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### "Sovereignty" Issues and the Church Bankruptcy Cases

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# “SOVEREIGNTY” ISSUES AND THE CHURCH BANKRUPTCY CASES

*David A. Skeel, Jr.\**

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### **I. Introduction**

As the wave of litigation by alleged victims of clergy sexual misconduct against the Catholic Church made its way through the judicial system at the turn of the new century, one diocese after another began hinting that it might respond by filing for bankruptcy. In 2004, the dam burst. The Boston Archdiocese, the diocese that seemed most likely to end up in bankruptcy, resolved its litigation through a global settlement. But the Archdiocese of Portland did not, and on July 6, it filed for Chapter 11. Within a few months, Portland was joined by two more dioceses, Tucson and Spokane.<sup>1</sup>

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\* S. Samuel Arsht Professor of Corporate Law, University of Pennsylvania Law School. I am grateful to Seth Chertok and Yang Liu for research assistance and to Jonathan Lipson and to the participants at the “Bankruptcy in the Religious Non-Profit Context” conference at Seton Hall University School of Law on November 5, 2004, for helpful comments.

<sup>1</sup> See, e.g., Matt Miller, *The Church and Chapter 11*, DAILY DEAL, Aug. 6, 2004 (discussing Portland diocesan bankruptcy filing and noting that Boston Archdiocese settled with 552 claimants in September 2003) [hereinafter Miller I]; Larry B. Stammer, *Oregon Diocese First to File Bankruptcy*, L.A. TIMES, July 7, 2004, at A1 (Portland filing); Matt Miller, *Tucson Diocese Details Prepack*, DAILY DEAL, Sept. 22, 2004 (Tucson diocesan filing September 20, 2004) [hereinafter Miller II]. In the

The filings sent bankruptcy lawyers and scholars scrambling for their pocket Bankruptcy Codes. As it turns out, they needn't have bothered, at least if they were looking for explicit guidance on church bankruptcy. The word "church" is nowhere to be found in Chapter 11 or any other corner of the bankruptcy laws. To use the cliché that seemed to crop up in every discussion, church bankruptcy is uncharted waters for a bankruptcy process that is designed with ordinary businesses in mind.<sup>2</sup>

Of particular concern was the danger that the bankruptcy laws, which provide for extensive oversight of the debtor's finances, might interfere with the religious affairs of the church, thus running afoul of the First Amendment guarantee of free exercise of religion. It isn't often that bankruptcy experts and constitutional law scholars participate in the same conversations. But the church bankruptcies have religious freedom experts using terms like "property of the estate," and bankruptcy experts puzzling over "deference" and "neutral principles" as they attempt to chart the lines between the Chapter 11 reorganization framework and the church's ministries and religious mission.

This article focuses on the three contexts where the tension between free exercise and the bankruptcy process comes most clearly to the fore.<sup>3</sup> To try to make sense of these issues, I will analogize the church bankruptcy cases to two other entities that may seem at first glance to have little in common with churches: municipalities and sovereign nations. The common theme is this: With municipalities and sovereign nations, as with religious entities, bankruptcy oversight creates tensions that can be loosely described as "sovereignty concerns."

The similarities between church and municipality bankruptcy – which is governed by Chapter 9, a special set of provisions designed specifically for municipalities – are particularly striking.<sup>4</sup> Indeed, I suspect that if the drafters of the bankruptcy laws had

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months since this Article was written, the Tucson diocese has confirmed a consensual reorganization plan in July 2005. The Portland and Spokane cases are still in Chapter 11.

<sup>2</sup> See, e.g., Miller I, *supra* note 1 (quoting Msgr. Thomas Cahalane).

<sup>3</sup> In an earlier article, I explored the question whether it is appropriate for churches to file for bankruptcy, and what obstacles a church might face. David A. Skeel, Jr., *Avoiding Moral Bankruptcy*, 44 B.C. L. REV. 1181 (2003).

<sup>4</sup> 11 U.S.C. § 901 *et seq.* (2005).

envisioned the possibility of a church bankruptcy filing, they would have either included religious organizations within Chapter 9 or adopted an analogous set of provisions for religious organizations. While sovereign bankruptcy is theory rather than fact, the International Monetary Fund and some commentators have called for such a framework in recent years.<sup>5</sup> Many of the issues that have been debated in the sovereign debt context closely parallel the religious freedom issues that arise in a church bankruptcy. A key concern, for instance, is that any sovereign bankruptcy regime not interfere with the sovereign's internal decision making.

