# THE CHURCH IN CHAPTER 11:
# THE LESSONS OF THE CATHOLIC DICOESE CASES

Since 2004, five Catholic Dioceses have filed chapter 11 cases and other Catholic dioceses and religious organizations have threatened to do so-all as a result of the claims of sexual abuse. These cases are extremely difficult aside from the horrific nature of the claims. They raise important issues regarding a non-profit debtor which is a hierarchical religious entity whose principal debts are personal injury claims and which operates as an important part of the local community. This article addresses the role of the creditors committee in asserting avoidance actions, the property litigation to determine what is property of the Diocese, the role of parishes and parishioners as parties in interest, and the constitutional issues that are unique to the Diocese cases. Portions of the following materials were written by counsel for the respective parties in these cases: the Diocese, the committee of sex abuse survivors and the parishes.[1] That their viewpoints and conclusions diverge is a reflection of the difficult issues in these cases.

## I.
## CREDITORS COMMITTEE STANDING TO PROSECUTE AVOIDANCE ACTIONS

A fundamental issue of every diocese case is what property is included in the estate which is directly impacted by the debtor's avoidance powers. In the cases involving the Diocese of San Diego and the Diocese of Spokane, the question of whether the Committee of Tort Litigants/Claimants (the "Committee") should be given the avoidance powers reserved to the Debtor-in-possession became a potentially significant issue.[2] Without a lot of fanfare, the grant of the avoidance powers to the Committee was denied in the Diocese of Spokane case. The

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[2] In the Diocese of Tucson case, no motion was ever filed nor did the pursuit of avoidance actions by the Diocese of Tucson become an issue. In the Archdiocese of Portland case, the Archdiocese of Portland ceded the § 544 power to the Committee of Tort Claimants very early in the case.

opposite happened in the Diocese of San Diego case. These materials will address, in general terms, the legal and practical considerations of whether the avoidance powers under Bankruptcy Code §§ 544, 547, 548, 549 and 550 (the "Avoidance Claims") should be assigned to the Committee under any circumstances and, if so, at what point in the proceedings should the issue really be considered by the Bankruptcy Court.

In the four diocesan Chapter 11 cases that were filed in the 9th Circuit (Diocese of Tucson, Diocese of Spokane, Diocese of San Diego and Archdiocese of Portland), each of those dioceses were organized as corporation soles. Also, in each of those dioceses, legal title to the real property on which parishes and, perhaps, other related entities were located, was held in the name of the diocese or the Bishop as the corporation sole.[3] In addition, as part of the mission and ministry of the church, the diocese had historically and until the filing of each of their Chapter 11 cases, made grants and gifts to parishes and other organizations. Furthermore, as the issues regarding property ownership started becoming more crystallized and decisions were rendered by the Courts in the Portland and Spokane cases, dioceses started taking steps to clarify property ownership.[4] Therefore, the types of Avoidance Claims sought were generally the same as in any other case -- fraudulent transfers and preferences.

Notwithstanding the fact that the granting of the right to assert the Avoidance Claims was given early in the San Diego case, one might say that it was done more to force a result than because the Committee was truly able to meet what should be a high burden in seeking to assert the Avoidance Claims. The motion to allow the Committee to assert the Avoidance Claims was filed in the Diocese of San Diego case a little over two months after the filing of the case. In the Diocese of Spokane case, a similar motion was filed in the first two months of the case but was not finally resolved until almost fifteen months later.

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[3] In the Diocese of Davenport case, the parishes were separately incorporated. While there was some discussion about potential fraudulent transfer claims or substantive consolidation claims, there were no motions filed seeking authority by the Committee to pursue any of the avoidance actions nor was there an adversary filed with respect to any substantive consolidation issues.

[4] For example, in San Diego, the Diocese amended its articles of incorporation to clarify that it held real and personal property in trust for the parishes and related Catholic entities. The Committee in the Diocese of San Diego case contended that such an amendment was a transfer and, therefore, was fraudulent.

Essentially and when boiled down to its simplest elements, the argument for granting the Committee the right to assert the Avoidance Claims is that the debtor would not do it. Nothing more, nothing less. In the case of the parish property issue, each diocese that has filed (with the exception of Davenport where the parishes are separately incorporated) has taken the position that parish property is not property of the estate.

With respect to other Avoidance Claims, the dioceses have taken the position that, among other things, there is no reason to expend estate resources on potential Avoidance Claims early in the case without knowing the nature and extent of the claims and whether the debtor will be able to pay the claims. On the other hand, the Committee sees those claims as pressure points in pushing a resolution of the case. Those pressure points are not just pressure on the debtor, but pressure on the parishes and parishioners.[5]

It would be correct to say that every court that has considered the issue of derivative standing on behalf of a committee or creditor to pursue Avoidance Claims on behalf of the estate has found such standing **but** only under certain circumstances. It would be equally correct to say that such standing does not come free of restrictions.

Every circuit that has considered the issue who has the right to bring Avoidance Claims has determined that that right belongs, in the first instance, to the debtor-in-possession. However, there are circumstances under which that right is either lost or required by the Court to be "assigned" to a committee or creditor. The forced surrender of those rights should never be lightly required by a Bankruptcy Court. Furthermore, there is some question as to whether there is even support for such a forced transfer under the Bankruptcy Code.

Under Bankruptcy Code § 1107, a debtor-in-possession has all the rights of a trustee except compensation, and certain duties of a trustee. Under Bankruptcy Code § 1106, a trustee is required to file a plan "as soon as practicable." Further, under Bankruptcy Code § 323, a trustee represents the estate and can sue and be sued on behalf of the estate. Moreover, Bankruptcy

[5] It is acknowledged that this is the view of debtor's counsel and that committee counsel may have a different view to give.

