning, May 2011

DONOR-ADVISED FUNDS

Nevada Supreme Court Lets Donor-Advised Fund Ignore Donor's Advice

In addressing an issue of first impression, the Nevada Supreme Court held that a charity could ignore all donor recommendations and use donor-advised funds as its directors determined with absolute impunity.

Author: RICHARD L. FOX, ATTORNEY

RICHARD L. FOX, LL.M. (Taxation), is a partner in the Philadelphia office of the law firm of Dilworth Paxson LLP (www.dilworthlaw.com) where he heads the Philanthropic and Nonprofit practice. Mr. Fox is also the author of the treatise, Charitable Giving: Taxation, Planning and Strategies (Thomson Reuters/WG&L) and a member of the editorial board of Estate Planning.

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A recent decision by the Nevada Supreme Court is the first to address the issue as to what rights, if any, a donor has when the sponsoring charity of donor-advised funds uses the funds other than based on the donor's recommendations. Although it determined that the charity in this case breached its duty of good faith and fair dealing by totally ignoring the donor's recommendations and using donor-advised funds only as its directors determined, the Nevada Supreme Court held that the donor was not entitled to any remedy because he had given up control over his contribution for tax purposes under a standard form of

donor-advised fund agreement. In the end, therefore, the directors of the sponsoring organization were allowed to use the donor-advised funds solely as they determined, which included paying themselves substantial compensation, paying legal fees to fight the donor, and sponsoring celebrity golf tournaments at lavish resorts, all with absolute impunity.

Background

In *Styles v. Friends of Fiji*, [1] a donor established a $2.5 million donor-advised fund with a charity known as Friends of Fiji (FOF), a Nevada nonprofit corporation based in Danville, California, pursuant to a standard form of donor-advised fund agreement. [2] Rather than approving the donor's recommendations for funds to be distributed from his donor-advised fund to various bona fide charities, including a recommended distribution to the William J. Clinton Foundation to support its Haiti relief efforts, FOF refused to distribute the donor-advised funds to any charity recommended by the donor. Instead, the two directors of the organization used such funds for their own purposes, which included paying themselves over $600,000 in compensation, expending approximately $500,000 in legal fees to fight the donor himself over the use of the funds, sponsoring celebrity golf tournaments at a lavish resort, transferring hundreds of thousands of dollars to another entity created and controlled by them, and buying penny stocks.

After a two-day trial, the Nevada District Court held that FOF breached certain specific terms of the donor-advised fund agreement and, moreover, "that the failure [of FOF] to attempt in any way to satisfy [the donor's] charitable goals is contrary to the intention and spirit of the [donor-advised fund] agreement and thus in violation of the implied covenant of good faith and fair dealing." Among the specific

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breaches of the donor-advised fund agreement, as determined by the Nevada District Court in its Findings of Fact and Conclusions of Law dated 12/11/2007, were the following:

(1) FOF failed to provide quarterly reports.

(2) FOF failed to disseminate fund reports, special mailings, annual reports, information on special events, or have any personal contact with the donor.

(3) FOF used the donor's contribution "for charitable purposes unrelated to those recommended by [the donor] and without consulting [the donor]."

(4) Although the donor-advised fund agreement required FOF to take all actions that were

> necessary to maintain its public charity status, "Friends of Fiji decided not to take those actions and instead the IRS determined that it was a private foundation."

Notwithstanding the determination that FOF had, in essence, acted badly, on the basis of the donor giving up all control over the funds for tax purposes, the trial court refused to award any remedy to the donor, thereby allowing FOF to ignore completely the donor-advised fund agreement and all donor recommendations with absolute impunity. The *Friends of Fiji* case was appealed to the Nevada Supreme Court on the basis that a remedy should have been awarded to the donor in the form of FOF transferring funds to another charity to create a $2.5 million donor-advised fund for the donor, which is all that the donor had originally sought when he initially contributed funds to FOF pursuant to a donor-advised fund agreement.

