Remedying Scandal: Pooling the Assets of Catholic Entities to Pay Off Tort Creditors through Substantive Consolidation in a Bankruptcy Proceeding*

SETTING THE STAGE

Over the last dozen years, twelve Catholic dioceses and archdioceses have filed for bankruptcy protection.[1] These filing have largely been the result of numerous tort claims and subsequent judgments relating to clergy sex abuse scandals. In all of these cases, the Catholic entities, usually in the form of an archdiocese or diocese, filed for bankruptcy under Chapter 11, a chapter of the Bankruptcy Code that gives debtors the ability to manage their respective organizations and financial affairs during their bankruptcy proceedings.[2] A common theme throughout all these cases is what assets and real property of the dioceses should become part of the bankruptcy estate.[3] Specifically, are the assets and real property of the various parishes, schools, hospitals, and cemeteries organized under the umbrella organization of the dioceses and archdioceses also property of the estate in the debtor diocese's bankruptcy case?

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[1] *See In re Archdiocese of Saint Paul and Minneapolis*; *In re Diocese of Gallup*, New Mexico; *In re Diocese of Helena*; *In re Diocese of Duluth*; *In re Archdiocese of Milwaukee*; *In re Catholic Diocese of Wilmington Inc*; *In re Roman Catholic Bishop of San Diego*; *In re Catholic Bishop of N. Alaska*; *In re Diocese of Davenport*; *In re Catholic Bishop of Spokane*; *In re Roman Catholic Church of the Diocese of Tucson*; *In re Roman Catholic Archbishop of Portland in Ore.*

[2] Chapter 11 and 13 are reorganization proceedings, whereas Chapter 7 is a liquidation proceeding.

[3] Roland F. Chase, DETERMINATION OF PROPERTY RIGHTS BETWEEN LOCAL CHURCH AND PARENT CHURCH BODY: MODERN VIEW, 52 A.L.R. 3d 324.

ROAD MAP

In the context of catholic dioceses and archdioceses filing for bankruptcy to shield themselves from the collection efforts of their creditors, what assets should be included in that religious organization's bankruptcy estate in order to maximize the sum available to creditors? This note will principally argue that the parameters of a religious organization's bankruptcy estate can extend beyond the diocese's central organization and reach into local parishes and other church associations that fall under the control of the overarching diocese.

Part I of this note discusses what constitutes property of the estate in a church bankruptcy and looks at how Catholic archdioceses and dioceses are incorporated under state law as well as the level of control that these dioceses, as a central governing authority, exert over their respective parishes and other organizations. Part II looks at how these many smaller organizations including churches, schools, and hospitals have begun to incorporate as separate religious corporations in an effort to fend off creditors' attempts to collect the debts incurred by the umbrella diocese organization. Part III takes account of these local parishes becoming separate legal entities from their diocese and then argues that because in many cases a diocese still retains a substantial amount of control over these smaller local entities, the doctrine of substantive consolidation can be used to combine the bankruptcy estate of the debtor diocese with that of a non-debtor parish that has been separately incorporated. Specifically, I will argue that the equitable powers granted to bankruptcy courts, pursuant to section 105 of the Bankruptcy Code,

allow for the substantive consolidation of two or more interrelated and hierarchical religious entities. Part IV argues that § 303(a) of the bankruptcy code, which states that non-moneyed businesses are immune from involuntary bankruptcy proceedings, should not prevent the equitable remedy of substantive consolidation from being used to combine the assets of the diocese umbrella organization with its local parish corporations.[4] Finally, Part V details the factual circumstances that would need to be present for a bankruptcy court to order the substantive consolidation of two separate legal entities.

Ultimately, this note will conclude that in certain instances a bankruptcy court may employ the remedy of substantive consolidation to reach beyond the legal boundaries of the diocese umbrella organization in order to combine the assets of legally distinct parish corporations with the assets of the debtor diocese, thereby enabling creditors to be paid more on their claims.

I. INTRODUCTION: WHAT IS PROPERTY OF THE ESTATE IN A CHURCH BANKRUPTCY?

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[4] Section 303 specifically protects three types of persons from involuntary bankruptcy (a) a farmer, (b) a family farmer, and (c) "a corporation that is not a moneyed, business, or commercial corporation." In order to be considered under the third exception, the mere status of being a non-profit organization may not be enough. *See In re The Centre for Management and Technology, Inc.*, 2007 Bankr. LEXIS 3734 (Bankr. D. Md. Oct. 26, 2007) (holding a corporation must show that it is both "(i) an eleemosynary organization under state law, and (ii) actually conducts itself as an eleemosynary organization.").

Before one can judge whether or not to consolidate the estates of two debtors or a debtor and a non-debtor, there must be a discussion into what exactly constitutes property of the estate. In bankruptcy, property of the estate is a term that is used to refer to the estate created immediately after an individual or entity files for bankruptcy.[5] The assets or property that make up this estate become the assets used to pay off creditors. Property of the estate is defined in the Bankruptcy Code pursuant to section 541(a).[6] This section provides in part that property of the estate consists of, among other things, all legal and equitable interests of the debtor in property as of the commencement of the case, including certain interests of the debtor in communal property, and any interest in property that the bankruptcy trustee can recover under certain provisions of the Bankruptcy Code.[7]

The parameters of the property within the bankruptcy estate are extremely significant as it is the source of all the funds that go towards paying back creditors.[8] Whenever property is deemed "property of the estate" it is also protected by the

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[5] 11 U.S.C. § 541

[6] *Id.*

[7] Ira Herman, *Understanding 'Property Of The Estate'* - Law360- The Newswire for Business Lawyers (2015), https://www.law360.com/articles/648239/understanding-property-of-the-estate (last visited Jan 5, 2017). The bankruptcy trustee, no matter what chapter is filed, has the power to void the debtor's property transfers that were preferential or the result of fraud. *See* 11 U.S.C. §§ 547, 548. For instance, when a debtor transfers his house to another person for one dollar in an attempt to avoid it becoming part of the bankruptcy estate and ultimately sold to pay off his creditors.

[8] *Id.*

automatic stay.[9] The main argument of this note is that property owned by an individual parish corporation in many situations can also be regarded as the property of the overarching diocese corporation and, because of this, when a diocese files for bankruptcy protection the assets of both organizations should go towards paying off creditors.

The first issue that must be looked at to determine the parameters of an archdiocese or diocese's bankruptcy estate is how it is incorporated. Principally, a diocese will be incorporated as either a corporation sole or a corporation aggregate. In a corporation sole, a legal entity is created consisting of a single (sole) natural person that controls all operations and processes of that entity.[10] In the case of the Catholic Church, this person is either the bishop or archbishop since he is the head of the diocese or archdiocese.[11] Corporation soles are a creation of state incorporation law and differ from state to state.[12] Many current state statutes also incorporate church law in the statute authorizing the corporation sole.[13] In other words, these state statutes allow the bylaws of a corporation to be tailored to fit the powers that a bishop has through internal church doctrine and policies. For example, the Washington state law that the diocese of Spokane was incorporated

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[9] *See* 11 U.S.C. § 362. The automatic stay's principle function is to freeze any collection actions or efforts on the part of creditors to collect on the debts owed by the person or entity filing for bankruptcy. This gives the debtor breathing space to get his financial affairs in order in an effort to pay off creditors through an orderly proceeding supervised by the bankruptcy court.

[10] Melanie DiPietro, THE RELEVANCE OF CANON LAW IN A BANKRUPTCY PROCEEDING, 29 Seton Hall Legis. J. 399, 404.

[11] *Id.*

[12] *Id.*

[13] *Id.* at 403.

under provides in pertinent part, "[a]ny person, being the bishop, overseer, or presiding elder of any church or religious denomination in this state, may, in conformity with the constitution, canons, rules, regulations, or discipline of such church or denomination, become a corporation sole . . . ."[14]

In the context of the Catholic Church, the law that applies to all persons and entities associated with the church is called "canon law".[15] Specifically, the 1983 Code of Canon Law lays out the various powers and responsibilities of bishops and priests.[16] As both the only member of the corporation sole and the head of the diocese under Canon Law, there is no doubt that the archbishop or bishop exerts substantial control over the affairs of the diocese. This hierarchical governing structure also ensures that the bishop or archbishop almost always has final authority over almost all diocese affairs.

