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BANKRUPTCY—THE LAST RESORT: PROTECTING THE DIOCESAN CLIENT FROM POTENTIAL LIABILITY JUDGMENTS

JOHN B. JARBOE

Prior to 1978, bankruptcy protection was available only to individuals and institutions who were insolvent—those whose assets exceeded liability on the balance sheet. Since the Bankruptcy Reform Act of 1978,\(^1\) however, bankruptcy has become a tool for use in planning and assisting not only individuals and institutions with solvency problems, but those with liquidity problems as well. In *Johns-Manville*,\(^2\) for example, the large manufacturer of asbestos products was confronted with literally thousands of lawsuits involving potentially billions of dollars in damages. Although solvent on the balance sheet, Johns-

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Manville sought bankruptcy protection under Chapter 11 of the Bankruptcy Code to manage what was otherwise financial chaos. Thus, while it is possible that by invoking the bankruptcy process one may risk trading one form of expensive chaos for another, Chapter 11 does provide the potential for bringing some manageability to the process.

THE ELEMENTS OF BANKRUPTCY

When a bankruptcy petition is filed, an estate is created, much like a probate estate. This estate both determines and limits the recovery of creditors and is comprised of all of the debtor's assets as of the day that the bankruptcy petition is filed. To the extent that the estate is insufficient to satisfy the claims of creditors, the Bankruptcy Code provides certain priorities, which require full and pro rata payments to be made to a senior class of creditors before the next junior class may receive any distributions. Therefore, the process for determining classes of creditors provided by Chapter 11 is extremely important in establishing a plan of reorganization.

While the bankruptcy estate includes every property interest of the debtor, the estate also includes those interests that may be recovered through the avoiding powers granted to the trustee. These powers include the avoidance of certain pre-petition transfers, such as fraudulent conveyances or preferential transfers. Property of the estate, however, does not include property which is held in trust by the debtor for another entity. This underscores the importance of separately maintaining property owned outright by the debtor from property of which the debtor may be a beneficiary or a fiduciary.

The Bankruptcy Code provides for the appointment of a trustee in all liquidation cases and generally provides for the retention of the debtor in possession in reorganization cases. The benefit in a reorganization is, of course, that the debtor may remain in possession and manage its affairs free of a trustee. This advantage comes at a price, however, in that the debtor in possession is charged with both the rights and the fiduciary re-

In many Chapter 11 cases, therefore, even though a trustee may not be appointed, the debtor is under pressure to avoid some of its own transfers under the scrutiny of the bankruptcy court and the creditors' committee.8

Chapter 7, the liquidation chapter of the Bankruptcy Code, provides a procedure in which all assets are first surrendered to a trustee and then distributed to creditors in prioritized classes.9 The first to be paid are the administrative expenses of the estate, certain wage benefits, and taxes. Next, the general unsecured claims are paid to the extent of actual pecuniary loss. Following that are unsecured claims of a penalty type. This suggests that where assets are insufficient to satisfy liabilities, punitive damages and other penalties may be subordinated to the claims of general creditors, such as the trade creditors. Moreover, in a Chapter 7 case, only an individual can receive a discharge.10 Because corporations and other entities do not receive a discharge in the procedure, Chapter 7 essentially offers no protection to such entities that intend to continue in business after bankruptcy.

Chapter 11 is the reorganization chapter most frequently utilized by ongoing organizations. Reorganization involves a plan, usually proposed by the debtor, for the orderly distribution of assets upon either the approval of creditors or, if fair and equitable, over creditor objection.11 Courts interpret the term "fair

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7 See id. ("A debtor in possession ... shall perform all the functions and duties ... of a trustee.").
8 Those transfers which the debtor may be under pressure to avoid include preferential transfers, defined by the Bankruptcy Code as any transfer made within 90 days preceding the bankruptcy on an antecedent debt which allows the transferee creditor to recover a greater portion of that debt than it would have received in a Chapter 7 bankruptcy. 11 U.S.C. § 547(b)(4)(A). The Bankruptcy Code also contains a fraudulent conveyance provision which provides for the avoidance of those transfers made for inadequate consideration or transfers made with actual intent to hinder and delay creditors. Id. § 548. Another means of avoiding fraudulent transfers is the statute of limitations, which is one year for bankruptcy. Id. The trustee in bankruptcy, however, is cloaked with the status of a levying creditor, and thus is given the benefit in bankruptcy court of the statute of limitations which exists in the forum state. In Oklahoma, for instance, the statute of limitations on fraudulent conveyances is four years, thereby enabling a trustee or debtor in possession to go back four years to avoid such transfers.
11 11 U.S.C. § 1129(b)(1) ("The court ... shall confirm the plan ... if the plan does not discriminate unfairly, and is fair and equitable with respect to each class of
and equitable” to mean essentially that creditors receive the same value under the Chapter 11 plan as they would receive under Chapter 7. Thus, if the plan meets the fair and equitable standard, and does not discriminate unfairly between creditors, a debtor’s plan can be approved over the objection of creditors.

