PROTECTING CHARITIES FROM STATE FRAUDULENT TRANSFER LAW

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Last year Senator Bennett and Representative Steubie introduced a bill amending the Florida Uniform Fraudulent Transfer Act (FUFTA). In essence, the bill would have given charities an absolute defense to the avoidance of charitable donations as fraudulent transfers by stating that such transfers, if made with the intent to defraud creditors, are for reasonably equivalent value. The Section formally opposed the bill primarily because it created a forum-shopping problem. Any transferor that was not paying its debts, could be forced involuntarily into bankruptcy, where nearly all donations to charities are voidable. The proposed departure from uniformity would have been functionally meaningless.

The proponents of the bill asked for help in solving the forum-shopping problem, while providing as much protection to charities as possible. A number of us pitched in. The result was a redrafted bill that would provide charitable donations some protection from FUFTA avoidance actions, but would not create incentive to place the donor involuntarily into bankruptcy. As to this redrafted bill, the Business Law Section withdrew its opposition to the bill. Instead we said the Business Law Section "takes no position" on the bill. The bill died in both houses without a vote.

The proponents of the bill intend to reintroduce it in the coming session, and have asked the Business Law Section for its affirmative support. Accordingly, the matter has been placed on the agenda of the Bankruptcy/UCC committee for discussion at the June meeting. My goal in this paper is to assist the Committee in its discussion.

I. THE FUNDAMENTAL QUESTION

Last year, the Bankruptcy/UCC Committee never actually focused on the fundamental issue, which is whether donations to charities should be protection from avoidance at the expense of the creditors of the donor. The centuries-old premise of fraudulent transfer law is that if you're not paying your creditors, you shouldn't be making gifts, and the person receiving the gift should have to give it back so the assets of the donor can be distributed to the donor's creditors. The innocence of the donee is irrelevant. Even if the lucky transferee has innocently spent the money and is no longer in a position to give it back, creditors are entitled to a judgment against the transferee. Having failed to give reasonably equivalent value, the good faith of the transferee is no defense.

So, the question might be restated: What is it about a charity that should permit it to retain the donation rather than return it to the donor's creditors?

A. THE SETTING IN WHICH THE ISSUE ARISES: TITHERS AND PONZI SCHEMERS

In recent years, the Bankruptcy Code has been amended to provide a narrow protection to charities from fraudulent transfer avoidance. Transfers protected are transfers made within the two years prior to bankruptcy by individuals not exceeding 15% of the individual's annual

income(or more if consistent with prior practice). Though applicable to charities generally, as defined in IRC §170(c)(1),(2), it is clear that congress' motive was to protect tithes. received by churches. It does not reflect a determination that charities, generally, are more deserving than creditors.

The setting in which the larger issue arises has invariably involved a ponzi scheme. To quote Soneet Kapila, trustee in the Pearlman bankruptcy, "A recession is like a low tide." Indeed, when the water recedes, the crabs, slugs and urchins appear. Similarly, when the economy recedes, people cut back on saving and investing, and many are forced to draw on savings and investments. Deprived of its life blood, a positive cash flow, a Ponzi scheme dies, which explains why so many Ponzi schemes have failed recently. Many fall directly into bankruptcy, but some find their way into state-law processes, such as receivership. Some, but not all, Ponzi schemers make a show of their generosity by making large donations to charities. Inevitably, the trustee or receiver seeks to recover the donations from the charities. But charities do not retain assets for a rainy day. They depend largely on cash flow. The cash comes in and it is put immediately to work. So, when the receiver demands return of the donations, the donations have been spent. Any repayment has to come out of future income, cutting into charitable works.

It is worth reflecting briefly on why the problem arises only out of failed Ponzi schemes. Legitimate individuals and corporations make large charitable contributions, too. But the individuals and corporations that are in a position to make large charitable contributions do not ordinarily meet financial collapse within two years of making the donation. Of course, as we have seen, in a severe recession asset value can drop precipitously. Still, most bankruptcy-bound individuals and corporations will have struggled economically in the two years prior to filing, and will not have been making large charitable donations. Ponzi schemes, in contrast, tend to collapse quickly, making it much more likely that the receiver can find charitable donations that have been made in the two to four years prior to the collapse. Finally, individuals in financial trouble do not utilize state processes such as receiverships and ABCs because individuals do not receive a discharge under state law. To get a discharge, individual debtors must file bankruptcy. So changes to state law would protect charities only where the trustee in bankruptcy needs to use state law to avoid charitable donations. Presumably this would occur where the trustee uses B.C. §544(b) to attack transfers made between 2 and 4 years prior to bankruptcy.