At first glance, it seems that the property held by individual parishes would be an exception to this rule since canon law also states that parishes are their own juridic persons that can own property in their own right.[17] Based on this canon, it

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[14] Wash. Rev. Code Ann. § 24.12.010 (LexisNexis, Lexis Advance through 2017 2nd Special Session). Each of the four diocesan Chapter 11 cases that were filed in the 9th Circuit (Diocese of Tucson, Diocese of Spokane, Diocese of San Diego and Archdiocese of Portland) were incorporated as corporation soles. Susan Boswell, THE CHURCH IN CHAPTE R 11: THE LESSONS OF THE C ATHOLIC DICOESE CASE S BISHOP ACCOUNTABILITY (2008), http://www.bishopaccountability.org/bankruptcy/general/2008_05_28_ABI_The_Church.pdf (last visited Oct 23, 2016).

[15] *Id.*

[16] *Id.*

[17] Canon 1256, Canon 1256 states that the intent of the Catholic Church, regarding all its entities, is to have parishes and schools maintain separate juridic existences. THE CODE OF CANON LAW*, 1983.*

seems clear that parishes should be able to exert control over their own property, however parishes' control over buying, selling, and even disposing of church property is significantly limited by other canon law provisions.[18] For instance, the sale or long-term lease of parish property requires the approval of the bishop if over a certain monetary threshold.[19] Therefore, while canon law does prescribe some autonomy for priests and other officials to operate their individual parishes, the central diocese retains ultimate control over any property with significant value.

With this in mind, the practices of canon law regarding parish property are instructive when determining if property physically located in a parish church or school should be included as part of the debtor diocese's bankruptcy estate. However, while the control a diocese exerts over parish property is an important factor when determining if two or more corporations with separate legal existences should be treated as effectively one in the same, an inquiry into the control exerted over real and personal property is largely unnecessary when a diocese is

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http://www.holyrosaryprovince.org/2011/media/essencial/code_of_canon_law_1983.pdf. It should also be noted, "being a separate juridic person under canon law does not give that juridic person a civil law identity." *Tort Claimants Comm. v. Roman Catholic Archbishop (In re Roman Catholic Archbishop)*, 335 B.R. 842, 865-66 (Bankr. D. Or. 2005).

[18] See Canons 1281, 1292 THE CODE OF CANON LAW*, 1983.* http://www.holyrosaryprovince.org/2011/media/essencial/code_of_canon_law_1983.pdf

[19] Currently $250,000. Diocese of Covington Policies and Procedures Manual: Sale and Long-term Lease of Property. http://www.covdio.org/wp-content/uploads/2014/12/Sale-or-Long-Term-Lease-of-Property.pdf; Parish Property Ownership in the Catholic Church, PERSONAL ORDINARIATE OF THE CHAIR OF ST. PETER (2012), http://ordinariate.net/parish-property-ownership (last visited Mar 5, 2017).

incorporated as a corporation sole. Consequently, its individual parishes do not have the additional legal protections that come with being a separate legal entity. In such circumstances, using substantive consolidation to combine the assets of a debtor diocese with non-debtor parishes is redundant because all property within the diocese umbrella corporation is effectively already the property of the debtor and therefore the bankruptcy estate, even if it was purchased by or is in the physical possession of an individual parish..

However, even dioceses' incorporated as corporation soles still argue that the assets contained in their parishes should be free from the reach of dioceses' creditors because, despite many dioceses exerting control over much of the property, that property is held by the dioceses for the benefit of their parishes in an express or resulting trust.[20] Some churches have asserted that the corporation sole itself also creates an express trust.[21] This has led church officials in past bankruptcy proceedings, such as the Dioceses of Spokane and Portland,[22] to argue that the

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[20] "A resulting trust, as distinguished from an express trust, is one implied by law from the acts and conduct of the parties and the facts and circumstances which at the time exist and attend the transaction out of which it arises." *Little v. Mettee*, 338 Mo. 1223, 1240, 93 S.W.2d 1000, 1009-10 (1936).

[21] Felicia Anne Nadborny, "LEAP OF FAITH" INTO BANKRUPTCY: AN EXAMINATION OF THE ISSUES SURROUNDING THE VALUATION OF A CATHOLIC DIOCESE'S BANKRUPTCY ESTATE, 13 Am. Bankr. Inst. L. Rev. 839, 852.

[22] In its holding, the Bankruptcy court in the Portland Archdiocese case held, "there is no authority. . . that would allow a division of a corporation or a unit or part of a legal entity to be a beneficiary of a trust. It is one thing to hold that an independent unincorporated association has the capacity to be the beneficiary of a trust. It is quite another to hold that a corporation can hold property in trust for a unit or part of itself."
Tort Claimants Comm. v. Roman Catholic Archbishop (In re Roman Catholic Archbishop), 335 B.R. 842, 867 (Bankr. D. Or. 2005).

restrictiveness of state corporation sole statues, which give the diocese legal title to all parish property, is contrary to church practices under canon law.[23] Because of this, the Church asserts that in reality dioceses do not hold or exert title over parish property, but instead only hold it in trust for the benefit of individual parishes, which canon law recognizes as their own separate entities.[24]

This argument was meant to keep these assets and funds out of dioceses' bankruptcy estates. This is because § 541(a)(1) of the Bankruptcy Code states that all legal or equitable interests of the debtor in property, as of the commencement of the case, are property of the bankruptcy estate.[25] Congress intended this definition to be interpreted broadly as it is vital to include all of a debtor's property in the estate.[26] However, the Code allows an exception to this rule when the debtor holds "bare legal title," but no equitable interest.[27] Consequently, this exception would be implicated when the debtor was merely a trustee or another party who was the beneficiary of the trust. In the Diocese of Spokane bankruptcy, the bankruptcy court did not find this argument persuasive. Instead, the court found that even though the Washington corporation sole statute did allow for the creation of an express

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[23] Stephen M. Bainbridge, FOR ALL THE SAINTS: HOW THE LIVES OF EXTRAORDINARY CATHOLICS CAN SHED LIGHT ON THE ORDINARY PRACTICE OF LAW: THE BISHOP'S ALTER EGO: ENTERPRISE LIABILITY AND THE CATHOLIC PRIEST SEX ABUSE SCANDAL, 46 J. Cath. Leg. Stud. 65, 91-92.
[24] Jennifer L. Ryan, THE DELICATE BALANCE BETWEEN RELIGIOUS FREEDOMS AND LEGAL ACCOUNTABILITY IN AN INCREASINGLY LITIGIOUS SOCIETY, 24 St. John's J.L. Comm. 243.
[25] 11 U.S.C.S. § 541.
[26] *Comm. of Tort Litigants v. Catholic Diocese of Spokane (In re Catholic Bishop of Spokane)*, 329 B.R. 304, 321 (Bankr. E.D. Wash. 2005), rev'd on other grounds, 364 B.R. 81 (Bankr. E.D. Wash. 2006).
[27] *Id.*; 11 U.S.C § 541(d).

trust, and that an express trust had indeed been created, the Diocese named itself as the beneficiary.[28] This meant that the Diocese was both the trustee and the beneficiary and that all property used by the parishes was still the property of the debtor Diocese.

Additionally, and perhaps more importantly, the court in the Spokane bankruptcy, much like the bankruptcy court in the Archdiocese of Portland case, held that a corporation could not devise property it held in trust to a segmented portion of the same legal entity.[29] In other words, because the catholic parishes in that case were not separately incorporated as their own entity, there was no discernable local parish entity that the Diocese could devise as a beneficiary of the trust. Instead, the bankruptcy court in the Spokane case treated the Diocese as a singular legal entity with the individual parishes not having their own separate legal existence.[30] In sum, the Spokane Diocese's argument that parish property should not be included as property of the bankruptcy estate because all parish assets were held in trust was rejected with the court noting that "[t]he debtor has all equitable and beneficial interest in the real property."[31]

Furthermore, many churches in bankruptcy have argued that canon law should apply to all disputes that involve a church entity, instead of the state incorporation law that the diocese was formed under.[32] While churches have a

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[28] *Catholic Diocese of Spokane*, 364 B.R. 81, 90 (E.D. Wash. 2006).
[29] *Id.*
[30] *Id.* at 91.
[31] *Id.* at 95.
[32] DiPietro *supra* note 12 at 406.

constitutional right to organize and govern themselves according to their own internal law,[33] this argument has been expressly rejected by several courts, which have found that courts should only defer to internal church doctrine when the two entities involved are both of the same religious organization.[34] A church is not exempt from the civil laws of states and the federal government merely because it is an institution that professes religious doctrine.

