# CHAPTER 11 AND THE CHURCH: GOVERNING LAW IN CHURCH BANKRUPTCIES

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## GOVERNING LAW IN CHURCH BANKRUPTCIES[1]

Speaking from experience, the chapter 11 bankruptcy of a church entity is an entirely different animal from a commercial chapter 11 case—so much so that it requires a different mindset when approaching it. What follows is a discussion of some of the legal principles that apply to a religious nonprofit entity that are not ordinarily (if ever) implicated in a commercial bankruptcy proceeding.

### A. Special Bankruptcy Code Provisions Applicable to Church Debtors

Section 303(a) of the Bankruptcy Code provides that an involuntary bankruptcy petition may not be filed against "a corporation that is not a moneyed, business, or commercial corporation." 11 U.S.C. § 303(a). The legislative history describes this as a continuation of the Bankruptcy Act of 1898's prohibition on involuntary bankruptcy relief against "eleemosynary [i.e., charitable] institutions" such as "churches, schools, and charitable organizations and foundation[s]."[2] In its chapter 11 case, Catholic Diocese of Wilmington, Inc. ("Wilmington") took the position that the non-consensual substantive consolidation of non-debtor affiliates with Wilmington's bankruptcy estate (which the creditors' committee had sought by way of an adversary proceeding) was outside the scope of the bankruptcy court's equitable powers under § 105(a) of the Bankruptcy Code because it would permit an end-run around § 303(a)'s

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[2] H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 321 (1977); Sen. Rep. No. 95-989, 95th Cong., 2d Sess. 33 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6277, 5787 & 5819.

prohibition on involuntary bankruptcy relief against nonprofit entities.[3] The bankruptcy court was never called upon to decide this issue, however, as the adversary proceeding was settled prior to a determination. But presumably this issue will be teed up in other church cases, if it has not been already.

Section 1112(c) of the Bankruptcy Code provides similar protection to charitable institutions by precluding conversion of a chapter 11 case to chapter 7 "if the debtor is a . . . corporation that is not a moneyed, business, or commercial corporation, unless the debtor requests such conversion." 11 U.S.C. § 1112(c). In light of this, some Church debtors have taken the position that a hypothetical chapter 7 liquidation analysis is not necessary to satisfy the "best interests of creditors" test under § 1129(a)(7)(A)(ii).[4] So far as this author is aware, however, the issue has not been decided by any bankruptcy court.

Section 1221 of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (2005) (hereinafter, "BAPCPA"), titled "Transfers Made by Nonprofit Charitable Corporations," amended §§ 363, 541, and 1129 of the Bankruptcy Code to

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[3] Op. Br. in Supp. of Debtor's Mot. for J. on the Pleadings (Phase II) at 25-31, *Official Committee of Unsecured Creditors v. Catholic Diocese of Wilmington, Inc. (In re Catholic Diocese of Wilmington, Inc.)*, Docket No. 204, Adv. Proc. No. 09-52866(CSS) (Bankr. D. Del. Oct. 8, 2010). *Cf. Helena Chemical Co. v. Circle Land & Cattle Corp. (In re Circle Land & Cattle Corp.)*, 213 B.R. 870, 876-77 (Bankr. D. Kan. 1997) (dismissing substantive consolidation complaint brought against non-debtor farmer by creditor of the debtor, finding such relief would run afoul of § 303(a)'s prohibition on involuntary bankruptcy relief against farmers); *Morse Operations, Inc. v. Robins Le-Cocq, Inc. (In re Lease-A-Fleet, Inc.)*, 141 B.R. 869, 876 (Bankr. E.D. Pa. 1992) (dismissing substantive consolidation complaint brought against non-debtor by creditor of the debtor, finding it "an indirect attempt to file an involuntary case against [the non-debtor], which, if attempted directly, would be subject to sanctions under § 303(i)").

[4] *E.g.*, Third Amended Disclosure Statement Regarding Plan of Reorganization Dated, May 25, 2005 at 85-86, *In re Roman Catholic Church of the Diocese of Tucson* aka *the Diocese of Tucson*, Case No. 4-bk-04-04721-JMM (Bankr. D. Ariz. May 25, 2005) (analogizing to chapter 9 test requiring only "a reasonable effort by the [church] debtor that is a better alternative to the creditors than dismissal of the case" (internal quotation marks, citation omitted)).

bring them in line with state law governing charitable nonprofit corporations. BAPCPA § 1221(a)-(c). As amended:

- § 363 now provides, in pertinent part, that, "in the case of a debtor that is a corporation or trust that is not a moneyed business, commercial corporation, or trust," the trustee or debtor-in-possession "may use, sell, or lease of property of the estate under [§ 363(b) and (c)] . . . only in accordance with nonbankruptcy law applicable to the transfer of property by a debtor that is such a corporation or trust," 11 U.S.C. § 363(d)(1);

- § 541 now provides, in pertinent part, that, "[n]otwithstanding any other provision of this title, property 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," 11 U.S.C. § 541(f); and

- § 1129 now provides, in pertinent part, that all transfers of property under a chapter 11 plan "shall be made in accordance with any applicable provisions of nonbankruptcy law that govern the transfer of property by a corporation or trust that is not a moneyed, business, or commercial corporation or trust," 11 U.S.C. § 1129(a)(16).

BAPCPA § 1221(d) provides, in pertinent part, that "[t]he 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." This is consistent with the States' historical role as *parens patriae* to enforce the terms of charitable trusts (the beneficiaries of which are, by definition, indeterminate and thus unable to speak for themselves).[5] BAPCPA § 1221(e) clarifies that nothing in § 1221 "shall be construed to require the [bankruptcy court] to remand or refer any proceeding, issue, or controversy to any other court or to require the approval of any other

[5] *See Hawaii v. Standard Oil Co. of Cal.*, 405 U.S. 251, 257-60 (1972) (discussing the history of the *parens patrie* concept); *Beatty v. Kurtz*, 27 U.S. 566, 584 (1829) (noting right of the state government, through its attorney general, to enforce a charitable trust as *parens patriae*); *Ky. Emples. Ret. Sys. v. Seven Counties Servs. (In re Seven Counties Servs.)*, 511 B.R. 431, 471 (Bankr. W.D. Ky. 2014) (noting BAPCPA § 1221 was enacted "so that a non-profit entity cannot escape supervision by its state's Attorney General").

court for the transfer of property." The impact of §§ 363(d)(1), 541(f), and 1129(a)(16) is illustrated in *In re Save Our Springs (S.O.S.) Alliance, Inc.*,[6] discussed below.

