

The New Corporate Web: Tailored Entity Partitions and Creditors' Selective Enforcement

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Abstract

Firms have developed sophisticated legal mechanisms that partition assets across some dimensions and not others. The result is a complex web of interconnected affiliates. For example, an asset placed in one legal entity may serve as collateral guaranteeing the debts of another legal entity within the larger corporate group. Conventional accounts of corporate groups cannot explain these tailored partitions. Nor can they explain the increasingly common scenario where one creditor is the primary lender to all or most of the legal entities in the group.

This article develops a new theory of selective enforcement to fill these gaps. When a debtor defaults on a loan, the default may signal a failure across the entire firm or it may signal an asset- or project-specific failure. Tailored partitions give a primary monitoring creditor the option to select between project-specific and firm-wide enforcement depending on the signal it receives. In this way, firm-wide risks and failures can be addressed globally while the costly effects of project-specific risks and failures can be locally contained. This option for precision makes monitoring and enforcing loan agreements less costly and, in turn, reduces the debtor's overall cost of capital.

These concepts of selective enforcement and tailored partitions have important implications for legal theory and practice. In addition to providing a cohesive justification for the web of entity partitions and cross liabilities that characterize much of corporate structure today, they also inform how bankruptcy courts should approach a wide range of legal and policy issues from holding-company equity guarantees and good-faith-filing rules, to fraudulent transfers and ipso facto clauses.

Introduction.....	1
I. Cross Liabilities, the Corporate Web, and Conventional Theories of Asset Partitions.....	6
A. Cross Liabilities.....	6
B. The Conventional Models of Asset Partitions.....	10
C. Limitations on the Conventional Model.....	13
II. Tailored Partitions and Selective Enforcement.....	14
A. Selective Enforcement: A Simplified Example.....	15
i. Option 1: Perfect (or High) Correlation and Integration.....	16
ii. Option 2: No Correlation and the Benefits of Partitions.....	21
iii. Option 3: Partial Correlation, Tailored Partitions, and Selective Enforcement.....	27
iv. A Further Aside about Security Interests.....	35
B. Variations on a Common Theme: Holding Company Guarantees and Subordinated Primary Creditors.....	37
i. Holding-Company Guarantees and Stock Pledges.....	37
ii. Subordinated Primary Creditors.....	43
III. Implications for Law and Theory.....	45
A. Good Faith Filing.....	45
B. Fraudulent Transfer Law.....	46
C. Bankruptcy and Ipso Facto Clauses.....	48
IV. Limitations on and Critiques of the Selective Enforcement Theory.....	52
A. Creditor Opportunism.....	52
B. Differentiating Motives.....	53
Conclusion.....	55
Appendix: Specific Provisions.....	56
A. Cross Defaults/Cross-Guarantees.....	56
B. Cross Guarantees of Payment/Cross Guarantees of Collection.....	57

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Introduction

Legal scholars have only a basic understanding of dynamic corporate groups. Existing theories explain why some assets of an economic enterprise might be divided into distinct legal entities.¹ And other theories provide one-off explanations for specific legal and economic relations that arise between those entities. But a cohesive theory of exactly how the whole web fits together has yet to emerge. This article begins to develop that theory by introducing the concepts of tailored partitions and selective enforcement.

Firms regularly separate and place assets into different legal entities to create value.² That value may come from risk partitions, withdrawal rights, regulatory compliance, tax planning, or some other source. The existing scholarship often examines these partitions as if they are the result of a binary, all-or-nothing decision.³ By this view, firms either isolate assets by a legal partition or integrate them in one entity. This dichotomy is unrealistic and has muddied the theoretical waters.

In reality, firms can tailor the impact and degree of any legal partition to create a precise structure. Certain contract provisions – such as cross guarantees,

¹ For early literature on this phenomenon, see Jonathan M. Landers, *A Unified Approach to Parent, Subsidiary, and Affiliate Questions*, 42 U. Chi. L. Rev. 589 (1975); Richard Posner, *The Rights of Creditors of Affiliated Corporations*, 43 U. Chi. L. Rev. 499 (1976). For more recent work see Edward M. Iacobucci and George G. Triantis, *Economic and Legal Boundaries of Firms*, 93 Va. L. Rev. 515 (2007); Henry Hansmann and Reinier Kraakman, *The Essential Role of Organizational Law*, 110 Yale L.J., 387 (2000).

² Throughout this article, I use the term “firm” in a general Coasean sense to indicate an economic enterprise under common control of one entrepreneur, owner, or hierarchy. See R.H. Coase, *The Nature of the Firm*, 4 *Economica* 386, 393 (1937) (noting that a firm “consists of the system of relationships which comes into existence when the direction of resources is dependent on an entrepreneur”). “Legal entities,” on the other hand, are artificial boundaries that define liabilities and claims on or against assets within a firm. Essential to this article is the fact that firms are divided up into legal entities. This distinction was explored and developed in large part by Ed Iacobucci and George Triantis. Iacobucci and Triantis, *supra* note 1 at 518-19 (defining differences between legal and economic theories of firm boundaries).

³ See, for example, Landers, *supra* note 1; Posner, *supra* note 1; Richard Squire, *Strategic Liability in the Corporate Group*, 78 U. Chi. L. Rev. 605 (2011); Douglas G. Baird and Anthony J. Casey, *No Exit? Withdrawal Rights and the Law of Corporate Reorganizations*, 113 *Columbia L. Rev.* 1 (2013); Iacobucci and Triantis, *supra* note 1; Henry Hansmann and Reinier Kraakman, *Organizational Law as Asset Partitioning*, 44 *Eur. Econ. Rev.* 807 (2000); see also Hansmann and Kraakman, *The Essential Role of Organizational Law*, *supra* note 1 at 399-401 (discussing partition decisions more generally).

cross defaults, cross accelerations, and holding-company guarantees⁴ – can be coupled with legal partitions to create a web of commonly owned assets and targeted liabilities. The prevalence of these tailored partitions is apparent in the capital structures at the core of many recent corporate bankruptcies. The coupling of legal partitions and cross-liability provisions was visible (and became an important issue) in the bankruptcies of Kodak, Lehman Brothers, Dana Corporation, Calpine, Residential Capital, Visteon, MSR Resorts, and many others.⁵ In each of those cases, the debtors filed as a group of commonly owned legal entities. Thus, for example, while Kodak is a single economic firm, the “Kodak bankruptcy” was actually the administrative consolidation of 16 different bankruptcy proceedings. Each of the 16 debtors had its own legal entity, but they were commonly owned and each entity had cross-guaranteed the secured debt of the other entities.⁶

While bankruptcy proceedings make these structures particularly salient and transparent, we can also observe the phenomenon when large public corporations like JcPenney take on major debt. The public filings associated with those transactions again reveal the prevalence of tailored partitions. The secured debt that JcPenney recently took on, for example, was cross-guaranteed by all of JcPenney Company, Inc.’s domestic subsidiaries.⁷

These tailored partitions create value by allowing the debtor and its creditors to achieve a balance between specific and general creditor enforcement in re-

⁴ I refer to these terms collectively as “cross-liability provisions.” I discuss some particulars of these provisions below at ____.

⁵ *In re Eastman Kodak Company, et al.*, Case No. 12-10202 (Bankr. S.D.N.Y. 2012), *In re Lehman Brothers Holdings Inc., et al.*, Case No. 08-13555 (Bankr. S.D.N.Y. 2008), *In re Dana Corporation, et al.*, Case No. 06-10354 (Bankr. S.D.N.Y. 2006), *In re Calpine Corporation, et al.*, Case No. 05-60200 (Bankr. S.D.N.Y. 2005), *In re Residential Capital, LLC, et al.*, Case No. 12-12020 (Bankr. S.D.N.Y. 2012), *In re Visteon Corporation, et al.*, Case No. 09-11786 (Bankr. D. Del. 2009), *In re MSR Resort Golf Course LLC, et al.*, Case No. 11-10372 (Bankr. S.D.N.Y. 2011).

⁶ See DECLARATION OF ANTOINETTE P. McCORVEY IN SUPORT OF FIRST DAY MOTIONS, *In re Eastman Kodak Company, et al.*, Case No. 12-10202 (Bankr. S.D.N.Y. 2012) (hereinafter “Kodak First Day Aff.”).

⁷ June 20, 2014 Credit Agreement Among J.C. Penney Company, Inc., et al and Wells Fargo Bank, N.A., available at <http://www.sec.gov/Archives/edgar/data/1166126/000116612614000039/creditagreement.htm> (hereinafter the “J.C. Penney Credit Facility”). Often the loan is structured as a revolving credit facility that allows borrowers to draw funds on an open line of credit and make periodic payments as long as a limit has not been exceeded (much like a common credit card). The funds are available to be drawn upon by any “Borrower.” Thus, a partitioned entity that is designated as a Borrower can make a draw. But the Borrowers guarantee the draws of all other Borrowers. Other partitioned entities may be designated as Guarantors but not Borrowers. In other circumstances, a Borrowing entity may be permitted to distribute the borrowed funds to designated subsidiaries who will also be guarantors.

sponse to signals of project failures.⁸ Thus, where two projects are partially but not fully related – say with a luxury hotel and a budget hotel – the firm can tailor partitions to allow common risks and failures to be dealt with collectively and independent risks and failures to be dealt with in a targeted and contained fashion. This precision lowers the firm’s cost of capital because creditors can more effectively monitor risk and respond to defaults.⁹

The recognition of this structural option changes the analysis of corporate groups. Under conventional models, creditors with no specialized expertise loan to the firm as a whole while creditors with expertise focus on particular projects. This assumes different creditors will specialize in monitoring different projects within one firm.¹⁰ But that is not how things look on the ground. Increasingly common is the structure where a single sophisticated creditor¹¹ has the expertise to monitor both the firm as a whole and the various projects individually. Theories of tailored partitions and selective enforcement can explain this. The central creditor loans to each legal entity while creating cross-liability provisions. When one entity defaults on its loan, the creditor then possesses a valuable selective-

⁸ Some have noted that different legal forms can be used to create stronger or weaker partitions. *See, for example*, Hansmann and Kraakman, *The Essential Role of Organizational Law*, *supra* note 1 at 399-401. In this paper, I suggest that the market is even more sophisticated than that. Tailored partitions are neither stronger nor weaker than absolute partitions. But they are more precise and create more options for a central creditor while reducing the hold-up threats possessed by others. Moreover, the decision is not simply one of off-the-rack entity partitions. Contractual cross-liabilities set the parameters of a partition with high specificity to achieve a desired suite of ex post enforcement options.

⁹ The firm achieves lower cost of capital because it is bound to behave better (i.e. less opportunistically) once the loan has been made. The exact mechanism for capital cost reduction may be a direct disciplining effect that improved enforcement has on debtor’s behavior, a reduction in monitoring expenditures, a signaling or screening effect that differentiates good debtors from bad, or a commitment effect that allows debtors to bind themselves to behave better. *See* Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 *Yale L.J.* 1807, 1819 (1998) (demonstrating how contractual commitments can reduce a debtors’ cost of capital); Hansmann and Kraakman, *The Essential Role of Organizational Law*, *supra* note 1 at 399-401 (“The idea that partitioning a fixed pool of assets can reduce overall costs of credit by reducing monitoring costs is already familiar.”) (citing Thomas H. Jackson and Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 *Yale L. J.* 1143 (1979); Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 *Yale L.J.* 49 (1982); and Posner, *supra* note 1); *see also* Alan Schwartz, *Priorities and Priority in Bankruptcy*, 82 *Cornell L. Rev.* 5201 (1998); Alan Schwartz, “Contracting about Bankruptcy,” 13 *J. Law, Econ. and Org.* 127 (1997); Yeon-Koo Che and Alan Schwartz, *Section 365, Mandatory Bankruptcy Rules and Inefficient Continuance*, 15 *J. Law Econ. and Org.* 441 (1999). Differentiating the precise mechanism that improves debtor behavior in a given case may not be of great import to creditors as long as the debtor behavior improves or the monitoring costs decrease.

¹⁰ Hansmann & Kraakman, *Organizational Law as Asset Partitioning*, *supra* note 3.

¹¹ The selective-enforcement option generally has value when it is consolidated in the hands of a single creditor or a small group of creditors. *See below at* ____.

enforcement option: it can 1) call a firm-wide default or 2) selectively waive or ignore some defaults while taking action on others. The second option allows the creditor to focus remedial action on a specific project.

Thus, in the budget- and luxury-hotels example, consider a simplified scenario where one hotel's default sends the sophisticated creditor one of two signals: 1) managers are generally incompetent and the problems will spread to the other hotel; or 2) managers are incompetent on a project-specific basis and the problems will not spread. Tailored partitions give the creditor the option to take action against the entire firm in response to signal 1 (by way of the cross-liability provisions) or only as to the specific project in response to signal 2.

The first option is valuable because it allows the creditor to act on general signals to contain firm-wide losses. It need not wait for the second hotel to default to assert its enforcement rights. Many of the large bankruptcies mentioned above fit this model. Kodak's bankruptcy was precipitated by a general demise of its business. While its traditional operations were shrinking because of technological changes in the market, the firm had also failed to move aggressively into new digital markets. At the same time, the company was burdened by massive post-employment obligations resulting from a decade of workforce reduction. Additionally, the potentially profitable licensing business was stalled in litigation with the likes of Apple, RIM, and HTC. Throw in an unprecedented financial crisis and it is not surprising that the bankruptcy of Kodak included all domestic entities.¹² One can safely assume that the primary creditors would have prevented any restructuring efforts that did not address all operations.

The second option – project-specific enforcement – is valuable because it reduces the significant ancillary effects caused by firm-wide responses to project-specific problems¹³ and prevents other parties from opportunistically forcing the

¹² See Kodak First Day Aff. at 12-15. “Firm-wide” and “global” enforcement refer to enforcement across an economic group. That group may be limited to domestic entities by jurisdiction laws. Entities that are both incorporated in and doing business in foreign jurisdictions will generally not have the option for one single bankruptcy filing. Instead, they have to seek protection under the laws of multiple jurisdictions regardless of the desire of the debtor or its major creditors. These proceedings are often run concurrently with U.S. proceedings. Chapter 15 of the bankruptcy code provides a mechanism for coordinating these proceedings. For an interesting example of a cross-border bankruptcy where the use of tailored partitions spanning international borders became a major issue, see *In re Vitro, S.A.B. de C.V.*, Case No. 11-33335-HDH-15, (Bankr. N.D. Tex. June 13, 2012); see also *In re Lehman Brothers Holdings Inc., et al.*, Case No. 08-13555 (Bankr. S.D.N.Y. 2008); *In re Lyondell Chemical Company, et al.*, Case No. 09-10023 (Bankr. S.D.N.Y. 2009). In the end, cross-border liabilities can be difficult to enforce and have complicated tax implications that are beyond the scope of this article.