In sum, despite the degree of autonomy that local parishes and their priests are afforded through canon law, bankruptcy courts have predominantly looked to the legal structure of a diocese to determine whether parish assets should be included in the diocese's bankruptcy estate.[35] This means that a diocese incorporated as a corporation sole is extremely vulnerable to tort claimants that seek to aggregate enough local parish assets in an effort to collect on the full amount of their judgment. In the context of a bankruptcy proceeding, this structure also leaves a diocese extremely vulnerable to the collection efforts of creditors at the

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[33] Generally, civil courts must defer to the decisions of church authorities in intra-church matters, it is a constitutional error to do otherwise. *Serbian E. Orthodox Diocese v. Milivojevich*, 426 U.S. 696, 718-20 (1976). *See also Watson v. Jones*, 80 U.S. (13 Wall.) 679 (1872) (noting that in disputes between church agencies civil courts may not substitute their judgments for those of church authorities in a hierarchical religious institution); *Kedroff v. St. Nicholas Church*, 344 U.S. 94, 116 (1952).

[34] Without interpreting the Code of Canon Law, a court may take judicial notice of its provisions. USCS Fed. Rules Evid. R. 201. Although the parishes may be separate entities under canon law, they are not individual entities under state law, which governs disputes outside of the church. *EEOC v. St. Francis Xavier Parochial Sch.*, 77 F. Supp. 2d 71 (D.D.C. 1999).

[35] However, courts have looked to canon law when attempting to make a determination of a party's intent when purchasing real property, constructing churches and making improvements on real property. *Catholic Diocese of Spokane*, 364 B.R. 81, 94 (E.D. Wash. 2006).

outset because the diocese is the only legal entity from which the newly created bankruptcy estate draws its assets. Therefore, if no other reason exists to exclude the assets of local religious associations (including catholic schools, cemeteries, and hospitals) from the bankruptcy estate, the assets of these organizations can be used to satisfy the claims of the diocese umbrella organization. This is true even if the local organization had no part in incurring the underlying debt, whether that debt stems from a bank loan or a sexual abuse judgment.

In recent years, some dioceses have begun to amend their articles of incorporation to create express trusts with local parishes being the beneficiary.[36] This provides parishes with some protection in the event that the diocese the parish falls within is forced to file bankruptcy due to unsustainable debt. However, only some state's religious incorporation laws allow for this type of express trust to be setup by a religious entity.

Dioceses in states whose incorporation laws do not provide for setting up trusts have instead largely begun to incorporate each individual parish, school, or other church organization.[37] This means that the diocese itself as well as each

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[36] "Articles of incorporation statutes often do not contain express statements of trust for specific beneficiaries, rather relying on vague and ambiguous references to Canon Law or verbatim repetitions of state statutes that allow for incorporation of religious offices." Susan Boswell, THE CHURCH IN CHAPTER 11: THE LESSONS OF THE CATHOLIC DIOCESE CASES at 13, http://www.bishop-accountability.org/bankruptcy/general/2008_05_28_ABI_The_Church.pdf.

[37] John Stucke, *Parishes, diocese to formalize relationship* SPOKESMAN.COM (2009), http://www.spokesman.com/stories/2007/apr/21/parishes-diocese-formalize-relationship/ (last visited Jan 5, 2017).

individual parish, school, hospital, and cemetery within a diocese will be separately incorporated as its own legal entity.[38]

However, even with this separate and new legal identity, the rules governing these nonprofit parish corporations are still derived by canon law, which means bishops still largely retain control over their parishes. In other words, separately incorporating each parish does little but set up a collection of shell corporations, whose own autonomy is significantly limited.[39]

While separately incorporating each parish or creating an express trust for the benefit of individual parishes serves as the first line of defense against any attempt by unsecured creditors to bring the assets of these parishes into the larger bankruptcy estate of the diocese, these measures do not guard against the equitable remedy of substantive consolidation. Therefore, if certain conditions are met, this remedy is able to obliterate all separate corporate forms no matter how many layers of incorporation have been established. Furthermore, in some cases this remedy may not even be necessary if parish assets have been given to the diocese for safekeeping and have subsequently been intermingled with the diocese's own funds or the funds of other parish entities. The following sections will deal with both of these situations.

II. COMBINING BANKRUPTCY ESTATES WITHOUT EQUITABLE REMEDIES

[38] Joseph A. Rohner IV, CATHOLIC DIOCESE SEXUAL ABUSE SUITS, BANKRUPTCY, AND PROPERTY OF THE BANKRUPTCY ESTATE: IS THE "POT OF GOLD" REALLY EMPTY?, 84 Or. L. Rev. 1181, 1211.

[39] Stucke, *supra* note 37. Noting that it is the bishop who appoints priests, expects their obedience, and thus controls the parishes.

When the assets of individual parishes are commingled to such an extent that they become untraceable to their original source, a bankruptcy court may elect to include all these assets in the debtor's bankruptcy estate, despite each parish being its own legal entity.[40] This was the case in the Diocese of Wilmington's bankruptcy case where the unsecured creditors' committee brought an adversary proceeding seeking declaratory judgment that the Diocese's pooled investment fund, which included the investment funds of its parish corporations as well as charitable and educational organizations such as schools and group homes, was part of the debtor Diocese's bankruptcy estate.[41] The Diocese operated this account on behalf of itself as well as the other organizations, however its name was the only one on the account.[42] The purpose of this fund was for the various organizations to pool their investment capital to maximize investment opportunities and minimize transaction fees.[43] As of the date of the petition, the value of the pooled investment fund was approximately $120 million.[44] The Diocese did not require the other organizations to participate in the fund.[45] Additionally, these non-debtor organizations also had the

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[40] *Official Comm. of Unsecured Creditors v. Catholic Diocese of Wilmington, Inc. (In re Catholic Diocese of Wilmington, Inc.)*, 432 B.R. 135, 162 (Bankr. D. Del. 2010).
[41] *Id.* at 141. The debtor was actually the secular, administrative arm of the Diocese. Therefore, it is likely the debtor did not assert a first amendment free exercise claim for this reason.
[42] *Id.* at 147.
[43] *Id.* at 142.
[44] *Id.*
[45] *Id.*

option to withdraw their own funds at will, subject only to the approval of the board of trustees of their respective corporations.[46]

The pooled investment account worked by the non-debtor investor transferring its funds to the debtor Diocese.[47] The Diocese would then make an accounting entry, whereby it reduced its balance in a sub-fund[48] in the account ledger by the amount of the investor's transfer and then increased the investor's balance on the ledger by the same amount.[49] This means that the non-debtor entities never had their own account that they could maintain and control without the help of the Diocese.[50] In an effort to defend itself against this large financial vulnerability, which the unsecured creditors committee argued made all investment funds the property of the debtor, the Diocese contended that the funds were held by the Diocese as trustee for the benefit of its parishes and other organizations in a resulting trust.[51] This argument was made due to an exception in the Bankruptcy Code's provision regarding property of the estate.[52] Specifically, § 541(d) states that property of the estate does not include "property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest."[53] Thus, if a valid trust existed the beneficiary parishes would have an equitable interest in

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[46] *Id.*
[47] *Id.* at 143-44.
[48] *Id.* at 144. These sub-funds were not actual bank accounts, but merely accounting entries that were earmarked to provide the balance of each entity's investments.
[49] *Id.*
[50] *Id.*
[51] *Id.* at 147-48.
[52] *Id.*

[53] 11 U.S.C. § 541(d).

the trust property, while legal title would be vested in the Diocese as trustee.[54] Further, if these funds were indeed held in trust they would be need to traceable back to their source in order to be excluded from property of the estate pursuant to § 541(d).[55]

A resulting trust, unlike an express trust, arises based on equity and is not expressly agreed upon by the parties. Specifically, a resulting trust is defined as one that is created where a person or entity makes "a disposition of property under circumstances which raise an inference that he [or it] does not intend that the person taking or holding the property should have the beneficial therein, unless the inference is rebutted or the beneficial interest is otherwise effectively disposed of."[56] Based on this definition, the bankruptcy court held that a resulting trust did exist between the debtor and non-debtor entities since all the parties had intended for those funds to remain the property of the investors and those investors could withdraw their funds at any time.[57] However, even though such a trust did exist, if the funds were commingled and subsequently became untraceable back to their original investors, the protections of the trust would be ineffective and therefore all funds in the investment account would become property of the debtor's estate.[58] The

