IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

In re:	Chapter 11
CATHOLIC DIOCESE OF WILMINGTON, INC., a Delaware Corporation,	Case No. 09-13560 (CSS)
Debtor.	
OFFICIAL COMMITTEE OF UNSECURED CREDITORS,	
Plaintiff,	
v.	Adv. Proc. No. 09-52866 (CSS)
CATHOLIC DIOCESE OF WILMINGTON, INC., *et al.*,	
Defendants.	

OPENING BRIEF IN SUPPORT OF DEBTOR'S
MOTION FOR JUDGMENT ON THE PLEADINGS (PHASE II)

Dated: October 8, 2010
Wilmington, Delaware

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NATURE AND STAGE OF PROCEEDING

On November 11, 2009, the above-captioned debtor-defendant (the "Debtor") filed a motion in the main bankruptcy case [D.I. 96] (the "PIA Motion") for interim and final orders authorizing it to use its pooled investment account (the "Pooled Investment Account" or "PIA") and process withdrawal requests from non-debtor investors, including the above-captioned non-debtor defendants (the "Non-Debtor Defendants"). The Official Committee of Unsecured Creditors (the "Committee") objected to the PIA Motion [D.I. 127] on the basis that, among other things, the motion incorrectly assumed that the funds in the PIA are not property of the estate. On November 18, 2009, the Court held a telephonic hearing concerning the PIA Motion, during which the Court suggested that the Committee commence an adversary proceeding to determine whether the PIA funds are property of the estate.

On December 18, 2009, the Committee filed a complaint [Adv. D.I. 1] (the "Complaint") seeking a determination regarding ownership of approximately $76 million of non-debtor funds in the PIA. In the Complaint, the Committee set forth the following four claims for declaratory relief and a fifth claim for substantive consolidation of the Debtor and Non-Debtor Defendants: (i) the Debtor and Non-Debtor Defendants constitute a single entity; (ii) a valid trust does not exist with respect to the PIA; (iii) the Debtor owns all legal and equitable interests in the PIA under the doctrine of merger; and (iv) the alleged trust funds cannot adequately be traced.

On January 12, 2010, the Court bifurcated the adversary proceeding into two phases. Pursuant to an order entered on January 28, 2010 [Adv. D.I. 25] (the "Scheduling Order"), the Court scheduled a trial on the second and fourth claims for relief set forth in the Complaint (the "Phase I Claims") to commence on June 2, 2010. The Scheduling Order stayed discovery on the remaining claims for relief in the Complaint (the "Phase II Claims").

Trial on the Phase I Claims commenced on June 2, 2010 and ended on June 4, 2010. On June 28, 2010, the Court issued its Opinion with respect to the Phase I Claims [Adv. D.I. 115]. The Court ruled, based on the "overwhelming weight of the facts" that the PIA funds of the Non-Debtor Defendants were held by the Debtor in a resulting trust (and in the case of St. Ann's, an express trust) on their behalf. Official Committee of Unsecured Creditors v. Catholic Diocese of Wilmington, Inc. (In re Catholic Diocese of Wilmington, Inc.), 432 B.R. 135, 149 (Bankr. D. Del. 2010) (hereinafter cited as "Phase I at __"). It further concluded, however, that these funds were commingled in both the Debtor's operating account and the PIA, and that the defendants had failed to meet their burden of identifying or tracing the non-debtor funds. Id. at 150. Accordingly, the Court ruled that the entirety of the PIA (with the exception of the investments made by St. Ann's) was property of the Debtor's estate under § 541 of the Bankruptcy Code. Id. at 161. The Non-Debtor Defendants, joined by the Debtor, filed a motion for reconsideration of the Court's June 28, 2010 Opinion, which was denied by the Court on July 21, 2010 [Adv. D.I. 134 & 135]. The Debtor and the Non-Debtor Defendants filed timely notices of appeal, and on August 19, 2010, the Court certified the appeals for direct review by the United States Court of Appeals for the Third Circuit [Adv. D.I. 177]. On September 29, 2010, the Third Circuit accepted the appeals.

On September 3, 2010, the Court directed that a status conference would be held on the Phase II Claims at the next omnibus hearing. On September 22, 2010, the Non-Debtor Defendants filed their *Motion for Judgment on the Pleadings* with respect to the Phase II Claims, along with an opening brief (the "NDD Brief") in support thereof [Adv. D.I. 191 & 192]. Also on September 22, the Debtor filed its *Chapter 11 Plan of Reorganization* in the main bankruptcy case [D.I. 765] (as subsequently amended, the "Plan"). The Plan does not propose consolidation of the Debtor with any other entity.

The Court held a status conference on the Phase II Claims on September 24, 2010, at which the Debtor indicated it intended to move for judgment on the pleadings. The Court directed the parties to confer on a combined briefing schedule and ruled that oral argument would be held approximately two weeks following the completion of briefing.

On September 29, 2010, the Debtor filed a motion in the main bankruptcy case [D.I. 782] (the "Exclusivity Motion") to extend its exclusive filing and solicitation periods under § 1121 of the Bankruptcy Code through and including December 30, 2010 and March 3, 2011, respectively. The Exclusivity Motion is scheduled for a hearing on October 21, 2010.

Contemporaneously herewith, the Debtor filed its Motion for Judgment on the Pleadings (Phase II) (the "Motion"). In support of the Motion, the Debtor respectfully represents as follows:

SUMMARY OF ARGUMENT

1. The Phase II Claims fail to state claims on which relief can be granted, because the non-conclusory allegations therein fail to show (i) that the corporate form was a sham and existed for no other purpose than as a vehicle for fraud, which is required by Delaware law to sustain an alter ego/veil piercing action, (ii) that the Debtor and the Non-Debtor Defendants disregarded entity separateness prepetition and voluntary creditors relied on this lack of entity separateness when extending credit, or (iii) the post-petition operations of the entities are so "scrambled" that separating them is prohibitive and hurts all creditors of all entities, the latter two elements being alternative prerequisites to substantive consolidation in the Third Circuit.

2. Even if the Alter Ego Claims (as hereinafter defined) were adequately pled, such claims are property of the Debtor's bankruptcy estate which the Committee has not sought stay relief or derivative standing to assert.

3. Even if the Substantive Consolidation Claim (as hereinafter defined) were adequately pled, non-consensual substantive consolidation of the Non-Debtor Defendants in this case would run afoul of the § 303 of the Bankruptcy Code, which (i) prohibits involuntary bankruptcy relief against not-for-profit entities, and (ii) prohibits holders of disputed, contingent claims from obtaining involuntary bankruptcy relief.

4. Even if the Substantive Consolidation Claim were adequately pled, substantive consolidation in chapter 11 may only be pursued in conjunction with a chapter 11 plan, and the Debtor presently has the exclusive right to file and solicit acceptances of a chapter 11 plan.

STATEMENT OF FACTS[1]

I. The Debtor

Catholic Diocese of Wilmington, Inc. (the "Debtor") is a not-for-profit, non-stock member corporation organized under Delaware law. (Compl. ¶ 6.) The Debtor is the secular legal embodiment of the Roman Catholic Diocese of Wilmington (the "Diocese"), an ecclesiastical entity under the Code of Canon Law governing the Roman Catholic Church (the "Church"). (Phase I at 139 n.2.) The Diocese includes the parishes and other diocesan departments, agencies, and ministries that carry out the mission of the Church, all of whom fall under the ecclesiastical authority of the ordinary of the Diocese, presently the Most Reverend W. Francis Malooly, D.D. (the "Bishop"). (Id.) The Bishop is the president and sole member of the Debtor. (Compl. ¶ 6.) The Reverend Monsignor J. Thomas Cini, who is the Vicar General for Administration of the Diocese, is the Debtor's Secretary. (Id. ¶ 14.) The Reverend Monsignor Joseph F. Rebman, the Vicar General for Pastoral Services of the Diocese, is the Debtor's Vice

President. (Id. ¶ 15.) Joseph Corsini is the Debtor's Treasurer and Chief Financial Officer. (Id. ¶ 14.) The Debtor has no board of directors or comparable governing body. (Id. ¶ 6.)

The Debtor, as trustee, manages the Pooled Investment Account for the benefit of itself and the Non-Debtor Defendants, among others. (Phase I at 149.) The Debtor has kept "meticulous, extensive and accurate accounting records" with respect to the Pooled Investment Account. (Id. at 143.)