Code §§544, 547, 548, 549, and 550 explicitly give these rights/obligations to trustees. Under Bankruptcy Code §1103, a committee has a statutory duty to "consult with the trustee or debtor-in-possession concerting the administration of the case." Section 1103 does not give a committee either the right or the duty to represent the estate, to administer the estate, or to sue or be sued on behalf of the estate.

Congress did not intend for these very important powers to be taken from a trustee or debtor-in-possession lightly. In re Gibson Group, Inc., 66 F.3d 1436, 1446 (6th Cir. 1995)[6] is instructive as a survey of the case regarding the requirements for granting derivative standing over the objection of a debtor-in-possession or trustee.[7] In Gibson Group, the 6th Circuit held that a creditor or creditors' committee may be granted derivative standing "where: (1) a demand has been made on the statutorily authorized party to take action; (2) the demand is declined; (3) a colorable claim that would benefit the estate if successful exists, based on a cost-benefit analysis performed by the court; and (4) the inaction is an abuse of discretion ('unjustified' in light of the debtor-in-possession's duties in a Chapter 11 case)." Id. at 1446.

It is submitted that the demand needs to be more than perfunctory. In the Diocese of San Diego case the demand was made very early in the Chapter 11 case. The declination by the debtor-in-possession was not a blanket declination but a response that the Diocese did not see the necessity to bring Avoidance Claims at that time which, again, was very early in the case. That was, however, not persuasive to the San Diego Bankruptcy Court who granted the Committee's motion.

In addition, if the Bankruptcy Court is considering whether to grant such a motion, it should hold an evidentiary hearing to determine whether the committee presents a colorable claim or claims for relief that on appropriate proof would support a recovery and whether an action asserting such claim(s) is likely to benefit the reorganization estate. In re STN

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[6] Even though Gibson predates Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A., 530 U.S. 1, 120 S.Ct. 1942, 147 L.Ed.2d 1 (2000), it is still good law in light of the fact that the Supreme Court left unanswered the question of whether a bankruptcy court can authorize another interested party to act in the stead of the trustee/debtor in possession.

[7] See also, In re Racing Services, Inc., 2007 SL 704984 (2007) for a more recent survey of the cases.

Enterprises, 779 F.2d 901 (2nd Cir. 1985). (Emphasis added.). This only makes sense given the significant expenditure of time and money that these cases require.

The question in the 9th Circuit is whether, by virtue of its decision in Estate of Spirtos v. One San Bernardino County Superior Court Case Numbered SPR 02211, 443 F.3d 1172, 1175 (9th Cir. 2006), the 9th Circuit has determined that the remedy of a third party who does not believe the trustee/debtor-in-possession is not performing its duties with respect to pursuing Avoidance Claims, is to remove the trustee or in the case of a debtor-in-possession, seek appointment of a trustee as opposed to obtaining a transfer of Avoidance Claims.[8] There is certain language in the Spirtos decision supporting that conclusion. In fact, when considered in conjunction with the other provisions of the Bankruptcy Code, the Spirtos decision accords with the statutory structure of Chapter 11. If a third party is dissatisfied with the debtor-in-possession's management of the estate and believes that it can show that the a debtor-in-possession is breaching fiduciary duties or the trustee is mismanaging the estate by not pursuing Avoidance Claims, then the statutory remedy is replacement of the trustee (or appointment of a trustee to replace the debtor-in-possession). A committee's right to request such a remedy is one of the rights granted by Bankruptcy Code § 1103.[9]

This argument was made in the Diocese of San Diego case and raised in the Diocese of Spokane case with two different results. In Spokane, where the Diocese of Spokane opposed giving the right to pursue Avoidance Claims to the Committee, the Avoidance Claims remained with the debtor-in-possession. In Portland, the debtor-in-possession consented to allowing the Committee to file an action under § 544(a)(3). The debtor, however, retained control of the other Avoidance Claims. In Tucson, this issue was resolved as part of the overall consensual resolution of the case. In San Diego, all Avoidance Claims were granted to the Committee over the objection of the Diocese of San Diego with a limitation of what could be brought without

[8] This interpretation of Spirtos does not preclude a voluntary assignment of those rights from the trustee/debtor in possession to a third party.

[9] Of course, one of the issues in the case of a religious entity is whether a Bankruptcy Court can appoint a trustee and not run afoul of the First Amendment.

further court order. Therefore, it remains to be seen whose interpretation of Spirtos is correct although the author believes the one advanced here is the correct one.

There are constitutional implications which a Bankruptcy Court should consider before allowing a Committee to bring Avoidance Claims, particularly those Avoidance Claims which affect the organization of the church. Churches have the constitutional right to organize and govern themselves according to their own internal law. Kedroff v. St. Nicholas Church, 344 U.S. 94, 116 (1952). As to disputes between church agencies, it is well settled that the civil courts may not substitute their judgments for those of church authorities in a hierarchical religious institution. Watson v. Jones, 80 U.S. (13 Wall.) 679 (1872). Civil courts must defer to the decisions of church authorities in such disputes, it is constitutional error to do otherwise. Serbian Eastern Orthodox Church v. Milivojevich, 426 U.S. 696, 718-20 (1976).

The Catholic Church is governed by the 1983 Code of Canon Law ("CIC"). Without interpreting the Code of Canon Law, a court may take judicial notice of its provisions. Fed. R. Evid. 201. Under the 1983 Code of Canon Law, a parish and a diocese are separate canonical entities ('juridic persons") in the internal structure of the Roman Catholic Church. Every diocese and parish is a juridic person. CIC 373; CIC 515, § 3. All church property is considered ecclesiastical property, and is held by a juridic person. CIC 1257 § 1. What belongs to one juridic person cannot simultaneously belong to another juridic person. The pastor of a parish, not the diocesan bishop, is the administrator of parish property. CIC 532, 1279. Each parish has the right to acquire, retain, and administer its own property. CIC 1254, 1255, 1259.