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[54] *In re Catholic Diocese of Wilmington, Inc.*, 432 B.R. at 147.
[55] *Id.*
[56] *Id.* at 149.
[57] *Id.*
[58] An alternative to the intermediate balance test is the "nexus" test where, as the court in *Begier v. IRS* held, "a trust is created for the benefit of the taxing authority whenever an employer withholds a portion of an employee's wages as income taxes. Thus, in the city's view, taxes withheld from an employee but not paid to the city do not become "property of the estate" when the employer files for bankruptcy even if

court, applying Delaware law and the intermediate balance test,[59] found exactly this, ruling that the specific funds that the non-debtor entities had invested in the pooled investment account were clearly commingled into one account and then became untraceable through various withdrawals and deposits by the Diocese itself.[60] Further, while this decision clearly caused harm to the individual parishes by allowing their investment funds to go towards paying off creditors in the Diocese's bankruptcy, it should be noted that this decision also allowed the non-debtor entities to have a claim against the Diocese for the loss of their investment funds. [61] Of course, allowing such a claim only partially accounts for the non-debtor investors' lost funds since, pursuant to traditional bankruptcy law, unsecured

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the employer had not segregated the "trust" funds from its other assets." *City of Farrell v. Sharon Steel Corp*., 41 F.3d 92, 93-94 (3d Cir. 1994).

[59] In cases where the trust property has been commingled, courts resolve the issue with reference to the so-called "lowest intermediate balance" rule, which is grounded in the fiction that, when faced with the need to withdraw funds from a commingled account, the trustee withdraws non-trust funds first, thus maintaining as much of the trust's funds as possible. Hence, pursuant to the lowest intermediate balance rule, if the amount on deposit in the commingled fund has at all times equaled or exceeded the amount of the trust, the trust's funds will be returned in their full amount. Conversely, if the commingled fund has been depleted entirely, the trust is considered lost. Finally, if the commingled fund has been reduced "below the level of the trust fund but not depleted, the claimant is entitled to the lowest intermediate balance in the account." In no case is the trust permitted to be replenished by deposits made subsequent to the lowest intermediate balance.
In re Catholic Diocese of Wilmington, Inc., 432 B.R. at 151.

[60] The court in this case, placed the burden of proving that the investment funds were held in a resulting trust and not commingled and irretraceable on the Diocese as the debtor.
Id. at 147.

[61] *Id.* at 161-62.

claims are paid out pro-rata, this means it was a near certainty that the parishes and other organizations would not be fully paid back on their lost investments.[62]

In sum, this case demonstrates that even when there is a trust account held by a debtor diocese for the benefit of its parishes, whether created expressly or through equity, this account is not on its face immune from becoming part of the debtor's bankruptcy estate. In this vein, the commingling of funds should be viewed as a major vulnerability for dioceses when a committee of creditors seeks to combine the assets of both debtor and non-debtor entities in an effort to collect as much as possible on its claims. Furthermore, assets that have become commingled and untraceable serve as an important factor when considering the substantive consolidation of a debtor diocese's bankruptcy estate with that of an affiliated non-debtor entity.

III. BACKGROUND AND ELEMENTS OF SUBSTANTIVE CONSOLIDATION

A bankruptcy court's power to substantively consolidate is not specifically enumerated within any provision of the Bankruptcy Code.[63] Instead, it is derived from the general equitable powers given to bankruptcy judges through § 105 of the

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[62] In bankruptcy, when the debtor is unable to pay back general unsecured creditors in full, these creditors generally must accept a *pro rata share* of the debt that is owed to them. These happens by totaling the remaining funds left in the bankruptcy estate after higher priority claims have been paid, and distributing the total pool of remaining funds proportionately among creditors, according to the amount of each creditor's claims.
Id. at 161.

[63] *Eastgroup Props. v. S. Motel Assocs., Ltd.*, 935 F.2d 245, 248 (11th Cir. 1991).

Code. The purpose of substantive consolidation is to ensure the equitable treatment of all creditors.[64] While § 105(a) does not permit a bankruptcy court to override or conflict with the explicit mandates of other code provisions, it does give judges the authority to carry out the express provisions of the Code as well as the ability to clarify whether a certain mandate should apply to a debtor on a case by case basis.[65] This limitation of § 105 is "simply an application of the axiom that a statute's general permission to take actions of a certain type must yield to a specific prohibition found elsewhere."[66] In essence, any equitable power of the bankruptcy courts derived from § 105 "can only be exercised within the confines of the Bankruptcy Code."[67]

When a party moves for substantive consolidation, he is requesting that the court consolidate both the assets and liabilities of two or more separately formed legal entities. In the corporate world, this usually happens when the assets and liabilities of subsidiaries are combined with their parent entity.[68] In a typical

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[64] *Id. at* 248.
[65] *Siegel*, 134 S. Ct. at 1194.
[66] *Id.*
[67] *Id.*
[68] In a Chapter 11 proceeding, as is the case in all of the Catholic Church's recent bankruptcy filings, the committee of unsecured creditors must seek standing to bring a motion for substantive consolidation since the ability to bring such a motion is traditionally reserved for the debtor as a debt in possession, which in this case would be the diocese. In 2003, the Third Circuit in Official Committee of Unsecured Creditors of *Cybergenics v. Chinery* held that bankruptcy courts, as courts of equity, have the authority to grant a creditors' committee derivative standing to bring an adversary proceeding in order to recover property for the benefit of the bankruptcy estate. With this ruling, the court found that allowing a derivative suit by a creditors' committee serves as a deterrent for the debtor in possession who is unwillingly to pursue its own avoidance actions against individuals or other related

Chapter 7 bankruptcy proceeding, the assets of each separate entity are put into a single pool, which constitutes the property of the estate for the debtor. In a Chapter 11 case, as is the case with most church bankruptcies, this basic principle is the same, however the added complexity of a Chapter 11 reorganization also means that class voting, classification of claims, and "cramdowns" are all also resolved using the combined asset pool.[69] Additionally in a Chapter 11, substantive consolidation disregards the liabilities shared between or among the multiple consolidated entities.[70]

Courts have stated that substantive consolidation should be used sparingly as an equitable remedy.[71] This is because the consolidated entities could have different debt-to-asset ratios and consolidation almost always redistributes wealth among the creditors of the various entities.[72] In other words, substantive consolidation can in effect shuffle the order in which the debts for all the related entities get paid off.[73] In light of these potential pitfalls, courts have indicated that substantive consolidation should be "used sparingly."[74] However, it seems that there

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entities. *See In re Cybergenics Corp.*, 226 F.3d 237 (3d Cir. 2000). This ruling has since been applied to bankruptcy courts, allowing them to confer standing on individual creditors and creditors' committees. *See In re Optim Energy, LLC*, No. 14-10262 (BLS), 2014 Bankr. LEXIS 2155, at *18 (U.S. Bankr. D. Del. May 13, 2014).

[69] Andrew Brasher, SUBSTANTIVE CONSOLIDATION: A CRITICAL EXAMINATION, 3 (2006).

[70] *Eastgroup Props.*, 935 F.2d at 248.

[71] *Id.*

[72] *Id.*

[73] *Id.*

[74] *Id.*

has been a trend in bankruptcy courts towards allowing substantive consolidation.[75] This may be the result of the increased use of corporate subsidiaries that operate under a parent entity's corporate umbrella in order to protect its assets from lawsuits by maximizing the separateness and limited liability of each related entity.[76]

A. THE ELEMENTS OF SUBSTANTIVE CONSOLIDATION

Historically, circuit courts have recognized three major tests when deciding whether or not to order substantive consolidation. The first test was the *Auto-Train* test first articulated by the D.C. Circuit. This test was then slightly altered by the Second Circuit in *In re Augie/Restivo Baking Co.*, resulting in that court effectively making its own standard. Finally, the Third Circuit in *In re Owens Corning* most recently enumerated a number of "principles" that must be considered before substantive consolidation can be ordered.