The Article proceeds as follows. I begin, in Part II, by considering the much debated question of what property comes into the bankruptcy "estate" when a diocese files for Chapter 11.<sup>6</sup> The most pressing issue is whether the churches, schools, and other property in a diocese should be treated as diocesan property, or whether they belong to the local parish or parishioners and are thus off limits to creditors in a diocesan bankruptcy. Part III considers whether bankruptcy's disclosure and oversight rules are likely to interfere with a church's free exercise rights. Finally, Part IV addresses several confirmation issues – issues that arise when the church debtor seeks to confirm a reorganization plan. Here, a particularly tricky question is whether a church debtor can use the so-called cramdown provisions, and confirm a reorganization plan over the objections of the clergy misconduct victims if negotiations with the victims break down.

To paraphrase the line generations of law students have been tempted to use each time they answer an exam question, these are difficult issues that do not admit of a simple answer. With each of the issues, I will offer my own conclusions as to the best resolution. But I will also suggest that the best strategy for a bankruptcy judge

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<sup>5</sup> For discussion of the IMF proposal and other proposed sovereign bankruptcy regimes, see for example, Patrick Bolton & David A. Skeel, Jr., *Private Sector Involvement in Sovereign Debt Restructuring: A New Role for the IMF?* (2005) (unpublished manuscript, on file with author); Kenneth Rogoff & Jeromin Zettelmeyer, *Bankruptcy Procedures for Sovereigns: A History of Ideas, 1976-2001*, 49 IMF STAFF PAPERS 470 (2002).

<sup>6</sup> Property of the estate is governed by 11 U.S.C. § 541.

<sup>7</sup> The cramdown provisions are set forth in 11 U.S.C. § 1129(b).

may be to finesse several of the issues, and to prod the parties to reach a consensual agreement on the terms of the reorganization plan.

## II. *Who Owns the Property?*

When a sovereign nation or a municipality cannot pay its obligations, much of its property is off limits to creditors. With sovereign debtors, sovereign immunity keeps creditors' hands off property within the sovereign's boundaries.<sup>8</sup> The laws of most U.S. states achieve a similar effect for municipalities. Although municipalities do not enjoy absolute protection, property used for governmental operations is immune from creditors.<sup>9</sup>

Church property is treated much more like the property held by private businesses. Unlike with sovereign debtors or municipalities, the foreclosure rules generally do not provide special protections for churches.<sup>10</sup> Sovereignty issues do not disappear in the church property context, however. Sovereignty – in the form of religious freedom concerns – comes into play when courts are asked to determine which church entity should be seen as owning the church's property. If a local church wishes to jump ship from its denomination, does the local church or the denomination own the church building?<sup>11</sup> Answering these questions has forced courts to negotiate the line between resolving ordinary property disputes and interfering with a church's

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<sup>8</sup> See, e.g., Patrick Bolton & David A. Skeel, Jr., *Inside the Black Box: How Should A Sovereign Bankruptcy Framework Be Structured?*, 53 EMORY L.J. 762, 781-82 (2004) (immunity of sovereign assets from seizure).

<sup>9</sup> See, e.g., Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 429-34 (1993) (limitations on seizure of municipal property).

<sup>10</sup> For an old case that underscores this point, and at the same time suggests a reluctance to allow a foreclosure, see *Mannix v. Purcell*, 19 N.E. 572 (Ohio 1888) (preventing creditors from foreclosing on church assets to satisfy personal creditors of the bishop). Thanks to Jonathan Lipson for bringing this case to my attention.

<sup>11</sup> The caselaw on these church property disputes is surveyed and analyzed in detail in Patty Gerstenblith, *Civil Court Resolution of Property Disputes Among Religious Organizations*, 39 AM. U. L. REV. 513 (1990). After this Article was drafted, and shortly before it went to press, the U.S. Bankruptcy Court for the Eastern District of Washington issued a ruling on the property issue in the Spokane case. The decision, which is being appealed, reaches very similar conclusions to those argued for in this part. *In re Catholic Bishop of Spokane*, 329 B.R. 304 (Bankr. E.D. Wash. 2005) (holding that the church's real property is part of the bankruptcy estate).

internal religious functions.