While the Bankruptcy Courts who have considered property ownership issues have rejected the argument that the determination of property ownership is to be governed by Canon Law, the issue of whether and under what circumstances a third party in a bankruptcy case can bring an action to avoid the organization of the church has never been determined by an appellate court. Every diocese case has been settled. The only appellate decision was rendered by the United States District Court in the Diocese of Spokane case. In that case, the District Court did not consider Canon Law in rendering its decision.

Even assuming that the Avoidance Claims can be transferred involuntarily from a trustee/debtor-in-possession, which it is suggested is not the case, a Bankruptcy Court should treat this as an extraordinary remedy. Many things should transpire in a church case before such a drastic remedy is granted to a Committee or other third party. First, the court should consider progress in the case. For example, if the bar date has not yet run, then there is no rational basis for a court to be able to determine whether there are sufficient assets to pay the claims without pursuit of the Avoidance Claims. If the debtor is trying to reorganize and has submitted a plan which outlines how it intends to move the case (even if the plan is criticized by the Committee), the court should not use the Avoidance Claims as a way to tilt the playing field on potential resolution of the overall case. The court should consider whether embarking on such litigation in the early stages of the case is really cost effective given the nature, time and expense of the litigation. Finally there are constitutional issues associated with such claims which cannot and should not be ignored by a court. The issue discussed is whether the Catholic Diocese of Spokane held the parishes' property in trust, which would exclude that property from the bankruptcy estate. The discussion presents the arguments of the various parties, along with the rulings of the United States Bankruptcy Court for the Eastern District of Washington and the United State District Court for the Eastern District of Washington.

## II.
## WHAT IS PROPERTY OF THE ESTATE: THE TRUST THEORIES

The Spokane Diocese argued that property classification is determined by Canon Law as opposed to state law. Butner v. US, 440 U.S. 48 (1979); In re Keller, 185 B.R. 796 (9th Cir. B.A.P. 1995). The Diocese claimed that RCW 24.12.010, the corporation sole statute, granted religious institutions the authority to hold and control property in accordance with their respective internal rules. Church of Christ v. Carder, 105 Wash. 2d 204 (1986); Save v. Bothell, 89 Wash. 2d 862 (1978); Bacon v. Gardner, 38 Wash. 2d 299 (1951); Labonite v. Cannery Workers' and Farm Laborers' Union, et al., 197 Wash. 543 (1938). Canon Law treats each parish as a separate legal entity (juridic person). The Diocese, as a corporation sole, must act in

accordance with Canon Law's treatment of property. Consequently, Canon Law requires that the Diocese hold the property in trust for parishes.

In the alternative, the Diocese argued that state law treats the parishes as unincorporated associations, which have legal rights independent of the Diocese. RCW 7.24.110-.130; Int'l Assoc. of Firefighters v. Spokane Air, 146 Wash. 2d 207 (2002); Leslie v. Midgate Center, Inc., 72 Wash. 2d 977 (1967). Since the state recognizes the parishes as unincorporated associations, the Bankruptcy Code must also recognize the legal capacity of the parishes. In Re General Teamsters, 265 F.3d 869 (9th Cir. 2001); Hairston v. Pac-10 Conference, 101 F.3d 1315 (9th Cir. 1996); Hispanic Taco Vendors WA v. Pasco, 994 F.2d 676 (9th Cir. 1993). Thus, parishes may be beneficiaries of trusts.

According to the Diocese, under Canon Law, state law, and the Bankruptcy Code, the Diocese holds title only as a trustee. 11 U.S.C. § 541; Dewsnup v. Timm, 502 U.S. 410, 432 (1992); Begier v. IRS, 496 U.S. 53 (1990); In re Rodeo Canon Development Corp., 362 F.3d 603 (9th Cir. 2004); In re Coupon Clearing Srv., Inc., 113 F.3d 1091 (9th Cir. 1997); Megafoods Stores, Inc., 163 F.3d 1063 (9th Cir. 1998). As a result, the Diocese has limited rights to the property, which prevents it from using the property to pay claims against the Diocese. Coupon Clearing Serv., supra.

In response, the tort claimants asserted that a corporation sole is secular in nature and engages in secular activities, such as creating contracts and acquiring, holding, and disposing of property. To support their claim, the tort claimants noted that the Washington Supreme Court has recognized the Diocese's total ownership and control over all aspects of the parishes' property. Munns v. Martin, 131 Wash. 2d 192 (1997); Weiss v. Bruno, 82 Wash. 2d 199 (1973); Wilkeson v. St. Luke's Parish of Tacoma, 176 Wash. 377 (1934). In addition, Washington courts treated the Diocese as the only legal entity and viewed the parishes as divisions of the Diocese. F.E.L. Publications Ltd. v. the Catholic Bishop of Chicago, 754 F. 2d 216 (7th Cir. 1985). Although the parishes may be separate entities under Canon Law, they are not individual entities under state law, which governs the current external dispute. EEOC v. St. Francis Xavier

Parochial School, 77 F. Supp. 2d 71 (DC Dist. Ct. 1999). The claimants argued that unincorporated parishes have no legal existence separate from the Diocese. F.E.L. Publications, supra; St. Francis Xavier Parochial School, 77 F. Supp. 2d 71 (1999); Central Catholic Edu. Ass'n v. Archdiocese of Portland, 323 Or. 238 (1996); Eberle v. Benedictine Sisters of Mt. Angel and Archdiocese of Portland in Oregon, 600 P.2d 926 (Or. App. 1979); Cf. Akoury v. Roman Catholic Archbishop of Boston, 2004 WL 2341333 (Mass. Super. 2004).

Further, the tort claimants argued that deeds to the parishes' property identified the "Bishop of Spokane Diocese" as the legal owner. The tort claimants argued that the Diocese had legal, beneficial, and equitable ownership of the parishes' property. Ray v. King County, 120 Wash. App. 564, 577 (2004); Grove v. Payne, 47 Wash. 2d 461, 465 (1955). The claimants asserted that the legal title on the deed controls under Washington law and settles the dispute.