It is assumed for purposes of the Motion that the Diocese, through the Debtor, provides centralized operational support for each of the Non-Debtor Defendants, including: (i) payroll processing services, (ii) personnel policies and procedures, (iii) health insurance and workers' compensation insurance, (iv) pension plans for lay employees and priests, (v) a website (www.cdow.org),[2] and (vi) an email server. (Compl. ¶¶ 45-50 & 53-55.) It is further assumed, solely for purposes of the Motion, that the Diocese, through the Debtor, (i) raises money through an annual appeal and uses the funds raised to support each of the Non-Debtor Defendants, (ii) subsidizes the operations of the Non-Debtor Defendants, and (iii) pays the legal fees of the Parish Corporations (as hereinafter defined). (Id. ¶¶ 38-40.) The Debtor occupies the same business premises as certain of the Non-Debtor Defendants. (Id. ¶ 56.)

II. The Parish Corporations

The parish defendants[3] are not-for-profit corporations organized under Delaware or Maryland state law, as applicable (collectively, the "Parish Corporations"). (Compl. ¶¶ 7-11.)

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[1] For purposes of the Motion, factual allegations in the Complaint are assumed to be true. The Debtor reserves all rights to dispute at trial the factual allegations in the Complaint, and no admission or waiver is intended, or should be implied, from this Statement of Facts.

[2] The Complaint characterizes the content of the website, a document (or rather, a collection of documents) that speaks for itself. To the extent the content of the website are material to resolution of the Motion, the Debtor requests that the Court take judicial notice of the website pursuant to Fed. R. Evid. 201 and draw its own conclusions as to the character of the content.

The Parish Corporations are the secular legal embodiments of parishes within the Diocese (the "Parishes"), each of which, like the Diocese, is a separate ecclesiastical entity under Canon Law. (Phase I at 139-40.) Each Parish Corporation is governed by a five (5) member Board of Trustees, of which the Bishop and the Chancellor of the Diocese are members. (Compl. ¶¶ 12 & 29.) The Parish pastor is the president and treasurer, and a member of the Board of Trustees, of each respective Parish Corporation. (Id. ¶ 29.) The Diocese has adopted statutes requiring Parish pastors to obtain the Bishop's approval in order to incur debt, make extraordinary expenditures, sell hard assets, or enter into a contract to acquire real property or to undertake other significant obligations. (Id. ¶ 31.) In addition, the Parishes are required to follow accounting procedures promulgated by the Diocese and to file budgets and annual reports with the Diocese. (Id.) The Parish Corporations provide funding to the Debtor through Parish assessments, which fund the Debtor's general operations. (Id. ¶ 41.)

The Debtor disputes the following allegations, but assumes their truth solely for purposes of the Motion: (i) Bishop Malooly, the Chancellor of the Diocese, and the pastor of the Parish are the controlling members of the board of each Parish Corporation; (ii) Parish pastors serve at the pleasure of the Bishop; (iii) Parish pastors are under a duty of obedience to the Bishop; (iii) the Bishop has the sole power to dissolve Parishes or establish new ones; (v) the Bishop has the authority to "suppress" any Parish, which results in a transfer of the Parish's assets either to other Parishes, or to the Diocese; and (vi) that "if a Parish elects to leave or

[3] The parish defendants are: St. Ann's Roman Catholic Church, St. John the Beloved Roman Catholic Church, Holy Spirit Roman Catholic Church, St. Thomas the Apostle Roman Catholic Church, and St. Francis De Sales Roman Catholic Church.

otherwise disassociate itself from the Diocese," it may not keep any of its assets, which instead belong to the Diocese.[4] (Compl. ¶¶ 12, 29, 30 & 32.)

III. The Diocesan Corporations

One of the primary vehicles used by the Bishop in governing the Diocese is the Curia, also known as the Diocesan Central Offices and Ministries (the "Diocesan Curia"). The Diocesan Curia is organized into six functional departments, each of which comprises a number of related agencies, ministries, and/or administrative offices. (Compl. ¶ 13.)

The following non-debtor defendants (collectively, the "Diocesan Corporations") are charitable and educational organizations within the Diocese:

> (i) Diocese of Wilmington Schools, Inc. ("DOW Schools") operates: (a) Christ the Teacher Catholic School, an elementary school located in Glasgow, Delaware, teaching grades pre-kindergarten through eighth grade; (b) Most Blessed Sacrament Catholic School, located in Ocean Pines, Maryland, teaching 240 students in grades kindergarten through eighth grade; (c) Saint Mark's High School, located in Wilmington, Delaware, teaching 1,350 students in grades ninth through twelfth; and (d) St. Thomas More Preparatory School, located in Magnolia, Delaware, teaching students in grades ninth through twelfth.
>
> (ii) Catholic Cemeteries, Inc. ("Catholic Cemeteries") is the owner, manager, and operator of three regional cemeteries (Cathedral Cemetery, All Saints Cemetery, and Gate of Heaven Cemetery), all located in Delaware.
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> (iii) Siena Hall, Inc. ("Siena Hall") formerly owned and operated a boys' home.
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> (iv) Children's Home, Inc. ("Children's Home") currently owns a vacant home in Wilmington, Delaware, on which it previously operated an orphanage.
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> (v) Seton Villa, Inc. ("Seton Villa") formerly provided therapeutic pre-adolescent group care for children (ages 6-12) who were not capable of living in a "family environment."

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[4] The Debtor notes that, to the extent these allegations concern *canonical* rights, duties, and powers of the Bishop, the Diocese, the Parishes, and the Parish pastors, they are properly factual allegations, in the same manner that questions of foreign law are, in a United States court, *factual* questions to be resolved based on *evidence* of what foreign law provides (whether by expert testimony or otherwise). However, to the extent these allegations concern rights, duties, and powers under civil law, they are legal conclusions that are not entitled to a presumption of truth. The Debtor assumes the Committee intended these allegations as factual allegations regarding canonical rights, duties, and powers, in which case they are accepted at face value (though disputed by the Debtor) solely for purposes of the Motion.

(vi) Catholic Youth Organization, Inc. ("CYO") serves young people and adults with training, workshops, large Diocesan events, participation in national conferences, as well as sponsoring and organizing the largest athletic league in the State of Delaware.

(Phase I at 140-41.)

The Diocesan Corporations correspond to agencies or ministries within the Diocesan Curia. Each of the Diocesan Corporations is separately incorporated as a not-for-profit, non-stock member corporation under Delaware law and is governed by a five (5) member Board of Trustees, of which the Bishop, Msgr. Cini, and Mr. Corsini (and with the exception of CYO's board, Msgr. Rebman), are members. It is assumed solely for purposes of the Motion that the members of the Diocesan Corporations serve at the pleasure of the Bishop. The Bishop is the president, and Mr. Corsini the treasurer, of each of the Diocesan Corporations. Msgr. Cini and Msgr. Rebman are also officers of certain of the Diocesan Corporations. (Compl. ¶¶ 15-20.)

IV. Catholic Diocese Foundation

Catholic Diocese Foundation ("Foundation") is a not-for-profit, non-stock member corporation organized under Delaware law. (Compl. ¶ 14.) Foundation was incorporated in 1928 for the purposes of promoting the Catholic religion, Catholic education and Catholic charity within the Diocese, but it is not a part of the Diocese. (Phase I at 140.) Foundation receives applications and provides grants for various, qualifying organizations and activities. (Id.) Foundation is governed by an eleven (11) member board Board of Trustees, of which the Bishop and Msgr. Cini are members. (Compl. ¶ 14.) The Bishop is president of Foundation, and Mr. Corsini is Foundation's Executive Director (a non-member employee position). (Id.) It is assumed, solely for purposes of the Motion, that the members of Foundation's board serve at the pleasure of the Bishop. (Id.) It is further assumed, solely for purposes of the Motion, that Foundation (i) subsidizes the operations of the Parish Corporations and the Diocesan Corporations and (ii) routinely provides financial support to the Debtor to offset the costs of lawsuits and other claims against the Debtor. (Id. ¶¶ 39-40.)