In the *Auto-Train* case, the court stated the broad rule, "Before ordering consolidation, a court must conduct a searching inquiry to ensure that consolidation yields benefits offsetting the harm it inflicts on objecting parties."[77] The court then went on to create a two-part test stating, "The proponent must show not only a substantial identity between the entities to be consolidated, but also that

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[75] *Id.*
[76] *Id.* at 248-49.
[77] *Drabkin v. Midland-Ross Corp. (In re Auto-Train Corp.),* 810 F.2d 270, 276 (1987).

consolidation is necessary to avoid some harm or to realize some benefit."[78] Further, the court explained that even if these elements are met, "a creditor may object on the grounds that it relied on the separate credit of one of the entities and that it will be prejudiced by the consolidation."[79] Finally, "If a creditor makes such a showing, the court may order consolidation only if it determines that the demonstrated benefits of consolidation "heavily" outweigh the harm."[80]

In contrast, the Second Circuit in *In re Augie/Restivo Baking Co.* articulated its own standard to determine whether substantive consolidation would result in the equitable treatment of creditors.[81] Again this court focused on a two-part test, however, in its test only one of the two factors needs to be proved.[82] These two considerations are: "(i) whether creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit **or** (ii) whether the affairs of the debtors are so entangled that consolidation will benefit all creditors."[83] Further, the court went on to elaborate that "[c]ommingling can justify substantive consolidation only where the time and expense necessary even to attempt to unscramble them is so substantial as to threaten the realization of any

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[78] *Id.*
[79] *Id.*
[80] *Id.*
[81] 860 F.2d 515, 518 (2d Cir. 1988).

[82] *Id.*
[83] *Id.*

net assets for all the creditors or where no accurate identification and allocation of assets is possible."[84]

The primary difference between the application of the *Auto-Train* and *Augie/Restivo* tests is centered on which of the interested parties should bear the burden of proving reliance of the debtor's separateness from its related entities.[85] Using the *Auto-Train* Test, once a prima facie case is established, the party objecting to substantive consolidation must then prove its reliance on debtor separateness from all other entities in order to defeat a motion for consolidation.[86] In contrast, the *Augie/Restivo* test places the initial burden on the proponent of the motion to prove its reasonable reliance on the related entities, despite their separate legal existence, effective unity in order to make its prima facie case for consolidation.[87] Therefore, when comparing the two tests it is much easier for a substantive consolidation to motion be granted using the *Auto-Train* test since the opponent of the motion has the burden of demonstrating reliance.[88]

Additionally, the Third Circuit in *In re Owens Corning* came up with its own standard for when to order substantive consolidation.[89] However, before the court laid out an element test, it enumerated five key principals that other courts should look to when deciding whether substantive consolidation should be considered based

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[84] *Id. at 519.*
[85] Alan Kolod, SUBSTANTIVE CONSOLIDATION: GETTING BACK TO BASICS, 14 Am. Bankr. Inst. L. Rev. 1, 27-28 (2006).
[86] *Id.*
[87] *Id.*
[88] *Id.*
[89] 419 F.3d 195 (3d Cir. 2005).

on the facts of a given case.[90] These principals are: (1) "Limiting the cross-creep of liability by respecting entity separateness. . . courts [must] respect entity separateness absent compelling circumstances calling equity into play."[91] (2) "The harms substantive consolidation addresses are nearly always those caused by *debtors* (and entities they control) who disregard separateness."[92] (3) The "[m]ere benefit to the administration of the case is hardly a harm calling substantive consolidation into play."[93] In other words, using substantive consolidation as a tool for efficiency and simplification in regards to the administration of the estate should not be permitted.[94] (4) "Because substantive consolidation is extreme (it may affect profoundly creditors' rights and recoveries) and imprecise, this "rough justice" remedy should be rare and, in any event, one of last resort."[95] (5) "While substantive consolidation may be used defensively to remedy the identifiable harms caused by entangled affairs, it may not be used offensively (for example, having a primary purpose to disadvantage tactically a group of creditors in the plan process or to alter creditor rights)."[96]

Finally, after taking all these principles into account, the court stated that the proponent for a substantive consolidation motion must prove that either: "(i) pre-bankruptcy, the entities to be consolidated disregarded separateness so significantly that their creditors relied on the breakdown of entity borders and

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[90] *Id.* at 211.
[91] *Id.*
[92] *Id.*
[93] *Id.*
[94] *Id.*
[95] *Id.*
[96] *Id.*

treated them as one legal entity; or (ii) after filing for bankruptcy, the entities' assets and liabilities are so scrambled that separating them is prohibitive and hurts all creditors."[97] For the proponent to prove either one of these alternative requirements, there must be evidence of abundant control exercised by the debtor diocese over its independently incorporated organizations.[98]

When reviewing the two alternative elements of the *In re Owens Corning* test, it should be noted that the extensive commingling of assets was also what led the bankruptcy court in the Diocese of Wilmington case to combine assets of related debtor and non-debtor entities. In that case, as previously stated, although the funds and assets of local parishes were held in trust by the Diocese, the Diocese still managed and controlled these assets through its central diocese account.[99] Because of this, the court held that the funds in this general account were commingled since they were maintained and controlled by the Diocese for its own benefit in addition to the benefit of the parishes.[100] This entanglement of funds was sufficient to allow

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[97] *Id.*

[98] *Id.* at 212. The state law remedy of piercing the corporate veil also disregards a corporation's separate legal existence and limited liability because directors or shareholders committed fraud. This can be the case when an entity is significantly undercapitalized and setup merely as a shell corporation to protect its owners or shareholders from personal liability. When the veil is lifted the protections of the corporate form, mainly limited liability, cease and owners of one entity can be held liable for the debts of another. When deciding whether to pierce the corporate veil, courts look to "(1) the level of control and domination [exerted by a company or owner] over an entity, (2) whether that control was used by the defendant to commit fraud or wrong, or [a] dishonest and unjust act and (3) whether the control proximately caused the injury or unjust loss complained of." *Consumer's Co-op v. Olsen*, 142 Wis. 2d 465, 484, 419 N.W.2d 211, 218 (1988).

[99] *In re Catholic Diocese of Wilmington, Inc.*, 432 B.R. at 150-51.

[100] *Id.*

the court to disregard the separate incorporations of church entities and rule this general fund was always in the possession of the debtor Diocese and therefore should be included in the Diocese's bankruptcy estate.[101] In sum, while the bankruptcy court in the Diocese of Wilmington case did not employ the equitable remedy of substantive consolidation, the court's logic is nevertheless consistent with the *In re Owens Corning* elements.

IV. FAILURE TO SUBSTANTIVELY CONSOLIDATE IN THE ARCHDIOCESES OF MILWAUKIE AND MINNEAPOLIS BANKRUPTCIES

In the wake of its own child sexual abuse scandal, the Archdiocese of Milwaukie filed for Chapter 11 bankruptcy in 2012.[102] Thereafter, the unsecured creditors committee in the case filed a motion seeking to combine the assets of the Archdiocese with the assets of the parishes it celestially controlled.[103] The unsecured creditors committee sought to accomplish this task through substantive consolidation, or in the alternative, an alter ego claim also known as piercing the corporate veil.[104]

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[101] *Id.*
[102] *Doe v. Archdiocese of Milwaukee (In re Archdiocese of Milwaukee)*, No. 11-20059-SVK, 2013 U.S. Dist. LEXIS 154035 (E.D. Wis. Oct. 22, 2013).
[103] *Id.*
[104] *In re Archdiocese of Milwauk*ie, Memorandum Decision on the Committee's Motion for Standing on Alter Ego and Substantive Consolidation Claims. https://www.wieb.uscourts.gov/opinions/files/pdfs/ADM_Memorandum_Decision_on_Parish_Assets_Motion12.7.pdf

In its brief, the committee asserted that despite the distinct corporate forms of the individual parishes, both entities were in reality one in the same.[105] This was because the Archdiocese willfully disregarded the parishes' corporate governing autonomy regarding its own temporal matters, as prescribed by the Wisconsin incorporation statute.[106] Specifically, the committee asserted that the parishes would cease to operate without the substantial financial backing provided to them by the Archdiocese, noting that the Archbishop himself was the leader of all the parishes corporate governing boards and that in practice he had the final say over who would be appointed to the parishes' boards, as well as who would continue to serve on them.[107] In sum, the committee's position was that although the Archdiocese had 210 Parishes, each of which was separately incorporated with the Wisconsin Secretary of State, the debtor intentionally disregarded the corporate formalities and separateness of its parishes.[108]

To the contrary, the debtor Archdiocese argued that the Wisconsin incorporation statute pertaining to the Catholic Church, Wis. Stat. § 187.19, specifically provided that individual parishes within a larger archdiocese could be separately incorporated at the discretion of the archbishop.[109] Therefore, the Archdiocese argued that many of the supposedly problematic corporate governance

