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IN PURSUIT OF CHURCH ASSETS

INSIDE THE SAN DIEGO DIOCESE BANKRUPTCY

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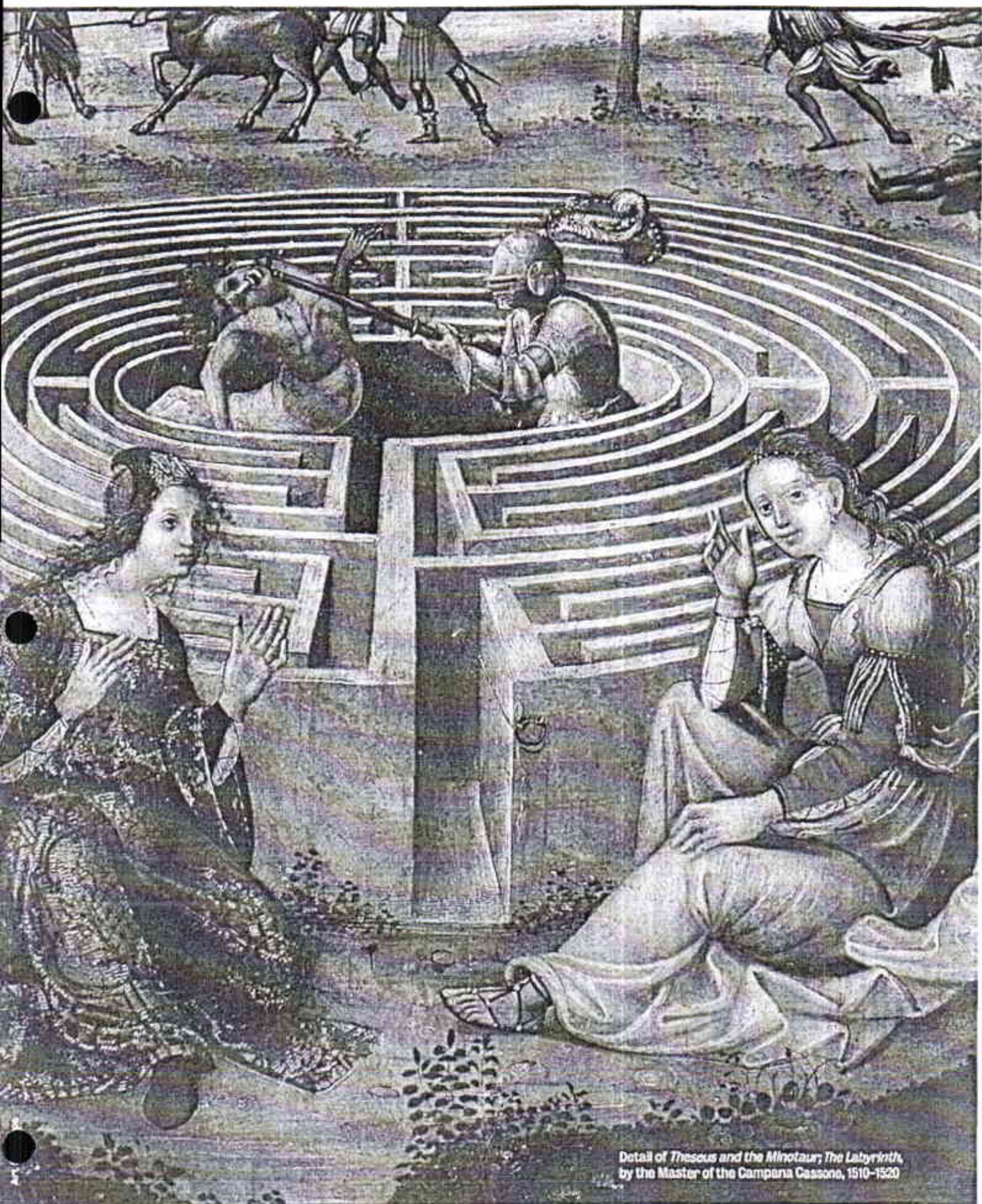
An Unholy Dispute