## B. State Law of Charitable Nonprofit Corporations

While it is clear from the Bankruptcy Code provisions discussed above that state law governing charitable corporations should play a significant role in a Church debtor's bankruptcy proceedings, it can be hard to pin down exactly what that law comprises in a given state. Potential sources of law include the common law of trusts, uniform statutory enactments, and secondary sources discussed below. But the primary take-away from all of these sources for present purposes, and a point on which they all agree, is as follows: ***donor-imposed restrictions on the use or disposition of assets by a charitable nonprofit corporation—including both express restrictions and, in some circumstances, implied-in-fact restrictions—are legally enforceable***.[7] As a result, the property of a Church debtor's estate must be understood and treated in accordance with its "restricted" or "unrestricted" character,[8] as illustrated by the *Save our Springs* case discussed below (involving a non-church nonprofit debtor, but dealing with the issue of restricted assets).

### 1. Uniform Prudent Management of Institutional Funds Act

49 states (all but Pennsylvania), the District of Columbia, and the U.S. Virgin Islands have all adopted the Uniform Prudent Management of Institutional Funds Act ("UPMIFA") to

[6] 388 B.R. 202 (Bankr. W.D. Tex. 2008), *aff'd sub nom. Save Our Springs Alliance, Inc. v. WSI (II)-COS, L.L.C.*, 632 F.3d 168 (5th Cir. 2011).

[7] *See generally* John K. Eason, *The Restricted Gift Life Cycle, or What Comes Around Goes Around*, 76 Fordham L. Rev. 693 (2007); Susan N. Gary, *Charities, Endowments, and Donor Intent: The Uniform Prudent Management of Institutional Funds Act*, 41 Ga. L. Rev. 1277 (2007).

[8] And of course, any assets held by the debtor in charitable trust are not property of the estate in any event. *See* 11 U.S.C. § 541(d).

govern the management of funds held by an "institution" exclusively for "charitable purposes." UPMIFA § 2(5). As defined in the UPMIFA, the term "institution" includes (i) an entity "organized and operated exclusively for charitable purposes," (ii) "a government or governmental subdivision, agency, or instrumentality, to the extent that it holds funds exclusively for a charitable purpose," and (iii) "a trust that had both charitable and noncharitable interests, after all noncharitable interests have terminated." *Id.* § 2(4). Consistent with the Uniform Trust Code and the Restatement (Third) of Trusts (both discussed below), the UPMIFA defines "charitable purposes" to include "the relief of poverty, the advancement of education or religion, the promotion of health, the promotion of a governmental purpose, or any other purpose the achievement of which is beneficial to the community." UPMIFA § 2(1).

Section 3(a) of the UPMIFA requires an institution to manage and invest charitable funds "[s]ubject to the intent of [the] donor expressed in [the] gift instrument." The term "gift instrument" is defined broadly to include any "record or records . . . under which property is granted to, transferred to, or held by an institution as an institutional [i.e., charitable] fund." *Id.* § 2(3). According to the official commentary, section 3(a) imposes an "overarching duty to comply with donor intent as expressed in the gift instrument." UPMIFA § 3(a) Comment.

### 2. Uniform Trust Code

30 states[9] and the District of Columbia have enacted the Uniform Trust Code ("UTC"), which was promulgated by the Uniform Law Commission in 2000.[10] The UTC applies, among

[9] Specifically: Alabama, Arizona, Arkansas, Florida, Kansas, Kentucky, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, New Hampshire, New Mexico, North Carolina, North Dakota, Ohio, Oregon, Pennsylvania, South Carolina, Tennessee, Utah, Vermont, Virginia, West Virginia, Wisconsin, and Wyoming. The legislation has been proposed in New Jersey this year. http://www.uniformlaws.org/Act.aspx?title=Trust%20Code (last visited 7/30/15).

other things, to charitable trusts. UTC § 102. For purposes of the UTC, a "charitable trust" is a trust that was created for a "charitable purpose," the definition of which is identical to that in the UPMIFA discussed above. UTC §§ 103(4) & 405(a). Under the UTC, "[u]pon acceptance of a trusteeship," the charitable trustee is required to "administer the trust in good faith, in accordance with its terms and purposes and the interests of the beneficiaries." *Id.* § 801. A trustee can "accept" trusteeship by (i) "substantially complying with a method of acceptance provided in the terms of the trust," or (ii) "accepting the trust property, exercising powers or performing duties as trustee, or otherwise indicating acceptance of the trusteeship." *Id.* § 701. Once a charitable trust is accepted by the trustee, the terms of the trust may be judicially enforced by the settlor or the state attorney general. *Id.* § 405(c) and Comment.

### 3. Restatement (Third) of Trusts

Volumes 1 and 2 of the Restatement (Third) of Trusts (the "Restatement"), which were published by the American Law Institute (the "ALI") in 2003, restated the law of trust creation and interpretation. Volume 3 of the Restatement, which was published by the ALI in 2007, restated the law of trustee powers and duties.

The Restatement deals with, among other things, charitable trusts. Restatement § 1(b). Charitable trusts are distinct from "private" trusts in that they do not have "specified or described persons who are designated as beneficiaries," but rather, they are "devoted to purposes the law deems appropriately beneficial to the public." *Id.* § 1, Comment *c*.; § 2, Comment *h.* ("A charitable trust . . . can be created although no definite beneficiary is provided."); § 27(1) ("[A] trust may be created for charitable purposes . . . ."). Permissible "charitable purposes" under the Restatement are identical to those set forth in the UPMIFA and the UTA. *See* Restatement § 28.