ARGUMENT

Federal Rule of Civil Procedure 12(c), made applicable to the above-captioned adversary proceeding by operation of Federal Rule of Bankruptcy Procedure 7012, provides that "after the pleadings are closed but within such time as not to delay the trial, any party may move for judgment on the pleadings." Fed. Civ. P. 12(c); Fed. R. Bankr. P. 7012. Judgment under Rule 12(c) is appropriate where no material issue of fact remains to be resolved and the movant is entitled to judgment as a matter of law. Jablonski v. Pan Am. World Airways, Inc., 863 F.2d 289, 290-291 (3d Cir. 1988). In determining a Rule 12(c) motion, the Court must view the facts presented in the pleadings, any judicially noticed facts, and the inferences to be drawn therefrom in the light most favorable to the nonmoving party. See id.; Oneida Motor Freight, Inc. v. United Jersey Bank, 848 F.2d 414, 416 n.3 (3d Cir. 1988) (finding judicial notice of adjudicative facts appropriate in determining Rule 12(c) motion).

As set forth below, the Debtor is entitled to judgment as a matter of law on the Phase II Counts because (i) the Complaint fails to state a claim on which relief can be granted, and (ii) even if the Complaint stated a plausible claim for relief, the Debtor is entitled to judgment as a matter of law on its Second, Third, Fourth, Fifth, and Sixth Affirmative Defenses.

I. THE COMPLAINT FAILS TO STATE A CLAIM UPON WHICH RELIEF CAN BE GRANTED

Federal Rule 12(h) provides that a defense of failure to state a claim upon which relief may be granted may be raised in a Rule 12(c) motion. Fed. R. Civ. P. 12(h)(2). Accordingly, a motion for judgment on the pleadings is governed by the same standard applicable to a motion to dismiss for failure to state a claim under Rule 12(b)(6). See Turbe v. Gov't of the Virgin Islands, 938 F.2d 427, 428 (3d Cir. 1991).

Rule 12(b)(6) dismissal tests the sufficiency of the pleading under Rule 8(a)(2), which provides that a pleading must contain a "short and plain statement of the claim showing that the pleader is entitled to the relief sought." Fed. R. Civ. P. 8(a)(2). While the liberal "notice pleading" standard of Rule 8 does not require detailed factual allegations, it does demand more than an unadorned, conclusory accusations. Ashcroft v. Iqbal, 129 S. Ct. 1937, 1949 (2009) (citing Bell Atl. Corp. v. Twombly, 550 U.S. 544 (2007)). Thus, "a pleading that offers labels and conclusions or a formulaic recitation of the elements of a cause of action will not do." Id. (internal quotations omitted).[5] "Nor does a complaint suffice it if tenders naked assertions devoid of further factual enhancement." Id. (internal quotations omitted). Rather, to survive scrutiny under Rule 12(b)(6), "a complaint must contain sufficient factual matter, accepted as true, to state a claim to relief that is plausible on its face." Id. (internal quotations omitted).

A claim is "plausible" when the plaintiff pleads factual content that allows the court to draw the reasonable inference that the defendant is liable under the legal theory asserted. Iqbal, 129 S. Ct. at 1949. "Where a complaint pleads facts that are merely *consistent with* a defendant's liability, it stops short of the line between *possibility* and *plausibility* of entitlement to relief." Id. (emphasis added) (internal quotations omitted). Put another way, where the well-pleaded facts do not permit the court to infer more than the mere *possibility* of liability, the complaint does not "show[] that the pleader is entitled to relief" under Rule 8(a)(2). Id. at 1950.

Whether a complaint states a plausible claim for relief is a context-specific inquiry, which "requires the reviewing court to draw on its judicial experience and common

[5] The Supreme Court went on to observe that, while the Rule 8 pleading standard "marks a notable and generous departure from the hyper-technical, code-pleading regime of a prior era, . . . it does not unlock the doors of discovery for a plaintiff armed with nothing more than conclusions." Iqbal, 129 S. Ct. at 1950.

sense." Iqbal, 129 S. Ct. at 1950. What suffices to make a claim "plausible" will "necessarily depend[] on substantive law and the elements of the specific claim asserted. . . . Some claims will demand relatively more factual detail to satisfy this standard, while others require less." In re Ins. Brokerage Antitrust Litig., No. 07-4046, 2010 U.S. App. LEXIS 17107, *45-46 n.18 (3d Cir. Aug. 16, 2010). For example, the seminal Twombly case involved an antitrust complaint alleging that the defendants conspired with one another in restraint of trade in violation of § 1 of the Sherman Antitrust Act. 550 U.S. at 550. The only concrete fact pled in support of the conspiracy allegation was parallel conduct on the part of the defendants that had the effect of restraining trade. Id. Under well-settled antitrust law, however, the plaintiffs would be required to produce some evidence at the summary judgment stage (so-called "plus factors") suggesting that the defendants' parallel conduct was the result of an illegal conspiracy rather than independent, self-interested choices made in response to similar economic circumstances. Id. at 553-54. Because the complaint failed to allege any such "plus factors," the Court reasoned, its allegation of an illegal conspiracy was a mere conclusory statement. Id. at 556-57. As a result, the complaint did not "show" the plaintiffs were entitled to relief as required by Rule 8(a)(2) and did not provide the defendants fair notice of the grounds upon which the conspiracy claim rested. Id. at 554.

In Iqbal, the Supreme Court set forth a two-step inquiry for considering Rule 12(b)(6) challenges to a complaint:

> [First,] begin by identifying pleadings that, because they are no more than conclusions, are not entitled to the assumption of truth. While legal conclusions can provide the framework of a complaint, they must be supported by factual allegations. When there are well-pleaded factual allegations, [the] court should assume their veracity and then determine whether they plausibly give rise to an entitlement to relief.

129 S. Ct. at 1950.[6] At issue in Iqbal was the sufficiency of a Pakistani detainee's claim of unconstitutional discrimination, as asserted particularly against the United States Attorney General and the director of the FBI. Id. at 1942. The Court began by identifying the necessary elements of the plaintiff's claim, which included a showing that (i) the defendants, through their own individual actions (as distinct from the actions of their subordinates), violated the Constitution, and (ii) the challenged detention policies were adopted not for a neutral, investigative purpose but for the purpose of discriminating on account of race, religion, or national origin. Id. at 1948-49. The Court then identified the following allegations as conclusory and not entitled to the assumption of truth:[7]

> (i) that the defendants knew of, condoned, and willfully and maliciously agreed to subject plaintiff to harsh conditions of confinement as a matter of policy, solely on account of his national origin and for no legitimate penological purpose; and
>
> (ii) that the Attorney General was the principal architect of this invidious policy, and the director of the FBI was instrumental in adopting and executing it.

Id. at 1951. Having cleared the underbrush, the Court went on to identify the only well-pleaded facts that had a bearing on the individual conduct of the defendants, namely:

> (i) that the FBI, under the direction of its director, arrested and detained thousands of Arab Muslim men as part of its post-9/11 investigation; and
>
> (ii) that the policy of holding post-9/11 detainees in highly restrictive conditions of confinement until they were "cleared" by the FBI was approved by the Attorney General and the director of the FBI in discussions in the weeks following 9/11.

Id. at 1960. The Court found that, taken as true, these allegations were *consistent with* the defendants' purposefully designating detainees "of high interest" because of their race, religion,

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[6] The Third Circuit follows this two-tiered approach. See Ins. Brokerage Antitrust Litig., 2010 U.S. App. LEXIS 17107 at *66 ("As the Supreme Court has instructed, we begin by identifying the complaints' bare assertions . . . .").

[7] The Court was careful to note that it "d[id] not reject these bald allegations on the ground that they are unrealistic or nonsensical . . . any more than the Court in Twombly rejected the plaintiffs' express allegation of a 'contract, combination or conspiracy to prevent competitive entry' because it thought that claim too chimerical to be maintained." Iqbal, 129 S. Ct. at 1951 (internal citation omitted). Rather, it was "the conclusory nature of the . . . allegations, rather than their extravagantly fanciful nature, that disentitle[d] them to the presumption of truth." Id.

or national origin. However, the Court posited a "more likely" explanation for the detention policies, namely that, in the aftermath of the 9/11 attacks perpetrated by certain Arab Muslims, the arrests "were likely lawful and justified by a nondiscriminatory intent to detain aliens who were illegally present in the United States and who had potential connections to those who committed terrorist acts." Iqbal, 129 S. Ct. at 1951. The Court concluded that, as between this "obvious alternative explanation" for the arrests, and the "purposeful, invidious discrimination" the plaintiff asked the Court to infer, "discrimination [wa]s not a plausible conclusion." Id. at 1951-52 (citing Twombly, 550 U.S. at 567).

