2019

A Non-Profit Entity may not be Substantively Consolidated with an Affiliated Debtor

Rachel Armely

ST. JOHN'S UNIVERSITY SCHOOL OF LAW

A Non-Profit Entity may not be Substantively Consolidated with an Affiliated Debtor

2019 Volume XI No. 2

A Non-Profit Entity may not be Substantively Consolidated with an Affiliated Debtor

Rachel Armely, J.D. Candidate 2020

Cite as: *A Non-Profit Entity may not be Substantively Consolidated with an Affiliated Debtor*, 11 ST. JOHN'S BANKR. RESEARCH LIBR. NO. 2 (2019).

Introduction

To date, over 19,000 sexual abuse claims, totaling claims in an aggregate amount of more than $4 billion, have been filed against individual dioceses within the Catholic Church.[1] This influx of claims comes as the result of certain state legislatures allowing individuals with previously time-barred claims to bring civil lawsuits against the dioceses.[2] Consequently, at least eighteen Catholic dioceses have filed voluntary petitions for relief under title 11 of the United States Code (the "Bankruptcy Code").[3]

In many cases, the majority of the Catholic dioceses' assets are held by inter-related, non-profit Catholic entities that often collectively hold billions of dollars in net assets.[4] However,

---

[1] *See* Tom Corrigan, *Catholic Church Used Bankruptcy for Sexual-Assault Cases. Now Others Are Following Suit*, The Wall Street Journal (Dec. 27, 2018, 5:30 AM), *available at* https://www.wsj.com/articles/catholic-church-used-bankruptcy-for-sexual-assault-cases-now-others-are-following-suit-11545906600.
[2] *See* Official Comm. of Unsecured Creditors v. Archdiocese of St. Paul & Minneapolis (*In re* Archdiocese of St. Paul & Minneapolis), 888 F.3d 944, 948 (8th Cir. 2018).
[3] *See Bankruptcy Protection in the Abuse Crisis*, *available at* http://www.bishop-accountability.org/bankruptcy.htm; *see also* Brian Roewe, *Archdiocese, Creditors Clash Over Bankruptcy Assets*, NATIONAL CATHOLIC REPORTER (May 27, 2016), https://www ncronline.org/news/accountability/archdiocese-creditors-clash-over-bankruptcy-assets,
[4] *See* Marie T. Reilly, *Appendix A: Case Information*, Penn State Law eLibrary (2018), https://elibrary.law.psu.edu/bankruptcy/37/.

because these claims are being brought solely against the dioceses, and not against their affiliated entities, the claimants are limited to recovering only from the assets independently held by the individual dioceses. Because the dioceses independently hold only a fraction of the Churches' collective assets, many that face these claims have voluntarily filed for bankruptcy. Plaintiffs have therefore tried to access the assets of the related non-profit, nondebtor entities based on their affiliation with the archdioceses.

Part I of this memorandum discusses the courts' power to combine a debtor's assets with the assets of an affiliated nondebtor through the remedy of substantive consolidation. Part II explains the specific rights of non-profit entities under the Bankruptcy Code, and how those rights prevent creditors from accessing a non-profit, nondebtor entity's assets.

Discussion

I. A Court may Substantively Consolidate the Assets and Liabilities of Separate Legal Entities under 11 U.S.C. § 105(a).

No provision exists within the Bankruptcy Code that expressly authorizes the remedy of substantive consolidation.[5] Substantive consolidation is an equitable remedy that is derived from the broad language of section 105(a) of the Bankruptcy Code.[6] Section 105(a) states that a court "may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [Title 11]."[7] Because the primary purpose of substantive consolidation is to ensure that all creditors are treated equitably, and because bankruptcy courts have general equitable powers, bankruptcy courts have the power under section 105(a) to enforce the remedy of

[5] *See In re* Owens Corning, 419 F.3d 195, 205 (3d Cir. 2005).
[6] *See* Huntington Nat'l Bank v. Richardson (*In re* Cyberco Holdings, Inc.), 734 F.3d 432, 439 (6th Cir. 2013).
[7] 11 U.S.C. § 105(a).

substantive consolidation if it would result in the equitable treatment of the creditors.[8] However, as explained in Part II of this memorandum, the courts' power under this section is limited.