Nevada Supreme Court affirms

Although the Nevada Supreme Court recognized that the trial court "determined that FOF failed to attempt in any way to satisfy Styles' charitable goals, and thus that it breached the implied covenant of good faith and fair dealing, it concluded that Styles failed to prove damages and that his claim failed." [3] In its decision, which came more than three years following the trial court determination, the Nevada Supreme Court stated that "the district court properly determined in accordance with the [donor-advised fund's] express terms that Styles gave up any interest in the money when he made the unrestricted gift to FOF, allowing FOF the discretion to reject any of his recommendations for the donation's use."

The court emphasized that Styles' intent to give up all control over the donor-advised funds was shown by his claiming a charitable income tax deduction, with the court citing case law holding that a charitable income tax deduction requires the surrendering of all control. The court stated that "while damages may be awarded when a party breaches the implied covenant of good faith and fair dealing, here, the district court, after reviewing the testimony and evidence, including the donor-advised fund agreement, concluded that Styles suffered no damages because once he made the unrestricted gift, he no longer had any interest in or control over the donation. That conclusion is legally sound and supported by substantial evidence." Thus, despite determining that FOF acted in bad faith by ignoring the donor's recommendations and the donor-advised fund agreement, the Nevada Supreme Court held that the directors of FOF were allowed to use the donor-advised funds solely as they determined without regard to any donor recommendations, all with absolute impunity.

Effect of decision

Because the vast majority of charities sponsoring donor-advised funds, including the nation's approximately 700 community foundations, are prudent and conservative and make their donors their number one priority, the issue raised in *Friends of Fiji* is clearly not a widespread problem, and the *Friends of Fiji* case should be considered an outlier. But, it is a case of first impression and shows, at least in the opinion of one state supreme court, that donor-advised funds can be used by the sponsoring charity wholly without regarding to donor recommendations and for purposes determined solely by the charity's directors.

This case, therefore, raises an issue regarding the potential vulnerability of donor-advised funds in situations where a sponsoring organization of donor-advised funds declares bankruptcy,[4] encounters financial difficulty, shuts down its donor-advised fund program, or,

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even worse, simply seeks to take advantage of a donor. Thus, donors should at least be aware of the potential risk they take when entrusting their money to an organization that offers donor-advised funds, and charities that oversee such funds should be prepared to answer questions in light of the *Friends of Fiji* decision. Moreover, the *Friends of Fiji* case highlights the need for a donor considering establishing a donor-advised fund to know:

- The prospective donee charity.
- Its board of directors.
- Its financial status.
- Its investment policy and strategy.
- The nature of its activities.
- Its donor-advised fund program history.
- Its reputation for dealing with donors.

Was court's reliance on "control" for tax purposes correct?

The Nevada Supreme Court based its conclusion on the donor giving up control for tax purposes, yet the premise that "control" for tax purposes should have been the determining factor is questionable. A donor

who creates an endowment at a university, for example, clearly gives up control of those funds for tax purposes, but that does not mean that the university can use the money for whatever purpose it wants. Indeed, the agreement as to the contribution's specific use in furtherance of the charity's purposes must be respected. Similarly, in every case where a restricted contribution to a charity is made for a particular purpose, the donor gives up control of the contributed funds; that likewise does not mean the charity can simply use the contribution for whatever purposes it chooses. It must abide by the restriction imposed by the donor. Thus, just because a donor gives up control of contributed funds for tax purposes does not mean the contribution cannot be restricted for a certain purpose with respect to which the charity must abide.[5]

In the context of a donor-advised fund, the donor clearly gives up control, just as with an endowment or a restricted contribution. Indeed, for tax purposes, a donor-advised fund must be "owned and controlled" by the sponsoring organization, and the donor may retain only "advisory privileges" with respect to the distribution of amounts held in the fund.[6] Furthermore, no charitable income tax deduction is allowed for a contribution to a donor-advised fund unless the donor obtains a contemporaneous written acknowledgement stating that the sponsoring organization "has exclusive legal control over the assets contributed."[7] It would appear, however, that despite the requisite exclusive ownership and control of a donor-advised fund by a sponsoring organization and notwithstanding the decision of the Nevada Supreme Court, a donor-advised fund should be considered sufficiently restricted for the particular purpose of distributing funds to other charities based on only donor recommendations and should not, therefore, be available for use as the directors of the sponsoring organization determine.

