

# REDEFINING INTO REALITY: SUBSTANTIVE CONSOLIDATION OF PARENT CORPORATIONS AND SUBSIDIARIES

## INTRODUCTION

Substantive consolidation is a bankruptcy procedure that redefines multiple bankruptcy estates into a single bankruptcy estate.<sup>1</sup> This redefinition results in the estate's assets and liabilities being added together to create a new bankruptcy estate.<sup>2</sup> Creditors with claims against any of the separate estates receive a claim against the new estate.<sup>3</sup> Although substantive consolidation is not limited to any certain legal entities, this Comment considers substantive consolidation solely in the context of parent corporations and their corporate subsidiaries because the relationships between parent corporations and subsidiaries are different than those between other legal entities.<sup>4</sup> Subsidiaries, by definition, are owned by their parent corporations.<sup>5</sup> This ownership gives the parent corporations a substantial amount of influence over their subsidiaries. Hence, some courts have found that some subsidiaries are “mere instrumentalities” of their parent corporations, their relationships being more like that between a person and their limbs than between distinct individuals.<sup>6</sup> This relationship increases the likelihood that creditors could reasonably be led to believe that the parent corporation and its subsidiaries were one entity and therefore should be considered when evaluating whether substantive consolidation should be allowed.

The main rationale behind applying substantive consolidation to certain cases is to promote equity.<sup>7</sup> Substantive consolidation promotes equity when it

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<sup>1</sup> *In re Hemingway Transp., Inc.*, 954 F.2d 1, 11–12 (1st Cir. 1992).

<sup>2</sup> Sabin Willett, *The Doctrine of Robin Hood: A Note on “Substantive Consolidation”* 4 DEPAUL BUS. & COMM. L.J. 87, 88 (2005).

<sup>3</sup> *Id.*

<sup>4</sup> *See id.* at 88–89 (distinguishing artificial persons from natural persons).

<sup>5</sup> BLACK'S LAW DICTIONARY 368 (8th ed. 2004).

<sup>6</sup> *See, e.g.,* *Sampsell v. Imperial Paper & Color Corp.*, 313 U.S. 215, 217 (1941); *Fish v. East*, 114 F.2d 177, 191 (10th Cir. 1940); *Stone v. Eacho*, 127 F.2d 284, 286 (4th Cir. 1942).

<sup>7</sup> *In re Owens Corning*, 419 F.3d 195, 216 (3d Cir. 2005) (concluding that “substantive consolidation at its core is equity”); *Union Sav. Bank v. Augie/Restivo Baking Co. (In re Augie/Restivo Baking Co.)*, 860 F.2d 515, 518 (2d Cir. 1988) (concluding that “the sole purpose of substantive consolidation is to ensure the

redefines bankruptcy estates to better reflect the intent exhibited by the respective creditors in their dealings with the entities.<sup>8</sup> Courts have developed various tests to determine the cases in which ordering substantive consolidation would promote equity.<sup>9</sup> Presently no single test has been universally embraced as the best method to promote equity consistently.

Most recently the Third Circuit Court of Appeals created a new test that seems to have combined the previous approaches.<sup>10</sup> The Third Circuit chose to create a new test because the court feared that previous tests created inconsistent outcomes that ignored equity.<sup>11</sup> Instead of reworking the tests or creating a new test in an attempt to pursue an equitable outcome, the court created its test to limit the ability of bankruptcy courts to allow substantive consolidation.<sup>12</sup> The test is inappropriate for parent corporations and subsidiaries because it creates an unwarranted predisposition against substantive consolidation and fails to consider the power that a parent corporation has over its subsidiaries.

This Comment advocates a new test specifically for evaluating whether substantive consolidation should be ordered for parent companies and their subsidiaries. This new test uses both subjective and objective components to carefully evaluate whether substantive consolidation would best fulfill the creditors' expectations. It minimizes inconsistency while taking into account the parent corporation's influence. The new test better promotes equity by improving on the current tests' flaws that hamper a court's ability to determine creditors' expectations.

This Comment is divided into six parts. Part I describes the parent-subsidiary relationship and the effects of substantive consolidation on this relationship. Part II describes the creation of substantive consolidation. Part III evaluates the avenues of support that legitimize the use of substantive consolidation. Part IV examines the circumstances surrounding the creation of

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equitable treatment of all creditors"); *Drabkin v. Midland-Ross Corp. (In re Auto-Train Corp.)*, 810 F.2d 270, 276 (D.C. Cir. 1987) (giving special attention to whether substantive consolidation "yields benefits offsetting the harm it inflicts on objecting parties").

<sup>8</sup> *In re Augie/Restivo Baking Co.*, 860 F.2d at 519 (determining that the expectations of the creditors at the time of the loan "create significant equities").

<sup>9</sup> See, e.g., *In re Owens Corning*, 419 F.3d at 211; *In re Augie/Restivo Baking Co.*, 860 F.2d at 518-19; *In re Auto-Train Corp.*, 810 F.2d at 276.

<sup>10</sup> *In re Owens Corning*, 419 F.3d at 211.

<sup>11</sup> *Id.* (referring to substantive consolidation as imprecise "rough justice").

<sup>12</sup> *Id.* (determining that impreciseness of the substantive consolidation test is a reason to employ substantive consolidation as a last resort).

the three current substantive consolidation tests. Part V outlines the current tests' flaws. Part VI outlines a new test for determining whether parent corporations and subsidiaries should be substantively consolidated.

## I. CORPORATE RELATIONSHIPS AND SUBSTANTIVE CONSOLIDATION

The relationship between a parent corporation and its subsidiary is complex and different from the relationships between other types of entities. It is important to evaluate the differences and acknowledge that parent corporations and their subsidiaries should be treated differently when considering whether to order the entities' substantive consolidation. The following two subsections serve to provide an overview and summary of two important considerations relevant to this Comment: the uniqueness of the parent-subsidiary relationship and the effects of substantive consolidation.

### A. *The Close Relationships Between Parent Corporations and Their Subsidiaries*

Interaction with corporations and subsidiaries is a daily occurrence for many people, but the distinctions between a parent corporation and a subsidiary are rarely apparent. Suppose a person searching for a new automobile logs onto the Ford Motor Company's website. That person would be offered a choice between eight different automobile brand names.<sup>13</sup> That same person could also decide to purchase one of the listed automobiles of a certain brand and proceed to obtain financing from one of the links provided on that website.<sup>14</sup> These options and services are the result of the cooperation of many different legal entities, including a multitude of subsidiaries.<sup>15</sup>

Subsidiaries have a close relationship with the parent corporation. A subsidiary is defined as "a corporation in which a parent corporation has a controlling share."<sup>16</sup> In the above example, Ford Motor Company was the parent corporation. From a practical standpoint, the relationship between parent corporations and subsidiaries is symbiotic. The parent corporation owns

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<sup>13</sup> Ford Motor Company Home Page, <http://www.ford.com> (last visited Jan. 23, 2008).

<sup>14</sup> Ford Motor Company Purchasing and Financing, <http://www.ford.com/vehicles/purchasing-financing>.

<sup>15</sup> See generally Ford Motor Company SEC 10-K Filing, Feb. 22, 2006, <http://www.sec.gov/Archives/edgar/data/37996/000003800906000031/ex21.htm>. (listing Ford Motor Company's major subsidiaries as of Feb. 22, 2006).

<sup>16</sup> BLACK'S LAW DICTIONARY 368 (8th ed. 2004).

the majority, if not all, of the subsidiary's stock.<sup>17</sup> This investment by the parent company has two direct effects. First, it allows the parent corporation to completely control the subsidiary corporation, just as the parent corporation's shareholders control the parent corporation, using it to advance the parent corporation's interests within an industry on a transactional level.<sup>18</sup> Second, the investment gives the parent corporation a stake in the performance of the subsidiary because the value of the parent company's interest is directly affected by the performance of the subsidiary.<sup>19</sup> Although subsidiaries are legally recognized as separate and distinct entities, in reality the effects of parent corporation ownership sometimes result in a blurring of the lines that causes third parties to believe that the separate entities are actually one unit.<sup>20</sup> The uniqueness of these relationships is an important consideration as substantive consolidation is a radical process that serves to give effect to the expectations of creditors. The following section illustrates the dramatic effects of substantive consolidation.

### *B. Substantive Consolidation's Effects*

When a corporation and its subsidiaries file for chapter 11 bankruptcy, they do so as separate legal entities.<sup>21</sup> The filings create "bankruptcy estates" that are completely separate and distinct regardless of closeness of the relationships between the parent corporation and its subsidiaries. Ironically, unlike bankruptcies of truly separate and distinct legal entities, the bankruptcy cases of the parent corporation and its subsidiaries are typically "administratively consolidated," with one judge presiding over the case and the same lawyers representing all of the debtors.<sup>22</sup> Despite this fact, "the separateness of the legal entities is preserved."<sup>23</sup>

The separate division of the bankruptcy estates can result in the creditors of both the corporation and the subsidiaries being treated differently in

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<sup>17</sup> *See id.*

<sup>18</sup> *See, e.g., In re Owens Corning*, 419 F.3d 195, 201 (3d Cir. 2005) (explaining how Owens Corning's subsidiaries, in exchange for *nothing*, accepted full responsibility for Owens Corning's debt if the parent company was unable to pay).

<sup>19</sup> *See* 1-6 White, *NEW YORK BUSINESS ENTITIES* ¶ 6.05 (2004) (noting the tax consequences of subsidiary ownership). Between profits paid to the shareholder, the parent corporation, and the resale value of the subsidiary, parent corporations incur substantial monetary benefit from the performance of their subsidiaries. *See id.*

<sup>20</sup> *See, e.g., Nesbit v. Gears Unlimited, Inc.*, 347 F.3d 72, 88 (3d Cir. 2003).

<sup>21</sup> Douglas G. Baird, *Substantive Consolidation Today*, 47 B.C. L. REV. 5, 6 (2005).

<sup>22</sup> *Id.*

<sup>23</sup> *Id.*

bankruptcy proceedings than they would have been if the parent corporation and subsidiaries were still solvent.<sup>24</sup> Although creditors, relying on the closeness of the entities, might have extended credit to the parent corporation in the form of a loan that benefits both the parent company and its subsidiaries, typically this possibility, and the creditors' expectations are completely ignored in bankruptcy;<sup>25</sup> the creditors are forced to collect solely from the parent corporation.<sup>26</sup> The result is inequitable as the creditors are forced to deal with an estate in bankruptcy comprised of merely a part of the unit to which the creditors believed they had extended credit. As a result of this inequitable practice, the creditors who had extended credit based on the entities as a unit but receive more based on the subsidiaries' bankruptcy estates being separate, receive a windfall.<sup>27</sup> Creditors who extended credit based on the entities' unity collect less and suffer unforeseen losses.<sup>28</sup>

Bankruptcy courts address this departure from reality by using substantive consolidation to redefine the petitioner, which ends up redefining the bankruptcy estates.<sup>29</sup> Substantive consolidation allows the court to ignore the separateness of the bankruptcy estates.<sup>30</sup> The assets and liabilities of the parent corporation and its subsidiaries are no longer separate but are treated as a larger combined bankruptcy estate.<sup>31</sup> The effects of substantive consolidations are dramatic, but no parties are more affected than the entities' creditors.

The differences between the traditional bankruptcy estate and the substantively consolidated bankruptcy estate primarily affect unsecured creditors.<sup>32</sup> Although a debtor parent corporation might seem to benefit from consolidation because its subsidiaries' assets can be used to pay off its debts, the use of the assets diminishes the subsidiaries' equity and therefore decreases the value of the parent corporation's ownership interest in the subsidiaries'

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<sup>24</sup> See *Nesbit*, 347 F.3d at 88 (noting that the closeness of the entities can lead to third parties dealing with the entities as "one unit").

<sup>25</sup> See *In re Owens Corning*, 419 F.3d 195, 210–11 (3d Cir. 2005) (recognizing that substantive consolidation can be used to address the creditors' expectations).

<sup>26</sup> See, e.g., *id.* The subsidiaries' individual creditors are forced to collect from the individual subsidiary to which they extended credit, completely disregarding those creditors' expectations. See *id.*

<sup>27</sup> See Mary Elisabeth Kors, *Altered Egos: Deciphering Substantive Consolidation*, 59 U. PITT. L. REV. 381, 382 (1998) (suggesting that unconsolidated entities' bankruptcy proceedings will result in different recoveries for creditors than would be attained by the same creditors from the consolidated entity).

<sup>28</sup> See *id.*

<sup>29</sup> *In re Hemingway Transp., Inc.*, 954 F.2d 1, 11–12 (1st Cir. 1992).

<sup>30</sup> See Kors, *supra* note 27, at 382 (comparing the process to pooling the bankruptcy estates together).

<sup>31</sup> *In re Owens Corning*, 419 F.3d 195, 206 (3d Cir. 2005).

<sup>32</sup> *Id.*

stock.<sup>33</sup> Fully secured creditors, likewise, are not affected because they still retain the value of their security interest. Unsecured creditors, on the other hand, have to deal with changes in both the amount of assets remaining in the estate and the amount of creditors vying for those assets.<sup>34</sup>

The difference in actual collection for unsecured creditors can be substantial but is limited to the distribution of the remaining assets.<sup>35</sup> For example, three unsecured creditors with claims against the subsidiary and who would otherwise receive equal portions of the subsidiary's remaining \$3 million in assets would only receive half that amount if they were consolidated with the parent corporation's nine unsecured creditors and \$3 million in remaining assets. In that example, the parent corporation's unsecured creditors would receive twice as much from the consolidation as they would have if the bankruptcy estates had not been consolidated. The decision to substantively consolidate the bankruptcy estates does not affect the total amount of assets distributed to the unsecured creditors but instead the distribution of the assets.<sup>36</sup> Substantive consolidation, therefore, provides courts with a useful tool to redefine bankruptcy estates to reflect the realities of the business world, allowing for the distribution of assets consistent with these realities.