[10] http://www.uniformlaws.org/ActSummary.aspx?title=Trust%20Code (last visited 1/27/15).

A trust is only created if the settlor properly manifests an intention to create a trust relationship. *Id.* § 13. However, no "magic words" are required to create a trust, and the intention to create a charitable trust will be inferred where property is given to the government or to a charitable institution for a specified charitable purpose. *See Valentini v. Shinseki*, 860 F. Supp. 2d 1079, 1105–6 (C.D. Cal. 2012) (construing deed of real property to the United States "for the purpose of [a] branch home for Disabled Volunteer Soldiers to be thereon located, established, constructed and permanently maintained" to have established a charitable trust imposing trustee duties on the federal government); Restatement § 28, Comment *a.* ("A disposition [of property] to [a charitable] institution for a specific purpose, . . . such as to support medical research, perhaps on a particular disease, or to establish a scholarship fund in a certain field of study, creates a charitable trust of which the institution is the trustee for purposes of the terminology and rules of this Restatement."). According to the official commentary to the Restatement,

> [c]haritable trusts are favored not only in regard to the rules to which they are subject . . . but also in matters of interpretation. Thus, courts prefer to find that a purpose is limited to charity and qualifies as a charitable purpose when uncertain language is susceptible of a broader, not strictly charitable interpretation.

Restatement § 28, Comment *a.* This being said, an "outright devise or donation" to a charitable institution, "expressly or impliedly to be used for its general purposes, is charitable but does not create a trust . . . ." *Id.*

### 4. Principles of the Law of Nonprofit Organizations

In 2000, the ALI began work on its Principles of the Law of Charitable Nonprofit Corporations, tentative drafts of which were approved between 2007 and 2013[11] (collectively, the "Principles," and each tentative draft, a "TD"). Chapter 4 of the Principles deals with gifts, which encompasses charitable trusts and restricted gifts. Principles, Chapter 4 Introductory Note TD 2 (2009); *id.* § 400, Comment *a.* For purposes of the Principles, a "gift" refers to a "donative transfer not in trust" (*id.* § 400, Scope and Cross-Reference) and is thus distinct from a "trust."

The Principles recognize that states vary on whether a gift made for a specific charitable purpose creates a charitable trust, but that courts "uniformly" hold that gift restrictions are enforceable against the donee even if it is not, strictly speaking, a "trustee." *See id.* § 400, Comments *b.* and *c.* Thus, under the Principles:

> (a) A transfer to a charity does not create a charitable trust unless the settlor expresses an intent to create a charitable trust and the trustee, which may be a charity, agrees to act as trustee of that trust according to its terms.
>
> (b) A gift to a charity not made in trust transfers complete ownership to the charity, although *the charity is bound by any conditions or restrictions . . . imposed by the donor in the gift instrument*. . . .

Principles § 400 (emphasis added). As used in this section, the term "charity" includes "any person receiving property, whether in trust or otherwise, for charitable purposes," and is not limited to the colloquial definition of a "charity." *Id.*, Scope and Cross-References ("A gift for charitable purposes may be made to an entity that is not itself a charity, such as another type of

[11] http://www.ali.org/index.cfm?fuseaction=projects.proj_ip&projectid=3 (last visited 7/31/15). The project has since been renamed the Restatement of the Law, Charitable Nonprofit Organizations.

nonprofit organization, or in trust to an entity that is not a charity, such as to a bank trustee. In addition, a charity might hire a professional fundraiser."). The Principles go on to say that

> the law will enforce, although not supply, terms in a trust or gift instrument, such as those requiring that the trust or gift—
>
> (a) Is to be used for a specified charitable purpose or activity. . . .
>
> (c) Is to be used to provide benefits within a specific geographic area. . . .

*Id.* § 410. While the Principles do not (as yet) define "charitable purpose," presumably it will be the same definition that is used by the UPMIFA, the UTC, and the Restatement.

To impose a legally binding limitation on a charitable gift, a donor need only "includ[e] such a term in an express statement made in a gift instrument." Principles § 400, Comment *d.(1).* While the Principles do not (as yet) define "gift instrument," the commentary to section 400 provides as follows:

> [T]he definition of gift instrument as set forth in . . . this Section does not depend on the terminology used to describe the document or other record. Indeed, the gift instrument may comprise more than one document or record, so long as they are integrated (that is, simultaneous and intended to be binding). Thus, a gift instrument includes, for example, a deed of gift; a cover letter and the accompanying check; a response and a written solicitation (or a written confirmation of a solicitation); and a charity's online solicitation webpage on which the donor indicates a particular purpose for a gift made by credit card.

*Id.* The commentary goes on to provide the following illustrations:

> 1. Donor A writes on the "purpose" line of his check: "For the Building Fund." Accordingly, A's gift is restricted. The donee charity has an existing building fund, and so the charity has no grounds to seek judicial modification of the restriction . . . .
>
> 2. The same facts as Illustration 1, except that the donee charity is not planning a new building, and has not established a fund to do so. The charity should have controls in place to ensure that a check bearing a notation of this sort is flagged before it is deposited, and that someone from the charity contacts the donor to

> clear up any misunderstanding. . . . . Otherwise, in a suit by the charity to modify the restriction, the court could take into account the size of the check in determining the particular purpose for which the gift is binding. For example, if this gift is for an immaterial amount, the court could find that it could properly be expended on building maintenance (if the charity owns real estate) or on rent (if the charity leases space).
>
> 3. M owns a 300-acre farm in a rural area of county X. This rural area has been identified at both the local and state levels as worthy of protection in its undeveloped state for its scenic, watershed, open-space, and wildlife-habitat values. M donates a conservation easement encumbering the farm to Land Trust, a corporate charity that operates to protect land with significant conservation values throughout county X. The instrument of conveyance provides that the easement is granted for the purpose of protecting the scenic, open-space, and wildlife-habitat values of the farm in perpetuity. It also prohibits certain uses of the farm that are inconsistent with that purpose. M's gift of the conservation easement is a restricted gift . . .

