UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA

The Official Committee of Unsecured Creditors, Appellant, v. The Archdiocese of Saint Paul and Minneapolis, et al., Appellees.	Court File No.: 16-CV-02712-ADM Judge Ann D. Montgomery

BRIEF OF AMICUS CURIAE COUNCIL ON FOUNDATIONS, INC. IN SUPPORT OF APPELLEES' BRIEFS

Appeal from the United States Bankruptcy Court
for the District of Minnesota
Honorable Robert Kressel, United States Bankruptcy Judge
Bankruptcy Case No. 15-30125

Steven W. Meyer
FOX ROTHSCHILD LLP
Campbell Mithun Tower – Suite 2000
222 South Ninth Street
Minneapolis, MN 55402
(612) 607-7000

Counsel for Amicus Curiae Council on Foundations, Inc.

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Page(s)

Cases

Statutes

Other Authorities

STATEMENT OF IDENTITY PURSUANT TO RULE 8017(C)(3)

In accordance with Fed. R. Bankr. P. 8017(c)(3), Council on Foundations, Inc. ("COF") states that it is a New York Not-For-Profit corporation with no shareholders or other equity owners, but with 776 members consisting of public and private foundations and other charitable entities. COF is interested in the outcome of this case because of the potential impact on its members and other charitable organizations. Specifically, the Appellant's argument that charitable institutions may be subject to substantive consolidation notwithstanding the protections afforded charitable entities pursuant to 11 U.S.C. Section 303(a) would have a negative impact on all charitable entities including COF's members. COF believes that a decision in Appellant's favor would have a chilling effect on charitable giving because it would allow charitable contributions to be used for purposes other than those intended by donors. COF further believes that failure to protect these charitable assets could discourage the formation and continuation of charitable foundations and similar organizations which are a significant source of philanthropy throughout the United States. COF files this brief in accordance with Fed. R. Bankr. P. 8017(a), (b) and (e). Contemporaneously herewith, COF has filed its Motion of Council on Foundations, Inc. for Leave to File Amicus Curiae Brief in Support of Briefs of the Appellees pursuant to Fed. R. Bankr. P. 8017(b).

STATEMENT REGARDING AUTHORS PURSUANT TO RULE 8017(C)(4)

In accordance with Fed. R. Bankr. P. 8017(c)(4), COF states that a) this brief was authored jointly by Suzanne Friday, Senior Legal Counsel and Vice President of Legal Affairs for COF, and Steven W. Meyer, Fox Rothschild LLP ("Fox"); no counsel

representing any party to this appeal participated in the preparation of this brief; b) no party or its counsel has contributed money that was intended to fund preparing or submitting this brief; and c) no person other than COF, its members or its counsel contributed money that was intended to fund preparing or submitting this brief.

BACKGROUND

COF's mission is to provide the opportunity, leadership, and tools needed by philanthropic organizations to expand, enhance, and sustain their ability to advance the common good. COF serves an important role at the national level as an active voice and champion for philanthropy and charitable institutions. In connection with the leadership component of its mission, COF has resources and personnel dedicated to address public policy and legal affairs issues affecting the growth and vibrancy of the community of philanthropic foundations and charitable organizations. COF has identified an important public policy issue in this appeal. Specifically, COF believes that if charitable foundations can become debtors in bankruptcy against their will through the use of substantive consolidation, donors' confidence that their gifts will be used for their intended purpose will be undermined. A ruling in favor of the Appellant, COF asserts, will have a chilling effect on the ability of foundations and other charitable entities to garner contributions to further their important missions.

Foundations play a critical role in overall charitable giving. COF defines a foundation as an entity that supports charitable activities by making grants to unrelated organizations or institutions or to individuals for scientific, educational, cultural, religious, or other charitable purposes. Most foundations are tax-exempt charitable

organizations under 26 U.S.C. 501(c)(3) and 26 U.S.C. 170(b) which, among other things, allows donors to deduct their contributions from their taxable income. Foundations fall into two broad categories—private foundations and public charities and the qualifications for each are described in 26 U.S.C. 509(a). Private foundations are generally financially supported by one or a small handful of sources. *Id.* Public charities include many charitable organizations such as hospitals and schools, but also include public foundations that make grants to other charities. *Id.* Unlike private foundations, public foundations obtain funding from multiple sources. *Id.*

Foundations have provided a very significant source of charitable giving in the United States. In 2015, US foundations accounted for over $58 billion in charitable giving (*Giving USA: 2015 Was America's Most-Generous Year Ever*, https://givingusa.org/giving-usa-2016/). Additionally, however, because of the size of their resources and their longevity, foundations have unique opportunities to advance charitable causes in more efficient and effective ways that are generally not available to individual donors. For example, foundations often focus on and gain substantive expertise in particular issues which allows them to make better informed decisions regarding the best way to deploy their funds to advance worthy causes. Further, they are often in a better position to commit to longer term funding plans that are coupled with a program to measure progress and impose accountability. Moreover, giving to a foundation permits a donor to contribute to an organization that promotes causes important to the donor for a long period into the future even beyond the donor's lifetime.

