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Feature

*1 TENSION BETWEEN THE TRUSTEE & THE TITHE

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The Bankruptcy Code increasingly runs up against important social policies articulated in other federal and state statutes. Congress resolved certain of the conflicts between labor law and bankruptcy by enacting §1113 of the Code. Conflicts with tax policies at all levels proceed unabated. The continuing unresolved interface with environmental policies is amply demonstrated by the “Toxins-Are-Us” column, which appears regularly in the *ABI Journal*. The decision in *Christians v. Crystal Evangelical Free Church (In re Young)*, 152 B.R. 939 (D. Minn. 1993) and its progeny have raised another arena of even heightened conflict, this time between the Code and the most important expression of America's political and religious values-- the First Amendment to the Constitution.

In January 1992, Bruce and Nancy Young filed for relief under chapter 7 of the Code. The Youngs contributed \$13,450 to their church during the preceding year. The bankruptcy trustee commenced an adversary proceeding against the church to avoid the Youngs' contributions as fraudulent conveyances pursuant to §548(a)(2) of the Code. [FN1] *Christians v. Crystal Evangelical *32 Free Church (In re Young)*, 148 B.R. 886 (Bankr. D. Minn. 1992).

Neither party raised First Amendment issues in the bankruptcy court, which concluded that the Youngs received nothing of “value” for their contributions. The Youngs obviously obtained neither an ownership interest in any of the church's assets nor a legal or equitable right against the church as a result of their contributions. The church admittedly provided services to the Youngs such as an opportunity to worship resulting in “feelings of association, comfort, affection, companionship and love.” 148 B.R. at 893. According to the bankruptcy court, however, these benefits “were mere gratuities lacking consideration and [are] deemed valueless.” *Id.* Elaborating on the issue of economic utility, the bankruptcy court held that “[s]trictly religious benefits are not economically valuable...[because] there is no objectively or subjectively reasonable way” to measure them. *Id.* at 894.

Early Developments of Fraudulent Conveyance Law

The initial purpose of Anglo-American bankruptcy law was to ensure fair and equitable distribution of non-exempt property to creditors. [FN2] Statutory authorization to recover fraudulent conveyances goes back at least as far as 1571 to the Statute of 13 Eliz., c. 5. Parliament aimed to eliminate the practice by which debtors placed their assets in friendly hands to frustrate attempts of creditors to satisfy their claims. After creditors eventually abandoned their efforts, the unscrupulous debtor would obtain a reconveyance of the transferred property.

Both the first and second American Bankruptcy Acts, of 1800 and 1841, respectively, provided for the recovery of fraudulent transfers. State courts attempted to provide similar remedies during the lengthy gaps between federal bankruptcy legislation. For example, in 1818 Chancellor Kent of New York announced that *any* voluntary conveyance by an indebted person was fraudulent toward his creditors. *Reade v. Livingston*, 2 Johns. Ch. 481 (N.Y. 1818). [FN3] Several other jurisdictions followed *Reade's* aggressive rule so that creditors could attack any gift made by an insolvent debtor regardless of her good faith. *See, e.g., Severs v. Dodson*, 53 N.J. Eq. 633 (1895). The United States Supreme Court, however, refused to follow the precedent of *Reade*. *See Warren v. Moody*, 122 US 132 (1887) (construing §14 of the Bankruptcy Act of 1867).

In 1898 Congress passed the Bankruptcy Act (the “Act”). Section 67e of the Act virtually reenacted the Statute of 13 Elizabeth. The drafters intended this section to be declaratory of the common law of fraudulent conveyances.

Uniform Fraudulent Conveyance Act

In 1918 the National Conference of Commissioners on Uniform State Laws (the “Commissioners”) approved the Uniform Fraudulent Conveyance Act (UFCA). In the preceding years, courts had created many legal presumptions of intent to defraud, which, in the opinion of the Commissioners, had “pushed presumption of fraud as a fact to an unwarranted extent.” 7A *Uniform Laws Annotated* (1985) at 428. The Commissioners designed the UFCA to permit for the first time direct recovery of conveyances by a debtor even where no actual intent to hinder, delay or defraud could be shown. Notwithstanding the breadth of the statutory reach of the UFCA, the courts still held that creditors could not attack a transfer merely in consideration of a present or future marriage (commonly known as “the purchase of the blushing bride”). [FN4]

Twenty-five jurisdictions eventually adopted the UFCA. With the amendments of the Chandler Act, Congress even incorporated the UFCA into the Act as new §67d in 1936. Congress hoped to promote consistency of interpretation of fraudulent conveyance issues with the states and because it believed that the UFCA was a statement of the better view of the common law than old §67e. [FN5]

Reform and New Laws

In 1978 Congress adopted the Bankruptcy Reform Act (P.L. 95-598) including § 548 of the Code, which was largely derived from §67d of the Act. Then, in 1984, the Commissioners promulgated the Uniform Fraudulent Transfer Act (UFTA) to replace the UFCA. The UFTA preserves the basic structure of the older UFCA but attempted to bring state law even into more harmony with §548 of the Code. Thirty-three states have adopted the UFTA. [FN6] Notwithstanding the adoption of §548 of the Code, the old common law rule of “the purchase of the blushing bride” appears to have survived. *See In re Shader*, 90 B.R. 85 (Bankr. D. Del. 1988).