Ownership issues have figured prominently in the recent church bankruptcies (and near bankruptcies), and their resolution remains subject to fierce dispute. A key question in each of the cases is this: Are the cathedrals and schools in a diocese owned by the diocese, the parish, the local parishioners, or someone else? To understand the dispute, we should begin by briefly considering the ownership of church assets under church and secular law.

In the nineteenth century, faced with the ticklish question of how religious organizations should be recognized in the secular law, many states passed statutes creating the corporate form known as a corporation sole.<sup>12</sup> A corporation sole is a person – in this case the bishop – and his or her successors, who are treated in much the same way as a secular corporation.<sup>13</sup> Many Catholic dioceses are set up as a corporation sole. In some dioceses, the parishes within the diocese are incorporated separately as non-profit corporations. In others, the parishes have not been housed in separate corporations.<sup>14</sup>

In dioceses whose parishes have not been separately incorporated, the basic ownership structure seems to suggest that the churches, schools, and other property are owned by diocese. But church officials have argued, under both canon and secular law, that this appearance is mistaken. First, according to one argument, which draws on both canon and secular law, church property is held in trust for the parishioners of the parish where it is located. On this view, the bishop is the trustee of a trust, but ownership is vested in the parishioners, as beneficiaries.<sup>15</sup> A

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<sup>12</sup> See, e.g., Miller I, *supra* note 1 ("Religious historians trace corporation sole to the early 19th century.").

<sup>13</sup> For a representative corporate sole statute, see UTAH DIV. OF CORPS. AND COMMERCIAL CODE, CORPORATION SOLE: HOW TO INCORPORATE (2002) (on file with author).

<sup>14</sup> See, e.g., Miller I, *supra* note 1 (noting that Portland parishes are not separately incorporated, whereas in 2003 "the eastern Oregon diocese of Baker transferred parish properties from a corporation sole to more than 60 separate corporations held by boards of trustees").

<sup>15</sup> *Id.* ("The church steadfastly maintains that while parish property is held in the name of the office of a bishop or archbishop, it is a trust relationship. That is codified in canon law. As a result, the church says, parish property should be excluded from an inventory of assets.").

second argument is that canon law requires that church property be held at the parish level, rather than at the diocesan level. Under this view, the true owners of the property are the parishes, rather than the diocese or the parishioners.

How should these conflicting interpretations be resolved? Start with the nonbankruptcy analysis of the trust issue. Under the leading Supreme Court case, *Jones v. Wolf*,<sup>16</sup> states can adopt and courts apply a “neutral principles” approach to property issues that implicate both state and religious law. If property ownership can be determined without interpreting religious doctrine, courts are permitted to wade in; otherwise, the issue must be left to church officials. In the church property cases, a key question is whether to recognize the existence of a trust. If the trust relations are set out explicitly, the arrangement may qualify as an express trust under secular law. With most dioceses, this level of formality does not seem to be present, though in some cases it may be. In the absence of an express trust, it is possible that a court would find an implied trust running from the bishop to the parishes or parishioners, although here too the answer is unclear.<sup>17</sup>

Now turn to bankruptcy. Bankruptcy law generally goes to great lengths to replicate the nonbankruptcy treatment of property law issues. Section 541, which determines what property becomes part of the bankruptcy estate, is designed to bring in everything that the debtor owns and nothing that it does not.<sup>18</sup> If the debtor owns a partial interest in property, for instance, the partial interest becomes property of the estate but the remainder does not. Of particular relevance for our purposes, § 541

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<sup>16</sup> 443 U.S. 595 (1979). In the Spokane case, the court noted that Washington uses the “compulsory deference” approach rather than neutral principles, but concluded that, because the bankruptcy property issue is not an intra-church dispute, a similar analysis applies. *In re Catholic Bishop of Spokane*, 329 B.R. at 323 (concluding that “the First Amendment does not prevent application of a law or body of law which is facially neutral and generally applied in the jurisdiction to a religious organization”).