### *C. The Importance of Perspective in Evaluating Substantive Consolidation Tests*

Substantive consolidation is a dramatic undertaking that attempts to help bankruptcy law better reflect the reality of business relationships and transactions outside of the bankruptcy court.<sup>37</sup> In the absence of consolidation, a corporation and its subsidiaries would be treated as completely separate and independent entities.<sup>38</sup> The relationship between a parent corporation and its subsidiary is much different than the relationships between other corporate entities because parent corporations actually have ownership over the subsidiary.<sup>39</sup> Substantive consolidation can help bankruptcy law to better reflect reality by combining the estates of corporations whose relationship is so

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<sup>33</sup> See, e.g., *id.*

<sup>34</sup> See, e.g., *id.*; *In re Augie/Restivo Baking Co.*, 860 F.2d 515, 519 (2d Cir. 1988); *Fish v. East*, 114 F.2d 177, 191 (10th Cir. 1940).

<sup>35</sup> Willett, *supra* note 2, at 88–89.

<sup>36</sup> *Id.*

<sup>37</sup> *In re Augie/Restivo Baking Co.*, 860 F.2d at 519 (substantive consolidation helps to reflect creditor's realistic expectations).

<sup>38</sup> Baird, *supra* note 21, at 6.

<sup>39</sup> BLACK'S LAW DICTIONARY 368 (8th ed. 2004).

close that the “lines” between them are blurred.<sup>40</sup> However, substantive consolidation ultimately affects the amount that each creditor collects.<sup>41</sup> Therefore, substantive consolidation should be applied while carefully considering its effects on the entities’ creditors. The next step in understanding substantive consolidation is to analyze its creation.

## II. WHERE SUBSTANTIVE CONSOLIDATION BEGAN

Substantive consolidation was created by the Supreme Court and reluctantly applied by the circuit courts of appeals.<sup>42</sup> This Section focuses on two main historical aspects of substantive consolidation. First, it looks at the Supreme Court’s creation of substantive consolidation. Second, it reflects upon the amount of time that passed before the courts of appeals openly embraced substantive consolidation.

### A. *The Creation of Substantive Consolidation*

Although the Third Circuit recently noted that a similar remedy had been suggested in an earlier Tenth Circuit decision,<sup>43</sup> most commentators trace the beginning of substantive consolidation to a Supreme Court case decided in 1941.<sup>44</sup> In *Sampsell*, a businessman named Downey incurred \$104,000 worth of debt while operating his unincorporated business.<sup>45</sup> Downey created a corporation and sold all of his goods to the corporation in exchange for stock.<sup>46</sup> He leased the old business’s office space to the corporation.<sup>47</sup> Just over two years later, Downey was adjudged a voluntary bankrupt.<sup>48</sup>

Noting that the corporation was not bankrupt and had received assets from Downey, the trustee in bankruptcy petitioned the court to bring the corporation’s assets into the bankruptcy estate.<sup>49</sup> At the subsequent hearing,

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<sup>40</sup> See *Sampsell v. Imperial Paper & Color Corp.*, 313 U.S. 215, 217 (1941).

<sup>41</sup> See *Kors*, *supra* note 27, at 382 (suggesting that unconsolidated entities will result in different recoveries for creditors than would be attained by the same creditors from the consolidated entity).

<sup>42</sup> *Sampsell*, 212 U.S. at 220–21 (affirming the district court’s right to consolidate the estates of different legal entities); see *Willet*, *supra* note 2, at 93–94.

<sup>43</sup> *In re Owens Corning*, 419 F.3d 195, 207 n.12 (citing *Fish v. East*, 114 F.2d 177 (10th Cir. 1940)).

<sup>44</sup> See *Baird*, *supra* note 21, at 15; *Kors*, *supra* note 27, at 392; *Willet*, *supra* note 2, at 88 (citing *Sampsell*, 313 U.S. at 215).

<sup>45</sup> *Sampsell*, 313 U.S. at 215.

<sup>46</sup> *Id.* at 215–16.

<sup>47</sup> *Id.* at 216.

<sup>48</sup> *Id.* at 215.

<sup>49</sup> *Id.* at 216.

the referee found that the corporation was merely an instrument to put Downey's assets beyond the reach of creditors and that therefore the transfer of goods to the corporation was "not in good faith."<sup>50</sup> The referee ordered that "the property of the corporation *was* property of the bankrupt estate and that it be administered for the benefit of the creditors of the estate."<sup>51</sup>

Between the time of incorporation and the time of Downey's bankruptcy, the corporation had incurred debt to Imperial Paper & Color Corp. ("Imperial Paper").<sup>52</sup> At the time of Downey's bankruptcy, the corporation owed \$5,400.<sup>53</sup> Subsequent to the issuance of the referee's order that consolidated the assets of the corporation and the bankruptcy estate, Imperial Paper filed a claim seeking priority on any funds retained through the liquidation of the corporation's assets.<sup>54</sup> After finding that Imperial Paper had been "instrumental" in and had full knowledge of Downey's scheme to hide his assets from creditors, the referee refused to grant any priority to Imperial Paper but instead allowed Imperial Paper to pursue the debt as a general unsecured claim.<sup>55</sup> This order, however, was reversed by a Ninth Circuit Court of Appeals holding that found Imperial Paper's claim should have priority.<sup>56</sup>

In reviewing the Ninth Circuit's decision, the Supreme Court found that the corporation, although legally a separate individual entity, was in reality no more than a puppet controlled by Downey.<sup>57</sup> The Supreme Court indicated that consolidation could occur "where the transfer [of assets] was fraudulent *or where the relationship between the stockholder and the corporation was such as to justify the use of summary proceedings to absorb the corporate assets into the bankruptcy estate of the stockholder.*"<sup>58</sup> The Supreme Court noted that, in both of those instances, the unsecured creditors "would have the burden of showing that their equity was paramount in order to obtain priority as

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<sup>50</sup> *Id.* at 216–17.

<sup>51</sup> *Id.* at 217 (emphasis added). The wording suggests that the court did not regard this order as an affirmative act that combined the estates but rather a clarification of a preexisting reality. Hence, it follows that the order was merely the method to legally reflect a reality that existed outside the realm of the courtroom.

<sup>52</sup> *Id.* at 216.

<sup>53</sup> *Id.* This claim was unsecured. *Id.*

<sup>54</sup> *Id.* at 217. The trustee in bankruptcy argued that Imperial Paper's claim should be not given preferential treatment but rather regarded as a general unsecured claim. *Id.*

<sup>55</sup> *Id.*

<sup>56</sup> *Id.*

<sup>57</sup> *Id.* The conclusion that a corporation could be another legal entity's puppet was not unheard of at this time, as the same concern was dealt with a year earlier by the Tenth Circuit. *Fish v. East*, 114 F.2d 177, 191 (10th Cir. 1940).

<sup>58</sup> *Sampson*, 313 U.S. at 219 (emphasis added).

respects the corporate assets.”<sup>59</sup> Although the Supreme Court ultimately found that Downey’s sale of goods to the corporation was a fraudulent conveyance, the Supreme Court reversed the Ninth Circuit’s judgment and affirmed the district court’s decisions to consolidate the entities and deny priority to Imperial Paper.<sup>60</sup>

The Supreme Court’s explicit language in *Sampsell* loosely framed modern substantive consolidation.<sup>61</sup> The Supreme Court’s holding first endorsed the manner in which the district court had consolidated the estates by pooling the assets and liabilities.<sup>62</sup> Second, the Supreme Court’s holding established that the consolidation of two entities does not automatically give rise to priority claims for disadvantaged general unsecured creditors.<sup>63</sup> Third, the Supreme Court made an important distinction in asserting that consolidation is justified not only in cases of fraudulent transfers but also in cases that involve a certain “relationship” between the two entities.<sup>64</sup> Unfortunately, the Supreme Court failed to give further guidance on how to identify the requisite “relationship” that would allow consolidation of the entities.<sup>65</sup> Today the struggle to define that relationship has led to different courts applying various interpretations and tests.<sup>66</sup>

Critics of substantive consolidation focus heavily on the fact that *Sampsell* involved a fraudulent transfer, an issue that can be remedied without substantive consolidation.<sup>67</sup> However, even a narrow interpretation of *Sampsell* recognizes that the Supreme Court’s holding implicitly endorsed consolidation under certain conditions.<sup>68</sup> By affirming the method in which

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<sup>59</sup> *Id.* The Supreme Court made it clear that general unsecured creditors whom would recover less from a consolidated bankruptcy estate than from the unconsolidated estates, cannot claim a preference merely based on the effects of consolidation on the creditors’ recoveries alone. *Id.*

<sup>60</sup> *Id.* at 220–21.

<sup>61</sup> *Id.* at 218–20.

<sup>62</sup> *See id.* (affirming the district court decision to consolidate the assets and liabilities of the two estates).

<sup>63</sup> *Id.* at 217.

<sup>64</sup> *Id.* at 219 (stating that the court had the absolute power to “subordinate claims or adjudicate equities” but that mere consolidation alone was not enough to justify giving priority to a general unsecured creditor).

<sup>65</sup> *See id.* The language makes clear that an alternative situation exists that can justify consolidation by distinguishing it from fraudulent transfer. *Id.* at 219. However, the Supreme Court only refers to it as “where the relationship between the stockholder and the corporation was such as to justify the use of summary proceedings to absorb the corporate assets into the bankruptcy estate of the stockholder.” *Id.*

<sup>66</sup> *See, e.g., In re Owens Corning*, 419 F.3d 195 (3d Cir. 2005); *In re Augie/Restivo Baking Co.*, 860 F.2d 515 (2d Cir. 1988); *In re Auto-Train Corp.*, 810 F.2d 270 (D.C. Cir. 1987).

<sup>67</sup> Willett, *supra* note 2, at 93–94; Baird, *supra* note 21, at 15–16.

<sup>68</sup> Baird, *supra* note 21, at 15–16 (stating that the Court endorsed substantive consolidation in *Sampsell* when a fraudulent transfer existed).

the district court had applied the consolidation itself, the Supreme Court showed approval for the practice itself.<sup>69</sup> Any argument that the holding only endorsed consolidation for fraudulent transfers would also completely ignore the express language of the court in indicating an alternative instance in which the application would be justified.<sup>70</sup> Thus, while the precedents set in *Sampsell* can be minimized, the Supreme Court's endorsement of substantive consolidation in *Sampsell* cannot be denied.<sup>71</sup> Substantive consolidation's application by the circuit courts of appeal only further served to endorse and legitimize it.

### B. *The Gradual Application of Substantive Consolidation*

After *Sampsell*, most courts were slow to start applying this new remedy of substantive consolidation.<sup>72</sup> However, during the year following the *Sampsell* decision, the Fourth Circuit adopted and applied consolidation as a remedy.<sup>73</sup> For example, in *Stone*, a Delaware corporation that operated clothing stores nationwide created a Virginia subsidiary corporation for the purpose of operating its Richmond, Virginia store.<sup>74</sup> In reality, however, the Virginia corporation did not conduct any independent business.<sup>75</sup> The Delaware corporation paid all wages, handled all contracts, and kept all of the records of the Richmond store.<sup>76</sup> The Fourth Circuit found that consolidation of both corporations was appropriate, as “the assets in [the] Virginia [corporation were] unquestionably the assets of the parent corporation” and that the subsidiary was a mere instrumentality of the Delaware corporation.<sup>77</sup>

For twenty-two years other courts of appeals resisted adopting substantive consolidation.<sup>78</sup> The Second Circuit was the first of the courts of appeals to embrace it in 1964.<sup>79</sup> Over the next four decades, nearly every circuit

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<sup>69</sup> See *Sampsell*, 313 U.S. at 215.

<sup>70</sup> *Id.*

<sup>71</sup> See Baird, *supra* note 21, at 15–16.

<sup>72</sup> See *In re Owens Corning*, 419 F.3d at 206–07.

<sup>73</sup> *Stone v. Eacho*, 127 F.2d 284, 290 (4th Cir. 1942) (holding that the assets and liabilities of the corporations should be pooled and that the proceedings should be consolidated).

<sup>74</sup> *Id.* at 286.

<sup>75</sup> *Id.* The Virginia corporation also had the same officers as the Delaware corporation. *Id.*

<sup>76</sup> *Id.* With small exceptions, the Delaware corporation handled the Richmond store like it handled the other stores. *Id.*

<sup>77</sup> *Id.* at 290.

<sup>78</sup> *In re Owens Corning*, 419 F.3d 195, 206–07 (3d Cir. 2005).

<sup>79</sup> *Id.*

embraced and acknowledged the legitimacy of substantive consolidation.<sup>80</sup> Since *Sampsell*, the Supreme Court has remained silent on the issue of substantive consolidation.<sup>81</sup> In the absence of guidance from the Supreme Court, different tests for defining the “necessary relationship” for consolidation have been established in different jurisdictions.<sup>82</sup> Today, adopting the proper methodology for determining when consolidation should occur is one of the most divisive issues in bankruptcy.<sup>83</sup>

### C. Reinforcing Substantive Consolidation Over Time

The Supreme Court established substantive consolidation to help bankruptcy law reflect realities in business relationships and interaction.<sup>84</sup> The remedy was further legitimized by its adoption and application by various courts of appeal.<sup>85</sup> A careful analysis of substantive consolidation reveals support for substantive consolidation from various sources. The next Section explores these sources of support in detail starting with the extent of power traditionally available to bankruptcy courts and finishing with an examination of the Bankruptcy Code itself.

