

THOU SHALT NOT REORGANIZE: SACRAMENTS FOR SALE

FIRST AMENDMENT PROHIBITIONS AND OTHER COMPLICATIONS OF CHAPTER 11 REORGANIZATION FOR RELIGIOUS INSTITUTIONS

INTRODUCTION

Imagine a system in which a church could be made to sell sacraments to the highest bidder. Envision an arrangement that would allow a secular trustee, employed by the United States government, to mandate that a priest accept confessions and instruct repentances—for a price.¹ What if atonement could simply be bought based on a sliding scale income ratio? Why not just raffle off guaranteed entrances into heaven or a fail-safe happy afterlife? The possibilities become endless and unimaginable. Theoretically, however, these potential externalities would be perfectly legal if chapter 11 reorganizations are followed to the letter of the law with respect to religious institution debtors. For several dioceses of the Catholic Church currently seeking bankruptcy protection under chapter 11, these extreme outcomes could conceivably become realities unless the courts recognize First Amendment religious freedoms and other unique issues pertinent to non-secular bankruptcies.

We live in a nation unquestionably divided by competing morals, rooted in large part in religion. This division is not wholly bound by political party lines, geography, or socioeconomic status.² Current events have led us to find ourselves in the midst of another attempt to exact a tolerable degree of separation between religion and state, on a national and arguably international scale, through the lens of American politics.³ The balance of secular and non-secular interests in our daily lives is no doubt a topic of conversation at many dinner tables around the country, and the White House seems to be no exception. President George W. Bush credits his faith as a major influence and source of strength in his duties and decisions, both in the United States and

¹ See MADELEINE GRAY, *THE PROTESTANT REFORMATION: BELIEF, PRACTICE AND TRADITION* (Sussex Academic Press 2003). The sale of indulgences to raise money for the church was one of the catalysts that sparked the Protestant Reformation, a schism of massive historical proportions. *Id.*

² See generally Ron Suskind, *Without a Doubt*, N.Y. TIMES, Oct. 17, 2004, at Magazine Desk 44.

³ See *id.*

abroad, as leader of the free world and Commander in Chief.⁴ The President's open devotion to his faith has played well with a majority of Americans⁵ and arguably contributed to his reelection to a second term. This approach struck a cord with many Americans who put more stock in faith than was previously anticipated. For example, same-sex marriage was brought to the forefront of American politics during the race for the White House in 2004.⁶ Previously a fringe social issue affecting a minority of the population, the topic of same-sex marriage was met with aggressive opposition along the campaign trail, much of which came from religious interest groups. Even public school policies, while historically unfamiliar in the court of public opinion and in the halls of the U.S. Supreme Court,⁷ are being scrutinized in courts of law with respect to competing secular and non-secular interests, including school prayer⁸ and discussions of evolution and creation theories in school textbooks.⁹

It seems that, for the moment, the faithful have spoken at least on moral grounds. Eleven states passed constitutional amendments banning the possibility of same-sex marriage through referenda in 2004.¹⁰ Also garnering national attention, the U.S. Supreme Court has heard a case considering the constitutionality of displaying a statue depicting the Ten Commandments outside a Texas courthouse and held the stand-alone monument is constitutional.¹¹ The American moral majority has communicated its message with a unified voice that is louder than recent memory can recall. The message is a simple one: religion is still important to much of the voting population, and

⁴ See *id.* (discussing faith and the presidency of George W. Bush).

[George W. Bush] truly believes he's on a mission from God. Absolute faith like that overwhelms a need for analysis. The whole thing about faith is to believe things for which there is no empirical evidence. . . . But you can't run the world on faith. . . . Once he makes a decision—often swiftly, based on a creed or moral position—he expects complete faith in its rightness.

Id. at 46–47.

⁵ See *id.*

⁶ See *id.*

⁷ See JOHN WITTE, JR., RELIGION AND THE AMERICAN CONSTITUTIONAL EXPERIMENT 203-11 (2d ed. 2005).

⁸ See *Elk Grove Unified Sch. Dist. v. Newdow*, 542 U.S. 1 (2004).

⁹ See Kristina Torres, *Evolution Appeal Cites Flawed Logic: School Board in Cobb Says Judge Erred in Ruling*, THE ATLANTA J.-CONS., Jan. 19, 2005, available at http://www.ajc.com/hp/content/auto/epaper/editions/today/metro_14ee70a944913082004d.html (discussing a Georgia public school district's appeal of a federal court ruling banning disclaimers about evolution in science textbooks as unconstitutional endorsements of religion).

¹⁰ *Voters Pass All 11 Bans on Gay Marriage*, THE ASSOCIATED PRESS, Nov. 3, 2004, <http://www.msnbc.msn.com/id/6383353> (last visited Nov. 9, 2005).

¹¹ *Van Orden v. Perry*, 125 S. Ct. 2854 (2005).

it has an indelible place in American life, policy, and values. In a nation so separated in its views on how religion should inform government, if at all, the national discourse in which we find ourselves begs the often discussed yet seldom resolved question: where do we draw the line between religion and state?

Federal bankruptcy law has been one area of U.S. law called upon in efforts to exact a line between religion and state; a line that history and the U.S. Supreme Court have drawn and redrawn time and again.¹² The financial difficulties of religious organizations have seldom been considered in detail by federal bankruptcy courts. Several dioceses of the Catholic Church, however, were recently left with no alternative outside of bankruptcy protection as the result of adverse judgments, settlements, and legal fees in massive tort claims concerning sexual abuse and misconduct by clergy members.¹³ Along with these filings, questions of First Amendment violations, particularly respecting the religion clauses,¹⁴ inevitably surface. The business of faith, at least as it was intended, is not inherently commercial, as is the case with traditional for-profit business bankruptcy filings. In fact, Congress and the Supreme Court have recognized numerous exceptions for religious organizations with respect to employment,¹⁵ taxation,¹⁶ and other restrictions that are otherwise required of secular institutions and individuals.¹⁷ On the flip side, the Establishment Clause of the First Amendment requires that the government not excessively entangle itself in religious affairs for fear of establishing or endorsing a particular religious practice or religion in general.¹⁸ The special case of religious liberty has been debated for centuries,¹⁹ and this debate continues to inform society's policies and practices with respect to religion in public life.

¹² See generally WITTE, *supra* note 7.

¹³ See *infra* Part I.A.

¹⁴ "Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise [of religion]. . . ." U.S. CONST. amend. I.

¹⁵ See, e.g., *Sherbert v. Verner*, 374 U.S. 398, 410 (1963) (creating an exception for Saturday sabbatarians in state unemployment benefits schemes); *Trans World Airlines, Inc. v. Hardison*, 432 U.S. 63, 76-77 (1977) (requiring employers to make reasonable accommodations for employee religious practices); *Corp. of Presiding Bishop of the Church of Jesus Christ of Latter-Day Saints v. Amos*, 483 U.S. 327, 338-39 (1987) (exempting religious organizations from Title VII prohibition against religious discrimination); see 42 U.S.C. §§ 1981, 1983, 2000e to 2000e-3 (2000).

¹⁶ See *Walz v. Tax Comm'n of N.Y.*, 397 U.S. 664, 675 (1970) (holding a state tax exemption of church property is not an establishment of religion).

¹⁷ See *Arver v. United States*, 245 U.S. 366, 375 (1918) (exempting clergy and religious pacifists from military service).

¹⁸ U.S. CONST. amend. I.

¹⁹ See WITTE, *supra* note 7.

The purpose of this Comment is to display the dire need for an amendment to the U.S. Bankruptcy Code (“Bankruptcy Code”)²⁰ that prohibits religious organizations from filing for bankruptcy protection under chapter 11.²¹ A prohibition against reorganization for non-secular bankrupts will avoid First Amendment violations with respect to free exercise and establishment of religion. This Comment will conclude that chapter 7²² liquidation provides for a more equitable and constitutionally sound option. That is not to say that the preclusion of chapter 11 reorganization for non-secular bodies is without sacrifice. In fact, the result in a liquidation sale may leave a religious institution with no remaining assets after the assets are collected, sold, and the proceeds are distributed to its creditors.²³ In bankruptcy, a local house of worship may have to close its doors. Organized religion in the United States is decentralized on the whole, however, and allows for many congregations and factions of different religions spread out within every state. The solution proposed herein rests upon the concept that traveling to a neighboring affiliated parish or house of worship is a better externality of bankruptcy than requiring local religious organizations to become entrepreneurial enterprises excessively entangled with government, in violation of the First Amendment religion clauses, to reorganize the local houses of worship.

Part I of this Comment will provide the context for this inquiry by detailing recent bankruptcy filings by religious organizations and the surrounding circumstances. Additionally, Part I provides an overview of bankruptcy law, including a discussion of the purpose of bankruptcy in the United States, the courts’ abstention options, chapter 11 reorganizations, and chapter 7 liquidations. Discussing these aspects of bankruptcy law will provide a better understanding of how these provisions may create First Amendment conflicts in a religious institution’s bankruptcy case. Part II examines the First Amendment religion clauses, the gradual weakening of their protections in recent years, and the Religious Freedom Restoration Act (“RFRA”)²⁴ as the appropriate contemporary statutory scheme under which religious liberty violations may be remedied. This examination provides a thorough analysis of the constitutional and statutory mandates to be considered with respect to non-secular bankruptcies. Part III discusses the potential conflict between religious liberty and the requirements of chapter 11 reorganization. Additionally, Part

²⁰ See 11 U.S.C. §§ 101-1330 (2000).

²¹ *Id.* §§ 1101-1174.

²² *Id.* §§ 701-784.

²³ *Id.*

²⁴ 42 U.S.C. §§ 2000bb to 2000bb-4 (2000).

III explains why chapter 7 liquidation is the more appropriate remedy. Further, this section provides an analysis of some of the red flags that courts should be aware of in non-secular bankruptcies. Part IV of this Comment proposes suggestions for avoiding or remedying potential First Amendment conflicts.

I. FALL FROM GRACE: BANKRUPTCY FILINGS BY RELIGIOUS DEBTORS MAKE HISTORY

Before embarking on an exploration of the First Amendment implications of a religious organization's bankruptcy reorganization efforts, it is essential to examine the context in which the need arose by looking to current events. It is estimated that costs associated with the recent child sex abuse scandals involving members of the Catholic Church have risen to more than \$770 million.²⁵ These lawsuits, combined with an economic recession, have led to falling investment income and fewer donations, causing many dioceses around the country to face potential financial ruin.²⁶ Many thought that the Archdiocese of Boston would be first in line if in fact a bankruptcy filing was on the horizon for a religious organization.²⁷ These rumors proved false, however, likely due to the closing of churches and the sale²⁸ or potential sale²⁹ of valuable property upon which the Archdiocese's buildings currently stand. Though seeing church buildings on the auction block is an increasingly common occurrence,³⁰ Boston Catholics have not yet been forced to wrestle with the unsettling revelation that their local houses of worship and private schools may become property of the estate subject to the will of the courts in a bankruptcy reorganization or liquidation effort. Members of the Catholic

²⁵ Cathy Lynn Grossman, *Abuse Isn't the Only Issue*, USA TODAY (Wash. D.C.), Nov. 8, 2004, at 2D.

²⁶ *Id.* "To cover a \$26 million abuse settlement without tapping parish assets or using gifts locked to specific purposes, the Archdiocese of Louisville cut[s] its operations budget 50%, laid off 20% of the staff and raised the tax each parish pays to the diocese." *Id.*

²⁷ See 70 *More Bring Sexual Abuse Lawsuits in Boston Archdiocese*, N.Y. TIMES, Jan. 30, 2003, at A14.

²⁸ Grossman, *supra* note 25. "To help meet an \$85 million abuse settlement, the Archdiocese of Boston sold the luxurious archbishop's residence and acres of prime parkland to neighboring Boston College." *Id.*

²⁹ Bella English, *Defeated, but Still Devoted*, BOSTON GLOBE, Nov. 14, 2004, at 9.

Their church is sitting on 14 acres of valuable real estate that could fetch up to \$500,000 per acre. So they came up with a plan, which they presented to the chancery: the archdiocese takes the land, and leaves the church on a small lot. . . . People we thought were coming in to be baptized are instead scoping out the property.

Id.

³⁰ See Grossman, *supra* note 25.

Church in other dioceses around the country, however, have not been so fortunate.

A. *Problems in Portland, Tucson, Spokane, and Beyond*

On July 6, 2004, the Roman Catholic Archdiocese of Portland, Oregon made history when it became the first Catholic diocese in the nation to file for bankruptcy.³¹ The archdiocese, and the insurance companies which insure it, have already paid \$53 million to settle sex abuse lawsuits arising since 1950, with \$21 million alone paid out in 2003.³² The bankruptcy filing put on hold two trials in which plaintiffs are seeking a total of \$155 million.³³ The church is being sued for negligence in failing to remove a priest accused of sexually abusing more than fifty boys over the course of three decades.³⁴ For now, the Archdiocese is protected from creditors by the automatic stay provision.³⁵ As a result, an additional sixteen individuals claiming to have been sexually abused by archdiocese priests diverted their suits against the Archdiocese to individual religious orders and the State of Oregon.³⁶ The situation is being closely watched across the country as many other Catholic dioceses also face major financial problems in the wake of sexual abuse claims.³⁷

As a result of clergy sexual abuse cases, the Roman Catholic Diocese of Tucson, Arizona filed a voluntary petition for chapter 11 bankruptcy reorganization on September 20, 2004, becoming the second diocese to seek such protection.³⁸ Having already paid out more than \$10 million in settlements over the past several years, the diocese faced twenty-two additional claims of clergy sexual misconduct.³⁹ There was some debate over the filing itself because critics note that the prepackaged reorganization plan did not include the seventy-five parishes and associated schools among the diocese's

³¹ Eli Sanders, *Catholics Puzzle Over a Bankruptcy Filing*, N.Y. TIMES, July 8, 2004, at A17.

³² *Id.*

³³ Laurie Goodstein, *Oregon Archdiocese Files for Bankruptcy Protection*, N.Y. TIMES, July 7, 2004, at A12. "The archdiocese announced its intention to file for bankruptcy just as jury selection was to begin in a civil trial." *Id.*

³⁴ Sanders, *supra* note 31.