For these and other reasons, foundations can offer donors the opportunity for their charitable contributions to have a far more effective and long-term impact.

Critical to their success, however, is prospective donors' confidence that their contributions will be used to further the philanthropic goals of the foundation. To the extent that this confidence is undermined, COF believes that the use, expansion and growth of foundations as a means to further the public good will be hindered. The possibility that foundations could be unwillingly drawn into a bankruptcy diminishes the donors' confidence that funds will in fact end up with the intended beneficiaries. Accordingly, COF files this amicus curiae brief in support of the Appellees' position that substantive consolidation may not be used against a non-debtor charity.

ARGUMENT

I. Substantively Consolidating a Non-Debtor Charity Into a Debtor's Bankruptcy Case is Directly Contrary to 11 U.S.C. Section 303(a).

A. 303(a) Prevents Substantive Consolidation for Two Reasons.

First, there are two distinct reasons why Section 303(a), which regulates involuntary bankruptcy petitions, prevents a bankruptcy court from using substantive consolidation to cause a non-debtor charity to become a debtor in bankruptcy. The first reason applies to any non-debtor entity, charitable or otherwise. Specifically, 11 U.S.C. 105 cannot be used to bring non-debtors under the jurisdiction of a bankruptcy court which, if permitted, would allow creditors or others to circumvent the protections afforded to non-debtors under 11 U.S.C. 303(a). While this is a very important reason for upholding the bankruptcy court's decision, it is also one that has already been thoroughly briefed by the parties to this appeal, and COF joins in that analysis.

COF, however, will focus on the second reason why Section 303(a) precludes the use of substantive consolidation in this matter. Specifically, Section 303(a) clearly states the longstanding congressional intent to prevent charitable organizations from becoming debtors in bankruptcy against their will. Allowing charitable entities to be subject to substantive consolidation is a backdoor means of accomplishing what Congress intended to prohibit.

B. The Equitable Powers of 11 U.S.C. Section 105 Cannot be Used in Contravention of Other Provisions of the Bankruptcy Code.

The authority for a court to substantively consolidate two or more entities into a single bankruptcy debtor is not specifically provided for in Title 11 of the United States Code ("Bankruptcy Code"). *Federal Deposit Insurance Corp. v. Colonial Realty Company*, 966 F.2d 57, 59 (2d Cir. 1992) ("There is no express authority for any substantive consolidation in the Bankruptcy Code. As this Court has stated, "[s]ubstantive consolidation has no express statutory basis but is a product of judicial gloss." Citing *In re Augie/Restivo Banking Co. Ltd.,* 860 F.2d 516, 518 (2d Cir. 1988)). Rather, courts have found such authority to exist by interpreting the general equitable provisions of 11 U.S.C. Section 105. *Id.* at 59. Section 105(a) states:

> The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.

11 U.S.C. Section 105(a).

While Section 105 may be used to "carry out the provisions" of the Bankruptcy Code, it cannot be used to contravene other sections of the Bankruptcy Code. *See In re Persig Farms, Inc.*, 46 B.R. 237, 249 (D. Minn. 1985) ("Yet section 105(a) does not give

bankruptcy courts the authority to contravene specific provisions of the bankruptcy code."); *In re Murgillo,* 176 B.R. 524, 531 (9th Cir. B.A.P. 1995) ("A court may exercise its equitable power only as a means to fulfill some specific code provision; it may not use its equitable powers to achieve a result not contemplated by the code."). Accordingly, the bankruptcy court's equitable powers cannot be used to achieve a result clearly barred by another provision of the Bankruptcy Code. The Bankruptcy Code includes a clear mandate against forcing a charitable organization into bankruptcy and allowing Section 105 to be used to achieve that end is precisely what *Persig Farms*, *Murgillo* and a host of other cases prohibit.

C. Section 303(a) Clearly Prevents Charitable Organizations From Becoming Unwilling Bankruptcy Debtors.

11 U.S.C. Section 303 establishes the means and limits on the ability to impose a bankruptcy on an unwilling party. Section 303(a) provides as follows:

> (a) An involuntary case may be commenced only under chapter 7 or 11 of this title, and only against a person**, except** a farmer, family farmer, **or a corporation that is not a moneyed, business, or commercial corporation**, that may be a debtor under the chapter under which such case is commenced.