## III. SUPPORT FOR SUBSTANTIVE CONSOLIDATION

Throughout its history, courts have cited various avenues of support for substantive consolidation.<sup>86</sup> However, many critics have argued that these avenues do not actually support the doctrine and therefore substantive consolidation is illegitimate as a remedy.<sup>87</sup> Careful examination reveals two

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<sup>80</sup> *Id.* (listing cases in which the other circuits acknowledged “substantive consolidation as a possible remedy”).

<sup>81</sup> See Willett, *supra* note 2, at 94 (stating that, other than *Sampsell*, there has not been another Supreme Court holding regarding substantive consolidation).

<sup>82</sup> *In re Owens Corning*, 419 F.3d at 207–08, 210–12 (citing the *Auto-Train* test, the *Augie/Restivo* test, stating the existence of other tests, and creating a new test).

<sup>83</sup> See, e.g., Willett, *supra* note 2, at 113–15; Baird, *supra* note 21, at 21–22; Kors, *supra* note 27, at 451.

<sup>84</sup> *Sampsell v. Imperial Paper & Color Corp.*, 313 U.S. 215, 217–19 (1941) (finding that the corporation was a puppet and finding that consolidation of the bankruptcy estates was an appropriate remedy to reflect that fact).

<sup>85</sup> See, e.g., *Stone v. Eacho*, 127 F.2d 284, 290 (4th Cir. 1942); see also *In re Owens Corning*, 419 F.3d at 206–07 (listing cases in which the other circuits acknowledged “substantive consolidation as a possible remedy”).

<sup>86</sup> *In re Owens Corning*, 419 F.3d at 209 (finding substantive consolidation legitimized by the Supreme Court in *Sampsell*); *In re Stone & Webster, Inc.*, 286 B.R. 532, 538 (Bankr. D. Del. 2002) (finding that substantive consolidation had statutory support).

<sup>87</sup> See, e.g., Willett, *supra* note 2, at 94; Baird, *supra* note 21, at 19.

main sources of support for substantive consolidation, the equitable powers of the bankruptcy court and the Bankruptcy Code.<sup>88</sup> This Section will evaluate the support provided by each source by first analyzing the equitable powers and then considering specific provisions of the Bankruptcy Code.

### A. *Equitable Powers of the Bankruptcy Court*

Although most of bankruptcy law has been created by statute, bankruptcy courts are regarded as courts of equity.<sup>89</sup> However, there are instances when strict adherence to the statutes would result in harsh unfair outcomes.<sup>90</sup> Thus equity in those instances would require that bankruptcy courts have the power to create and employ common law.<sup>91</sup> The ability for bankruptcy courts to apply and adopt common law remedies is widely debated.<sup>92</sup>

A recent Supreme Court decision regarding federal common law has done little to offer any guidance.<sup>93</sup> In *Grupo Mexicano De Desarrollo, S.A.* (“*Grupo*”), a Mexican holding company issued guaranteed notes that were bought by American investment firms.<sup>94</sup> A few years later, the Mexican holding company ran into financial trouble because of a downturn in the local economy.<sup>95</sup> In attempts to pay off certain debts, the Mexican company made an announcement that it was going to put “its right to receive \$17 million of Toll Road Notes” into a trust account for employee compensation and that it “had transferred its right to receive \$100 million of Toll Road Notes to the Mexican government.”<sup>96</sup> The American investment firms immediately took

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<sup>88</sup> *In re Owens Corning*, 419 F.3d at 209 (finding substantive consolidation legitimized by the Supreme Court in *Sampsel*); *In re Stone & Webster, Inc.*, 286 B.R. at 538 (finding that substantive consolidation had statutory support).

<sup>89</sup> See Marcia Krieger, “*The Bankruptcy Court is a Court of Equity*”: What Does that Mean?, 50 S.C. L. REV. 275 (1999).

<sup>90</sup> Adam J. Levitin, *Toward a Federal Common Law of Bankruptcy: Judicial Lawmaking in a Statutory Regime*, 80 AM. BANKR. L.J. 1, 3 (2006) (describing the situation as a “Pyrrhic victory” because it “prevents the goal of the Code from being fulfilled”).

<sup>91</sup> *Id.* at 86–87 (stating that common law is necessary to “reconcil[e] bankruptcy courts’ status as ‘courts of equity’ with the statutory terms of the Bankruptcy Code”).

<sup>92</sup> See Willett, *supra* note 2, at 94 (arguing that bankruptcy courts do not have the power to employ common law remedies). See also Levitin, *supra* note 90, at 86–87 (arguing that bankruptcy courts do have the power to employ common law remedies “due to the uniformity power of the Bankruptcy Clause of the Constitution”).

<sup>93</sup> The Supreme Court addressed the legitimacy of federal common law in *Grupo Mexicano De Desarrollo, S.A. v. Alliance Bond Fund, Inc.*, 527 U.S. 308 (1999).

<sup>94</sup> *Grupo Mexicano De Desarrollo*, 527 U.S. at 310.

<sup>95</sup> *Id.* at 311.

<sup>96</sup> *Id.* at 311–12.

action by “accelerat[ing] the principal amount of their Notes” and filing suit claiming that the Mexican company was either presently insolvent or at risk of becoming insolvent.<sup>97</sup> The investment firms claimed that the notes were the Mexican company’s greatest asset and that the allocations “would ‘frustrate any judgment’ [that they] could obtain.”<sup>98</sup> Hence, the investment firms requested that the district court give them a preliminary injunction to prevent the transfer of the notes.<sup>99</sup> The district court issued the preliminary injunction, and the Second Circuit subsequently affirmed that decision.<sup>100</sup>

In writing the majority opinion, Justice Scalia found that the district court did not have the power to issue the preliminary injunction.<sup>101</sup> As no statute allowed the district court to issue the injunction pending the outcome of the claim, the injunction could only have been valid if the court had the power to issue it under federal common law.<sup>102</sup> In finding that federal courts’ equity power is limited to the application of common law in existence when the Judiciary Act of 1789 was enacted, the majority effectively restricted the equity powers of the federal courts to those explicitly granted by statute and common law remedies existing in 1789.<sup>103</sup>

Although *Grupo* seems to undercut substantive consolidation’s common law support,<sup>104</sup> *Grupo*’s applicability to federal bankruptcy law is widely debated.<sup>105</sup> Recent cases tend to support the position that *Grupo*’s holding does not apply to bankruptcy law.<sup>106</sup> The year after the Supreme Court’s *Grupo* decision, the Ninth Circuit affirmed support for substantive consolidation.<sup>107</sup> Two years later the Delaware bankruptcy court, citing Justice

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<sup>97</sup> *Id.* at 312.

<sup>98</sup> *Id.*

<sup>99</sup> *Id.* at 311.

<sup>100</sup> *Id.* at 312–13.

<sup>101</sup> *Id.* at 333.

<sup>102</sup> *Id.*

<sup>103</sup> *Cf.* Baird, *supra* note 21, at 20 (stating that *Grupo* prevented federal courts from creating “new powers”).

<sup>104</sup> See Willett, *supra* note 2, at 99–100 (suggesting that *Grupo* applies to bankruptcy law because “the bankruptcy court is simply a judicial unit of the district court”).

<sup>105</sup> See Levitin, *supra* note 90, at 50–57.

<sup>106</sup> See Seth D. Amera & Alan Kolod, *Substantive Consolidation: Getting Back to Basics*, 14 AM. BANKR. INST. L. REV. 1, 40–41 (2006).

<sup>107</sup> *Alexander v. Compton (In re Bonham)*, 229 F.3d 750, 765, 771 (9th Cir. 2000) (finding that substantive consolidation had “survived enactment of the Bankruptcy Code” and affirming “the order of the bankruptcy court substantively consolidating Bonham’s estate with WPI and APFC”).

Scalia's opinion, suggested that *Grupo* did not apply to bankruptcy law.<sup>108</sup> The court specifically emphasized that the majority opinion had distinguished bankruptcy law and fraudulent conveyance law from the federal law dealt with in *Grupo*.<sup>109</sup> Even more recently, the Third Circuit went a step further in deciding that:

[T]he Court's opinion in *Grupo Mexicano* acknowledged that bankruptcy courts *do* have the authority to deal with the problems presented by that case . . . [h]ad the company in *Grupo Mexicano* been in bankruptcy, the bankruptcy court would have had the authority to implement the remedy [that] the district court lacked authority to implement the remedy the district court lacked authority to order under general equity power outside the bankruptcy context.<sup>110</sup>

Hence, the Third Circuit concluded that *Grupo* actually supported, not limited, the equity powers available in bankruptcy law.<sup>111</sup> Therefore, substantive consolidation is supported by powers not available to other federal courts. This support is further bolstered by sections of the Bankruptcy Code.

#### *B. Statutory Support for Substantive Consolidation*

Although the equitable powers under bankruptcy law are probably enough to support substantive consolidation, some argue that provisions of the Bankruptcy Code support substantive consolidation.<sup>112</sup> Two of the most cited sections of the Bankruptcy Code regarding substantive consolidation are §§ 105(a) and 1123(a)(5)(C).<sup>113</sup> The next two Sections look at the application of each in the context of supporting substantive consolidation.

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<sup>108</sup> *In re Stone & Webster, Inc.*, 286 B.R. 532, 538 (Bankr. D. Del. 2002). Although the court had noted that *Grupo* did not apply, the court proceeded to hold that the applicability of *Grupo* was irrelevant because substantive consolidation had statutory support. *Id.* at 540.

<sup>109</sup> *Id.* at 538 (citing a lengthy passage in which Justice Scalia claims that bankruptcy law can take care of the concerns of the creditors in *Grupo*).

<sup>110</sup> *In re Owens Corning*, 419 F.3d 195, 209 n.14 (3d Cir. 2005). Although the Third Circuit found that the case did not pass its substantive consolidation test, the Third Circuit expressly acknowledged the legitimacy of substantive consolidation. *Id.* at 216.

<sup>111</sup> *Id.* at 210–11.

<sup>112</sup> *See, e.g., In re Bonham*, 229 F.3d at 764; *In re Stone & Webster, Inc.*, 286 B.R. at 539; *In re Affiliated Foods, Inc.*, 249 B.R. 770, 775 (Bankr. W.D. Mo. 2000).

<sup>113</sup> *See, e.g., Willett, supra* note 2, at 99–100.

### 1. Section 105(a)

Section 105(a) is attractive as a justification for substantive consolidation because it seems to reinforce the emphasis on the equitable nature of the bankruptcy courts.<sup>114</sup> Section 105(a) reads:

The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of the process.<sup>115</sup>

The Ninth Circuit has read § 105(a) as the affirmation of “the bankruptcy court’s general equity powers.”<sup>116</sup> Pursuant to the powers affirmed in § 105(a), the Ninth Circuit found that “[t]he theory of substantive consolidation emanates from the core of bankruptcy jurisprudence.”<sup>117</sup>

Other courts have been uncomfortable in finding such a broad grant of power in § 105(a).<sup>118</sup> Instead, they generally argue that the power granted must be read as being much narrower.<sup>119</sup> Federal courts have generally found that § 105(a) cannot override express provisions of the Bankruptcy Code.<sup>120</sup> Critics of substantive consolidation argue that substantive consolidation contradicts provisions of the Bankruptcy Code that refer to a “debtor” as a singular entity and not multiple entities.<sup>121</sup> However, in deciding to consolidate bankruptcy estates, the courts are not combining multiple legal entities but rather acknowledging that the other entities are merely property of one entity.<sup>122</sup> The courts are not acknowledging the presence of fraudulent conveyances but rather that the claims of separateness and individual legal

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<sup>114</sup> Levitin, *supra* note 90, at 31–32 (noting the frequency at which parties in a bankruptcy case refer to § 105(a) if the Bankruptcy Code is unclear as to an issue).

<sup>115</sup> 11 U.S.C. § 105(a) (2000).

<sup>116</sup> *In re Bonham*, 229 F.3d at 764.

<sup>117</sup> *Id.*

<sup>118</sup> *See, e.g., In re Kmart Corp.*, 359 F.3d 866, 871 (7th Cir. 2004); *United States v. Sutton*, 786 F.2d 1305, 1308 (5th Cir. 1986); *Southern Ry. Co. v. Johnson Bronze Co.*, 758 F.2d 137, 141 (3d Cir. 1985).

<sup>119</sup> *See Willett, supra* note 2, at 94; *Baird, supra* note 21, at 19.

<sup>120</sup> *See Willett, supra* note 2, at 90, 115 n.16.

<sup>121</sup> *See, e.g., id.* at 90.

<sup>122</sup> *See, e.g., Stone v. Eacho*, 127 F.2d 284, 286 (4th Cir. 1942) (stating that the subsidiary corporation had made “no pretense of separate incorporation”).

existence itself are deceptive in nature.<sup>123</sup> This section of the Bankruptcy Code gives general support for substantive consolidation. Although this section alone provides enough support for the use of substantive consolidation, the Bankruptcy Code also contains specific support for substantive consolidation.

