

**State Regulation of Charitable  
Bequests in Nonprofit Bankruptcies**

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### **Introduction**

In most States, the use and disposition of assets of nonprofit organizations is subject to the oversight and approval of State regulators, exercising their *parens patriae* powers. When a not-for-profit entity becomes a debtor in a case under the Bankruptcy Code, questions arise as to whether endowment funds in the debtor's possession are property of the estate and the extent to which the State regulatory and jurisdictional scheme is affected by the automatic stay imposed upon the bankruptcy filing. These questions are considered below.

#### **I. Are Donor Restricted Funds Property of the Bankruptcy Estate?**

Frequently, charitable gifts and bequests are dedicated to a particular purpose, or are otherwise made with restrictions attached. Under State law, these restrictions are generally recognized and enforced. Those restrictions call into question whether donor-restricted funds are property of the charitable debtor's bankruptcy estate that can be used generally to conduct the debtor's operations.

Pursuant to the Bankruptcy Code, the filing of a bankruptcy petition creates an estate comprised of all the property enumerated under section 541, wherever located and by whomever held, including "all legal or equitable interests of the debtor in property as of the commencement of the case."<sup>1</sup> Although the Bankruptcy Code defines property of the estate in the broadest possible terms, the United States Supreme Court has held that any legal or equitable interest in any particular asset is determined pursuant to state law, notwithstanding the commencement of a bankruptcy proceeding.<sup>2</sup>

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<sup>1</sup> 11 U.S.C. § 541(a)(1).

<sup>2</sup> See *Barnhill v. Johnson*, 503 U.S. 393, 398, 112 S.Ct. 1386, 1389 (1992) ("property' and 'interests in property' are creatures of state law."); *Butner v. United States*, 440 U.S. 48, 54-55, 99 S.Ct. 914, 918 (1979) ("Congress has generally left the determination of property rights in the assets of a bankrupt's estate to state law.").

Prepetition restrictions on property held by a debtor, such as a donor's restriction on the use of funds, are enforceable in bankruptcy. A long line of bankruptcy cases has held that the debtor's property interest is subject to those restrictions being enforced, thereby limiting their status as property of the estate.<sup>3</sup> In particular, donor-restricted funds and property in the possession of a debtor that is held in trust by the debtor for a nondebtor have been held not to constitute property of the estate under section 541.<sup>4</sup> The bankruptcy estate has no rights or interests in property broader than the rights and interests that the debtor had prior to the commencement of the case.<sup>5</sup> Further, the bankruptcy court's jurisdiction over a debtor's property extends only as far as the debtor's particular interest in the property.<sup>6</sup>

Some courts have held that donor-restricted funds are held in actual or constructive trust by the debtor, and have therefore concluded that the trust funds are not property of the bankruptcy estate.<sup>7</sup> In this regard, section 541(d) of the Bankruptcy Code provides that “[p]roperty in which the debtor holds, as of the commencement of the case, only legal title and

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<sup>3</sup> See, e.g., *Chicago Board of Trade v. Johnson*, 264 U.S. 1 (1924); *Salisbury v. Ameritrust Tex., N.A.*, 151 B.R. 394 (Bankr. N.D. Tex. 1993).

<sup>4</sup> See e.g. *Farrell v. Sharon Steel Corp.*, 41 F.3d 92, 95 (3d Cir. 1994) (“debtors do ‘not own an equitable interest in property ... [they] hold[] in trust for another,’ and that therefore funds held in trust are not ‘property of the estate.’”) (citing *Begier v. IRS*, 496 U.S. 53, 59, 110 S.Ct. 2258, 2263 (1990)); *Universal Bonding Ins. Co. v. Gittens & Sprinkle Enters.*, 960 F.2d 366, 371 (3d Cir. 1992) (beneficiaries of trust may reclaim their equitable interest in the trust fund); *Indiana Lumbermens Mutual Insurance Co. Inc. v. Construction Alternatives Inc.*, 161 B.R. 949, 951 *aff'd*, 2 F.3d 670, rehearing and suggestion for rehearing denied (6th Cir. 1993) (“bankruptcy estate does not include property over which the debtor is a trustee.”); *Mitsui Mfr. Bank v. Unicom Computer Corp.*, 13 F.3d 321, 323 (9th Cir. 1994) (“something held in trust by a debtor for another is neither property of the bankruptcy estate under section 541(d), nor property of the debtor for purposes of section 547(b)”).