*Id.*

### 5. Restricted Assets in Chapter 11 – *In re Save Our Springs Alliance*

Save Our Springs (S.O.S.) Alliance, Inc. ("SOS") was a non-profit corporation whose primary purpose was to advance community awareness of water pollution and to protect local water sources, often through litigation against property developers. SOS relied almost entirely on donations to fund its operations, and its few hard assets consisted primarily of office furniture and equipment. SOS lost a lawsuit against a property developer, and the developer was awarded judgment on its counterclaim for approximately $300,000 of attorneys' fees. Unable to pay this amount or reach an alternative settlement with the assignee of the judgment (Sweetwater), SOS filed for chapter 11 relief and proposed a plan that would pay Sweetwater and other creditors *pro rata* from a $60,000 fund to be raised from donors for that purpose, with SOS retaining all of its other assets post-confirmation, including the remaining cash from a restricted gift received by SOS prepetition to fund its education initiatives. Sweetwater objected to confirmation on a

number of grounds, including that the plan was not proposed in good faith as required by § 1129(a)(3) because the plan did not provide for the maximum repayment of creditors, insofar as the restricted cash would be retained by SOS. In this connection, Sweetwater had also adduced evidence at trial that SOS had commingled the restricted funds with general operating funds and used them to fund general operations prepetition. *Save Our Springs*, 388 B.R. at 209-22.

While confirmation was ultimately denied on other grounds (relating to its classification scheme and feasibility), the bankruptcy court overruled the objection based on the good faith requirement, reasoning, in pertinent part, as follows:

> While the question is a close one precisely because of the Plan's impermissible classification scheme and the small size of the payments proposed, the Court nevertheless finds that its provision for Sweetwater's claim to be paid pro rata with other unsecured claims from a designated fund consisting of only $60,000, obtained by the Debtor from specific donations solicited for that purpose, does not amount to bad faith. The evidence presented at the hearing demonstrated SOS's lack of assets, the recent decline in donations that it has received since Sweetwater and the other judgment creditors obtained their judgments, and the difficulty that SOS has had in soliciting future donations and/or commitments to donate for the purpose of funding the Creditor Settlement Fund under the Plan.
>
> In addition, SOS's donors' ability to restrict their donations to particular uses, not including the payment of judgments, is clearly problematic in determining how much SOS should be required to pay on those judgments. Sweetwater argues that the Debtor's position that certain of its donations are "restricted" and so are not property of its estate and not available to pay its creditors, is evidence that it lacks good faith in proposing its Plan. In particular, Sweetwater argues that because SOS commingled its grant funds, they either never were truly "restricted" or they have lost their "restricted" character. The Court disagrees, however, and finds that the restricted funds held by the Debtor are not property of the estate.

> . . . . As pointed out by the Debtor in its Brief, § 541(f) now provides [that state law governs transfers of property by non-profit debtors].
>
> Nothing in the terms of the grants themselves would require physical segregation of SOS's restricted funds, nor have the parties pointed to anything in Texas law that would require such segregation. The Debtor did account for its restricted monies separately.
>
> . . . . [However, based on evidence adduced by Sweetwater], the Court finds, the Debtor spent at least $18,829.93 of the [restricted educational g]rant without authorization.
>
> . . . . Sweetwater apparently contends[] the Debtor and its major donors are playing fast and loose with the Debtor's major asset, its donations, by labeling them "restricted" when it suits their purposes during bankruptcy and the process of proposing a plan of reorganization, and ignoring those "restrictions" when it did not, prior to the bankruptcy filing.
>
> The Court finds, however, that the Debtor's apparent unauthorized use of restricted funds should not override the express intent of the donors, and should therefore not destroy the overall character of the funds as restricted. The evidence on the issue was limited to the Debtor's inability to explain the accounting that indicates its use of some of the funds was not unauthorized. The Court finds, however, that there was insufficient evidence to establish any sort of complicity between the Debtor and the donors, and or malfeasance or bad faith on the part of the Debtor. Confirmation of this Debtor's Plan has presented a number of unusual and even unique issues, including what a debtor in SOS's position can and must offer creditors when its source of income is donors who have the right to choose whether or not to fund a plan. Based on all the evidence presented and the totality of the circumstances of this case, the Court finds and concludes that there was no credible evidence that the Plan was proposed with bad intent or malfeasance, or in contravention of any applicable law. It appears that the Debtor was merely exercising its rights under the Code.

*Save Our Springs*, 388 B.R. at 246-49 (internal footnotes, citations, quotation marks omitted).

While the treatment of restricted assets under a chapter 11 plan for a Church debtor has not yet produced any written opinions (so far as this author is aware), the issue arises in every church case. For instance, in *Wilmington*, the debtor held approximately $33 million of assets

subject to donor-imposed restrictions that precluded them from being used to pay general creditor claims. However, certain restricted assets *could* be used to pay certain types of claims, *e.g.*: (i) the proceeds of a capital campaign for the construction of a new school could be used to pay claims relating to the municipal bonds that were used to finance the construction, and (ii) restricted gifts for the care of elderly clergy could be used to satisfy pension obligations to retired clergy. The creditors' committee, comprised of holders of clergy sex abuse claims, disputed whether the debtor's assets were restricted (among the many other things it disputed). The debtor ultimately proposed a "toggle" plan that proposed a global settlement of clergy sexual abuse claims, on the one hand, or a fully-litigated outcome, on the other hand. The classification and treatment of creditors under the litigation toggle (which was structured as a "pot plan" with the size of the pot to be determined through litigation) was based upon the debtor's understanding of which of its assets were unrestricted versus restricted, and what the permitted expenditures of restricted funds would be. But it also accounted for the possibility that, through litigation, it could be determined that all assets were unrestricted and should be shared *pro rata* by all unsecured creditors. To provide voting creditors adequate information about the range of possible outcomes under the toggle plan, the debtor had to include four separate distribution analyses (one for the settlement toggle, and a high-low-middle for the litigation toggle) and three separate liquidation analyses (a high-low-middle).[12] Wilmington's plan was ultimately confirmed under the settlement toggle, obviating what would no doubt have been complex and protracted litigation on the restricted assets (among other things).