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[105] *Id.*
[106] *Id.*
[107] *Id.*
[108] *Doe v. Archdiocese of Milwaukee (In re Archdiocese of Milwaukee)*, 2013 U.S. Dist. LEXIS 154035 (E.D. Wis. 2013).
[109] *See* Debtor Br. in Opposition to Substantive Consolidation, *Doe v. Archdiocese of Milwaukee (In re Archdiocese of Milwaukee)*, 2013 U.S. Dist. LEXIS 154035 (E.D. Wis. 2013) (No. 11-20059-SVK).

practices asserted by the unsecured creditors' committee were actually required by the same state incorporation statute that specifically dealt with Roman Catholic Churches.[110] For instance, it was explicitly stated in the statute that the bishop or archbishop has the ability to appoint several members of individual parishes' corporate boards.[111]

Furthermore, in its brief, the debtor made clear that the close collaboration between the Archdiocese and its parishes was not a new occurrence and had historically been endorsed by Wisconsin state law.[112] Specifically, the Archdiocese stated that, "The Parish Corporations located within the [Debtor, a non-stock corporation] are separate civil corporations. Other than a few Parish Corporations, which are wholly-owned by religious orders, the Parish Corporations are all organized and operate pursuant to Wis. Stat. § 187.19. In Wisconsin, parish corporations have been separately incorporated since 1883."[113]

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[110] Wis. Stat. Ann. § 187.19 (LexisNexis, 2017).
[111] *Id*. "The bishop of each diocese, being the only trustee of each Roman Catholic church in his diocese, may cause any or all congregations therein to be incorporated by adding four more members as trustees as hereinafter provided. The bishop and vicar-general of each diocese, the pastor of the congregation to be incorporated, together with two laypersons, practical communicants of such congregation (the latter to be chosen from and by the congregation), shall be such trustees."
[112] Jennifer Hasselberger, *'It is important to know that parishes and Catholic schools are separately incorporated...'*, CANONICAL CONSULTATION AND SERVICES, L.L.C., Feb. 14, 2015, http://canonicalconsultation.com/1/post/2015/02/it-is-important-to-know-that-parishes-and-catholic-schools-are-separately-incorporated.html. (last visited Jan 5, 2017).
[113] *In re Archdiocese of Milwauke*e, Memorandum Decision on the Committee's Motion for Standing on Alter Ego and Substantive Consolidation Claims. https://www.wieb.uscourts.gov/opinions/files/pdfs/ADM_Memorandum_Decision_on_Parish_Assets_Motion12.7.pdf, pg. 2.

Finally, the debtor stated that despite the operational collaboration between the Archdiocese and the parishes, it did not hold title to any parish property and individual parishes were always treated as separate entities in regards to their finances.[114] In sum, the debtor contended that the committee's criticism of the Archbishop having too much operational and financial control over the parishes had no merit, as the involvement of the Archbishop in the corporate affairs of the parishes was explicitly prescribed for in the Wisconsin incorporation statute, especially when it came to corporate leadership.[115]

In this case, the court concluded that even though the Archbishop exerted control over the parishes in the areas of religious exercise, such as when appointing priests or establishing procedures for the administration of sacraments,[116] these were instances of the traditional controls the Archbishop has over his parishes due

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("(Wis. Stat. § 187.19 is based on Chapter '37 of the Laws of Wisconsin (1883), and many of the Parish Corporations came into existence in 1883, with the majority incorporated prior to 1930). In accordance with the Wisconsin Statutes, each Parish Corporation has a designated Board of Trustees as prescribed by statute. Parish corporations own their own property, finance their own activities, manage their own assets and are responsible for their own corporate activities").

[114] Jennifer Hasselberger, *'It is important to know that parishes and Catholic schools are separately incorporated...'* CANONICAL CONSULTATION and SERVICES, L.L.C. (Feb. 14, 2015), http://canonicalconsultation.com/1/post/2015/02/it-is-important-to-know-that-parishes-and-catholic-schools-are-separately-incorporated.html. (last visited Jan 5, 2017).

[115] *In re Archdiocese of Milwaukee*, Memorandum Decision on the Committee's Motion for Standing on Alter Ego and Substantive Consolidation Claims. https://www.wieb.uscourts.gov/opinions/files/pdfs/ADM_Memorandum_Decision_on_Parish_Assets_Motion12.7.pdf, pg. 2

[116] *Id.*

to canon law. [117] Accordingly, these factors should not be considered in a substantive consolidation or alter ego claim.[118] This was likely because of constitutional issues arising from the First Amendment, free exercise clause.[119] In essence, the combining of two otherwise separate religious entities and effectively penalizing one of the entities by making it contribute to paying off the debts of the other could be unconstitutional.[120] This is because if the control one entity, in this case the Archdiocese, exerts over the other entity, the parishes, was based predominantly on religious doctrine, any consolidation action by a court would restrict the church's free exercise of religion and therefore could be held unconstitutional.[121]

Furthermore, the court agreed with the debtor and ruled that the degree of control the Archbishop exerted over the parishes' secular corporate operations did not interfere with those non-religious operations. This was because the Wisconsin statute pertaining to the governance of parish corporations gave the Archbishop

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[117] Jennifer Hasselberger, *'It is important to know that parishes and Catholic schools are separately incorporated...'* CANONICAL CONSULTATION and SERVICES, L.L.C. (Feb. 14, 2015), http://canonicalconsultation.com/1/post/2015/02/it-is-important-to-know-that-parishes-and-catholic-schools-are-separately-incorporated.html. (last visited Jan 5, 2017).

[118] *Id.*

[119] Tom Corrigan, *Judge Says Constitution May Protect Bankrupt Archdiocese* THE WALL STREET JOURNAL (June 3, 2016), http://blogs.wsj.com/bankruptcy/2016/06/03/judge-says-constitution-may-protect-bankrupt-archdiocese/ (last visited Mar 5, 2017).

[120] *Id.*

[121] Tom Corrigan, *Twin Cities Archdiocese, Abuse Victims at Odds Over Bankruptcy Plan*, THE WALL STREET JOURNAL, May 26,2016, http://www.wsj.com/articles/twin-cities-archdiocese-abuse-victims-at-odds-over-bankruptcy-plan-1464299751 (last visited Feb 5, 2017).

substantial control over the parishes' governing boards.[122] Accordingly, the substantive consolidation claim and alter ego claims asserted by the unsecured creditors committee ultimately failed.[123]

While the incorporation law in Wisconsin was formulated specifically for parishes within an archdiocese or diocese in the Roman Catholic Church, which resulted in both the alter ego and substantive consolidation claims being defeated without much of an inquiry into the fact specific elements of either claim, parishes in other states have incorporated using statutes not specifically geared toward the Catholic Church and its hierarchical structure.[124] For instance, the Archdiocese of Minneapolis and Saint Paul used a more generic incorporation statute before it filed for bankruptcy in 2015, once again due to numerous tort claims related to sexual assault.[125] In that case, the tort creditors again sought to use substantive consolidation and the alter ego doctrine to reach as many of the parishes' assets as possible and fully satisfy their claims.[126]

Unlike almost all the parishes in Wisconsin, many of the parishes individually incorporated with the Minnesota Secretary of State did not use the

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[122] *In re Archdiocese of Milwaukee*, Memorandum Decision on the Committee's Motion for Standing on Alter ego and Substantive Consolidation Claims. https://www.wieb.uscourts.gov/opinions/files/pdfs/ADM_Memorandum_Decision_on_Parish_Assets_Motion12.7.pdf, pg. 9.
[123] *Doe v. Archdiocese of Milwaukee (In re Archdiocese of Milwaukee)*, 2013 U.S. Dist. LEXIS 154035, at *4 (E.D. Wis. Oct. 22, 2013).
[124] *See* Minn. Stat. Ann. § 315.15 (LexisNexis, 2017), https://www.revisor.mn.gov/statutes/?id=315.15.
[125] *In re Archdiocese of St. Paul & Minneapolis*, 553 B.R. 693 (Bankr. D. Minn. 2016).
[126] *Id.*

state's parish incorporation statute to form their own entity.[127] Instead, many parishes used incorporation statues that were geared toward any non-profit organization.[128] In other words, being a religious organization was not a prerequisite. Specifically, many of the parishes within the Archdiocese of Minneapolis and Saint Paul were incorporated under Minnesota Statute 317A, which permits the establishment of such corporations for any lawful purpose and allows the corporation to be established by any natural person or persons, instead of requiring incorporation by an archbishop or bishop.[129] Similarly, parishes incorporated under this statute also do not require the archbishop and vicar general to serve on the corporation's board of directors.[130] Therefore, the reasoning used by the court in the Archdiocese of Milwaukie bankruptcy case, which stated that the religiously oriented Wisconsin incorporation statute was the major reason the Archbishop exerted so much control over individual parishes, was not a viable defense for the Archdiocese of Minneapolis.