The Rise of Free Exercise Protection

The First Amendment provides in relevant part that “Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof...” The Supreme Court has afforded varying degrees of protection to religious practices under the First Amendment.

The Supreme Court gave the Free Exercise clause its broadest application in a series of cases commencing in

1963. *Sherbert v. Verner*, 374 U.S. 398 (1963) involved a Seventh Day Adventist who had been fired for refusing to work on Saturday, her Sabbath. The South Carolina Employment Security Commission denied Sherbert's claim for unemployment compensation, a decision ultimately affirmed by the South Carolina Supreme Court.

The U.S. Supreme Court reversed, holding that a state cannot deny benefits to one whose conduct is prompted by religious principles unless justified by a "compelling state interest in the regulation of a subject within the state's constitutional power to regulate." 374 U.S. at 403 (quoting *NAACP v. Button*, 371 U.S. 415, 418 (1963)). According to the court, "only the gravest abuses, endangering paramount interests, give occasion for permissible limitation" on rights under the Free Exercise clause. *Id.* at 406.

Nine years later, the court broadened the scope of Free Exercise application in *Wisconsin v. Yoder*, 406 U.S. 205 (1972), holding Wisconsin's compulsory high school education law unconstitutional as applied to the Amish. Several Amish families claimed that attendance at high school was contrary to their religion and way of life. The Supreme Court agreed, stating that "[a] regulation neutral on its face may, in its application, nonetheless offend the constitutional requirement for governmental neutrality if it unduly burdens the free exercise of religion." *33406 U.S. at 220. There are, according to the court, "areas of conduct protected by the Free Exercise clause of the First Amendment...beyond the power of the state to control, even under regulations of general applicability." *Id.*

Several later decisions continued to apply this broad Free Exercise analysis. *See, e.g., Thomas v. Review Board of the Indiana Employment Security Division*, 450 U.S. 707 (1981) (Jehovah's Witness could not be denied unemployment compensation because he refused to work on production of tank turrets); *Hobbie v. Unemployment Appeals Commission of Florida*, 480 U.S. 136 (1987) (employee who converted to Seventh Day Adventism after commencing employment could not be denied benefits for refusing to work on her Sabbath); and *Frazee v. Illinois Department of Economic Security*, 489 U.S. 829 (1989) (unemployment benefits case).

The Decline and Fall of Free Exercise Protection

Cracks in the court's Free Exercise jurisprudence could begin to be detected even while it exercised great solicitude for the Amish tradition and persons to whom states denied unemployment compensation benefits. In *National Labor Relations Board v. The Catholic Bishops of Chicago*, 440 U.S. 490 (1979) the court confronted the appeal of a decision by the 7th Circuit Court of Appeals that the NLRB had no jurisdiction over an unfair labor practices complaint filed by several unions against Roman Catholic high schools that refused to bargain collectively. The Supreme Court affirmed; however, its reasoning was quite narrow. The court declined to address the Free Exercise issue, holding instead that the National Labor Relations Act simply did not apply to teachers in a school operated by a church to teach both religious and secular subjects.

Then, in 1990, the Supreme Court made a remarkable change of course in its Free Exercise analysis in *Employment Division, Dept. of Human Resources of Oregon v. Smith*, 494 U.S. 872 (1990). A drug rehabilitation center fired two counselors because they had used peyote for sacramental purposes in their Native American Church. The state denied unemployment benefits to the discharged counselors who appealed to the Oregon Supreme Court, which reversed, holding that the First Amendment rights of the counselors prevailed over the Oregon statute making illegal any use of peyote. The state then petitioned the U.S. Supreme Court for review.

The Supreme Court reversed, holding that a state can prohibit religiously inspired use of peyote where the law does not represent an attempt either to regulate religious beliefs, the communication of those beliefs or the

raising of children in those beliefs. The court went on to conclude that generally applicable religion-neutral criminal laws that have the effect of burdening a particular religious practice need not be justified by a compelling governmental interest.