[12] *See* Disclosure Statement Pursuant to Section1125 of the Bankruptcy Code With Respect to the Second Amended Chapter 11 Plan of Reorganization of Catholic Diocese of Wilmington, Inc. at 5-13 (summary of claim classification/treatment, distribution analysis), 26-28 (description of debtor's assets), and Ex. C (hypothetical chapter 7 liquidation analysis), *In re Catholic Diocese of Wilmington, Inc.*, Docket No. 1322, Case No. 09-13560(CSS) (Bankr. D. Del. May 23, 2011).

## C. First Amendment Religion Clauses

The "Religion Clauses" of the First Amendment provide as follows: "Congress shall make no law respecting an establishment of religion [the "Establishment Clause"], or prohibiting the free exercise thereof [the "Free Exercise Clause"]." U.S. Const. amend. I. The Religion Clauses are enforceable against the States by virtue of the Due Process Clause of the Fourteenth Amendment. *See* U.S. Const. amend. XIV, § 1; *Cantwell v. Connecticut*, 310 U.S. 296, 302 (1940).

### 1. Establishment Clause

The Supreme Court's Establishment Clause jurisprudence is unsettled.[13] However, for present purposes—and at the risk of oversimplification—suffice it to say that the Establishment Clause is implicated by any law or legal process that "foster[s] 'an excessive government entanglement with religion.'" *Lemon v. Kurtzman*, 403 U.S. 602, 613 (1971) (quoting *Walz v. Tax Comm'n of City of N.Y.*, 397 U.S. 664, 674 (1970)). And unlike the Free Exercise Clause, which secures rights that are personal in nature and thus waiveable by the religious actor, the Establishment Clause represents a structural limitation on governmental power that does not

[13] *See Lemon v. Kurtzman*, 403 U.S. 602, 612-613 (1971) (setting forth what has come to be known as the "*Lemon* test"); *Lynch v. Donnelly*, 465 U.S. 668, 687 (O'Connor, J., concurring) (setting forth the "endorsement test"); *Capitol Square Review and Advisory Bd. v. Pinette*, 515 U.S. 753, 800, n. 5 (1995) (Stevens, J., dissenting) (agreeing that an "endorsement test" should apply but criticizing its "reasonable observer" standard); *Santa Fe Independent School Dist. v. Doe*, 530 U.S. 290, 319 (2000) (Rehnquist, C.J., dissenting) (noting *Lemon*'s "checkered career in the decisional law of this Court"); *County of Allegheny v. ACLU*, 492 U.S. 573, 655-56 (Kennedy, J., joined by Rehnquist, C.J., and White and Scalia, JJ., concurring in judgment in part and dissenting in part) (criticizing the *Lemon* test); *Van Orden v. Perry*, 545 U.S. 677, 686 (2005) (declining to apply *Lemon* test to challenge to display of Ten Commandments on the grounds of the Texas capitol).

admit of a "waiver" analysis.[14] *See generally* Carl H. Esbeck, *The Establishment Clause as a Structural Restraint on Governmental Power*, 84 Iowa L. Rev. 1, 98-104 (1998).

### 2. Free Exercise Clause

The Supreme Court's Free Exercise Clause jurisprudence appears well-settled. The Free Exercise Clause categorically prohibits "governmental regulation of *beliefs* as such," *Sherbert v. Verner*, 374 U.S. 398, 402 (1963); accordingly, government

> may not compel affirmation of religious belief, punish the expression of religious doctrines it believes to be false, impose special disabilities on the basis of religious views or religious status, or lend its power to one or the other side in controversies over religious authority or dogma.

*Employment Div. v. Smith*, 494 U.S. 872, 877 (1990) (internal citations omitted). The Free Exercise Clause also prohibits governmental bans on the performance of (or abstention from) physical acts "only when they are engaged in for religious reasons, or only because of the religious belief that they display. *Smith*, 494 U.S. at 877. However, it does *not* prohibit enforcement of "a valid and neutral law of general applicability on the ground that the law proscribes (or prescribes) conduct that [a religious actor's] religion prescribes (or proscribes)," unless the law at issue impinges upon some other constitutional protection in addition to the religious actor's free exercise rights. *Id.* at 879 (internal quotation marks, citation omitted). In determining whether a law burdening religious practice is neutral, the Supreme Court looks first to the text of the law, and then to the law's underlying purposes and the circumstances of its

[14] In this author's experience, a frequent retort to an Establishment Clause argument by a religious actor is an appeal to equity or general fairness, i.e., that the religious actor is attempting to obtain the benefits of the law at issue without the attendant burdens, or using the Establishment Clause "as a sword, instead of a shield." In this author's view, if the Establishment Clause is properly viewed as a limitation on government power as such, then the motivations of the religious actor and the abstract fairness of the result it seeks are irrelevant to the legal analysis.

enactment. *See Church of the Lukumi Babaly Aye, Inc. v. City of Hialeah*, 508 U.S. 520, 533-34 (1993) (finding municipal ordinance prohibiting killing of animals "not for the primary purpose of food consumption" was not neutral because it was specifically intended to prohibit ritual animal sacrifices by Santeria practitioners).

### 3. Church Autonomy (or Ecclesiastical Abstention) Doctrine

Sometimes the Religion Clauses overlap. One such area of overlap is the "church autonomy doctrine" (or "ecclesiastical abstention" doctrine), which generally requires civil courts to defer to church authorities on matters of internal church governance and polity.