³⁵ See 11 U.S.C. § 362(a) (2000). The filing of a petition triggers an automatic stay, which operates as an injunction to enjoin efforts by creditors to collect prepetition debts from the debtor or the estate and prohibits attempts to interfere with property of the estate. *Id.*

³⁶ See *Bankruptcy Diverts – Not Stops Flow of Lawsuits*, BCD NEWS AND COMMENT, Nov. 9, 2004, Vol. 43, No. 20.

³⁷ *Id.*

³⁸ *Diocese of Tucson Becomes 2nd to File for Bankruptcy*, N.Y. TIMES, Sept. 21, 2004, at A18.

³⁹ *Id.*

assets.⁴⁰ The Tucson diocese planned to compensate meritorious plaintiffs in sexual misconduct suits by categorizing claims and dispersing payments from a pool of funds consisting of approximately \$3.2 million in real property sales and an unspecified amount from insurance claims and other undisclosed sources.⁴¹ The gap between the diocese's assessments of its property values and those of its creditors widened over time.⁴² Some attorneys for sexual abuse victims placed the value of the Tucson diocese's property assets at close to \$100 million—a far cry from the \$3.2 million that the diocese listed in its prepackaged filing.⁴³ It is important to note that none of these figures accounted for potential future claimants who were abused in the past and have yet to bring suit, possibly increasing diocesan liabilities.⁴⁴

One year after filing, however, the Tucson diocese emerged from bankruptcy protection.⁴⁵ The diocese reached a settlement agreement, thus putting an end to its bankruptcy filing.⁴⁶ The diocese has already made an initial payment of \$15.7 million toward the \$22.3 million settlement agreement.⁴⁷ The settlement is intended to compensate more than fifty victims of sexual abuse at the hands of Tucson diocese clergy members.⁴⁸

Additionally, in December 2004, the Roman Catholic Diocese of Spokane, Washington joined the list of religious bodies currently seeking bankruptcy protection.⁴⁹ The diocese failed to reach settlement agreements with twenty-eight claims stemming from sexual misconduct allegations and has an additional thirty claims yet to consider.⁵⁰ With only \$11 million in assets and

⁴⁰ Michael Clancy, *Tucson Diocese Faces Liquidation; Payouts to Victims Could Affect Parish Schools, Churches*, ARIZ. REPUBLIC, Nov. 7, 2004, at 1B. "Parish property is believed to be worth at least \$50 million, far more than the \$16.6 million in assets the diocese listed in its bankruptcy filing." *Id.*

⁴¹ *Id.*

⁴² *Id.*

⁴³ Matt Miller, *Tucson Faces Unholy War in Ch. 11*, DAILY DEAL, Sept. 24, 2004, available at WESTLAW, 2004 WLNR 465686.

⁴⁴ *Spokane Diocese Files Chapter 11*, BCD NEWS AND COMMENT, Dec. 21, 2004, at A7. "In Portland's case, Judge Elizabeth Perris ruled that people who'd been abused in the past but hadn't yet connected the abuse with damage in their lives *could file claims* even after the [] deadline, *as could those* with repressed memories of abuse." *Id.* (emphasis added)

⁴⁵ Matt Miller, *Tucson Diocese Rises out of Ch. 11*, DAILY DEAL, Sept. 22, 2005, available at WESTLAW, 2005 WLNR 14919313.

⁴⁶ *Id.*

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ *Supra* note 44.

⁵⁰ *Id.*

upwards of \$80 million in liabilities,⁵¹ bankruptcy protection was inevitable. The diocese has already spent nearly \$940,000 from 1999 to 2004 in efforts to settle just ten cases alleging sexual misconduct.⁵²

With two U.S. religious bodies currently in bankruptcy and rumors of others on the verge of following suit,⁵³ how will the courts handle these controversial, high-profile cases? Perhaps equally as important, how will the drama unfold in the court of public opinion? These cases of first impression for the U.S. Bankruptcy Courts will undoubtedly set important precedents. Should First Amendment constitutional arguments prevail, these cases and those that follow may blaze a trail to the nation's capitol for the Supreme Court to decide.

It is worth noting that many localized religious organizations (including all parishes in both the Portland and Tucson dioceses of the Catholic Church involved in bankruptcy) are organized as "corporations sole."⁵⁴ This creates a unique legal relationship where, in the case of the Catholic Church, the archbishop or bishop is listed as the sole member, director, and trustee.⁵⁵ Depending on the degree of incorporation of its ministries, a diocese organized as a corporation sole may be organized in a way that pools all of its assets under one corporate umbrella, allowing all of the assets to be subject to bankruptcy court jurisdiction for use in satisfying outstanding creditors.⁵⁶ Others may be structured such that each parish or faction is incorporated individually, creating less overall liability and providing fewer assets to seize.⁵⁷

⁵¹ *Id.* Close to \$76 million of the \$81 million in liabilities is derived from sex abuse claims. *Id.*

⁵² *Id.*

⁵³ *Davenport Diocese Next?*, BCD NEWS AND COMMENT, Oct. 19, 2004, at A2. "After negotiations with [thirty-seven] men who claim primarily three priests at the Diocese of Davenport (Iowa) abused them in the last [fifty] years, Bishop William Franklin's [sic] warned parishioners that insurance and finances are unlikely to meet the victims' demands." *Id.* "In what is seen as a compromise, Chief Justice Ronald George announced last week that up to 150 Northern California clergy abuse cases will be heard in Alameda County." Jahna Berry, *Judge Sabraw Assigned Up To 150 Abuse Cases*, THE RECORDER (S.F.), May 11, 2004, at 1.

⁵⁴ Matt Miller, *Iowa Diocese Near Ch. 11 Filing*, DAILY DEAL, Oct. 19, 2004, available at WESTLAW, 2004 WLNR 4657508.

⁵⁵ *Id.*

⁵⁶ *Id.*

⁵⁷ While the ways in which religious institutions are financially structured impacts how corresponding bankruptcy filings are handled tactically, a detailed discussion of the legal relationships thereby created is largely beyond the scope of this Comment.

B. Overview of Bankruptcy Law

Bankruptcy is addressed in Article I of the U.S. Constitution.⁵⁸ The framers bestowed upon Congress the exclusive power to establish uniform laws on the subject of bankruptcy throughout the United States.⁵⁹ Title 11 of the U.S. Code is the federal body of law that governs bankruptcy matters.⁶⁰ As such, bankruptcy law is exclusively federal.⁶¹ Core bankruptcy proceedings are heard in specialized federal courts designed to hear such proceedings.⁶² While there are state collection law remedies available outside of bankruptcy,⁶³ when a bankruptcy petition is filed, federal bankruptcy law trumps state collection efforts by way of the Supremacy Clause in Article VI of the U.S. Constitution.⁶⁴ Bankruptcy cases are the most common form of federal court proceeding in the United States.⁶⁵

1. Purpose, Goals, and Function of American Bankruptcy Law

Bankruptcy law governs the relationship between debtors and creditors in bankruptcy proceedings.⁶⁶ The commencement of a bankruptcy case puts creditors on notice to assert all claims against the debtor seeking relief or risk losing them altogether.⁶⁷ In essence, bankruptcy law provides an equitable alternative to state collection remedies designed to allow individual creditors to collect debts from recalcitrant debtors. In situations concerning multiple creditors, bankruptcy law puts all creditors on equal ground at the outset and avoids the inequity, cost, and inefficiency of the race of diligence under state law.⁶⁸ This is the practical purpose of bankruptcy law.

⁵⁸ U.S. CONST. art. I, § 8, cl. 4.

⁵⁹ *Id.*

⁶⁰ See 11 U.S.C. §§ 101-1330 (2000).

⁶¹ See U.S. CONST. art. I, § 8, cl. 4.

⁶² 28 U.S.C. § 157(b)(1) (2000). The Bankruptcy Code contains fifteen examples of core proceedings, however, use of the word “include” indicates that the list is not exclusive. *Id.* § 157(b)(2). “There are four convenient categories into which these illustrations can be placed: (1) matters of administration; (2) avoidance actions; (3) matters concerning property of the estate; and (4) others.” 1-3 COLLIER ON BANKRUPTCY ¶ 3.02[3] (Alan N. Resnick & Henry J. Sommer eds., 15th ed. rev. 2004).

⁶³ See generally CHARLES JORDAN TABB, THE LAW OF BANKRUPTCY § 1.3, at 10-25 (1997).

⁶⁴ See U.S. CONST. art. VI, § 2.

⁶⁵ CHARLES J. TABB & RALPH BRUBAKER, BANKRUPTCY LAW PRINCIPLES, POLICIES, AND PRACTICES 55 (Anderson Publ'g Co. 2003) [hereinafter TABB & BRUBAKER]. “In the year ending September 30, 2002, an amazing 1,547,094 bankruptcy cases were commenced.” *Id.*

⁶⁶ See generally GEORGE M. TREISTER ET AL., FUNDAMENTALS OF BANKRUPTCY LAW (1993).

⁶⁷ TABB, *supra* note 63, § 7.1, at 468-72.

⁶⁸ TABB & BRUBAKER, *supra* note 65, at 67.

In terms of societal function, the law of bankruptcy embodies two competing policy considerations: providing a fresh start to debtors and protecting the rights of creditors.⁶⁹ The fresh start policy is designed both to relieve the honest debtor of the burden of repaying insurmountable debts and to provide him with enough assets to resume a productive life as a responsible, contributing, debt-paying member of society.⁷⁰ Bankruptcy also seeks to protect creditors by arranging the orderly repayment of debts.⁷¹ The Bankruptcy Code provides for creditor protection by gathering all of the debtor's property and placing it into a central estate,⁷² automatically staying all collection efforts⁷³ to prevent aggressive creditors from devouring the estate, and providing an opportunity for all creditors to be treated fairly and have their claims repaid in an organized, predictable manner.

Bankruptcy is designed to assist financially distressed debtors in liquidating assets and discharging remaining debt⁷⁴ or restructuring and repaying debt in full or in part.⁷⁵ There are six methods of relief available under the Bankruptcy Code.⁷⁶ Chapter 7, commonly identified as "liquidation," provides the mechanism for taking control of the property of the debtor, selling it, and distributing the proceeds to creditors on a pro rata basis.⁷⁷ This chapter is the most common type of bankruptcy case.⁷⁸ It is available to individuals as well

Under the race of diligence, the first creditors who grab the debtor's assets will be paid in full. Those who come later in time will get nothing. . . . Instead, the more equitable result in the situation where all creditors cannot be paid in full is for the creditors to share the debtor's property on a pro rata basis Each creditor thus also shares part of the loss from the debtors collective default.

Id.

⁶⁹ *Id.* The conflict between the two policies arises because, in support of the fresh start concept, bankruptcy law inevitably allows debtors to shield some assets from creditors. See, e.g., David S. Cartee, Note, *Surrendering Collateral Under Section 1329: Can the Debtor Have Her Cake and Eat It Too?*, 12 BANKR. DEV. J. 501, 502 (1996).

⁷⁰ The fresh start policy "intends to aid the unfortunate debtor by giving him a fresh start in life, free from debts, except of a certain character, after the property which he owned at the time of bankruptcy has been administered for the benefit of creditors." *Stellwagen v. Clum*, 245 U.S. 605, 617 (1918).

⁷¹ See H.R. REP. NO. 95-595, at 366-68 (1977), as reprinted in 1978 U.S.C.A.N. 5963, 6321-24.

⁷² 11 U.S.C. § 541(a) (2000).

⁷³ *Id.* § 362 (the "automatic stay" provision).

⁷⁴ *Id.* § 701-784.

⁷⁵ *Id.* § 1101-1174.

⁷⁶ *Id.* § 109.

⁷⁷ *Id.* § 701-784; see TREISTER, *supra* note 66, at 17.

⁷⁸ TABB & BRUBAKER, *supra* note 65, at 66.

as corporations whose businesses lose all going concern value⁷⁹—when the business as a whole is worth *less* than the sum of its alienable parts. The purpose of chapter 7 is to determine an equitable distribution of the debtor's property among its creditors and to provide the debtor with a fresh start through the unique bankruptcy law discharge provision.⁸⁰ Chapter 9 provides for the special case of municipal bankruptcy.⁸¹ Chapter 11 is a reorganization provision for debtors usually engaged in business, including individuals, partnerships, and corporations.⁸² The purpose of chapter 11 reorganization is to preserve the going economic value of the corporation and to rebuild the business as a viable, profitable entity rather than liquidate it⁸³—the whole is worth *more* than the sum of its parts. The fresh start concept applies to the debtor in chapter 11 cases upon the confirmation of a binding reorganization plan intended to benefit debtor and creditor alike by the payment of debt through continued operation of the business.⁸⁴ Chapter 12 is a type of reorganization designed to give special relief to family farmers.⁸⁵ Chapter 13 provides a reorganization option that allows an individual with regular income, whose debts fall below a specified amount, to retain possession of his or her assets and pay creditors in full or in part over a period of years through a guarantee of future earnings.⁸⁶ The fresh start principle is evidenced here in the discharge granted to the debtor at the end of the predetermined payback period.⁸⁷ Finally, with the amending of the Bankruptcy Code in 2005, chapter 15 provides a mechanism to deal with cross-border insolvency.⁸⁸

2. Abstention

A bankruptcy court has the option to abstain from hearing a particular civil proceeding within a case or the case entirely.⁸⁹ Abstention from hearing a civil proceeding in a bankruptcy case is a matter of the court's discretion and rests

⁷⁹ 1-1 COLLIER ON BANKRUPTCY ¶ 1.03[2][a] (Alan N. Resnick & Henry J. Sommer eds., 15th ed. rev. 2004).

⁸⁰ See *infra* Part I.D.

⁸¹ 11 U.S.C. §§ 901-946.

⁸² *Id.* §§ 1101-1174; TREISTER, *supra* note 66, at 17.

⁸³ See *Id.* §§ 1101-1174.

⁸⁴ *Id.* Chapter 11 includes a special subchapter applicable only to railroads that is beyond the scope of this Comment. *Id.*

⁸⁵ *Id.* §§ 1201-1231.

⁸⁶ *Id.* §§ 1301-1330. Debts are usually paid over a period of three to five years. 1-1 COLLIER ON BANKRUPTCY, *supra* note 79, ¶ 1.03[6].