Like the complaints in Twombly and Iqbal, the Committee's complaint rests upon a formulaic recitation of the elements of the Phase II Claims. As discussed below, the few well-pleaded facts that are not contradicted by adjudicative facts, even when taken as true, are at best inconclusive as to the Committee's entitlement to the extraordinary relief it seeks. Accordingly, the Phase II Claims fail as a matter of law, and judgment should enter for the Debtor.

A. The Alter Ego Claims are Not Plausible

The Committee's First Claim for Relief (Alter Ego: The Diocese, the Parishes, and the Non-Debtor Affiliates constitute a single entity) seeks a declaration that the non-debtor defendants "are mere instrumentalities agents and/or alter egos" of the Debtor and that the Debtor and the non-debtor defendants "are a single legal entity." (Compl. ¶ 74.) The Third Claim for Relief (Declaratory Relief: Diocese owns all legal and equitable interest in the Investment Account) assumes that the Debtor and the Non-Debtor Defendants are merged into a single entity and, as a logical consequence thereof, seeks a declaration that no trust can exist with respect to the PIA because the legal and beneficial interests reside in the same entity. (Id. ¶ 82.) These two Claims for Relief shall be hereinafter referred to, collectively, as the "Alter Ego Claims." For the reasons set forth below, the Alter Ego Claims fail to state plausible claims for relief under the Twombly/Iqbal standard and Delaware law. Accordingly, the Court should enter judgment dismissing the Alter Ego Claims.

1. Fraud is a Necessary Element of Alter Ego Liability

The Debtor joins in the NDD Brief, and incorporates it by reference as if set forth fully herein. As set forth in the NDD Brief, the Alter Ego Claims are governed by Delaware law, which recognizes but one legal theory – referred to interchangeably as "alter ego" or "veil piercing" – for the disregard of corporate boundaries. (NDD Br. at 6-7 n.3 & n.4.) Under Delaware law, as elsewhere, piercing the corporate veil under the alter ego theory "requires that the corporate structure cause fraud or similar injustice" – in other words, "the corporation must be a sham and exist for no other purpose than as a vehicle for fraud." Wallace v. Wood, 752 A.2d 1175, 1184 (Del. Ch. 1999) (Steele, V.C.); accord Kaplan v. First Options, 19 F.3d 1503, 1521 (3d Cir. 1994) (applying Pennsylvania law, finding that the corporate veil is pierced "only when the corporation was an artifice and a sham to execute illegitimate purposes and an abuse of the corporate fiction and immunity that it carries" (internal quotations omitted)).

2. The Complaint Fails to Allege (or Even Suggest) Fraud

Turning to the Complaint, the Debtor identifies the following allegations material to the Alter Ego Claims as conclusory and *not* entitled to the assumption of truth under the Twombly/Iqbal analysis:

> (i) that the Debtor sought bankruptcy relief "in order to obtain leverage over the victims [of sexual abuse] and to hide financial resources owned and controlled by the Diocese from victims" (Compl. ¶ 27; see id. ¶ 72 (similar));
>
> (ii) that "the Diocese exercises complete control and domination over the Parishes and Non-Debtor Affiliates, such that the Parishes and Non-Debtor Affiliates are mere instrumentalities, agents and/or alter egos of the Diocese that have no legal existence separate and distinct from the Diocese" (id. ¶ 28; see id. ¶¶ 70-71 (similar));

(iii) that, "[w]ith respect to the Non-Debtor Affiliates, the Diocese exercises complete day to day operational and financial control and domination" through the Bishop, Monsignor Cini, Mr. Corsini, and Monsignor Rebman (id. ¶ 33; see id. ¶ 70 (similar));

(iv) that, "as a result of the complete day to day operational and financial control and domination exercised by the Diocese over the Parishes and Non-Debtor Affiliates, the Parishes and the Non-Debtor Affiliates have failed, on information and belief, to observe proper corporate formalities and have not dealt with each other at arms [*sic*] length" and that "the Diocese, through the exercise of its complete operational control and domination, has caused the Parishes and the Non-Debtor Affiliates to transfer property to the Diocese and each other for either no or only nominal consideration" (id. ¶ 36);

(v) that, "[u]nder these circumstances, it would be unfair and inequitable to treat the Parishes and Non-Debtor Affiliates as separate entities" (id. ¶ 73); and

(vi) that "[d]isregarding the alleged corporate separateness of the Parishes and the Non-Debtor Affiliates is necessary to avoid the gross injustice and unfairness that would result to the abuse victims if the Diocese were permitted to remove the bulk of the assets in the Investment Account from its bankruptcy estate and place those assets beyond the reach of its abuse victims and other creditors of the Diocese" (id.).[8]

The remaining, non-conclusory allegations pertaining to the Alter Ego Claims relate to the operational, financial, and managerial ties between the Debtor and the Non-Debtor Defendants set forth in the Statement of Facts above. As noted in the NDD Brief, even if these facts are accepted as true for purposes of the Motion, and even in the aggregate, they fail to demonstrate any "fraud or similar injustice" or that any of the Non-Debtor Defendants are "sham" entities that exist "for no other purpose than as a vehicle for fraud" as required by Delaware law to maintain an alter ego cause of action.[9] Cf. Doe v. Gelineau, 732 A.2d 43, 49-51 (R.I. 1999) (applying Rhode Island law, finding operational, managerial, and financial ties

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[8] In addition to being conclusory, this allegation begs the question presented. The Debtor can only "remove" from its estate what is "in" its estate to begin with. If veil piercing is the necessary predicate to the assets *coming into* the estate in the first place, then *removal* of the assets *from* the estate cannot serve as the predicate for veil piercing.

[9] As noted in the NDD Brief, such allegations would need to be pled with particularity under Fed. R. Civ. P. 9(b), made applicable to this adversary proceeding by Fed. R. Bankr. P. 7009. However, because the allegations fail to meet even the liberal notice pleading standard of Rule 8, the Court need not reach this issue. See Iqbal, 129 S. Ct. at 1954 (finding that, although Rule 9 permitted plaintiff to aver discriminatory intent generally, it did not "give him license to evade the less rigid—though still operative—strictures of Rule 8").

between separately incorporated diocese and boys' home did not create triable issue of fact as to the use of the corporate form to perpetrate fraud; accordingly, dismissal of "alter ego" claim against diocese brought by claimant against boys' home was appropriate).[10] Accordingly, while the Committee's allegations are *consistent* with *possible* alter ego liability (based upon some set of facts not pled in the Complaint), they do not *show* that such liability is *plausible* (based on the facts that are actually pled in the Complaint), so as to put the defendants fairly on notice of the nature of the Committee's claims. Indeed, the alleged facts regarding the operational, financial, and managerial ties between the Debtor and the Non-Debtor Defendants admit of an "obvious alternative explanation," see Iqbal, 129 S. Ct. at 1951, falling well short of fraud, namely, that the entities are unified in their faith and share a common purpose of promoting the teachings of Jesus Christ and carrying out the good works of the Church within the territorial jurisdiction of the Diocese, all under the *ecclesiastical* leadership of the Bishop. "Just as all cows are mammals but not all mammals are cows," the mere fact that the Bishop is the Debtor's sole member as well as a trustee of each of the defendant entities does not mean that every action taken by the Bishop or the Debtor can be attributed to the Non-Debtor Defendants. Gelineau, 732 A.2d at 50. "Like other individuals that are affiliated with several different corporate entities, [the Bishop is] capable of acting in different capacities," and the Committee has alleged no facts that indicate the Bishop wears his "Debtor" hat when taking actions concerning any of the Non-Debtor Defendants. Id.