<sup>17</sup> A trial court concluded that the Boston archdiocese’s ownership rights were not subject to an implied trust. *Akoury v. Roman Catholic Archbishop*, 2004 Mass. Super. LEXIS 349, \*7 (Mass. Dist. Ct. Sept. 14, 2004) (“There is simply no evidence here to warrant a finding of a resulting trust in real estate.”). For a discussion of the implied trust issue, see Gerstenblith, *supra* note 11, at 550-66.

<sup>18</sup> Under 11 U.S.C. § 541(a)(1), “all legal or equitable interests of the debtor in property as of the commencement of the case” are treated as part of the “estate.”

specifically states that only the debtor's legal title, not any equitable interest in property, becomes part of the estate if legal title is all that the debtor holds.<sup>19</sup> Thus, if a diocesan debtor holds legal title to a church or school as the trustee of a trust, with the beneficial interests belonging to the parishes or parishioners, only the bare legal title would come into the estate.

This initial determination does not end the analysis, however. There is more to the story. The trustee (or debtor-in-possession) is given the power to augment the estate by retrieving preferential pre-bankruptcy payments and avoiding some interests that might be recognized outside of bankruptcy. Of particular relevance is § 544(a) (3), which permits the trustee to eliminate any interest that could be voided by "a bona fide purchaser of real property."<sup>20</sup> The language is confusing, but the concept is simple: The trustee can eliminate any property interest that would have been trumped outside of bankruptcy by a sale to a bona fide purchaser.

This issue comes into play with church bankruptcies in connection with the argument that diocesan property is held in an implied or constructive trust for the parishes or parishioners. Would a constructive trust be trumped by a sale to a bona fide purchaser? The answer seems to be yes. "Under most states' laws," as Judge Easterbrook puts it in a leading case, "the buyer in good faith of *real* property can obtain a position superior to that of the rightful owner, if the owner neglected to record his interest in the filing system. Section 544(a) (3) gives the trustee the same sort of position."<sup>21</sup>

When we import Easterbrook's reasoning, which arose in an ordinary bankruptcy case, into the church context, it may initially seem to raise church-state concerns. The Bankruptcy Code seems to override the teaching of the church as to how property should be held. But the conflict is more illusory than real. It is quite simple for the church to set up an explicit trust arrangement, or to separately incorporate the parishes within a diocese and vest title in the parishes where the churches or schools are located. If a church has not taken these steps, by contrast, finding an implied trust to have existed and then honoring it in bankruptcy would be

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<sup>19</sup> *Id.* § 541(d).

<sup>20</sup> *Id.* § 544(a) (3).

<sup>21</sup> *Belisle v. Plunkett*, 877 F.2d 512 (7th Cir. 1989).

a recipe for trouble. It would “obfuscate land titles and [] make real estate transactions more complex and costly,” as one commentator puts it, since potential purchasers might have no idea that the property was subject to an implied trust, even if they diligently searched the real estate records.<sup>22</sup>

Thus far, I have treated the property ownership issue as a doctrinal question, but there is a more practical point as well. The best solution to the property question may be for the bankruptcy court to avoid resolving it. Chapter 11 is designed to be a negotiated process, and everyone may be better off if the parties devise a reorganization plan that finesses the question of whether the diocese owns the property. From the diocesan debtor’s perspective, resolving the question could put it in the awkward position of arguing in the bankruptcy court that it doesn’t own the property, but then later wishing to switch sides and act as if the diocese does own the property if the time comes to shut down or sell a church or school. Indeed, the dilemma is not simply hypothetical. After suggesting several years ago that its property is held in trust for its parishioners, the Boston Archdiocese has recently argued that it has the authority to close and possibly sell a number of churches in the Archdiocese.<sup>23</sup> The victims and their lawyers face a much simpler dilemma. If the issue is resolved and the court concludes that the local churches and schools are not owned by the diocese, the assets available for compensating the victims will be sharply reduced.

In short, there is a lot to be said for deciding not to decide the question of who owns the churches and schools in a diocese. But if the court does wade into these waters, and the state where the property is located follows the neutral principles approach, the issue can be resolved the same way it would be resolved if the property were held by a private business, without running aground on church-state concerns.

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<sup>22</sup> Gerstenblith, *supra* note 11, at 566.