⁸⁷ 1-1 COLLIER ON BANKRUPTCY, *supra* note 79, ¶ 1.03[2][d][iv].

⁸⁸ 11 U.S.C. § 1501(a) (2005).

⁸⁹ 11 U.S.C. § 305(a)(1); 28 U.S.C. § 1334(c)(1) (2000).

upon either the interest of justice or the interest of comity with state courts or state law.⁹⁰ Therefore, under this provision a bankruptcy judge could abstain from hearing a matter even if the court has jurisdiction over the controversy.⁹¹ Similarly, § 305(a)(1) of the Bankruptcy Code grants the bankruptcy court the power to abstain from hearing a case altogether, even when jurisdiction is otherwise appropriate.⁹² Relief under § 305(a)(1) is limited, however, to situations where the interests of both the creditors and the debtor would be better served by dismissal or suspension.⁹³ Abstention under § 305, while legally and theoretically possible, is an extraordinary remedy to be used sparingly.⁹⁴ Abstention, though rarely invoked, could provide a bankruptcy court with a procedural method of avoiding First Amendment complications in non-secular bankruptcies.

C. Chapter 11 Reorganization

Chapter 11 reorganizations make up only a small percentage of bankruptcy cases filed in a given year.⁹⁵ Reorganization relief, though typically associated with business entities, is not limited to for-profit entities.⁹⁶ In fact, it is not difficult for a party seeking bankruptcy protection to meet the eligibility requirements set forth in the Bankruptcy Code, thus furthering the Code's general preference for easy access. With few exceptions, any "person" as defined in the Bankruptcy Code may file for chapter 11 reorganization.⁹⁷ The definition of "person" is broad and includes individuals, partnerships, and corporations.⁹⁸ Individuals eligible for chapter 11 relief may include sole proprietors of businesses or even consumers who for any number of reasons prefer relief under chapter 11 to that which is available under either chapters 7

⁹⁰ 28 U.S.C. § 1334(c)(1).

⁹¹ *Id.*; see also *Coker v. Pan Am. World Airways, Inc. (In re Pan Am. Corp.)*, 950 F.2d 839, 846 (2d Cir. 1991) (stating a federal court exercising bankruptcy jurisdiction may defer to a state court).

⁹² 11 U.S.C. § 305(a)(1).

⁹³ *Id.*; accord *In re Martin-Trigona*, 35 B.R. 596, 598-99 (Bankr. S.D.N.Y. 1983) (refusing to dismiss case under § 305(a)(1) because it was not in the interest of the debtors).

⁹⁴ *Id.*

⁹⁵ TABB & BRUBAKER, *supra* note 65, at 55. "In the year ending September 30, 2002, . . . [l]ess than 1% of the cases filed were chapter 11 reorganizations." *Id.*

⁹⁶ See, e.g., *In re Machne Menachem, Inc.*, 304 B.R. 140, 143 (Bankr. M.D. Pa. 2003) (denying confirmation as void for public policy of a not-for-profit organization's chapter 11 reorganization plan); *In re Sheehan Mem'l Hosp.*, 301 B.R. 777 (Bankr. W.D.N.Y. 2003) (denying the motion for conversion to chapter 7 of a not-for-profit corporation).

⁹⁷ 11 U.S.C. § 109. "Persons" excluded from filing chapter 11 include stockbrokers, banks, and insurance companies. *Id.*

⁹⁸ 11 U.S.C. § 101(41).

or 13.⁹⁹ Additionally, an eligible debtor must have one of the listed connections to the United States: residence, domicile, place of business, or property therein.¹⁰⁰ Neither of these general eligibility requirements is difficult to meet for most parties seeking bankruptcy protection. Because most U.S. religious organizations are structured as corporations,¹⁰¹ the requirements are easily met making bankruptcy relief a legal possibility.

The driving force behind the case for chapter 11 reorganizations is that it is possible for all parties involved to benefit once a debtor's finances are restructured at an agreeable cost.¹⁰² The parties hoping to benefit include not only debtors and creditors, but also suppliers, vendors, employees, stockholders, and the public at large.¹⁰³ The idea that a business is worth more as a going concern is perhaps best explained by the legislative history of the Bankruptcy Code:

The purpose of a business reorganization case, unlike a liquidation case, is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders. The premise of a business reorganization is that assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap.¹⁰⁴

If a debtor's business can earn positive income, the theory is that it may be more economically sound for the debtor to retain its property and generate revenue.¹⁰⁵ Chapter 11 reorganization focuses on current and future prospects without respect to the debtor's prior history.¹⁰⁶ Reorganization under chapter 11 requires that each creditor or equity interest holder be entitled to receive at least what it would receive in a chapter 7 liquidation of the debtor's assets,¹⁰⁷ thus mandating at the outset that creditors end up at least in the same position

⁹⁹ See *Toibb v. Radloff*, 501 U.S. 157, 166 (1991) (allowing debtors not engaged in business to file for chapter 11 relief).

¹⁰⁰ 11 U.S.C. § 109(a).

¹⁰¹ See *supra* notes 55-57 and accompanying text.

¹⁰² TABB & BRUBAKER, *supra* note 65, at 595.

¹⁰³ *Id.*

¹⁰⁴ H.R. REP. NO. 95-595, at 220 (1977), as reprinted in 1978 U.S.C.C.A.N. 5963, 6179.

¹⁰⁵ TABB & BRUBAKER, *supra* note 65, at 595.

¹⁰⁶ *Id.*

¹⁰⁷ 11 U.S.C. § 1129(a) (2000).

they would be if the debtor did not seek reorganization. This requirement is commonly known as the “best interests of the creditors test.”¹⁰⁸

A chapter 11 case typically involves the following steps: getting the debtor into bankruptcy; operating the business while the debtor is in bankruptcy; creating a reorganization plan that capitalizes on the going concern value of the business; negotiation and acceptance of the plan by creditors; confirmation of the plan by the court; discharge, pursuant to the plan, of debts owed; and payments by the debtor to the creditors as outlined in the plan.¹⁰⁹ The intricate reorganization process outlined in chapter 11 of the Bankruptcy Code has been the subject of volumes of treatises.¹¹⁰ For purposes of this Comment, special attention will be paid to what happens while a business is in the midst of bankruptcy—and, at times more importantly, who calls the shots.

1. The Role of the Debtor-In-Possession

In a chapter 11 case, the management in place at the time of the filing typically continues in its management and operation capacities, taking on the role of “debtor in possession.”¹¹¹ A debtor in possession (“DIP”) retains significant control over the insolvent business’s assets, including cash, real property, accounts receivable, and other property of the estate.¹¹² Theoretically, however, the opportunity to stay in business afforded to a debtor in bankruptcy must not be to the detriment of its creditors.¹¹³ Limitations on business operations are listed in detail in the administrative powers portion of the Bankruptcy Code.¹¹⁴ The court retains the ability to limit or deny various operational activities including: the use of collateral, general business decision making power, and control of transactions occurring outside of the ordinary

¹⁰⁸ See DAVID G. EPSTEIN ET AL., BANKRUPTCY § 10-3, at 736 (West Publ’g Co. 1993).

¹⁰⁹ *Id.* § 1-10, at 12-13.

¹¹⁰ See, e.g., W. HOMER DRAKE JR. & CHRISTOPHER S. STRICKLAND, CHAPTER 11 REORGANIZATIONS (West Group 2d ed., 2002); MICHAEL A. GERBER, BUSINESS REORGANIZATIONS (Lexis Publishing 2d ed., 2000); LYNN M. LOPUCKI & CHRISTOPHER R. MIRICK, STRATEGIES FOR CREDITORS IN BANKRUPTCY PROCEEDINGS (Aspen Publishers 2003).

¹¹¹ EPSTEIN ET AL., *supra* note 108, § 10-4, at 737. “The person sitting in the president’s chair the day before the petition is filed will be the same person sitting there the day after.” *Id.* A debtor in possession is defined as simply the debtor when no trustee has been appointed to serve in the case. 11 U.S.C. § 1101(1).

¹¹² EPSTEIN ET AL., *supra* note 108, § 10-5, at 738. The policy underlying the DIP’s continued management role is that a business’s current managers are the most informed with respect to its needs and are the most capable to lead the business through financial crisis. 7-1100 COLLIER ON BANKRUPTCY ¶ 1100.06 (Alan N. Resnick & Henry J. Sommer eds., 15th ed. rev. 2004).

¹¹³ EPSTEIN ET AL., *supra* note 108, § 10-5, at 738.

¹¹⁴ *Id.* (citing 11 U.S.C. §§ 361-365).

course of business.¹¹⁵ These limitations, however, are not absolute. For example, § 363(c)(1) of the Bankruptcy Code allows a debtor to conduct its business as it ordinarily does without judicial review.¹¹⁶ What is ordinary for one debtor may not be ordinary for another, and accordingly, the “ordinary course of business” standard varies depending upon the case and the parties involved.¹¹⁷ While courts will typically avoid interfering with a DIP’s exercise of business judgment,¹¹⁸ situations also arise in which the debtor must show that a proposed transaction is fair to all parties.¹¹⁹

The duties of the DIP include accounting for all property received, furnishing information to parties in interest, reporting and accounting, and conducting general business operations within the ordinary course.¹²⁰ The DIP is bound by a duty of care, “requiring it to exercise the measure of care, diligence and skill that an ordinarily prudent person would exercise under similar circumstances.”¹²¹ The DIP is also held to a duty of loyalty, including the avoidance of self-dealing,¹²² conflicts of interest and the appearance of impropriety,¹²³ and fair treatment of all parties.¹²⁴ Perhaps the most salient of these duties of loyalty is the obligation to maximize the value of the estate.¹²⁵ In fact, the Supreme Court noted in *Wolf v. Weinstein*,¹²⁶ “[so] long as the Debtor remains in possession, it is clear that the *corporation* bears essentially the same fiduciary obligation to the creditors as does the trustee for the Debtor out of possession.”¹²⁷ The Court specifically extended this duty to maximize

¹¹⁵ *Id.*

¹¹⁶ 11 U.S.C. § 363(c)(1).

¹¹⁷ See *Armstrong World Indus. v. James A. Phillips, Inc. (In re James A. Phillips, Inc.)*, 29 B.R. 391 (S.D.N.Y. 1983) (defining “ordinariness” broadly).

¹¹⁸ See, e.g., *In re Simasko Prod. Co.*, 47 B.R. 444, 448-49 (Bankr. D. Colo. 1985) (approving debtor’s financing order despite creditor’s objection of bad economic risk).

¹¹⁹ See, e.g., *In re Rittenhouse Carpet, Inc.*, 56 B.R. 131, 133 (Bankr. E.D. Pa. 1985) (holding that the debtor’s proposed contract with a potential insider could be approved only upon a showing of fairness to all parties).

¹²⁰ 11 U.S.C. § 1106(a); see also *Id.* § 1107(a) (requiring the DIP to perform nearly all of the functions of a trustee in a chapter 11 case).

¹²¹ See 7-1107 COLLIER ON BANKRUPTCY ¶ 1107.02[4] (Alan N. Resnick & Henry J. Sommer eds., 15th ed. rev. 2004) (citing *United States v. Block (In re Rigden)*, 795 F.2d 727, 730 (9th Cir. 1986)).

¹²² See, e.g., *Lopez-Stubbe v. Rodriguez-Estrada (In re San Juan Hotel Corp.)*, 847 F.2d 931, 950 (1st Cir. 1988).

¹²³ *Id.*; see also *Bennitt v. Gemmill (In re Combined Metals Reduction Co.)*, 557 F.2d 179, 196-97 (9th Cir. 1977).

¹²⁴ See, e.g., *In re Cent. Ice Cream Co.*, 836 F.2d 1068, 1072 (7th Cir. 1987).

¹²⁵ See, e.g., *Commodity Futures Trading Comm’n v. Weintraub*, 471 U.S. 343, 352 (1985); *La. World Exposition v. Fed. Ins. Co.*, 858 F.2d 233, 246 (5th Cir. 1988).

¹²⁶ 372 U.S. 633 (1963).

¹²⁷ *Id.* at 649.

the value of the estate to chapter 11 DIPs.¹²⁸ Thus, in a chapter 11 case, the DIP has essentially the same fiduciary duties as the trustee.¹²⁹ Courts have held both the unauthorized payment of prepetition debt¹³⁰ and the failure to maximize the value of estate assets¹³¹ to be in breach of a DIP's duty of loyalty.

2. *The Role of the Trustee*

One of the most important decisions creditors must make in the course of a chapter 11 case is whether to seek to supplant the DIP by moving to appoint a trustee.¹³² While a DIP presumptively remains in possession of the estate and in control of the business, upon motion of a party in interest,¹³³ the court may enter an order appointing a trustee at any time after commencement of the case and before the confirmation of the reorganization plan.¹³⁴ A DIP has essentially the same rights and limitations in the operation of its business as does a chapter 11 trustee.¹³⁵ The Bankruptcy Code lists two reasons for the appointment of a trustee: for cause, and when in the best interests of creditors.¹³⁶ The "for cause" standard requires appointment for reasons relating to "fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case" or for some similar reason.¹³⁷ The "interests of the creditors" standard is fairly straightforward, allowing the court to appoint a trustee if such appointment would be in the interests of creditors or equity security holders, without regard to the number of those affected or the size of

¹²⁸ See *Weintraub*, 471 U.S. at 355.

¹²⁹ See *Ford Motor Credit Co. v. Weaver*, 680 F.2d 451, 461 (6th Cir. 1982).

¹³⁰ See *In re Sal Caruso Cheese, Inc.*, 107 B.R. 808 (Bankr. N.D.N.Y. 1989).

¹³¹ See *Home Ins. Co. of Ill. v. Adco Oil Co.*, 154 F.3d 739, 743 (7th Cir. 1998), *cert. denied*, 526 U.S. 1017 (1999).

¹³² See TREISTER, *supra* note 66, § 9.02(g), at 403.

¹³³ While it is largely believed that the court may not order the appointment of a trustee on its own initiative, there is some debate over whether the court itself is a party in interest, and accordingly, whether it may act sua sponte to appoint a trustee. Compare *Courmoyer v. Town of Lincoln*, 53 B.R. 478, 486 (D.R.I. 1985) (holding that a bankruptcy court is not a party in interest for purposes of trustee appointment), *aff'd*, 790 F.2d 971 (1st Cir. 1986) with *In re Landscaping Services, Inc.*, 39 B.R. 588, 590 (Bankr. E.D.N.C. 1984) (holding that a bankruptcy court may initiate a request for appointment of a trustee if doing so is necessary to carry out provisions of the Bankruptcy Code).