In addition, the tort claimants asserted that no trust, whether express, statutory, or constructive existed. The corporation sole statute's language does not create a statutory trust, but merely restricts the Bishop's personal interests in any of the Roman Catholic Church's property. RCW 24.12.030; County of San Luis Obispo v. Ashurst, 146 Cal. App. 3d 380 (1983). Further, the Washington Supreme Court recognizes the Bishop's unrestricted right to sell the parishes property. Wilkeson, supra. No express trust exists because the deeds clearly establish a fee simple title in the Diocese. Ray, 120 Wash. App. 564 (2004); Grove, 47 Wash. 2d 461 (1955). Finally, there was no evidence of misconduct by the Bishop directed toward the parishes, a necessary element to the formation of a constructive trust, and, therefore, there was no constructive trust. Engel v. Breske, 37 Wash. App. 526 (1984).

The Diocese countered that a trust did exist. First, the Diocese asserted that the Articles of Incorporation include the language necessary to create a statutory or express trust. The Diocese argued that it incorporated the language of RCW 24.12.020 and .030 into its Articles of Incorporation, which was sufficient to create a trust. Second, the Diocese argued that even if a statutory trust did not exist, an express trust existed because: (1) the Articles of Incorporation included the necessary language, (2) the parishes intended to transfer the property to the Diocese

for the benefit of the parishes and parishioners, (3) the Diocese's restricted use of the property evidenced an express trust, and (4) both the Diocese and the parishes acted in a manner that evidenced an express trust. Hoffman v. Tieton View Meth. Ch., 33 Wash. 2d 716 (1949) (intent); Niemann v. Vaughn Community Church, 118 Wash. App. 824, 836 (2003) (restricted use); Diel v. Beekman, 7 Wash. App. 139, 145 (1972), overruled on other grounds, Chaplin v. Sanders, 100 Wash. 2d 853 (1984)(conduct).

Finally, the Diocese argued that at a minimum a constructive trust existed. A constructive trust is an equitable remedy where an entity holds legal title to property, but a court requires that entity to hold the property in trust for a beneficiary in order to avoid inequitable results. Baker v. Leonard, 120 Wash. 2d 538 (1993); Consulting Overseers Mgmt., Ltd. v. Shtikel, 105 Wash. App. 80 (2001); Mehelich v. Mehelich, 7 Wash. App. 545 (1972).

The United States Bankruptcy Court for the Eastern District of Washington held that all disputed real property titled in the name of the "Bishop of Spokane Diocese," belongs to the Diocese. Therefore, the debtor has all equitable and beneficial interest in the real property. The Court refused to apply Canon Law because the dispute was not an internal dispute between divisions of the Catholic Church.

As a result, the Court applied Washington law to the property classification. Although RCW 24.12.040 (corporation sole statute) authorized the Diocese to hold the property in trust for the parishes, the provision did not require that the Canon Law govern the Diocese's secular activity. The provision relied upon by the Diocese, RCW 24.12.030, did not contain the language necessary to create a statutory trust. In other words, the statute merely authorizes the bishop or other religious leader to hold the property in trust for the religious institution, but did not state that the religious organization held the property in trust for any specified beneficiary. Nor did the Articles of Incorporation or any other writing create an express trust. The Court recognized that the Diocese could have created an express trust, but it failed to produce any necessary written documents that did so.

The Court also held that the parishes failed to meet their burden of proof regarding the existence of a constructive trust. A constructive trust is an equitable remedy created by a court, not private parties. In re North American Coin & Currency, Ltd., 767 F.2d 1573 (9th Cir. 1985), cert. denied, Daniel Torres v. Eastlick, 475 U.S. 1083 (1986). Neither the parishes nor the parishioners had a legal interest in the real property as no express or constructive trust was established and the title deeds to the property were in the name of the Diocese. As a result, the Diocese was the sole legal owner of the property. Ray v. King County, 120 Wash. App. 564, 577, 86 Pl.3d 183 (2004); King County v. Hanson Inv. Co., 34 Wash. 2d 112, 119, 208 P.2d 113 (1949).

On appeal of the summary judgment, the United States District Court for the Eastern District of Washington reversed and remanded, holding that the Bankruptcy Court needed to determine, after an evidentiary hearing, whether a constructive or resulting trust existed. The Court stated that the Washington Supreme Court had recognized that such trusts might arise where title to property exists in the name of a party other than the actual purchaser. Brown v. State of Washington, 130 Wash. 2d 430 (1996). In other words, Washington will look at the deed language, the circumstances surrounding the deed, and subsequent conduct to determine if a resulting trust exists. Scott v. Wallimer, 49 Wash. 2d 161, 162 (1956); Harris v. Ski Park Farms, Inc., 120 Wash. 2d 727 (1993), cert. denied, 114 S.Ct. 697 (1994). The District Court stated that the parishes' own financial contribution and their assumption of the responsibility, maintenance, and operation of the property presented a question of fact. In re Torres, 827 F.2d 1299 (9th Cir. 1987).

## III.
## AVOIDANCE ACTIONS: STRONG-ARM POWERS AND FRAUDULENT CONVEYANCES

A diocese, like every other debtor, has the strong-arm and avoidance powers at its disposal. However, the five cases filed to date clearly demonstrate that the debtor will not

litigate that issue with the parishes or other Catholic entities in the diocese. In the four diocese cases that did not have did not have separately incorporated parishes, the debtors scheduled substantially all of the real property vested in the diocese as property held for the benefit of a third person. In the Diocese of Davenport (Iowa), the parishes have been separately incorporated for decades and the properties claimed by the parishes have been vested in the parishes generally from the time of their incorporation. The tangible personal property that is located in the parishes generally is not scheduled by the debtor. In all of the cases, the debtor's cash management system has included an excess cash sweep account which includes funds that the parishes have collected and are obligated to forward to the diocese under local rules or "norms" promulgated by the bishop. This cash account goes by various names but is generally referred to as the Diocesan Bank or some variation thereof.