**How
plaintiffs
attorneys
successfully
challenged
the
San Diego
diocese in
bankruptcy
court**

**By
Ron Donoho**

Standing 6 foot 6, attorney James I. Stang, a partner in the Los Angeles firm of Pachulski Stang Ziehl Young Jones & Weintraub, looms large in any courtroom he enters. In the past 27 years he has participated in thousands of bankruptcy proceedings as debtors counsel, bankruptcy trustee, and bankruptcy trustee counsel for unsecured creditors committees. But few of those cases, he says, compare in emotional drama to the bankruptcies of Roman Catholic dioceses following claims of clergy sexual abuse. That's because the creditors in those

Ron Donoho is the executive editor of *San Diego Magazine*. Research editor Helen Christophi assisted with reporting this story.



Detail of *Theseus and the Minotaur; The Labyrinth*, by the Master of the Campagna Cassone, 1510-1520

cases include the alleged victims of sexual assault.

In February the Catholic Diocese of San Diego, faced with more than 160 pending lawsuits for clergy sexual abuse, became the fifth Roman Catholic diocese to file for Chapter 11 protection. The filing came one day before the first trial was initially scheduled for a San Diego courtroom. The San Diego diocese was preceded in bankruptcy by dioceses in Portland, Oregon; Tucson, Arizona; and Spokane, Washington, in 2004, and Davenport, Iowa, in 2006. All sought to avoid making huge settlements with claimants for either ignoring claims of sexual abuse or harboring pedophile priests.

Stang, who served as counsel to official creditors committees in both the Spokane and Davenport proceedings, represents no individual plaintiffs. As creditors counsel, he does not currently represent any survivor of sexual abuse. "I'll never be on John Doe's trial—I'll help get him to trial," Stang says. "My role is to guide creditors through the bankruptcy wilderness. I will get the property of the diocese's estate to be valued as high as possible, and process getting the claims valued."

After the February filing, Judge Louise DeCarl Adler twice asked the San Diego diocese to amend and refile its financial disclosure statements. She called the diocese's accounting system "byzantine," and professed to be "mystified" why 770 bank accounts held by the 98 San Diego parishes hadn't been included among the diocese's assets.

Bankruptcy attorney Susan G. Boswell, managing partner in the Tucson office of Quarles & Brady who represents the San Diego diocese, says her client did not misrepresent itself to the court. "Prior to this filing, the diocese didn't do reports on a consolidated basis," says Boswell, who also represented the Tucson diocese. "Separate divisions had their own accounting and reporting systems. Now they issue monthly operation reports to the U.S. Trustee on a consolidated basis. It's not a small task to combine all this."

Church cases are unique Chapter 11s, says Stang. "There are issues in these cases you don't see anywhere else. In the section 341 hearing [first meeting of the creditors] in San Diego, there was a woman crying and saying a lot of personal stuff."

Indeed, creditor Dianna Williams, trembling as she put on her reading glasses at the April hearing, addressed San Diego Bishop Robert H. Brom as he sat directly across from her at a U-shaped table. "Bishop Brom, in 2004 you sent word that you would help us with therapy," she said. "I'm plagued with panic attacks. I couldn't take my children to

school. I had suicidal thoughts. I started therapy, and you stopped it. I've lost my faith, my sister; I lost my virginity and my innocence and most of my life."

In tears, Williams beseeched Brom to do right by her and the hundreds of other claimants. In a stern but compassionate tone, U.S. Trustee Steven Katzman reminded the courtroom that questions must be directed at the church's financial situation. Still, Brom interrupted him, telling Williams, "I can't respond in this context." Leaning forward, he told her, "I want to do what's right in your regard. It may include much more therapy. I don't know why it was terminated. ... I can promise you that I will personally look into it."