¹³⁴ 11 U.S.C. § 1104(a) (2000).

¹³⁵ EPSTEIN ET AL., *supra* note 108, § 10-5, at 738. These rights include the right to sell, use, or lease property of the estate, the authority to obtain financing, and the power to assume or reject executory contracts or leases. 11 U.S.C. § 1107(a).

¹³⁶ 11 U.S.C. § 1104(a)(1)-(2).

¹³⁷ *Id.* § 1104(a)(1).

their claims.¹³⁸ After consulting with the parties in interest, either the creditors' committee or the U.S. Trustee appoints the trustee¹³⁹ for the case, subject to the court's determination that a trustee is necessary.¹⁴⁰ While the debtor is presumed to remain in possession at the outset of a chapter 11 case, such possession may be inappropriate where there are irremediable conflicts of interest among or between parties.¹⁴¹ In particular, where there is evidence that current management has played a role in leading the debtor into bankruptcy and has failed to change operations after the commencement of a case, management's inability to guide the debtor through bankruptcy may sway the court toward approving the appointment of a trustee.¹⁴²

The appointment of a trustee shifts power from the DIP, causing the trustee to become the essential and foremost figure in a reorganization case.¹⁴³ In *Commodity Futures Trading Commission v. Weintraub*, the Supreme Court opined, "Congress [has] contemplated that when a trustee is appointed, he assumes control of the business, and the debtor's directors are 'completely ousted.'"¹⁴⁴ The duties of the trustee include responsibility for operating the debtor's business to preserve the value of the estate, submitting reporting requirements, investigating the conduct of prior management, filing schedules and statements of affairs, and evaluating the desirability of continued operations so as to inform a feasible reorganization plan if possible.¹⁴⁵ The trustee, as a representative of the debtor's estate, is under an affirmative duty to protect the property of the estate.¹⁴⁶ As a fiduciary in a reorganization case, the trustee is under a general duty of loyalty to both the estate and its creditors.¹⁴⁷ Additionally, the trustee is bound by a duty to exercise "due care,

¹³⁸ *Id.* § 1104(a)(2).

¹³⁹ The trustee must be a "disinterested person." *Id.* §§ 101(14), 1104(b), 1104(d).

¹⁴⁰ See TREISTER, *supra* note 66, § 9.02(g), at 405; *see also* 11 U.S.C. § 1104(c). While the court has the authority to order the appointment and approval of a trustee, the court itself does not select the trustee to avoid any appearance of impropriety. See TREISTER, *supra* note 66, § 9.02(g), at 405; *see also, e.g., In re Plaza De Diego Shopping Ctr., Inc.*, 911 F.2d 820, 830 (1st Cir. 1990).

¹⁴¹ See 7-1104 COLLIER ON BANKRUPTCY ¶ 1104.02[1] (Alan N. Resnick & Henry J. Sommer eds., 15th ed. rev. 2004).

¹⁴² *See, e.g., In re Sharon Steel Corp.*, 871 F.2d 1217, 1228-29 (3d Cir. 1989).

¹⁴³ See TREISTER, *supra* note 66, § 9.02(g), at 405.

¹⁴⁴ 471 U.S. 343, 352-53 (1985) (quoting H.R. REP. NO. 95-595, at 220-221 (1977) *as reprinted in* 1978 U.S.C.C.A.N. 5963, 6180).

¹⁴⁵ 11 U.S.C. §§ 704, 1106.

¹⁴⁶ See 7-1106 COLLIER ON BANKRUPTCY ¶ 1106.02[2] (Alan N. Resnick & Henry J. Sommer eds., 15th ed. rev. 2004).

¹⁴⁷ *See Mosser v. Darrow*, 341 U.S. 267, 271 (1952) ("Equity tolerates in bankruptcy trustees no interest adverse to the trust.").

diligence and skill as to both affirmative and negative conduct”¹⁴⁸ similar to that of the DIP.

3. *The Role of the Examiner*

Finally, the Bankruptcy Code also provides for the appointment of an examiner when no trustee is appointed.¹⁴⁹ If a trustee is not appointed, the court must order the appointment of an examiner upon the request of a party in interest, if doing so is in the interest of creditors, equity security holders, and other interests of the estate or if “the debtor’s fixed, liquidated, unsecured debts, other than debts for goods, services, or taxes, or owing to an insider, exceed \$5,000,000.”¹⁵⁰ In all other cases, the installation of an examiner is discretionary.¹⁵¹ “An examiner investigates and reports on issues designated by the court, such as the debtor’s past dealings, financial condition and prospects for a successful reorganization.”¹⁵² The examiner does not usurp control from the DIP; in fact, the DIP is required to continue in its role, bound by its powers and duties, after the appointment of an examiner.¹⁵³ The examiner’s role may, however, be expanded by the court to include any “duties of the trustee that the court orders the debtor in possession not to perform.”¹⁵⁴

D. *Chapter 7 Liquidation*

Bankruptcy under chapter 7,¹⁵⁵ often referred to as simply “liquidation,” allows the bankruptcy court to take control of a debtor’s non-exempt property, sell it, and distribute the proceeds to creditors on a pro rata basis in an effort to satisfy debts owed.¹⁵⁶ Chapter 7 is the chapter under which most bankruptcy cases are filed.¹⁵⁷ It is available to individuals as well as corporations whose businesses lose all going concern value.¹⁵⁸ With respect to the commercial application of the liquidation provision, when an insolvent business taken as a

¹⁴⁸ 7-1106 COLLIER ON BANKRUPTCY, *supra* note 146, ¶ 1106.02[3] (citing *Sherr v. Winkler*, 552 F.2d 1367, 1375 (10th Cir. 1977)).

¹⁴⁹ 11 U.S.C. §§ 1104(c), 1104(d), 1106(b).

¹⁵⁰ *Id.* § 1104(c)(2); *see also* *Morgenstern v. Revco D.S., Inc. (In re Revco D.S., Inc.)*, 898 F.2d 498 (6th Cir. 1990).

¹⁵¹ 11 U.S.C. § 1104(b).

¹⁵² 7-1100 COLLIER ON BANKRUPTCY, *supra* note 112, ¶ 1100.06[2].

¹⁵³ 11 U.S.C. § 1106(b).

¹⁵⁴ *Id.*

¹⁵⁵ *Id.* § 701-784.

¹⁵⁶ *Id.*; *see generally* TREISTER, *supra* note 66, at 17.

¹⁵⁷ TABB & BRUBAKER, *supra* note 65, at 66.

¹⁵⁸ 1-1 COLLIER ON BANKRUPTCY, *supra* note 79, ¶ 1.03[2][a].

whole is worth *less* than the sum of its alienable parts, chapter 7 is typically the most favorable form of relief for the debtor.¹⁵⁹ The purpose of chapter 7 is to determine an equitable distribution of the debtor's property among its creditors and to provide the individual debtor with a fresh start through the discharge provision.¹⁶⁰ Chapters 7, 11, 12 and 13 of the Bankruptcy Code each have distinct discharge provisions and limitations.¹⁶¹

The fresh start justification does not apply to a corporate debtor under chapter 7 because, following the liquidation sale, the corporation ceases to exist, thereby removing the need for a fresh start.¹⁶² As such, future claimants are essentially barred from bringing actions against a liquidated corporation because it would no longer exist. Simply put, there would be no corporation left to sue. Under chapter 11, in contrast, future claimants are not barred from bringing suit because reorganization prolongs the life of the corporation to withstand bankruptcy and emerge intact. In a corporation's filing under chapter 11, only those debts that arose prior to the confirmation of a reorganization plan will be discharged at the end of the agreed upon payment schedule.¹⁶³

The Bankruptcy Code contains a variety of exceptions to the discharge injunction.¹⁶⁴ Some common types of debt that are *not dischargeable* in chapter 7 include child support,¹⁶⁵ alimony,¹⁶⁶ taxes,¹⁶⁷ debts incurred by acts of fraud,¹⁶⁸ and debts incurred as the result of willful and malicious conduct resulting in harm.¹⁶⁹ Accordingly, debts based on intentional torts such as assault or battery are nondischargeable under § 523(a)(6), provided that the debtor's acts in committing the torts were both willful and malicious.¹⁷⁰ As a

¹⁵⁹ *Id.*

¹⁶⁰ *See supra* Part I.D.

¹⁶¹ While this Comment focuses on the applicable provisions under chapters 7 and 11, discharge provisions are as follows: 11 U.S.C. § 727(b) (2000) (chapter 7); 11 U.S.C. § 1141 (chapter 11); 11 U.S.C. § 1228 (chapter 12); 11 U.S.C. § 1328 (chapter 13).

¹⁶² TABB, *supra* note 63, §10.1, at 692-95.

¹⁶³ TREISTER, *supra* note 66, § 9.06, at 473.

¹⁶⁴ *See* 11 U.S.C. § 523.

¹⁶⁵ *Id.* § 523(a)(5).

¹⁶⁶ *Id.*

¹⁶⁷ *Id.* § 524(a)(1).

¹⁶⁸ *Id.* § 523(a)(2), (a)(4).

¹⁶⁹ *Id.* § 523(a)(6) ("for willful and malicious injury by the debtor to another entity or to the property of another entity").

¹⁷⁰ *See* *Ross v. Cunningham (In re Cunningham)*, 59 B.R. 743, 746 (Bankr. D. Ill. 1986) (finding that the resulting debt was nondischargeable where the debtor struck the plaintiff in the face repeatedly with knowledge of what he was doing and that he would cause harm).

further safeguard, a finding of malicious and willful conduct in either a civil or criminal proceeding based on the underlying harm will collaterally estop a debtor from relitigating issues of maliciousness and willfulness in a dischargeability proceeding in bankruptcy.¹⁷¹

E. Criticism of Chapter 11: More Harm than Good?

If the twin goals of chapter 11 reorganization are to aid insolvent businesses in surviving financial woes while maintaining operations in order to pay creditors for outstanding debts,¹⁷² why do so many chapter 11 cases fail? It has been estimated that at least two-thirds of businesses seeking chapter 11 relief fail to achieve that relief within a few years—most of them within the first few months of filing.¹⁷³ These statistics are more startling, however, upon examining the success rates of particular kinds of cases. For instance, statistically, large businesses have a better chance of success in chapter 11 reorganization than small businesses.¹⁷⁴ Also, corporations on the whole tend toward higher success rates than sole proprietorships.¹⁷⁵

II. THE FIRST AMENDMENT RELIGION CLAUSES

The First Amendment to the U.S. Constitution precludes Congress from enacting legislation that establishes religion or prohibits the free exercise of religion.¹⁷⁶ Both the Establishment and Free Exercise Clauses are deeply rooted in U.S. history and were enacted to assure future generations the

¹⁷¹ See *Hagan v. McNallen (In re McNallen)*, 62 F.3d 619, 625 (4th Cir. 1995) (holding that collateral estoppel barred the debtor from asserting issues in bankruptcy that were previously adjudicated in state civil court); *Bristol Lumber Co. v. Hopkins (In re Hopkins)*, 82 B.R. 952, 954 (Bankr. N.D. Ill. 1988) (holding that the chapter 7 debtor is collaterally estopped when previously litigated issues in a state criminal suit are the same as those in the nondischargeability suit).

¹⁷² See *supra* Part I.B.1.

¹⁷³ See Lynn M. LoPucki, *The Debtor in Full Control – Systems of Failure Under Chapter 11 of the Bankruptcy Code?*, 57 AM. BANKR. L.J. 99, 120-21 (1983); see also Ed Flynn, *Statistical Analysis of Chapter 11*, in BANKRUPTCY ANTHOLOGY 690 (Charles J. Tabb ed., 2002) (calculating 83% of chapter 11 cases fail to confirm a reorganization plan).

¹⁷⁴ See Lynn M. LoPucki & William C. Whitford, *Patterns in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 78 CORNELL L. REV. 597, 600 (1993) (reporting 96% of reorganization plans confirmed in cases of large publicly held companies).

¹⁷⁵ LoPucki, *supra* note 173, at 108-09, 120-21.

¹⁷⁶ U.S. CONST. amend. I.

freedom of religion as well as the freedom from religion.¹⁷⁷ The Supreme Court has recognized the religion clauses were intended to protect against governmental intrusion on religious liberty, and through the Fourteenth Amendment, the religion clauses apply to the states.¹⁷⁸ While the religion clauses were meant in part to provide for separation between church and state,¹⁷⁹ the Supreme Court has conceded that a categorical separation is nearly impossible to achieve, although boundaries can be set to avoid overstepping historical limits.¹⁸⁰ These limits will no doubt be put to the test in evaluating a non-secular reorganization in chapter 11 as the allowances and restrictions required by bankruptcy law intersect with those of traditional religious liberty jurisprudence.

A. *The Establishment Clause*

The Establishment Clause forbids laws that impose religious ideas or conduct on people against their will.¹⁸¹ The three main categories of government actions that would violate the Establishment Clause are as follows: forcing a person to attend or remain away from religious services, forcing a person to profess a belief or disbelief in any religion therefore creating a preference for one religion over another, or preferring religion to non-religion because preferential treatment indirectly affects persons in the non-favored group.¹⁸² This concept of separationism¹⁸³ is evident throughout the long and often unpredictable litany of Establishment Clause cases that the Supreme Court has heard since its first modern formulation of Establishment Clause jurisprudence in *Everson v. Board of Education*.¹⁸⁴ In *Everson*, Justice Black wrote of the proscription against the establishment of religion, “[n]either a state nor the Federal Government can, openly or secretly, participate in the affairs of any religious organizations or groups, and vice versa.”¹⁸⁵ Justice Black remained wedded to this idea, stating in later cases that “religion is too

¹⁷⁷ See *Everson v. Bd. of Educ.*, 330 U.S. 1, 8-9 (1947). See generally James Madison, A Memorial and Remonstrance Against Religious Assessments Presented to the General Assembly of the State of Virginia (June 20, 1785).

¹⁷⁸ See *Everson*, 330 U.S. at 13.