¹³ These ancillary effects arise because default triggers hold-up rights for other creditors and counterparties and introduces new bargaining costs by increasing the number of parties at the bargaining table. See below at ____.

default to spread. Examples of these project-specific enforcement actions are less common in the bankruptcy dockets because one of the benefits of the contained enforcement is the primary creditor's ability to avoid bankruptcy proceedings altogether. When a creditor can limit the hold-up power held by others, it can push for a restructuring more effectively through out-of-court measures. Examples of creditors opting for project-specific enforcement are, thus, more likely to take the form of waived guarantees in enforcement actions. For example, when Sunstone Hotels¹⁴ hit financial trouble it let 10 of its 42 hotels go into default. Because of a cross-default provision in its bond indenture, this move gave the bondholders the right to call a firm-wide default that would have likely collapsed the entire enterprise into bankruptcy. The bondholders opted to forego the firm-wide enforcement option and they voted to amend the indenture to remove the threat of cross default. This allowed Sunstone (and its bondholders) to walk away from ten hotels (including the W in San Diego) without triggering the rights of any other creditors on the 32 remaining properties including Hilton, Marriot, and Renaissance hotels across the country.¹⁵

As I demonstrate below, the first option is not available when there are partitions without cross liability and the second option is not available without legal partitions. Intuitively, one might think that the second option could be achieved through security interests. But in a world with multiple creditors, this is not the case.¹⁶

The failure to recognize that tailored partitions create these valuable options generates confusion for the courts and introduces supposed puzzles and complexities that do not exist in the real world. For example, some hold the view that corporations undo the entire effect of entity partitioning by causing affiliated legal entities to agree to cross-liability provisions.¹⁷ These scholars puzzle at why a corporation would partition an entity just to re-integrate it at the next moment.

¹⁴ The parent entity here is Sunstone Hotels Investors, Inc. I refer the economic enterprise as Sunstone Hotels.

¹⁵ Kris Hudson, *Sunstone REIT Forfeits W Hotel*, The Wall Street Journal (June 2, 2009) available at <http://online.wsj.com/news/articles/SB124441071403592235>; Nadja Brandt, *Sunstone Seeks Rebound with \$1 Billion of Hotels after Forfeiting Property*, Bloomberg News (Jan. 13 2011) available at <http://www.bloomberg.com/news/2011-01-13/sunstone-plans-to-buy-1-billion-of-hotels-this-year-after-prices-decline.html>. Another example – complicated a bit by cross-border issues – occurred when the lien lenders to Tecumseh Products waived a cross default that had been triggered by insolvency proceedings initiated by one subsidiary. Without the waiver, the lenders could have accelerated loans against all entities and begun a process of firm-wide enforcement. See SEC filing at <http://www.sec.gov/Archives/edgar/data/96831/000095012407002105/k13932e8vk.txt>

¹⁶ See below at ____.

¹⁷ See, e.g., William H. Widen, *Corporate Form and Substantive Consolidation*, 75 Geo. Wash. L. Rev. 237, 305 (2007) (“Creation of a web of guarantees by a consolidated group of companies is a business technique that breaks down the asset partitioning.”).

Why create this corporate web when the firm could just partition or not partition?¹⁸

The concepts of tailored partitions and selective enforcement dislodge this riddle and reveal major implications for laws of finance and bankruptcy. By examining how these structures create value, I attempt to provide some guidance on difficult questions surrounding issue like fraudulent transfers, ipso facto clauses, and good-faith filing. In Part I, I describe cross-liability provisions and tailored partitions and explore why it has been difficult to fit that description within existing theories of asset partitions. In Part II, I demonstrate how tailored partitions and selective enforcement work and how they create value. I also describe some of the more common variations on the structures used to create enforcement options. In Part III, I examine the implications that theories of tailored partitions and selective enforcement have for the laws of finance and capital structure, focusing primarily on bankruptcy law. In part IV, I discuss potential critiques of the theories of selective enforcement and tailored partitions.

I. Cross Liabilities, the Corporate Web, and Conventional Theories of Asset Partitions

The coupling of entity partitions with contractual cross-liabilities provides a broad variation of capital structures from which debtors and creditors can choose. I do not attempt to catalog those possibilities here. I do, however, provide a prototypical example. In this Part, I describe some common components of the corporate web and discuss how that practice compares to conventional accounts of asset partitions. In the Appendix, I have also included the language of some common contract provisions that the parties use.

A. Cross Liabilities

Most commonly, the cross liabilities at play will be cross-default provisions or cross guarantees. The cross-default provisions we are concerned with run across entities. *Intra*-entity guarantees are less puzzling. For example, a large primary loan¹⁹ to one entity might have a provision in it that treats the default on any other debt to that same entity as a default of the primary loan. The reasoning behind this structure is straightforward. The default on one obligation is a signal of distress that a primary creditor wants to take into account in monitoring that debtor: it is the canary in the coal mine.

¹⁸ Most recently, Richard Squire raised these questions in *Strategic Liability in the Corporate Group*, *supra* note 3; see also Widen, *Corporate Form and Substantive Consolidation*, *supra* note 17.

¹⁹ The loan could be secured or unsecured.

The puzzle posed by the corporate web and the analysis of tailored partitions arises only when the default crosses legal boundaries. The *inter*-entity cross default will cause a major loan to one entity to be in default whenever another affiliated entity defaults on a debt obligation. Bank may make a large loan to SubCo. It will then include a provision that states that if AffiliateCo defaults on any “Material Indebtedness,” SubCo is in default on its loan from Bank. The default by AffiliateCo does not have to be on a loan from Bank. It can be on any material loan. Thus, if AffiliateCo misses payment on any debt obligation – a supply contract, for example – that might trigger a default on SubCo’s loan from Bank.

An example of this structure can be found in the \$750 million unsecured credit facility that Darden Restaurants, Inc. (owner of the Red Lobster and Olive Garden restaurants) took out in 2007.²⁰ That agreement provided that Darden would be in default on the credit facility if “any Material Subsidiary (i) fails to make any payment... in respect of any Material Indebtedness” or defaults in any other way.²¹

A cross guarantee²² is similar to a cross-default provision. But the default of one entity does not necessarily trigger the default on any other loans. Instead, the cross guarantee makes the guarantor entity liable for the default of the direct borrower. If AffiliateCo borrows \$1 billion, and SubCo guarantees it, then AffiliateCo’s default puts SubCo on the hook for \$1 billion.

Cross guarantees will often run in both directions. Thus, SubCo and AffiliateCo might collectively borrow \$2 billion and each might guarantee the other’s obligations. The cross guarantees may also be coupled with cross-default clauses. In that way, the default of either entity on any loan (not just the \$2 billion primary loans) is a default of both entities on the \$2 billion.²³

Notably, the cross guarantees are almost always “unconditional guarantees of payment” and not “guarantees of collection.” That means that the creditor can go

²⁰ September 20, 2007 \$750,000,000 Credit Agreement among Darden Restaurants, Inc. and Bank of American, N.A., et al. at § 8.01(e), available at <http://www.sec.gov/Archives/edgar/data/940944/000119312507205607/dex101.htm> (hereinafter the “Darden Credit Facility”).

²¹ *Id.*

²² In the contracts discussed in this article, the nouns “guaranty” and “guarantee” are used to mean the same thing. There is no consistent standard of usage. In non-legal usage, “guarantee” is preferred. See Bryan A. Garner, *Dictionary of Modern Legal Usage*, 394 (Oxford University Press 2d Edition 1995). The agreements referred to in this article use both versions. When not quoting directly from an agreement, I will use the word “guarantee.”

²³ Cross-default provisions may be a superfluous belt-and-suspenders approach here. Calling a cross-guarantee on a major affiliate loan will likely create such a liquidity crisis as to lead to a de facto default of the guarantor’s other significant debt as well when it cannot make its payments.

after the guarantor for payment without ever taking any action against the primary debtor. In the large corporate context, where these loans might be in the hundreds of millions or billions of dollars, this has particular importance because a default will often trigger the lender's right to accelerate the loan. That means that the remaining balance of the loan becomes due immediately. If the debtor defaults because it missed a payment, the lender then has the option to go straight to the guarantor entity for payment in full. This will generally give the lender the power to foreclose on the guarantor's assets or force it into bankruptcy without taking any action against the primary debtor.²⁴

In the context of these large corporate credit facilities, the exact structure of the guarantee will vary. The credit facility might call for joint-and-several liability of the various legal entities. The facility would provide an open line of credit that designated entities can draw upon. Then later it would provide that the designated entities "jointly and severally, hereby absolutely, unconditionally and irrevocably guarantee[] the punctual payment [of the debt] when due..., and all obligations of each other Loan Party and each other Subsidiary of the Company now or hereafter existing under or in respect of the Loan Documents..."²⁵ The parties designated as jointly and severally liable may or may not be identical to the parties designated as borrowers who can draw on the line of credit. Alternatively, the guarantee may be set forth in a separate guarantee agreement that is executed by all guarantor entities.²⁶

Cross liabilities of one sort or another are common when large corporations (public or private) take on debt through a primary creditor.²⁷ The option that these guarantees create is most valuable when held exclusively by a primary or major creditor or lender syndicate.²⁸ With the other possibility – multiple credi-

²⁴ See Appendix for more detail on these distinctions.

²⁵ March 31, 2009 Amended and Restated Credit Agreement Among Eastman Kodak Company and Kodak Canada, Inc. and CitiCorp USA, et al, available at <http://www.sec.gov/Archives/edgar/data/31235/000003123509000042/exhibit48.htm> (hereinafter the "Kodak Credit Facility").

²⁶ See, e.g., June 20, 2014 Guarantee and Collateral Agreement Among J.C. Penney Company, Inc., et al and Wells Fargo Bank, N.A., available at <http://www.sec.gov/Archives/edgar/data/1166126/000116612614000039/creditagreem ent.htm> (exhibit C) (hereinafter the "J.C. Penney Guarantee Agreement").

²⁷ See, e.g., July 29, 2011 Second Amended and Restated Credit Agreement among The J.M Smucker Company, et al., and Bank of Montreal, et al. (hereinafter the "Smucker Credit Facility"); July 30, 2012 \$1,500,000,000 Five Year Competitive Advance and Revolving Credit Facility Agreement Among Bristol Meyers Squibb Company, The Borrowing Subsidiaries and Bank of America, N.A. et al. (hereinafter the "Bristol Myers Squibb Credit Facility"); Darden Credit Facility, *supra* note 20; J.C. Penney Credit Facility, *supra* note 7; Kodak Credit facility, *supra* note 25; the dockets of the cases cited *supra* note 5.

²⁸ A lending syndicate is a group of lenders who offer a loan as a group. Each bank essentially buys into a position in the credit facility. Thus, ten banks may provide the fund-

tors holding multiple options – the bargaining dynamics become more complicated as one lender can destroy the option of another. The analysis in this paper suggests, then, that selective enforcement creates the most value when the firm consolidates the option to select in one major creditor or one syndicate. Thus, we should expect to see the selective-enforcement option appear most often in the hands of a single creditor or group of creditors that coordinate their agreement *ex ante*. We do see this.²⁹ The loans often contain provisions prohibiting the debtor from putting similar provisions in agreements with other lenders.³⁰ Where we see multiple lender groups who do have cross-guarantee provisions in their loan documents, there is often a corresponding intercreditor agreement that coordinates the use of those provisions.³¹ For example, it is common for a first lien lender to demand that junior debt (second lien or unsecured credit facilities or junior notes) be subject to a standstill agreement that prohibits junior creditors from taking actions to enforce defaults without permission from a senior lender for a set period of time.³²

These various cross-liability arrangements interact with legal partitions to provide creditors with an *ex post* choice to invoke asset partitions in response to some risks or to ignore them in response to others. I explore below how this selective-enforcement option creates value. But first, we have to understand why assets are partitioned at all. In the next section, I explore the conventional account of asset partitions.

ing for a \$1 billion loan. A lead bank may arrange the deal and act as administrative agent. The administrative agent will be authorized to take most actions on behalf of the syndicate with regard to the debtor. And the syndicate in many ways acts as one lender. Disagreements among the banks will be determined by the contractual terms of the credit facility. The credit facility will also set forth terms on how banks can enter and leave the syndicate. *See, e.g.*, Darden Credit Facility, *supra* note 20; J.C. Penney Credit Facility, *supra* note 7; Smucker Credit Facility, *supra* note 27.

²⁹ The precise exact magnitude of this phenomenon warrants further empirical examination.

³⁰ *See, e.g.*, Darden Credit Facility, *supra* note 20 at § 7.03(e) (restricting the debtors' ability to enter into any "Guarantees by any Subsidiary of Indebtedness of the Borrower or any Wholly-Owned Subsidiary").

³¹ *See, e.g.*, J.C. Penney Credit Facility, *supra* note 7 (requiring all second lien debt to be subject to an intercreditor agreement); *see also* Smucker Credit Facility, *supra* note 27 (requiring intercreditor agreement).

³² On standstill agreements and intercreditor agreements in general, see Gretchen M. Santamour and Amy Onder, *The Evolving Characteristics of Subordination and Intercreditor Agreements and Their Enforceability in Bankruptcy*, 1 J. of Payment Sys. of Law, 239 (2005).

B. The Conventional Models of Asset Partitions

The separation of unrelated risks is the most commonly identified goal of asset partitions.³³ By this account, a firm with two unrelated assets will separate them to unbundle risks. A firm with related assets, on the other hand, will keep them together in one legal entity. Choosing the right structure reduces the cost of capital by improving creditors' ability to monitor.

As a preliminary matter, it is worth noting – as it will come up later – that the existing literature often conflates the ideas of enforcement and monitoring. The term monitoring assumes the ability to enforce. For purposes of my analysis, however, it is necessary to separate the two. Monitoring will refer to oversight intended to detect signals of value loss. Enforcement will refer to action taken in response to those signals. I show below that the need for specific enforcement rights is the driving force behind tailored partitions.