For example, in the seminal case of *Serbian Eastern Orthodox Diocese of the United States of America and Canada v. Milivojevich*, the bishop of the Serbian Eastern Orthodox Diocese for the United States and Canada, who had been suspended and ultimately removed and defrocked as Bishop in connection with the Serbian Orthodox Church's reorganization of the diocese, sued the church in Illinois state court seeking an injunction against interference with diocesan assets held by Illinois not-for-profit corporations and a declaration that he was the true diocesan bishop. 426 U.S. 696, 697-708 (1976). After a lengthy trial, the church won on most issues. *Id.* The Illinois Supreme Court reversed in part, holding that the bishop's removal and defrockment had to be set aside as "arbitrary" because the proceedings against him had not, in its view, been conducted in accordance with the church's constitution and penal code. *Id.* The Supreme Court reversed, finding that "the First and Fourteenth Amendments mandate that civil courts shall not disturb the decisions of the highest ecclesiastical tribunal within a church of hierarchical polity, but must accept such decisions as binding upon them, in their application to the religious issues of doctrine or polity before them." *Id.* at 709. In other words, in resolving the secular legal dispute before it (i.e., regarding entitlement to the property held by Illinois not-

for-profit corporations), the courts were required to defer to the church as to who was the proper bishop.

*Maffei v. Roman Catholic Archbishop of Boston*, 867 N.E. 2d 300 (Mass. 2007), illustrates the application of *Milivojevich* to a dispute that has become common in the Roman Catholic Church as dioceses and archdioceses seek to consolidate operations. *Maffei* arose out of the suppression of a Catholic parish[15] and the resulting appropriation of the parish's real property by the Roman Catholic Archbishop of Boston (the "RCAB").[16] 867 N.E.2d 300, 305 (Mass. 2007). A group of parishioners appealed the suppression decree to the RCAB and, when that failed, appealed to the Vatican. *Id.* at 309 n.18. In the meantime, the parishioners who had donated the real property to the parish (who were also signatories on the appeal to the Vatican) sued the RCAB in Massachusetts state court, seeking declaratory and injunctive relief to prevent closure of the parish and transfer of its real property to the RCAB. *Id.* at 305. The trial court granted summary judgment in favor of the RCAB, and the Supreme Judicial Court of Massachusetts ("SJC") took direct review. *Id.* at 306. The SJC affirmed, reasoning, in pertinent part, as follows:

> The claims of all three plaintiffs rest, in whole or in part, on the presumption that the RCAB owed them a legal duty, grounded in the "trust and confidence" inherent (they allege) in the priest-parishioner relationship, to inform them that, under canon law, St. James could be suppressed at a future time. . . .
>
> We conclude that summary judgment in the RCAB's favor was proper. First . . . , insofar as the plaintiffs' causes of action are predicated on the alleged fiduciary or confidential relationship

[15] Suppression is a term of art under Canon Law, which refers to the process by which a parish's legal existence is terminated.

[16] Anecdotally, the RCAB's appropriation of the suppressed parish's assets was later determined by Church authorities to have been wrongful, as Canon Law dictated that the assets go not to the archdiocese, but rather to the parishes that were to receive the remaining parishioners of the suppressed parish.

> between a member of the Roman Catholic Church clergy and his congregants, the claims in this case raise matters of internal church governance that the First Amendment to the United States Constitution forbids us to consider. We may not, consistent with the First Amendment, inquire into any alleged pastoral duties owed by the Roman Catholic priesthood to its laity concerning matters of canon law. Second, to the extent that the plaintiffs' claims pertain to matters legally cognizable in our civil courts, they fail in one or more of their essential elements. . . .

*Id*. at 305-06 (internal citations omitted) (*citing*, *inter alia*, *Milivojevich*, 426 U.S. at 708-09). At the time the SJC rendered its decision, it did not know (or care) about the status of the parishioners' appeal to the Vatican. *Id.* at 309 n.18 ("The present status of the religious appeal is unknown; it has no bearing on the questions of civil law we decide today."). Rather, and in light of the limitations imposed by the Religion Clauses of the First Amendment, the SJC considered only "neutral principles of law" in evaluating the parishioners' claims:

> We have jurisdiction over church property disputes if and to the extent, and only to the extent, that they are capable of resolution under "neutral principles of law" – which the United States Supreme Court has defined as "well-established concepts of trust and property law familiar to lawyers and judges." [*Jones v. Wolf*, 443 U.S. 595, 603 (1979).]
>
> The standards enunciated above clearly forbid our consideration of the religious obligations, if any, of a clergy member to his or her congregants, or of the "trust and confidence" that may be engendered in congregants solely by virtue of the clergy's religious authority. We certainly must also stand apart from questions of canon law: we must avoid inquiry into whether the RCAB . . . owed a fiduciary, confidential, or any other duty to discuss with the plaintiffs the nature of property ownership under canon law. We may not inquire into the ecclesiastical authority of Reverend Vartzelis and Reverend Lord to bind the RCAB by making oral promises about church property, to examine the actual status or disposition of church property under canon law, or to attempt to interpret any particular provision of canon law. As a matter of constitutional law, such disputes are beyond our authority.

*Maffei*, 867 N.E. 2d at 310-11 (some internal citations omitted).

In *Hosanna-Tabor Evangelical Lutherna Church & School v. EEOC*, the Supreme Court held that the Religion Clauses of the First Amendment barred a parochial school teacher/minister from bringing an employment discrimination suit against her religious employer, reasoning as follows:

> The members of a religious group put their faith in the hands of their ministers. Requiring a church to accept or retain an unwanted minister, or punishing a church for failing to do so, intrudes upon more than a mere employment decision. Such action interferes with the internal governance of the church, depriving the church of control over the selection of those who will personify its beliefs. By imposing an unwanted minister, the state infringes the Free Exercise Clause, which protects a religious group's right to shape its own faith and mission through its appointments. According the state the power to determine which individuals will minister to the faithful also violates the Establishment Clause, which prohibits government involvement in such ecclesiastical decisions.