Additionally, with respect to the Parish Corporations in particular, the Bishop's involvement in corporate governance is unremarkable, because it is *expressly contemplated by*

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[10] The Gelineau observed that courts "are loath to act like Vlad the Impaler" when it comes to veil piercing, and "are not inclined to perforate a corporation's legal shell merely to stick one or more of its constituent or affiliated entities with liability for the corporation's misdeeds," because "respect for the legitimacy of the corporate form and its protective shield of limited liability usually dissuades courts from using their remedial swords to run them through—at least without extreme provocation to do so." 732 A.2d at 44-45.

both Delaware and Maryland corporate law regarding the establishment of Roman Catholic Church corporations. See 27 Del. C. § 115 ("In every congregation of the Roman Catholic Church, the ordinary of the diocese [i.e., the Bishop], the pastor of the congregation for the time being, . . . [and others] shall be constituted a body politic and corporate . . . ."); Md. Corporations & Associations Code § 5-315 ("The corporators of a religious corporation subject to this part shall be the following individuals, appointed or elected according to the discipline and government of the Roman Catholic Church: (1) The ordinary of the archdiocese . . . ."). It is difficult to imaging the states' legislatures, in enacting these statutes, intended to erect a corporate structure that could be torn down by the courts by virtue of the corporators' compliance with the statute requiring the Bishop's membership in the corporation.

B. The Substantive Consolidation Claim is Not Plausible

The Committee's Fifth Claim for Relief (Declaratory Relief: Substantive Consolidation) seeks a judgment ordering substantive consolidation of the Debtor's estate with the Non-Debtor Defendants (the "Substantive Consolidation Claim"). (Compl. ¶ 97.) For the reasons set forth below, the Substantive Consolidation Claim fails to state a plausible claim for relief under the Twombly/Iqbal standard and Third Circuit law. Accordingly, the Court should enter judgment dismissing the Substantive Consolidation Claim.

1. Substantive Consolidation is an Extraordinary Remedy Available in Only Two Narrow Circumstances

Substantive consolidation is a construct of federal common law, emanating from equity, which treats separate legal entities as if they were merged into a single survivor left with all the cumulative assets and liabilities, save for inter-entity liabilities, which are erased. In re Owens Corning, 419 F.3d 195, 205 (3d Cir. 2005) (Ambro, J.). Substantive consolidation has been well described as "a blunt instrument that has a profound effect on creditors' rights," In re

Garden Ridge Corp., No. 09-1261, 2010 U.S. App. LEXIS 14024, *9 (3d Cir. July 9, 2010) (Ambro, J., dissenting), and a "rough justice," "last-resort remedy" called for only in "seldom-seen situations," Owens Corning, 419 F.3d at 200 & 211. In Owens Corning, the Third Circuit outlined several principles which cabin the use of substantive consolidation, first among them being "[l]imiting the cross-creep of liability by respecting entity separateness," to protect the general expectations of state law, the Bankruptcy Code, and the commercial markets. 419 F.3d at 211. Another guiding principle is that substantive consolidation may only be used *defensively* to remedy identifiable harms caused by entanglement of the debtor's and non-debtors' affairs – it may not be used *offensively* "to disadvantage tactically a group of creditors in the plan process or to alter creditor rights." Id.

Consistent with the foregoing principles, among others, the Third Circuit articulated the following definitive standard governing substantive consolidation:

> In our Court what must be proven (absent consent) concerning the entities for whom substantive consolidation is sought is that (i) prepetition they disregarded entity separateness so significantly their creditors relied on the breakdown of entity borders and treated them as one legal entity, or (ii) postpetition their assets and liabilities are so scrambled that separating them is prohibitive and hurts all creditors.

Id. (footnotes omitted). The court explained that the former rationale is meant to protect the prepetition expectations of creditors who were "misled by debtors' actions . . . and thus perceived incorrectly (and relied on this misperception) that multiple entities were one." Id. at 211 n.19. The court explained that the latter rationale was "at bottom one of practicality when the entities' assets and liabilities have been hopelessly commingled," such that without consolidation "*all* creditors will be worse off" and with consolidation "the lot of *all* creditors will be improved". Id. at 211 n.20 (emphasis added) (internal quotations omitted).

2. The Complaint Fails to Allege Facts Establishing Disregard of Corporate Formalities or Reliance by Voluntary Creditors

A proponent of substantive consolidation under the "creditor reliance" theory must allege facts sufficient to establish a *disregard* of corporate separateness creating *contractual* expectations of creditors that they were dealing with the entities as one indistinguishable entity. Owens Corning, 419 F.3d at 212. Proponents who are creditors must also show that, in *their* prepetition course of dealing with the entities, *they* actually and reasonably relied on the entities' supposed unity. Id. Tort claimants are specifically excluded from this calculus because, "as involuntary creditors, [they] by definition did not rely on anything in becoming creditors." Id. at 212 n.21.

The only allegations in the complaint remotely responsive to the "creditor reliance" standard are conclusory and not entitled to a presumption of truth, namely:

> (i) that, "as a result of the complete day to day operational and financial control and domination exercised by the Diocese over the Parishes and Non-Debtor Affiliates, the Parishes and the Non-Debtor Affiliates have failed, on information and belief, to observe proper corporate formalities" (Compl. ¶ 36); and
>
> (ii) that "separateness of these entities was disregarded so significantly prior to the Petition Date, that creditors relied on the breakdown of entity borders and treated them as one legal entity" (Compl. ¶ 93).

Beyond these conclusory averments, there are simply no allegations in the Complaint from which the Court could infer a "disregard" of corporate formalities on the part of the Non-Debtor Defendants—indeed, the fact that the Non-Debtor Defendants' affairs are governed by boards of trustees indicates at least *some* regard for corporate formalities. More importantly, there is nothing in the Complaint that remotely suggests the creation of *contractual* expectations on the part of a *voluntary* creditor that the Debtor and the Non-Debtor Defendants operated as a single enterprise. To the contrary, the plaintiff Committee is made up entirely of involuntary tort creditors who, by definition, could not have "relied" on anything when extending credit to the

Debtor. Against this backdrop, the Substantive Consolidation Claim is properly viewed as an "offensive" tactic to enhance the recoveries to the Committee's preferred constituency at the expense of the Non-Debtor Defendants, whose substantial claims against the Debtor arising from Phase I of this proceeding would be eliminated by operation of substantive consolidation.

3. The Complaint Fails to Allege Facts Establishing Post-Petition "Scrambling" or Harm to All Creditors in the Absence of Consolidation

The "scrambling" theory of substantive consolidation is most often invoked in circumstances involving multiple debtors using a centralized cash management system, where the resolution of post-petition inter-company balances and disentanglement of cash on an estate-by-estate basis would be prohibitively expensive and dilute recoveries to all creditors—or, as stated by the Third Circuit, where "Humpty Dumpty cannot be reassembled or, even if so, the effort will threaten to reprise Jarndyce and Jarndyce, the fictional suit in Dickens' Bleak House where only the professionals profited." Owens Corning, 419 F.3d at 211 n.20. The "hopeless commingling" of assets and liabilities does not justify substantive consolidation unless separate accounting would "reduce the recovery of *every* creditor—that is, every creditor will benefit from the consolidation." Id. at 214 (emphasis in original). Put another way, a requirement of the "scrambling" theory is that "no creditor's rights will be impaired" by the proposed consolidation. Id. Moreover, the benefit to creditors sought to be preserved by substantive consolidation under the "scrambling" theory must be "from cost savings that make assets available rather than from the shifting of assets to benefit one group of creditors at the expense of another." Id.

While Owens Corning dealt with the consolidation of multiple debtor entities, it left open the possibility of consolidation of debtor and non-debtor entities. 419 F.3d at 208 n.13. However, nothing in the opinion suggests a lesser standard would apply to the consolidation of debtor and non-debtor entities. See Garden Ridge, 2010 U.S. App. LEXIS at *9-10 n.2 (Ambro, J., dissenting) (noting distinction between consensual, "deemed" consolidation and remedial consolidation, finding the latter would still be governed by the principles of Owens Corning). Accordingly, to prevail on the "scrambling" theory, the Committee must establish that no creditor of the Debtor *or any of the Non-Debtor Entities* would be impaired by the proposed consolidation, and all would benefit from it in the form of cost savings. See Owens Corning, 419 F.3d at 215.

The only allegations in the Complaint remotely responsive to this "scrambling" standard are conclusory and not entitled to a presumption of truth, namely:

> (i) that "the financial affairs of the Diocese, the Parishes and the Non-Debtor Affiliates are inextricably intertwined and interdependent" (Compl. ¶ 37);
>
> (ii) that "after the Petition Date, the assets and liabilities of the Diocese, the Parishes and the Non-Debtor Affiliates are so scrambled that separating them is prohibitive and hurts all creditors" (id. ¶ 94).