<sup>23</sup> See Akowry, 2004 Mass. Super. LEXIS 349, at \*9 (refusing to grant preliminary injunction that would have enjoined archdiocese from closing their parish church). Catharine Wells discusses the archdiocese’s conflicting incentives in detail in her contribution to this symposium. Catharine Pierce Wells, *Who Owns the Local Church? A Pressing Issue for Dioceses in Bankruptcy*, 29 SETON HALL LEGIS. J. 375 (2005).

### *III. Bankruptcy Court Scrutiny and Intervention in Church Decision Making*

A second sovereignty-related concern is the danger that the bankruptcy process may interfere with sovereign decision making. Chapter 9, the provisions that govern municipal bankruptcy in the U.S., explicitly addresses this concern by precluding the court from "interfer[ing] with . . . any of the political or governmental powers of the debtor."<sup>24</sup> The sovereign bankruptcy proposals that have been debated in recent years also take these concerns into account by attempting to minimize the amount of interference with sovereign decision making.<sup>25</sup> With church bankruptcies, by contrast, the Bankruptcy Code does not make any special concessions to church decision making.<sup>26</sup> This leaves the First Amendment and the Religious Freedom Restoration Act as the principal bulwarks against bankruptcy court interference with church functions.<sup>27</sup>

The potential friction between the bankruptcy process and sovereign decision making comes in three areas. The first is the pervasive bankruptcy oversight of a debtor that files for bankruptcy. Bankruptcy requires extensive disclosure, and it provides sweeping access to a debtor's officers and its financial records.<sup>28</sup> As intrusive as this oversight is, however, it does not seem likely to interfere with church decision making in any constitutionally impermissible way. Since bankruptcy is a privilege rather than a right, a church that files for bankruptcy should be viewed as inviting a certain amount of scrutiny of its financial

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<sup>24</sup> 11 U.S.C. § 904(1).

<sup>25</sup> See, e.g., INT'L MONETARY FUND, THE DESIGN OF THE SOVEREIGN DEBT RESTRUCTURING MECHANISM – FURTHER CONSIDERATIONS, at 7 (Nov. 27, 2002), available at <http://www.imf.org/external/np/pdr/sdrm/2002/112702.pdf> (listing, as one of the principles guiding the IMF's proposed framework, that the "mechanism should not interfere with the sovereignty of debtors").

<sup>26</sup> I have speculated elsewhere that this is probably an accident. The drafters of the Bankruptcy Code do not seem to have contemplated the possibility that a church might file for bankruptcy. Skeel, *supra* note 3, at 1194.

<sup>27</sup> U.S. CONST. amend. I; Religious Freedom Restoration Act 42 U.S.C. § 2000bb (1994).

<sup>28</sup> See, e.g., 11 U.S.C. § 521(1) (requiring debtor to file list of creditors and statement of assets and liabilities); FED. R. BANKR. P. 2004.

affairs.<sup>29</sup>

The second source of friction is more dramatic. Although the bankruptcy laws assume that the debtor's existing managers – in this case the bishop or other church leaders – will continue to run its financial operations in Chapter 11, creditors are entitled to ask the court to appoint a trustee.<sup>30</sup> In a church bankruptcy, appointment of a trustee would mean wresting control over the diocese's churches and schools from church officials, and putting it in the hands of a private, secular decision maker. Just as it is hard to imagine a sovereign or municipal bankruptcy regime that purported to dictate political decisions, it is almost inconceivable that a court would attempt to displace church decision makers in favor of a trustee. I add the qualifier "almost" because at least one California court attempted to do essentially the same thing, appointing a receiver under state law to take over for officials of a church whose officers had been accused of malfeasance. The legislature stepped in and passed a statute that effectively overturned the order, however, and a California appellate court suggested in dicta that the receivership was probably unconstitutional.<sup>31</sup>

The final friction is the trickiest, since it is much more intrusive than bankruptcy's disclosure obligations but less draconian than appointing a trustee. Under the bankruptcy laws, any proposal to "use, sell, or lease" property that is outside of the "ordinary course of business" is subject to a hearing and "approval by a bankruptcy court."<sup>32</sup> This suggests that a church could not start a substantial new soup kitchen ministry or close and sell a school during the bankruptcy case unless the bankruptcy judge gave it the go ahead. The court approval requirement skates quite close to the First Amendment line, and it is possible that a court would overturn a bankruptcy judge's veto in an extraordinary

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<sup>29</sup> For further discussion of this conclusion, see Skeel, *supra* note 3, at 1194.