Under a donor-advised fund agreement, a contribution is clearly subject to the donor's legal right to make nonbinding recommendations from the donor-advised fund to bona fide charities. Although the donor's legal right is merely to make nonbinding recommendations with respect to a donor-advised fund, it is a legal right, so that the sponsoring organization could not choose to ignore a donor or a donor's recommendation. To the contrary, sponsoring organizations would be free simply to ignore a third-party nondonor and a recommendation made by such third party on the grounds that he or she has no right even to make a recommendation regarding distributions from a donor-advised fund, nonbinding or otherwise.

The donor, however, has a clear and bona fide expectation, based on the language of the donor-advised

fund agreement and the accompanying guidelines, policies, or promotional literature, that those recommendations will be honored by the sponsoring organization. This arrangement, as specifically

prescribed by the donor-advised fund agreement and related program materials, clearly contemplates that donor-advised funds will not be used by the sponsoring organization for its general support, but will be restricted to making grants to other charities based only on the recommendations of its donors, subject only to the final authority of the sponsoring organization to approve or reject such recommendations.

The only indication in the agreement establishing a donor-advised fund, or the related program materials, that a donor-advised fund will ever be used for anything other than donor-recommended grants is the imposition of a fee in connection with the administration of the donor-advised fund, which the sponsoring organization generally indicates will be used for its general support. This is further evidence that a donor-advised fund is not intended to be used for the general support of the sponsoring organization, with the limited exception of administrative fees charged against the donor-advised fund. Moreover, based on the pre-Pension Protection Act of 2006 donor-advised fund legal jurisprudence, the most that any "unconditional" or "unrestricted" language contained in any donor-advised fund agreement should mean is that no conditions or restrictions may be placed on the contribution that would prevent the donor-advised fund from being used in a manner consistent with the charitable purposes of the sponsoring organization's donor-advised fund program.

Prior to the Pension Protection Act of 2006 actually providing a definition of a donor-advised fund under Section 4966(d)(2) , the IRS, in determining whether a sponsoring organization of a donor-advised fund qualified for public charity treatment, relied on the rules applicable to community foundations under Reg. 1.170A-9(f)(11) . Under these rules, a contribution by the donor could not be subject to any "material restriction or condition (within the meaning of §1.507-2(a)(8))." Under Reg. 1.507-2(a)(8), the material restriction or condition applies only to one that prevents the organization "from freely and effectively employing the transferred assets, or the income derived therefrom, in furtherance of its exempt purposes." Thus, treating a donor-advised fund as a fund that is restricted to or conditioned on being used solely to make grants to bona fide charities recommended by a donor would not be considered to create a "material restriction or condition" under these rules, as the purpose of the donor-advised fund program is to make grants to other charities in furtherance of the sponsoring organization's tax-exempt purposes. It was only because of this rule that certain donor-advised fund agreements provided specific language indicating that the contribution be "unrestricted" or "unconditional." This language was never intended, and should be not be relied on, therefore, to permit the sponsoring organization to use a donor-advised fund for its general support.

Consequently, even in the face of "unconditional" or "unrestricted" language within the body of a donor-advised fund agreement, a contribution by a donor to establish a donor-advised fund is clearly not

intended to be used for the general support of the sponsoring organization or as determined by its directors. Instead, it is intended to be used based solely on donor recommendations, subject only to the final authority of the sponsoring organization to approve or reject such recommendations so as to ensure that the distribution from the donor-advised fund will be used for proper charitable purposes.