In the risk-partition model, related assets will be integrated to create value.³⁴ Two oil refineries in Texas can be monitored by one creditor with expertise in the

³³ Other motivations behind partitions include withdrawal rights, (see Baird and Casey, *No Exit? Withdrawal Rights and the Law of Corporate Reorganizations*, *supra* note 3; see also Yeon-Koo Che and Alan Schwartz, *Section 365, Mandatory Bankruptcy Rules and Inefficient Continuance*, 15 *J. Law Econ. and Org.* 441 (1999) (discussing the value of contractual withdrawal rights)), limited liability, (see, e.g., *Tronox Worldwide LLC v. Anadarko Petroleum Corporation*, 450 *Bankr.* 432 (Bankr. S. D. N. Y. 2011)), contract bundling, (see Kenneth Ayotte and Henry Hansmann, *Legal Entities as Transferable Bundles of Contracts*, 111 *Mich. L. Rev.* 715 (2012)), and compliance with regulations, (see, e.g., *In re Energy Future Holdings Corp, et al.* Case No. 14-10979 (Bankr. D.Del. 2014)). These explanations are not mutually exclusive. That withdrawal rights motivate partitions in some cases does not suggest that limited liability or some other goal cannot also motivate partitions in other cases (or even in the same cases). To the contrary, the tailoring options identified in this article suggest that there is more diversity of partitioning than previously recognized. The combination of partitions and cross liabilities allows for this diversity by allowing the firm and its creditors to design precise enforcement options that maximize specific benefits of partitions while minimizing the costs.

³⁴ By some accounts, unrelated assets can be integrated to provide protection against bankruptcy or insolvency. Hansmann and Kraakman refer to this diversification as a “bankruptcy protection device” and note that it is well known in the finance literature. Hansmann and Kraakman, *The Essential Role of Organizational Law*, *supra* note 1 at 400 (collecting finance sources); see also Adam C. Kolasinski, *Subsidiary Debt, Capital Structure and Internal Capital Markets*, 94 *J. Fin. Econ* 327 (2009) (discussing diversification across assets as a means of coinsurance and collecting sources). While theoretically plausible, this account is unlikely to explain a significant amount of integration as diversification will rarely be an efficient means of bankruptcy protection relative to other available options. See Anthony J. Casey and Anthony Niblett, *Bankruptcy Insurance* (modeling the various methods of protecting against the risk of bankruptcy filings) (work in progress).

region and the industry.³⁵ Some have suggested this creates economies of scale for monitoring.³⁶ The point is far from obvious. A monitor can ignore separate legal entities if it wants to create the economies associated with integration. All it needs to do is contractually require that the debtor provide consolidated financials. This is commonplace.

But integration provides *other* cost savings. For example, full integration will eliminate administrative and management costs associated with maintaining separate legal entities. Likewise, integration creates less paperwork for certain transactions: one loan document is less expensive to write than two are. Separately, there are economies of enforcement. It is cheaper for a creditor to conduct one rather than two enforcement actions (such as a foreclosure or bankruptcy proceeding). Finally, and most importantly, the law will often restrict enforcement options to only one project if the projects are not integrated. A default at refinery A alone will not trigger enforcement rights against refinery B if they are not integrated – even where the default of A reveals information that B is failing as well. All of the savings here arise when the assets and their default risks are related in some way.

Things are different when the assets are unrelated. Consider a firm that owns an oil refinery in Texas and a hotel in New York. Those projects will be more costly to finance if the firm places them in one legal entity.³⁷ Imagine the firm that runs the refinery and the hotel has two primary unsecured creditors and owes each the same amount. One creditor specializes in monitoring oil refineries and the other specializes in monitoring hotels. If the hotel asset becomes worthless without either creditor’s detection, the two creditors will be left fighting over the oil refinery’s assets as protection for their investments. In this example, the creditor that monitors oil refineries has lost value because of the other creditor’s failure to monitor the hotel.³⁸

Though the literature generally speaks about this scenario in terms of specialized “monitoring,” the real driver here is enforcement. A creditor can always require a debtor to keep separate books and records for different assets even without a legal entity partition. This allows the creditor to monitor assets separately

³⁵ Hansmann and Kraakman, *The Essential Role of Organizational Law*, supra note 1; Hansmann and Kraakman, *Organizational Law as Asset Partitioning*, supra note 3; Squire, supra note 3; Iacobucci and Triantis, supra note 1.

³⁶ See Iacobucci and Triantis, supra note 1 at 558-60; but see William H. Widen, supra note 17 at 274.

³⁷ Henry Hansmann and Reinier Kraakman introduced the example of the oil refinery and hotel assets. Hansmann and Kraakman, *The Essential Role of Organizational Law*, supra note 1 at 399 and Hansmann and Kraakman, *Organizational Law as Asset Partitioning*, supra note 3.

³⁸ *Id.*

just as if there was an entity partition. But the creditor has little incentive to do that when all enforcement measures will bleed across assets.

That bleeding will *always* occur when the assets are housed in the same legal entity. A creditor who specializes in monitoring the oil refinery has to enforce against the firm as a whole when it receives a signal. For example, any bankruptcy proceeding will include all assets of the firm. Even a foreclosure sale of one asset will implicate the rights of the creditors of the firm as a whole if they claim that the sale is below value or that it has certain other adverse consequences. Essentially, as Ed Iacobucci and George Triantis pointed out, all enforcement actions will be taken against a legal entity.³⁹ And so, without an entity partition, there is no way to fully contain an enforcement action against a single asset or group of assets. The outcome of that enforcement action will, therefore, depend on the combined condition of both the oil refinery and the hotel.

As a result, the integrated firm has a blended capital structure that compromises asset-specific financing. Because the failure of any one asset will ripple across the entire firm, a creditor cannot contain enforcement to the failing asset – even with asset-specific security interests.⁴⁰ Creditors must enforce (and, therefore, must monitor) risk in both the energy and travel industries or charge a premium for assuming a risk they cannot monitor and respond to effectively. The crucial point is that the assets have different risks that are not correlated and the monitoring expertise to reduce those risks lies with different lenders.⁴¹

This blending will also increase the cost of credit if – as most people assume – different capital structures produce different monitoring incentives that are optimal for different assets.⁴² For example, riskier projects are less likely to be financed with public debt. Likewise, unproven management may need to adopt a structure that includes expert monitors with security interests.⁴³ A blended capital structure prevents this tailoring. Additionally, managers of integrated firms can more easily cross-subsidize between projects to serve private interests and all

³⁹ Iacobucci and Triantis, *supra* note 1.

⁴⁰ Iacobucci and Triantis develop the important point that security interests fail to achieve the partitioning necessary to fully unblend the capital structure. Iacobucci and Triantis, *supra* note 1. See below at ____.

⁴¹ Hansmann and Kraakman, *The Essential Role of Organizational Law*, *supra* note 1; Hansmann and Kraakman, *Organizational Law as Asset Partitioning*, *supra* note 3; Squire, *supra* note 3.

⁴² “There are many variations that create the need for asset-specific financing. For example, one asset might be highly regulated and enjoy stable returns, while the other may be a high-technology company with highly variable returns. The optimal leverage ratios for the two may be radically different.” Iacobucci and Triantis, *supra* note 1 at 552-53.

⁴³ Iacobucci and Triantis, *supra* note 1; Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 Yale L.J. 49 (1982).

firms will pay (in a higher cost of credit) for this opportunity to divert value unless they can credibly commit not to take advantage of it.⁴⁴

C. Limitations on the Conventional Model

The discussion up to this point presents a choice: integrate or partition. We can discover the correct choice by categorizing groups of assets as related or unrelated. The implicit assumption is that partitions are binary and that asset relationships are as well. This assumption makes the point salient and the models elegant. A single creditor can monitor related assets as one bundle. Separate creditors can monitor unrelated assets in separate legal entities. But when the relationship between assets is not all or nothing, the optimal partition will not be all or nothing either.

Moreover, firms will often employ partitions even when there is a single creditor monitoring all projects. These are not cases where creditors specialize in different projects, but rather where one creditor is monitoring all assets that are nonetheless divided into different legal entities. Indeed, the common characteristic that has appeared repeatedly in the bankruptcies, out-of-court restructurings, and public-loan documents of the last decade is the presence of a central creditor sitting above the entire firm. This is true for Kodak, JC Penney, ResCap, Sunstone Hotels, Visteon, Smuckers, and others.⁴⁵ For these cases, the analysis of tailored partitions and selective enforcement provides insight into the corporate web.

To understand selective enforcement we need to think not about hotels and refineries but about assets that are differentiated in more nuanced ways. For example, a luxury hotel and an economy hotel may experience the same value loss if the real estate market crashes. But they may be affected differently by a general economic downturn. A strain on income of wealthy travelers may benefit a budget hotel at the expense of the luxury hotel. The optimal enforcement response to a signal indicating a real estate market crash will, therefore, be different from the optimal response to a signal of a general economic downturn. As a result, a capital structure that allows the creditor to choose the response *ex post* will be more valuable than one that locks the response in *ex ante*.

In the next section, I examine a hypothetical capital structure to show how the mechanisms of tailored partitions and selective enforcement do exactly that and explore how they create value.

⁴⁴ Iacobucci and Triantis, *supra* note 8. Hansmann and Kraakman, *The Essential Role of Organizational Law*, *supra* note 1; Hansmann and Kraakman, *Organizational Law as Asset Partitioning*, *supra* note 3.

⁴⁵ See cases cited *infra* notes ___ and ___ and ___ .

II. Tailored Partitions and Selective Enforcement

To summarize what is to come, the demonstrative example for tailored partitions will include two assets whose performances are closely but not completely correlated. A primary creditor⁴⁶ financing these assets will face a dynamic enforcement project. This creditor can monitor some aspects of management and risk jointly in a bundle. Some signals produced from those monitoring efforts will pertain to the entire firm. They will carry information about the future performance of both assets. But other aspects of risk and management of the two assets will be unrelated. Because information about those risks will be limited to a single asset, enforcement mechanisms will, in turn, be optimally contained to that single asset.

The two assets in the example are a luxury hotel on Chicago's lake shore and a budget hotel near Chicago's O'Hare Airport. Many aspects of managing these assets are related, but some are not. In each period, a single primary creditor monitoring these assets receives one of three signals for each asset. Thus, for the luxury hotel: 1) no signal; 2) management is incompetent at everything; or 3) management is incompetent just at running the luxury hotel. Because signal 2 suggests firm-wide incompetence that will spread to the management of other assets, the primary creditor will want to react by calling a default that can be enforced against both hotels. For signal 3, on the other hand, the primary creditor will want to contain the default to allow it to take enforcement action⁴⁷ against the luxury hotel while allowing business at the budget hotel to continue as normal.

To put things a little differently, the failure signals provide information about the expected return and value of each loan. Signal 2 tells the primary creditor that both loans are now worth less (have lower expected returns). As long as the creditor has other investment opportunities, it wants to take cash out and invest in better projects. Signal 3 tells the creditor that only the luxury-hotel loan has gone down in value. It wants to cash out only that loan. There is no reason to cash out the budget-hotel loan if it still has returns at or above market.

The following sections examine a firm and its capital structure in various scenarios. I look at 1) a firm with perfectly correlated risks and operational characteristics across projects to demonstrate the value of a legal integration; 2) a firm

⁴⁶ From here on out I will refer to the creditor taking advantage of the cross liability as the "primary creditor" or "primary lender." The other creditors will be referred to as the "general creditors."

⁴⁷ I use the phrase "enforce" generally in this section to include the various options a creditor may have upon default. These include foreclosure, forcing bankruptcy, or renegotiation of terms. The goal of these actions for the creditor will usually be redemption, liquidation, or obtaining control. The characteristic value of selective enforcement that I discuss in this section applies across these various enforcement options.

with perfectly independent risks and characteristics across projects to demonstrate the value of a legal partition; and 3) a firm with partial correlation and partially related characteristics across projects to demonstrate the value of tailored partitions and selective enforcement.

A. Selective Enforcement: A Simplified Example

Entrepreneur has identified a property on Chicago's lake front for developing her high-end project. The hotel will have great views and access to the major attractions of the city. Entrepreneur forms HotelCo, a Delaware corporation. She is the sole owner. HotelCo has received the go ahead from the city to build the hotel. The only thing Entrepreneur needs is financing. But this is not a problem. She has a strong record of accomplishment in the luxury hotel business and banks have lined up to lend to HotelCo.

We will start with a single-creditor structure (which, for now, makes it unnecessary to discuss security interests and priority). HotelCo borrows \$1 billion from Bank – who knows the hotel industry well – to finance the project and things go well. As is often the case, the success of one project leads to another, and Entrepreneur decides to expand. She has three options: 1) build another luxury hotel on Chicago's lake front; 2) build an oil refinery in Texas; or 3) build an economy hotel near Chicago's O'Hare airport.

When she approaches Bank, the lending officer (being familiar with the legal scholarship on risk partitioning) knows exactly what to say to options 1 and 2 but is mystified by how to deal option 3.⁴⁸

⁴⁸ It is difficult in any case to know exactly what role a creditor plays in demanding a certain structure. The debtor may instead adopt a structure in anticipation of marketing its debt to creditors. Moreover, when there is an existing relationship, the debtor may try to adopt the structure it expects that creditor to prefer. Even when direct negotiations occur, the evidence of a creditor's control may be difficult to find. Creditors do not always exercise their control through direct and transparent mechanisms. Rather, the influence is more subtle and the decision process can only be inferred by the results. Several scholars have, however, demonstrated (empirically and theoretically) the active role that creditors play in decisions that are made in the lead up to bankruptcy. See Michael Roberts and Amir Sufi, *Control Rights and Capital Structure: An Empirical Investigation*, 64 J. Fin. 1657, 1667 and 1690–91 (2009) (describing mechanisms for creditor control); Douglas G. Baird and Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. Penn. L. Rev. 1209 (same); Frederick Tung, *Leverage in the Board Room: The Unsung Influence of Private Lenders in Corporate Governance*, 57 UCLA L. Rev. 115, 178-79 (2009) (same); Jonathan C. Lipson, *Governance in the Breach, Controlling Creditor Opportunism*, 84 S. Cal. Rev. 1035 (2010) (same); Kenneth M. Ayotte and Edward R. Morrison, *Creditor Control in Chapter 11*, 1 J. Legal Anal. 511, 538 (2009) (presenting evidence of creditor control).

i. Option 1: Perfect (or High) Correlation and Integration

Because option 1 is the conventional case of perfectly (or nearly perfectly) correlated assets, Bank is happy to finance the new luxury hotel and suggests that the project be called LuxuryTwo and be wrapped into the HotelCo legal entity. Bank will simply double the loan, and both hotels will serve as collateral⁴⁹ for the entire loan. The fact that these are separate hotels contained in one corporate entity is of no import. Bank is expert at monitoring loans to luxury hotels. It has precise covenants in place to measure Entrepreneur's performance in running these hotels. At the first sign of incompetence, Bank will call a default and take over both hotels. Similarly, Bank has its thumb on the pulse of Chicago's hotel industry and its real estate market. Once again, at the first sign of a decline in either market, Bank will use its covenants to step in and take over the operation and likely force the sale of both hotels.⁵⁰ Here we start with the extreme assumption that long run performances of the hotels are perfectly correlated. There will be no failure at one property without failure at another.