In other words, it is harder to argue that the substantial amount of power the Archbishop exerts over individual parish corporations is predominantly the result of the statutory requirements of Minnesota's parish incorporation law when there is

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[127] Minn. Stat. Ann. § 315.15 (LexisNexis, Lexis Advance through Chapter 1 of the 2017 Regular Session) https://www.revisor.mn.gov/statutes/?id=315.15.
[128] Jennifer Hasselberger, 'IT IS IMPORTANT TO KNOW THAT PARISHES AND CATHOLIC SCHOOLS ARE SEPARATELY INCORPORATED...' CANONICAL CONSULTATION AND SERVICES, L.L.C. (Jan 5, 2015), http://canonicalconsultation.com/1/post/2015/02/it-is-important-to-know-that-parishes-and-catholic-schools-are-separately-incorporated.html.
[129] Minn. Stat. Ann. § 315.15 (LexisNexis, Lexis Advance through Chapter 1 of the 2017 Regular Session) https://www.revisor.mn.gov/statutes/?id=315.15.
[130] *Id.*

sufficient evidence which points to the fact that the Minneapolis Archdiocese often decided to incorporate its churches under a more general incorporation statute.[131] One institution in the Archdiocese was even established and remains organized as a congregational corporation pursuant to Minnesota Statute 315.01, even though it no longer operates in accordance with that corporate structure.[132]

Even for those parishes that did incorporate under the Minnesota parish incorporation statute (which is similar to the Wisconsin statute in that it calls for the bishop and vicar general to have a seat on and appoint members of each parishes' board) the mere fact that the bishop's extensive control over parish organizations is explicitly authorized in the statute does not on its face defeat a claim of substantive consolidation. This is because, unlike in the consolidation motion filed with the Archdiocese of Milwaukie, the Minneapolis Archbishop did not just have broad control of individual parishes' corporate boards, the finances of the Minneapolis Archdiocese and the parish corporations were also more intertwined than their counterparts in Milwaukie.[133] This was also the unsecured creditors committee's main line of argument when it tried to demonstrate to the bankruptcy court that the individual parishes' financial holdings were substantially intertwined with those of the Archdiocese.

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[131] Jennifer Hasselberger, 'IT IS IMPORTANT TO KNOW THAT PARISHES AND CATHOLIC SCHOOLS ARE SEPARATELY INCORPORATED...' Canonical Consultation and Services, L.L.C. (Jan 5, 2017), http://canonicalconsultation.com/1/post/2015/02/it-is-important-to-know-that-parishes-and-catholic-schools-are-separately-incorporated.html.
[132] *Id.*
[133] *Id.*

In defending against the motion for substantive consolidation the Archdiocese of Milwaukee proved that its finances were not significantly intermingled with its parishes and that the parishes also had control over and managed their own financial activities. In other words, the parishes within the Archdiocese of Milwaukee were at least semi-autonomous because they were in control of what they would spend their budgets on, even if some of the funding for those budgets were the result of financial backing from the Archdiocese itself.[134] However, this was not true in the case of the Archdiocese of Minneapolis. For example, in 2007, the Archdiocese was the guarantor of nearly $100 million in debt incurred by parishes or other institutions under the umbrella of the Archdiocese.[135] Furthermore, in many parish corporations the salaries of numerous parish employees are subsidized or completely funded by the Archdiocese.[136] If a parish is significantly underfunded this can also be a factor in determining whether its corporate form is really only being used as a shell to shield the larger more capitalized corporation from liability. For instance, if it could be proven that a parish was so underfunded that it underpaid or was unable to pay its contributions to an archdiocese's common health insurance or pension funds, this could be enough

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[134] *See* Debtor Br. in Opposition to Substantive Consolidation, *In re Archdiocese of Milwaukee*, 428 B.R. 792 (E.D. Wis. 2012) (No. 11–20059–svk).
[135] Jennifer Hasselberger, 'IT IS IMPORTANT TO KNOW THAT PARISHES AND CATHOLIC SCHOOLS ARE SEPARATELY INCORPORATED' CANONICAL CONSULTATION AND SERVICES, L.L.C. (Jan 5, 2017), http://canonicalconsultation.com/1/post/2015/02/it-is-important-to-know-that-parishes-and-catholic-schools-are-separately-incorporated.html. (last visited Jan 5, 2017).
[136] *Id.*

to prove that a parish corporation is really only being used as a vehicle to avoid creditors.

In defending against the claims of the unsecured creditor's committee the Archdiocese of Minneapolis asserted the same First Amendment religious protections as the Archdiocese of Milwaukie, mainly that Catholic canon law prescribed for an archbishop to be the leader of all parishes within its dominion and to have ultimate control over all celestial practices. Therefore, the extensive involvement of the Archbishop in the corporate governance of the parishes was protected by the religious freedom clause of the First Amendment.

However, as with the Archdiocese of Milwaukie, the duties of religious practice can be separated from the duties of governing a corporate entity. Therefore, while First Amendment protections may inhibit any remedy of substantive consolidation in regards to the control an archbishop exerts over the religious operations of parishes, an archdiocese should not be protected by the First Amendment when the purely financial and secular decisions of the parishes' corporate boards are at issue. As previously stated, this was the case in the Diocese of Wilmington's bankruptcy, where most of the parishes' investment account funds where deemed to be property of the estate for the Wilmington diocese itself. The First Amendment was no defense in that action because the financial operation of the Diocese was purely secular.

Neither the bankruptcy court nor the district court on appeal in the Minneapolis case considered these First Amendment issues, instead the motion for

substantive consolidation brought by the unsecured creditors' committee was denied based purely on the what the courts found was a limitation of the Bankruptcy Code. Specifically, both courts recognized that while a bankruptcy court is given broad equitable powers through the Bankruptcy Code's § 105 provision, those equitable powers cannot conflict with any provision expressly stated in the Code. The bankruptcy court found that:

> [S]ubstantively consolidating a debtor with non-debtors over their objections squarely implicates § 303(a). In addition to its other statutory standing, procedural and substantive requirements, § 303(a) bars the involuntary bankruptcy of "a corporation that is not a moneyed, business, or commercial corporation." 11 U.S.C. § 303(a). The accompanying legislative history explains, "Eleemosynary institutions, such as churches, schools, and charitable organizations and foundations, likewise are exempt from involuntary bankruptcy." S. Rep. No. 95-989, at 32 (1978), as reprinted in 1978 U.S.C.C.A.N. 5787, 5818.
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> To determine whether an entity is a "moneyed, business, or commercial corporation," courts consider "the classification of the corporation by the state; the powers conferred upon it; and the character and extent of its main activities." Yehud-Monosson USA, Inc. v. Fokkena (In re Yehud-Monosson USA, Inc.), 458 B.R. 750, 755-56

(B.A.P. 8th Cir. 2011) (quoting Missco Homestead Ass'n v. United States, 185 F.2d 280, 282 (8th Cir. 1951)).[137]

Therefore, the bankruptcy and district courts both found that using the bankruptcy court's equitable power to order substantive consolidation of a eleemosynary debtor, the Archdiocese, with a eleemosynary non-debtor, the parishes, would contravene § 303(a) and therefore such a use would be impermissible.[138]

However, consolidating the assets of parishes and an archdiocese itself should not be seen as forcing an otherwise separate parish corporation into a bankruptcy proceeding. This is because the parish corporations themselves would not have to file a separate reorganization plan, submit a list of creditors, close any bank accounts in the entity's name, meet with the United States Trustee, or comply with any other separate filing requirements.[139] Instead, substantive consolidation would have the limited result of allowing certain parish assets to go towards paying off the debts of the larger diocese.[140] This means that while the assets of both entities would be treated

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[137] *In re Archdiocese of St. Paul & Minneapolis*, 553 B.R. 693, 700 (Bankr. D. Minn. 2016).