Substantive consolidation is an equitable remedy that combines the assets and liabilities of separate legal entities so that the assets and liabilities are treated as though they belong to one single entity.[9] The remedy "treats separate legal entities as if they were merged into a single survivor left with all the cumulative assets and liabilities" previously held by each individual entity.[10] Accordingly, substantive consolidation allows for a debtor to satisfy its debts by utilizing the assets of an affiliated entity.[11]

Under certain circumstances, a court is permitted to substantively consolidate a debtor with an affiliated, nondebtor entity.[12] The United States Court of Appeals for the Ninth Circuit concluded that the substantive consolidation of a debtor with a nondebtor is proper where the affairs of a debtor are so entangled with a related nondebtor that consolidation of the entities would benefit all creditors.[13] Additionally, the United States Court of Appeals for the Second Circuit held that the substantive consolidation of a debtor with a nondebtor was proper where the entities demonstrated a "flagrant disregard" for the separate forms of the entities.[14] Because a debtor can be consolidated with a nondebtor, substantive consolidation can have the effect of involuntarily forcing a nondebtor entity into bankruptcy.

---

[8] *See* Alexander v. Compton (*In re* Bonham), 229 F.3d 750, 764 (9th Cir. 2000).
[9] *See id.* at 764; *see also In re* Owens Corning, 419 F.3d at 205.
[10] Genesis Health Ventures, Inc. v. Stapleton (*In re* Genesis Health Ventures, Inc.), 402 F.3d 416, 423 (3d Cir. 2005).
[11] *See In re* Continental Vending Machine Corp., 517 F.2d 997, 1000 (2d Cir. 1974); *see also In re* Archdiocese of St. Paul & Minneapolis, 888 F.3d at 951 (internal citation omitted).
[12] *See* Soviero v. Franklin, 328 F.2d 446, 449 (2d Cir. 1964); *see also* White v. Creditors Serv. Corp. (*In re* Creditors Serv. Corp.), 195 B.R. 680, 692 (Bankr. S.D. Ohio 1996).
[13] *See In re* Bonham, 229 F.3d at 766 (internal citation omitted).
[14] *See Soviero*, 328 F.2d at 448.

In *Bonham*, the debtor's estate was comprised of relatively no material assets, and her creditors filed aggregated claims for over $53 million.[15] Upon investigation, the trustee found that the debtor was operating a Ponzi scheme, and that two of her initial investors were merely vehicles used to perpetuate the scheme.[16] As a result, the trustee filed a motion for the substantive consolidation of the debtor's estate with two related, nondebtor investors' estates.[17] The Ninth Circuit held that substantively consolidating the debtor with the nondebtor entities was proper for two reasons: (1) the related nondebtor entities were merely instrumentalities of the debtor and had no separate existence of their own, and (2) because the debtor's affairs were "excessively entangled" with the related entities, substantively consolidating the entities would benefit all of the creditors.[18]

In *Soviero*, the sole directors and stockholders of the debtor corporation were also the sole directors and stockholders of thirteen "separate" corporations, each of which were engaged in the retail of the same products.[19] Although each affiliated corporation filed separate tax returns and maintained individual accounting records, the records were maintained by the same staff of bookkeepers that kept the bankrupt corporation's records, and the corporations were provided funds by the bankrupt corporation whenever necessary.[20] In that case, the Second Circuit concluded that the debtor expressed a "flagrant disregard" for the individual corporate forms of the affiliated entities.[21] Accordingly, the court held that the corporate identities of the affiliated

15 *In re* Bonham, 229 F.3d at 759.
16 *Id.* at 760.
17 *Id.*
18 *Id.* at 766.
19 *Soviero*, 328 F.2d at 447.
20 *Id.* at 447–448.
21 *Id*.

corporations were to be ignored so that all the creditors could receive "that equality of treatment which it is the purpose of the bankruptcy act to afford."[22]

II. A Non-Profit, Nondebtor Entity may not be Substantively Consolidated with an Affiliated Debtor.

Before a court can decide whether to substantively consolidate a debtor with a nondebtor, it must first ensure that it has jurisdiction over the nondebtor.[23] Despite the broad, general powers of section 105(a), a bankruptcy court is not permitted to "override explicit mandates of other sections of the Bankruptcy Code."[24] Thus, if the substantive consolidation of two entities would result in a violation of a provision of the Bankruptcy Code, a court would be prohibited from granting the remedy.

A. Section 303(a) Prohibits a Non-Profit From Being Involuntarily Forced Into Bankruptcy

Section 303 of the Bankruptcy Code permits creditors to file an involuntary chapter 7 or chapter 11 bankruptcy petition against a debtor.[25] The remedy provides a way for creditors to seek protection from a debtor that is not paying its debts as they become due, and to force the debtor to stop wasting its assets.[26] By placing the debtor into bankruptcy, creditors are able to "avoid impairment of potential assets that could satisfy the debts [owed] to the creditors."[27] Although the remedy provides a powerful way for creditors to ensure they are treated equitably, section 303(a) contains express limitations on who a petition may be filed against. Section 303(a) explicitly prohibits an involuntary petition from being filed against a corporation that is "not a