Conclusion

Although the conclusion reached by the Nevada Supreme Court in *Friends of Fiji* may be subject to debate, it is the only case that has addressed the issue as to what rights, if any, a donor has when the sponsoring charity of donor-advised funds uses the funds other than based on the donor's recommendations. The answer, according to the Nevada Supreme Court, is that the donor has absolutely no rights in this context. Thus, donors should at least be aware of the potential risk they take when entrusting their money to an organization that offers donor-advised funds, and charities that oversee such funds should be prepared to answer questions in light of this case.

[1] Nev. S.Ct., No. 51642 (2/8/2011), *aff'g* Styles v. Friends of Fiji, District Court, Clark County, Nevada, No. 51642 (12/11/2007).

[2] As a matter of full disclosure, the author of this article became professionally involved in the Friends of Fiji case when the plaintiff sought his legal advice in December 2006 after reading an article by the author, Fox, "Planning for Donor Control and Other Strings Attached to Charitable Contributions," 30 ETPL 441 (September 2003), later reprinted by the Nevada Lawyer in July 2004. This author had no involvement in the planning for the plaintiff's contribution to FOF, which occurred in 2002, and the Friends of Fiji litigation was handled exclusively by Nevada lawyers having no connection to the author.

[3] Note that the trial court decision in this case, District Court, Clark County, Nevada, No. 51642 (12/11/2007), is discussed in Fox, "Recent DAF Cases Raise Issues of Charities Facing Financial Difficulties," 37 ETPL 32 (January 2010).

[4] Indeed, as a result of losing a substantial lawsuit and in the face of a $6.2 million judgment against it, the NationalHeritage Foundation, a Virginia-based charity, was recently forced to file for Chapter 11 bankruptcy protection. Ultimately, its donor-advised funds were used to satisfy the claims of creditors, resulting in its donor-advised funds being wiped out, to the detriment of its donors.

[5] For a further discussion of these issues, see Fox, *supra* note 2.

[6] Sections 4966(d)(2)(A)(ii) and (iii).

[7] Section 170(f)(18)(B) . For more information on the tax treatment of donor-advised funds, see Fox, "Charitable Limitations and Reforms of the Pension Protection Act-Part 2," 33 ETPL 3 (December 2006). See also Fox, *Charitable Giving: Taxation, Planning, and Strategies*, Second Edition, chapter 31 (Thomson Reuters/WG&L, 2009).

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Enclosure 7

National Heritage Foundation Debacle Offers Lesson About Donor-Advised Funds, The Chronicle of Philanthropy, February 2010 (opinion piece).

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OPINION

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✔ PREMIUM

National Heritage Foundation Debacle Offers Lessons About Donor-Advised Funds

By Richard L. Fox

The implosion of the National Heritage Foundation—at its peak, a more-than $200-million organization—provides a cautionary tale for donors, especially the growing number who create so-called donor-advised funds.

In January the National Heritage Foundation, in Virginia, filed for bankruptcy following a court decision that ordered it to pay millions of dollars to donors who said they had been misled by the organization.

In the latest twist in the saga, the organization has filed a plan of reorganization that involves using money from its donor-advised funds to pay its creditors and cover other expenses. Such a move would clearly cause distress for the donors, who intended their dollars to be used for charitable purposes.

Donor-advised funds provide an alternative to setting up a private foundation by giving people a way to put money into an account, take a tax deduction at the time of the transfer, and then make recommendations about which charities should receive money from the fund.

The National Heritage Foundation bankruptcy, and other potential situations in which charities run into financial trouble, discontinue donor-advised funds, or, even worse, appear to simply take advantage of a donor raise the question: Can money from donor-advised funds be used to pay the claims of creditors or for other uses not intended by the donors?