The significance of a plan of reorganization is that it allows the debtor to offer other value as a substitution for assets which the debtor does not wish to relinquish. "Other value” includes, for instance, future earnings. Although the value that has to be offered to the creditors in the plan must be equal to the assets of the debtor on the date of filing, not every asset must necessarily be surrendered in the process. Since the plan can be paid out over time, future revenues may be substituted for those assets which a trustee would otherwise take in a liquidation bankruptcy. Thus, Chapter 11 provides an opportunity to protect assets that may not be protected in any other context.

Generally, bankruptcy may be initiated either voluntarily by the debtor or involuntarily, by three creditors holding claims totaling at least $10,000 in the aggregate. Section 303 of the Code, however, exempts eleemosynary institutions from involuntary bankruptcy. Thus, charitable organizations, including churches, etc., may not be placed in an involuntary bankruptcy and a diocese, therefore, can invoke the jurisdiction of the bankruptcy court only as a conscious, voluntary decision. In the case of In re Allen University, for example, a university was found to be exempt from involuntary bankruptcy despite operating several commercial enterprises. Unlike other areas of the law where charitable exemptions are at risk of loss, charitable organizations may not partially or wholly lose the benefits of the exemption from involuntary bankruptcy.

Regarding the eligibility to file in bankruptcy, an incorporated diocese is clearly eligible to file Chapter 11. Although some questions may remain about the eligibility of unincor-

\[\text{12} 11 \text{ U.S.C. § 1129(b)(2)(A)(i-ii).}
\[\text{13} 11 \text{ U.S.C. § 301 (voluntary cases); 11 U.S.C. § 303 (involuntary cases).}
\[\text{14} 11 \text{ U.S.C. § 303(a).}
\[\text{15} \text{In re Allen University, 497 F.2d 346 (4th Cir. 1974).}
\[\text{16} 11 \text{ U.S.C. § 1112.}
\[\text{17} 11 \text{ U.S.C. § 109(a) (providing that “any person that resides or has a domicile, a place of business, or property in the United States, or a municipality, may be a debtor under this title.”). Section 101 defines any “person” as any individual, partnership, or corporation. 11 U.S.C. § 101(41).}
rated associations to file bankruptcies, most of the cases dealing with churches or other unincorporated charitable and religious organizations have held that such organizations are eligible to file under Chapter 11. An unincorporated diocese, therefore, could likely take advantage of that protection if necessary.

**THE BENEFITS OF BANKRUPTCY**

Given this background, how does a diocese, or any religious organization, benefit from filing in bankruptcy? The first benefit, a cornerstone of bankruptcy, is the automatic stay provided by Section 362 of the Code. When a bankruptcy petition is filed, an automatic stay is imposed which operates as an injunction, prohibiting any proceeding against the debtor or debtor's property. The bankruptcy court jurisdiction is nationwide, protecting the property of the debtor wherever located. In a case involving a trustee, the automatic stay allows the trustee to gather and distribute assets without interference from third parties. In a Chapter 11 case, the automatic stay immediately stops any action, such as attachment of bank accounts, against the debtor. Thus, the automatic stay provides the debtor with a certain amount of breathing room in which to concentrate on long-term planning.

The automatic stay, along with a continuing injunction provided upon the confirmation of a plan of reorganization, prevents creditors from attaching specific assets as long as such creditors are offered equivalent value under the plan. This ability to prioritize the assets to be sacrificed to fund the plan allows a debtor to protect important assets which do not have any legal significance or status of their own under the Bankruptcy Code. Substitution of future income, therefore, may be a means of protecting diocesan works of art, antiquities, and other valued assets.