The Religious Freedom Restoration Act

Shortly after the Supreme Court's decision in *Smith*, a broad coalition of religious and civil rights groups proposed the Religious Freedom Restoration Act, (P.L. 103-141) (RFRA). RFRA passed the House on a voice vote and by 97-3 in the Senate. President Clinton immediately signed RFRA into law on November 16, 1993.

Congress expressly intended RFRA to reverse the Supreme Court's 1990 decision in *Smith* and restore the "compelling interest" test of *Sherbert* and *Yoder* in Free Exercise analysis. A plaintiff under RFRA bears the initial burden of establishing that a rule of general applicability constitutes a substantial burden on her free exercise of religion. If the plaintiff satisfies this requirement, the government then shoulders the burden of establishing that the two elements of the compelling interest test are met. The government carries its burden only if it establishes that the challenged rule (1) furthers "a compelling governmental interest" and (2) "is the least restrictive means of furthering that compelling governmental interest."

Is RFRA Constitutional?

Initially, several courts applied RFRA without difficulty, prohibiting enforcement of governmental regulations that probably would have been upheld under *Smith*. See, e.g., *Western Presbyterian Church v. Board of Zoning Adjustment*, 862 F.Supp. 538 (D.D.C. 1994) (allowing church to continue feeding program for homeless in spite of zoning regulations); *Bessard v. California Community Colleges*, 867 F.Supp. 1454 (E.D. Cal. 1994) (prohibiting state from requiring a loyalty oath of a Jehovah's Witness as a condition of employment); and *Campos v. Coughlin*, 854 F.Supp. 194 (S.D.N.Y. 1994) (allowing incarcerated prisoners to wear beads for religious purposes).

The constitutionality of RFRA has *34 come under attack in a few cases. Several governmental bodies have argued that Congress in RFRA has usurped exclusively judicial functions including "delineation of the boundaries of constitutional rights and calibration of the proper balance between competing interests of constitutional magnitude." *Belgard v. State of Hawaii*, 883 F.Supp. 510, 513 (D. Hawaii 1995). At least one district court has found RFRA constitutionally infirm. *Flores v. City of Boerne*, 877 F.Supp. 355 (W.D. Texas 1995). The 5th Circuit has reversed, however, holding that RFRA was a permissible exercise of Congressional power under Section 5 of the 14th Amendment ("Congress shall have power to enforce, by appropriate legislation, the provisions of the article.") *Flores v. City of Boerne*, Slip Op. 95-50306 (5th Cir. 1996) It seems likely that the Supreme Court will be called upon ultimately to resolve RFRA's constitutionality.

***In re Young* Revisited**

The losing church in the *Young* case appealed to the district court of Minnesota. *In re Young*, 152 B.R. 939 (D. Minn. 1993). The district court first affirmed the decision of the bankruptcy court regarding the applicability of §548 to the Youngs' tithes: "There are no justifiable grounds to differentiate between religious donations and other gratuitous transfers, such as gifts to family members, which are clearly avoidable." 152 B.R. at 949.

The church raised constitutional issues for the first time on appeal. The district court, however, considered the matter seven months before the enactment of RFRA and thus applied the *Smith* standards. It concluded both that §548 was a “neutral statute of general applicability” and that it did not have more than an “incidental effect” on religion. *Id.* at 953. Perhaps with the potential passage of RFRA in mind, the district court went out of its way to comment that it believed that “treating creditors as fairly as possible” constituted a compelling governmental interest, apparently of greater import than the integrity of state unemployment funds or the high school education of all children. Not surprisingly, the church appealed to the 8th Circuit, this time with the additional RFRA argument in its quiver. A decision is expected at any time. [FN7]

At least one other bankruptcy court has considered the avoidability of tithes in cases since RFRA's enactment. *In re Newman*, 183 B.R. 239 (Bankr. D. Kan. 1995). The bankruptcy court concluded that the church failed to meet the initial RFRA burden. In other words, the avoidability of donations is not a “substantial burden” on Free Exercise because §548 “does nothing to prevent the debtors' ...religious obligation to tithe.” 183 B.R. at 251. The trustee's retroactive recovery of precisely those tithes simply is not “burdensome.” The *Newman* decision also held that the recovery of fraudulent conveyances is a “compelling governmental interest” in part because it “has been a basic tenet of bankruptcy law for 400 years.” *Id.* at 252. The court did not address the contrary implication suggested by the historical analysis described above: no statute authorized recovery of constructively fraudulent conveyances until promulgation of the UFCA in 1918; courts have consistently protected transfers in contemplation of marriage; and, until 1992, no court had avoided a contribution to a church.