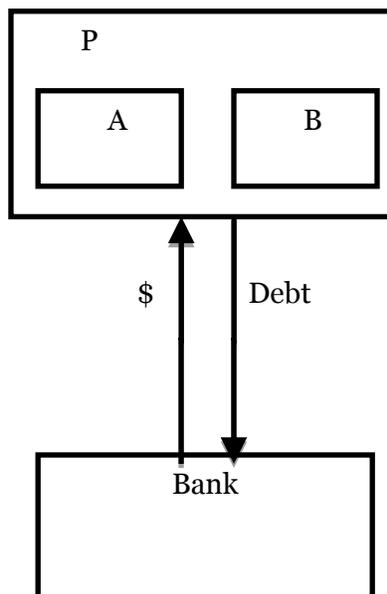
Neither Bank nor Entrepreneur wants to create a separate legal entity for LuxuryTwo because the partition introduces unnecessary costs. For Entrepreneur the partition creates administrative costs that have no value to the business as a whole. These costs are likely small in a relative sense; but they are also unnecessary. With the two hotels integrated into HotelCo, Entrepreneur can have one loan agreement, one management team, one tax return, one bank account, one payroll, and so on. Similarly, she can enter into common contracts more easily. And in the event of a major corporate event, she can sell the company as a unit and avoid the renegotiation of various contracts.⁵¹ The integrated firm with its financing structure is depicted in figure 1.

⁴⁹ Though I start with one major unsecured creditor and discuss security interests below, the term collateral roughly approximates the situation here. Upon default, the creditor will enforce the default and become a lien creditor against the assets of the entire legal entity. The enforcement rights will include repossessing and forcing the sale of the assets or forcing bankruptcy. Assuming only one primary creditor, the unsecured nature of the loan does not significantly alter the availability of these enforcement rights. The creditor may incur additional transaction costs in getting the lien judgment. The real difference, however, is not in enforcement but rather in priority of payment. The secured creditor will be paid first and the security interest will reduce the risk of having its claim diluted by subsequent creditors. Those benefits of a security interest are well explored elsewhere.

⁵⁰ On the use of covenants, see, e.g., Roberts and Sufi, *supra* note 48.

⁵¹ None of these benefits are absolute. There may be times when legal partitioning is valuable because it eliminates the ability to commonly contract. Thus, legal partitioning may be valuable precisely because it breaks up the firm's contracts into isolated (and assignable) bundles. See Ayotte and Hansmann, *Legal Entities as Transferable Bundles of Contracts*, *supra* note 33. But that benefit is likely to be more important when risk correlation is not perfect.

Figure 1: Integration



Beyond eliminating these administrative transaction costs, the benefits of legal integration are largely under theorized. Scholars have generally accepted integration as the status quo and focused on justifying deviations from there. In passing, some suggest the idea of information economies as a primary value of integration. But the existence of those economies is questionable.

Bank has likely achieved economies of scale in information by lending to hotels throughout the city regardless of legal partitions. For example, Bank could choose to investigate only one hotel to which it lends and use that information as its signal for further action across all loans. Even if information came out at different times for different borrowers, this might be a cost saving mechanism for bank. Why monitor ten properties when you can monitor one?⁵² But regardless of the source of that information, the corporate structure of LuxuryOne and LuxuryTwo will have no effect. Bank gets the information with or without the partition. Bank need only investigate the hotel and real estate market once under any structure. Bank may get even better general information about the hotel industry

⁵² Bank would obviously have to take into account problems with reducing the evasion costs of borrowers who only need to cover up bad news on one property rather than many. Bank may randomize or take other measures to prevent this. The risk of evasion and costs of preventing it will be part of Bank's cost-savings analysis.

(and thus LuxuryTwo) from monitoring LuxuryOne. Similarly, looking at just LuxuryOne and LuxuryTwo, with identical risks and operational characteristics, Bank need only assess Entrepreneur's competence once.⁵³ But again, that information is available regardless of the partition.

Counterintuitively, some have suggested that the information economies from integration arise not when assets are similar but when they are uncorrelated and the investor is seeking diversification.⁵⁴ This suggestion is unpersuasive. Perhaps, the blending of information reduces monitoring where one assumes that a debtor's manager is better at compiling a diversified portfolio and monitoring it than the creditors. Most empirical work suggests the opposite.⁵⁵ And, in any event, information blending can easily be required in a partitioned firm. The legal partition changes neither the blending nor the expertise in diversification. Both can be implemented regardless of the corporate structure as long as the same manager is at the top of the hierarchy. The only cost benefit of integration here is the reduced administrative costs in maintaining fewer legal entities and documenting fewer loans.

Another argument for integration when assets are unrelated may be that it provides deeper protection for a creditor. For example, creditor loans 100 to project A and 100 to project B. There are no other assets. If A loses 10 and B gains 10, enforcement against an integrated firm leaves creditor whole. Enforcement against separate legal entities, on the other hand, leaves creditor down 10. Basic finance theory tells us this alone is not a convincing justification for integration. After all, the gain in reduced risk to creditor is achieved only by shifting that risk to the equity holders. The cost of capital remains constant.⁵⁶ Put another way,

⁵³ While some suggest that partitioning makes it difficult to monitor because of different boards of directors, it is not clear how this cost will be significant when assets are correlated and lenders could require that the boards be identical.

⁵⁴ This is not the same as saying that conglomerates create value. Here the question is whether the conglomerate is legally integrated or partitioned. Iacobucci and Triantis, *supra* note 1.

⁵⁵ Kolasinski, *supra* note 34 at 328 (collecting sources).

⁵⁶ Franco Modigliani and Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 Am. Econ. Rev. 261 (1958); see also Kolasinski, *Subsidiary Debt, Capital Structure and Internal Capital Markets*, *supra* note 34 (explaining the same point for guarantees and noting that subsidiary guaranteed debt "at best...transfer[s] risk from subsidiary creditors to holders of other securities, [and] leave[s] total risk and cost of capital unchanged"). Another theory might be that integration allows for diversification of bankruptcy risk – thus protecting against the additional costs associated with bankruptcy and insolvency. But diversification is rarely going to be an effective means of protecting against bankruptcy risk. See note ___ above. See Anthony J. Casey and Anthony Niblett, *Bankruptcy Insurance* (modeling the various methods of protecting against the risk of bankruptcy filings) (work in progress).

lender could achieve the exact same expected outcome by loaning to separate entities and then hedging with an investment in equity.⁵⁷

Buried in and implicitly conflated with the idea of information economies is a major source of real value that integration provides for creditors: economies of enforcement. Monitoring and information economies do not require integration but enforcement economies do. Returning to perfectly correlated assets, Bank knows that any sign of distress at either hotel indicates distress at the other as well. But the defaults that allow Bank to act on these signals may not occur simultaneously. Perhaps Bank has taken advantage of monitoring efficiencies involved in lending to related projects (for example, by doing inspections on only one property). Bank may have observed and documented a default on one project. But documenting and verifying the same default on the other project will be costly and time-consuming. Alternatively, default triggers may simply materialize at different times.⁵⁸

Bank, therefore, does better when the assets are integrated in one entity. Bank will include a long list of default triggers in a loan agreement. Sometimes these defaults serve as early signals that something may be wrong.⁵⁹ Default leads to an investigation. If things turn out to be okay, Bank will often waive the default. If the investigation shows problems, Bank will take action. Bank may waive default in exchange for renegotiated terms or (in the extreme case) call a default and accelerate the debt. Other times the defaults are simply technical violations that allow Bank to act on non-default signals. Bank may have received a non-default signal and was waiting for a default to act.⁶⁰

Thus, if Bank knows that the real estate market is taking a dive, it will want to enforce against both LuxuryOne and LuxuryTwo. When the properties are integrated into HotelCo, Bank needs to wait only until a default occurs with regard to one of the projects. That default allows Bank to exercise its rights firm-wide as to both projects. If, on the other hand, LuxuryOne and LuxuryTwo are partitioned into separate legal entities without cross liabilities, Bank would have to wait for

⁵⁷ *Id.*

⁵⁸ This will certainly be true as we relax the assumption of perfect correlation and assume only high correlation. For example, nearly identical projects may experience shocks at different time. A problem may become apparent at a smaller hotel first even if it is ultimately going to affect both the large and small hotel.

⁵⁹ Roberts and Sufi, *supra* note 48.

⁶⁰ These covenant provisions are essentially options that Bank can use for enforcement in the face of other information that a borrower is in decline. The debtor may be in technical default the majority of the time. But Bank only acts when some other problem has arisen. If both projects are likely to be in technical default at most times, integration may be less important. But the possibility of a cure to the technical default makes it risky for creditor to rely on these options alone. On the risk of opportunistic use of these default triggers see below at ____.

two defaults to exercise full control. LuxuryOne, Inc.⁶¹ might default first making it clear to Bank that it needs to call default on both loans. But in the absence of a default by LuxuryTwo, Inc., the legal partition would keep Bank from doing this. In the face of perfect or high correlation, waiting for LuxuryTwo, Inc. to default before taking action will force Bank to sit on the sidelines knowing that assets are wasting away. The delay also gives management time to take costly gambles with LuxuryTwo. Those gambles can have negative expected total returns but positive expected private returns to Entrepreneur.⁶² Bank will, therefore, not want LuxuryOne and LuxuryTwo to be partitioned. And Entrepreneur will want to use the integration ex ante to commit to not taking these gambles. That commitment will lower the Entrepreneur's cost of credit. In the absence of the ability to signal type, the commitment is valuable.⁶³

Crucial to the analysis below, these economies of enforcement can be achieved through an alternative mechanism. Where assets are partitioned, Bank could manufacture the same enforcement rights by demanding contractual cross-liability provisions. Thus, even if LuxuryOne and LuxuryTwo are owned by separate entities, the default by one can trigger enforcement rights against both.

Still, for perfectly correlated assets, there is no enforcement difference between integration and partition with cross liability. And so there is no reason to incur even the minimal additional administrative costs of partitioning assets and the transaction costs of negotiating cross-liability provisions. Additionally, under current law the enforceability of cross-liability provisions is far less than certain.⁶⁴ Integration is therefore the optimal mechanism to create enforcement economies when there is no other independent reason to use a partition.

Sometimes, however, reasons unrelated to risk may require partitions. For example, a firm doing business in multiple jurisdictions might create separate legal entities to ease compliance with different regulations and tax regimes.⁶⁵ Because the regulatory benefits of partitioning can be significant and the administrative costs of partitions and cross-liability provisions just discussed are likely to be relatively small, we should expect to (and do) see firms combining partitions

⁶¹ I add the "Inc." to denote when I am referring to the project in its legally partitioned form. Of course, an LLC or some other form might be chosen.

⁶² Michael C. Jensen and William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. of Fin. Econ. 305 (1976).

⁶³ Alan Schwartz, *Priorities and Priority in Bankruptcy*, 82 Cornell L. Rev. 5201 (1998).

⁶⁴ See George G. Triantis, *A Tussle with TOUSA: Avoiding Fraudulent Transfers in Intercorporate Guaranties*, in *Annual Review of Insolvency Law*, Janis P. Sarra, editor, Toronto: Carswell, 2009.

⁶⁵ See Ayotte and Hansmann, *supra* note 33 at 718-19.

and cross liabilities to create tailored partitions that achieve compliance savings while maintaining the value of enforcement economies.

These cases present the strongest case for cross liabilities and the corporate web. Bank will insist on cross-liability provisions that undo the economic impact of the artificial regulation-driven legal partition. The result is a legal partition for regulatory or other purposes with an economic re-integration by way of cross-liability provisions. As long as the re-integration is not frustrating some other valuable end – such as regulatory goals⁶⁶ – the cross-liability provision should be viewed favorably.⁶⁷ The focus of the remainder of this Part is on more nuanced motivations.

The take away so far is that firms will rarely partition perfectly correlated assets for risk allocation, monitoring, or enforcement purposes. But as the administrative and transaction costs are likely to be small and few assets are actually perfectly correlated, it is not surprising that firms (for the reasons discussed in the next two sections) routinely partition and adopt cross-liability provisions.

ii. Option 2: No Correlation and the Benefits of Partitions

Here, Bank is asked to finance a hotel and an oil refinery. Again, this case tracks conventional accounts. There is no correlation between the hotel and the oil refinery. Bank will not only refuse to finance the second project but it will demand that Entrepreneur partition the second project into a second legal entity. Bank has expertise in monitoring hotels. If Entrepreneur builds a refinery, finances it by another lender, and houses it within HotelCo, the success of Bank's original investment will turn in large part on the success of the refinery. Because Bank has no ability to monitor this project, it would have charged a much higher interest rate for the loan in the first place if HotelCo reserved the right to enter the refinery business. This is an extreme example of ex post risk alteration.⁶⁸ Almost certainly, Bank will have required – in the original loan agreement – a covenant prohibiting HotelCo from undertaking this project without its blessing, (which will not be forthcoming). And HotelCo would have agreed to that cove-

⁶⁶ For example, partitioning and re-integration to get around legal limitations on firm size would be problematic.

⁶⁷ This point raises questions about proposals, such as Richard Squire's, for using high levels of risk correlation as a trigger for invalidating cross-liability provisions. Squire, *supra* note 3.