## 2. Section 1123(a)(5)(C)

Another argument against the sufficiency of § 105(a) focuses on the phrase “to carry out the provisions of this title.”<sup>124</sup> Therefore § 105(a) would only legitimately support substantive consolidation if the objectives of another provision of the Bankruptcy Code would be fulfilled.<sup>125</sup> Section 1123(a)(5)(C) explicitly directs chapter 11 plans to contain provisions that “provide adequate means for the plan’s implementation, such as merger or *consolidation of the debtor with one or more persons.*”<sup>126</sup> Section 1123(a)(5)(C) was used in conjunction with § 105 as support for consolidation in the decision of *In re Stone & Webster*.<sup>127</sup> The court recognized that § 1123(a)(5)(C) alone was not sufficient to confer the necessary power to consolidate the bankruptcy estates prior to the plan’s confirmation.<sup>128</sup> However, the court found that the equitable powers in § 105(a) were sufficient to help the court use § 1123(a)(5)(C) as a basis for substantive consolidation.<sup>129</sup> Today, some critics are clearly uncomfortable with using § 1123(a)(5)(C) to support substantive consolidation, but they ultimately concede that § 1123(a)(5)(C) can be used to support it.<sup>130</sup>

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<sup>123</sup> That is to say, the separate legal entity is merely a legal fiction, created quite possibly for some mere economic, social, organizational, or other benefit that helps the other entity attain its goals. For example, many corporations are created for tax avoidance purposes or to limit liability to the owners as they transact their business.

<sup>124</sup> Levitin, *supra* note 90, at 31–32.

<sup>125</sup> *Id.*

<sup>126</sup> 11 U.S.C. § 1123(a)(5)(C) (2000) (emphasis added).

<sup>127</sup> *In re Stone & Webster, Inc.*, 286 B.R. 532, 541–43 (Bankr. D. Del. 2002). Notably, the court spent a substantial amount of time explaining how substantive consolidation could be supported by federal common law, despite the recent *Grupo* decision, and by the broad equitable power of § 105, only to discard that reasoning in favor of demonstrating that § 1123(a)(5)(C) also supports substantive consolidation. *Id.* at 537–43.

<sup>128</sup> *Id.*

<sup>129</sup> *Id.*

<sup>130</sup> See, e.g., Baird, *supra* note 21, at 19 (referring to § 1123(a)(5)(C) as a “thin reed” to justify substantive consolidation and arguing that it cannot be seen as giving “the debtor the ability to merge . . . with any third party it pleases”); Willett, *supra* note 2, at 91–92 (arguing that the use of § 1123(a)(5)(C) to justify substantive consolidation is a “strange” interpretation).

### C. Reconciling the Avenues of Support for Substantive Consolidation

In the aftermath of the *Grupo* decision, courts have systematically and vigorously defended the practice of substantive consolidation as legitimate and well-supported.<sup>131</sup> Recent analysis by the Ninth and Third Circuits seems to establish that the *Grupo* decision at the very least did not apply to bankruptcy law and might have even alluded to the greater equity powers available in bankruptcy law but not in other federal law.<sup>132</sup> No matter how narrow the reading of its holding, *Sampsell* still supports the proposition that bankruptcy courts have the power to consolidate bankruptcy estates.<sup>133</sup> The equitable powers in bankruptcy are the main bases of support for substantive consolidation.<sup>134</sup> However, even if the Supreme Court changes course and decides otherwise, the doctrine of substantive consolidation is well supported by the Bankruptcy Code.<sup>135</sup> Like the Delaware bankruptcy court did in *In re Stone & Webster*, other courts can and will simply shift toward citing §§ 105(a) and 1123(a)(5)(C), and substantive consolidation will continue to live on.<sup>136</sup> Although sources of support for substantive consolidation are widely debated, the greatest disagreement between courts revolves around determining when substantive consolidation should be applied.

## IV. MODERN APPROACHES TO DETERMINING WHETHER SUBSTANTIVE CONSOLIDATION IS APPROPRIATE

Substantive consolidation's application has been a source of frustration for circuit courts.<sup>137</sup> Currently a total of three different tests exist to determine when substantive consolidation should be applied: the *Auto-Train* test, the *Augie/Restivo* test, and the *Owens Corning* test.<sup>138</sup> Each approach was designed to try to eliminate perceived flaws in previous tests, but no single

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<sup>131</sup> See *supra* notes 107–11 and accompanying text.

<sup>132</sup> See *supra* notes 107–11 and accompanying text.

<sup>133</sup> See *supra* Part II.A.

<sup>134</sup> At least the equitable powers available in bankruptcy law are widely cited and seem to be the “easiest” approach to justify substantive consolidation. See *supra* notes 108 and accompanying text.

<sup>135</sup> See *supra* notes 115 & 126 and accompanying text.

<sup>136</sup> The equitable support seems to be often cited because of its ease in application, while many circuits leave the window open for statutory justification should the Supreme Court restrict common law in bankruptcy. See, e.g., *In re Owens Corning*, 419 F.3d 195, 209 (3d Cir. 2005) (explicitly declining to address the issue of statutory support for substantive consolidation).

<sup>137</sup> *Id.* at 210–12 (describing the confusion, imprecision, and vagueness associated with most substantive consolidation tests).

<sup>138</sup> *Id.*

approach has been consistently embraced.<sup>139</sup> This section reviews the circumstances behind the three tests' creation, the tests' application, and the policies advocated by each respective court of appeals in creating each test. It also explores the possibility and feasibility of partially consolidating debtors for some creditors and not others.

#### A. *The Birth of the Auto-Train Test*

In 1987, the Court of Appeals for the District of Columbia attempted to define the type of relationship sufficient for substantive consolidation in *In re Auto-Train*.<sup>140</sup> In doing this, the court created the *Auto-Train* test.<sup>141</sup> In *In re Auto-Train*, the Auto-Train Corporation (“Auto-Train”) filed for bankruptcy.<sup>142</sup> A few months later, Auto-Train filed a motion to consolidate Railway, Auto-Train’s subsidiary, into the bankruptcy estate.<sup>143</sup> The court granted the petition and consolidated Railway into Auto-Train’s estate.<sup>144</sup>

On appeal, the Court of Appeals for the District of Columbia articulated a three-part analysis for substantive consolidation.<sup>145</sup> The court found that a bankruptcy court could only order substantive consolidation after satisfying three conditions.<sup>146</sup> First, the court must find the existence of a “substantial identity between the entities to be consolidated.”<sup>147</sup> Second, the bankruptcy court must find that “consolidation is necessary to avoid some harm or to realize some benefit.”<sup>148</sup> Third, if a creditor makes a showing that it “relied on the separate credit of one of the entities and that it will be prejudiced by consolidation,” then the bankruptcy court can only grant substantive consolidation if it finds that “the demonstrated benefits of consolidation ‘heavily’ outweigh the harm.”<sup>149</sup> Focusing on this final consideration, the court of appeals noted that Railway’s creditor had sufficiently proved that it had relied on the separate credit of Railway and that it would be prejudiced by the consolidation.<sup>150</sup> Furthermore, the court of appeals found that the cost of

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<sup>139</sup> *Id.* at 210.

<sup>140</sup> *In re Auto-Train Corp.*, 810 F.2d 270, 277–78 (D.C. Cir. 1987).

<sup>141</sup> *See In re Owens Corning*, 419 F.3d at 207–08.

<sup>142</sup> *In re Auto-Train Corp.*, 810 F.2d at 272.

<sup>143</sup> *Id.*

<sup>144</sup> *Id.* at 273.

<sup>145</sup> *Id.* at 276.

<sup>146</sup> *Id.*

<sup>147</sup> *Id.*

<sup>148</sup> *Id.*

<sup>149</sup> *Id.*

<sup>150</sup> *Id.* at 277–78.

“disentangling the corporate books” was not sufficient to outweigh this interest.<sup>151</sup> However, in its opinion the court of appeals did not help define the term “substantial identity,” nor did it provide any guidance on how consolidation could avoid harm or realize benefit.<sup>152</sup>

This “modern” *Auto-Train* test is merely the result of the reworking of older tests.<sup>153</sup> Prior to *In re Auto-Train*, many courts looked at the closeness of the relationship between the entities to determine whether one entity was a “mere instrumentality” of another.<sup>154</sup> For example, in *Fish v. East*, the Tenth Circuit found that the matter was little more than a question of “fact and degree.”<sup>155</sup> To best determine how close the relationship was between the entities, the court established a ten-factor test.<sup>156</sup> The practice of weighing such factors evolved over time, with different circuit courts of appeals applying different factors.<sup>157</sup> Thus in an attempt to clarify the situation, the Court of Appeals for the D.C. Circuit simplified the principle behind these tests by requiring a “substantial identity” between the entities.<sup>158</sup> In addition it also included other principles found in past Second Circuit decisions, thereby creating a more comprehensive test.<sup>159</sup> However it did not take long for another court of appeals to abandon this new approach and create another test.

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<sup>151</sup> *Id.* at 278.

<sup>152</sup> Willett, *supra* note 2, at 101–02 (referring to the “informing principle of [the] ‘doctrine’” as “vacuous”).

<sup>153</sup> *See id.* (noting that substantive consolidation began with tests that looked at closeness of the entities).

<sup>154</sup> *See, e.g., Fish v. East*, 114 F.2d 177, 191 (10th Cir. 1940).

<sup>155</sup> *Id.*

<sup>156</sup> *Id.* (listing the factors as whether “(1) The parent corporation owns all or majority of the capital stock of the subsidiary; (2) The parent and subsidiary corporations have common directors or officers; (3) The parent corporation finances the subsidiary; (4) The parent corporation subscribes to all the capital stock of the subsidiary or otherwise causes its incorporation; (5) The subsidiary has grossly inadequate capital; (6) The parent corporation pays the salaries or expenses or losses of the subsidiary; (7) The subsidiary has substantially no business except with the parent corporation or no assets except those conveyed to it by the parent corporation; (8) In the papers of the parent corporation, and in the statements of its officers, “the subsidiary” is referred to as such or as a department or division; (9) The directors or executives of the subsidiary do not act independently in the interest of the subsidiary but take direction from the parent corporation; (10) The formal legal requirements of the subsidiary as a separate and independent corporation are not observed”).

<sup>157</sup> *See, e.g., Willett, supra* note 2, at 101–02.

<sup>158</sup> Notably, this test does not actually clarify anything as the terminology is vague. The “substantial identity” is a modification of the Tenth Circuit’s “degree” analysis. Since it is less specific than the Tenth Circuit’s test, it does less to give anyone an idea of what “degree” is required for consolidation.

<sup>159</sup> *See Chem. Bank N.Y. Trust Co. v. Kheel*, 369 F.2d 845, 847–48 (2d Cir. 1966) (finding that consolidation should occur when it is necessary to avoid harm or realize benefit and that a disadvantaged creditor can object citing reliance on the entities’ separateness in extending credit).

*B. A Split in Application: The Creation of the Augie/Restivo Test*

During the following summer, the Second Circuit ignored the Eleventh Circuit's *In re Auto-Train* ruling and created a new path for the application of substantive consolidation.<sup>160</sup> In *In re Augie/Restivo Baking Co.*, the Second Circuit dealt with a bankruptcy court's decision to consolidate two bakery companies.<sup>161</sup> Augie's Baking Co. ("Augie's") and Restivo Brothers Bakers, Inc. ("Restivo"), were originally two separate bakeries.<sup>162</sup> Restivo was a debtor to Manufacturers Hanover Trust Company ("MHTC") and Augie's was a debtor to Union Savings Bank ("Union").<sup>163</sup> About a year before bankruptcy, Restivo and Augie's entered into a deal in which Restivo purchased Augie's for half of Restivo's stock.<sup>164</sup> At the time of its purchase, Augie's had \$2.4 million in secured debts that it owed to Union.<sup>165</sup> After the sale, Augie's operations were combined with Restivo's operations, but no move was made to dissolve Augie's.<sup>166</sup> Restivo then adopted the name Augie/Restivo Baking Co. ("Augie/Restivo") and took over all of the bookkeeping for both companies.<sup>167</sup> Prior to Augie/Restivo's bankruptcy, MHTC extended another \$2.7 million to Augie/Restivo, some of it secured by a subordinated mortgage on land owned by Augie's.<sup>168</sup>

In bankruptcy, both Augie/Restivo and Augie's were consolidated by the bankruptcy court pursuant to a reorganization plan that involved selling assets to another bakery.<sup>169</sup> Although Union was opposed to consolidation, the court found that the consolidation and sale were "in the interests of the creditors of both companies."<sup>170</sup> However, the sale never occurred due to problems in

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<sup>160</sup> See *In re Owens Corning*, 419 F.3d 195, 207–08 (3d Cir. 2005) (noting that the D.C. Circuit's *Auto-Train* and the Second Circuit's *Augie/Restivo* tests were two distinct approaches to substantive consolidation).

<sup>161</sup> *In re Augie/Restivo Baking Co.*, 860 F.2d 515, 515, 517 (2d Cir. 1988).

<sup>162</sup> *Id.* at 516.

<sup>163</sup> *Id.*

<sup>164</sup> *Id.* at 517. The deal was not a merger and involved no formal conveyance of assets from one entity to the other. *Id.* at 519.