Apart from the Pooled Investment Account (with respect to which there are "meticulous, extensive and accurate" accounting records), there are no assets of the Debtor or the Non-Debtor Defendants the Committee alleges are commingled. Nor is there any debt for which the Committee alleges it is unclear which entity is liable. See Owens Corning, 419 F.3d at 214 (finding no "scrambling" where there was "no question which entity owns which principal assets and has which material liabilities"). Even if some degree of financial entanglement could be implied from the allegations in the Complaint, there would be no reason to believe that this Court could not properly order and oversee an accounting process that would disentangle the finances of the Debtor and the Non-Debtor Defendants. See id. at 215 (finding that, even in the face of accounting irregularities, the bankruptcy court could oversee an accounting process, "dealing with inaccuracies as they arise and not in hypothetical abstractions").

Perhaps more importantly, it is unclear from the Complaint whether "all creditors" who will allegedly be harmed in the absence of substantive consolidation (Compl.

¶ 94) includes – as it must – all creditors of all of the Non-Debtor Defendants. The Complaint is silent on this point, leaving the reader to speculate who these creditors might be, and how they would be harmed in the absence of substantive consolidation.[11]

Finally, irrespective of the effect of the proposed consolidation on the Debtors, it is obvious that at least some creditors of the Debtor (namely, the Non-Debtor Defendants) would be impaired by the proposed consolidation, because their substantial PIA-related claims against the Debtor resulting from the Phase I proceedings would be wiped out in exchange for the dubious cost-savings associated with the purely hypothetical disentanglement of their finances from the Debtor's finances. Under these circumstances, again, the Substantive Consolidation Claim is properly viewed as an impermissible "offensive" use of the doctrine to enhance tort creditors' rights at the expense of other creditors.

II. DEBTOR IS ENTITLED TO JUDGMENT AS A MATTER OF LAW ON ITS AFFIRMATIVE DEFENSES TO THE ALTER EGO CLAIMS

A. The Alter Ego Claims Violate the Automatic Stay

As its Second Affirmative Defense to the Complaint, the Debtor raised that the Complaint violated the automatic stay to the extent it asserted causes of action belonging to the Debtor's bankruptcy estate. (Debtor's Ans. at 16.) Section 362(a)(3) of the Bankruptcy Code prohibits "any act . . . to exercise control over property of the estate." 11 U.S.C. § 362(a)(3). Actions taken in violation of the automatic stay are void *ab initio*. Maritime Elec. Co. v. United Jersey Bank, 959 F.2d 1194, 1206 (3d Cir. 1991). Alter ego causes of action under Delaware law against related corporations of a debtor are property of the debtor's bankruptcy estate. See In re iPCS, Inc., 297 B.R. 283, 293-298 (Bankr. N.D. Ga. 2003). Cf. Schimmelpenninck v.

[11] As discussed below, even if the Complaint set out how the creditors of the Non-Debtor Defendants would fare under the proposed consolidation, there is no way to ensure testing of these allegations via the adversary process, as none of these creditors are parties to this proceeding or, for that matter, have actual notice of the Complaint.

Byrne (In re Schimmelpenninck), 183 F.3d 347, 366 (5th Cir. 1999) (reverse veil piercing/alter ego action under Texas law against entity controlled by debtor belonged to debtor's bankruptcy estate); Searcy v. Knight (In re Am. Int'l Refinery), 402 B.R. 728, 745 (Bankr. W.D. La. 2008) (same, under Nevada law).[12] Even if the Committee were to properly seek stay relief to pursue the Alter Ego Claims belonging to the Debtor's bankruptcy estate, the Debtor does not believe the Committee could meet its burden of establishing "cause" for such relief. See 11 U.S.C. § 362(d); In re RNI Wind Down Corp., 348 B.R. 286, 299 (Bankr. D. Del. 2006) (Sontchi, J.) (movant under § 362(d) has initial burden of establishing *prima facie* "cause"). Regardless, the Committee has not sought stay relief. Accordingly, the Complaint is void *ab initio* as to the Alter Ego Claims, and judgment dismissing them is appropriate. See Welt v. Conston Corp., (In re Conston, Inc.), 181 B.R. 175 (Bankr. D. Del. 1995) (dismissing complaint filed in violation of the stay); Healy/Mellon-Stuart Co. v. Coastal Group, Inc. (In re Coastal Group, Inc.), 100 B.R. 177 (Bankr, D. Del. 1989) (same).

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[12] The Debtor notes that these decisions turned upon whether, under applicable state law, a debtor would be authorized to "pierce its own veil" to impose liability upon non-debtor entities. However, even if applicable state law provided that veil piercing was solely a "creditor" remedy, § 544 of the Bankruptcy Code invests the representative of the bankruptcy estate with all the rights and powers of a hypothetical judgment lien creditor as of the petition date. 11 U.S.C. § 544(a). Accordingly, even if a debtor could not "pierce its own veil" under state law, an alter ego/veil piercing action would still be assertable by the debtor in possession under § 544, and such action would constitute property of the estate by virtue of § 541(a)(7) (including within the estate "[a]ny interest in property that the estate acquires after the commencement of the case").

B. The Committee Lacks Standing to Pursue the Alter Ego Claims

As its Third Affirmative Defense to the Complaint, the Debtor raised that the Committee lacked standing to pursue the Alter Ego Claims on behalf of the Debtor's estate. (Debtor's Ans. at 16.) Derivative standing for an official committee to pursue estate causes of action is not automatic, and is governed by well-settled law requiring, at a minimum, a demand upon the debtor to pursue the litigation, followed by an unreasonable refusal to proceed, in violation of the debtor's fiduciary duty to its estate and creditors. See Official Comm. of Unsecured Creditors of Cybergenics Corp. ex rel. Cybergenics Corp. v. Chinery, 330 F.3d 548, 568-569 (3d Cir. 2003) (en banc). Thus, in Cybergenics, derivative standing was authorized where (i) the Debtor notified the bankruptcy court it would not pursue any fraudulent transfer actions, arguing that the probability of recovery was sufficiently low that the costs of litigation would likely outweigh any benefits, (ii) the creditors' committee responded *by volunteering to bear all of the costs* of a particular action so that it could go forward, and (iii) the Debtor nonetheless refused to pursue the action. 330 F.3d at 554.

As discussed above, the Alter Ego Claims are property of the Debtor's bankruptcy estate. The Debtor, as the duly authorized representative of its bankruptcy estate, has the sole ability to prosecute – or, in its business judgment, *not to* prosecute – the Alter Ego Claims in accordance with its fiduciary duties to creditors. See 11 U.S.C. § 1107(a) (investing debtor in possession with the rights of a trustee) & § 363 (authorizing trustee's use of property of the estate). To be clear, the Debtor does not intend to pursue the Alter Ego Claims against the Non-Debtor Defendants. However, the Debtor does not believe the Committee can meet its burden under Cybergenics of establishing the Debtor's refusal to pursue the Alter Ego Claims is unreasonable. Regardless, the Committee has not sought derivative standing to bring the Alter

Ego Claims on behalf of the Debtor's estate. Accordingly, judgment should enter dismissing the Alter Ego Claims for lack of standing.

III. DEBTOR IS ENTITLED TO JUDGMENT AS A MATTER OF LAW ON ITS AFFIRMATIVE DEFENSES TO THE SUBSTANTIVE CONSOLIDATION CLAIM

As its Third, Fourth, Fifth, and Sixth Affirmative Defenses to the Complaint, the Debtor raised (i) that the Committee lacked standing to pursue the Substantive Consolidation Claim, (ii) that the Substantive Consolidation Claim violates the Debtor's exclusivity rights under § 1121(b) of the Bankruptcy Code, (iii) that the Substantive Consolidation Claim violates § 303 of the Bankruptcy Code governing involuntary bankruptcy relief, and (iv) that the Committee failed to join parties necessary to adjudication of the Substantive Consolidation Claim. (Debtor's Ans. at 16-17.) These defenses are all premised, to varying degrees, on the nature of substantive consolidation as an equitable remedy, and the well-settled law in the Third Circuit circumscribing the bankruptcy courts' use of their inherent equitable powers. In <u>In re Combustion Engineering, Inc.</u>, the Third Circuit explained the bankruptcy courts' equitable powers thus:

> Bankruptcy courts are courts of equity, empowered to invoke equitable principles to achieve fairness and justice in the reorganization process. As courts of equity, bankruptcy courts have broad authority to modify creditor-debtor relationships.
>
> Section 105(a) of the Bankruptcy Code expressly provides bankruptcy courts the equitable power to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." 11 U.S.C. § 105(a). This section has been construed to give a bankruptcy court broad authority to provide equitable relief appropriate to assure the orderly conduct of reorganization proceedings.
>
> Nevertheless, the equitable powers authorized by § 105(a) are not without limitation, and courts have cautioned that this section does not authorize the bankruptcy courts to create substantive rights that are otherwise unavailable under applicable law, or constitute a roving commission to do equity. Importantly . . . , § 105(a) does not give the court the power to create substantive rights that would otherwise be unavailable under the Code.