Further Considerations

Some three years after its decision in *Smith*, the Supreme Court considered the case of *Church of Lukumi Babalu Aye Inc. v. City of Hialeah*, 508 U.S. ___, 124 L.Ed.2d 472 (1993). A church that practiced the Santeria religion appealed from the decision of the 11th Circuit affirming the district court, which had upheld the constitutionality of several ordinances of the City of Hialeah, Fla. The ordinances had the effect of prohibiting the Santeria adherents from engaging in animal sacrifice. The city's ordinances were of general applicability. Nonetheless, they provided for a number of exemptions for the killing of animals on the ground of “necessity” for reasons such as hunting and fishing, euthanasia, extermination, slaughterhouses and kosher food preparation. [FN8]

Considering the breadth of these exemptions as well as the circumstances surrounding the adoption of the ordinances, the court held that the “application of the ordinances' test of necessity devalues religious reasons for killing by judging them to be of lesser import than non-religious reasons. Thus, religious practice is being singled out for discriminatory treatment.” [FN9] The Supreme Court therefore subjected the ordinances to “rigorous scrutiny” to see if they met “interests of the highest order” and were “narrowly tailored.” The court found them wanting. [FN10]

Churches have argued for the extension of the *Lukimi* reasoning to the bankruptcy setting on the grounds that §522 of the Code provides for a series of exemptions. The Code's many exemptions undermine the claim that the maximization of recovery for creditors serves a compelling governmental interest. Additionally, if the Code is not a “generally applicable” statute, then the trustee must proceed under the “compelling state interest/least restrictive means” test regardless of the constitutionality of RFRA. So far no court has concluded that the *Lukimi* analysis is applicable to avoidance actions. Although the Code permits a substantial series of exemptions, §548 itself contains none. This avenue of defense is also before the 8th Circuit in the *Young* appeal.

Conclusion

The issues raised by the potential of avoidance claims against churches, synagogues, mosques and other worshiping bodies raise fundamental questions about the extent of governmental authority. The Constitution provides for a federal government of limited powers, including the power to establish uniform laws on the subject of bankruptcies. Article I, section 8, clause 3. The Bill of Rights proscribes the exercise of power with respect to First Amendment freedoms.

In recent years courts have expanded governmental powers at the expense of religious liberty. Congress and the president have responded by attempting to preserve a greater domain within which individuals and organizations may conduct themselves free from state intrusion. However, the judiciary has resisted these efforts in the area of the avoidance of constructively fraudulent conveyances. Ultimately, the Supreme Court will be called upon to resolve strike a balance between the respective spheres of sovereignty of church and state.

[FN1]. Section 548, in relevant part, provides:

(a) The trustee may avoid any transfer of an interest of the debtor in property...that was made...on or within one year before the date of the filing of the petition if the debtor...--

(2)(A) received less than a reasonably equivalent value in exchange for such transfer...; and

(B)(I) was insolvent on the date that such transfer was made...or became insolvent as a result of such transfer.

[FN2]. See *Wilson v. City Bank of St. Paul*, 17 Wall. 473, 478 (1873) (construing the Bankruptcy Act of 1867); see, also, Statute of 34 and 35 Henry VIII, c. 4 (1542-43).

[FN3]. Apparently the New York legislature thought the learned Chancellor had gone too far and in 1829 went to the other extreme, declaring that what constitutes a fraudulent conveyance is always a question of fact. N.Y. Rev. Stat. (1829) pt. II, c. 7, tit. 3.

[FN4]. See, e.g., *Braecklein v. McNamara*, 147 Md. 17, 127 Atl. 497 (1925).

[FN5]. Analysis of H.R. 12339, 74th Cong., 2d Sess. 213 (1936).

[FN6]. At least one case decided under the UFTA has held that “[a]ny consideration not involving utility for the creditors does not comport with the statutory definition [of value].” *In re Agricultural Research and Technology Group*, 916 F.2d 528, 540 (9th Cir. 1990).

[FN7]. The Department of Justice initially intervened in the 8th Circuit on behalf of the trustee, filing a brief arguing that avoidance actions neither constituted a “substantial burden” under RFRA and, even if they did, that §548 served a compelling governmental interest. Several *amici* representing various religious organizations contacted the White House in June 1994 to convince the president that the position of the department was inconsistent with the intent of RFRA. Three months later, at 9:40 p.m. the evening before oral arguments, Justice faxed a notice that it was withdrawing both its brief and as an intervenor, apparently at the personal direction of the president. See, “Clinton Orders Justice to Abandon Tithing Case,” *Wash. Times*, Sept. 16, 1994, at A1, A12.

[FN8]. 124 L.Ed.2d at 497-498.

[FN9]. *Id.* at 493.

[FN10]. *Id.* at 498.

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