<sup>5</sup> See, e.g., *Salisbury v. Ameritrust Tex., N.A.*, 151 B.R. at 398 (“the estate received [trust assets] subject to any restrictions imposed by state law, prepetition.”).

<sup>6</sup> See, e.g., *Connecticut General Life Ins. Co. v. Universal Ins. Co.*, 838 F.2d 612, 618 (1st Cir. 1988) (“when a debtor is in possession of property impressed by a trust ... the bankrupt estate holds the property subject to the outstanding interest of the beneficiaries”).

<sup>7</sup> See, e.g., *In re Joliet-Will County Community Action Agency*, 847 F.2d 430 (7<sup>th</sup> Cir. 1988) (holding that federal and state agency grants to nonprofit community organizations that impose restrictions on the grants' use were made to the organization as a trustee, such that the debtor lacked beneficial title to the funds and hence they were not property of the estate); *Parkview Hospital v. St. Vincent Medical Center*, 211 B.R. 619 (Bankr. N.D. Ohio) (debtor hospital's contributors manifested an intent that the hospital's development fund would be used for specific charitable purposes, supporting a finding of an express charitable trust that removed the funds from the chapter 11 estate).

not an equitable interest ... becomes property of the estate ... only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold." If the funds are not property of the estate, under applicable state law they can only be used for their dedicated purposes, and not used or administered for the benefit generally of creditors in the bankruptcy case.<sup>8</sup>

If a restricted gift of funds is kept out of the bankruptcy estate, the only way for the debtor to modify the restriction and use the funds for general purposes would be to petition the appropriate court under the doctrine of *cy pres*<sup>9</sup> to modify the restriction. Query whether a bankruptcy court as a court of equity would be an appropriate court to adjudicate a request to modify the restriction in reliance on the *cy pres* doctrine or whether principles of comity mandate that such requests be directed to and resolved by the state courts. Since the trust funds are not property of the estate, the better view may be that the bankruptcy court has no jurisdiction over the funds and cannot entertain the *cy pres* request.

## **II. The Disposition of Assets by a Charitable Debtor and New Sections 363(d)(1) and 503(f) of the Bankruptcy Code**

The disposition of property of charitable entities in bankruptcy has been the subject of both litigation and recent legislation.

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 made two significant changes to the law that affect the disposition of property in nonprofit organization bankruptcies. First, new section 363(d)(1) of the Code was added to provide that a trustee (or

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<sup>8</sup> See, e.g., *In re Bishop College*, 151 B.R. 394 (Bankr. N.D. Tex. 1993). On the other hand, if the funds are property of the estate, presumably the charitable debtor would be allowed to use them in the ordinary course of business under section 363 of the Bankruptcy Code, but (i) using these assets inconsistently with their restrictions is not ordinary course of business and (ii) as discussed in the text, new section 363(d)(1) of the Code eliminates that possibility.

<sup>9</sup> Under the doctrine of *cy pres*, where it is shown that a particular charitable purpose for which a trust was created becomes impossible of achievement or illogical or impracticable, the trust does not fail but rather the court can authorize that the property may be applied to some other charitable purposes falling within the general intention of the trust's settler. *Id.* at 400.

debtor in possession) may use, sell or lease property only “in accordance with applicable nonbankruptcy law that governs the transfer of property by a corporation or trust that is not a moneyed, business or commercial corporation or trust.” Second, section 503(f) of the Code was added, likely in response to the litigation initiated by the Pennsylvania Attorney General in the bankruptcy proceeding of Allegheny Health, Education and Research Foundation<sup>10</sup> (discussed below). New section 503(f) provides:

“[P]roperty 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 ... The parties who may appear and be heard in a proceeding under this section include the attorney general of the State in which the debtor is incorporated, was formed, or does business.”<sup>11</sup>

Coupled with section 363(d)(1) of the Bankruptcy Code, section 503(f) dictates that nonprofit enterprises in bankruptcy, such as public hospitals, museums, or charities, cannot be sold to for-profit taxpaying entities without compliance with state-law regulatory provisions requiring approval for the sale of nonprofit enterprises to for-profit buyers.

