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# Dioceses, Donors, and Bankruptcy

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## Introduction

- Recent developments in several states have increased the possibility we will see many more chapter 11 bankruptcies filed by Catholic dioceses
- Chapter 11 filings affect the entire Catholic community including parishes, foundations, schools and other Catholic entities

## Overview

- Our goals for today:
  - Introduce bankruptcy concepts, process and risks for Catholic entities that support a Catholic diocese in Chapter 11
  - Address challenges, risks and areas of concern for Catholic entities and their constituencies following bankruptcy filing
  - Discuss practical impacts of bankruptcy on Catholic entities, donors and beneficiaries
  - Suggest possible approaches for Catholic entities to prepare for bankruptcy filing by a diocese

## Cautions

- The legal issues surrounding diocesan bankruptcies and their impact upon related Catholic entities are evolving but not yet settled
- We cannot answer questions relating to specific fact patterns since many issues involve factual analysis by the court
- Engage professionals sooner rather than later
  - Counsel should be familiar with nonprofit bankruptcies, charitable giving, and nonprofit structure and governance matters
  - Crisis communications advisor

## Bankruptcy Basics: What is a chapter 11 bankruptcy?

- Chapter 11 is intended to permit a debtor to reorganize and restructure its operations and assets
- Participants in diocesan chapter 11 case will include
  - Debtor in possession
  - Creditors committee
  - Diocese's insurers
- Other Catholic entities, donors and grant recipients may also be drawn into the case

## Bankruptcy Basics: What is a chapter 11 bankruptcy? (continued)

- Objective of chapter 11 is to negotiate an equitable plan of distribution for claimants and other creditors
- Chapter 11 offers several advantages for dioceses
  - Stops litigation relating to clergy abuse claims
  - Permits equitable distribution of property to claimants rather than first to trial priority
  - Provides forum for addressing insurance coverage issues
  - Provides discharge of ALL clergy abuse claims and channeling injunction for claims

## Bankruptcy Basics: What is a chapter 11 bankruptcy? (continued)

- Chapter 11 offers several advantages for claimants
  - Avoids public and painful litigation
  - Offers simplified process for claims resolution
  - Provides court-supervised assembly of assets for payment of claims
- Chapter 11 has disadvantages
  - Time-consuming
  - Costs
  - Publicity
  - Stress upon Catholic community

## Bankruptcy Basics: What is a chapter 11 bankruptcy? (continued)

- Diocese must propose and obtain bankruptcy court approval of a plan to address claims of abuse
- Funding options for a diocese include:
  - Insurance proceeds
  - Proceeds of liquidated assets
  - Diocesan reserves
  - Future Diocesan contributions
  - Contributions from parishes
  - Contributions from other Catholic entities
  - Increased parish assessments
  - Exit financing



# Bankruptcy Basics: What is a chapter 11 bankruptcy? (continued)

- Bankruptcy filing will likely implicate other Catholic entities
  - Publicity
  - Inquiries from constituencies
  - Costs of recovering documents and records
  - Use of funds by diocese
  - Service agreements/leases
  - Media inquiries
  - Litigation holds

## How could a Catholic foundation be affected by the bankruptcy?

- There are three principal areas of substantive concern for foundations
  - How will a bankruptcy filing affect the foundation as an independent nonprofit entity?
  - How will a bankruptcy filing affect assets transferred to the foundation by the diocese?
  - How will a bankruptcy filing affect the status of funds owned or managed by the foundation for the benefit of the diocese and other Catholic entities?

## How could a Catholic foundation be affected by the bankruptcy? (continued)

- Foundations may be subject to broad requests for information, documents and records
- Foundations may be required to impose litigation holds on document destruction
- Foundation leadership and board will be distracted by case demands
- Foundation will incur unanticipated professional fees

## How could a Catholic foundation be affected by the bankruptcy? (continued)

- Transfers of assets from the diocese to a foundation may be challenged by creditors committee
  - If funds are unrestricted in the hands of the diocese, they may be subject to recovery for the benefit of creditors
  - Potential risks include below-market leases, use of employees, funding of start-up expenses
  - The bankruptcy code contains limited defenses to such challenges for foundations

