

Unclear bankruptcy rules challenge Catholics and Disciples: Nonprofit status may help determine legal precedents

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The nonprofit status of the Catholic Archdiocese of Portland, Oregon, which filed for bankruptcy last month, and the Protestant-affiliated National Benevolent Association, which filed for protection in February, may help determine legal precedents for church bodies that say they are unable to meet their financial obligations.

The vast majority of organizations that file for bankruptcy protection are for-profit companies. Statutes and abundant case law set clear priorities for the court as it straightens out companies' finances: creditors come first, shareholders second.

Nonprofits are different in several important ways—not the least because such filings have been relatively rare. Also, nonprofits don't have shareholders. They are exempted from taxes in exchange for meeting a mission such as housing the poor or, in the archdiocese's case, operating a church.

And, when a nonprofit files for bankruptcy protection, the court faces a tough decision: Can money donated to serve a charitable mission be used to pay off creditors?

Take, for example, the case of National Benevolent Association, a large St. Louis-based agency affiliated with the Christian Church (Disciples of Christ). The association, which serves abused children, the disabled and the elderly, filed for bankruptcy this year after issuing more than \$200 million in bonds.

"There's always the tension in these cases between repaying creditors and the mission of the charity," said Howard Seife, a New York attorney with Chadbourne &

Parke LLP.

In its first bankruptcy court hearing in Texas, Judge Ronald B. King made it clear that the nonprofit has a new top priority. “They have a mission, and the new mission is to pay the creditors,” said King, according to a transcript of a February 18 hearing. Seife, who represents creditor KBC Bank, said the statement was telling. “If there is a trend, it is to put the interests of the creditors as paramount,” Seife said.

But Stephanie Wickouski, an attorney with Gardner Carton & Douglas in Washington, D.C., said there isn’t enough legal precedent on nonprofit bankruptcies to draw broad conclusions. “These arguments are still somewhat groundbreaking on both sides,” she said.

A critical test, she said, is whether a nonprofit’s assets fall under the “charitable trust doctrine.” The doctrine, part of common law, holds that if money is donated to a charity for a specific purpose, it cannot be used in any other way. “One controversy is whether the not-for-profit corporation is essentially a charitable trust,” Wickouski said.

If assets of the Portland archdiocese qualify under the doctrine, Wickouski said, local Catholics may argue that their donations should not be used to pay creditors. In a letter posted on the archdiocese Web site, Archbishop John G. Vlazny wrote that among assets being claimed by plaintiffs’ attorneys are “various trust funds holding charitable contributions.” But Vlazny wrote that he would not and cannot use assets held in charitable trust.

The archdiocese’s filing for Chapter 11 bankruptcy protection July 6 temporarily shielded the archdiocese from claims by lenders and more than 60 plaintiffs in clergy abuse cases. But the degree of protection ultimately will depend on the U.S. Bankruptcy Court and how it defines the organization and its assets.

Bankruptcy researchers and officials at nonprofit associations said they don’t know of any tallies of nonprofit bankruptcies. But such filings are rare, they said.

Chapter 11 bankruptcy protection gives organizations leeway to reorganize without completely liquidating. That’s attractive to owners who want to salvage at least part of their business while paying off debt. Nonprofits in financial distress often simply close up shop and cease operations, said G. Ray Warner, a law professor and bankruptcy expert at St. John’s University in New York.

Some troubled nonprofits, instead of shutting down or filing for bankruptcy, merge with another nonprofit with a similar mission, said Craig Stevens, the officer in charge of the association and nonprofit practice at Aronson & Company, a Maryland accounting firm.

As nonprofits have grown and taken on more characteristics of the for-profit world, courts have had to discern how to handle their bankruptcy cases. -*Jeff Kosseff, Religion News Service*