> The general grant of equitable power contained in § 105(a) cannot trump specific provisions of the Bankruptcy Code, and must be exercised within the parameters of the Code itself. When the Bankruptcy Code provides a specified means . . . to obtain a specific form of equitable relief, those standards and procedures must be observed.

391 F.3d 190, 235-236 (3d Cir. 2004) (internal quotations, citations omitted). Based upon these principles, the Combustion Engineering court vacated a § 105(a) channeling injunction in an asbestos chapter 11 plan where the specific requirements of § 524(g) (regarding the channeling of asbestos claims) had not been met. Id. at 236 (finding "the general powers of § 105(a) cannot be used to achieve a result not contemplated by the more specific provisions of § 524(g)").

In Owens Corning, the Third Circuit acknowledged a body of law and scholarship questioning the statutory basis for substantive consolidation in light of the acknowledged limitations upon the bankruptcy courts' general equity powers under § 105(a). See 419 F.3d at 208 n.14 (citing, *inter alia*, J. Maxwell Tucker, Grupo Mexicano and the Death of Substantive Consolidation, 8 Am. Bankr. Inst. L. Rev. 427 (2000) (hereinafter "Tucker")). The court also acknowledged that, "[b]ut for joint spouse estates in Bankruptcy Code § 302(a), consolidation is permitted only in the context of a confirmed plan of reorganization and the requirements that entails." Id. (citing Tucker, supra, at 449 (citing 11 U.S.C. § 1123(a)(5)(C)). However, because § 1123(a)(5)(C) of the Bankruptcy Code specifically authorizes "consolidation of the debtor with one or more persons" pursuant to a plan "notwithstanding any otherwise applicable non-bankruptcy law," and because the "deemed" consolidation before the court had arisen in the context of a chapter 11 plan, the court did not need to address "[w]hether § 105(a) allows consolidation outside a plan," and specifically preserved that issue for another day. Id.; accord In re Stone & Webster, 286 B.R. 532, 540-43 (Bankr. D. Del. 2002) (Walsh, J.) (declining to consider whether § 105(a), standing alone, would provide a sufficient basis for consolidation where consolidation before the court was brought pursuant to a chapter 11 plan and, accordingly, expressly authorized by § 1123(a)(5)(C)).

This is another day. As the proposed consolidation in this case arises outside the context of a chapter 11 plan, it directly implicates the limits of this Court's general equitable powers under § 105(a), particularly because (i) non-consensual substantive consolidation of the Non-Debtor Defendants with the Debtor would effectively provide for involuntary bankruptcy relief against not-for-profit entities at the instance of creditors of another entity (i.e., the Debtor) holding disputed, contingent litigation claims, all in direct contravention of § 303 of the Bankruptcy Code, and (ii) substantive consolidation outside the plan process, during the Debtor's exclusive plan filing and solicitation periods, would impermissibly intrude on the Debtor's exclusivity rights and would fail under basic due process principles because the creditors of the Non-Debtor Defendants have no actual or constructive notice of this adversary proceeding.

A. The Substantive Consolidation Claim Constitutes an Impermissible, Back-Door Involuntary Bankruptcy Petition

Involuntary bankruptcy relief is governed by § 303 of the Bankruptcy Code, which expressly provides that an involuntary petition may not be brought against a corporation that is not a "moneyed, business or commercial corporation." 11 U.S.C. § 303(a). The phrase "moneyed, business or commercial corporation" refers to for-profit corporations. Strassburger v. Quinn (In re Grace Christian Ministries, Inc.), 387 B.R. 352, 355 (Bankr. W.D. Pa. 2002). Thus, a *not*-for-profit corporation may *not* be an involuntary debtor. Id. This comports with the legislative history of § 303, which indicates that "schools, churches, charitable organizations and foundations" are protected from involuntary bankruptcy. Id. (citing H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 321 (1977); S. Rep. No. 95-595, 95th Cong., 2d Sess. 33 (1978), reprinted in 1978 U.S.C.C.A.N. 5963, 6277, 5787 & 5819).

Section 303 also requires, among other things, that an involuntary petition be filed by the "holder of a claim against [the alleged debtor] that is not contingent as to liability or the subject of a bona fide dispute as to liability or amount." 11 U.S.C. § 303(b)(1). The disqualification of petitioning creditors holding disputed claims was introduced into the Bankruptcy Code in 1984, in response to the filing of involuntary petitions and the granting of involuntary relief even where the debtor's reason for not paying was a legitimate and good-faith dispute over his or her liability. In re Henry, 52 B.R. 8, 9-10 (Bankr. S.D. Ohio 1985). This practice permitted creditors "to use the Bankruptcy Code as a club against debtors who have bona fide questions about their liability, but who would rather pay up than suffer the stigma of involuntary bankruptcy proceedings," and the proposed disqualification of disputed claims was viewed as "necessary to protect the rights of debtors and to prevent misuse of the bankruptcy system as a tool of coercion." Id. (quoting statements of Senator Baucus, the proponent of the amendment, 130 Cong. Rec. S7618 (June 19, 1984)); accord Key Mechanical Inc. v. BDC 56 LLC (In re BDC 56 LLC), 330 F.3d 111, 118-19 (2d Cir. 2003) (noting that, absent the disqualification of disputed claims, "creditors could, on the basis of relatively untested claims, haul a solvent debtor with whom they have legitimate disputes into bankruptcy court and force it to defend an involuntary proceeding while the bankruptcy court leaves for a later merits determination whether the debtor is even properly before it").

None of the Non-Debtor Defendants, which are not-for-profit corporations, could be involuntarily petitioned into bankruptcy. Even if they were for-profit entities, they could not be petitioned into bankruptcy by creditors *of the Debtor*. And even if the petitioning creditors had claims against the Non-Debtor Defendants, they could not seek involuntary bankruptcy relief based upon disputed litigation claims (at least, not without subjecting themselves to sanctions, see 11 U.S.C. § 303(i)). Were the Committee permitted to substantively consolidate the Non-

Debtor Defendants with the Debtor, it would be obtaining relief against he Non-Debtor Defendants that is specifically precluded by § 303. Under these circumstances, the general equitable powers of § 105(a) power must yield to the specific provisions of § 303. See Combustion Eng'g, 391 F.3d at 235-236 (finding § 105(a) could not be used to circumvent requirements of § 524(g)); Helena Chemical Co. v. Circle Land & Cattle Corp. (In re Circle Land & Cattle Corp.), 213 B.R. 870, 876-77 (Bankr. D. Kan. 1997) (dismissing substantive consolidation complaint brought against non-debtor farmer[13] by creditor of the debtor; finding such relief would run afoul of limitations on involuntary bankruptcy petitions under § 303); Morse Operations, Inc. v. Robins Le-Cocq, Inc. (In re Lease-A-Fleet, Inc.), 141 B.R. 869, 876 (Bankr. E.D. Pa. 1992) (dismissing substantive consolidation complaint brought against non-debtor by creditor of the debtor, finding it "an indirect attempt to file an involuntary case against [the non-debtor], which, if attempted directly, would be subject to sanctions under § 303(i)").

Beyond the limitations imposed upon the general § 105(a) power by more specific provisions of the Bankruptcy Code, "involuntary substantive consolidation of the case of a debtor with the non-case of a non-debtor is a type of relief fraught with conceptual problems." Lease-A-Fleet, 141 B.R. at 869.