Katzman cut off the dialogue. "There have been some horrific crimes done here," he said. "But we have to focus the questions on financial affairs so your lawyers can make at least some measure of justice in this process."

One of those lawyers—Irwin M. Zalkin, who represents Williams and more than 60 other claimants—reached for a microphone and responded, "This is about lives, too. Not just schedules and oversights, but about human lives."

Boswell attempted to join in. "This diocese has great empathy for the victims," she said. But she barely got the words out when the courtroom erupted in derisive laughter.

"This kind of thing makes people uncomfortable," Stang said after the hearing had ended. "But it's part of the case. Williams has a monetary claim, and she needs therapy, which costs money."

Judge Adler decided that determining ownership of parish property should take precedence over determining the amount of claims, as advocated by the diocese. She appointed an accountant to audit the diocese's books, and in July she ordered a separate trial to determine the titles of church property. Later that month Adler received auditor

R. Todd Neilson's 175-page report, which raised serious questions about the diocese's financial statements. "From an accounting perspective," Neilson wrote, "it would be a critical misrepresentation to report that assets belonging to others are included in the Diocesan Office Funds Financial Statements as the Debtor's assets."

On August 10, Judge Adler reacted dramatically to the auditor's report. She sent the diocese and its counsel an order to show cause at a hearing set for early September why the church's bankruptcy case should not be dismissed. Boswell wouldn't comment on how the diocese planned to respond, but she said the diocese disagreed with the auditor's report and was prepared to answer the court's concerns.

"Most other [bankruptcy cases] involve people who take financial risks. The survivors of abuse did not undertake any risk; they simply trusted and got hurt."

Before Judge Adler's order, the legal questions in San Diego paralleled those in previous church bankruptcies: Who owns title to diocesan property, and what is its market value. But after her order, the principal question became the integrity of the diocese itself. Just six months after filing under Chapter 11, the San Diego diocese faced the risk of becoming the first church to be thrown out of bankruptcy court.

As creditors counsel, Stang coordinated the work of attorneys for 23 law firms that represented more than 160 individual clients. It is an impressive legal group—a collection of “the best and brightest,” as several members are quick to note. Stang relished the passion he saw among the plaintiffs’ lawyers, as well as the sentiment expressed by the claimants.

“Every Monday night, I met with a committee of creditors to discuss legal questions, but we also addressed some significant emotional issues,” says Stang. “You may hear some of these attorneys say, ‘It’s not about the money.’ But you can’t appreciate that sentiment until you get involved with them. The main thing they want is that no other kids get molested. The financial cost of the abuse settlements made the Church focus on the need to address its institutional and clergy problems.”

Andrea Leavitt, a San Diego sole practitioner who represents 14 claimants who allege sexual abuse, says that working as a creditors team helped the plaintiffs’ attorneys effectively oppose the diocese, with its greater financial resources. At her offices in stylish Emerald Plaza just blocks from the bankruptcy court, Leavitt’s boardroom often served as headquarters for the creditors group and their counsel.

Leavitt says the group is aware of the special nature of the proceedings. “Every step of the way, there are decisions coming out of our cases that are history-making,” she says. “Really, these cases are remarkable. It’s the first time in the history of the Catholic Church that it hasn’t been in control of the society, the government, or the courts in the community in which it resides.”

She also is impressed by the dedication of team members. “You would think we’d be cynical and jaded at this point,” Leavitt says. “But we cry for each other’s clients, and our own clients, over and over again. We get physically sickened by it sometimes. You’d think we’d be over it after five and a half years, but we’re not.”