[22] *Id.* at 448–449 (internal quotations omitted).
[23] *See In re* Archdiocese of St. Paul & Minneapolis, 888 F.3d at 952.
[24] *Id.* (citing Law v. Siegel, 571 U.S. 415 (2014)).
[25] *See generally* 11 U.S.C. § 303; *see also In re* Stroop, 47 B.R. 986, 989 (Bankr. D. Colo. 1985).
[26] *See In re* Murrin, 461 B.R. 763, 777 (Bankr. D. Minn. 2012); *see also In re* All Media Properties, Inc., 5 B.R. 126, 134 (Bankr. S.D. Tex. 1980).
[27] *In re* Stroop, 47 B.R. at 989.

moneyed" corporation.[28] A debtor is not "moneyed" if it was incorporated as a non-profit organization under state law.[29] Thus, if a corporation is classified as non-profit under state law, it may not be involuntarily forced in bankruptcy.

In *In re United Kitchen Associates*, fifteen creditors of a debtor corporation, who were collectively owed more than $19,000, filed a petition to place the debtor into involuntary bankruptcy.[30] Despite the fact that the debtor was incorporated as a non-profit under state law, the petitioners argued that the corporation should not be classified as non-profit for purposes of section 303(a) because the corporation had not filed an exemption number for status as a non-profit corporation with the Internal Revenue Service (the "IRS").[31] The Western District of Louisiana Bankruptcy Court held that because the debtor was classified as a non-profit organization under state law, and because its failure to file for an exemption number with the IRS did not change its status as a non-profit organization under state law, the debtor could not be involuntarily forced into bankruptcy under section 303(a).[32] Therefore, so long as a corporation does not either engage or fail to engage in activity that would alter its non-profit status under state law, the corporation may not be involuntarily forced into bankruptcy.

B. Substantively Consolidating a Debtor With a Non-Profit, Nondebtor Entity Would Involuntarily Force a Non-Profit into Bankruptcy

A debtor may not be substantively consolidated with a non-profit nondebtor. Substantive consolidation combines the assets and liabilities of the entities involved so that the entities are consolidated into a single entity whose combined assets are used to repay creditors.[33] Accordingly, in a case where a debtor is consolidated with a nondebtor, the nondebtor effectually

---

[28] *See* 11 U.S.C. 303(a).
[29] *See In re* United Kitchen Associates, 33 B.R. 214, 216–217 (Bankr. W.D. La. 1983).
[30] *Id.* at 215.
[31] *Id.*
[32] *Id.* at 216–217.
[33] *See In re* Genesis Health Ventures, Inc., 402 F.3d at 423.

becomes a debtor subject to a bankruptcy case, and its assets are used to repay creditors. Because section 303(a) explicitly prohibits a bona fide, non-profit corporation from being subject to an involuntary bankruptcy proceeding, and because substantive consolidation necessarily pulls a nondebtor into bankruptcy involuntarily, it follows that substantively consolidating a non-profit with a debtor would result in a clear violation of the provision.

In *In re Archdiocese of Saint Paul & Minneapolis*, the debtor was a religious organization that maintained substantial control over, and whose assets were primarily held by, a group comprised of over 200 affiliated, non-profit, nondebtor entities.[34] Collectively, the affiliated non-profit entities' net assets were valued at approximately $1.7 billion.[35] There, the debtor's creditors moved to substantively consolidate the debtor with its affiliated entities, arguing that because the debtor had direct control and supervision over all the material aspects of the affiliated entities, the assets of the entities should be treated as the assets of the debtor.[36] In that case, the Court of Appeals for the Eighth Circuit concluded that substantively consolidating the debtor with the non-profit entities would have the effect of pulling the non-profit entities into involuntary bankruptcy, and would cause the court to contravene section 303(a).[37] Accordingly, the Eighth Circuit held that the debtor could not be substantively consolidated with the affiliated entities.[38] In addition, the Eighth Circuit noted that the creditors' argument could theoretically apply to any non-profit organization incorporated under the laws of the state; thus, if the Court recognized the argument as valid, it would "effectively nullify the protections of section 303(a)."[39]

---

[34] *Id*. at 948–950.
[35] *See* Brian Roewe, *Archdiocese, Creditors Clash Over Bankruptcy Assets*, NATIONAL CATHOLIC REPORTER (May 27, 2016), https://www ncronline.org/news/accountability/archdiocese-creditors-clash-over-bankruptcy-assets.
[36] *In re* Archdiocese of St. Paul & Minneapolis, 888 F.3d at 948.
[37] *Id.* at 953.
[38] *Id.*
[39] *Id.*

Conclusion

If an entity is classified as a non-profit organization under state law, the entity may not be involuntarily forced into bankruptcy under section 303(a). Thus, a bona fide non-profit, nondebtor entity cannot be substantively consolidated with a debtor, regardless of their affiliation with each other.