11 U.S.C. Section 303(a) (emphasis added).

Accordingly, an entity that is not a "moneyed, business, or commercial corporation" cannot be involuntarily placed in bankruptcy. The legislative history of Section 303(a) makes clear that Section 303 is intended to exclude charities from its purview. "Eleemosynary institutions, such as churches, schools, and charitable

organizations and foundations **are exempt from involuntary bankruptcy.**" S. REP. 95-989, 32, 1978 U.S.C.C.A.N. 5787, 5818 (emphasis added).

Exempting charitable organizations from involuntary bankruptcies is not new and, in fact, was the law under the Bankruptcy Act which governed bankruptcy practice prior to the enactment of the Bankruptcy Code in 1978:

> The exemption granted these institutions is a continuation of earlier bankruptcy law. The pertinent provisions of the Bankruptcy Act of 1898 were phrased somewhat differently. Section 4 thereof (former 11 U.S.C.S. Section 22) stated that, "... any moneyed, business, or commercial corporation ... may be adjudged an involuntary bankrupt...". Hence, it was by judicial interpretation that eligibility for involuntary bankruptcy was limited to corporations organized for profit, and that charitable or educational institutions were excluded, at least unless transactions indicated otherwise.

In re United Kitchen Associates, Inc., 33 B.R. 214, 216 (Bankr. W.D. La. 1983). Footnote 2 of Appellant's Brief (pages 43-44) suggests that the only reason for the exemption of charitable organizations was to protect them from bill collectors. Courts, however, interpreting the long standing protection for charitable organizations, have seen a much broader congressional intent in the statute. "If the chief purpose of a corporation be religious, charitable, or educational it will **not come within the purview of the Bankruptcy Act** . . . ." *In re Michigan Sanitarium & Benevolent Ass'n*, 20 F. Supp. 979, 982 (E.D. Mich. 1937) (emphasis added). Citing *Schuster v. Ohio Farmers' Co-Op. Milk Ass'n*, 61 F.2d 337, 338 (6th Cir. 1932). The *Michigan Sanitarium* court also discussed the rationale for excluding charitable organizations from involuntary bankruptcy:

> Congress desired to encourage persons philanthropically inclined to give their money and their time and services through an eleemosynary corporation in promulgating charitable and

> benevolent, philanthropic, and humanitarian doctrines, and to that end we believe so drafted the Bankruptcy Act as not to include corporations of this character, in which those who contribute their moneys and their time and effort do so without hope of monetary gain or any reward except that gained through seeing the objects and purposes of the corporation successfully carried out.

Michigan Sanitarium, 20 F. Supp. at 982. The reason, therefore, that Congress excluded charitable entities from bankruptcy is to encourage philanthropy by assuring donors that the intended beneficiary of their generosity would receive the benefit of their gifts.

Allowing substantive consolidation of a non-debtor charitable institution would frustrate that purpose to the same extent that allowing them to be the subject of an involuntary petition would. The possibility that charitable organizations could be brought into a bankruptcy of another entity with its assets used to pay that entity's creditors could adversely affect donors' confidence that contributions will go to the intended charitable purpose which, in turn, could diminish contributions to foundations and other charities. It is this broader policy concern that the *Michigan Sanitarium* court identified, and it is the same reason that COF urges this Court not to expand use of Section 105 to force charitable organizations into bankruptcy against their will.

Not only will it have a chilling effect on future giving, forcing a charity into bankruptcy through substantive consolidation will be a breach of the trust of prior donors who made sacrifices to fund a cause that is important to them. For both public and private foundations, the donors have given some portion of their resources for an identified societal need and received no tangible benefit in return. Substantive consolidation would take away the one benefit these donors reap—the knowledge and

comfort that they made a personal sacrifice to further a cause that is important to them. In the context of a substantive consolidation motion, it is not clear that they would even have standing to object to the motion. *In re Gulf States Steel, Inc. of Alabama,* 289 B.R. 739, 742 (Bankr. N.D. Ala. 2002) (unsuccessful bidder at bankruptcy auction whose only pecuniary loss is the speculative profit it might have made usually lacks standing to challenge a bankruptcy order approving a sale. Citing *Big Shanty Land Corp. v. Comer Properties, Inc.,* 61 B.R. 272, 277 (N.D. Ga. 1985)). Frustrated donors clearly are not a classic interested party such as a creditor, an owner or a governmental regulatory entity and some courts may question whether they will suffer a pecuniary loss that would permit them to even have a say in what happens to their donation. They may be powerless to even try to prevent the diversion of their contributions from the intended beneficiaries.