### **III. State’s Exercise of Regulatory Powers**

As stated above, a determination that donor-restricted funds constitute trust property that is not included in the bankruptcy estate removes the property from the jurisdiction of the bankruptcy court. As a result, the disposition of such property is subject to state regulators’ *parens patriae* powers. The question then becomes, to what extent, if any, is the State’s regulatory powers subject to restriction under the automatic stay provisions of section 362 of the Bankruptcy Code?

<sup>10</sup> *In re Bankr. Appeal of Allegheny Health, Educ. & Research Found.*, 252 B.R. 332 (W.D. Pa. 1999); *In re Bankr. Appeal of Allegheny Health, Educ. & Research Found.*, 252 B.R. 309 (W.D. Pa. 1999).

<sup>11</sup> 11 U.S.C. § 503(f).

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Section 362 of the Bankruptcy Code provides for an automatic stay upon the filing of a bankruptcy petition to protect the debtor, property of the estate, and property of the debtor from certain actions by third-parties.<sup>12</sup> The general policy behind this section is to grant complete, immediate, and temporary relief to the debtor from creditors, and promote an orderly administration of the bankruptcy case.<sup>13</sup> However, the commencement or continuation of a proceeding by a governmental unit to enforce its “police or regulatory power” is not stayed.<sup>14</sup>

Although “police or regulatory power” is not defined in the Bankruptcy Code, courts have held that the police and regulatory exception to the automatic stay should be broadly construed and that no “unnatural efforts [should] be made to limit its scope.”<sup>15</sup> In support of its interpretation, the Third Circuit stated:

Given the general rule that preemption is not favored, and the fact that, in restoring power to the States, Congress intentionally used such a broad term as “police and regulatory powers,” we find that the exception to the automatic stay provision contained in 362(b)(4)-(5) should itself be construed broadly, and no unnatural efforts be made to limit its scope. The police power of the several States embodies the main bulwark of protection by which they carry out their responsibilities to the People; its abrogation is therefore a serious matter. Congress should not be assumed, therefore, to have been miserly in its refund of that power to the States. Where important state law[s] ... protect some public interest, they should not be overridden by federal legislation unless they are inconsistent with explicit congressional intent such that the supremacy clause mandates their suppression...<sup>16</sup>

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<sup>12</sup> 11 U.S.C. § 362(a)(1).

<sup>13</sup> *Penn Terra Ltd. v. Dep't of Environmental Resources, Commonwealth of Pennsylvania*, 733 F.2d 267, 271 (3d Cir. 1984).

<sup>14</sup> 11 U.S.C. § 362(a)(3); 11 U.S.C. § 362(b)(4) (the filing of a bankruptcy petition does not operate as a stay “under paragraph (1), (2), (3), or (6) of subsection (a) of this section, of the commencement or continuation of an action or proceeding by a governmental unit ... to enforce such governmental unit's or organization's police and regulatory power, including the enforcement of a judgment other than a money judgment, obtained in an action or proceeding by the governmental unit to enforce such governmental unit's or organization's police or regulatory power.”).

<sup>15</sup> *Penn Terra Ltd. v. Dep't of Environmental Resources, Commonwealth of Pennsylvania*, 733 F.2d at 273.

<sup>16</sup> *Id.*

According, the policy of this provision is to permit regulatory, police and criminal actions to proceed in spite of section 362(a)(1), and to permit enforcement of resulting judgments or orders, other than money judgments. To determine whether an action is excepted from the automatic stay as a police or regulatory power action, the courts have developed two tests to judge the government's action: the "pecuniary purpose test" and the "public policy test."

If either test is satisfied, then the exception applies. Under the pecuniary purpose test, the court must ask "whether the governmental proceeding relates primarily to the protection of the government's pecuniary interest in the debtor's property, and not to matters of public safety."<sup>17</sup> Proceedings which relate primarily to matters of public safety are excepted from the stay. Pursuant to the public policy test, a court "distinguishes between proceedings that effectuate public policy and those that adjudicate private rights."<sup>18</sup> Only government actions designed to effectuate public policy are exempted from the automatic stay.<sup>19</sup>

Using these tests, courts have applied the exception to a broad range of governmental actions.<sup>20</sup> Significantly, however, even when a governmental action is excepted from the stay, the bankruptcy court retains the power under section 105 of the Bankruptcy Code to enjoin an action by a governmental unit "where the exercise of State power, even for the protection of the

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<sup>17</sup> *In re James*, 112 B.R. 687, 704 (Bankr. E.D. Pa. 1990) (quoting *In re Commerce Oil Co.*, 847 F.2d 291, 295 (6th Cir. 1988)); see also *NLRB v. Continental Hagen Corp.*, 932 F.2d 828, 833 (9th Cir. 1991).