<sup>165</sup> *Id.* at 517. At the time of the sale, Augie's represented its assets at approximately \$2.53 million in addition to its real property. *Id.*

<sup>166</sup> *Id.* Specifically Restivo combined the bookkeeping of both companies and shifted operations to Augie's plant. *Id.*

<sup>167</sup> *Id.*

<sup>168</sup> *Id.* Although MHTC was the main creditor of Augie/Restivo, the company also incurred debts to several unidentified trade creditors. *Id.*

<sup>169</sup> *Id.* The deal involved Leon's Bakery paying \$7.5 million in exchange for the assets of the combined entities. *Id.*

<sup>170</sup> *Id.*

obtaining financing.<sup>171</sup> Union thereafter appealed the decision to substantively consolidate the estates.<sup>172</sup> At the time, Augie's debt to Union was undersecured by \$300,000.<sup>173</sup> As a result of substantive consolidation, the sale of Augie's assets was poised to result in payouts to Augie/Restivo's creditors, whose debt had priority, rather than to Union for its general unsecured debt.<sup>174</sup> After the Eastern District of New York affirmed the bankruptcy court's consolidation decision, the case was appealed to the Second Circuit.<sup>175</sup>

In analyzing whether the substantive consolidation order should be preserved, the Second Circuit first noted that “[t]he sole purpose of substantive consolidation is to ensure the equitable treatment of all creditors.”<sup>176</sup> The court proceeded to review and distill the previous substantive cases down to what the Second Circuit perceived as “mere[ ] variants on two critical factors: (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.”<sup>177</sup>

The Second Circuit set forth policy rationale for the first “factor” by noting that the fulfillment of creditors’ expectations is “important to the efficiency of credit markets.”<sup>178</sup> The court noted that creditors’ expectations determined the terms of a borrower’s loan.<sup>179</sup> The court concluded that creditors’ expectations “create significant equities” and that efficiency would be destroyed by substantively consolidating estates when the entities’ creditors, in extending

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<sup>171</sup> *Id.*

<sup>172</sup> *Id.*

<sup>173</sup> *Id.*

<sup>174</sup> *Id.* Postpetition, Augie/Restivo and MHTC conducted “more than twenty-five ‘cash collateral’ stipulations, in which it was agreed that Augie/Restivo’s accounts receivable constituted cash collateral.” *Id.* As a result, MHTC had a super-priority claim against the consolidated estate that amounted to \$2.7 million. *Id.* Priority claims from tax related debt totaled more than \$1.2 million. *Id.*

<sup>175</sup> *Id.* at 516.

<sup>176</sup> *Id.* at 518. This concept would seem to imply a balancing of equities in the sense that the decision of whether to allow substantive consolidation should be based on whether consolidation would result in more or less equity than the status quo. For example, if substantive consolidation would be “more equitable” for the combined creditors, then it should be granted. However, if substantive consolidation would be “less equitable” for the combined creditors, then it should be denied.

<sup>177</sup> *Id.* (quoting 7 COLLIER’S ON BANKRUPTCY ¶ 1100.06 (Lawrence P. King ed., 2007) and citing *Chem. Bank N.Y. Trust Co. v. Kheel*, 369 F.2d 845, 847 (2d Cir. 1966)).

<sup>178</sup> *Id.* at 518–19.

<sup>179</sup> *Id.*

credit to their respective debtors, relied on the separateness of the entities themselves.<sup>180</sup>

In analyzing whether the estates of Augie/Restivo and Augie's should be consolidated under the first factor, the Second Circuit focused on the fact that Augie's creditor, Union, had obviously extended credit relying on Augie's being its own separate entity.<sup>181</sup> It also noted that MHTC had dealt with the pre-sale Restivo in much the same way.<sup>182</sup> Given this information, the court found that Union should have a superior claim to that of MHTC regarding Augie's assets.<sup>183</sup> The Court also found that Augie/Restivo's trade creditors, who believed that they were dealing with a single entity, could be part of Augie's case after making a proper showing.<sup>184</sup> Therefore, the Second Circuit held that no cause existed for upholding substantive consolidation under the first factor.<sup>185</sup>

In analyzing whether the estates of Augie/Restivo and Augie's should be consolidated under the second factor, the Second Circuit focused on the costs of separating both entities.<sup>186</sup> The court specifically noted that substantive consolidation under the second factor should only be applied "where 'the time and expense necessary even to attempt to unscramble them [is] so substantial as to threaten the realization of any net assets for all the creditors' . . . or where no accurate identification and allocation of assets is possible."<sup>187</sup> Finding that the assets of Augie's were traceable even though the business functions had been consolidated, the Second Circuit determined that substantive consolidation was not justified under the second factor.<sup>188</sup> As substantive

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<sup>180</sup> *Id.* at 519. Here, the Second Circuit associates equity with efficiency and seems to indicate that both are advanced if the creditors' expectations are best met. *See id.*

<sup>181</sup> *Id.* at 518–19. This was obvious as Union's credit had been extended to Augie's prior to the sale and had been unaware of any discussions about Augie's sale prior to its last extension of credit. *Id.* at 516–17.

<sup>182</sup> *Id.* at 519 (noting that in extending credit to Augie/Restivo, MHTC obtained guarantees from Augie's).

<sup>183</sup> *Id.*

<sup>184</sup> *Id.* The court did not specifically mention how much the trade creditors were owed, and it only mentioned the trade creditors a few times as if they were not a large concern in determining the outcome of its evaluation. *See id.* However, it is important to note that the Second Circuit only set aside the trade creditors' equity concerns after deciding that the outcome of its decision would not affect the creditors' ability to recover. *Id.*

<sup>185</sup> *Id.*

<sup>186</sup> *Id.* (expressing concern that the untangling of multiple entities' affairs might be prohibitively costly).

<sup>187</sup> *Id.* (quoting *Chem. Bank N.Y. Trust co. v. Kheel*, 369 F.2d 845, 847 (2d Cir. 1966) and *In re Commercial Envelope Mfg. Co.*, 3 Bankr. Ct. Dec. (CRR) 647, 648 (Bankr. S.D.N.Y. 1977)).

<sup>188</sup> *Id.*

consolidation was justified under neither factor, the Second Circuit reversed the order of substantive consolidation.<sup>189</sup>

The resulting test is seen as more restrictive and more definite in the application of substantive consolidation.<sup>190</sup> However, the real difference in the approaches is that the Second Circuit's *Augie/Restivo* test focuses on the creditors' subjective expectations. In *In re Augie/Restivo*, the Second Circuit changed course by employing a more subjective test in determining which outcome would be more equitable.<sup>191</sup> Although, again, the purpose was to achieve the greatest equity, this test differs from the *Auto-Train* test in that the *Auto-Train* test was more concerned with determining the objective expectations of creditors instead of the subjective expectations of each individual creditor.<sup>192</sup> To complicate matters further the Third Circuit Court of Appeals found this approach inadequate and thus created a third test.

### C. The Third Circuit Creates a Third Test

Prior to 2005, the Third Circuit had not formally recognized substantive consolidation.<sup>193</sup> After sidestepping the issue in earlier cases,<sup>194</sup> the Third Circuit finally recognized substantive consolidation and developed its own test in *In re Owens Corning*.<sup>195</sup> In that case, Owens Corning owned multiple subsidiaries that operated individually and independently.<sup>196</sup> In 1997, Owens Corning pursued financing to purchase Fibreboard Corporation.<sup>197</sup> Due to growing potential legal troubles and a bad credit rating, obtaining the

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<sup>189</sup> *Id.* at 521.

<sup>190</sup> See *In re Owens Corning*, 419 F.3d 195, 210 (3d Cir. 2005) (deciding that the *Auto-Train* "threshold [was] not sufficiently egregious and too imprecise for easy measure" and thus the court preferred the *Augie/Restivo* test to that of *Auto-Train*).

<sup>191</sup> *In re Augie/Restivo Baking Co.*, 860 F.2d at 518–19. The court merely looked at evidence relating to the previous interactions between the respective creditors and debtors. *Id.*

<sup>192</sup> *Id.* at 517–19; *In re Auto-Train Corp.*, 810 F.2d 270, 276 (D.C. Cir. 1987) (requiring a "substantial identity" between the entities to be consolidated).

<sup>193</sup> See *In re Owens Corning*, 419 F.3d at 210 (commenting that the court had only dealt with the issue of substantive consolidation twice before).

<sup>194</sup> See, e.g., *In re Genesis Health Ventures Inc.*, 402 F.3d 416, 422–24 (3d Cir. 2005) (evaluating substantive consolidation and distinguishing it as not applicable for the matter at hand); *Nesbit v. Gears Unlimited, Inc.*, 347 F.3d 72, 86–88 (3d Cir. 2003) (evaluating substantive consolidation from a bankruptcy context and then trying to apply it in a Title VII context).

<sup>195</sup> *In re Owens Corning*, 419 F.3d at 210–12. The court considered both the *Auto-Train* and the *Augie/Restivo* tests, but determined that neither test furthered the "appropriate" principles. *Id.*

<sup>196</sup> *Id.* at 200–01. The separation was complete in every measure since each subsidiary had its own set of records and documented transactions between the parent and subsidiaries. *Id.*

<sup>197</sup> *Id.* at 201.

necessary funds to purchase Fibreboard Corporation was difficult.<sup>198</sup> However, Owens Corning was able to obtain the \$2 billion in requisite financing from a group of banks (the “Banks”) by obtaining guarantees from its subsidiaries.<sup>199</sup> The financing agreement also expressly required Owens Corning and its subsidiaries to limit their relationships in ways that would protect their separateness in governance, financial accounting, and record keeping.<sup>200</sup> The agreement also limited Owens Corning from conducting transactions with its subsidiaries that might “result in losses to that subsidiary.”<sup>201</sup>

In 2000, Owens Corning, along with seventeen subsidiaries, filed for bankruptcy.<sup>202</sup> About two years later, substantive consolidation was proposed by several creditor groups and the combined debtors.<sup>203</sup> This substantive consolidation was proposed to include all of the debtors, including Owens Corning, its subsidiaries which had filed for bankruptcy at the same time, and three subsidiaries which had not filed for bankruptcy.<sup>204</sup> Even more unlike other past substantive consolidations, proponents of the plan sought substantive consolidation merely for the purposes of paying off creditors and confirming the plan.<sup>205</sup> After the plan was confirmed, the “consolidated” entities were to resume operations as independent entities.<sup>206</sup> Despite objections from the Banks, the motion for consolidation pursuant to the plan was granted.<sup>207</sup> The order was appealed to the Third Circuit.<sup>208</sup>

In its approach to substantive consolidation, the Third Circuit, like other circuits, looked at the history of substantive consolidation.<sup>209</sup> In reviewing substantive consolidation’s history, the court focused particularly on the twin

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<sup>198</sup> *Id.* (acknowledging Owens Corning’s potential asbestos-related liability).

<sup>199</sup> *Id.* The subsidiaries, in exchange for *nothing*, accepted full responsibility for Owens Corning’s debt if their parent company was unable to pay. *Id.*

<sup>200</sup> *Id.*

<sup>201</sup> *Id.*

<sup>202</sup> *Id.* at 201–02.

<sup>203</sup> *Id.* at 202.

<sup>204</sup> *Id.*

<sup>205</sup> *Id.* (referring to the plan as “deemed consolidation”).

<sup>206</sup> *Id.*

<sup>207</sup> *Id.* The lower court used an objective “substantial identity” test, like that in *Auto-Train*, as the basis for its decision. *Id.*

<sup>208</sup> *Id.* at 203. Prior to the ruling on the substantive consolidation motion, the bankruptcy judge recused himself from the proceedings. *Id.* at 202. The Third Circuit appointed another judge to rule on the substantive consolidation motion. *Id.*

<sup>209</sup> *Id.* at 205–09.

tests of *Auto-Train* and *Augie/Restivo*.<sup>210</sup> The court then considered substantive consolidation in light of certain principles that it wanted to advance.<sup>211</sup> These principles included

(1) Limiting the cross-creep of liability by respecting entity separateness . . . (2) The harms substantive consolidation addresses are nearly always those caused by *debtors* (and entities they control) who disregard separateness. Harms caused by creditors typically are remedied by provisions found in the Bankruptcy Code . . . (3) Mere benefit to the administration of the case . . . is hardly a harm calling substantive consolidation into play. (4) Indeed, because substantive consolidation is extreme . . . and imprecise, this “rough justice” remedy should be rare and . . . one of last resort . . . (5) While substantive consolidation may be used defensively to remedy the identifiable harms caused by entangled affairs, it may not be used offensively.<sup>212</sup>

In light of these principles, the court decided that substantive consolidation can only be an option when “(i) prepetition [the debtors] disregarded 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.”<sup>213</sup> While declining to elaborate on the second option, the Third Circuit stated that the first option’s conditions were satisfied when three criteria are fulfilled:<sup>214</sup> proponents must show the existence of “corporate disregard creating contractual expectations of creditors, that they were dealing with debtors as one indistinguishable entity” and that “they actually and reasonably relied on [the] debtors’ supposed unity.”<sup>215</sup>

In applying its new substantive consolidation test, the Third Circuit found that the Owens Corning consolidation failed right from the start.<sup>216</sup> The Third Circuit found that no corporate disregard had existed prior to the

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<sup>210</sup> *Id.* at 207–08 (noting that most courts used one of these two tests).

<sup>211</sup> *Id.* at 211. The Third Circuit’s whole rationale for a new test revolved around these factors, which served, in the Third Circuit’s opinion, to give perspective to its new test. *Id.*

<sup>212</sup> *Id.* All of the factors seem to merely bar application of substantive consolidation for reasons other than equity among creditors. *See id.*

<sup>213</sup> *Id.* at 211.

<sup>214</sup> *Id.* at 212.

<sup>215</sup> *Id.*

<sup>216</sup> *Id.* at 212–13 (finding that Owens Corning did not disregard corporate separateness and therefore not examining whether the creditors, other than the Banks that opposed substantive consolidation, reasonably or actually relied on their unity).

consolidation.<sup>217</sup> It found that no “substantial identity” existed between the entities, and, therefore, the consolidation under the first option was unjustified.<sup>218</sup> Furthermore, the court found that substantive consolidation under the second option was completely unjustified as consolidation would not result in every creditor receiving more than they would have without consolidation.<sup>219</sup> In finding that substantive consolidation was wholly inappropriate, the court concluded that substantive consolidation is about equity and therefore should only be used to accomplish equitable result.<sup>220</sup>

Some scholars have expressed their belief that the newfound *Owens Corning* test is the beginning of a trend toward restricting the application of substantive consolidation.<sup>221</sup> However, when the holding is considered in light of the policy considerations mentioned in the dicta, it is difficult to believe that the *Owens Corning* test is anything more than an attempt to further clarify this vague area of law and to prevent the abuses of process that lead away from equity.<sup>222</sup> The five principles that the Third Circuit referred to in justifying the need for a new test outline applications of substantive consolidation that have little to do with equity or unlikely could actually serve to prevent an equitable result.<sup>223</sup> Furthermore, in its conclusion, the Third Circuit announces the court’s willingness to apply substantive consolidation so long as it leads to an equitable result, which is the same driving purpose found and acknowledged by the Second Circuit in *In re Augie/Restivo Baking Co.*<sup>224</sup> In a unique twist the Third Circuit also toyed with the idea of consolidating entities for certain creditors only.