<sup>30</sup> 11 U.S.C. § 1104.

<sup>31</sup> *People v. Worldwide Church of God, Inc.*, 178 Cal. Rptr. 913 (Cal. Ct. App. 1981). "How the state . . . can control church property and the receipt and expenditure of church funds without necessarily becoming involved in the ecclesiastical funds of the church is difficult to conceive." *Id.* at 551 (describing the California legislation).

<sup>32</sup> 11 U.S.C.S. § 363(b)(1) (LexisNexis 2005).

case.<sup>33</sup> But several factors argue in favor of generally upholding the requirement that the bankruptcy court approve extraordinary transactions. First, the court’s role is reactive; it simply approves or disapproves financial decisions, rather than initiating them. Perhaps more importantly, if the church felt particularly strongly about the decision in question, it could ask for its bankruptcy case to be dismissed.<sup>34</sup> Alternatively, if the church continued with the case, it could take the requested action after its reorganization plan was confirmed.

#### *IV. Confirmation Issues When the Parties Can’t Get Along*

The final context where sovereignty concerns may significantly alter the reorganization comes as the parties near the moment of truth, when the time comes to either approve or disapprove a proposed reorganization plan. Chapter 11 provides two extremely important “sticks” to move the process along, and to increase the likelihood that the parties will actually agree to a consensual reorganization plan. If the debtor is unreasonable, creditors can ask the court to convert the case from Chapter 11 to Chapter 7, which means appointing a trustee and selling off the assets.<sup>35</sup> If, on the other hand, a class of creditors is recalcitrant, a reorganization plan that doesn’t fully compensate them can be “crammed down” over their objections so long as no lower priority creditors are paid anything.<sup>36</sup>

In a sovereign bankruptcy, liquidation simply would not be a realistic option. Countries can’t be shut down and their assets sold for the benefit of their creditors.<sup>37</sup> Interestingly, the possibility of liquidating the assets of a church is easier to imagine – after all, churches are less tied to a physical location than cities and countries are – but the bankruptcy laws take this stick away from creditors by precluding creditors of a nonprofit corporation

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<sup>33</sup> It is interesting to note in this regard that § 363 is not one of the provisions that is incorporated into Chapter 9. See 11 U.S.C. § 901 (listing provisions from Chapters 3-11 that are included in Chapter 9). This omission presumably reflects a conclusion that § 363 oversight is inappropriate for a municipal debtor.

<sup>34</sup> *Id.* § 1112(b) (any party in interest can ask for dismissal “for cause”).

<sup>35</sup> *Id.* § 1122 (conversion to Chapter 7).

<sup>36</sup> *Id.* § 1129(b) (cramdown).

<sup>37</sup> It probably would not be realistic to shut down a municipality, either, although two commentators have suggested the possibility. McConnell & Picker, *supra* note 9.

from asking the court to convert the case to Chapter 7.<sup>38</sup> Only the debtor can seek conversion. As a result, the liquidation stick isn't available to focus the debtor's attention on striking a deal.

The second stick, cramdown, is not ruled out altogether, but it too is an awkward fit if the debtor is a church or other sovereign entity. The initial problem is one of valuation: In order to determine whether higher priority creditors can be paid in full, it is often necessary for the court to determine the value of the debtor's assets. Valuation is difficult with an ordinary corporate debtor;<sup>39</sup> the complexity of valuation, as well as related uncertainties, is magnified in the case of a sovereign debtor.<sup>40</sup>

The second difficulty is that cramdown in an ordinary bankruptcy case usually wipes out the debtor's shareholders, due to the relentless logic of insolvency. If higher priority creditors must be paid in full before lower priority creditors and shareholders get anything, there won't be anything left over by the time we get to the shareholders if the company is insolvent. Wiping out the shareholders of a widely held, for-profit corporation is relatively straightforward, but it doesn't translate well into the sovereign context. Countries do not have shareholders; they have political leaders and citizens. A literal application of the cramdown principles seems to suggest that the sovereign's existing decision makers must be displaced, and their authority transferred to creditors or their representatives. As discussed in the last part, this is not somewhere bankruptcy can or should go.