The debtor's status as a bona fide purchaser of real property under Section 544 is an important tool to include the parish properties in the estate as the parishes' claimed interest generally is unrecorded. Section 544 is not generally useful in the case of personal property alleged to be parish property as most state law provides that a judgment creditor takes subject to unrecorded interests in personal property. Finally, Sections 544 and 548 are useful to avoid transfers from the Diocesan Bank and for avoidance of the diocese's unilateral declarations that it holds all property in trust for all parishes and Catholic entities in the diocese.

Since the diocese will not contest the parishes' ownership of the real or personal property or assert the strong-arm and avoidance powers, the creditors committee is the only real party in interest to commence, prosecute and settle (subject to Court approval) litigation to enforce all of the estate's rights under Bankruptcy Code §§ 544, 547, 548, 549 and 550. The litigation would raise a number of issues typically found in strong-arm litigation but the defendants should be expected to raise various affirmative defenses, including constitutional defenses based on the First Amendment of the U.S. Constitution and the Religious Freedom Restoration Act, which was extensively briefed in the chapter 11 cases of the Archdiocese of Portland and the Diocese of Spokane.

The defendant parishes and Catholic entities will allege that they are the beneficiaries of a trust over the real property assets.[10] Various trusts will be asserted including an express trust based on the articles of incorporation of the diocese's civil corporate incarnation or a resulting trust based on the theory that the real property was acquired through contributions of the parishes, parishioners or other contributors. In some jurisdictions, dioceses are amending their articles of incorporation to reflect express trusts. Pre-amendment articles of incorporation often do not contain express statements of trust for specific beneficiaries, rather relying on vague and ambiguous references to Canon Law or verbatim repetitions of state statutes that allow for incorporation of religious offices. In the Spokane case, the Court found that the pre-amendment articles of incorporation did not create an express trust because, inter alia, the inexact trust language ran in favor of the diocese itself. Over the last few years, articles of incorporation have been amended to provide expressly that all property in the diocese is held in trust for the parishes, schools and Catholic faithful. These articles of incorporation are recorded with the Secretary of State and in the county recorders' offices.

Assuming that the diocese has not amended its articles of incorporation or that the amendments are within the time window that would allow them to be set aside as fraudulent conveyances, the defendants will assert an interest as beneficiaries of a resulting trust. California law provides that an unrecorded resulting trust interest is subordinate to the rights of a bona fide purchaser of real property without knowledge of the resulting trust. Moultrie v. Wright, 154 Cal. 520, 523, 98 P. 257, 259 (1908) ("If Doane had no notice when he took the mortgage, nor prior to his death, and the administratrix bought for the benefit of the estate, without notice, she would hold as an innocent purchaser free from the trust. Riley v. Martinelli, 97 Cal. 580, 32 Pac. 579, 21 L. R. A. 33, 33 Am. St. Rep. 209; De Lany v. Knapp, 111 Cal. 169, 43 Pac. 598, 52 Am. St. Rep. 160."); Miller & Starr, California Real Estate § 11:90 ("Purchaser or encumbrancer not subject to the trust**.** When the public records do not indicate the existence of the trust by either

[10] For the purposes of this portion of this article, California law will be used as the applicable state law for analysis of the strong-arm powers and avoidance actions.

recordation of the trust or a deed that identifies the grantee as a "trustee," a purchaser or encumbrancer of real property subject to a trust, who pays valuable consideration for the property or encumbrance, takes the title free and clear of the restrictions of the trust or of the claims of the beneficiaries unless the purchaser has *actual* notice of the trust.") (Footnotes omitted). Use of the strong-arm powers to take free and clear of the unrecorded resulting trust interests avoids the fact intensive litigation that would have been the result of the District Court's reversal and remand of the Spokane Bankruptcy Court's summary judgment decision.

The committee should be able to demonstrate that, in the circumstances of a diocese case, a bona fide purchaser would **not** be charged with inquiry notice. Although each state has its own laws of what circumstances would put a bona fide purchaser of real property on inquiry notice, including occupancy of the property by a third party, as a general proposition use of a parish property as a church or school should not give rise to a duty to inquire beyond the state of recorded title. The Portland case is the only one of the diocese cases to have addressed this issue head on. The plaintiff successfully established on summary judgment that the use of the parish properties as churches and other facilities associated with the parishes generally would not have given rise to inquiry notice. In re Roman Catholic Archbishop of Portland in Oregon, 335 B.R. 868, 888 (Bankr. D. Or. 2005) ("I conclude that there is no genuine issue of material fact that the TCC is entitled under § 544(a)(3) to avoid any unrecorded interests in the test properties.")

One of the procedural issues that may be faced in the strong-arm litigation is whether the parishes are in fact the correct defendants in a resulting trust dispute, as opposed to the Catholic population that donated the funds for the acquisition of the property. In the Portland case, the committee addressed this issue by certifying a defendant class including all Catholics in the Portland Archdiocese that contributed funds to the parishes. This certification process took nearly six months delaying the adjudication of the substantive issues. In the Spokane case, the committee named all parishes and a number of Catholic entities as defendants and no individuals sought to intervene in the case. An association of parishes appeared in the case without formally intervening as a defendant (its counsel represented the parishes as defendants) and in certain

pleadings claimed to be an association of parishioners and parishes. In the San Diego case, the Court directed the committee to limit the litigation to four parishes and repeatedly denied standing to an ad hoc committee of parishioners.

The Debtor's avoidance powers under Section 544(b) are another important tool to the enhancement of the bankruptcy estate to ensure payment of creditors claims in full. In the diocese cases, these transfers generally are to related Catholic entities or social service agencies as gifts or subsidies. These transfers may be either actual or constructive fraudulent conveyances.