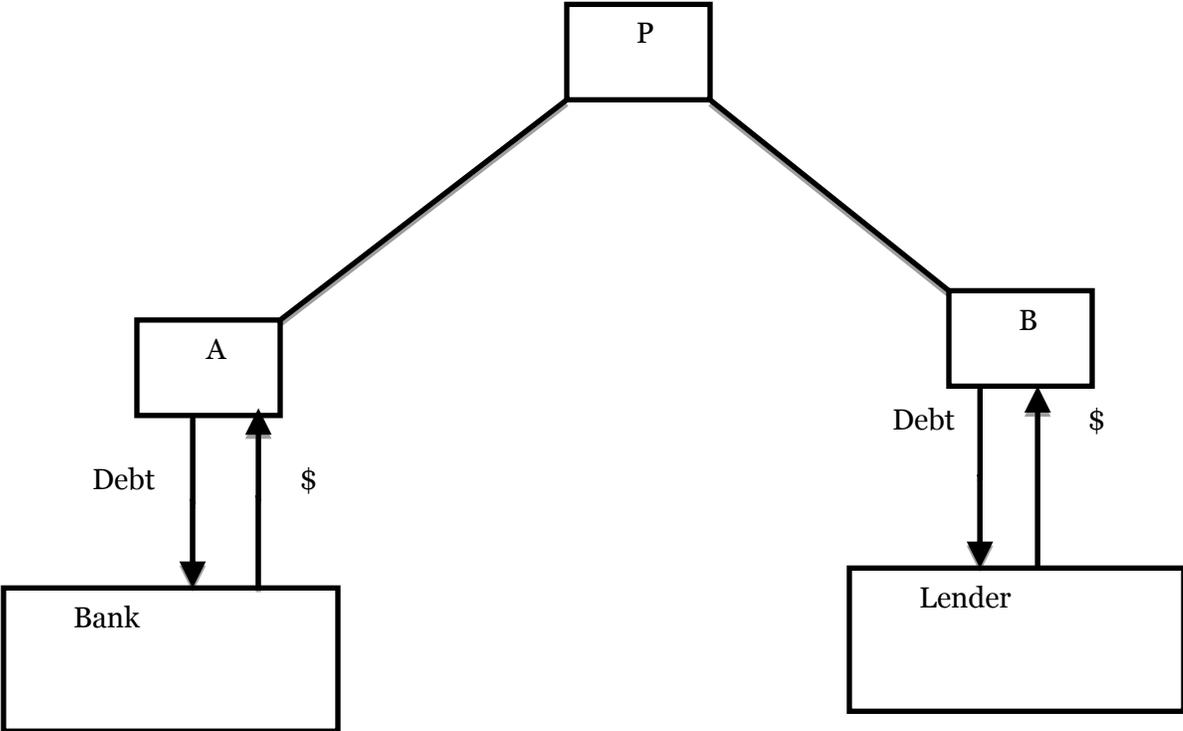
⁶⁸ Saul Levmore and Hideki Kanda, *Explaining Creditor Priorities*, 80 Va. L. Rev. 2103 (1994).

nant to gets the best interest rate.⁶⁹ So Entrepreneur creates HotelCo, Inc. and OilCo, Inc.

By partitioning the assets, Entrepreneur can go to a different lender who specializes in oil refineries to get a loan. This structure is depicted in figure 2:

⁶⁹ This prohibition is usually produced by the collective effect of negative covenants regarding liens, mergers, material obligations, acquisitions, fundamental changes, and the like. *See, e.g.*, Darden Credit Facility *supra* note 20 at Article VII.

Figure 2: Partitions



The new lender wants nothing to do with the hotel business. And with a partition, neither lender worries about the other project. A failure of OilCo will have no effect on HotelCo. Bank can focus on monitoring the hotel industry and the lender to OilCo, Inc. can focus on monitoring the refining industry. Because these operations are completely unrelated, none of the enforcement economies discussed above will be available and nothing is lost from the partition. It should be surprising if we saw integration or cross-liability provisions adopted in this case.

Indeed, the use of cross-liability provisions in cases of no correlation should be the most suspect of all. Such provisions suggest inefficient cross subsidies that are 1) a sign of incompetence; 2) opportunistic risk alteration; or 3) the use of internal capital markets to transfer value and circumvent the limits that external capital markets have placed on one of the projects.⁷⁰

The third item in that list is the most concerning. Incompetent subsidies destroy value. But any transfer or transaction that a business undertakes in its day-to-day operations may be the result of incompetence. Rarely does the law provide a mechanism to second guess business transactions based on incompetence alone.⁷¹ The second problem, risk alteration, is potentially costly because creditors usually loan to an entity based on its assets and the expected risk and return from future uses of those assets. When entity A takes on liabilities for the debts of entity B, the expected risk and return change. A is taking on B's liabilities and reducing B's exposure to risk. Even if A receives a market premium compensating it for the new exposure, it has just changed the risk profile of its business. Because a market premium was paid, this doesn't change the relative value of the firm as a whole but does change the value of the relative investments across the different layers of investors. But risk alteration is unavoidable and occurs every day with every loan. Any purchase, sale, payment, or other transfer can change the firm's risk profile to some degree. The possibility of some risk alteration is, therefore, priced into every loan.

Additionally, if A does not receive a premium payment for those liabilities, then A has just transferred to B the market value of the risk reduction. The lenders to A are now protected by a smaller set of assets (and the lenders to B are protected by a larger set).⁷² This is the equivalent of a dividend or cash give away. The law plainly allows such transfers in the absence of fraud or constructive fraud. Again, the risk of such transactions is, therefore, priced into every loan.

⁷⁰ Iacobucci and Triantis, *supra* note 1.

⁷¹ For example, the business judgment rule in Delaware protects normal incompetence and requires something much higher for liability or injunction.

⁷² See Saul Levmore and Hideki Kanda, *Explaining Creditor Priorities*, 80 Va. L. Rev. 2103 (1994). Of course, lenders can prohibit these particular transfers with covenants. But those covenants may not be perfectly enforceable.

Subsidies to circumvent external market limitations are different. They are rarely possible unless management is hiding movements in internal capital markets to achieve artificially low costs in the external market. That is, they are possible where creditors are being tricked and think they are lending on a safe project when they are actually lending on a much riskier project. That destroys value for lenders and creates a misallocation of capital in the economy as whole.

Because the first two possibilities – risk alteration or incompetence – are at best value-neutral motivations and the third is always value destroying, courts should be especially skeptical in cases where cross liabilities are incurred between entities with uncorrelated risks. We may then desire fraudulent transfer law to be relatively strong here. Fraudulent transfer laws invalidate certain transactions that harm creditors and make it more difficult for them to monitor assets.⁷³ Because there is no value-creating justification here, prohibiting these transactions might be favored. Rules that prohibit value-destroying transactions without affecting value creation are the gold standard. This suggests a strong justification for the importance the law of constructive fraudulent transfer places on the “for value” requirement in these cases. If the transaction includes a true market premium for the cross liability then there is no value transfer from one entity to the other. Entity B has not circumvented the costs of external markets because it paid the market price to Entity A.⁷⁴

A market premium, however, is not likely to have been paid. In our example, HotelCo, Inc. is rarely going to be the lowest cost lender to OilCo, Inc. A guarantee from HotelCo, Inc. to OilCo, Inc. would be unnecessarily costly. Imagine that the finance market would charge OilCo, Inc. \$100 for a loan guarantee from an outside Investor. Investor, the guarantor, is liquid, diversified, and has expertise in monitoring refineries. The same guarantee from HotelCo, Inc. should cost more (say \$110). This is because HotelCo, Inc. has a higher cost of capital than Investor has and is not as effective at monitoring. The differential will materialize as an increase in the capital cost for HotelCo, Inc. Now that HotelCo, Inc. is on

⁷³ See Douglas G. Baird and Thomas H. Jackson, *Fraudulent Conveyance Law and its Proper Domain*, 38 Vand. L. Rev. 829 (1985).

⁷⁴ The risk alteration problem still exists. There is a transfer of value from creditors to shareholders. But that is an unavoidable cost of any layered financial structure and is always priced into a transaction. Recent proposals to compensate executives with inside debt are attempts to reduce risk alteration incentives. See, generally, Rangarajan Sundaram and David Yermack, *Pay Me Later: Inside Debt and Its Role in Managerial Compensation*, 63 J. Fin. 1551 (2007); see also Kelli A. Alces and Brian D. Galle, *The False Promise of Risk-Reducing Incentive Pay: evidence from Executive Pensions and Deferred Compensation*, 38 J. of Corp. Law 53 (2012). These proposals suggest that if executives are compensated as if they have invested at every level, their incentives will be more in line with a single owner model. None of these proposals, however, suggests risk alteration can be reduced to zero.

the hook for OilCo, Inc.'s debts and it and its creditors cannot efficiently monitor OilCo's operations, investors in HotelCo, Inc. will charge a higher interest rate to the tune of \$110.⁷⁵ In our example, then, either HotelCo or OilCo loses out. OilCo, Inc. pays \$110 for a guarantee that it could have received for \$100. Or OilCo, Inc. pays \$100 to HotelCo, Inc. for a guarantee that costs HotelCo, Inc. \$110. In both cases, HotelCo, Inc. incurs an increased cost of capital of \$110. Entrepreneur's total enterprise is out \$10 relative to a market transaction. Thus, even if OilCo, Inc. pays a market premium, the transfer is still likely to be a sign of incompetence or of opportunistic risk alteration.

In this situation, courts tend to place a heavy burden on OilCo, Inc. to show that it paid market value for the guarantee when HotelCo, Inc. is insolvent and the guarantee results in a loss to HotelCo, Inc.'s creditors. This may be an effective rule. But we might consider an even heavier burden such as viewing the lack of correlation as an independent badge of fraud that could substitute for insolvency. To be clear, that is not to say that the transaction would be automatically invalid. Generally, the courts require *two badges* of fraud to invalidate a transfer.⁷⁶ Thus, a cross guarantee with no correlation would be valid if for value and invalid if not.

On the other hand, there is one scenario where cross-liabilities of this sort may be value creating and appropriate. That is where there is private information that cannot be conveyed to the market. The joint managers of the conglomerate may have information about the success of the projects available to OilCo, Inc. but cannot convince any lender of the accuracy of that information.⁷⁷ In that case, if HotelCo, Inc. is sitting on uninvested cash or available credit, the best investment may be the one about which it has inside information. These cases should, however, be rare. And the cost of invalidating this small subset of valuable transactions may be relatively small.

The bigger caveat is that a court may find it challenging to create a clear metric for measuring correlation. This is no small matter. Correlation is a fuzzy thing and the best entrepreneur's are likely to be those who see correlation where others do not. Indeed, the logic above might be taken to mean courts should second guess all decisions companies make to enter new markets or that the law should require those companies to use legal partitions without cross liabilities when they

⁷⁵ The costs will be born by all investors (equity and creditors). The key is that the overall cost of capital goes up.

⁷⁶ See Douglas G. Baird, *One and Half Badges of Fraud*, at 3-4 (work-in progress, manuscript on file with the author).

⁷⁷ See George G. Triantis, *Organizations as Internal Capital Markets: the Legal Boundaries of Firms, Collateral, and Trusts in Commercial and Charitable Enterprises*, 117 Harv. L. Rev. 1102 (2004) (describing the value of that can be created by when managers with private information can move capital freely from one project to another).

enter those markets. After all, expansion into a new market has a similar impact on creditors. But the idea of a court deciding that a computer company like Apple should not have entered the telecom industry is worrying. Short of a meaningful and objective metric for correlation we should, therefore, be reluctant to change the law much in this context.

iii. Option 3: Partial Correlation, Tailored Partitions, and Selective Enforcement

In this section, I explore considerations that arise when the firm is looking to go forward with two partially related projects. Entrepreneur's two projects will be LuxuryOne (her luxury hotel) and EconoRoom (her budget hotel). The risks facing a luxury hotel on the lake shore and a budget hotel near the airport are correlated across some dimensions but quite distinct across others. Conventional accounts imply that there is a binary switch at some point along the continuum. For a lot of correlation, integrate. For very little, partition. This assumes that in a world of partial correlation, the parties must simply accept the second best. The parties simply bear the costs of partitioning if they are less than the costs of integration and vice versa.

But this ignores the tools available to lenders, borrowers, and their lawyers to create value in structuring deals. If it were possible to tailor the partition, lenders could reserve the option to respond to firm-wide signals⁷⁸ globally and uncorrelated project-specific signals locally on a contained case-by-case basis.

There are several dimensions across which risk can be partially correlated. In the hotels example, these might include real estate markets, luxury- and economy-hotel markets, geographic hotel markets, and Entrepreneur's skill at managing the two types of businesses. While the real estate near O'Hare and on the lake shore will be equally affected by the general economy in Chicago, a dramatic shift in crime near downtown Chicago might affect only the real estate value of LuxuryOne. Similarly, the impact of shifts in the tourism business will be highly correlated between the projects. But a decline in local tourism (vacationers from the suburbs) may affect LuxuryOne without affecting EconoRoom. And while Entrepreneur may be an astute business woman with a knack for property management, her experience with luxury hotels may not translate to success with the budget traveler staying next to the airport. Finding the perfect concierge who knows the best restaurants and night clubs might not have the same value at both hotels.

⁷⁸ I use the term "firm-wide signal" to refer to a signal that carries information about the enterprise as a whole even though it may have been produced from the performance or monitoring of a specific project.

I focus on Entrepreneur's management skills. Assume that Bank still has the expertise that it takes to monitor both projects. This is not like the oil refinery business. But Bank's monitoring will produce different signals about the business in different states of the world. To start with, assume that Bank looks at the cash flows and operation reports of a hotel to know whether management is doing its job. The borrower has agreed to provide accurate books and records to Bank on a quarterly basis. When Bank receives reports from LuxuryOne it receives one of three signals: 1) no new information; 2) management is incompetent at everything; or 3) management is incompetent at just the luxury-hotel business. When it receives reports from EconoRoom it receives a similar set of signals: 1) no new information; 2) management is incompetent at everything; 3) management is incompetent at just the budget-hotel business. As discussed above, signals 2 and 3 may trigger defaults in some case.⁷⁹ In other cases, the firm will look for a default to act on an unrelated signal.

As a starting point, Bank's desire to limit the flow of internal capital markets is not on its own a compelling explanation for partitions here.⁸⁰ An internal-capital-markets theory would suggest that a large bank may finance all projects of the firm but require entity partitions simply to restrict the flow of capital between projects. The limitation on this story is that the cross-liability provisions are a direct path for capital to flow from one project-entity to another. If LuxuryOne, Inc. borrows funds collateralized by the assets of EconoRoom, Inc. that is the functional equivalent of moving capital from EconoRoom, Inc. to LuxuryOne, Inc. EconoRoom will have reduced borrowing capacity and LuxuryOne will have increased borrowing capacity. Indeed, the parties often draft the agreements to *allow* any entity to draw on the total amount of the revolving loan. The loan may be for \$1 billion to be allocated among the entities as the debtor sees fit. In those cases, the lenders do not restrict the flow of capital between the project-entities. If anything, the provisions to allow the capital to flow at the managers' discretion while maintaining the lender's option to choose which asset to enforce against.⁸¹

⁷⁹ Signal 1 will never trigger a default.

⁸⁰ George Triantis makes the case that restrictions on internal capital markets may explain the use of partitions in scenarios where there is one large institutional lender and cross guarantees are in place. *See* Triantis, *supra* note 77.