In its brief, the Appellant suggests that substantive consolidation merely expands the assets that are included in the voluntary bankruptcy of the Appellant. *Appellant Brief at page 42.* This statement implies that the ultimate impact of substantive consolidation on the non-debtor is somehow less severe or intrusive than placing that same entity in bankruptcy via an involuntary petition. In fact, however, from the non-debtor's perspective, the non-debtor lands in the same if not worse position than it would in an involuntary bankruptcy.

Substantive consolidation is far more than an expansion of the assets of a debtor in an existing bankruptcy case. As one court has stated:

> "substantive consolidation is a remedy that "is [a] mechanism for administering the bankruptcy estate of multiple, related entities." In re Babcock & Wilcox Co., 250 F.3d 955, 958 (5th Cir.2001); *see*

> Gandy v. Gandy (In re Gandy), 299 F.3d 489, 499 (5th Cir.2002). According to the Fifth Circuit, "[s]ubstantive consolidation '**treats separate legal entities as if they were merged into a single survivor** left with all the cumulative assets and liabilities (save for inter-entity liabilities, which are erased). The result is that claims of creditors against separate debtors morph to claims against the consolidated survivor.'

In re Ward, 2016 WL 4691049, page 18 (Bankr. N.D. Tex. 2016) (emphasis added).

In a substantive consolidation, the non-debtor entity loses its separate status and becomes part of the bankruptcy debtor. It no longer has distinct assets to manage, sell, lease or, in the case of a charitable organization, give to the causes it was created to support. Its board of directors loses control of the non-debtor's activities. Much of what the board of the entity could have done is now directed by others and is subject to bankruptcy court approval. *See e.g.*, 11 U.S.C. 363(b) (the use, sale and lease of a debtor's assets outside the ordinary course of business only permitted after notice and hearing); 11 U.S.C. 364(b) and (c) (secured and unsecured debt incurred outside of the ordinary course only permitted after notice and hearing). In an involuntary bankruptcy, the non-debtor and its board at least have the possibility of continuing some control over the entity's activities. Not so with substantive consolidation where the non-debtor is typically subsumed into the debtor all for the benefit of the debtor's creditors.

Further, for-profit operating businesses that are substantively consolidated could, conceivably, continue to conduct business under Chapter 11 of the Bankruptcy Code. For charitable organizations, it's hard to imagine any bankruptcy scenario in which the organization would continue its core function—philanthropy. The whole point of substantive consolidation is to make the non-debtor's assets available to pay creditors and

not to diminish those assets by making contributions to other charities. Again, as articulated in *Michigan Sanitarium*, this is not what Congress intended – it intended to protect charities and preserve their separate and distinct existence.

CONCLUSION

The Appellant has not pointed to a single case in which a non-debtor charity was substantively consolidated with a debtor in bankruptcy. In addition to the fact that doing so is unsupported by the law, there would be negative policy ramifications that would adversely affect positive work done by the robust community of U.S. charitable foundations. COF respectfully requests that the Court affirm the bankruptcy court's order granting the Appellees' motion for summary judgment.

Dated: October 27, 2016

FOX ROTHSCHILD LLP

By: s/ Steven W. Meyer
Steven W. Meyer (#160313)

Campbell Mithun Tower – Suite 2000
222 South Ninth Street
Minneapolis, Minnesota 55402-3338
Telephone: (612) 607-7000
Email: smeyer@foxrothschild.com

ATTORNEYS FOR COUNCIL ON FOUNDATIONS, INC.

CERTIFICATION OF COMPLIANCE

Pursuant to Fed. R. Bankr. P. 8015 and D. Minn. Local Rule 8015(a)(7)(B)(i), I certify that this brief contains 2,887 words, exclusive of addendum pages and those parts of the brief exempted by Fed. R. Bankr. P. 8015(a)(7)(B)(iii). The brief has been prepared in proportionally spaced typeface using Microsoft Office Word 2010 and 13 point Times New Roman type.

Dated: October 27, 2016

FOX ROTHSCHILD LLP

By: s/ Steven W. Meyer
Steven W. Meyer (#160313)

Campbell Mithun Tower – Suite 2000
222 South Ninth Street
Minneapolis, Minnesota 55402-3338
Telephone: (612) 607-7000
Email: smeyer@foxrothschild.com

ATTORNEYS FOR COUNCIL ON FOUNDATIONS, INC.