## IV.
## THE REPRESENTATION OF PARISHES

When representing parishes and/or parishioners in the Catholic diocese Chapter 11 cases, attention must be given to the formation of the committee or organization which will represent such interests, the composition of such committee or organization, the recognition of such committee or organization and, not least, the compensation of professionals retained by such committee or organization. The majority of the issues which arise in relation to these four concerns arise from a doubt whether such committee is in substance separate from the diocese and from a question whether the parishes are legally distinct from the diocese.

Is a parishes' committee just a mouthpiece of the diocese or bishop – a second opportunity for the bishop's views to be presented to the court? Frequently, the history of the committee's formation is used to support the argument that the committee is not independent of the bishop and represents no interest not already represented. The history of a committee's formation is required to be disclosed under Bankruptcy Rule 2019.

Committees come into existence in a variety of ways. Sometimes they are organized in advance of a chapter filing in anticipation of such a possibility. Sometimes they are organized soon after the chapter filing in reaction to that event. In the San Diego case, the Diocese filed its chapter 11 petition on February 27, 2007 and what turned out to be the Organization of Parishes of the Diocese of San Diego ("OPSD") had its initial meeting on or about March 9, 2007.

Notwithstanding the brief elapsed time, the court referred to the OPSD as "Johnny-come-lately" to the case suggesting that the earlier the parishes can organize the greater legitimacy will their committee command in the bankruptcy case.

The matter is not one of timing alone. The courts begin these cases unconvinced that the parishes actually exist as separate entities from the diocese.[11] Therefore, the courts look for a history of parishes organizing to deal with diocese-wide issues as entities separate and distinct from the diocese. If there is no such history, it is reasonable for the courts to conclude that the parishes are not separate and distinct from the diocese. Of course, unsecured creditors committees and bondholders committees do not organize into committees or ad hoc committees absent a bankruptcy or anticipated bankruptcy so that one could argue that a committee of parishes is not likely to exist absent a bankruptcy or threat of bankruptcy. But, it appears that there is a presumption of separateness in the case of general creditor committees which presumption does not exist in the case of parishes.

The composition of the committee representing the parishes has varied from case to case. In the Spokane case, the Association of Parishes represented not just the parishes but also "the interest of parish ministries and parishioners." The Association of Parishes was composed of pastoral and parishioner representatives from each parish.

Similarly in Portland, the organization formed to represent the parishes actually represented some, but not all, parishes in the archdiocese of Portland, and 78 individuals described as parishioners, beneficiaries, donors, settlors, "and other parties with direct connections to parish services and properties."

By contrast, the OPSD was comprised exclusively of the 98 parishes in the San Diego Diocese and the representatives on the OPSD were all parish priests. The OPSD was formed as a California unincorporated association under Calif. Corp. Code Section 18000 et seq. The parishioners in San Diego formed, or attempted to form, their own organization, an Ad Hoc Committee of Parishioners which was comprised of 5 parishioners and a California non-profit

[11] The Diocese of Davenport is an exception since there each parish is incorporated as a separate legal entity under state law.

corporation, named "Parishioners for Churches and Schools," which was formed to pay the fees and expenses of the professionals employed by the Ad Hoc Committee "to the extent the fees are not otherwise paid . . ."

While there were informal discussions to merge the OPSD with the Ad Hoc Committee, such discussions bore no fruit because of: (a) uncertainty regarding which group would have control of the merged organization over such things as employment of professionals and (b) unease among the clergy in granting significant control over the affairs of the parishes to the laity. On this last part, it is important to keep in mind that Cannon Law provides that the parish priest is the representative of the parish on all "juridical matters," (Canon 532) and custom and culture along with Cannon Law, are important sources of norms in the Catholic Church.

Nevertheless, Spokane and Portland are examples where the laity was included in the parish committee. From at least one perspective such inclusion is useful. Because of the doubt concerning the independence from the diocese (i.e. bishop) of any committee representing parishes, a committee comprised entirely of clergy who as a general proposition owe obedience to the bishop has a difficult burden in establishing its separateness from the diocese. On the other hand, a committee which includes lay people without any formal hierarchical relationship to the bishop could have a much easier time advocating for a separate voice in the bankruptcy case.

The whole point of forming a committee and populating it with appropriate members is to be able to participate in the bankruptcy case of the diocese in question. Participation means the opportunity to raise and be heard on any issue under Chapter 11 (11 U.S.C. §1109(b)) and to intervene as appropriate in any adversary proceeding.

If the committee is granted formal recognition under 11 U.S.C. §1102 its ability to so participate is granted specifically by statute. On the other hand, if such committee does not have formal recognition under §1102, it must be a "party in interest."

Under §1102 additional committees may be appointed by the court with the selection of members by the U.S. Trustee. The factors generally considered include: (1) the concern for

adequate representation, (2) the dissimilar interest of the relevant constituencies, (3) the composition of any existing committee, (4) the nature and complexity of the case, (5) the stage of the case at which appointment is sought and (6) the cost associated with the appointment. In re Hills Stores Co., 137 B.R. (Bankr. S.D.N.Y. 1992); Mirant Americas Energy Mktg., L.P. v. Official Committee of Unsecured Creditors of Enron Corp., 2003 WL 22327118 (S.D.N.Y.).

In neither San Diego nor Spokane did the AOP or the OPSD seek official recognition. In the San Diego case official recognition was not requested because it was decided that it would prematurely precipitate litigation over the separateness of the parishes – an underlying and overhanging issue throughout the case. Since compensation of the OPSD professionals had to a large extent been dealt with through voluntary post-petition assessments by each parish, it was concluded that it was most cost effective and least disruptive to rely on the status of the OPSD as "party in interest."