A second important benefit of bankruptcy involves the valuation hearing conducted to determine the asset pool necessary to fund the plan. Again, the creditors are entitled to recover only the value of what the debtor had on the day of the filing of the petition. Thus, the valuation hearings are likely to

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estimate properties at liquidation values as opposed to ongoing business values, since the creditors are only necessarily entitled to recover the equivalent of a Chapter 7 liquidation. A church building, for example, would only be valued at what a willing buyer would pay at a foreclosure sale for a special purpose piece of property, rather than at its replacement or book value. Again, the process allows the debtor to prioritize properties, rather than waiting for creditors to pick and choose the assets they wish to levy.

The notion of prioritizing things of value is illustrated by a story about two fellows on a camping trip. They awoke one morning, bright and early, to see a huge brown bear lumbering down at them as fast as the bear could go. One of the fellows calmly sat down and started putting on his running shoes, while his panicky friend said, “What in the world are you doing? You can’t possibly outrun that bear.” The fellow lacing up the shoes calmly looked at his friend and said “I don’t have to outrun that bear. All I’ve got to do is outrun you.” In a similar fashion, Chapter 11 provides an opportunity in the face of imminent disaster to exchange prioritized sacrifices for that which is really important.

A third advantage of Chapter 11 is that a corporate debtor may discharge debts which an individual debtor may not discharge in Chapter 7. These debts include, most notably, claims for punitive damages or for willful and malicious injury. Punitive damages may be subordinated to the claims of general creditors or discharged entirely if the available assets in the asset pool are insufficient to satisfy all claims. A plan, once confirmed, defines all rights of the creditors who receive only what is in the plan. Therefore, if the asset pool, which the debtor must establish to fund the plan, is insufficient to satisfy even those claims having a higher priority than punitive damages, such claims may be discharged.

Although the bankruptcy court does not have jurisdiction to adjudicate issues of causation and damages in tort, the court does play a role in the Code process for the estimation of claims, both for the purpose of allowing voting to confirm a plan and for

21 11 U.S.C. § 1141(d) (providing that confirmation of plan “discharges the debtor from any debt that arose before the date of such confirmation ....”); 11 U.S.C. § 726(a)(4) (allowing distribution in payment for any fine, penalty, forfeiture, or punitive damages).
determining whether the plan is fair and equitable. The bankruptcy court estimates the debtor's likely tort and other liabilities to arrive at a number against which the plan is evaluated. It is thus possible to predict in the plan what kind of pro rata distribution would be received by creditors.

This estimation process, while not res judicata as to causation and damages, does allow a goal to be set and establishes a target which is used to determine whether the distribution of assets to a class of creditors meets the fair and equitable test. In addition, even though the estimation is not binding, it still performs an important function. The court, evaluating the estimation as a third party, subjects claims to a process similar to alternative dispute resolution. Therefore, the estimation may have positive effects on settlement negotiations. Ultimately, the estimation process is used to define and limit the available asset pool from which claims are paid.

One of the most important benefits offered by the Bankruptcy Code is a binding notice and bar date which meet constitutional due process standards. Indeed, it is possible for a debtor to discharge even those debts of which it is unaware and, in some instances, claims of which the holder is currently unaware. The Code provides that confirmation of a Chapter 11 plan discharges all debts except as otherwise specifically provided in the plan. These debts do not need to be liquidated, nor do they need to be represented by a filed claim. If the notices of the bankruptcy and the hearing confirmation are adequate to satisfy constitutional due process requirements, those claims may be discharged. In Mullane v. Central Hanover Bank & Trust Co., the Supreme Court held that a publication notice constituted adequate notice for unidentified, conjectural beneficiaries. Similarly, in Menard-Sanford v. Mabey (In re A. H. Robbins), the Fourth Circuit approved a notice discharging future claims because such notice was not substantially less likely to provide notice than other feasible and customary substitutes. In

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22 The Bankruptcy Court has jurisdiction over the relationship between a debtor and creditor, however, a tort victim does not become a creditor until a court settlement or judgment makes him so. St. Regis Paper Co. v. Quality Pipeline, Inc., 469 So. 2d 820, 823-24 (Fla. Dist. Ct. App.), cert. denied, 479 So. 2d 118 (Fla. 1985).
26 880 F.2d 694 (4th Cir. 1989).
mass tort claims where there is reasonable certainty of future claims, courts have taken an additional step. By appointing either committees or representatives to be involved in the plan confirmation process representing the rights of unknown future claimants, the courts have found procedural due process to be satisfied. These appointments by the courts are thus considered sufficient to discharge, or at least deal with, those claims that are not filed, and perhaps, unknown to the debtor at the time of filing. Therefore, a diocese should be able to provide a notice stating:

Diocese 'X' has filed bankruptcy in the bankruptcy court of the district of 'X,' and any person having a claim resulting from the intentional or negligent injury caused by a person acting on behalf of or in the name of the Diocese is directed to file such claim by such and such bar date, and if not, it will be forever barred.