Many of the cases filed against the San Diego diocese benefited from amendments to the state’s code of civil procedure controlling how and when alleged victims may report child sexual abuse. In the early 1990s, the age limit for reporting abuse was raised from 18 to 21. (Cal. Code Civ. Proc. § 340.1.) In 1998 that statute was amended to permit victims of childhood sexual abuse to sue institutional employers of perpetrators for damages resulting from

a breach of an independent duty, such as negligent hiring or supervision, until they reach the age of 26. In 2002 the Legislature again amended the section, permitting victims over the age of 26 to sue institutional employers if they can prove the employer knew, had reason to know, or had notice of the unlawful sexual conduct but failed to act. In addition, the statute of limitations for bringing past claims was waived for that entire year.

Although working as a team with other plaintiffs’ attorneys was efficient, Leavitt says, it did require round-the-clock communications. “Sometimes we had daytime telephone conferences that lasted four hours or more. We’re all looking at the chessboard frontwards and backwards, and on different levels, looking at all the ramifications.”

“There’s a core group that drove the train,” adds Zalkin, a principal in the San Diego firm of Zalkin & Zimmer. “Ray Boucher had the thankless job of being liaison counsel—he tried to keep us all on the same page.” Zalkin says. “Then there’s John C. Manley, Venus Soltan, Leavitt, Kathy Freeburg, Larry Drvon, and others. Steve Rubino came in from New Jersey. Terry Giles is from Houston. We got pissed sometimes, sometimes we hugged. It’s like a family.”

Stang reiterates that the coalition of creditors counsel is empowered by its numbers but motivated by its mission. “Most other representations involve people who take financial risks, and the bankruptcy addresses whether they won or lost,” he says. “The survivors of abuse did not undertake any risk; they simply trusted and got hurt. In the end, we’re representing the good guys.”

Diocesan attorney Boswell, of course, takes exception to Stang’s comment. “I don’t know exactly what Jim’s thinking is,” she says. “[T]errible things happened, and [the people who were abused] have claims they want to assert and put forward. I wouldn’t say there are good guys and bad guys. Each side has a positioning interest.”

The diocese, Boswell contends, was working hard to achieve a settlement. “The people [in the diocese] now were not there when the harm occurred,” she says. “They are trying to bring matters to a reasonable conclusion. Each side has a different view of how we can reach that goal.”

Bishop Brom says that given the size of the claims against the diocese, filing for bankruptcy protection was the most feasible way of preserving the diocese. “It was the best way available to compensate all the victims of sexual abuse as fairly and equitably as our resources will allow without crippling our ability to accomplish the mission of the Church,” Brom says.

Prior to its bankruptcy filing, the diocese’s last settlement offer to the consolidated group of plaintiffs’ lawyers was \$95 million, which included individual settlements ranging from \$10,000 to \$800,000. In August, Zalkin said the plaintiffs’ attorneys hadn’t estimated a total amount for the claims, but

he noted that the average of individual settlements in similar sexual-abuse cases in California ranges from \$1.3 million to \$1.8 million.

In comparison, the Diocese of Orange settled with 87 sexual-abuse claimants for \$100 million in 2005, including one case with an individual who allegedly was molested for three years by a priest who later died of AIDS. In July the Roman Catholic Archdiocese of Los Angeles paid \$660 million to settle a case brought by more than 500 claimants.

In San Diego, the settlement question was all about the money. Bishop Brom signed financial disclosures stating the diocese's net worth at \$100 million, then amended it to \$130 million. Attorneys for the creditors called that number laughably low.

"The diocese didn't want to be honest about how much it's worth," says Zalkin. "They have provided us with scant and misleading information. We could have finished this bankruptcy in two and a half months if they had really put their arms around the worth of their assets. But I didn't see good faith displayed by them. They refused to get real."

As just one example of hiding the ball on real estate assets, plaintiffs lawyers cited the valuation of Holy Cross Cemetery, located on 43 acres in the heart of San Diego. In a disclosure statement, the diocese listed its assessed value at \$11 million. But in 2005, during the penalty phase of a suit against the cemetery, its general manager testified that "we think it has no value because once a grave has been used, it has no value because it cannot be sold. ... In fact, it's a liability." When the manager failed to produce a balance sheet at the hearing, plaintiffs counsel speculated that, based on sales of adjacent lots, "an acre of land over there is worth 1.6 million dollars."