⁸¹ That the loan documents can be and are structured in either way once again suggests that tailored partitions create great freedom for the parties to craft a precise capital structure. The point here, however, is that the common use of tailored partitions that do not restrict internal capital flow suggests another motive for the partition is at play. Additionally, restrictions on internal capital markets can be achieved to some degree through security interests. Triantis notes that the "choice between them is an intriguing and unexplored topic." *Id.* at 1139. But often the partitions are coupled with security interests and so firms are not always choosing one or the other. Again this suggests that there is more driving the structure than mere restrictions on capital flow.

That leaves perhaps Bank's interest in getting accurate and separate books and records for each project. Under certain circumstances, Entrepreneur may have an incentive to obscure signals about her incompetence on a given project. Secretly moving assets from one project to another may accomplish this smokescreen. It will be (at least marginally) easier to do that under a one-entity structure.⁸² The relative ease comes in defending against claims of fraud. Commingling funds within one legal entity will likely be easier to defend ex post as mere incompetence rather than outright fraud. While the incompetence argument can be attempted even when funds are smuggled across legal boundaries, there will be more hoops that will need to be intentionally jumped through in that world. Those hoops makes it easier to verify the fraudulent intent.

Still, I label this weak support. The hoops implicit in a partition can be created (at least roughly) by contract. Thus, entity partitioning that is created to deter fraud will, in most cases, be superfluous of covenants. And in the cases where fraud is occurring, it is not at all clear that the extra hoops will do much to marginally deter someone who has already accepted the more significant expected threshold costs of committing fraud.

More important to Bank than the relatively rare case of fraud will be what it can do with the signals of non-fraud risk that it receives. If Bank receives signal 1 from both projects, it does nothing. It does not matter how firm structured its partitions. If Bank receives signal 2 from both projects, it enforces against both projects.

But when Bank receives signal two from LuxuryOne and signal one from EconoRoom its response becomes more complicated. If the assets are integrated in one legal entity, Bank will enforce against both assets. Signal two tells it about EconoRoom as much as about LuxuryOne and the maximizing response is to call all the loans before the incompetence worsens or spreads. This is not possible when the assets are fully partitioned into separate legal entities. Without cross liability, signal two is a default by LuxuryOne while signal one is not a default by EconoRoom. In this scenario, Bank must sit on the information that EconoRoom is about to crash until it separately defaults. Bank cannot preemptively intervene the way it could if the entities were integrated. In the meantime, EconoRoom may be depreciating in value. Management and equity will have strong incentives to take on self-interested risky projects that have negative expected value for LuxuryOne as a whole

Ex post, Bank wishes the entities were integrated. But the solution is not for Bank to demand integration ex ante. To see this, consider what happens when Bank receives signal one from LuxuryOne and signal three from EconoRoom.

⁸² Iacobucci and Triantis, *supra* note 1; Kolasinski, *supra* note 34 at 328.

This essentially captures the world where Entrepreneur has proved to be a successful manager of luxury hotels but an incompetent manager of budget hotels. Here, Bank wants to enforce only against EconoRoom and leave entrepreneur to run LuxuryOne.

The following example demonstrates this intuition. Let's say that when Bank made both loans it expected a 10% return (adjusted for risk) from each. Assume also that Bank has limited capital and if it had more capital it could take advantage of other investment opportunities with a 9% expected return. A year has passed and Bank has received a signal of failure at EconoRoom but not LuxuryOne. Now the expected return on the remaining value of EconoRoom is 5%. LuxuryOne still has an expected return of 10%. The rational action for Bank is to call a default and cash out only the loan to EconoRoom and reinvest the money at 9%. Any recovery against LuxuryOne would lead to a loss. Trying to recover losses on the EconoRoom loan from the value of LuxuryOne would be akin to the sunk-cost fallacy. The best Bank could do is reinvest the money recovered from LuxuryOne in the market at 9%. When Bank calls a default against LuxuryOne or an integrated entity that owns it, the debtor might even be able to use a bankruptcy proceeding to force a renegotiation of the loan at somewhere between 9 and 10% – even where the loan prohibits prepayment or refinancing!⁸³

The facts as we have assumed them to this point – with no other creditors – might still allow Bank to limit its actions to just the EconoRoom assets in a world of no partitioning. Bank could call a default, take a lien, and threaten foreclosure on some or all assets. Firms with one creditor cannot generally file for bankruptcy and so Entrepreneur would not be able to do much more than threaten state-court litigation.

But few firms have one creditor⁸⁴ and multiple creditors complicate things. If Bank is unsecured, any enforcement action will be against the legal entity as a

⁸³ See, for example, *In re AMR Corporation*, 730 F.3d 88 (2nd Cir. 2013) (debtor used bankruptcy to refinance loan without paying a prepayment penalty that was otherwise required for refinancing). This maneuver is possible because bankruptcy law treats loans as claims due at the time of filing. The claims do not include payment for unaccrued future interest. Thus, a \$100 loan with a 10% interest rate due tomorrow is the same as a \$100 loan with a 20% interest rate due five years from now even though the five year loan has a higher expected return the day before the bankruptcy filing. Creditors can try to avoid this outcome by inserting make-whole provisions (pre-payment penalties) that are explicitly triggered by a loan acceleration that is associated with the bankruptcy filing. *Id.* The enforceability of these provisions is uncertain and different courts treat them differently in various circumstances. *Id.*

⁸⁴ Those that do are often specifically designed to be bankruptcy remote and essentially hold assets without any operations or employees. The validity of the bankruptcy remoteness of these entities was brought into question in some recent cases. See, e.g., *In re General Growth Properties*, 09-11977 (Bank. S.D.N.Y. 2009); Douglas G. Baird and

whole.⁸⁵ This will trigger rights of Entrepreneur and the other creditors to bring to initiate firm-wide litigation or to push the entire firm into bankruptcy.

And if Bank, itself, wants to use bankruptcy remedies, it will have to do so against the entire legal entity. This raises numerous problems for Bank. Bank wants LuxuryOne to continue to operate but wants to liquidate EconoRoom. As noted above, Entrepreneur may use the bankruptcy to refinance the loan on LuxuryOne. Additionally, bankruptcy triggers Entrepreneur's exclusive control of the plan of reorganization.⁸⁶ She may be able to use that power to extract value from Bank. Even worse, the general creditors of HotelCo can become obstacles to the restructuring by raising objections to any plan supported by Bank.⁸⁷

These rights might threaten the value of the primary creditor's investment in the non-distressed projects and allow third parties (or the debtor, itself) to extort some of that value. In its efforts to keep LuxuryOne afloat, bank may be forced to make concessions to the other parties who do business only with EconoRoom. On the other side, the general creditors or other parties who do business exclusively with LuxuryOne may now have bankruptcy objections or strategic hold-up options that would not otherwise exist.

A more streamlined process could be accomplished if the bankruptcy only involved EconoRoom and let LuxuryOne continue to operate as usual. In that scenario, the general creditors of EconoRoom can try to extract value from Bank, but their actions will be limited to EconoRoom. The legal partition facilitates this.

Additionally, Bank may wish to enforce its rights without dealing with a bankruptcy proceeding. But in fully integrated firms when one creditor calls a default, the enforcement action will often trigger defaults on agreements the debtor has with other parties. These are not "cross-defaults" per se. Rather, the impact of the enforcement action makes it impossible for the debtor to fulfill other *unrelated* obligations. For example, a primary creditor may accelerate a large loan forcing immediate payment. Or a secured creditor may sweep the debtor's cash collateral. Either measure ties up debtor's cash flow. This lack of liquidity will cause breaches throughout the entire legal entity. In this way, Bank's action in response to the failure of EconoRoom provides general creditors the possibility of pushing all of HotelCo into default and bankruptcy. Entrepreneur may even respond to Bank's notice of default in ways that encourage other creditors to push for bank-

Anthony J. Casey, *No Exit? Withdrawal Rights and the Law of Corporate Reorganizations*, 113 Columbia L. Rev. 1 (2013).

⁸⁵ Iacobucci and Triantis, *supra* note 1.

⁸⁶ 11 U.S.C. § 1121.

⁸⁷ For a catalogue of the various objections that parties use to block a restructuring, see Jared Elias, *Do Activist Investors Constrain Managerial Moral Hazard in Chapter 11?: Evidence from Junior Activist Investing*, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2308994, at appendix 1.

ruptcy.⁸⁸ In this way, both Entrepreneur and general creditors can make Bank's enforcement more complicated. This, in turn, provides leverage for value extraction. This can impose costs on Bank who must either limit its enforcement options or allow the value to be extracted.

Bank's status as secured or unsecured does not change the dynamic. Bank may view its security interest in EconoRoom as providing it the flexibility to take action against that project alone. But a foreclosure on EconoRoom may trigger defaults on junior debt and other agreements. The effects – essential freezing liquidity – can ripple out and cause default on LuxuryOne's agreements as well. Any one of the general creditors⁸⁹ might then push the entire legal entity into bankruptcy. Now Bank has to deal with a costly bankruptcy with regard to LuxuryOne. Entrepreneur and other general creditors⁹⁰ can then use the procedural levers of bankruptcy to extract value from Bank.⁹¹

Filing rules are broad enough that it will be quite difficult for Bank to challenge a bankruptcy filing of HotelCo in the face of its foreclosure threat and the presence of other creditors. Bankruptcy may reduce the value of LuxuryOne for all involved or it may simply impose transaction costs on Bank. In turn, the threat of filing may alone be enough to extract value from Bank when Bank threatens foreclosure on EconoRoom.

The available strategic maneuvers are fewer when the entities are legally partitioned. When bank threatens to enforce against EconoRoom by liquidating it or taking it over, the best Entrepreneur or general creditors can do is threaten a bankruptcy filing vis-à-vis EconoRoom, Inc.⁹² This threat imposes costs associated with bankruptcy but the value of LuxuryOne is unaffected. Moreover, the costs of that smaller bankruptcy may be significantly lower. This is particularly true where the additional creditors of LuxuryOne would complicate the bargaining dynamic.

⁸⁸ See, e.g., *In re Kingston Square Associates*, 214 B.R. 713 (Bankr. S.D.N.Y. 1997).

⁸⁹ Technically the code will require three creditors, 11 U.S.C. § 303, but that is rarely a meaningful obstacle.

⁹⁰ I am assuming that management is included with the Entrepreneur.

⁹¹ Bankruptcy creates all kinds of opportunity for strategic maneuvering. Jared Elias, *Do Activist Investors Constrain Managerial Moral Hazard in Chapter 11?: Evidence from Junior Activist Investing*, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2308994, at appendix 1. For example, the termination of derivative accounts could destroy value and liquidity. See Kenneth Ayotte and David A. Skeel, *Bankruptcy Law as a Liquidity Provider*, 80 U. Chi. L. Rev. 1557 (2014) for more on liquidity and bankruptcy law.

⁹² Even generous good-faith-filing rules should protect this outcome and prevent the bankruptcy of LuxuryOne. *But see* *In re General Growth Properties*, 09-11977 (Bank. S.D.N.Y. 2009); Baird and Casey, *supra* note 3. See below at ___ on good-faith-filing rules.

In some cases, Bank, itself, may prefer to push EconoRoom into bankruptcy. The primary motive here will be to achieve a free-and-clear sale.⁹³ When the assets are partitioned, Bank can respond to the default signal from EconoRoom by finding a buyer, pushing EconoRoom into bankruptcy, and orchestrating a free-and-clear sale. The court order that accompanies such a sale provides significant value over a foreclosure sale outside of bankruptcy.⁹⁴

This option is not so simple when there is one integrated legal entity. The free-and-clear sale can only be accomplished in bankruptcy. But legal entities – not assets – file bankruptcy.⁹⁵ Thus, the only way to sell EconoRoom free and clear is to take HotelCo – with LuxuryOne along for the ride – into bankruptcy. The various procedural hold-up maneuvers and costs of bankruptcy once again emerge. Partitioning allows Bank to avoid that problem.⁹⁶ Finally, bankruptcy is much simpler when the assets are more confined.

To summarize, when Bank receives a firm-wide signal, it will want to enforce against the entire enterprise. Cross-liability provisions allow this. When bank receives a project-specific signal, it will want to enforce against the failing project alone. Broader enforcement will impose costs by triggering hold-up rights for other creditors. Partitions (even with cross-liability provisions) protect the option to enforce on a project-specific basis. Figure 3 depicts the tailored partition:

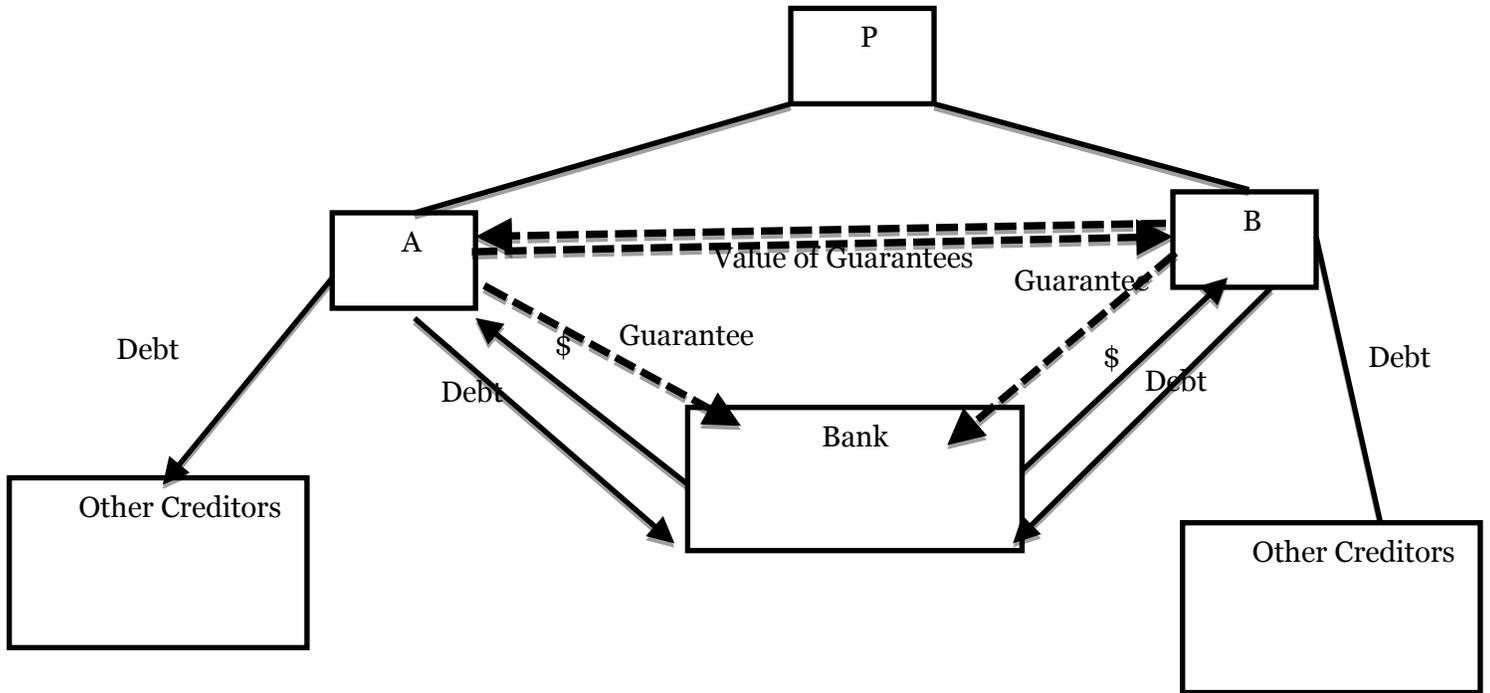
⁹³ See Anthony J. Casey, *The Creditors' Bargain and Option-Preservation Priority*, 78 U. Chi. L. Rev. 759, 787-89 (2011) (describing the free-and-clear sale process).