## How could a Catholic foundation be affected by the bankruptcy? (continued)

- Generally, the assets of a corporation are not available to satisfy the claims of creditors of related parties
  - In extreme cases, both the bankruptcy code and state law permit creditors to seek recovery from the assets of related parties through “**substantive consolidation**” or “**alter ego**” attacks

## How could a Catholic foundation be affected by the bankruptcy? (continued)

- What is substantive consolidation?
  - Equitable doctrine developed by bankruptcy courts to pool assets in “extraordinary” situations
  - Effect is to consolidate assets and liabilities of another entity
    - Inherently unfair to creditors of a nondebtor entity
    - Requires intense factual analysis
  - Requires balancing of harms by court
  - Only one appellate court has recognized this remedy when applied to a nondebtor

## How could a Catholic foundation be affected by the bankruptcy? (continued)

- What is substantive consolidation? (continued)
  - In the case of the Archdiocese of St. Paul & Minneapolis, the committee sought to collapse assets of more than 200 affiliated Catholic entities (including innocent parties with no abuse claims lodged against them) with those of the Archdiocese
  - Court of Appeals ruled that “**substantive consolidation**” of a nondebtor, nonprofit entity was not permitted under the Bankruptcy Code
  - Court left open a possible challenge to entity status based upon state law concepts of **alter ego or fraud**

## How could a Catholic foundation be affected by the bankruptcy? (continued)

- What is substantive consolidation? (continued)
  - Alter ego seeks to hold one entity liable for the obligations of another based upon inequitable conduct
  - Alter ego challenges are based upon state law, not bankruptcy code
    - Requires detailed factual analysis
    - Generally requires element of unfairness to creditors and an inequitable result will occur if the acts in question are treated as those of the debtor entity alone



## How could a Catholic foundation be affected by the bankruptcy? (continued)

- Factors considered by courts in assessing alter ego and substantive consolidation claims
  - Fraud or insider preferences
  - Corporate structure
  - Solvency of foundation
  - Separation in management
  - Indirect control
  - Compliance with corporate formalities
  - Shared assets, offices, websites, employees, records
  - Transfers of assets between entities
  - Shared deposit accounts
  - Use of foundation as diocesan “slush fund”

## How might a diocesan bankruptcy affect donors and grant recipients?

- Even if a substantive consolidation or alter ego challenge is successful, creditors must successfully overcome a second layer of protections for certain donors and grant recipients in order to expose completed gifts to the claims asserted on behalf of creditors of the diocese
- Important to consider the source of funds owned or managed by the foundation
- The manner in which funds are held by the foundation will be critical in assessing which funds carry the most risk in terms of availability for the payment of creditors' claim

## How might a diocesan bankruptcy affect donors and grant recipients? (continued)

- A donor may generally create a binding restriction on a gift even though a trust relationship is not created
- Problems are raised when written agreements do not exist or are not clear
- Claimants' attorneys may not always concede validity of donor restrictions in negotiations

## How might a diocesan bankruptcy affect donors and grant recipients? (continued)

- A foundation's unrestricted funds will likely be subject to the claims of its creditors and the creditors of the diocese if the corporate veil is set aside
  - “...where donations are made for the general purpose of carrying on a business of any kind ...the absolute control ...being bestowed upon the donee, the property is liable for debts incurred for the purpose intended.”
- While it is assumed that a gift to a nonprofit entity is a gift for charitable purposes, if there are no restrictions imposed by the donor, the gift may be used for the general expenses of the recipient

## How might a diocesan bankruptcy affect donors and grant recipients? (continued)

- Funds likely to be protected from creditors include:
  - Managed funds for other entities (other than the diocese)
  - Agency funds
  - Donor-restricted gifts
  - Purpose-restricted donor-created endowments
- Funds that may or may not be subject to the claims of creditors include:
  - Non-endowed donor-advised funds
  - Quasi-endowments
  - Unrestricted endowment funds
- Funds that are likely available for creditors are the unrestricted funds of the foundation

## How might a diocesan bankruptcy affect donors and grant recipients? (continued)

- If funds are held by foundation on behalf of another entity as its agent, with no variance power or restrictions as to their use, a bankruptcy court is likely to conclude that such funds are not available to satisfy the claims of the *foundation's* creditors
  - Note, however, that if the other entity is subject to creditors' claims, these funds may be available for the other entities' creditors
- If the use of the funds is restricted in purpose, then it is more likely that such restrictions will be recognized

## How might a diocesan bankruptcy affect donors and grant recipients? (continued)

- Binding restrictions may be found in solicitation materials, gift agreements or other documents so long as the donor's intent can be determined
- Better practice is to have clear gift agreements that set forth any and all of the donor's intentions
  - Signatures of donor and foundation
  - Clear gift receipt policies
  - Adherence to gift receipt policies
- Can donor prohibit use of gift for certain purposes?