Ponzi schemes differ from ordinary individuals and corporations in another way that affects the balancing of equities between charities and creditors. The creditors of ordinary individuals and corporations are professional creditors, such as banks and bondholders. In contrast, most of the creditors of Ponzi schemers are defrauded investors who have entrusted their savings to the schemer in hope of a handsome return. While there is nothing in fraudulent transfer law that distinguishes among creditors, when choosing between a charity and an innocent creditor, the defrauded investor is a more sympathetic player than most banks and bondholders.

B. WHO ARE THE WINNERS AND LOSERS?

If charities are not protected from fraudulent transfer law, it is possible that a large judgment against a charity will drive it into dissolution. But realistically, trustees and receivers,

knowing they can't get blood from a stone, will be willing to arrive at a settlement that the charity can afford, perhaps with some difficulty, to pay. So the losers are those who do not receive the benefit of the charitable works that have been cut back. The losers might also be the employees of the charity to the extent that the diversion of income causes a reduction in staff benefits. The winners are the defrauded investors who receive some additional distribution. But they are not the only winners. Also in the winners column are the professionals whose fees and expenses are paid first, before the distribution to the defrauded investors.

Conversely, if charities are to be protected from fraudulent transfer law, the winners are the beneficiaries of the charitable works, and the losers are the professionals and defrauded investors who receive a smaller distribution.

In choosing between the beneficiaries of the charitable works and the defrauded investors, the benefit and detriment to the professionals and employees should probably be disregarded. Ideally, one should attempt to measure the benefit of a donation to the charitable beneficiaries as compared to the lost benefit to defrauded investors. Measuring the former would require extensive empirical study, but it would depend on the efficiency with which the charity is run and the nature of the benefits provided. Still, valuing a meal or shelter to a homeless person would be wholly subjective. Measuring the payout to defrauded investors would also vary from case to case, but I have heard estimates that in most Ponzi cases, the proportion of distribution derived from charities is on the order of just a few percent.

In my opinion, these are some of the factors the Committee should consider in deciding whether charities should be protected from state fraudulent conveyance law.

II. THE DETAILS

If the Committee and the Business Law Section decides to support the protection of charities from fraudulent transfer law, numerous practical questions arise as to how to do it. At the end of the day, the proposed bill had been greatly improved. It is attached below. By providing little more protection of transfers to charities within the two years prior to bankruptcy than is provided by the Bankruptcy Code, the incentive to force the ponzi scheme involuntarily into bankruptcy is minimized. If state-law receivership makes the most sense, then receivership it shall be.

What is a charity? The bill takes the definition from the Bankruptcy Code, which borrows §170(c) from the Internal Revenue Code. The category is quite broad, including organizations operated exclusively for religious, charitable, scientific, literary or educational purposes or to foster national or international amateur sports competition..." It also includes organizations of war veterans, fraternal societies operating as a lodge and certain cemetery companies. In my view, the definition needs to be pared down to "An organization operated exclusively for religious or charitable purposes." The Elks Lodge does not need this protection.

What kinds of transferors are included? The bill protects only transfers made by a natural person or a qualified religious or charitable entity or organization. This is problematic. The protection of transfers from charitable organizations to charitable organizations seems

anachronistic. It's there because it was intended to affect existing litigation, but the litigation has been settled. It makes no sense. Limiting transfers to those made by natural persons follows the Bankruptcy Code. It would operate if the Ponzi schemer personally make the contribution, but not if one of the schemer's corporations writes the check. In contrast, the bill just passed in Minnesota, protects all transfers to charities, which is much more protective. But if a substantial number of contributions are made by the schemer's corporations within the two years prior to collapse, it begs for an involuntary bankruptcy petition.

Transfers by ordinary individuals within the 2 years before bankruptcy cannot be protected by changing state law, because individuals in financial trouble always file bankruptcy to obtain the discharge. Perhaps the protection of all transfers under state law should apply only for those made more than 2 years prior to bankruptcy.

Should large charities be excluded from the protection? The Red Cross or United Way could write a large check without fear of dissolution, and probably without a severe cut back on services. Should an attempt be made to protect only the most vulnerable charities? Or only the most efficient charities? How could we do that? Probably can't.

There are more details that might be mentioned here, but this paper is already too long. If the Committee and the Section support the fundamental idea, we will work on the details, keeping the Committee and the Section apprised.