¹⁷⁹ *Id.* at 16, 18 (maintaining the First Amendment “erect[s] a wall between church and state” and asserting the wall “must be kept high and impregnable”).

¹⁸⁰ *Walz v. Tax Comm’n of N.Y.*, 397 U.S. 664, 671 (1970).

¹⁸¹ U.S. CONST. amend. I.

¹⁸² See *Everson*, 330 U.S. at 16, 18.

¹⁸³ See WITTE, *supra* note 7, at 202-03.

¹⁸⁴ 330 U.S. 1 (1947).

¹⁸⁵ *Id.* at 15-16.

personal, too sacred, too holy, to permit its ‘unhallowed perversion’ by a civil magistrate”¹⁸⁶ and that “a union of government and religion tends to destroy government and to degrade religion.”¹⁸⁷ Separationism is just one of the recurrent doctrines used by the high court in examining the disestablishment of religion¹⁸⁸ and has been applied to cases concerning religion and public education,¹⁸⁹ as well as cases dealing with tax exemption and support for religious institutions.¹⁹⁰ Since the early 1970s, separationist logic has often merged with other doctrines employed by the Court.¹⁹¹ One message, however, remains constant; to avoid conflict with the Establishment Clause, a statute must not foster “an excessive government entanglement with religion.”¹⁹²

In *Lemon v. Kurtzman*, the Supreme Court struck down a Pennsylvania state reimbursement policy that provided refunds to non-secular schools for the costs of teaching secular subjects that were required by the state.¹⁹³ The Court held the policy created an “excessive entanglement between government and religion,”¹⁹⁴ and was thus unconstitutional in violation of the Establishment Clause.¹⁹⁵ The Court announced a formal three-part test for determining the constitutionality of laws challenged as establishing religion: first, the law must have a secular purpose; second, the law must have a primary effect that neither advances nor inhibits religion; and third, the law must not foster an excessive entanglement between church and state.¹⁹⁶ Chief Justice Burger opined for the majority that whether a permissible, incidental entanglement between church and state becomes excessive depends upon “all the circumstances of a particular relationship.”¹⁹⁷ In *Lemon*, the non-secular schools were affiliated with local churches and were staffed by religious clergy members, particularly nuns.¹⁹⁸ The Court reasoned that a religious, non-lay educator would be likely to teach even secular subjects with an eye toward religion and would likely not

¹⁸⁶ *Engel v. Vitale*, 370 U.S. 421, 432 (1962).

¹⁸⁷ *Id.* at 431.

¹⁸⁸ WITTE, *supra* note 7, at 188. Other approaches include “accommodationism,” “neutrality,” and more recently, “endorsement,” “coercion,” and “equal treatment.” *Id.*

¹⁸⁹ See, e.g., *Wallace v. Jaffree*, 472 U.S. 38 (1985); *Engel*, 370 U.S. 421.

¹⁹⁰ See *Tex. Monthly v. Bullock*, 489 U.S. 1 (1989); *Walz v. Tax Comm’n of N.Y.*, 397 U.S. 664 (1970).

¹⁹¹ WITTE, *supra* note 7, at 191.

¹⁹² *Lemon v. Kurtzman*, 403 U.S. 602, 613 (1971) (quoting *Walz*, 397 U.S. at 674).

¹⁹³ *Id.* at 625.

¹⁹⁴ *Id.* at 614.

¹⁹⁵ *Id.* at 625.

¹⁹⁶ *Id.* at 612-13.

¹⁹⁷ *Id.* at 614.

¹⁹⁸ *Id.* at 615-16.

remain religiously neutral as to the state's mandated secularized curriculum.¹⁹⁹ In its finding of excessive entanglement between church and state in the reimbursement policy at issue, the Court held that “[a] comprehensive, discriminating, and continuing state surveillance will inevitably be required to ensure that these restrictions are obeyed and the First Amendment otherwise respected These prophylactic contacts will involve excessive and enduring entanglement between state and church.”²⁰⁰

With respect to government aid to religious groups, the Supreme Court recently put forth a revised version of the *Lemon* test in *Agostini v. Felton*.²⁰¹ The court preserved the excessive entanglement component.²⁰² The Court in *Agostini* examined first “whether the government acted with the purpose of advancing or inhibiting religion.”²⁰³ Second, the Court inquired “whether the aid has the ‘effect’ of advancing or inhibiting religion”²⁰⁴ with an eye toward whether the aid promotes an excessive entanglement between government and religion.²⁰⁵ The *Agostini* Court reiterated that not all entanglements have the proscribed effect of advancing or inhibiting religion.²⁰⁶ As previously noted, the current state of the law requires entanglement to be *excessive* before running afoul of the Establishment Clause.²⁰⁷ Nonetheless, the prohibition against excessive entanglement between church and state is alive and well in modern Establishment Clause jurisprudence.

B. The Free Exercise Clause

The Free Exercise Clause has been interpreted more often by the United States Supreme Court than the Establishment Clause.²⁰⁸ As of August 2004, out of the 161 cases focusing on the religion clauses, 112 have involved interpretation of the Free Exercise Clause.²⁰⁹ The constitutional protection of free exercise of religion has traditionally been held to prevent government from imposing coercive actions or requirements against the practice of religion

¹⁹⁹ *Id.* at 619.

²⁰⁰ *Id.*

²⁰¹ 521 U.S. 203 (1997).

²⁰² *Id.* at 233.

²⁰³ *Id.* at 222-23.

²⁰⁴ *Id.* at 223.

²⁰⁵ *Id.* at 232.

²⁰⁶ *Id.*

²⁰⁷ *See, e.g., Bowen v. Kendrick*, 487 U.S. 589, 615-17 (1988).

²⁰⁸ WITTE, *supra* note 7, at 271-303.

²⁰⁹ *Id.*

and penalizing access to public benefits or rights because of religious beliefs or practices.²¹⁰ At the onset of the Supreme Court's exploration of free exercise jurisprudence, the focus was grounded in ideas of "liberty of conscience, freedom of religious expression, religious pluralism and equality, and separation of church from state."²¹¹ Over the past twenty years, however, the Court has taken away much of the bite of free exercise protection, reducing its force to a guarantee of neutrality at best.²¹² The religious liberty right invoked by the Free Exercise Clause, however, has regained some of its teeth through the adoption of RFRA as a method of challenging federal law.²¹³

A plaintiff in a typical Free Exercise case must show "the coercive effect of the [restriction] as it operates against . . . practice of [her] religion."²¹⁴ In the past, courts have found this "coercive effect" when the government compelled citizens to violate the tenets of their religion²¹⁵ or when government action made receipt of a public benefit or right conditional upon renunciation of a religious practice.²¹⁶ Thus, a plaintiff must establish that she is being injured or penalized by her adherence to the tenets of her religion, or that her conduct in the course of exercising her beliefs has been unduly restricted.²¹⁷ The Free Exercise Clause proscribes not only overt discrimination, but also practices that are fair in form, yet discriminatory in operation.²¹⁸

In *Sherbert v. Verner* in 1963, the Supreme Court announced a two-part balancing test for determining whether a governmental action unduly burdens an individual's free exercise of religion.²¹⁹ The *Sherbert* Court employed a strict scrutiny standard of review for the first time in interpreting the Free Exercise Clause.²²⁰ First, a court must decide whether the conduct, regulation, or law at issue burdens the free exercise of religion.²²¹ Second, the restriction

²¹⁰ See *Crow v. Gullet*, 541 F. Supp. 785, 790 (D.S.D. 1982), *aff'd*, 706 F.2d 856 (8th Cir. 1983), *cert. denied*, 464 U.S. 977 (1983); see also *Cantwell v. Connecticut*, 310 U.S. 296, 303 (1940) (holding the First Amendment's concept of the free exercise of religion is a liberty safeguarded by the Fourteenth Amendment).

²¹¹ WITTE, *supra* note 7, at 185.

²¹² *Id.*

²¹³ 42 U.S.C. § 2000bb(a)-(b) (2000). RFRA compels a strict scrutiny analysis of Free Exercise claims against federal law, raising the government's burden to that of compelling interest. *Id.*

²¹⁴ *Sch. Dist. of Abington v. Schempp*, 374 U.S. 203, 223 (1963).

²¹⁵ See *Wisconsin v. Yoder*, 406 U.S. 205, 234 (1972).

²¹⁶ See *Sherbert v. Verner*, 374 U.S. 398, 404-05 (1963).

²¹⁷ See *Life Science Church v. Internal Revenue Serv.*, 525 F. Supp. 399, 407 (N.D. Cal. 1981).

²¹⁸ See *Braunfeld v. Brown*, 366 U.S. 599, 607 (1961).

²¹⁹ 374 U.S. at 403-09.

²²⁰ *Id.* at 406-09.

²²¹ *Id.* at 403; see also *Thomas v. Review Bd. of Ind. Employment Sec. Div.*, 450 U.S. 707, 716-18 (1981).

on the free exercise of religion must be balanced against the importance of the state's compelling interest in the regulation or restriction.²²² However, even if the state's interest weighs heavier in this balance, the regulation or restriction is invalid if the state's interest could be achieved by less restrictive means.²²³ Thus, the strict scrutiny standard for claims brought under the Free Exercise Clause requires that a law or program be narrowly tailored to meet a compelling state interest without infringing on a party's rights more than necessary.²²⁴ Accordingly, the burden is high for the government in cases bearing this standard of review, making the claimant more likely to succeed on her Free Exercise claim. This close, discerning judicial inquiry vests in the courts the power to strike down the law altogether or to tailor it to minimize harm to the claimant.²²⁵ The Supreme Court used this standard in several subsequent Free Exercise Clause cases in the years after 1963.²²⁶

In 1990, in *Employment Division v. Smith*,²²⁷ the Supreme Court rejected a claim that the Free Exercise Clause prohibited a state from denying unemployment benefits to Native American Church members who lost their jobs because of peyote use in a religious sacrament.²²⁸ The Court broadly held that the Free Exercise Clause does not entitle claimants who challenge applications of neutral laws on religious grounds to have their claims examined under heightened constitutional scrutiny.²²⁹ The *Smith* decision dramatically limited the Court's earlier decisions in *Sherbert*²³⁰ and *Wisconsin v. Yoder*,²³¹ in which the Court had applied strict scrutiny to claims of religious accommodation. Justice Scalia recognized that leaving accommodation to the political process would disadvantage minority religions, but contended that applying strict scrutiny would be worse, resulting in "a system in which each conscience is a law unto itself or in which judges weigh the social importance

²²² *Sherbert*, 374 U.S. at 406; see also *Thomas*, 450 U.S. at 711.

²²³ *Sherbert*, 374 U.S. at 407; see also *Thomas*, 450 U.S. at 712.

²²⁴ *Sherbert*, 374 U.S. at 407; see also *Thomas*, 450 U.S. at 712.

²²⁵ WITTE, *supra* note 7, at 147.

²²⁶ *Id.* at 148 (citing *Frazee v. Ill. Dep't of Employment Sec.*, 489 U.S. 829 (1989); *Hobbie v. Unemployment Appeals Comm'n of Fla.*, 480 U.S. 136 (1987); *Thomas*, 450 U.S. 707; *Widmar v. Vincent*, 454 U.S. 263 (1981); *McDaniel v. Paty*, 435 U.S. 618 (1978); *Wisconsin v. Yoder*, 406 U.S. 205 (1972)).

²²⁷ 494 U.S. 872 (1990).

²²⁸ *Id.*

²²⁹ *Id.* at 882-85.

²³⁰ 374 U.S. 398, 403 (1963) (holding any incidental burden on the free exercise of religion may be justified by a compelling state interest).

²³¹ 406 U.S. 205, 214 (1972) (finding a state may not compel school attendance beyond eighth grade if doing so would interfere with a legitimate religious belief unless there exists a state interest of "sufficient magnitude" to overcome the right to freely exercise religion).

of all laws against the centrality of all religious beliefs.”²³² The majority opinion in *Smith* made no mention of the Establishment Clause, addressing only the potential effects of strict scrutiny on the government’s regulatory scheme.²³³ The *Smith* decision was the subject of tremendous criticism.²³⁴

C. RFRA Still Constitutional as Applied to Federal Law

In response to the Supreme Court’s decision in *Smith*,²³⁵ which in effect limited the potency of the Free Exercise Clause, Congress passed the Religious Freedom Restoration Act (“RFRA”) in 1993.²³⁶ The purpose of RFRA, as stated in the Act itself, is to “restore the compelling interest test”²³⁷ as set forth in *Sherbert* and *Yoder*, “and to guarantee its application in all cases where free exercise of religion is substantially burdened.”²³⁸ Under this standard, the Act provides “a claim or defense to persons whose religious exercise is substantially burdened by government.”²³⁹ In terms of restoring the teeth to the bite of free exercise protection, the Act provides:

- (a) In general. Government shall not substantially burden a person’s exercise of religion even if the burden results from a rule of general applicability, except as provided in subsection (b) of this section.
- (b) Exception. Government may substantially burden a person’s exercise of religion only if it demonstrates that application of the burden to the person—
 - (1) is in furtherance of a compelling governmental interest; and (2) is the least restrictive means of furthering that compelling governmental interest.²⁴⁰

RFRA is essentially an attempt by Congress to legislate around the Supreme Court’s decision in *Smith* and effectively reinstates the strict scrutiny standard of review for Free Exercise claims. Congress made no attempt to disguise the legislation as anything but a direct response to *Smith*, even going so far as to

²³² *Smith*, 494 U.S. at 890.

²³³ *See id.* at 873-90.

²³⁴ WITTE, *supra* note 7, at 150 (“The weakening of free exercise scrutiny introduced by *Smith* was widely denounced as a travesty to religious liberty.”); *see also* Douglas Laycock, *The Supreme Court’s Assault on Free Exercise, and the Amicus Brief That Was Never Filed*, 8 J. L. & RELIGION 99 (1990).

²³⁵ 494 U.S. at 872.

²³⁶ 42 U.S.C. §§ 2000bb to 2000bb-4 (2000).

²³⁷ *Id.* § 2000bb(b)(1).