<sup>18</sup> *Continental Hagen*, 932 F.2d at 833.

<sup>19</sup> *Id.*

<sup>20</sup> See, e.g., *Universal Life Church, Inc. v. United States*, 128 F.2d 1294, 1297 (9th Cir. 1997) (IRS's revocation of church's tax exemption status falls with the police or regulatory exception); *NLRB v. 15th Avenue Iron Works, Inc.*, 964 F.2d 1336 (2d Cir. 1992) (NLRB unfair labor practice proceedings and enforcement proceedings are police or regulatory powers actions by a governmental unit, and therefore are exempt from automatic stay); *Brock v. Morysville Body Works, Inc.*, 829 F.2d 383 (3d Cir. 1987) (OSHA citation enforceable against debtor notwithstanding automatic stay, pursuant to police powers expectation).

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public health and safety, [is] so contrary to the policy of the Bankruptcy Code that it should not be permitted.”<sup>21</sup>

One case worthy of special mention in this area is *In re Bankruptcy Appeal of Allegheny Health, Education and Research Foundation* (“*AHERF*”), *supra*. There, the bankruptcy court had enjoined the Attorney General of the Commonwealth of Pennsylvania, pursuant to section 362(a) of the Bankruptcy Code, from proceeding in Pennsylvania Orphans’ Court to enjoin the Debtors’ disposition of donor-restricted funds. Appeals were taken by the Commonwealth’s attorney general and other interested parties. While the parties to the appeal pressed the district court to decide the underlying issue; *i.e.* the extent of AHERF’s estate property, the precise issue before the court was whether the 362 injunction was appropriate. In deciding the propriety of the injunction, the district court assumed *arguendo* that the interest which the Commonwealth sought to protect was property of the estate and that the Orphans’ Court proceedings were an attempt to exert control over such property. The district court concluded that such actions fell within the police and regulatory exemption of section 362(b). Initially, the district court noted that the 1998 amendment to section 362 broadened the police and regulatory powers exception to the automatic stay to include actions against property of the debtor’s estate. As a consequence, the district court stated:

if the police powers exception is otherwise applicable, the 1998 amendments make clear that it operates with regard to the Orphans’ Court litigation against Debtor AHERF ... even though that litigation might be deemed an action to exercise control over property of the debtor estate under section 362(a)(3) as well as an action against the debtor, section 362(a)(1).

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<sup>21</sup> *Penn Terra*, 733 F.2d at 273; *United States v. Commonwealth Cos. (In re Commonwealth Cos.)*, 913 F.2d 518, 527 (8th Cir. 1990); *Brennan v. Poritz*, 198 B.R. 445, 450 (D.N.J. 1996) (“[t]he plain language of § 105 restrains the bankruptcy court’s discretionary authority to issue § 105 injunctive relief, as the statute specifically states that any action taken under § 105 must be designed to carry out the provisions of the bankruptcy code. Because the bankruptcy code expressly exempts state actions brought under state police or regulatory powers from the automatic stay, it is only in rare cases that a § 105 injunction of a police power exercise will ‘carry out’ the code’s provision.”).

252 B.R. at 325.

The district court acknowledged that no reported decision could be found regarding relief from an automatic stay in bankruptcy for proceedings wherein the state is exercising its *parens patriae* powers to protect the assets and/or charitable mission of a charitable trust or other non-profit charitable corporation. Nevertheless, upon examination of case law interpreting a state's exercise of its *parens patriae* powers, the court concluded that the police powers exception includes the traditional parental powers of the Commonwealth of Pennsylvania and; therefore, "the police power exception of section 362(b)(4), as amended, clearly applied and exempted the Commonwealth from automatic stay of the Orphans' Court litigation ..." *Id.* at 36.

The district court left open the possibility that the bankruptcy court could consider an order pursuant to section 105 of the Bankruptcy Code to enjoin the Orphans' Court action. However, the district court cautioned the bankruptcy court as to the exercise of its discretionary powers under section 105.