The Lease-A-Fleet court observed that substantive consolidation is a powerful tool that is "pregnant with consequences," counseling caution as a general matter. Id. at 872. Where the target of the consolidation is a non-debtor, the court found this caution "must be multiplied exponentially," particularly in light of due process concerns vis-à-vis the target entity's creditors, who will bear the brunt of the effects of consolidation. Id. (noting the court, based on this concern, had ordered notice of the adversary proceeding be provided to all creditors of the non-debtor target). Accord In re Julien Co., 120 B.R. 930 (Bankr. W.D. Tenn. 1990) ("At

[13] Section 303 also prohibits involuntary relief against a farmer. 11 U.S.C. § 303(a).

the very least, notice to [the non-debtor target's] creditors should be required before their claims are potentially consolidated with the [debtor's] creditors' claims."); In re Alpha & Omega Realty, Inc., 36 B.R. 416, 417 (Bankr. D. Idaho 1984) (finding that motion to consolidate non-debtor entity with debtor entity did not afford due process to the separate creditors of the non-debtor parties). Indeed, given the effect of substantive consolidation on creditor rights, due process would appear to require, at a minimum, that (i) creditors of the entities sought to be consolidated be given due notice of the application to consolidate their debtors with the concomitant right (ii) to be present at the hearing on the application, (iii) to be hear, by testimony or otherwise, and (iv) the right to controvert by proof every material fact which bears on the issue involved. In re N.S. Garrott & Sons, 48 B.R. 13 (Bankr. E.D. Ark. 1984) (citing Charles Seligson and Charles F. Mandell, Multi-Debtor Petition-Consolidation of Debtors and Due Process of Law, 73 Commercial Law Journal 341 (1968)). Indeed, Owens Corning presupposed at least this level of creditor involvement in a substantive consolidation proceeding, when it instructed that a *prima facie* case for substantive consolidation under the "creditor reliance" rationale may be rebutted by a creditor opponent of substantive consolidation "if they can prove they are adversely affected and actually relied on [the entities'] separate existence." 419 F.3d at 212. Here, however, the only parties having actual notice of the pendency of these proceedings are the parties hereto—how, then, can the creditors of the Non-Debtor Defendants be expected to put on their rebuttal cases?

The Lease-A-Fleet court also noted (correctly) that involuntary substantive consolidation of non-debtor entities would place them in "an unusual circumstance, betwixt and between the Bankruptcy Code," stating:

> It is not even clear exactly what of [the involuntary non-debtor consolidatee] would actually be consolidate with the Debtor's estate if the relief sought by [the plaintiff] were granted to it. [The] complaint does not clarify this mystery, as it merely requests that the court "substantively consolidate" [the non-debtor] and the

> Debtor. We therefore query: if this relief were granted, would [the non-debtor] then have a bankruptcy "case" or would it arrive in this court, in some other form, as a non-debtor somehow attached to the Debtor's case? It seems to this court that it is cruel and unusual, among other things, for an entity to be in some way appended as a party to a debtor's case, but to not have the benefit of the automatic stay, avoidance powers, or the right to formulate a plan of reorganization, as does any debtor.

141 B.R. at 874. In an involuntary bankruptcy proceeding, of course, the result would be clear—an order for relief would be entered, and the alleged debtor would become an actual debtor under the applicable chapter of the Bankruptcy Code, with all the rights and obligations attendant thereto. Under the Committee's Complaint, however, the endgame is no more clear than in the Lease-A-Fleet case. A judgment merely "substantively consolidating" the Debtor and the Non-Debtor Defendants would resolve the questions of property ownership, to be sure—but in all other respects it would release this chapter 11 case from its statutory moorings and set it adrift with § 105(a) as its only rudder. Section 105(a) simply cannot be construed, consistent with Combustion Engineering, to sanction the creation of quasi-involuntary bankruptcy proceedings where the requirements of a statutory involuntary proceeding under § 303 are not otherwise met. See 391 F.3d at 236 (finding asbestos channeling injunction under § 105(a) improper where requirements of § 524(g) not met).

B. Substantive Consolidation in a Chapter 11 Case Cannot be Sought Outside a Chapter 11 Plan

As noted by the Owens Corning court, among others, the only statutory basis for consolidation in the chapter 11 context is § 1123, which provides, in pertinent part, as follows: "Notwithstanding any otherwise applicable nonbankruptcy law, a plan shall . . . provide adequate means for the plan's implementation, such as . . . merger or consolidation of the debtor with one or more persons . . . ." 11 U.S.C. § 1123(a)(5)(C). The plain language of the statute indicates the means for implementation of a plan set forth in § 1123(a)(5) are illustrative, rather than exclusive, and are permissive, rather than mandatory. See id. Thus, there is no requirement that a confirmable plan substantively consolidate the debtor with any non-debtor entity. If the plan does propose substantive consolidation, however, it will be subject to all the procedural protections of the plan process, including notice and disclosure to all parties, voting, and satisfaction of the requirements as to the content of the plan under § 1123 and confirmation of the plan under § 1129. The contents of the plan would necessarily include adequate means to implement the plan, to address, among other things, the "betwixt and between" status of the proposed non-debtor consolidatees. See 11 U.S.C. § 1123(a)(5) (requiring plan to contain adequate means for its implementation). And the requirements for plan confirmation would require a showing that the plan is in the best interests of creditors, does not discriminate unfairly among classes of creditors, and is fair and equitable. 11 U.S.C. § 1129(a)(7) & (b)(1). None of these protections are present in the present adversary proceeding, as the Committee's Complaint (i) was not served upon creditors of the Non-Debtor Defendants (or, for that matter, on general creditors of the Debtor), (ii) hardly provides any meaningful information regarding the basis for, or effects of, substantive consolidation,[14] and (iii) was never intended to be put to a vote of creditors. Indeed, given that the bar date in this chapter 11 case did not apply to creditors of Non-Debtor Defendants, it is not presently possible to determine who they are, even if one were to attempt to serve them. Thus, just as substantive consolidation under § 105(a) cannot be used to circumvent the requirements of an involuntary bankruptcy proceeding under § 303 of the Bankruptcy Code, an adversary complaint cannot be used to sidestep the procedural and substantive hurdles to plan confirmation under § 1123 and § 1129. See Combustion Eng'g, 391

[14] See N.S. Garrott & Sons, 48 B.R. at 18-19 (denying confirmation of substantive consolidation plan where plan and disclosure statement were "vague at best" as to the effect of consolidation on unsecured creditors, which appeared to violate the best interests test under § 1129(a)(7)).

F.3d at 236 (finding asbestos channeling injunction under § 105(a) improper where requirements of § 524(g) not met).

Permitting substantive consolidation to go forward in an adversary proceeding divorced from any chapter 11 plan also creates tension with the Debtor's exclusivity rights under § 1121 of the Bankruptcy Code. Exclusivity is a fundamental debtor right in chapter 11. Its purpose is to afford the debtor the opportunity to propose a chapter 11 plan and to solicit acceptances of such plan without the deterioration and disruption to the debtor's business operations that might be caused by the filing of competing plans by non-debtor parties. Geriatrics Nursing Home v. First Fidelity Bank, N.A., 187 B.R. 128, 133 (D.N.J. 1995). As noted above, chapter 11 plans *may*, but are not *required*, to provide for the consolidation of the debtor with non-debtor entities. See 11 U.S.C. § 1123(a)(5)(C). The Committee's Complaint, however, seeks to *compel* substantive consolidation, in effect dictating the central, material terms of any future chapter 11 plan, while at the same time skirting the procedural and substantive requirements of the plan process. Cf. Motorola, Inc. v. Official Comm. of Unsecured Creditors (In re Iridium, Inc.), 478 F.3d 452, 466 (2d Cir. 2007) (noting that, in the § 363 sale context, a debtor in possession is prohibited from entering into a transaction "if it would amount to a *sub rosa* plan of reorganization . . . that will, in effect, short circuit the requirements of Chapter 11 for confirmation of a reorganization plan" (internal quotations omitted)). This is at odds with the Debtor's exclusive right to file and prosecute a *non*-consolidating plan during its exclusivity period. Accordingly, even if substantive consolidation were permitted to go forward in the context of an adversary proceeding, it should *not* be permitted to go forward during the Debtor's exclusivity period. The Bankruptcy Code plainly contemplates the Debtor would be afforded an opportunity to prosecute its Plan without interference from the Committee, and the use of the naked § 105(a) power, decoupled from § 1123(a)(5)(C), should not be permitted to trump this.

CONCLUSION

WHEREFORE, for the reasons set forth herein, the Debtor respectfully requests that the Court (i) enter judgment for the Debtor dismissing the Phase II Claims with prejudice and (ii) award the Debtor such other and further relief as is just and proper.

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