It may even be possible to discharge claims of which the claimant is unaware, as long as they exist at the time of the filing, and provided the notice is adequate. It may also be possible, under similar circumstances, to bar even repressed memory cases in states which have the discovery rule as a basis for the statute of limitations. Although it is impossible to prevent the filing of future actions to test the adequacy of notice, one can better defend such suits if a final order exists based upon at least one court's notion of constitutional due process.

An additional benefit of bankruptcy, as indicated in the Johns-Manville and A. H. Robins mass tort cases, is the provision of a single forum for global settlement with insurance companies and tort claimants. Courts have held that the proceeds of liability insurance policies are property of the estate because these policies are assets from which creditors' claims may be satisfied. In addition, cases have suggested that the bankruptcy court itself has jurisdiction to hear a declaratory judgment action on coverage issues since coverage affects the administration of the bankruptcy estate. Although several courts have held that jurisdiction exists where insurance cover-

age produces an asset that is property of the estate, a bankruptcy court's jurisdiction to hear that type of action may not be absolute. Furthermore, courts have held that the plan and confirmation order may provide an injunction which protects the insurance companies from further action as long as they have contributed to the tort settlement. Although the Bankruptcy Code provides for discharge of only the debtor’s obligations, in cases where the insurance companies have contributed, courts have issued what are called “channeling orders,” which channel claims of all creditors to the asset pool created by the insurance company contribution. Thus, the debtor may effectively enjoin the claimants from pursuing any other property or remedy. The Johns-Manville plan, which included such a trust and asset pool, was recently codified into the Bankruptcy Code, but applies only to asbestos bankruptcies. Interestingly enough, the other mass tort cases were not included at the time.

If the insurance company does not cooperate in the creation of a settlement pool, any claim retained under subrogation rights may possibly be discharged in the plan as a contingent liability in existence at the time of confirmation. Not surprisingly, when the threat of bankruptcy becomes real, insurance companies are quite interested. Furthermore, notwithstanding subrogation rights, claims of insurance companies may be discharged just as tort claims to the extent that assets are insufficient.

THE POTENTIAL PITFALLS OF BANKRUPTCY

The benefits provided by the Bankruptcy Code come at a price, however, and include some negative considerations. First, bankruptcy is an expensive and cumbersome proceeding and, in response to this expense, the use of “pre-packaged plans” is increasing. These plans are Chapter 11 filings for the purpose of obtaining court approval on settlements that are essentially


worked out and are typically filed together with the petition rather than at a later date. Thus, in cases where a settlement has been essentially worked out, use of a Chapter 11 bankruptcy can help prevent minor players from rejecting a deal at the last minute. Nevertheless, unless the majority of creditors have accepted some kind of plan, the proceedings in bankruptcy can be lengthy, cumbersome, and very expensive.

A second negative consideration under Chapter 11 reorganization involves the appointment of a creditor's committee, typically drawn from among the twenty largest unsecured creditors. In the case of a diocese with significant tort liability, the creditors' committee is likely to include the tort claimants and their attorneys. Membership on that committee facilitates access to and review of the records and ongoing affairs of the diocese on a day-to-day basis. A creditors' committee also has the right to bill the debtor for the cost of administration, including attorney and accountant fees, dramatically increasing the expense of a bankruptcy. In addition, creditors' committees can raise and comment on any issue in the case as part of their authority to investigate the affairs of the debtor. Several courts have construed this as constituting authority for the creditors' committee to actually bring an action if the committee determines that the debtor in possession is not sufficiently aggressive in pursuing such things as equitable actions, fraudulent conveyances, avoidances, etc.