²³⁸ *Id.*

²³⁹ *Id.*

²⁴⁰ *Id.* § 2000bb-1.

cite both *Sherbert* and *Yoder* as the cases that represent Congress's preferred method of free exercise adjudication.²⁴¹ It seems that countless Supreme Court decisions inevitably include the assertion that the role of the Court is simply to interpret laws, and the proper vehicle for legislation is Congress. With respect to RFRA, it seems that Congress followed the Court's age-old advice. Yet this exercise of checks and balances between the judicial and legislative branches does not end here.

The Supreme Court fought back in *City of Boerne v. Flores*.²⁴² In *Boerne*, the Court held RFRA was unconstitutional as applied to the states.²⁴³ In a case involving a zoning ordinance as applied to a church,²⁴⁴ the Court found that it was beyond Congress' power to impose RFRA on the states²⁴⁵ under section 5 of the Fourteenth Amendment.²⁴⁶ The Court determined RFRA was in fact an attempt to invoke substantive change in constitutional protections.²⁴⁷ Thus, the Court held RFRA was unconstitutional as applied to the states because it allowed considerable Congressional intrusion into the states' general authority to regulate for the health and welfare of their citizens.²⁴⁸ However, *Boerne* left RFRA in effect as applied to judicial review of federal laws.²⁴⁹

After *Boerne*, questions as to the Act's validity with respect to federal law have been answered in a series of bankruptcy cases where trustees have sought to use the fraudulent conveyance provision of the Bankruptcy Code²⁵⁰ to recover tithes made by bankrupt debtors to their respective churches in the one-year period preceding the debtor's bankruptcy filing.²⁵¹ In a leading decision on the subject, *Christians v. Crystal Evangelical Free Church*,²⁵² the Eighth Circuit expressly upheld RFRA's application to federal laws.²⁵³

²⁴¹ *Id.* § 2000bb.

²⁴² 521 U.S. 507 (1997).

²⁴³ *Id.* at 536.

²⁴⁴ *Id.* at 511-12.

²⁴⁵ *Id.* at 536.

²⁴⁶ This section empowers Congress to enforce liberty provisions of the Fourteenth Amendment through the use of appropriate legislation. U.S. CONST. amend. XIV, § 5.

²⁴⁷ *Boerne*, 521 U.S. at 532.

²⁴⁸ *Id.* at 534. Congress has responded to the ruling in *Boerne* with the Religious Land Use and Institutionalized Persons Act. 40 U.S.C. § 2000cc to 2000cc-5 (2000).

²⁴⁹ *Christians v. Crystal Evangelical Free Church (In re Young)*, 141 F.3d 854, 856 (8th Cir. 1998).

²⁵⁰ See 11 U.S.C. § 548(a)(2) (2000).

²⁵¹ *In re Young*, 141 F.3d at 861.

²⁵² *Id.*

²⁵³ *Id.* (finding that allowing the trustee to recover tithing contributions substantially burdened the debtors' free exercise of religion under RFRA, and RFRA was an appropriate means for Congress to modify the Bankruptcy Code).

III. THE UNIQUE CASE OF RELIGIOUS ORGANIZATIONS

The Bankruptcy Code presently includes a provision that effectively strips creditors of the power to force non-profit corporations, such as religious organizations, into bankruptcy.²⁵⁴ Similarly, judges are without power to convert a case filed by a non-profit organization from chapter 11 to chapter 7 unless the non-profit entity consents to the conversion.²⁵⁵ This presents a particularly troubling problem in chapter 11 reorganization filings. Given the consent requirement of § 1112(c) of the Bankruptcy Code, the decision is left to the religious organization to choose the path of least resistance—a choice that is essentially coercive. The institution may remain in chapter 11 and be forced to sacrifice religious tenets in order to turn a profit to satisfy creditors. The religious body as DIP then has a duty, along with having other secular fiduciary responsibilities, to maximize the value of the estate without respect for the organization's religious tenets.²⁵⁶ If the religious body fails to fulfill this duty, the court may appoint a secular trustee to run the religious body's business affairs for the benefit of its creditors with virtually no mandate to uphold the group's faith, values, or restrictions, thus invoking even more potential for religious liberty infringement.²⁵⁷ Alternatively, the religious body may agree to a conversion to chapter 7, which in turn involves liquidation, potentially leaving the group without a local house of worship or money to provide for those who lead the faithful. Admittedly, neither is an ideal choice from the perspective of the religious body or its congregants. However, the religious institution is in bankruptcy, after all, and some sacrifices must be made. The goal of avoiding constitutional Free Exercise and Establishment Clause violations in non-secular bankruptcies should prevail as the government treads in an area that it is want to enter while attempting to balance the interests of creditors and debtors alike.

²⁵⁴ 11 U.S.C. § 303(a). The Bankruptcy Code expressly excludes non-profit corporations from involuntary bankruptcy. "An involuntary case may be commenced only under chapter 7 or 11 of this title, and only against a person, except a farmer, family farmer, or a corporation that is not a moneyed, business, or commercial corporation, that may be a debtor under the chapter under which such case is commenced." *Id.*

²⁵⁵ *See Id.* § 1112(b)-(c). While § 1112(b) generally provides for conversion to chapter 7 when doing so would be in the best interests of the creditors of for-profit debtors, section 1112(c) forbids this practice with respect to non-profit corporations absent consent.

²⁵⁶ *See, e.g.,* *Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S. 343, 352, 358 (1985).

²⁵⁷ 11 U.S.C. § 1104.

A. *Analysis: Chapter 7 as a Constitutionally Sound Remedy*

Regardless of denomination, sect, or belief, religion is recognized as a personal choice in the United States. Faith is simply not a commodity. A religious organization exists for the benefit of its congregants, not its creditors. Failure to recognize this distinction results in an unjustifiable burden on the free exercise of religion.²⁵⁸ Additionally, the heavy judicial supervision required in a reorganization case is easily characterized as the type of government intrusion into religious affairs that the Establishment Clause was designed to protect against.²⁵⁹ Thus, while chapter 11 reorganization may restrict the right of a religious official as DIP in the free exercise of his religion, similarly the trustee's fiduciary duties require him to make decisions based upon what is most beneficial to the estate without regard for the religious nature of the bankruptcy.²⁶⁰ This results in an entanglement of government in the affairs of religion in violation of the Establishment Clause. Yet in the eyes of bankruptcy law as it currently reads, a religious affiliated DIP is treated no differently than a secular bankrupt.²⁶¹ Chapter 7 liquidation, in contrast, is a neutral remedy, free from restraints on religious liberty.²⁶² Therefore, chapter 7 is the only constitutionally sound chapter for non-secular debtor corporations.²⁶³

Chapter 11 reorganization allows the court to intervene and take over operations of the non-secular debtor.²⁶⁴ Evidence of management's role in leading the debtor into bankruptcy and an inability to guide the debtor through bankruptcy may incline the court to approve the appointment of a trustee.²⁶⁵ These standards are relevant to non-secular bankruptcies in that if a religious official, as DIP, is obligated by his faith to make decisions adverse to the organization's creditors' interests, control of operations may be shifted to a secular trustee. The trustee has no obligation to conduct the "business" of the

²⁵⁸ See *supra* Part II.B.

²⁵⁹ See *supra* Part I.C.2.

²⁶⁰ Indeed, the trustee may be held personally liable for willful and deliberate acts in violation of his duties or for acts of negligence. See *Sherr v. Winkler*, 552 F.2d 1367, 1375 (10th Cir. 1977) (citing *Mosser v. Darrow*, 341 U.S. 267, 272 (1951)).

²⁶¹ See *supra* Part I.C.

²⁶² See *supra* Part I.D.

²⁶³ This is true despite changes to chapter 7 brought about by the Bankruptcy Abuse Prevention Act of 2005 which make filing more difficult and more expensive. See generally Eric Dash, *Debtors Throng to Bankruptcy as Clock Ticks*, N.Y. TIMES, Oct. 15, 2005, at A1.

²⁶⁴ 11 U.S.C. §§ 1101-1174

²⁶⁵ See, e.g., *In re Sharon Steel Corp.*, 871 F.2d 1217, 1228-29 (3d. Cir. 1989).

religious body in compliance with the tenets of the faith. Rather, she is obligated to conduct operations for the benefit of the reorganization effort. The Supreme Court has extended this duty to maximize the value of the estate to chapter 11 DIPs.²⁶⁶ Additionally, in a chapter 11 case, the DIP has essentially the same fiduciary duties as the trustee.²⁶⁷ Thus, in reorganization both the DIP and the trustee are charged with the duty to make certain that the debtor's business becomes optimally profitable to maximize the estate.²⁶⁸ This concept of importance in evaluating a non-secular bankruptcy where a religious official, acting as DIP, may be forced to make decisions based on his faith that could breach his proscribed duty of loyalty in a chapter 11 case.

For example, after commencing a bankruptcy filing, an archbishop, as DIP, may be compelled to use church funds to pay prepetition debts owed to vendors who supply items necessary to hold mass. Alternatively, he might make extraordinary decisions based on his faith and belief in charity that would fail to maximize the value of the estate. He may decide to divert church funds from one area to another based on his religious mandate of charity and compassion. All of these decisions could be reversed in a reorganization case. Any breach of duty could result in the installment of a trustee to completely usurp subsequent decision-making power from the church, leaving the church powerless to exercise control over its operations, substantially burdening the archbishop's right to freely exercise his chosen faith. Further, the archbishop may feel compelled to make decisions *against* what his faith holds in fear of breaching his duty to protect the property of the estate and losing all control over operations, thus chilling his exercise of faith and characterizing reorganization as a prior restraint on the free exercise of religion.

The appointment of an examiner does not provide a solution to the free exercise and excessive entanglement problems in a non-secular chapter 11 bankruptcy case. A religious organization's bankruptcy filing, particularly if it is partly the result of massive tort claims, could likely involve unsecured debt in excess of \$5 million, and therefore an examiner would be appointed as a matter of law if requested by a party in interest.²⁶⁹ If the court expands the role

²⁶⁶ See *Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S. 343, 358 (1985).

²⁶⁷ See *Ford Motor Credit Co. v. Weaver*, 680 F.2d 451 (6th Cir. 1982).

²⁶⁸ See *Weintraub*, 471 U.S. at 358.

²⁶⁹ 11 U.S.C. § 1104(c)(2); see also *Morgenstern v. Revco D.S., Inc. (In re Revco D.S., Inc.)*, 898 F.2d 498 (6th Cir. 1990).

of the examiner, as it is likely to do in significant cases,²⁷⁰ the DIP is left with decision-making power, but the examiner may be asked to step in to perform duties that the DIP does not perform.²⁷¹ Thus, even if the court attempts to tread lightly around the DIP's religious liberty by avoiding trustee control, the expanded role of the examiner may trample any efforts to protect religious freedom by forcing an examiner to do the trustee's "dirty work" instead.

In disputing a non-secular bankrupt's ability to reorganize under chapter 11, claims of free exercise infringement could be sustained most effectively under RFRA. A Free Exercise challenge made by a religious official under RFRA is likely to be sustained. Once a burden on religion is established, RFRA requires the *Sherbert* strict scrutiny standard of review; the government must show a narrowly tailored compelling state interest such that the least restrictive means is applied.²⁷² While some bankruptcy cases indicate that a religious burden is justified by the importance of the Bankruptcy Code,²⁷³ others have held that no compelling government interest exists in bankruptcy to restrict a debtor's First Amendment rights.²⁷⁴ In *McDaniel v. Paty*,²⁷⁵ the Supreme Court found the choice between the practice of religion and the exercise of political rights as a citizen was in fact not a choice at all and was thereby found to be impermissibly coercive.²⁷⁶ The Court found in favor of free exercise.²⁷⁷ This type of coercion is analogous to the dilemma that a religious official is put in when forced to choose between core religious mandates and the interests of creditors in reorganization. Like in *McDaniel*, Free Exercise should prevail with respect to reorganization. Additionally, chapter 7 is a less restrictive means of balancing the interests of creditors and debtors because a liquidation sale produces no substantial Free Exercise restrictions.

²⁷⁰ TREISTER, *supra* note 66, at 407. "It is not unusual in the larger cases for the court to increase an examiner's responsibilities." *Id.*

²⁷¹ 11 U.S.C. § 1104(c)(2).

²⁷² 42 U.S.C. § 2000bb-1 (2000).

²⁷³ See *Weinman v. Word of Life Christian Ctr. (In re Bloch)*, 207 B.R. 944, 951 (D. Colo. 1997) (stating even if the Bankruptcy Code places a substantial burden on religious practices, such a burden is justified by a compelling governmental interest); *Morris v. Midway S. Baptist Church (In re Newman)*, 203 B.R. 468, 477 (D. Kan. 1996).

²⁷⁴ See *United States v. Crystal Evangelical Free Church (In re Young)*, 82 F.3d 1407, 1420 (8th Cir. 1996) (holding bankruptcy is not related to national security or public safety; therefore, it is not a compelling governmental interest).

²⁷⁵ 435 U.S. 618 (1978).

²⁷⁶ *Id.* at 632.

²⁷⁷ *Id.*

Similarly, an Establishment Clause argument could be sustained against chapter 11 reorganization for religious debtors. The prohibition against excessive entanglement between church and state continues to be relied upon in contemporary Establishment Clause cases²⁷⁸ and should be considered carefully by courts encountering non-secular bankruptcies. Reorganization requires the kind of excessive entanglement with religion that the Establishment Clause was meant to prevent. Chapter 11 cases are typically long and involved processes that continue for years even after a plan has been confirmed. Judicial oversight of the DIP to detect any breach of the DIP's duties. Management of the case by a trustee, if appointed, also requires close supervision of the bankrupt's affairs, including filing and disclosure requirements. Additionally, the trustee is compensated by the federal government, and in the case of a non-secular bankruptcy, the trustee is paid to assist religion in reorganization. This type of government involvement in the workings of a religious organization would likely rise to the level of excessive entanglement that the First Amendment proscribes.

Under the *Lemon* test²⁷⁹ for determining the constitutionality of laws challenged as establishing religion, chapter 11 reorganization would likely not pass constitutional muster. While chapter 11 has a secular purpose and its primary effect neither advances nor inhibits religion, the supervision requirements foster an excessive entanglement between church and state.²⁸⁰ The same type of "comprehensive, discriminating, and continuing state surveillance"²⁸¹ that Justice Berger was concerned about in *Lemon* is also present throughout the reorganization process. The same "prophylactic contacts"²⁸² inherent in managing a chapter 11 case would create an equally excessive and enduring entanglement between religion and state.²⁸³ The same kind of prolonged and intricate supervision found to be violative of the Establishment Clause in *Lemon* may also be required of modern day bankruptcy courts and trustees in the course of a non-secular chapter 11 reorganization case. Chapter 7 relief steers clear of establishing religion

²⁷⁸ See *supra* Part II.A.