#### *D. A Potential Fourth Test: Partial Consolidation*

In a small footnote in *In re Owens Corning*, the Third Circuit touched on the idea of “partial consolidation.”<sup>225</sup> In a partial consolidation, a creditor who

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<sup>217</sup> *Id.* at 212.

<sup>218</sup> *Id.* at 212–13.

<sup>219</sup> *Id.* at 214–15.

<sup>220</sup> *Id.* at 216. This interesting bit of dicta mirrors the primary purpose of substantive consolidation cited in *In re Augie/Restivo*. *In re Augie/Restivo Baking Co.*, 860 F.2d 515, 518 (2d Cir. 1988).

<sup>221</sup> *See, e.g.*, Willett, *supra* note 2, at 113–15 (referring to the Third Circuit’s decision as limiting substantive consolidation to a point at which it is no longer needed in bankruptcy law).

<sup>222</sup> *See Baird*, *supra* note 21, at 14–15 (noting that the district court in *In re Owens Corning*, “had broken too much china” in ordering substantive consolidation despite its result of less equity among creditors).

<sup>223</sup> *See In re Owens Corning*, 419 F.3d at 211.

<sup>224</sup> *See Baird*, *supra* note 21, at 14 (noting that in creating the new test, the Third Circuit “focused squarely on the principles set out in *Augie/Restivo*”).

<sup>225</sup> *In re Owens Corning*, 419 F.3d at 210 n.16.

had relied on the separateness would be entitled to the recovery that the creditor would have received without consolidation.<sup>226</sup> The rest of the creditors would recover from the consolidated entities.<sup>227</sup> Partial consolidation could only be possible when employing a solely subjective test for creditor reliance, as an objective test would only favor reliance of separateness or unity, not both.<sup>228</sup>

### *E. Reflecting on the Current Tests and Partial Consolidation*

The three tests represent three different attempts to reconcile past tests and fix problems in determining the cases in which substantive consolidation should be applied.<sup>229</sup> The *Auto-Train* test hinges on whether a substantial identity is present between the entities and evaluates evidence that demonstrates the closeness of the entities' relationships.<sup>230</sup> The *Augie/Restivo* test looks at whether each creditor actually relied on the entities' separateness or unity.<sup>231</sup> The *Owens Corning* test requires those petitioning for consolidation to prove corporate disregard, that they actually relied on the creditor's unity, and that their reliance was reasonable.<sup>232</sup> Partially consolidating entities may be a solution, but it requires an actual reliance test similar to the *Augie/Restivo* test.<sup>233</sup> Partial consolidation would not result in a new test but instead would just minimize the effects of consolidating the entities. Each test was designed to promote equity by trying to best fulfill the expectations of the entities' creditors.<sup>234</sup> However, each test fails to consistently accomplish this goal.

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<sup>226</sup> Kors, *supra* note 27, at 450–51.

<sup>227</sup> *See id.*

<sup>228</sup> *See id.* (noting that “if circumstances lead one party to rely on the single status of the one debtor, it is unlikely that other creditors are relying on the joint status of the two entities, especially as reliance must be reasonable”).

<sup>229</sup> *In re Owens Corning*, 419 F.3d at 210–12 (improving on imprecise previous test); *In re Augie/Restivo Baking Co.*, 860 F.2d 515, 518 (2d Cir. 1988) (reconciling past tests into “variants on two critical factors”); *In re Auto-Train Corp.*, 810 F.2d 270, 276 (D.C. Cir. 1987) (reconciling previous approaches to create the *Auto-Train* test).

<sup>230</sup> *In re Auto-Train Corp.*, 810 F.2d at 276.

<sup>231</sup> *In re Augie/Restivo Baking Co.*, 860 F.2d at 518.

<sup>232</sup> *In re Owens Corning*, 419 F.3d at 210–12.

<sup>233</sup> *See id.* at 211; *see also* Kors, *supra* note 27, at 450–51 (noting that “if circumstances lead one party to rely on the single status of the one debtor, it is unlikely that other creditors are relying on the joint status of the two entities, especially as reliance must be reasonable”).

<sup>234</sup> *In re Owens Corning*, 419 F.3d at 216; *In re Augie/Restivo Baking Co.*, 860 F.2d at 518–19; *In re Auto-Train Corp.*, 810 F.2d at 276.

## V. HOW THE MODERN APPROACHES FAIL

Currently, the four main substantive consolidation tests can be separated into three categories based on the nature of the evidence required to evaluate whether substantive consolidation is appropriate.<sup>235</sup> The *Auto-Train* test is an objective test that requires evidence related to how the public perceives the relationship between the relevant entities.<sup>236</sup> The first option in the *Augie/Restivo* test and the concept of partial consolidation are subjective tests that require evidence of actual dealings and the “state of mind” of the creditor or creditors that the entities dealt with.<sup>237</sup> The *Owens Corning* test is a hybrid test that requires both an objective assurance that reliance is reasonable, which would also satisfy the “corporate disregard” element, and a subjective test that requires “actual reliance” from the creditor or creditors.<sup>238</sup>

The common theme underlying each of the three tests was that the ultimate goal, or purpose to be attained, was equity.<sup>239</sup> Equity, in the case of substantive consolidation, is best served by trying to fulfill the expectations of the creditors.<sup>240</sup> This pursuit of equity also results in greater efficiency in the credit markets, lower interest rates, and better terms for debtors.<sup>241</sup> The advancement of equity is good for both creditors and the debtors.<sup>242</sup> Each of

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<sup>235</sup> Basically each test has different aims and different thresholds that can be characterized based on whether the test is looking from the “reasonable person” perspective, from the creditor’s actual perspective, or some combination of both.

<sup>236</sup> See *In re Auto-Train Corp.*, 810 F.2d at 276 (requiring that the proponent of substantive consolidation show “a substantial identity between the entities to be consolidated”).

<sup>237</sup> See *In re Augie/Restivo Baking Co.*, 860 F.2d at 518 (requiring that the proponents of substantive consolidation show that “creditors dealt with the entities as a single economic unit and ‘did not rely on their separate identity in extending credit’”); Kors, *supra* note 27, at 382.

<sup>238</sup> See *In re Owens Corning*, 419 F.3d at 212 (requiring that proponents prove both that they “actually,” subjectively, and “reasonably,” objectively “relied on debtors’ supposed unity”).

<sup>239</sup> *Id.* at 216 (concluding that “substantive consolidation at its core is equity”); *In re Augie/Restivo Baking Co.*, 860 F.2d at 518 (concluding that “the sole purpose of substantive consolidation is to ensure the equal treatment of all creditors”); *In re Auto-Train Corp.*, 810 F.2d at 276 (giving special attention to whether substantive consolidation “yields benefits offsetting the harm it inflicts on objecting parties”).

<sup>240</sup> *In re Augie/Restivo Baking Co.*, 860 F.2d at 519 (determining that the expectations of the creditors at the time of the loan, “create significant equities”).

<sup>241</sup> See *id.* at 518 (noting that creditors’ expectations determine the terms of a loan). If courts promote equity, the result will be that lenders do not have to raise rates or have harsher terms to account for the risk of nonpayment in bankruptcy due to mistaken beliefs about the nature of the entities. See *id.*

<sup>242</sup> Creditors are able to offer the lowest rates possible and incur the least amount of risk if the courts are more consistently fulfilling their expectations than not. Debtors, even those outside of bankruptcy, can incur debt at reduced rates, which lowers the absolute cost of the debt over time.

these tests has its own flaws and problems from a conceptual standpoint that will lead to failures in best achieving equity.<sup>243</sup>

#### A. Fundamental Problems with the “Objective” Tests

Numerous scholars and courts have written on the erratic application and problems of poorly defined standards consistent with an objective approach to substantive consolidation.<sup>244</sup> The *Auto-Train* threshold of proving a “substantial identity” between the entities requires objective consideration of the circumstances.<sup>245</sup> Like all objective tests, this means that the court has to create “factors” and balance them “objectively” to determine whether a substantial identity exists.<sup>246</sup> The biggest problem with this approach is that balancing the factors to determine the outcome of the test requires assigning various weights to each factor.<sup>247</sup> Given the diversity in industries, business models, and business organizations, providing objective weights for the factors that consistently deliver an equitable result is a nearly impossible task.<sup>248</sup> This leaves deciding the weight of each factor to the sole discretion of the presiding judge, something that makes many creditors and attorneys very uneasy.<sup>249</sup>

Another problem with objective tests is that they can very well result in an outcome that prevents equity.<sup>250</sup> Even if the factors could be adequately weighed, the test would not necessarily determine whether the creditor or

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<sup>243</sup> See Willett, *supra* note 2, at 114–15 (calling substantive consolidation “less precise”).

<sup>244</sup> See, e.g., *In re Owens Corning*, 419 F.3d at 210 (deciding that the approach has a “threshold too imprecise for easy measure”); Willett, *supra* note 2, at 101–03 (referring to objective identity tests as vague and unclear in their application).

<sup>245</sup> See *In re Auto-Train Corp.*, 810 F.2d 270, 276 (D.C. Cir. 1987).

<sup>246</sup> See Willett, *supra* note 2, at 101–03 (debating the factors that different circuit courts have previously used to determine the outcome of an objective substantial identity test).

<sup>247</sup> See *id.*; see also *In re Owens Corning*, 419 F.3d at 211 (noting that the approach does not guide on how to determine the weight of each factor).

<sup>248</sup> Some corporations have very close relationships with their subsidiaries and the subsidiaries seemingly work as an “instrumentality” of their parents. Other subsidiaries may have more defined roles; and yet others may be similar to those in the *Owens Corning* case and be viable corporations independent of their parent corporations. The closeness of the entities in many cases might also be a factor of the industry that they operate within, thereby making it difficult to define factors that would objectively determine a sufficient level of closeness to constitute a “substantial identity.”

<sup>249</sup> See, e.g., Willett, *supra* note 2, at 101–03; see also *In re Owens Corning*, 419 F.3d at 210.

<sup>250</sup> See generally *In re Owens Corning*, 419 F.3d at 210, 216 (concluding that the purpose of substantive consolidation is equity, but then completely abandoning the *Auto-Train* test as not accomplishing that purpose).

creditors actually relied on the unity of the relevant entities.<sup>251</sup> This argument sounds like, “this test fails merely because it is not subjective.” However because the creditors relied on the separateness of the entities, an inequitable windfall would result for the actual creditor if the entities were consolidated.<sup>252</sup> This is especially true if other creditors had also relied on the separateness of the entities and would recover less through consolidation.<sup>253</sup> For these reasons an objective test by itself cannot guarantee the maximization of equity.<sup>254</sup> However abandoning the objective test for a subjective approach would not be any better because subjective tests have their own flaws.

### *B. Fundamental Problems with the “Subjective” Tests*

The first option in the *Augie/Restivo* test, like other subjective tests, has a major evidentiary problem. To determine whether substantive consolidation should occur, a judge is forced to look at the evidence presented and then determine what the creditor or creditors’ state of mind was when the parties were dealing with each other.<sup>255</sup> The end result may often be based on the amount of evidence at hand and the judge’s best guess rather than the absolute truth.

For cases with a large volume of evidence in favor of one side or the other, the decision may be more equitable, assuming that the amount of evidentiary support is a function of absolute truth and not the disparity in power between the litigating entities.<sup>256</sup> However, when evidence is lacking or is inconclusive, the conclusion may not result in the most equitable outcome.<sup>257</sup> Furthermore,

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<sup>251</sup> Equity results when the creditors’ expectations are met. See *In re Augie/Restivo Baking Co.*, 860 F.2d 515, 518 (2d Cir. 1988). The outcome of the objective test has absolutely no bearing on whether the creditors’ actual expectations are met.

<sup>252</sup> This result, although it would not change the absolute payout, destroys both efficiency and equity by increasing the creditors’ risk that their loan expectations will not be fulfilled. See *In re Augie/Restivo Baking Co.*, 860 F.2d at 520.

<sup>253</sup> See *id.*

<sup>254</sup> However, that is not to say that an objective test itself is not useful in determining situations where the law should discourage unreasonable reliance on bad assumptions.

<sup>255</sup> See, e.g., *In re Augie/Restivo Baking Co.*, 860 F.2d at 519 (looking only at the actual creditors’ actual expectations in dealing with the respective businesses).

<sup>256</sup> This would be true in cases like *In re Augie/Restivo Baking Co.*, where the creditors had been dealing with the entities long before the entities became close. *Id.* at 516.