Notice where this leaves us. Taking away both liquidation and cramdown would remove two of the key mechanisms that Chapter 11 provides to prod the parties toward agreement. If neither of the sticks is available, the risk that the negotiated

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<sup>38</sup> 11 U.S.C. § 1112(c).

<sup>39</sup> Bankruptcy lawyers long cited valuation difficulties as an important reason why consensual reorganization plans have traditionally been more common than cramdown plans. See, e.g., David A. Skeel, Jr., *The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases*, 78 VA. L. REV. 461, 484 (1992); Lynn M. LoPucki & William C. Whitford, *Bargaining Over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125, 143-58 (1990).

<sup>40</sup> An important issue in municipal bankruptcies, for instance, is whether to take future tax revenues into account in deciding whether to confirm a proposed reorganization plan; similarly, in a church bankruptcy, it is not clear if future contributions from parishioners should be considered.

process will break down will be much higher than in an ordinary Chapter 11 case. The possibility of impasse is particularly worrisome in the church bankruptcy context, because dioceses generally have filed for bankruptcy only after efforts to resolve the cases brought by clergy misconduct victims collapse.<sup>41</sup> If the stalemate continues after the diocese files for bankruptcy, and bankruptcy's most important sticks are neutralized, the diocese may simply be unable to propose a confirmable reorganization plan.

Is there any way out of this impasse? The solution that a few courts have used in cases involving nonprofit corporations is to apply a modified version of the cramdown rule in order to avoid the issue of whether the existing decision makers must be displaced. In a case involving a rural electric cooperative, the Seventh Circuit emphasized that the individuals who controlled the cooperative were not like ordinary shareholders, since they had no right to receive the profits of the cooperation.<sup>42</sup> Another court used similar reasoning with respect to individuals who had an interest in a nonprofit hospital that filed for bankruptcy.<sup>43</sup> Both courts reasoned that the cramdown rule only applies to those who have a direct financial stake in the debtor.<sup>44</sup> In a church bankruptcy, this reasoning would suggest that the absolute priority rule applies to creditors but not to the church officials who oversee the diocese.

Unfortunately, actually applying this strategy in a church bankruptcy would put the bankruptcy court in a very difficult position. The churches that have filed for bankruptcy thus far have had only one real class of creditors, the vast damage claims of clergy malpractice victims. In effect, the cases boil down to two

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<sup>41</sup> See, e.g., Stammer, *supra* note 1, at 1 (quoting letter from Portland Archbishop Vlazny to parishioners about the diocese's bankruptcy filing, which stated that the "pot of gold is pretty much empty now").

<sup>42</sup> *In re Wabash Valley Power Ass'n*, 72 F.3d 1305 (7th Cir. 1995).

<sup>43</sup> *In re Whittaker Mem'l Hosp. Ass'n*, 149 B.R. 812 (Bankr. E.D. Va. 1993).

<sup>44</sup> In *In re Eastern Maine Electric Cooperative, Inc.*, 125 B.R. 329 (Bankr. D. Me. 1991), a bankruptcy court held that the absolute priority rule did apply to members of the electric cooperative that filed for bankruptcy in that case, because the members' right to recover "patronage capital" made them similar to ordinary shareholders. For a brief, useful discussion of the cases, see Gary W. Marsh, *Intensive Care: Application of the Absolute Priority Rule to Non-Profit Entities*, 17-1 AM. BANKR. INST. J. 18 (1998).

main parties, the church debtor and the class of tort claims. In practice, this means that the church's other creditors are likely to be paid in full, and the sticking point is simply how much to set aside for the misconduct victims. This is the class that may refuse to approve a proposed plan, and this is the class that may not be paid in full. As a result, in deciding whether to approve a proposed cramdown plan, the bankruptcy judge would essentially be required to determine what the payout should be. This would require her to assess the value of the church's assets (possibly including the expected future contributions of parishioners) in order to decide whether to approve the plan. Rather than blessing or not blessing an agreement made by the parties, the judge would be required to pick sides, and in effect to determine the terms of the reorganization herself.