²⁷⁹ *Lemon v. Kurtzman*, 403 U.S. 602, 612-13 (1971).

²⁸⁰ *Id.* at 614.

²⁸¹ *Id.* at 619.

²⁸² *Id.*

²⁸³ In the face of criticism that exempting religious organizations from reorganization protection is *in itself* a violation of the Establishment Clause, it is important to note that some legislative accommodations of vital religious interests, including employment, taxation, and military service, have been given generous constitutional protection. See *supra* notes 16-18 and accompanying text.

because it does not involve close, lengthy judicial scrutiny, surveillance, or excessive entanglement with the government or its agents.²⁸⁴ Liquidation involves committing far less government time and resources to the affairs of the debtor. A liquidation sale is thus more likely to pass constitutional muster with respect to a non-secular bankruptcy than a reorganization effort.

The constitutionally sound alternative to reorganization is quite simple: a non-secular bankruptcy filed under chapter 7 would avoid troublesome First Amendment complications. In chapter 7, there is little concern about burdening the free exercise of a religious debtor's faith through judicial intervention or excessive government entanglement. Following a liquidation sale in chapter 7, the corporation ceases to exist.²⁸⁵ This distinction is important as it pertains to non-secular bankruptcies. In chapter 7 liquidation, religious bodies, which, for purposes of bankruptcy, are generally organized as corporations, would cease to exist after a sale of assets is complete. As such, future claimants would be barred from bringing actions against a particular religious organization that has been liquidated (i.e., an individual diocese) because the corporation would be dissolved. Under chapter 11, in contrast, future claimants would not be barred from bringing suit because reorganization permits the corporation to emerge from bankruptcy. While this distinction may indicate that chapter 11 is the better choice after all, on balance, chapter 7 should be preferred because the First Amendment constitutional restrictions implied in non-secular chapter 11 cases outweigh the potential foreclosure of opportunity to bring suit by future claimants. The potential loss of opportunity to bring an action against a dissolved religious organization, while unfortunate, may have a silver lining in that it may cause claimants to bring claims forward sooner, thus furthering an ancillary goal of bankruptcy law.²⁸⁶

All is not lost for the civil litigant seeking to bring suit against an insolvent religious organization liquidated in chapter 7. With respect to the religious institutions currently in bankruptcy, tort claims against religious officials for sexual misconduct are not subject to discharge.²⁸⁷ While the chapter 7 discharge provision may leave some creditors at a disadvantage (particularly after dissolution of the debtor's business), debts based on intentional torts such

²⁸⁴ See *supra* Part I.D.

²⁸⁵ TABB, *supra* note 63, § 10.1 at 692-95.

²⁸⁶ Additionally, future claimants may not be barred entirely if chapter 7 liquidation dissolves a religious organization. Such claimants may assert claims against the religious official individually or possibly against the larger governing body of the religious hierarchy, if applicable.

²⁸⁷ See 11 U.S.C. § 523(a)(6) (2000).

as assault or battery are nondischargeable under § 523(a)(6) of the Bankruptcy Code, provided that the debtor's acts in committing the torts were both willful and malicious.²⁸⁸ Therefore, successful tort judgments against religious officials for sexual misconduct are nondischargeable debts, and would remain intact even in the liquidation of a religious organization's assets.²⁸⁹ Because bankruptcy law would collaterally estop a debtor from relitigating issues of maliciousness and willfulness in a dischargeability proceeding, parties seeking nondischargeability determinations for intentional torts committed by a clergy member will not bear the extra burden of proving intentionally tortious conduct if such conduct has already been shown.²⁹⁰ Prior determinations will suffice, preventing the religious body from refuting the nondischargeability determination and protecting the judgment creditor's interests.

Chapter 7 is not only the more constitutionally sound method of relief for non-secular bankruptcies, it is also more economically feasible given the high failure rate of similarly sized entities who have filed under chapter 11.²⁹¹ The daunting failure rate of medium-sized corporations in their reorganization efforts makes chapter 7 a more economical and efficient course for religious organizations seeking bankruptcy protection.²⁹²

While a bankruptcy court could avoid facing First Amendment objections altogether by abstaining from hearing a particular civil proceeding within a case or the case entirely,²⁹³ that result is unlikely in the case of non-secular bankruptcies. The foreclosure of chapter 11 reorganization for non-secular bodies and the promotion of chapter 7 liquidation in its place remains in line with both of bankruptcy law's competing policy considerations of providing a fresh start to debtors (inapplicable to corporate debtors) and protecting the

²⁸⁸ See *Ross v. Cunningham (In re Cunningham)*, 59 B.R. 743, 746 (Bankr. N.D. Ill. 1986) (finding resulting debt nondischargeable where debtor struck plaintiff in face repeatedly, injuring her eye, with knowledge of what he was doing and with knowledge that he would cause harm).

²⁸⁹ The nondischargeability determination does not take effect as a matter of law for the intentional tort exception in § 523(a)(6). Rather, the creditor is required to apply to the court for such a determination within sixty days of the first creditors' meeting. See FED. R. BANKR. P. 4007(c).

²⁹⁰ See *Hagan v. McNallen (In re McNallen)*, 62 F.3d 619, 625 (4th Cir. 1995) (holding that collateral estoppel barred the debtor from asserting issues in bankruptcy that were previously adjudicated in state civil court); *Bristol v. Hopkins (In re Hopkins)*, 82 B.R. 952, 954 (Bankr. M.D. Ill. 1988) (holding a chapter 7 debtor is collaterally estopped from litigating issues in the nondischargeability suit that were previously litigated in a state criminal suit).

²⁹¹ See *supra* Part I.D.

²⁹² See *supra* Part I.D.

²⁹³ 11 U.S.C. § 305(a)(1) (2000); 28 U.S.C. § 1334(c)(1) (2000).

rights of creditors.²⁹⁴ Chapter 7 continues to be an equitable alternative to state collection remedies, and creditors can recover debts owed to them, at least in part, through an orderly and fair collection process. While it is true that the driving force behind chapter 11 reorganizations is the possibility of all parties to benefit once a debtor's finances are restructured,²⁹⁵ at what cost are we willing to tolerate the infringement of constitutional religious liberty rights? Chapter 11 reorganization focuses on current and future prospects of a business, however, a religious institution should have no prospects other than faith. It is likely that creditors will not be paid in full as the result of a liquidation sale, however reorganization is not a sure bet of substantial repayment. In fact, many reorganization attempts fail. At least two-thirds of businesses seeking chapter 11 reorganization fail within a few years, and most fail in the first few months.²⁹⁶ Further, under the best interests of the creditors test, creditors in chapter 11 must end up at least in the same position they would be if the debtor liquidated.²⁹⁷ Why unduly burden religious freedom in the interim?

B. Other Potential Pitfalls to Consider in Non-Secular Bankruptcies

In addition to challenges on First Amendment grounds, bankruptcy filings involving religious organizations also raise questions regarding fraudulent transfer law and the implied good faith requirement in filing for bankruptcy protection. These potential obstacles will add to the mounting pile of issues that courts must take into consideration in navigating the special case of non-secular bankruptcy.

If an amendment to the Bankruptcy Code prohibiting non-secular institutions from filing for chapter 11 reorganization protection were to be adopted, the courts would need to be mindful of fraudulent conveyances, preferences, and general bad faith actions aimed at shielding assets from becoming property of the estate. The foreclosure of reorganization would leave liquidation under chapter 7 as the alternative. As such, an institution may be more motivated to impermissibly move non-exempt assets out of the estate in efforts to preserve them. Majority religious organizations in the United States are typically large and decentralized, organized as subsidiaries of

²⁹⁴ TABB & BRUBAKER, *supra* note 65, at 67.

²⁹⁵ *Id.* at 595.

²⁹⁶ LoPucki, *supra* note 173, at 109-10, 120-21.

²⁹⁷ *See* 11 U.S.C. § 1129(a)(7)(A)(ii).

larger institutions.²⁹⁸ (i.e., an individual diocese of the Catholic Church), thus protecting the hierarchical governing bodies from liability.²⁹⁹ As a result, shielding assets among non-obvious insiders is a potential issue to consider. Also, some critics question whether religious bodies seeking relief from massive tort claims should even be permitted to file for bankruptcy protection for lack of good faith.³⁰⁰

1. *Fraudulent Transfer: A Deadly Sin in Bankruptcy*

Although the Tucson, Arizona diocese emerged from bankruptcy, some lessons can be learned by examining what might have happened if a settlement was not reached. To further complicate matters in the Tucson filing discussed in Part I.A.,³⁰¹ plaintiffs alleged that the diocese committed fraudulent transfers in three real estate sales prior to the diocese's chapter 11 filing.³⁰² Sexual abuse victims contended that that the Tucson diocese transferred an office building, a school, and a large parcel of land to other Catholic Church entities for less than reasonable market value in order to shield those assets from potential seizure in bankruptcy.³⁰³ A fraudulent transfer is the transfer of assets to a party who will shelter interests so that they are not taken by hostile creditors.³⁰⁴ The purpose of the law of fraudulent transfers is to protect creditors from unfair transactions that hamper efforts to collect from debtors.³⁰⁵ Fraudulent transfer law allows creditors or the trustee to set aside unfair transfers that shield a debtor's assets from creditors.³⁰⁶ These transfers can be avoided in two ways: the trustee may avoid fraudulent transfers under § 548 of the Bankruptcy Code or creditors may seek to set aside the transfers under applicable state law.³⁰⁷ Additionally the trustee may invoke state fraudulent

²⁹⁸ See *supra* notes 55-57 and accompanying text.

²⁹⁹ See *supra* notes 55-57 and accompanying text.

³⁰⁰ These pitfalls will be discussed in this Comment as red flags to be considered, though specific recommendations as to measures to be taken by the courts or Congress to remedy these additional hazards are beyond the scope of this inquiry.

³⁰¹ See *supra* notes 38-44 and accompanying text.

³⁰² See *supra* notes 38-44 and accompanying text.

³⁰³ Miller, *supra* note 43.

³⁰⁴ See 11 U.S.C.S. § 548(a) (2005). The trustee may avoid any transfer of the debtor's property or obligations made within two years before the date of filing if the debtor possessed actual intent to hinder, delay, or defraud creditors; or if the debtor received less than a reasonably equivalent value in the transfer and was insolvent at the time or became insolvent as a result; or if the debtor incurred debts beyond its ability to pay. *Id.*

³⁰⁵ TABB, *supra* note 63, § 6.27, at 412-15.

³⁰⁶ *Id.*

³⁰⁷ *Id.*

transfer law under the Bankruptcy Code as long as there is at least one actual creditor in existence who would be able to attack the transfer under state law.³⁰⁸ The bite of state law is stronger in terms of its reach-back period.³⁰⁹ Under bankruptcy law, a trustee may avoid fraudulent transfers made within two years of the bankruptcy filing, however, under applicable state law the statute of limitations can be longer.³¹⁰

State fraudulent transfer law follows one of three models, the most common of which is the Uniform Fraudulent Transfer Act (“UFTA”).³¹¹ Under the UFTA model, the case for actual fraudulent transfers in the Tucson diocese real estate sales³¹² seems strong. Among the applicable indicators of fraud provided by the UFTA,³¹³ the following are cause for suspicion in the case of the Tucson diocese: the transfer or obligation was to an insider; before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit; the value of consideration received by the debtor was not reasonably equivalent to value of the asset transferred or the amount of the obligation incurred; and the debtor became insolvent shortly after the transfer was made.³¹⁴ While none of these factors alone are sufficient to establish a fraudulent transfer,³¹⁵ the presence of several of these factors would likely have been persuasive in the plaintiffs’ case against the Tucson diocese had it not settled out of court.

2. *Bad Faith Filing by “The Faithful?”*

While there is no statutory requirement of good faith in a debtor’s filing for chapter 11 relief,³¹⁶ many courts impose an implied good faith requirement to foreclose a debtor’s use of chapter 11 reorganization as strategy to avoid or

³⁰⁸ See 11 U.S.C. § 544(b)(2) (2000).

³⁰⁹ TABB & BRUBAKER, *supra* note 65, at 393.

³¹⁰ *Id.*

³¹¹ *Id.* at 392-93; *see also* UFTA.

³¹² *See supra* notes 41-43 and accompanying text.

³¹³ TABB & BRUBAKER, *supra* note 65, at 396. “The UFTA in § 4(b) lists eleven factors relevant to a determination of the debtor’s actual intent.” *Id.*

³¹⁴ *Id.*

³¹⁵ *Id.* at 395. “There is no magic combination or requisite number of ‘badges’ needed to establish actual fraud.” *Id.*

³¹⁶ There is, however, an express requirement in the Bankruptcy Code that a reorganization plan under chapter 11 be proposed in good faith. 11 U.S.C. § 1129(a)(3) (2000).

defraud its creditors.³¹⁷ While bankruptcy law no longer expressly requires a demonstration of insolvency at the time of filing, if a debtor files for bankruptcy for reasons other than a genuine need to restructure debt, a court may dismiss the petition altogether.³¹⁸ A court could conceivably dismiss a case for cause in response to a bad faith filing determination.³¹⁹ An implied duty of good faith in filing is another factor for courts to consider in encountering non-secular bankruptcies, particularly those that file in the wake of enormous tort liability from sexual misconduct cases.