<sup>257</sup> It requires the judge to use his or her own best judgment in deciding what would be most equitable. Although this might not be necessarily bad, it gives similar “vague” and “unpredictable” results that others complain about when referring to objective tests like *Auto-Train*. See, e.g., *In re Owens Corning*, 419 F.3d 195, 210 (3d Cir. 2005) (deciding that the approach has a “threshold too imprecise for easy measure”); Willett, *supra* note 2, at 101–03 (referring to objective identity tests as vague and unclear in their application).

before even worrying about the equitable problems inherent to an unclear result in a “subjective balancing test” one must question how the evidence should be weighted for the test.<sup>258</sup> For example, independent of the other facts in the Owens Corning case, the creditor banks received guarantees from Owens Corning’s subsidiaries for Owens Corning’s \$2 billion loan.<sup>259</sup> The creditors put special provisions in their loan agreements requiring Owens Corning to keep its subsidiaries independent and separate.<sup>260</sup> Thus, subjectively, the outcome could be determined either way. The creditors, in their agreement, clearly expressed their intent for the debtors to stay separate.<sup>261</sup> On the other hand, maybe the creditors added these express provisions because they believed that the entities were acting as one and wanted to prevent any future mergers with Owens Corning.<sup>262</sup> Furthermore, it is very difficult for the creditors to argue that they believed they were dealing with separate entities when Owens Corning’s combined subsidiaries guaranteed a \$2 billion loan despite having an aggregate book value of approximately \$30 million.<sup>263</sup> If the subsidiaries were independent businesses, rather than owned by Owens Corning, no guarantees would have been given, even if the businesses were suppliers that were completely dependent on

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<sup>258</sup> It seems that the factors in an objective test are merely guidelines that might be helpful to prove that substantial identity is more likely than not. The subjective test has a similar problem. One can look at all of the “relevant” evidence, but unless none of it contradicts itself, a court is forced to do the unpleasant task of determining which evidence should be given more weight. Therefore, the argument that the objective test is more vague and imprecise than a subjective test is based on nothing more than the premise that “specifying factors to give guidance for a test results in a more vague and unreliable test.”

<sup>259</sup> *In re Owens Corning*, 419 F.3d at 201. This hypothetical requires that these facts be considered independent of the rest of the *Owens Corning* case for the mere reason of simplicity. The whole purpose of the hypothetical is to be an exercise in interpretation that demonstrates how easy it can be for a conclusion to be unclear and inconsistent.

<sup>260</sup> *Id.*

<sup>261</sup> *Id.* “Clearly” may be a slight understatement, the credit agreement had multiple provisions related to these issues. *Id.*

<sup>262</sup> In this respect, the creditors would have been dealing with the subsidiaries as one unit and at the same time trying to protect their future interests by having the credit agreement change the status quo to a more favorable situation. Furthermore, it cannot be seen as “equitable” for a court to conclude that a creditor relied on entities’ separateness when the creditor knew or should have known that some of the terms of the deal would not have been agreed to “but for” the unity and closeness, not to mention control, exhibited by the supposedly separate entities. See *infra* note 263.

<sup>263</sup> *In re Owens Corning*, 419 F.3d at 201. One might argue that the subsidiaries had valid non-monetary reasons for guaranteeing the loan. However, guaranteeing a loan that is more than sixty-five times the aggregate book value of the subsidiaries themselves makes no sense from any perspective. Better relationships, public relations, or other intangible benefits can be purchased at a far cheaper price.

Owens Corning.<sup>264</sup> Again, before the evaluation, the basic issues revolve around trying to determine what the evidence proves and then determining how the evidence should be weighted in applying the subjective test.

The last problem that arises when trying to apply subjective tests is when there are multiple creditors who relied on opposing beliefs. Suppose creditors A and B actually relied on the separateness of the entities in extending credit to the subsidiaries, while creditors C, D, and E, whose claims constitute approximately seventy percent of the combined credit extended to both the parent company and the subsidiaries, relied on the belief that the parent company and subsidiaries were one entity. Both sides have an “actual belief” that the entities were either separate or one, but problems arise in their treatment under a subjective test.<sup>265</sup> One might argue for partial consolidation, but then the result in this hypothetical would be the same as complete consolidation.<sup>266</sup> In *In re Owens Corning*, the Third Circuit noted the possibility of this problem arising under subjective tests, but decided against providing guidance for a possible solution.<sup>267</sup> The likelihood of multiple creditors is high in a bankruptcy case, thus, this is a real problem under subjective tests, especially since little guidance exists on how to deal with the issue. With the failures of both the objective test and the subjective test, combining the two might seem like a good answer. However, merely combining the subjective and objective tests without further modification fixes some problems while simultaneously creating new ones.

### C. *The Problems with the Owens Corning Hybrid Test*

Afraid of the potential inequitable application of substantive consolidation, the Third Circuit decided to combine both approaches and created a hybrid

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<sup>264</sup> Though the result would not have differed in *In re Owens Corning*, maybe future courts should take a closer look at the influence that a parent corporation has over its subsidiaries to determine whether a truly independent business would act as the subsidiaries had.

<sup>265</sup> Under the subjective test, depending on how you read it, either both prevail and the test results in a stalemate, A and B prevail and the entities remain separate, or C, D, and E prevail and the entities are substantively consolidated.

<sup>266</sup> In partial consolidation, the estates would be treated as consolidated for C, D, and E but not for A and B. In a practical manner, A and B would share pro rata the amount left over after C, D, and E get their equal shares, three-fifths of the total assets. Hence, the result would be no different than actually consolidating the entities. See Kors, *supra* note 27, at 450–51.

<sup>267</sup> *In re Owens Corning*, 419 F.3d at 211 n.22 (noting that the Third Circuit specifically declined to analyze the outcome when an opposing creditor also satisfies the tests).

test: the first rationale in the *Owens Corning* test.<sup>268</sup> In doing so the Third Circuit sought to limit the application of substantive consolidation to an extent that almost guaranteed that the cases in which consolidation is applied would assuredly result in the most equitable outcome.<sup>269</sup> The Third Circuit seems to have accomplished its objective in that respect. However, the first rationale in the *Owens Corning* test prevents equity because it fails to address the problems underlying each test and instead combines the two tests and creating a higher threshold that must be met to substantively consolidate the entities.<sup>270</sup> Now, instead of worrying about one test being too indefinite and promoting less equitable results, a proponent of consolidation must worry about passing two balancing tests, each with its own inherent issues.<sup>271</sup> Even worse, the problem is compounded when both tests have evidence of a nature that deciding the outcomes of both balancing tests is difficult for a court.<sup>272</sup> This test does not advance equity, which, as the Third Circuit noted, is the primary purpose of the substantive consolidation area of law.<sup>273</sup> Instead the test merely makes it difficult for the court to substantively consolidate entities when it would be less equitable to do so.

#### *D. The Tests' Failures and the Need for a New Test*

For various reasons each of the current substantive consolidation tests are prone to inconsistency and to failure in determining the cases in which consolidation would create the most equitable result. Although the courts of appeals all agree that substantive consolidation should only be applied to promote equity, the promulgation of different tests by different courts of appeals indicates the courts' lack of faith in the current tests' ability to consistently determine the most equitable outcome.<sup>274</sup> Equity results only when the expectations of the entities' creditors are fulfilled.<sup>275</sup>

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<sup>268</sup> *Id.* at 211–12. The first rationale focuses on both actual and reasonable reliance, thus requiring both objective and subjective evidence. *Id.*

<sup>269</sup> *Id.* at 216.

<sup>270</sup> See Willett, *supra* note 2, at 113–14 (noting that the *Owens Corning* test “limit[ed] substantive consolidation to more predictable situations”).

<sup>271</sup> The Third Circuit did not fix either test but rather combined them to make it difficult for a proponent to succeed in a motion for substantive consolidation. The original issue with the tests was whether a test could give a “false reading” regarding which outcome would be more equitable. The Third Circuit merely combined two of the tests, thus making it more difficult for a proponent to win on both grounds but not clarifying how to weight evidence and factors or how to treat the tests when the outcome is close for either one or both.

<sup>272</sup> In this case, the tests are inconclusive, and the court would be forced to arbitrarily pick a side.

<sup>273</sup> *In re Owens Corning*, 419 F.3d at 216.

<sup>274</sup> *Id.* (concluding that “substantive consolidation at its core is equity”); *In re Augie/Restivo Baking Co.*, 860 F.2d 515, 518 (2d Cir. 1988) (concluding that “the sole purpose of substantive consolidation is to ensure

Objective tests fail for two reasons. First, they require the creation and weighing of different factors that may be more prominent in some industries than others.<sup>276</sup> Second, even assuming that a perfectly nuanced weighing system could be created, the test fails to attempt to ascertain the creditors' actual expectations, which are central to promoting equity.<sup>277</sup> Therefore, an objective test's outcome provides little guidance in determining the most equitable course of action.

While objective tests have clear flaws, subjective tests fail to better clarify whether consolidation would create the most equitable result. First, subjective tests suffer from an evidence weighing problem similar to that of objective tests.<sup>278</sup> A court must determine the evidence's relevance and weight given the industry and past relations. Second, subjective tests can be satisfied simultaneously by opposing parties.<sup>279</sup> The simultaneous satisfaction of the test produces no clear guidance on whether the substantive consolidation's application would create a more equitable result. The flaws of subjective tests' make the subjective tests an insufficient alternative to objective tests.

The *Owens Corning* hybrid test raises the evidentiary threshold for substantive consolidation at the expense of equity.<sup>280</sup> Rather than addressing the problems inherent to subjective or objective tests, the *Owens Corning* hybrid test requires the proponents of consolidation to pass both an objective and a subjective test.<sup>281</sup> While the *Owens Corning* test provides greater predictability, the predictability comes at the expense of equity.<sup>282</sup> A substantive consolidation motion in bankruptcy is not a matter of unclear law but rather a function of the unclear status of the parent corporation and its subsidiaries. Hence, the *Owens Corning* test's predictability advantage is severely outweighed by the equity it sacrifices by disallowing consolidation in cases where consolidation might be more equitable. Instead of abandoning substantive consolidation in all but the few instances in which consolidation

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the equitable treatment of all creditors"); *In re Auto-Train Corp.*, 810 F.2d 270, 276 (D.C. Cir. 1987) (giving special attention to whether substantive consolidation "yields benefits offsetting the harm it inflicts on objecting parties").

<sup>275</sup> *In re Augie/Restivo Baking Co.*, 860 F.2d at 518.

<sup>276</sup> *In re Owens Corning*, 419 F.3d at 210; Willett, *supra* note 2, at 101–03.

<sup>277</sup> See *In re Augie/Restivo Baking Co.*, 860 F.2d at 518.

<sup>278</sup> See, e.g., *In re Owens Corning*, 419 F.3d at 210; Willett, *supra* note 2, at 101–03.

<sup>279</sup> *In re Owens Corning*, 419 F.3d at 211 n.22.

<sup>280</sup> *Id.* at 216.

<sup>281</sup> *Id.* at 211–12.

<sup>282</sup> See Willett, *supra* note 2, 113–14 (noting that the *Owens Corning* test "limited substantive consolidation to more predictable situations").

would clearly be more equitable, courts need to adopt a new test that can better limit inconsistencies while maximizing the likelihood that the outcome is the most equitable result.

## VI. CREATING A NEW SUBSTANTIVE CONSOLIDATION TEST SPECIFICALLY FOR CORPORATIONS AND THEIR SUBSIDIARIES

In creating a new test for substantive consolidation, courts must tailor the test to the type of relationship that it will be used to evaluate. Because subsidiaries and their parent corporations have different relationships between themselves than those of other entities that might be considered for substantive consolidation, a special test needs to be tailored to account for these differences. Although subsidiaries are by definition separate entities, subsidiaries are subject to outside control and influence by virtue of their existence.<sup>283</sup> The mere ownership of the subsidiary gives the parent company a position of superiority in the relationship. If nothing else, it can be assumed that the subsidiaries have strong incentives to pursue actions for the benefit of their parent corporation that they otherwise would not for any other business.<sup>284</sup> From the parent corporation's standpoint, the subsidiary exists for the benefit of the parent corporation. Therefore, the parent corporation has incentives to either explicitly or implicitly influence its subsidiaries to act in ways that would benefit the parent corporation. Any substantive consolidation test or policy must therefore acknowledge that subsidiaries and parent corporations should be treated differently due to the nature of their relationships.

Although the *Owens Corning* test fails to ensure that the most equitable outcome will be more consistently reached than by using solely a subjective or an objective test, the *Owens Corning* test can be modified to create a new hybrid test. The new hybrid test would improve on past tests by limiting inconsistent results to cases in which both the subjective and objective tests were inconclusive. In those instances the impact of a bad decision would have a minimal impact on equity because the difference between the outcomes would result in a very small difference in equity. The new hybrid test would improve on the other tests by allowing only one outcome to be reached,

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<sup>283</sup> BLACK'S LAW DICTIONARY 368 (8th ed. 2004).

<sup>284</sup> See *In re Owens Corning*, 419 F.3d 195, 201 (3d Cir. 2005) (explaining how Owens Corning's subsidiaries, in exchange for nothing, accepted full responsibility for Owens Corning's debts if the parent company were unable to pay).

focusing primarily on creditors' actual intent, and by eliminating the *Owens Corning* test's predisposition against substantive consolidation. These improvements will allow the test to better direct the courts toward the most equitable outcome.