## How might a diocesan bankruptcy affect donors and grant recipients? (continued)

- Generally, only a donor may impose binding restrictions on the use of a gift
  - Board-designated “quasi-endowments” are not likely to be treated differently than unrestricted reserves of the nonprofit
- Another type of fund that may fall into a gray area is an unrestricted endowment fund which limits the amount the foundation may spend, but does not limit the purposes for which the funds may be spent



## How might a diocesan bankruptcy affect donors and grant recipients? (continued)

- Donor advised funds owned by the foundation but subject to the donor's advisory privileges likely fall into the gray area between restricted and unrestricted gifts
- There is no case law in the bankruptcy setting addressing how donor-advised funds will be viewed
- If the donor's intention as reflected in the gift agreement limits use of the fund to support a specific Catholic initiative, it would seem courts would be more likely to conclude the gift is unavailable to creditors
- If the donor's intention is very broadly stated, it is less likely to be protected from creditors

## How might a diocesan bankruptcy affect operations?

- Daily operations will likely be affected upon filing
  - Internal management of bankruptcy case
  - Donor inquiries
  - Media inquiries
  - Internal communications
  - Litigation holds
  - Management of gifts
  - Management of diocesan conflicts of interest

## How might a diocesan bankruptcy affect operations? (continued)

- Litigation could affect the foundation
  - Bankruptcy may involve several motions and proceedings that may affect foundation
  - Avoidance litigation could be brought by the diocese or committee
  - Alter ego or substantive consolidation challenges could be threatened
  - Clergy abuse claims could implicate the foundation
- Litigation may have an impact on operations, budgets and board participation

## How might the diocese's plan affect the foundation?

- Diocese may look to the foundation to assist with plan funding
- Options to consider include:
  - Loan to diocese
  - Purchase and leaseback of assets
  - Gift from unrestricted funds
- Consideration of any plan funding requests will take time, effort and support of multiple constituencies
- Release and channeling injunction provided by plans are extremely important

## How might the diocese's plan affect the foundation? (continued)

- Any consideration of assisting with plan funding carries additional issues to assess:
  - Assessment of the reaction from current and future donors
  - Structure of assistance likely very important
  - Use of funds by diocese may affect reaction in community
  - Clear communications to donors, gift recipients and Catholic community is necessary
  - Use of restricted funds must be avoided without appropriate legal analysis and court determination if necessary

## What should we do to prepare for a diocesan bankruptcy?

- Assemble team
  - Counsel
  - Crisis communications advisor
  - Management committee
- Review corporate structure, governance and operations
  - Board membership and selection processes
  - Board voting
  - Reserved powers in diocesan officers

## What should we do to prepare for a diocesan bankruptcy?

- Review legal relationships with diocese
  - Leases and other contracts
  - Shared employees
  - Website
  - Funds solicitation campaigns and materials
  - Conflicts of interest
- Review fund agreements
  - Ownership
  - Donor restrictions
- Review minutes

## What should we do to prepare for a diocesan bankruptcy? (continued)

- Review public records and tax returns
- Review insurance coverage
- Review fund transfers between foundation and diocese
  - Historical
  - Current



# What should we do to prepare for a diocesan bankruptcy? (continued)

- Review policies
  - Gift acceptance
  - Conflict of Interest – be clear that Board members with conflicts can be excluded from meetings
    - Diocesan officers will have competing fiduciary duties
- Review existing gift agreements
- Review prototype gift agreements
- Establish communications plan with professional assistance
  - GET IN FRONT OF PUBLICITY
  - Prepare for inquiries

## Conclusion

- Best practices:
  - Anticipate a bankruptcy filing and plan now
  - Assemble your team early
  - Clarify relationship(s) with the diocese
  - Triage potential issues
  - Pray early and often

# Questions?

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