It is unclear whether a chapter 11 bankruptcy petition filed by an otherwise financially sound debtor in response to massive tort liability (as is the case with religious debtors currently seeking bankruptcy protection) would be dismissed for bad faith. At present, the presiding bankruptcy courts in Oregon³²⁰ and Washington have not dismissed such petitions on these grounds. The cases go on, but because the implications involved are unique in their religious ties, the matters themselves are shrouded in uncertainty. The courts have been inconsistent in their recognition and application of an implied good faith requirement.³²¹

As University of Pennsylvania Professor of Law David Skeel recently observed, a series of high profile bankruptcy cases concerning dismissal for cause and the unwritten requirement of good faith resulted in competing outcomes.³²² The question of whether companies were in violation of the implied duty of good faith by filing for bankruptcy solely for strategic advantage was of central importance in both Continental Airlines' 1984 bankruptcy³²³ and the use of bankruptcy protection by Johns-Manville and other asbestos manufacturers to consolidate numerous tort liability claims.³²⁴ The court permitted each of these cases to continue without dismissing for cause in violation of an implied good faith requirement.³²⁵

³¹⁷ See, e.g., *Little Creek Dev. Co. v. Commonwealth Mortgage Corp.* (*In re Little Creek Dev. Co.*), 779 F.2d 1068 (5th Cir. 1986) (holding the debtor, with one asset and few unsecured creditors, sought chapter 11 relief in bad faith to avoid paying bond requirement in a state court foreclosure action).

³¹⁸ 11 U.S.C. § 1112(b) (authorizing the bankruptcy court to dismiss a case for cause).

³¹⁹ For a detailed analysis of the implied good faith filing requirement, see Lawrence Ponoroff & F. Stephen Knippenberg, *The Implied Good Faith Filing Requirement: Sentinel of an Evolving Bankruptcy Policy*, 85 NW. U. L. REV. 919 (1991).

³²⁰ *In re Roman Catholic Archbishop*, Bankr. L. Rep. (CCH) ¶ 80,225 (Bankr. D. Or. Jan. 10, 2005).

³²¹ See Ponoroff & Knippenberg, *supra* note 314.

³²² David A. Skeel, Jr., *Avoiding Moral Bankruptcy*, 44 B.C. L. REV. 1181, 1185 (2003).

³²³ *Id.*; see generally *In re Cont'l Airlines Corp.*, 38 B.R. 67 (Bankr. S.D. Tex. 1984).

³²⁴ Skeel, *supra* note 322, at 1185; *In re Johns-Manville Corp.*, 36 B.R. 727 (Bankr. S.D.N.Y. 1984).

³²⁵ Skeel, *supra* note 322, at 1185; *In re Johns-Manville Corp.*, 36 B.R. 727.

In more recent years, courts have changed gears to emphasize the requirement of a valid reorganizational purpose. Professor Skeel provides the decision of the U.S. Court of Appeals for the Third Circuit in *Official Committee of Unsecured Creditors v. Nucor Corp. (In re SGL Carbon Corp.)*³²⁶ as an example that should surely inform parties involved in current and future religious organization chapter 11 filings.³²⁷ Facing litigation with costs to the company estimated at \$240 million, SGL Carbon filed for bankruptcy and released a statement announcing its purpose in filing.³²⁸ The company stated it did not file for bankruptcy was not because of financial distress, but instead to protect itself against impending antitrust claims.³²⁹ Sound familiar?³³⁰ The religious organizations in Oregon, Arizona, and Washington who are currently seeking bankruptcy protection and reorganization privileges were also financially sound before filing, and each publicly announced that it filed purely as a method by which to manage tort liability resulting from clergy sexual misconduct cases.³³¹ The analogy is quite strong, providing at least some precedent as to how current and future courts may handle this type situation.

The decision in *In re SGL Carbon Corp.* is of value to those who oppose the recent filings by the Catholic Church. The court held the distractions of litigation, which the company claimed presented a serious threat to its continued successful operations and posed potential financial ruin, were not a sufficient justification for seeking bankruptcy protection.³³² In denying SGL Carbon Corporation bankruptcy protection, the court stressed the requirement of a valid reorganizational purpose and that bankruptcy law was not a vehicle by which to invoke favorable litigation advantages.³³³ The court paid particular attention to the following factors in its dismissal for cause: SGL

³²⁶ 200 F.3d 154 (3d Cir. 1999).

³²⁷ Skeel, *supra* note 322, at 1186; *see In re SGL Carbon Corp.*, 200 F.3d at 165-66.

³²⁸ Skeel, *supra* note 322, at 1186; *see also In re SGL Carbon Corp.*, 200 F.3d at 156-58.

³²⁹ Skeel, *supra* note 322, at 1186; *see also In re SGL Carbon Corp.*, 200 F.3d at 156-58.

³³⁰ Skeel, *supra* note 322, at 1186.

The similarities between SGL Carbon's and the Archdiocese of Boston's predicaments are striking. In each case, the crisis stemmed from the prospect of enormous liability from lawsuits filed against an otherwise financially healthy entity. Were it not for this litigation—litigation based in each instance on alleged misbehavior involving the would-be debtor itself—the prospect of bankruptcy would never have arisen.

Id.

³³¹ *See supra* Part I.A.

³³² Skeel, *supra* note 322, at 1186-87; *see also In re SGL Carbon Corp.*, 200 F.3d at 162.

³³³ Skeel, *supra* note 322, at 1187; *see also In re SGL Carbon Corp.*, 200 F.3d at 162-65.

Carbon Corporation admittedly sought bankruptcy protection as a way to manage unfavorable litigation, the company was otherwise financially healthy, and the company stressed that bankruptcy would not interfere with its ordinary course of business.³³⁴

These justifications are strikingly similar to the reasoning put forth by the Catholic dioceses currently in bankruptcy upon filing their petitions. In fact, representatives from the Portland and Tucson dioceses conceded that the filings were prompted by a flurry of litigation surrounding clergy sexual abuse cases, that the organizations were otherwise not insolvent, and that the protection of bankruptcy would allow the dioceses' churches, schools, and social programs to continue undisturbed.³³⁵ It seems that the bad faith argument that proved meritorious in denying SGL Carbon Corporation bankruptcy protection would be relevant and beneficial to plaintiffs protesting the Catholic dioceses' petitions. The case would also seem to serve as a warning sign to religious organizations considering future filings as a method of managing unfavorable sexual abuse litigation.³³⁶

Although no plaintiffs have challenged the current non-secular filings as having been executed in bad faith as of yet, the possibility exists that the courts can avoid analyzing all of the sensitive, likely precedent-setting issues, involved with a religious organization's bankruptcy filing by simply dismissing the cases for cause. At the moment, the risk of dismissal for lack of good faith is just that—a risk. However, an otherwise financially solvent religious organization may have a difficult time finding a legitimate purpose for reorganization outside of managing injurious and costly litigation in response to clergy sexual abuse claims.³³⁷

³³⁴ Skeel, *supra* note 322, at 1187; *see also In re SGL Carbon Corp.*, 200 F.3d at 162-63.

³³⁵ *See supra* Part I.A.

³³⁶ *See Skeel, supra* note 322, at 1187. “SGL Carbon highlights a significant risk to a diocese or archdiocese that decides to file for bankruptcy in order to address clergy sexual misconduct litigation.” *Id.*

³³⁷ *Id.* at 1188. “Given that the Archdiocese [of Boston] is financially healthy apart from the estimated five hundred clergy sexual misconduct cases filed against it, a bankruptcy court could conclude that the Archdiocese does not have a genuine ‘reorganizational purpose’ and should therefore be kicked out of Chapter 11.” *Id.*

IV. PROPOSED SOLUTIONS

A. *Amend the Bankruptcy Code*

The justification for amending the Bankruptcy Code to exempt or preclude religious organizations from filing for bankruptcy protection under chapter 11 is simple: a church, synagogue, mosque, temple, or any other religious center is meant to be run for the benefit of its congregants—not for the benefit of its creditors, including judgment creditors, no matter how sympathetic society may be towards them. Chapter 11 reorganization allows the judicial system to intervene, either through the court’s discretion or through the installment of a trustee,³³⁸ and take over operations of the debtor seeking bankruptcy protection and relief. In essence, during a chapter 11 reorganization, the court is charged with the task of making certain that the debtor’s business becomes optimally profitable for the benefit of its creditors through the requirement to maximize the value of the estate.³³⁹ This type of judicial intervention into the workings of a religious organization is not only undesirable, but is also violative of the First Amendment religion clauses.³⁴⁰ An amendment to the Bankruptcy Code foreclosing religious bodies from filing for chapter 11 relief is one remedy that would avoid this conflict.³⁴¹

A helpful analogy might be a comparison of the inability of individual states to file for bankruptcy.³⁴² Chapter 9 permits municipalities to file for bankruptcy.³⁴³ An entity eligible for chapter 9 relief is defined as a “political subdivision or public agency or instrumentality of a State.”³⁴⁴ This may

³³⁸ 11 U.S.C. § 1104 (2000).

³³⁹ See, e.g., *Commodity Futures Trading Comm’n v. Weintraub*, 471 U.S. 343, 352 (1985); *La. World Exposition v. Fed. Ins. Co.*, 858 F.2d 233, 246 (5th Cir. 1988).

³⁴⁰ See *supra* Part II.

³⁴¹ What is “religious?” In differentiating between religious institutions and groups that are merely religious-affiliated, a standard that has been followed is that a *religious* institution must teach and profess the religion itself in its ordinary course of operations. Simply extolling the values of a particular faith, as is the case with religiously affiliated entities, would not be sufficient to trigger the protections afforded to religious institutions. See *Catholic Charities of Sacramento, Inc. v. Super. Ct.*, 85 P.3d 67, 87 (Cal. 2004) *cert. denied*, 125 S. Ct. 53 (2004) (holding that a charity, incorporated separately from the church, did not qualify as a “religious employer,” and as such did not qualify for a religious exemption).

³⁴² “In its ultimate effect, municipal debt adjustment is much like corporate reorganization under chapter 11 of the Bankruptcy Code.” 6-900 COLLIER ON BANKRUPTCY ¶ 900.01[2] (Alan R. Resnick & Henry J. Sommer eds., 15th ed. rev. 2005).

³⁴³ 11 U.S.C. §§ 901-946 (2000).

³⁴⁴ *Id.* § 101(40).

include cities, towns, and villages within a state, but not the state itself.³⁴⁵ For a variety of reasons beyond the scope of this inquiry, including state sovereignty,³⁴⁶ states may not seek bankruptcy protection. From a practical standpoint, however, the comparison is worthy of exploration. States are foreclosed from filing for bankruptcy because operating a state for the benefit of its creditors would be, at the very least, against public policy. The beneficiaries of a state's operations should be the residents of that state, not creditors to whom the state owes debts. Similarly, a religious organization should operate for the benefit of its congregants, not with a mandate of profitability. While an outright foreclosure of bankruptcy under any chapter is not an appropriate remedy to the conflict, perhaps religious organizations should be held accountable to a special section of the Bankruptcy Code, similar to the special provision governing municipalities under chapter 9. This new chapter could be drafted in a way that steers clear of the religious liberty perils of chapter 11.

Foreclosing the possibility of chapter 11 reorganization for religious organizations and encouraging chapter 7 liquidation in its place provides a mechanism to pay creditors on a pro rata basis through the sale of assets while avoiding a situation where the government is free to force religious centers to adopt a for-profit operating model in violation of religious tenets and to the detriment of the faithful. Essentially, amending the Bankruptcy Code to eliminate the possibility of chapter 11 filings for religious organizations would circumvent the almost certain First Amendment clashes discussed above, while ensuring an orderly payment of debts through the neutral process of liquidation. Inaction by Congress with respect to an amendment to the Bankruptcy Code could leave dangerous precedents in place, either by forcing the judicial system to act beyond its powers by constructively legislating from the bench or by leaving judges to formulate inconsistent make-shift rules along the way in attempts to compensate for religious liberty infringement.³⁴⁷

³⁴⁵ See *id.*

³⁴⁶ See U.S. CONST. amend. X. The Constitution also forbids the states from impairing obligations of contract. See U.S. CONST. art. I, § 10; S. REP. No. 73-407, at 2 (1934).

³⁴⁷ This Comment in no way suggests using chapter 7 to make non-secular debtors judgment proof, however, it proposes that liquidation is a constitutionally sound filing route. Religious bodies, in fact, tend to have sizeable assets in comparison to other non-profits, particularly in buildings and real property. See Grossman, *supra* note 25. “[The church is] building-rich and cash-poor.” *Id.*

B. Challenge the Code under RFRA to seek a free exercise exception or government accommodation

A free exercise challenge made by a religious official under RFRA is likely to be sustained.³⁴⁸ Congress and the U.S. Supreme Court have afforded constitutional protection to several legislative accommodations of important religious interests, including taxation, employment, and military service.³⁴⁹ While actions brought under the Free Exercise Clause receive a rational basis form of review, parties may plead RFRA to attain a strict scrutiny analysis.³⁵⁰ This form of review requires the government to show a narrowly tailored compelling state interest and that the least restrictive means is applied.³⁵¹ Legislative accommodations of vital religious interests have been found not to be violative of the Establishment Clause.³⁵²

C. Challenge the Code under the Establishment Clause as an excessive entanglement in religion

An Establishment Clause claim would likely be sustained in a case of a religious debtor filing for reorganization under chapter 11.³⁵³ Reorganization would involve government involvement in religion that rises to the level of excessive entanglement, which the First Amendment and Establishment Clause jurisprudence proscribe, particularly under the control of a trustee.³⁵⁴

CONCLUSION

Chapter 11 reorganization is infeasible for religious institutions seeking bankruptcy protection. The First Amendment's protection of free exercise and proscription against excessive entanglement of government in religion create actionable objections to the use of reorganization by religious bodies. Chapter 7 provides a constitutionally sound alternative. As such, liquidation is the appropriate tool for non-secular debtors seeking bankruptcy relief. The Bankruptcy Code should be amended with respect to its application to religious debtors to encourage the use of chapter 7 and foreclose the opportunity to file

³⁴⁸ See *supra* notes 15-17 and accompanying text.

³⁴⁹ See *supra* Part I.C.

³⁵⁰ See *supra* Part I.C.

³⁵¹ 42 U.S.C. § 2000bb-1 (2000).

³⁵² See *supra* notes 15-17 and accompanying text.

³⁵³ See *supra* Part I.A.

³⁵⁴ *Id.*

under chapter 11. Alternatively, respecting non-secular debtors, the Bankruptcy Code could be challenged as a violation of free exercise rights under RFRA or as a violation of the Establishment Clause. A religious accommodation should be granted in the absence of an amendment. Finally, in encountering religious bankruptcies, particularly those currently pending, courts should be aware of subtle fraudulent transfer attempts by religious bankrupts to shield assets from the estate and should assess the good faith filing intentions of non-secular debtors facing massive tort liability.

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