Another tool that is available in an ordinary Chapter 11 case would lead to the same problems. If a debtor fails to propose a plan in a timely fashion, the bankruptcy judge can lift the so-called exclusivity period – the period during which the debtor is the only one who can propose a reorganization – and permit creditors to propose their own reorganization plan.<sup>45</sup> If the victims ask the bankruptcy judge to take this step, and the judge agrees, the victims can propose their own cramdown plan, presumably with a more attractive proposed payout to the victims.<sup>46</sup> As with a church-proposed cramdown, the bankruptcy judge would be forced to pick sides when it determined whether to approve the victim-proposed cramdown. With a victim-proposed cramdown, the analysis would be complicated even further by the possibility that the payout requirements would effectively tie church leaders' hands going forward, and thus would risk running aground of First Amendment concerns.

What, then, is a bankruptcy judge to do? If I were the judge, and I were forced to give a thumbs up or thumbs down on a cramdown plan proposed by the church, I would be extremely

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<sup>45</sup> Under 11 U.S.C. § 1121, only the debtor can file a plan for the first 120 days of the case, but courts can, and often do extend this exclusivity period. See 11 U.S.C. § 1121 (d) (authorizing court to extend or reduce exclusivity period).

<sup>46</sup> For an argument that the exclusivity period should routinely be ended in ordinary bankruptcy cases after a debtor proposes a cramdown plan that relies on so-called "new value" contributions, see Bruce A. Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations*, 44 STAN. L. REV. 69 (1991).

reluctant to approve the plan. Given the awkward fit between proposals that leave the debtor's existing operations in place and the Chapter 11 cramdown rules, and the difficulty of determining what an acceptable cramdown should look like, I would be inclined to reject any cramdown proposal about which there were any serious doubts.

The best solution, in my view, would be to leave the issue open, and indeed to use the uncertainty to encourage the church and the victims to come to an agreement. A recent case in a very different context provides a nice analogy of how this might be done. In the takeover battle between Oracle and PeopleSoft, Oracle brought suit in the Delaware Chancery Court asking the court to force PeopleSoft to remove its poison pill takeover defense. Although Delaware courts have never required a target like PeopleSoft, who has consistently rejected all takeover offers, to remove a poison pill, Vice Chancellor Leo Strine hinted that he just might take this step if the parties failed to settle their differences. In the face of the uncertainty on both sides as to how the court would rule, Oracle eventually raised its bid and PeopleSoft agreed to the takeover.<sup>47</sup>

In the church bankruptcy context, the judge may be able to achieve a similar effect by leaving open both the possibility of a cramdown bid, and the possibility that she might permit creditors to propose a reorganization plan if the church drags its feet. This uncertainty isn't a perfect substitute for the liquidation and cramdown options in an ordinary bankruptcy case, but it could help discourage both sides from digging in their heels and taking unreasonable positions.

## V. Conclusion

Chapter 11 is an awkward fit for financially troubled sovereign entities. Its provisions are designed with financial considerations and for profit entities in mind, not for entities whose principal purpose is political or religious. Given this divergence of focus, it is hardly surprising that Chapter 11 does

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<sup>47</sup> See, e.g., Maureen O'Gara, *Judge Wants PeopleSoft to Explain Why It Turned Oracle Down*, JREPORT (Nov. 25, 2004), available at [http://java.sys-con.com/read/47207\\_p.htm](http://java.sys-con.com/read/47207_p.htm).

not provide answers for many of the questions that arise when a sovereign entity encounters financial distress. This article has considered a series of issues that seem to fall between the cracks in one way or another, including the question of who owns church property; the tension between Chapter 11 oversight, on the one hand, and sovereignty or religious freedom concerns, on the other; and the difficulty of prodding the parties to agreement in a church bankruptcy case. In each of these contexts, I have suggested that the bankruptcy court will often be better off leaving the issues unresolved, and impressing upon the parties the interest they have in negotiating to a consensual solution.

By focusing on a series of difficult issues, I don't mean to suggest that bankruptcy is an ineffective mechanism for resolving the financial distress of sovereign entities. Despite the difficulties, the basic structure of Chapter 11 (and Chapter 9) works surprisingly well in this context. Churchill's famous statement about democracy seems equally true as a description of the negotiated Chapter 11 process: It's the worst system imaginable for dealing with a church or other sovereign bankruptcy, except for all the rest.