A substantial negative factor to be considered in a diocesan bankruptcy proceeding is the possibility of subjecting other church entities to the jurisdiction of the bankruptcy court on theories of substantive consolidation, alter ego, or contribution. Critical to that determination is whether the debtor has indiscriminately transferred funds back and forth between affiliates, or whether it has acted as though an affiliate is effectively the same entity as the debtor. The trustee or the debtor in possession has both the right and obligation to bring any action at law which might enhance the estate and thus, the recovery of the creditors. These potential actions include contribution actions

36 Sections 1103 and 1109 imply a qualified right to initiate proceedings when the trustee or debtor in possession unjustifiably fails to bring suit or abuses its discretion in not suing to avoid a preferential transfer. 11 U.S.C. §§ 1103(c)(5) and 1109(b).
against other dioceses, treatment hospitals, religious organizations, or others for damages caused by an offending priest. The risk does exist in bankruptcy that a trustee or a creditors' committee may institute an action in bankruptcy court that the debtor does not wish to pursue. Contributions, for example, which a diocese made, without consideration, to support one of its affiliated entities over the years, may be subject to avoidance as fraudulent conveyances, even if the affiliated entity can establish and prove its separateness. Restricted gifts and trusts, moreover, are also at risk for avoidance. Here, the key determination is whether the restrictions have been properly documented and honored in practice, or whether the funds have been treated as though available for the general purposes of the diocese.

Another negative aspect of bankruptcy is the risk of dismissal. In situations where the debtor is unable to gain approval of a plan, the court can either convert to Chapter 7, dismiss the case, or appoint a trustee. Section 1112(c) states that a court cannot convert to a Chapter 7 if the debtor is not a moneyed business or commercial corporation. In the case of a religious organization, therefore, dismissal is certainly more likely than conversion to Chapter 7. Another option is the appointment of a trustee, whose function is either to liquidate the assets of the debtor or to run the business until a plan is approved and the enterprise is turned over to management. While it is conceivable that a trustee could serve as a receiver for property of the diocese while the plan is being formulated, a bankruptcy court is unlikely to undertake that kind of delicate balancing of responsibilities. Therefore, if a trustee would normally be appointed in a commercial case, the court would probably dismiss the bankruptcy of a religious organization, leaving it to deal with creditors one on one.

In addition, there are serious administrative inconveniences and expenses involved in bankruptcy. First, the act of filing a bankruptcy is in itself an alienation of 100 percent of the assets of the diocese. Such an action cannot be undertaken without the

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37 11 U.S.C. § 1112(c) ("The court may not convert a case under this chapter to a case under chapter 7 of this title if the debtor is a farmer or a corporation that is not moneyed, business, or commercial corporation unless the debtor requests such conversion.").

This is a major stumbling block because it prevents bankruptcy from being used quickly to head off a sheriff's sale or a levy on assets. The cost, as previously discussed, cannot be underestimated as a factor. Indeed, cost may very well be the stumbling block that prevents bankruptcy from being effective.

Several non-legal considerations must also govern the decision whether or not to utilize bankruptcy as a tool. First of all, the inevitable publicity and increase in media attention to the affairs of the Church is unlikely to be positive. Certainly, tensions will be heightened with parishes, the chancery, and other diocesan entities whose assets might be threatened. Also, the impact of filing bankruptcy on annual appeals, donations, and other fundraising drives would probably be negative, particularly where people believe that the funds they are asked to give will be administered by a bankruptcy court. Finally, it is important to realize that bankruptcy is merely a monetary solution to underlying economic problems. To the extent that the diocese's problems result from tort or individual injury problems, a bankruptcy plan which quantifies claims does not assist, and may indeed hamper, the ability of a diocese to offer alternatives such as non-monetary assistance to victims as part of possible settlements.

**CONCLUSION**

As a final comment, effective bankruptcy planning should be done prior to the eve of bankruptcy. Otherwise, options may be limited. Nevertheless, it is inappropriate to threaten bankruptcy without being prepared to carry it out. Keep in mind that asset protection planning is, in effect, bankruptcy planning. If asset protection is properly planned in advance, Chapter 11 bankruptcy may provide a somewhat comfortable refuge for a diocese, rather than a very uncomfortable last resort.

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39 J. Michael Fitzgerald, *The Official Catholic Directory: Civil and Canon Law Requirements*, 30 CATH. LAW. 107, 129 (1986) (requiring approval of Holy See when alienation constitutes greater than one million dollars of property value as well as for “vowed property” or property which has historic or artistic value).