Another example, Leavitt says, was a pending land sale that was missing from the diocese's balance sheet until she pointed it out to the court. In 2005 the church-affiliated University of San Diego High School moved to Carmel Valley, where it was renamed Cathedral Catholic High School. The real estate in San Diego then was sold to a private buyer for \$65 million. Boswell says the transaction wasn't listed because the seller is Catholic Secondary Education—Diocese of San Diego Corporation (CSE), a separate corporation governed by a board of church officials. She says the diocese had only an interest in the property, and that there is a legal distinction between owning the property and having an interest in it. But according to Leavitt, representatives from the diocese earlier told a state court that the diocese and CSE are the same entity and that the property was gifted. CSE was created in 2003, about the same time sexual-abuse lawsuits against the diocese began piling up.

At the section 341 hearing in April, U.S. Trustee Katzman brought up two more investments—one for \$17 million, another for \$10 million—that did not appear on the diocese's asset schedules. Diocese officials apologized, blaming clerical error. Katzman then asked Richard Miranda, the diocese's chief financial officer, if current market appraisals had been used for 32 listed properties. Miranda replied that current appraisals

did not exist. So Katzman asked the pertinent question: Are valuations likely to be higher today than they were when the properties were last assessed—in some cases more than 50 years ago? Miranda acknowledged the obvious.

Finally, attorney Manley asked Brom who might have the actual dollar amount of the assets owned by the diocese. "I don't know who knows what the net worth of the diocese is," Brom replied.

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xactly who owns church property is a matter of, well, theology. Professor Arnold Rosenberg of the Thomas Jefferson School of Law in San Diego says he doubts that the diocese would succeed in arguing that parish assets are owned separately and not by the diocese. Under canon law, title to church property is held by a corporation sole, a legal entity unique to Catholic dioceses structured to have a single member, the bishop. But Rosenberg notes that lower courts in the Portland and Spokane bankruptcies rejected arguments based on canon law and followed civil law principles. "Therefore, the courts held that parish assets could be part of the bankruptcy settlements," he says.

Rosenberg says that in some dioceses—such as those in Denver and Florida—the parishes set up separate corporations to hold title to property. But he believes these were organized a long time ago, based on farsighted legal advice. "If parishes were reorganized shortly before the diocese files Chapter 11, it could be seen as a fraudulent transfer to make the debtor less solvent," he says.

Rosenberg believes it's likely that the diocese would be determined to be the legal owner of most parish assets, apart from a handful of properties that may have been placed in the name of a parish or an individual church official. "Under California law, the holder of title to real property is presumed to be the owner unless another person or entity can prove that title was being held in trust for its benefit. The burden of proof is a heavy one."

The ownership matter, however, remains unsettled. A bankruptcy judge in Spokane ruled in August 2005 that the diocese owned the parish properties, and that the parishes had no legal, equitable, or beneficial interest in their individual churches and schools. But on appeal, a district judge ruled that having legal title in the name of the diocese did not, as a matter of law, preclude the parishioners from having a resulting trust ownership. (*Committee of Tort Litigants v. Catholic Diocese of Spokane*, 364 B.R. 81 (2006).) The case was remanded for further findings of fact relating to a possible property trust. But before the court reviewed affidavits to determine whether the parishes are beneficiaries of a resulting trust, the Spokane diocese settled the case for \$48 million.

Leavitt suggests that if the San Diego diocese had prevailed in arguments for parish ownership similar to those asserted by

the diocese in Spokane, it might have exposed the parishes as defendants in fraudulent-conveyance claims based on property transfers made during litigation and after bankruptcy.