132 S. Ct. at 706. Applying *Hosanna-Tabor*, bankruptcy courts in the *Wilmington* and *Archdiocese of Milwaukee* cases disallowed proofs of claim filed by clergy that were disputed by the debtor. *In re Archdiocese of Milwaukee*, 515 B.R. 579, 581-84 (Bankr. E.D. Wis. 2014); *In re Catholic Diocese of Wilmington, Inc.*, 513 B,.R. 639, 644-50 (Bankr. D. Del. 2014).

**D. Federal Religious Freedom Restoration Act**

In response to *Employment Division v. Smith*, 494 U.S. 872 (1990), Congress enacted the Religious Freedom Restoration Act of 1994 ("RFRA"), 107 Stat. 1488, 42 U.S.C. § 2000bb *et seq.*, which provides, in pertinent part, that "[g]overnment shall not substantially burden a person's exercise of religion even if the burden results from a rule of general applicability." 42 U.S.C. § 2000bb-1(a). If government substantially burdens a person's exercise of religion, that person may assert violation of RFRA as a claim or defense in a judicial proceeding and obtain appropriate relief against the government. 42 U.S.C. § 2000bb-1(c). To prevail in such a proceeding, the government must establish that the application of the burden to the person is the

least restrictive means of furthering a compelling governmental interest. *See* 42 U.S.C. § 2000bb-1(b).

As originally enacted, RFRA defined "government" to include both the federal and state governments. However, in *City of Boerne v. Flores*, 521 U.S. 507, 533-34 (1997), the Supreme Court struck down RFRA as unconstitutional as applied to the states, which prompted a corrective amendment to the statute. As amended by the Religious Land Use and Institutionalized Persons Act of 2000, 114 Stat. 803, 42 U.S.C. § 2000cc *et seq.*, RFRA limits the definition of "government" to the federal government and U.S. territories. 42 U.S.C. § 2000bb-2(1) & (2). RFRA is, by its terms, applicable "to all Federal law, and the implementation of that law, whether statutory or otherwise, and whether adopted before or after November 16, 1993," and any "Federal statutory law adopted after November 16, 1993, is subject to [RFRA] unless such law explicitly excludes such application by reference to [RFRA]." 42 U.S.C. § 2000bb-3(a) & (b).

In bankruptcy, RFRA has been interpreted to prohibit the recovery by a chapter 7 trustee of tithes made by the debtors to their church prepetition. *Christians v. Crystal Evangelical Free Church (In re Young)*, 82 F.3d 1407 (8th Cir.), *vacated and remanded*, 521 U.S. 1114 (1997), *reinstated on remand*, 141 F.3d 854 (8th Cir. 1998).[17] It was also interpreted to prohibit the unsecured creditors committee's lawsuit to appropriate the funds of a catholic cemetery trust in the Archdiocese of Milwaukee case. *Listecki v. Official Committee of Unsecured Creditors (In*

[17] The holding in *Young* was partially codified by the 2005 amendments to the Bankruptcy Code, which included an exemption from avoidance under § 548 for certain charitable contributions. 11 U.S.C. § 548(a)(2).

*re Archdiocese of Milwaukee)*, 496 B.R. 905 (E.D. Wis. 2013), *rev'd*, 780 F.3d 731 (7th Cir. 2014).[18]

## E. Church Law

Like other hierarchical religious institutions, the Roman Catholic Church has its own laws and legal system, known generally as canon law. Unlike American law, canon law cannot be properly understood independent from Catholic theology and religious doctrine upon which it is premised. Canon law is not positive law in the manner of, e.g., the United States Code. It is a legal system based on Christian theology, as understood in accordance with the doctrines of the Roman Catholic Church, and natural law, as understood through the Catholic intellectual tradition, all carried into effect through the provisions of posited laws (positive law). There are, therefore, different sources of "canon law" (rendering it difficult, for example, to "cite" to the "applicable canon law"), as well as different levels of imperativeness to different provisions of the *1983 Code of Canon Law* (the "1983 Code").[19]

[18] The district court held that the committee was acting "under color of law" and thus constitute a state actor for purposes of applying RFRA, but the court of appeals reversed on this point. A petition for certiorari has been filed, but as of the writing of these materials, a global settlement has been reached in the underlying chapter 11 case that will likely moot the litigation between the cemetery trust and the creditors' committee. In this author's view, the Seventh Circuit Court of Appeals' opinion is going to be of little practical relevance going forward because even if a creditors' committee does not constitute a state actor subject to RFRA, the bankruptcy court clearly does. Thus, to the extent the creditors' committee would have needed to invoke the jurisdiction of the bankruptcy court in order to appropriate the assets of the cemetery trust, the bankruptcy court's exercise of such jurisdiction clearly would have constituted state action subject to scrutiny under RFRA. *See In re Young*, 82 F.3d 1407, 1417 (8th Cir. 1996) (holding chapter 7 trustee's avoidance and recovery of debtors' prepetition tithes to their church as fraudulent transfers would violate RFRA), *vacated on other grounds*, 521 U.S. 1114 (1997), *reaffirmed on remand*, 141 F.3d 854 (8th Cir. 1998).

[19] The authoritative text of the 1983 Code is, of course, in Latin. For the *illiterati* (including this author), *The Code of Canon Law Latin-English Edition, New English Translation*, which was prepared under the auspices of the Canon Law Society of America (Washington: Canon Law Society of America, 1989), serves as a quasi-"official" translation.

Laws that are based on, or carry out, the divine law as understood and taught by the *Magisterium* (i.e., teaching authority) of the Church and interpreted by scripture scholars and theologians have a particularly imperative quality because they are understood as founded upon the commands of God. Thus, some of the posited laws of the 1983 Code merely articulate, in canonical form, obligations that are believed to exist whether or not they are articulated in a posited law (for instance, the duty to render due worship to God).

The requirements of the natural law are believed to be a consequence of the "nature" of things as created by God, which therefore carries imperative, obligatory force for that very reason. The Roman Catholic intellectual, philosophical and theological tradition has a very well developed, concrete, and specific understanding of many (though not all) of the requirements of the natural law. It is taken as an article of faith, affirmed by the *Magisterium* of the faith, that compliance with the requirements of the natural law is obligatory for all members of the Church as a matter of religious faith and devotion to God. Some aspects of the natural law are also articulated in one way through posited laws in the 1983 Code and elsewhere (such as in decrees by a diocesan bishop), which are binding as canon law when so articulated.