⁹⁴ *Id.*

⁹⁵ Iacobucci and Triantis, *supra* note 1.

⁹⁶ The primary creditor may also wish to limit its enforcement actions on a specific project to contain the scope of any potential lender liability. This is unlikely to be the main driving force as lender liability is rare, but the lending lawyers do consider it when determining the scope of enforcement. On the rise and fall of lender liability. See Lipson, *supra* note 48 at 1059-67; Daniel R. Fischel, *The Economics of Lender Liability*, 99 Yale L. J. 131 (1989).

Figure 3: Tailored Partitions



All of this allows precise ex post balancing. The key is that the boundaries of the partition can be defined after the relevant circumstances have materialized. In the all-or-nothing view, it is a choice of the lesser of two evils. In the tailored-partition world, the partition can be calibrated to achieve the best of both worlds.

Notably, the above theory only works when few (one, maybe two) creditors have the option for tailored enforcement. If many creditors have cross-liability provisions, any project-specific default would trigger cross-enforcement rights in the hands of many parties. This reintroduces hold-up opportunities and the selective-enforcement option would be worthless. Consistent with this, a primary creditor often prohibits the debtor from including cross-liability provisions in loans or agreements with other creditors or it restricts those provisions to immaterial loans.⁹⁷

iv. A Further Aside about Security Interests

I have mostly bracketed security interests up until now. One might expect a discussion of security interests here as a possible mechanism for creating traditional partitions or selective-enforcement options. That is only partly true. Security interests do separate priority rights in assets. And they do create asset-specific foreclosure rights. Combining that partitioning with cross liabilities allows for some, but not all, of the selective-enforcement benefits of tailored partitioning.

Cross-liability provisions in security agreements can trigger firm-wide enforcement rights. In the integrated world, default on payment of a loan secured by the LuxuryOne assets can certainly create a default on a separate loan secured by the EconoRoom assets if the loan agreements provides for that. In that sense, the lender has the choice whether to call default against LuxuryOne or against both hotels. But on the other side of the equation, there are significant limitations to Bank's ability to contain its enforcement action to just one asset in the absence of a legal partition.

As Iacobucci and Triantis pointed out, the true value of a legal partition can be traced largely to the "legal personality" of the corporate entity.⁹⁸ The key is that enforcement actions are taken against legal persons. Entity partitions limit the impact of enforcement actions by defining the boundaries of the legal person against whom actions are taken. Security interests, which are asset specific, do not do this.⁹⁹

⁹⁷ See *infra* notes 30 and 31.

⁹⁸ Iacobucci and Triantis, *supra* note 1 at 533-34.

⁹⁹ Iacobucci and Triantis, *supra* note 1 ("In sum, although the priority afforded by security interests is asset specific in legal doctrine, it yields in many respects to the overall focus of debt financing on the debtor as an indivisible person.").

Thus, a security interest in the LuxuryOne assets creates specific priority rights in those assets. But the creditor must take any legal action other than foreclosure against HotelCo as a whole. The extreme example is bankruptcy. Bank may want to push LuxuryOne into bankruptcy to achieve a free-and-clear sale. But assets cannot be put into bankruptcy, only legal persons. In a structure with security interests but no legal partitions, any bankruptcy involving LuxuryOne will by necessity involve EconoRoom.¹⁰⁰ This triggers the potential hold-up rights for other creditors and management.

Even a foreclosure of LuxuryOne triggers some rights in other creditors of HotelCo. For example, if Bank forecloses and sells LuxuryOne, any other general creditor might later argue that the sale was a fraudulent transfer. Moreover, a partition that limits tailoring of enforcement rights to foreclosure is significantly less effective than one that provides tailoring across all remedies.

Security interests and entity partition will, therefore, generally have different goals – the former is targeted at priority of payment and the latter at enforcement options.¹⁰¹ Because they achieve different goals, security interests and partitions often together. A lender who desires priority may also desire an enforcement option.¹⁰²

¹⁰⁰ Iacobucci and Triantis, *supra* note 1 at 533-34.

¹⁰¹ There will also be certain assets in which security interests cannot be taken. In some cases, creditor will require legal entity partitions to create a rough and imperfect substitute for security interests. The concept of legal entities substituting for security interests has been explored in the literature on structural priority. *See* Baird and Casey, *supra* note 3 at 12, 29; Widen, *supra* note 17 at 244, 248 & n.32; *See* Douglas G. Baird, *The Rights of Secured Creditors After ResCap* (work in progress; manuscript on file with the author).

¹⁰² Richard Squire appears to disagree with this in *Strategic Liability in the Corporate Group*, *supra* note 3. He presents a story of cross guarantees coupled with partitions as nothing more than a means for opportunistic wealth transfer. But he also suggests that secured loans and cross-guarantees have the same effect and are redundant when coupled together. *Id.* As a result, he presents an analysis that can only explain cross-liabilities that exist in the absence of security interests. *Id.* In justifying this limited nature of his analysis, Squire suggests that partitions coupled with cross-guarantees rarely travel with secured debt. He supports this conclusion by noting the basic premises that public corporations commonly do not have secured debt and often have cross guarantees. *Id.* His conclusion does not logically follow from those basic premises, and it does not comport with reported bankruptcy cases where many large public companies enter with secured debt. *See, e.g.* Kodak First Day Aff. It may be that large public companies are more likely to take on unsecured debt. But a significant number do take on secured debt. And when they do so, they include cross-liability provisions just like the many private companies who take on secured debt. In fact, partitions coupled with cross-liability provisions are common whenever there is a primary creditor (secured or unsecured). Moreover, evidence shows that even public corporations tend to take on secured debt as they approach insolvency. *See* Kenneth M. Ayotte and Edward R. Morrison, *Creditor Control in Chapter 11*, 1 J Legal Analysis 511, 518 (noting that 90 percent of debtors in their data set of public and private companies entered bankruptcy with secured debt). The power of the model of se-

B. Variations on a Common Theme: Holding Company Guarantees and Subordinated Primary Creditors

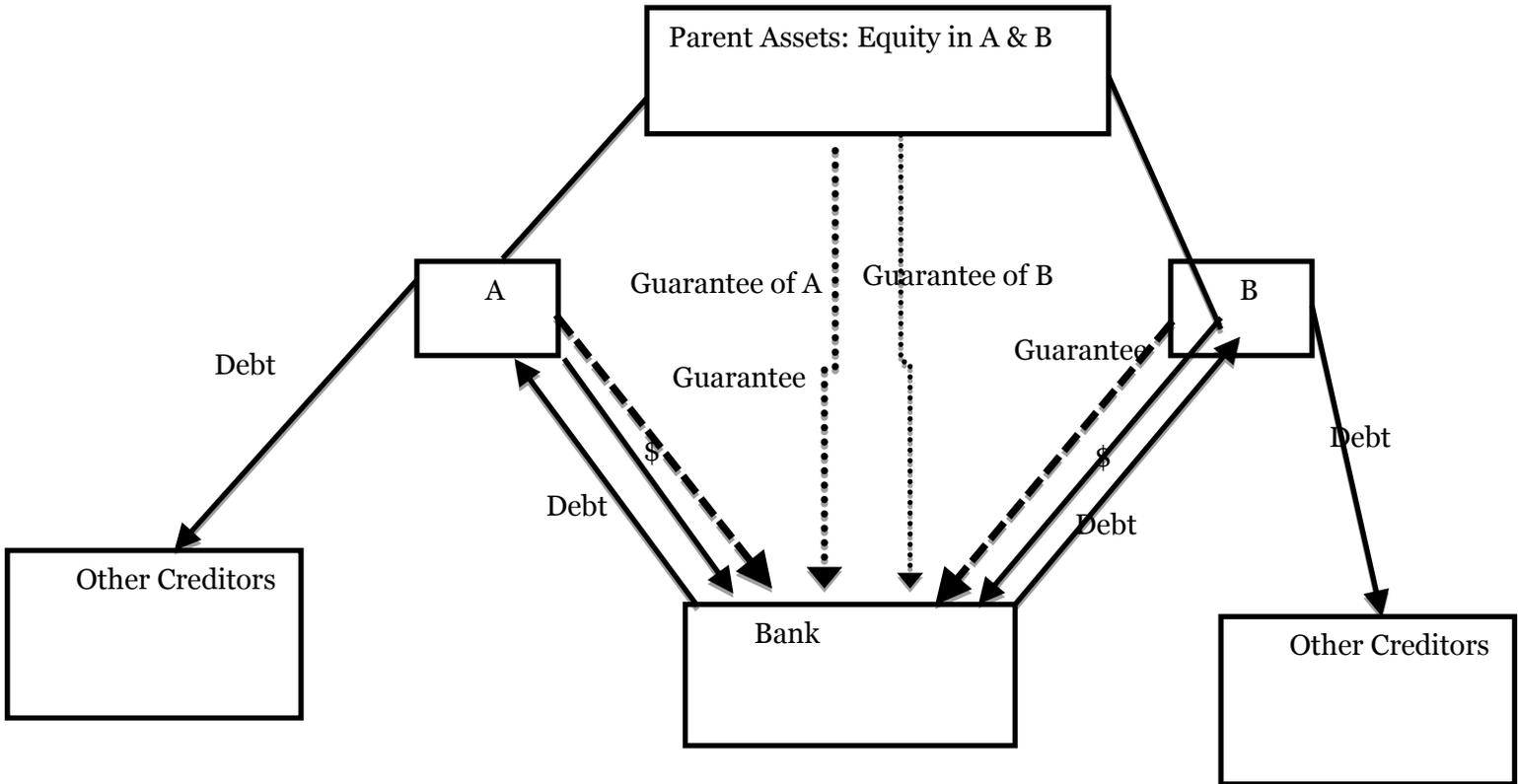
The analysis above presents simplified examples of affiliate cross-guarantees. But the actual capital structures we see in practice can have layers upon layers of entities. Firms can combine overlapping webs of cross-liabilities of varying form to choose very specific enforcement rights. I pause here to identify two noteworthy variations on the model presented above.

i. Holding-Company Guarantees and Stock Pledges

One common structure is a guarantee of subsidiary debt from a parent holding company whose only asset is its equity in the subsidiaries. This is depicted in figure 4:

lective enforcement is that it can consistently explain the tailored financial structures of large firms – public or private, with secured or with unsecured debt.

Figure 4: Equity Guarantees/Stock Pledge



Again, under existing accounts one might puzzle at this structure. Why has the debtor created all of these separate entities only to cross guarantee all of the partitions away? Moreover, what value is a security interest in equity of the subsidiaries? After all, that is usually the second or third most junior possible position in the capital structure of an enterprise. (The most junior is equity in the holding company.) These questions can all be answered by analyzing the selective-enforcement rights that are at work.

Imagine that one likely signal is that management is incompetent but that assets are fine. But that is not the only likely signal. Other signals like those explored above could suggest that all assets are losing value or that one of the assets is losing value. When management is incompetent, Bank wants to oust them from every entity. In our previous examples, that would require calling defaults or cross defaults at every entity. But calling cross defaults between the operating companies carries the risk of triggering hold-up rights for all other creditors.

This is where the equity guarantee comes in. By combining the equity guarantee with the operating companies' cross guarantees, the structure allows all of the options discussed above: calling a default on A; calling a default on B; or calling a default on both. But it includes another option: calling a default on parent alone. The effect here is an immediate foreclosure right on the equity of the subsidiaries. This gives the lender the right to appoint new directors of all of the operating entities and take complete control of operations. Indeed, under some agreements the pledged stock documents will be delivered to the lender at the time of the loan along with executed instruments of transfer, irrevocable proxies, and acknowledgement of equity interest registration page.¹⁰³ The lenders draft these documents with the purpose of transferring control and voting rights (and allowing the replacement of directors) instantaneously upon default or notice of default.

When the equity guarantee is invoked (by calling a default only against the parent), the primary creditor does not get any liquidation right over the subsidiaries assets. But it also does not trigger any rights of general creditors of those operating subsidiaries. The operating companies continue with business as usual, but with the primary creditor calling all of the shots.