On the other hand, the Ad Hoc Committee of Parishioners in the San Diego case did request the U.S. Trustee to appoint it as an additional official committee. In addition, the Ad Hoc Committee filed joinders in several motions filed by the debtor – for example, the debtor's motion extending exclusivity. The Official Committee of Creditors in the San Diego case, itself composed entirely of tort claimants, objected to the appointment of the Ad Hoc Committee and to its joining in the debtor's motions. The U.S. Trustee never appointed the Ad Hoc Committee as an official committee and the matter died because of inaction and the dismissal of the diocese's Chapter 11 case. The court, however, did strike the Ad Hoc Committee's joinder denying them status as a party in interest.

Section 1109(b) provides a non-exhaustive list of "parties in interest." Such status, however, requires more than simply being interested in the outcome of the case. In re Addison Community Hospital Authority, 175 B.R. 646 (Bank. E.D. Mich. 1994). In order to be a "party in interest," such party must have a direct legal interest in the bankruptcy case; otherwise the reorganization process would be overburdened by the participation of non-creditors. None of the committees in any of the diocese cases have been expressly denied the ability to participate in the

case other than the Ad Hoc Committee in San Diego and that, as noted, was only with respect to its joinder in several motions brought by the debtor and without any written ruling or analysis. A committee can only be effective if it is able to secure competent professionals and it can only secure such assistance if the issue of compensation can be dealt with satisfactorily. There have been various approaches to this issue. The first is to request and get official recognition under §1102(a)(2) since such "additional committee" is empowered by §1103 to employ professionals at the expense of the estate. Another approach has been to file what has been called a "precautionary" motion requesting that the court allow post-petition contributions by parishioners to be restricted and used for the payment of the committee's professionals. A third approach has been to do nothing and rely on state law, corporate, contract and trust, to support the right to receive payment in the event of a dispute.

With respect to the first approach, official recognition, it was attempted by the Ad Hoc Committee of Parishioners in the San Diego case and, as noted, such request was never acted upon by the U.S. Trustee and then was overtaken by events when the San Diego case was dismissed.

In the Portland case, the Committee of Catholic Parishes, Parishioners and Interested Parties ("Parishioners Committee") initially filed a precautionary motion to be permitted to use parish donations which it alleged were not part of the debtor's estate to pay its professionals. The Parishioner's Committee also argued that to deny it access to parish donations would interfere with the members' free exercise of religion and run afoul of the Religions Freedom Restoration Act, 42 U.S.C. §2000bb et seq. The Tort Claimants Committee opposed the precautionary motion but offered a compromise which was ultimately accepted thus avoiding a court ruling on the Parishioners Committee's motion.

The compromise was that the Parishioners Committees' counsel would be recognized as "class counsel" for the Parishioners Committee as representative not only of its members but also as class representative of <u>all</u> parishioners, donors, potential trust beneficiaries, interested parties and, further, that as such class representatives the Committee would assume primary

responsibility, in place of the debtor, for litigating the adversary proceeding begun by the Tort Claimants Committee to determine ownership of assets claimed by the parishes to be held "in trust" by the archdiocese.

The final approach, and the one followed in San Diego, was to rely on the fact that the OPSD was an entity organized under an express California statute as an unincorporated association and that the governance document called for an assessment against each member to pay for the fees and costs of the OPSD's professionals. While this approach is not free from risk since the representatives of the tort claimants could argue that the donations to the parish, were still property of the estate because the parishes were not separate from the estate, it was concluded that donations to the OPSD, clearly a separate legal entity, would likely not be found to be donation to the diocese.

## V.
## CONSTITUTIONAL ISSUES IN THE DIOCESE CASES

The Catholic diocese bankruptcies have brought several constitutional issues to the fore, which are likely to be re-visited in any federal bankruptcy involving a religious organization.

Ownership of Parish Property. As part of the determination of what is in the "estate" of the religious organization that has filed for federal bankruptcy, one of the issues typically raised is whether the parishes in a hierarchical church are part of the diocese's estate. The issue also comes up independently of bankruptcy in circumstances where a rogue parish seeks to separate itself from its mother religious organization.

Catholic dioceses in bankruptcy have argued that canon law should determine the ownership of the parishes. In Spokane, ". . . the debtor and defendants argue[d] that no civil court has authority to even examine the rights of creditors to church property as those rights are determined by internal church doctrine." In re the Catholic Bishop of Spokane, 329 B.R. 304, 321 (Bankr. E.D. Wash. 2005), rev'd on other grounds, 364 B.R. 81 (Bankr. E.D. Wash. 2006). In Portland, the bankruptcy court characterized the issue as follows: "Debtor argues under various theories that this court is required to consider and apply internal church law to determine

what is property of the bankruptcy estate. It raises this issue as an affirmative defense, claiming that 'the adjudication of the Complaint could potentially entangle the Court in religious matters in violation of the First Amendment of the United States Constitution.'" In re Roman Catholic Archbishop of Portland, 335 B.R. 842, 853 (Bankr. D. Or. 2005).

No court to date has been willing to look to religious law to determine property ownership. This is due in part to the leading Supreme Court case, Jones v. Wolf, 443 U.S. 595, 602 (1979), which held that property ownership in church disputes should be determined by "neutral principles of law."

In Portland, the Archdiocese further argued that the First Amendment places limits on the bankruptcy court's jurisdiction over religious entities. "The parties dispute the extent to which the First Amendment's religion clauses limit the bankruptcy court's jurisdiction to determine what is property of the bankruptcy estate when the debtor is, as in this case, a religious organization." 335 B.R. at 851. The court was not persuaded to relinquish jurisdiction over the issue.