In the Portland case, a bankruptcy judge also ruled that the First Amendment's religious freedom guarantee does not bar a court's jurisdiction in bankruptcy litigation that challenged whether property belonged to the diocese. (*In re Roman Catholic Archbishop of Portland in Oregon*, 335 B.R. 842 (2005).) The Portland diocese appealed that decision, but then settled the case for \$74.5 million.

"The parish-diocese issue haunts these cases," said Victor A. Vilaplana, of counsel to the San Diego office of Foley & Lardner who represents the separate parishes in San Diego. Commenting in early summer, Vilaplana said, "I think it's important to get the claim amount. It may be that the undisputed diocese assets plus its insurance might be enough to satisfy the claims—thereby avoiding the issue of whether the diocese owns the parish churches and schools."

Both sides in the San Diego case appeared open to creative solutions. In April, Boswell and plaintiffs attorneys discussed mediation, among other alternatives, as a way to get a global valuation of the claims before settling individual cases. Were that feasible, plaintiffs lawyers argued, the mediators should be judges who had presided over similar clergy-abuse cases in Los Angeles and Northern California.

"Judges should be the ones to handle valuation of clergy sexual-abuse claims," argued Stang. "They have experience with clergy sex cases. There are terrible crimes here, but religious organizations tend to come to a judge with a bit of a halo over them."

Boswell suggested that the mediation process used in Spokane, Portland, and Tucson could serve as a model in the San Diego abuse cases. She argued further that settlements made by the San Diego diocese should be comparable to those made in the other dioceses, and not tied to the valuation of property in the San Diego real estate market.

But Judge Adler apparently did not agree, declaring at another April hearing, "The debtor's real estate is worth top dollar because of where it is located." In May she proposed an arbitration plan for valuing claims—commonly called "baseball arbitration"—in which the parties submit their last, best offers, then the hearing officer chooses one as binding. Diocesan lawyer Michael Webb was noncommittal

about the arbitration idea: "I don't accept it or reject it out of hand," he said.

The auditor's report in July—and Judge Adler's order weeks later to show why she shouldn't dismiss the case—changed everything. In early September, U.S. Magistrate Judge Leo Papas presided over closed-door negotiations that resulted in a global settlement of \$198.1 million covering 144 of the clergy-abuse cases, spanning from 1938 to 1993. The amount is more than double the diocese's final offer of \$95 million last February. In a pastoral statement, Bishop Brom announced that "we have accepted a plan for the compensation of victims, even though the total settlement amount actually takes us beyond available resources and

will result in some damaging consequences for the mission of the Church in this diocese for a number of years."

Stang says the plaintiffs lawyers now will work with Superior Court Judge Peter Lichtman, who earlier this year arrived at the individual case amounts in the Diocese of Los Angeles settlements. Lichtman, he says, will allocate the valuations of individual claims. "In Los Angeles, Judge Lichtman sat down with all the lawyers and worked out each settlement on a case-by-case basis," Stang says. "He has a lot of experience, and a sense of what is involved. There's not really a formula to this."

One creditor who attended the section 341 hearing in April says that when the diocese filed for bankruptcy, he felt victimized all over again. "On a personal level, it felt like another tactic of hiding the truth," says the creditor, who is represented by Leavitt. "We were

about to begin trial in state court, and then they chose another venue—the federal court system. All we've ever wanted is to get the truth heard."

Now a nonpracticing Catholic, the creditor says he lost his faith in the Church long ago. "There's just a distinct level of mistrust with the diocese," he says. "They talk incessantly about transparency, but actions speak louder than words. At the section 341 hearing, I was really interested to see how connected the bishop would be with the financial situations of his company."

It would be fair to say that the bishop is now thoroughly aware of his diocese's financial situation. "To realize this settlement," Brom wrote in his pastoral statement, "we have found it necessary to petition for release from bankruptcy court. ... Hopefully, the settlement that has been accomplished will serve to begin a healing process, especially for the victims of abuse, but also for the Church. Once again, I want to apologize to those abused and their families and, in the name of the Church, to beg their forgiveness." ■

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