Because the vast majority of charities that offer donor-advised funds are prudent and conservative and make their donors their No. 1 priority, this is not a widespread problem.

Yet donors should be aware of the potential risks involved. With the growing popularity of donor-advised funds—some $22-billion in assets are held by the biggest groups—combined with the rise in groups offering such funds and the challenging economic environment, the need for strong oversight and caution also grows.

In another recent case involving donor-advised funds—one in which I represent the donor—my client accused an organization called Friends of Fiji, which is incorporated in Nevada and has its office in Danville, Calif., of ignoring his wishes and using his donations instead to pay the charity's directors substantial salaries, sponsor celebrity golf tournaments at lavish resorts, and transfer funds to another entity controlled by the directors. The trustees in the case have denied wrongdoing.

The Nevada District Court determined that Friends of Fiji failed to use the donor's contribution to satisfy his charitable goals, and, as a result, was "in violation of the implied covenant of good faith and fair dealing." However, it also ruled that the donor had no recourse against the charity. The case is now on appeal before the Nevada Supreme Court.

In both this and the National Heritage Foundation case, the nonprofit organizations overseeing the donor-advised funds have argued that donors give up all of their rights at the time they transfer funds to a donor-advised account.

Donors and the courts, however, should reject the position that such organizations face no limits on how they may use the money in donor-advised funds.

When a charity declares bankruptcy, courts have generally attempted to identify those charitable assets that donors earmarked for a specific cause—and therefore exclude them from the bankruptcy estate and the claims of creditors.

For example, in a case involving Parkview Hospital, a nonprofit institution in Toledo, Ohio, that closed its doors shortly before filing for bankruptcy, the court found that donors had earmarked money to provide osteopathic care, and therefore the funds "were not assets of the bankruptcy estate which can be administered for the benefit of the creditors in the bankruptcy case."

In *Hobbs v. Board of Education of Northern Baptist Convention*, the Grand Island College, in Nebraska, was unable to continue its operations due to its deteriorating financial condition and was forced to close, "with a large indebtedness staring it in the face."

In protecting its endowment from creditors, the court emphasized that the donors intended for their contributions to be kept intact for educational purposes. Thus, the endowment was considered sufficiently restricted so that, in the face of the bankruptcy and closure of the college, the endowment was sheltered from creditors.

The courts have distinguished between cases in which a charity is given "absolute control" over contributions by its donors, where the money may be used for general purposes, including paying creditors, and contributions for restricted purposes, such as to establish an endowment.

Donor-advised funds should be considered sufficiently restricted to be excluded from the sponsoring organization's bankruptcy estate and the claims of creditors.

Just as with restricted endowments, a charity holding donor-advised funds has ownership and control over the funds, but it should not be considered to have "absolute control."

Indeed, it is clearly understood that donors who set up such funds can recommend how the money in them is distributed to charities. While the sponsoring organization has the final authority to approve or reject such recommendations, donors do not expect their money to be used for general purposes or to pay off creditors.

Many court cases involving commercial transactions have held that where a party to an agreement is provided some level of control over a transaction, that party must still exercise that control in good faith. The same principle should be applied to donor-advised funds. Although a sponsoring organization may have ownership and control over a donor-advised fund, it should not be permitted to exercise such control in a manner that is not faithful to the spirit and intention of the donor-advised-fund agreement.

Until the courts clarify that position, donors should be aware of the potential risk they take

when entrusting their money to an organization that offers donor-advised funds.

And they should consider including a provision in the donor-advised fund agreement that specifies how their money should be handled in the event that the organization declares bankruptcy or becomes insolvent.the money in the account should be transferred to another organization i.

CAnd charities that oversee such funds also should be prepared to answer new questions from what could well become an increasingly skeptical pool of donors.

Richard L. Fox is a lawyer in Philadelphia who specializes in advising nonprofit groups and donors and is author of Charitable Giving: Taxation, Planning, and Strategies.

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