[138] 2016 U.S. Dist. LEXIS 169176*.

[139]Dep't of Just., OPERATING GUIDELINES AND REPORTING REQUIREMENTS FOR DEBTORS IN POSSESSION AND CHAPTER 11 TRUSTEES (2013), https://www.justice.gov/sites/default/files/ustregions/legacy/2013/01/10/ch11_guidelines_reporting_req.pdf.

[140] Likewise, an alter ego or veil piercing motion should also not be seen as forcing a non-debtor parish into an involuntary bankruptcy because a non-debtor entity that

as one in order for the claims of the debtor's creditors, the two entities remain legally distinct. (Substantive consolidation would not be ordered unless the assets of both entitles were significantly intermingled or were effectively the property of only one of the entities). In sum, it is the assets of two or more entities that are being consolidated using this equitable remedy; the non-debtor entity is not being forced into the bankruptcy proceeding in order to start paying off the debts it incurred independent of the debtor entity.

V. THE FACTUAL CIRCUMSTANCES THAT WILL ALLOW FOR SUBSTANTIVE CONSOLIDATION

In its decision validating a bankruptcy court's right to substantively consolidate, the Third Circuit in *In re Owens Corning* held that a proponent of such a remedy must prove that either: "(i) pre-bankruptcy, the entities to be consolidated "disregarded separateness so significantly that their creditors relied on the breakdown of entity borders and treated them as one legal entity; or (ii) after filing for bankruptcy, the entities' assets and liabilities are

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is truly an "alter ego" of a voluntary debtor is regarded as the same entity not a separate one. Therefore, by piercing the corporate veil, the moving party has to prove that the two legally distinct entities are effectively one in the same and therefore not actually legally separate. Further, since they are one and the same, the voluntary petition filed by the initial debtor also encompasses the non-debtor entity as well. *See* In re Pearlman, 462 B.R. 849, 855 (Bankr. M.D. Fla. 2012).

so scrambled that separating them is prohibitive and hurts all creditors."[141] For the proponent to prove either one of these alternative requirements there must be evidence of abundant control exercised by the debtor diocese over its independently incorporated organizations.[142] There are various instances where a diocese could exert sufficient control over its organizations to demonstrate that the separate incorporation of these organizations is really only a legal shell meant to minimize liability of the diocese by segmenting its assets across all of its parishes.[143]

One such instance that could clearly demonstrate the control a diocese has over a parish or school corporation is in the selection process of such an entity's board of directors or other governing structure.[144] When a state's incorporation law gives a parish the power to elect its own trustees or directors to serve on the newly created corporation's board, this decision should be left to the members of the local parish.[145] However, it is common that these members are effectively appointed by the bishop or archbishop since the potential board member's name is often submitted to these officials seeking their express approval.[146] Furthermore, while canon law can justify the bishop exerting control over all aspects of church life having to do with

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[141] In re Owens Corning, 419 F.3d 195, 211 (3d Cir. 2005).
[142] *Id.*
[143] *Id.*
[144] *See* Committee of Unsecured Creditors Br. in Support of Alter Ego and Substantive Consolidation Motion at 10, *In re Archdiocese of St. Paul and Minneapolis*, 553 B.R. 693, 700 (Bankr. D. Minn. 2016).
[145] *Id. at 10-11.*
[146] *Id.*

the practice of religion, financial or administrative decisions that are purely secular in nature should be free from the diocese's influence;[147] anything less clearly disregards the parish corporation's separate legal identity.[148] This is especially the case when the local corporation that the diocese is controlling is completely separate from the religious arm of the church.[149] For example, a diocese should have no influence on the retirement or investments plan decisions of a local parish corporation if it is separately incorporated.[150]

Additionally, situations where a diocese exercises direct control over the assets of a parish corporation demonstrate that a parish corporation's legal separateness is being disregarded.[151] For example, if a diocese requires that its parishes or schools obtain permission from the archbishop or bishop to purchase or sell any interest in real or personal property either outright or above a certain dollar amount.[152] It was alleged this practice took place in Archdiocese of Minneapolis, where to sell property owned by the parish corporations, parishes were required to submit to the Archdiocese, among other things, a description of the property, the name of the buyer, the sale price, as well as a statement that the parish sees no adequate use for the property in the future.[153] These types of restrictions clearly go beyond the

[147] *Id.* at 13.
[148] *Id.*
[149] *Id.* at 14.
[150] *Id.* at 18.
[151] *Id.* at 13-14.
[152] *Id.* at 14.
[153] *Id.*

defined religious practice mandates of canon law,[154] which itself is hundreds of years old.[155]

Furthermore, any restrictions a diocese may put on a local parish that is seeking to obtain a loan through a mortgage or other financing arrangement should also be regarded as an infringement of the local corporation's legal identity.[156] Again, secular financial transactions are not a part of the Catholic Church's governing principles.[157]

Finally, the separate corporate form of parish corporations should allow them to make their own decisions regarding legal counsel or any other professional services agreement.[158] Historically, this has not always been the case as dioceses have exercised control in deciding what legal counsel should be hired and what legal strategies are in the best interest of their parish corporations.[159] This is particularly problematic when an issue deals exclusively with a local parish or school and not the larger diocese.[160] For example, a local parish school should be free of the control of the diocese when making a decision on whether or not it needs to install another elevator to accommodate the needs of students with disabilities.[161] This is a purely

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[154] *Id.*
[155] Canon law dates back to the twelfth century.
[156] Committee of Unsecured Creditors Br. *supra* note 144 at 14.
[157] *See* Canon 1292, § 1 - Minimum and Maximum Sums, Alienation of Church Property.
[158] Committee of Unsecured Creditors Br. *supra* note 144 at 14.
[159] *Id.*
[160] *Id.*
[161] *Id.*

local matter that has no bearing on the larger diocese, especially since such a decision is secular in nature. Further, the parishes' lack of independent legal counsel could lead to many conflicts of interest for the attorney or law firm if the interests of the parishes and the diocese itself begin to diverge.[162] Accordingly, any interference by the diocese in the local parish or schools decision making process should be regarded as the diocese disregarding the processes of a separate legal entity, thereby providing grounds for a court to deem the legal separateness of the entities as nothing more than a legal fiction and ordering the consolidation of their assets.

Finally, it should be noted that all of the above situations demonstrate areas where a diocese can exert undue control over its parishes within a secular context. This is because the control exercised by the diocese, bishop, or even the pope pursuant to canon law or other religious doctrine is likely protected by the First Amendment free exercise clause.[163] Specifically, the control a diocese exercises over its parishes in the area of religious practice is a factor that a court should not consider when deciding whether or not to order substantive consolidation.[164] In general, this is a restraint on the free exercise of religion[165] and not the argument this note seeks to make. Instead, this note argues that dioceses are treating the religious and secular functions of parish corporations as one in the same and are therefore disregarding the authority of parish corporations to make their own

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[162] *Id.*
[163] *Id.*
[164] *Id.*
[165] *Id.*

decisions regarding purely financial and other secular matters. This in turn should lead to a bankruptcy court disregarding the separate legal existences of the debtor diocese and the local parish corporations under its umbrella. As a result, these many separate entities should be consolidated into one for the purposes of the debtor's bankruptcy estate and the distribution to its creditors.

CONCLUSION

While substantive consolidation is not always necessary to get to the assets of parish corporations, as was demonstrated in the Diocese of Wilmington case, the above fact patterns and examples show that it should be a remedy available when a diocese intentionally sets up layers of shell corporations and then disregards their corporate form for secular purposes. Furthermore, while a motion or adversary proceeding for substantive consideration in this context would ultimately pit victims of clergy sex abuse against the assets of many parishes, schools, and other non-profit civic organizations that have done nothing wrong. It is my belief that substantively consolidating the estates of the debtor diocese with non-debtor parish corporations is the lesser of two evils. The abuse victims as judgment creditors must be made whole in everyway possible, even if that means that local schools and parishes must foot some of the bill.

In sum, the *In Re Owens Corning* court, which further developed the doctrine of substantive consolidation, opined that a "perfect storm" is needed to invoke such

a broad and powerful equitable remedy. [166] With these words in mind, the numerous clergy sex scandals that have taken place within dioceses across the country may just be the impetus needed for such a storm.

[166] "There is simply not the nearly "perfect storm" needed to invoke it." 419 F.3d 195, 216 (3d Cir. 2005).