Finally, because all human communities require regulations for the sake of public order and the protection of rights that are not mandated by either divine law or natural law, but which flow from it and nevertheless are necessary at particular times and in particular circumstances simply for the sake of public order and the protection of rights, some laws in the 1983 Code and other sources of canon law do not have the same level of imperativeness or obligatoriness as divine law or natural law, and can be dispensed from or over-ridden by the just requirements of civil authorities.

The Roman Catholic Church has a number of tribunals (or quasi-tribunals) charged with the interpretation, implementation, and enforcement of canon law (including what western lawyers would consider "civil" and "criminal" aspects). And anecdotally, canonical legal proceedings can be every bit as complex as (if not more than) secular legal proceedings. What does this all mean for a Church bankruptcy? It depends who you ask.

The debtors in the two earliest Church bankruptcy cases—the Diocese of Spokane and the Archdiocese of Portland—were faced with a problem that became the central issue in their cases, namely: they were organized for secular legal purposes as "corporations sole" whereby the bishop held legal title to all parish real property (the parishes themselves operating as unincorporated associations for secular legal purposes), despite that under canon law, the (arch)diocese and parishes were separate juridic entities each having title to its own property. Consistent with canon law, the debtors scheduled the parish real property as property held in trust for the parishes, and thus not property of the bankruptcy estate. Clergy sex abuse claimants in each case sued for a determination that the parish real property belonged to the debtors. The parishes intervened in the litigation and, together with the debtors, argued that their independent legal existence and ownership of their real property was not reasonably disputable under canon law, and thus, under the church autonomy doctrine, the courts were required to defer to canon law as to the ownership of the property. *Comm. of Tort Litigants v. Catholic Diocese of Spokane (In re Catholic Bishop of Spokane)*, 329 B.R. 304, 320-25 (Bankr. E.D. Wash. 2005); *Tort Claimants Comm. v. Roman Catholic Archbishop of Portland in Or. (In re Roman Catholic Archbishop of Portland in Or.)*, 335 B.R. 842, 851 (Bankr. D. Or. 2005). However, the courts sided with the abuse claimants, characterizing the litigation as purely secular disputes between the debtors and third-party creditors, which could be resolved under neutral principles of law.

*Spokane*, 329 B.R. at 323 ("[This controversy] involves the rights of creditors of the religious organization, not disputes among its members or component parts."); *Portland*, 335 B.R. at 853 ("Who owns the property is, quite simply, not a theological or doctrinal matter."). Judge Perris went on to observe that,

> as a religious organization, [the Archdiocese of Portland] is free to organize its internal affairs in accordance with internal church law. It has choices about how to organize itself under civil law in a way that recognizes and implements its internal organization with relation to the secular world.[20] A court's enforcement of the consequences of those choices, whether or not they accurately reflect the church's internal property-ownership view, neither rearranges the church's polity in violation of the First Amendment nor interferes with the church's right to make those choices.

*Portland*, 335 B.R. at 853.

The diocese and parishes in *Spokane* appealed to the district court, which reversed, concluding that, while canon law did not *govern* the dispute, it was nonetheless *relevant* to determining whether the diocese and the parishes intended to establish a trust relationship. *Comm. of Tort Litigants v. Catholic Diocese of Spokane*, No. 05-CV-274-JLQ, 2006 U.S. Dist. LEXIS 47828, at *38 (E.D. Wa. June 30, 2006) ("This Court finds that it may consider Canon Law in making a determination of the parties' intent when purchasing the real property, constructing churches and making improvements on the real property."). Conducting its own

[20] The author notes that, while this may be true today, this was not necessarily true at the time that the dioceses and archdioceses were founded, which in many instances was before the advent of nonprofit corporations, and certainly before most of the alternative entity structures that are now available. Absent the ability to incorporate, and given that unincorporated associations could not hold title to real property, vesting title to real property in the bishop *qua* corporation sole, though not perfectly congruent with canon law, was certainly more so than vesting title in an individual bishop or pastor and then running the risk that, if that individual died intestate, the property would pass to his heirs rather than to his successor in office. This being said, Judge Perris's observation is certainly valid in that the corporate and alternative entity options available today provide much more flexibility to align a Church entity's secular and ecclesiastical legal structures.

review of the record, the district court concluded there was sufficient evidence to suggest that at least some of the parish property was intended to be held in trust by the diocese. *Id*. at *34. In light of such intent, the district court concluded that Washington trust law would recognize a "resulting trust" on such property for the benefit of the parishes, *id.* at *35-36, and remanded to the bankruptcy court for further proceedings. The litigation was ultimately mooted by confirmation of the debtor's chapter 11 plan of reorganization on April 24, 2007, which provided for the creation of a fund that included proceeds from insurance policies and contributions from the diocese, certain of its affiliates, and the parishes, to pay abuse claimants.

After the *Spokane* and *Portland* decisions, Church debtors have generally not taken the position that property disputes are *per se* governed by canon law. However, as noted by the district court in *Spokane*, canon law may nonetheless be *relevant* to determining certain issues that may arise in the case of a Church debtor. For example, where application of a secular legal standard (e.g., whether a resulting trust exists) requires factual inquiry into the customs, practices, or state of mind of Catholic persons or entities, canon law may provide relevant evidence of the fact at issue (e.g., if parish real property is owned by the parish under canon law, it would be reasonable to infer that Catholics who donate property to an archdiocese for the establishment of a parish intend for that property to be held for the benefit of the parish, regardless of who holds legal title). Canon law would also likely be relevant to determining whether application of a given law burdens the free exercise of religion, since if the law proscribes (or prescribes) conduct that is prescribed (or proscribed) by canon law, then that would appear sufficient to establish a burden under the Free Exercise and RFRA analysis.