A. *The Improved "Hybrid" Substantive Consolidation Test*

An improved substantive consolidation test evaluates the creditors' relationships with the entities in both an objective and subjective manner without discouraging substantive consolidation in situations in which substantive consolidation would result in greater equity. Furthermore, an improved substantive test eliminates as much discretion, vagueness, and arbitrariness as possible. Because the basis of equity in substantive consolidation is the creditors' subjective expectations, the primary focus of a new test should be on the creditors' subjective expectations.<sup>285</sup> However, unlike in the *Owens Corning* test, the burden to prove actual reliance should be distributed to all creditors whether they are proponents of substantive consolidation or opponents of substantive consolidation.<sup>286</sup>

Evidence of actual intent should be treated in one of two ways. First, evidence of express intent to deal with entities as one unit or separately should obviously be given the highest priority and should be considered conclusive evidence of actual intent, thus giving creditors an extra incentive to include "intent" or "reliance" clauses within their credit contracts. Second, evidence of implicit intent should be evaluated to determine whether it is very likely or very unlikely that the creditors believed that they were dealing with one unit or a separate entity. If the court determines that the evidence is sufficient to make a conclusion about intent, then the court treats the conclusion as the creditors' actual intent. If not, then the court leaves the actual intent as "unknown" for now, instead of arbitrarily trying to decide the outcome of the evidence.

After evaluating all of the evidence of actual intent, the court then needs to do some math. At this point the court should first add the value of the substantive consolidation proponent's and opposition's claims together to determine a base number. Next, the court needs to separate the claims into three groups based on the court's determination of whether the creditor actually relied on the belief that the entities were one, unknown, or separate. Finally, the court needs to total the claims in each group. If the total amount of

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<sup>285</sup> *In re Augie/Restivo Baking Co.*, 860 F.2d 515, 518 (2d Cir. 1988).

<sup>286</sup> *See In re Owens Corning*, 419 F.3d at 211-12.

claims in either the “one” or “separate” categories is greater than 50% of the base number, then consolidation should either be ordered or denied depending on whether the majority actually relied on the “oneness” of the entities or their separateness. If not, then the court should immediately proceed to an objective evaluation.

The objective evaluation in this new test is used to refine the outcome of the subjective evaluation. Because the difference between subsidiaries being separate entities or “mere instrumentalities” is a matter of “fact and degree,” the court needs to evaluate whether it is more likely than not that a reasonable creditor would rely on the subsidiaries as mere instrumentalities of the parent company.<sup>287</sup> A determination that it is more likely than not that a reasonable creditor would rely on the subsidiaries as mere instrumentalities would result in the court granting substantive consolidation, while the opposite conclusion would result in the court denying substantive consolidation.

#### *B. The New Substantive Consolidation Test Improves on the Older Tests*

The primary problem with older substantive consolidation tests was that the tests were too vague and allowed for too much judicial discretion, thus leading to inconsistent results. Additionally, the tests were overly restrictive and prevented substantive consolidation, many times at the cost of equity.<sup>288</sup> The new substantive consolidation test does not solve these problems completely but rather minimizes their interference with an equitable outcome. While it mainly utilizes a subjective evaluation, it also includes an objective component to reduce discretion and inconsistency while promoting “reasonable reliance.”

When evaluated against a purely subjective approach, the new test improves in its accuracy and inconsistency inherent in the subjective approach. By requiring a level of evidence that proves reliance to be “very likely,” the approach limits the amount of guesswork required or needed by the court. In the event of a gray area, the court merely places the creditor aside in its sorting and continues on. Furthermore, by requiring that the court can only rule on substantive consolidation if it finds that greater than 50% of the total value of the claims show actual reliance on the corporations’ unity or separateness, the test limits discretion and guessing to instances where evidence does not clearly point one way or the other.

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<sup>287</sup> Fish v. East, 114 F.2d 177, 191 (10th Cir. 1940).

<sup>288</sup> *In re Owens Corning*, 419 F.3d at 211–12; see Willett, *supra* note 2, 101–03 (noting that the *Owens Corning* test “limited substantive consolidation to more predictable situations”).

Furthermore, the new test eliminates the second problem of the subjective approach because both proponents and opponents cannot simultaneously satisfy the requirements of the new test.<sup>289</sup> If the subjective requirements are satisfied without needing to proceed to the objective evaluation, proponents and opponents cannot both simultaneously claim that their position is supported by claims that value more than fifty percent of the base value. If the court proceeds to the objective evaluation, both sides cannot simultaneously claim that they “reasonably” relied on the unity or separateness of the entities.

The new test also improves on purely subjective approaches by encouraging “reasonable” reliance. The outcome of the objective evaluation results in advancing the position taken by creditors who most “reasonably” relied on the entities’ unity or separation. If no objective evaluation is necessary, then the position advanced is the one which the majority of claims comes from creditors who clearly actually relied upon the entities’ separateness or unity, thus implicitly suggesting that reliance was reasonable if the majority of claims come from a large group of creditors. A foreseeable issue involves a case in which the claims of one large creditor exceeds fifty percent of the total claims against the debtors. In that case, the large creditor’s claims alone satisfy the actual test, thereby circumventing any consideration as to whether the creditor’s reliance was reasonable. In that case, however, the primary policy of maximized equity is assuredly advanced because the high bar requires the court to determine, at the least, that the creditor “very likely” actually relied on the entities’ separateness or unity. The requirements of a solely subjective test are much lower because the test sacrifices any reasonableness requirement, without at least trading it, for a greater likelihood of equity.

When compared to a purely objective test, the new test improves on the objective test’s lack of precision and vagueness.<sup>290</sup> Although the new test does not create an official list of factors to weigh that clearly establishes the method by which the test is to be evaluated, the test creates a simple standard that can allow courts to develop constraints through holdings, or even give guidance in dictum, over time. The new test limits the extent to which impreciseness and vagueness can come into play by filtering out cases that can be conclusively addressed without the objective evaluation. All of the cases that result in decisions based solely on the subjective evaluation are virtually guaranteed to

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<sup>289</sup> See *In re Owens Corning*, 419 F.3d at 211 n.22.

<sup>290</sup> *Id.* at 211–12.

result in the most equitable outcome. Therefore, the remaining cases subjected to the objective evaluation are those in which actual reliance is difficult to ascertain. The application of the new test's objective evaluation therefore sheds some light on the actual reliance of creditors sorted into the "unknown" category during the subjective evaluation. The end result is that while some of the issues of the objective test will exist until courts can consistently provide better guidance, the impact of these issues is constrained and minimized through the dual application of both objective and subjective evaluations.

The new test corrects the biggest problem of a solely objective approach: disregard for the creditors' actual intent.<sup>291</sup> By utilizing a subjective evaluation as the main component of the test, the new test emphasizes the maximization of equity. As the level of equity promoted by the courts, in terms of substantive consolidation, is based on the creditors' actual reliance, the test focuses first and foremost on whether the court can almost conclusively determine the most equitable outcome with direct evidence of actual reliance. Only when the subjective evaluation reaches an "inconclusive" result does it then proceed to the objective evaluation. At that point, the court is aided by the additional evidence in an attempt to determine the outcome that would most likely result in the highest equity.

The new test is less hostile to proponents of substantive consolidation. A less hostile test is important because the relationships between parent corporations and their subsidiaries encourage a move away from separateness and toward a "substantial identity." Furthermore, the test better promotes equity as proponents of substantive consolidation should not be treated any differently than those that oppose it. While the hybrid *Owens Corning* test was unnecessarily harsh and hostile toward proponents of substantive consolidation, the new test places all creditors on equal ground with equal burdens of proof.<sup>292</sup> In putting all creditors on equal ground, the test at least attempts to achieve equity in all cases, rather than adopting a policy that favors denying consolidation if evidence leads to an unclear results.

While some might argue that by favoring the status quo when the evidence is close, the *Owens Corning* test gives some guidance regarding the risk to creditors for use in their dealings, the new test provides clear unequivocal guidance to creditors on how to avoid this problem. By placing a high value

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<sup>291</sup> See *In re Augie/Restivo Baking Co.*, 860 F.2d 515, 518 (2d Cir. 1988) (noting that equity is promoted when creditors' expectations are fulfilled).

<sup>292</sup> See Willett, *supra* note 2, at 101-03.

on “actual reliance” and evidence of express intent, the test gives creditors an incentive to include specific clauses within their credit agreements specifying their intent to deal with entities as one or separately. More guidance would most likely be useless because the substantive consolidation conflicts that are currently arising exist despite the guidance provided by the current tests. A better policy for preventing such conflicts involves adopting a test that encourages all creditors to more diligently investigate those to whom they seek to offer credit. Unlike the Owens Corning test that only encourages diligence among those creditors whom are relying on the entities’ unity, by placing everyone on an equal footing the new test encourages all creditors to be diligent in investigating those to whom they are extending credit.

*C. The New Test Better Accomplishes the Goal of Substantive Consolidation*

The primary emphasis behind the new test is equity. Because equity is achieved when the court best satisfies the creditors’ expectations, an emphasis on the creditors’ actual reliance is necessary. Inconsistency is constrained by requiring the court to apply an objective test when the creditors’ actual reliance is not clear. Although the objective test may not always provide a clear result, potential inconsistency from judicial discretion occurs only in instances in which both tests have unclear results. This improves on both the objective and subjective tests by requiring an unclear result from both tests before the court has to make an educated guess as to which outcome would be most equitable. Even the *Owens Corning* test requires courts to make educated guesses if one of its tests presents an unclear outcome.<sup>293</sup> The limitation of discretion lessens the potential inconsistency in the test results. By limiting inconsistency in application, the test better promotes equity by more often determining the most equitable result.

The new test minimizes or eliminates flaws present with the currently established tests. Although the new test does not completely cure the issues concerning the weighing and determination of evidence inherent in the

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<sup>293</sup> See *In re Owens Corning*, 419 F.3d at 211–12 (providing no guidance as to how to refine the terms reasonable and actual reliance).

subjective and objective tests, the new test minimizes the extent to which these flaws can affect the new test by requiring the court to refrain from making determinations from unclear results unless both the subjective and objective components fail to provide clear guidance. The new test improves on solely objective tests by focusing heavily on actual reliance evidence while avoiding the possibility of solely subjective tests of having both sides satisfy the test. Finally, the new test improves on the *Owens Corning* hybrid test by removing the predisposition against substantive consolidation while maintaining the similarly high level of consistency sought in the *Owens Corning* test's promulgation. The new test promotes equity and minimizes the potential damage that courts can do when application is wrong or inconsistent.

### CONCLUSION

Substantive consolidation is an important and useful tool to promote equity. It redefines bankruptcy estates to better reflect creditors' expectations. By using substantive consolidation to better fulfill the creditors' expectations equity is achieved, but by limiting substantive consolidation to a few situations for the sake of predictability sacrifices equity and leaves us with a harsh rigid system that is detached from reality. This Comment's new test can minimize inconsistency and promote equity by helping bankruptcy law better reflect the realities of business between parent corporations and their subsidiaries.

Since *Sampsell*, courts have readily acknowledged that having control over an entity can result in the entity being relegated to a "mere instrumentality" of the controller. The influence that a parent company has over its subsidiaries makes their relationship closer than those between other types of entities. Decisions of whether to order substantive consolidation should account for the parent corporation's control over its subsidiaries.

Currently three tests have been established for determining whether entities should be substantively consolidated.<sup>294</sup> The *Auto-Train* test objectively evaluates whether the entities have a "substantial identity."<sup>295</sup> The *Augie/Restivo* test determines whether the creditors subjectively actually relied on the entities unity.<sup>296</sup> The *Owens Corning* test restricts the ability for bankruptcy courts to order substantive consolidation by requiring that

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<sup>294</sup> *Id.*

<sup>295</sup> *In re Auto-Train Corp.*, 810 F.2d 270, 277-78 (D.C. Cir. 1987).

<sup>296</sup> *In re Augie/Restivo Baking Co.*, 860 F.2d at 518-19.

proponents show corporate disregard of the entities separateness and demonstrate that they actually and reasonably extended credit in reliance on the entities unity.<sup>297</sup> The *Owens Corning* test combines the *Auto-Train* approach by looking at objective factors, reasonableness and corporate disregard of separateness, and a subjective factor, actual reliance.<sup>298</sup> The *Auto-Train* and *Augie/Restivo* tests fail at promoting equity by their inconsistency and imprecision, and the *Owens Corning* test fails because it prevents consolidation from being ordered for cases in which consolidation would better reflect creditor's expectations.<sup>299</sup>

This Comment's new test minimizes the inconsistency and imprecision created by the *Auto-Train* and *Augie/Restivo* tests by utilizing them in a manner that minimizes the effects of weighing evidence inconsistently. The new test focuses heavily on the actual creditor's expectations. For a substantive consolidation motion to be granted or denied solely based on actual reliance, the test requires the court to conclude that creditors with claims that amount to more than fifty percent of the total claims very likely relied on the belief that they were dealing with the entities as a unit or as an entity separate from the others. By requiring the court to conclude that reliance was "very likely," the test accounts for inconsistent methods of evaluating evidence and differences in industry norms. If no conclusion is reached after evaluating actual reliance, then the court proceeds to look objectively to determine the reasonableness of relying on the entities' unity or separateness. This combination relegates inconsistency to the small amount of cases in which the outcome for both the subjective and objective test is unclear and allows bankruptcy courts to order substantive consolidation in many cases where substantive consolidation would have been denied under the *Owens Corning* test.

Adopting a new test for determining when entities' estates should be consolidated will promote equity and help bring bankruptcy law back into reality. This new test will offer a reliable and more precise alternative to massively restricting the instances in which consolidation can be granted. It assuages various courts' fears by improving on the flaws and problems in the current tests.<sup>300</sup> Although the test may not be perfect, it vastly improves on the

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<sup>297</sup> *In re Owens Corning*, 419 F.3d at 211–12.

<sup>298</sup> *Id.*

<sup>299</sup> *Id.*; see Willett, *supra* note 2, at 101–03.

<sup>300</sup> See *In re Owens Corning*, 419 F.3d at 211–12; Willett, *supra* note 2, at 101–03 (noting that the *Owens Corning* test "limited substantive consolidation to more predictable situations").

other alternatives currently available when estates need to be redefined into reality.

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