There, the court declined to reach a final determination on parish ownership, but rejected the argument that there was a First Amendment barrier to judicial determination of neutral principles of law governing property ownership between parishes and the diocese. The Portland bankruptcy court held that "[t]here is no *First Amendment* impediment to this court's jurisdiction to determine whether property in which title is held by debtor belongs to the bankruptcy estate or to others," and "[t]he requirements of protection of religious freedom, including RFRA, do not prohibit this court from deciding this issue."[12] Id. at 868 (emphasis added). However the court declined to decide the issue on summary judgment because an issue of fact remained as to

[12] The court explained the defense arising from the Religious Freedom Restoration Act as follows: "Defendants raise two different RFRA arguments in defense to the TCC's claims. First, they argue that RFRA requires the court to rule under s541 of the Bankruptcy Code that the assets of the parishes are separate from the assets of debtor because, under canon law, parish property is owned by the parish. Second, they argue that use of the bankruptcy trustee's powers as a bona fide purchaser of real property under s544(a)(3) to avoid any unrecorded interests in parish and school real property would substantially burden the exercise of religion by those who have contributed to the acquisition and maintenance of parish and school property and who worship and are educated there." Id. at 859.

whether "RFRA would preclude avoidance of all unrecorded interests in real property titled in debtor's name." Id.

The Spokane bankruptcy court reached the issue, holding that the parish property belonged to the dioceses. The court found that "[a]n express trust exists. The Bishop, as trustee, holds the property in trust for the Diocese, the legal entity which commenced the underlying bankruptcy proceeding." In re the Catholic Bishop of Spokane, 329 B.R. 304, 328 (Bankr. E.D. Wash. 2005), *rev'd on other grounds*, 364 B.R. 81 (Bankr. E.D. Wash. 2006).

The cases over parish assets (outside the bankruptcy context) have gone both ways: sometimes neutral principles indicate that the parish is not owned by the diocese and sometimes it is. Episcopal Church Cases, 61 Cal. Rptr. 3d 845 (Cal. Ct. App. 2007) (held that under a "neutral principles" analysis the state statute read together with the church canon rebutted any presumption that interest in the local church property was in the local congregation alone, and found that the property was held in trust for the national church and diocese); In re Church of St. James the Less, 888 A.2d 795 (Pa. 2005) (held that a "neutral principles" analysis established that St. James clearly intended its property to be held in trust for the Diocese and National Episcopal Church); Presbytery of Beaver-Butler of the United Presbyterian Church, v. Middlesex Presbyterian Church, 489 A.2d 1317 (Pa. 1985) (applying "neutral principles" of law, the court held that the church was created and incorporated at the local level, and all the property was retained by the local parish; it was never intended to be transferred to the national church).

The San Diego bankruptcy court never needed to reach the parish ownership issue, because the bankruptcy was dismissed before the court was required to decide the issue. In that case, the court set a new precedent by appointing a financial expert to review the diocese's books and found that the diocese was not forthcoming regarding its holdings. The bankruptcy court then remanded the actions to the state court because, "the Court finds that resolution of the sexual abuse lawsuits is central to the administration of the Debtor's bankruptcy case…Further, the Debtor has not moved forward on its plan of reorganization…Unless the proposed payment

amount is substantially increased, the Court foresees a lengthy confirmation process**."** In re Roman Catholic Bishop of San Diego, 374 B.R. 756, 762 (Bankr. S.D. Cal. 2007).

Statute of Limitations Legislation. In the case of the San Diego diocese bankruptcy, the cases facing the diocese were made possible by California legislation in effect during 2003 that lifted the statute of limitations on childhood sexual abuse, even if the statute of limitations previously expired. CAL. CIV. PROC. CODE § 340.1 (2003). This sort of legislation, now in effect in Delaware and being introduced in numerous states, is called "window" legislation, because it gives survivors of child sex abuse a window of opportunity to get to court.

During the process of considering the size of the estate or the question of estimation, the San Diego diocese argued that the window legislation was unconstitutional, and therefore it could not be liable for those lawsuits filed pursuant to the window. Defendants argued the legislation violated due process because it was retroactive and violated the free exercise of religion because it purportedly targeted the Catholic Church.

Retroactivity. The retroactivity argument was also made in clergy sex abuse cases outside the bankruptcy. The California courts rejected the constitutional arguments against the window legislation. Roman Catholic Bishop of Oakland v. Superior Court, 128 Cal. App. 4th 1155, 1161 (Cal. Ct. App. 2005) (held that legislation reviving the statute of limitation on civil claims is not unconstitutional); see also Liebig v. Superior Court, 209 Cal. App. 3d 828, 835 (Cal. Ct. App. 1989) (state legislature had the power to retroactively extend a civil statute of limitations to revive a cause of action time-barred under a former limitations period); Lent v. Doe, 40 Cal. App. 4th 1177, 1186-87 (Cal. Ct. App. 1995) (state legislature had the power to retroactively extend the period of limitations for civil causes of action that arose from childhood sexual abuse).

The one area where the California courts found that the window was unconstitutional involved those cases where the plaintiff had filed a claim that was rejected on statute of limitations grounds before the window legislation went into effect. See Perez v. Roe 1, 53 Cal.

Rptr. 3d 762, 775 (Cal. Ct. App. 2006). That small category of cases continues to be litigated in California.

Targeting. In the leading case addressing the argument of targeting, a federal district court ruled that the window legislation did not violate the free exercise rights of the Church, stating that "[i]n this case, no one suggests that child abuse is a religiously approved, much less religiously mandated, practice," and therefore, "SB 1779 does not impermissibly regulate the free exercise of religion because the legislation does not interfere with religious beliefs, opinions, or practices." Melanie H. v. Sisters of Precious Blood, Civil No. 04-1596-WQH-(WMc) at 7-8, (S.D. Cal. 2005).

## VI.
## CONCLUSION

The Catholic Diocese cases have taken different paths, all of which led to consensual resolutions. Each Diocese has a different character which may warrant different approaches. Common to all of the cases are extremely difficult issues somewhat unique to Catholic Diocese chapter 11 cases.