If the assets were wasting away, the lender would use its other guarantees to call default and liquidate the assets. But when the signal is simply that the company needs new management, the lender can take over cleanly and run the company (or sell it to someone who can). This provides a much different option for enforcement than a simple security interest or cross guarantee. Consistent with

¹⁰³ See, e.g., *Madison Capital Funding LLC v. HomeOrganizers, Inc.* 10-CH-10531 (Cook County Illinois Circuit Court March 16, 2010).

this analysis, lenders often include a covenant that explicitly prohibits the parent company from having any other creditors. Indeed, the covenants will go as far as prohibiting the company from doing anything at all (beyond the administrative tasks required to exist as a holding company).¹⁰⁴

The temporary restraining order in *Madison Capital Funding LLC v. HomeOrganizers, Inc.*¹⁰⁵ gives an example of how these provisions are intended to work but also how uncertainty about how courts will respond can impair their effectiveness. In that case, Madison Capital, the primary creditor, had made loans to HomeOrganizers, Inc. and its subsidiaries. HomeOrganizers, Inc. was the holding company parent for operating companies including Closet World, CBD Franchising, Inc., Home Closets, Inc., Closets By Design, Inc., Closet World Arizona, LLC, Closet Dimensions, Inc., and CBD Las Vegas, LLC (collectively the “operating subsidiaries”).¹⁰⁶ The loans were guaranteed by all entities and were secured by all of their assets including the equity that HomeOrganizers, Inc. held in all of the operating subsidiaries.¹⁰⁷ After the HomeOrganizers group had defaulted on several covenants, Madison Capital sent a notice to all entities containing the following: 1) notice of ongoing default; 2) notice of its exercise of voting rights; 3) written consents showing its votes to remove all directors of the subsidiaries and elect a sole director chosen by the creditor to replace them; and 4) no-

¹⁰⁴ An agreement might make it a default if

Holdings shall (i) conduct, transact or otherwise engage in, or commit to conduct, transact or otherwise engage in, any business or operations other than those incidental to its ownership of the Capital Stock of the Company [Borrower], (ii) incur, create, assume or suffer to exist any Indebtedness or other liabilities or financial obligations, except (x) nonconsensual obligations imposed by operation of law, (y) obligations pursuant to the Loan Documents to which it is a party and (z) obligations with respect to its Capital Stock, or (iii) own, lease, manage or otherwise operate any properties or assets other than the ownership of shares of Capital Stock of the Company [Borrower]...

See, e.g., June 29, 2004, Second Amended and Restated Lease and License Financing and Purchase Option Agreement between Arabica Funding, Inc. and Caribou Coffee Company, Inc. available at <http://www.sec.gov/Archives/edgar/data/1332602/000095014405009087/g96252a1exv10w19.txt>.

Other forms of this prohibition might be in the form of a representation and warranty or negative covenant. *See, e.g.*, October 8, 2004 Consent and Amendment No. 3 to Credit Agreement between Blue Ridge Paper Products, Inc., et al and General Electric Capital Corporation available at http://www.sec.gov/Archives/edgar/data/1284293/000110465904030272/a04-11454_1ex10d1.htm; *see also* September 22, 2008 CT Technologies Intermediate Holdings, Inc. Note Purchase Agreement.

¹⁰⁵ 10-CH-10531 (Cook County Illinois Circuit Court March 16, 2010).

¹⁰⁶ *Id.*

¹⁰⁷ *Id.*

tice of the express instruction that no officer shall take any action outside of the ordinary course without approval from the new director.¹⁰⁸

Consistent with the above model of selective enforcement against a holding company, the assets of the operating companies did not appear to be losing value and the creditor's action were aimed at taking control to oust management or sell the business without involving any other creditors. At the time of the default notice, the operating companies were, in fact, experiencing record sales.¹⁰⁹

The "old"¹¹⁰ managers of the HomeOrganizers Group responded to the default notice by threatening to put the subsidiary entities into bankruptcy. Madison Capital then immediately brought an action in state court seeking a restraining order and injunction to prevent the "old" board or management from attempting to file for bankruptcy.¹¹¹ A temporary restraining order was issued.¹¹²

At this point, from a state law perspective, Madison Capital owned and controlled the operating subsidiaries.¹¹³ No other creditors had any rights triggered by foreclosure, so the only remedy available to the old managers should have been a state law action arguing that the foreclosure of the equity in the operating subsidiaries was not proper under the loan agreement. If Madison Capital prevailed on that issue, it was in the driver's seat to continue to run the companies, or hold a foreclosure sale and auction the equity in the operating companies to the highest bidder. In such a sale, Madison Capital would have been entitled to the proceeds up to the full amount it was owed including any default or prepayment penalties.

The old managers of HomeOrganizers, Inc. took a different view of things. They went ahead with the bankruptcy filing anyway.¹¹⁴ They also filed an adversary proceeding in the bankruptcy court seeking an injunction prohibiting Madison Capital from exercising any voting rights that interfered with the governance of HomeOrganizers, Inc. or the operating subsidiaries.¹¹⁵ Madison Capital, for its

¹⁰⁸ *Id.*

¹⁰⁹ See Jan Norman, "Closet Company emerges from Bankruptcy," Orange County Register Online Blog, available at <http://jan.blog.ocregister.com/2010/08/27/closet-company-emerges-from-bankruptcy/44113/#more-44113>.

¹¹⁰ I refer to the directors in place before the notice became effective as the old managers.

¹¹¹ *Id.*

¹¹² *Id.* The notice was sent on March 9, 2010. The court issued its order on March 16, 2010.

¹¹³ The parent holding company should have been irrelevant as it no longer had any assets.

¹¹⁴ *In re HomeOrganizers, Inc. et al.*, Case No. 10-19762 (Bankr. C.D.Cal. 2010).

¹¹⁵ Adversary Case 2:10-ap-0154, COMPLAINT BY HOMEORGANIZERS, INC. AGAINST MADISON CAPITAL FUNDING LLC, *In re HomeOrganizers, Inc. et al.*, Case No. 10-19762 (Bankr. C.D.Cal. 2010) docket #16.

part, filed an emergency motion to dismiss the bankruptcy cases.¹¹⁶ This set the ground for a potential jurisdictional battle between the state court and the bankruptcy court. If Madison Capital's selective-enforcement rights were to be respected, the bankruptcy filing was improper and derogated their state rights. But if the bankruptcy court was inclined to hear the case, could it be bound by the state court order? The order was based on the premise that Madison Capital controlled the board of HomeOrganizers. That is plainly a state law issue. But the order was not a final judgment on the merits. Rather it was a statement of the likelihood of the outcome for the purposes of an ex parte decision on a temporary restraining order. If the bankruptcy court adjudicated the issue first and reached the opposite conclusion, things would have become messy.

As is often the case with uncertainty of this sort, the parties quickly reached a settlement.¹¹⁷ That agreement allowed the old managers to maintain control subject to close oversight and a tight timetable for a sale of all assets of the group in satisfaction of the debt owed to Madison Capital. In the end, the company was sold in bankruptcy (to a fund that also included management) and Madison Capital was paid the full amount owing on the loans (though it is not clear whether they collected any default penalties).¹¹⁸ The use of the selective-enforcement option here functioned to give Madison Capital leverage to achieve a strong settlement, but the legal uncertainty behind the enforceability of the web left them with less than complete victory of quick foreclosure and sale without a bankruptcy proceeding.

* * *

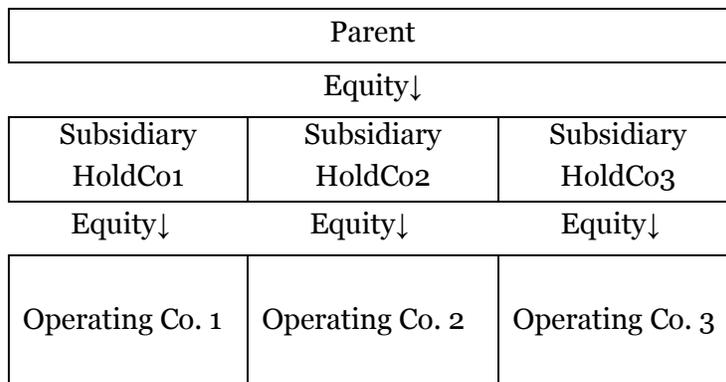
The single holding company model just described is merely the tip of the iceberg. Tailoring can create multiple levels with various iterations and options from which the primary creditor can choose. For example, the structure in Figure 5 might be used.

¹¹⁶ *In re HomeOrganizers, Inc. et al.*, Case No. 10-19762 (Bankr. C.D.Cal. 2010) docket #28.

¹¹⁷ *In re HomeOrganizers, Inc. et al.*, Case No. 10-19762 (Bankr. C.D.Cal. 2010) docket #66.

¹¹⁸ *In re HomeOrganizers, Inc. et al.*, Case No. 10-19762 (Bankr. C.D.Cal. 2010) See Jan Norman, "Closet Company emerges from Bankruptcy," Orange County Register Online Blog, available at <http://jan.blog.ocregister.com/2010/08/27/closet-company-emerges-from-bankruptcy/44113/#more-44113>.

Figure 5:



The loan proceeds would go to the three operating companies with cross guarantees, cross-default provisions, or stock pledges from all entities. Upon receiving a signal and a default trigger from Operating Co. 1, the primary creditor could choose to 1) enforce against Operating Co. 1's assets; 2) enforce against all the operating companies' assets; 3) enforce against the equity in Operating Co. 1 to take control of it; 4) enforce against the equity in all three Subsidiary Hold Co.'s to take control of the enterprise. Even further, if the default of Operating Co. 1 was a signal about Operating Co. 2 and not Operating Co. 3, the primary creditor could enforce against the assets of 1 & 2 or the equity of 1 & 2, and so on.

ii. Subordinated Primary Creditors

The implicit assumption so far has been that the major or primary creditor holding the selective-enforcement rights is not subordinated to other lenders. Thus, the primary or major creditor could be a senior secured creditor or an unsecured creditor of a debtor that has no secured debt. That need not be the case.

A primary creditor can exercise an effective option for selective-enforcement even when some other lenders have senior claims on assets of the firm. The Sunstone Hotels example mentioned in the introduction provides an example of this variation.¹¹⁹

Prior to becoming publicly traded, Sunstone Hotels had a primary secured creditor holding recourse debt that was cross-collateralized by its various hotel properties. Around 2005, Sunstone Hotels began a capital restructuring which included an initial public offering of equity and the renegotiation of its credit facilities. As part of that restructuring, Sunstone also issued public debt in the form

¹¹⁹ See sources cited *supra* note 15.

of unsecured notes that included cross-default provisions. At the same time, it began transitioning its secured debt to separate non-recourse mortgage loans on each hotel that were not cross-collateralized.¹²⁰

The result of the change was that the secured lender could only respond to a default on a project-specific basis. A payment default on one hotel allowed the secured lender to foreclose on that specific hotel but not on any of the others. This was true regardless of the fact that the same bank held the loans to each hotel. At the same time, the cross-default provisions in the unsecured bonds entitled the bondholders to call a firm-wide default anytime one hotel defaulted on a payment to any lender (including a default on the secured loans). Thus, when 10 hotels went into default in 2008 and 2009, the secured lender had a threat of foreclosure on each of those.¹²¹ But the threat stopped there. Only the bondholders could decide whether to opt for enforcing the defaults against the remaining 32 hotels. In this case, the majority of bondholders consented to an amendment that removed the threat of cross default.¹²² The bondholders' consent to amendment suggests they were of the view that management was competent and that the demise of the 10 hotels was not likely to spread.

This is all to say that the primary creditor holding the selective-enforcement option does not need to be the most senior lender in the capital structure. The factors that dictate which lender will play the role of selective enforcer at the center of the web are complicated. The likelihood that a secured lender will be over-secured on a given project, the volatility and option value associated with a given project, and the particular expertise of the available lenders all play a role. An over secured lender on a volatile project, for example, may be too quick to pull the default trigger at the expense of more junior creditors.

It is also likely that the availability of relevant market information plays a role. Thus, a senior secured lender might be the best central monitor for a privately held company where the information necessary to assess firm-wide risk has to come from compiling information gathered from active and close monitoring of all assets. For a public company with publicly traded debt, on the other hand, the securities markets provide a constant flow of information about assets. Analysts who specialize in watching the hotel industry will transfer information into price changes for publicly trade shares and bonds in real time. In those cases, the role of the secured lender in assessing firm-wide risk (as opposed to asset-specific risk) may be less important. The key now is that a centralized (potentially unsecured) authority has the power to respond to information signals from the

¹²⁰ See sources cited *supra* note 15.

¹²¹ See sources cited *supra* note 15.

¹²² See sources cited *supra* note 15

market and not that a lender has the expertise to monitor and produce those signals. Thus, one might predict that a company like Sunstone would do exactly what it did here: shift to a subordinated primary creditor structure after its equity became publicly traded.

At its core, the inquiry into why a firm might choose a specific lender as its primary or major creditor is simply an extension of the existing theory that different risk profiles demand different optimal capital structures. Finance literature has long pointed out that different types of creditor make better monitors for different types of assets.¹²³ I add only that different types of creditors also make better *primary enforcers* for different types of assets as well.

III. Implications for Law and Theory

The usefulness of a theory of tailored partitions and selective enforcement is that it provides insight into increasingly complex and varied structures to understand what motivates the agreements that form today's corporate webs and how the law should view them. In this section, I explore the implications of the foregoing analysis for some of the pressing legal questions posed by the new corporate web.¹²⁴

A. Good Faith Filing

For the selective-enforcement option to have value, it must be real. A great deal of importance, therefore, rests on the rules of good faith filing. The takeaway then is that when the primary creditor opts to enforce against one entity, the courts should keep the other entities separate. An enforcement action against affiliate A should not trigger the right of a completely stable affiliate B to file for bankruptcy. The law should not allow the junior creditors or equity holders of either entity to use the default event of A alone to justify the bankruptcy filing of B.¹²⁵ This is why the primary creditor will often prohibit other loans from having cross-default provisions.¹²⁶

¹²³ Iacobucci and Triantis, *supra* note 1 at 552-53.

¹²⁴ The implications go beyond the issues discussed here. I present here only a few of the more salient issues that where the implications can be worked through. Other issues are more complicated. For example, the entire law of substantive consolidation has arise and been analyzed without a full understanding of selective enforcement or of several other central dynamics to legal entity partitions. The complete overhaul of that doctrine merits an article dedicated solely to that task. I attempt that elsewhere. See [**Working title: A Coasean Alternative to Substantive Consolidation**].

¹²⁵ *Contrast In re General Growth Properties, Inc.*, 409 B.R. 43 (S.D.N.Y. 2009).

¹²⁶ This reasoning applies equally to the questions of enforcing voting rights triggered by equity guarantees and a creditor's ability to use those rights to prevent a spurious bankruptcy filing. See the discussion of the dispute between Madison Capital and Home-Organizers above at ___.

B. Fraudulent Transfer Law

Every cross-liability provision results in a value transfer and a risk alteration. But transfers and alteration occur with virtually every transaction a firm engages in. The prototypical transfer is a dividend. Dividends do not create value ex post. They just transfer money from the firm to equity holders. That said, dividends may add value ex ante by providing a mechanism for equity to recognize returns on their investment. This can potentially lower the cost of capital. In any event, the law plainly allows dividends. Of course, dividends can be abused. They can shift value to equity in a way that creates a value-destroying transfer and risk alteration for creditors. That risk is priced into loans.

Cross-liability provisions create a value transfer that is less likely to be abused than dividends. Indeed, most negative value pure transfers that might be created by a cross-liability provision can be manufactured more cheaply by way of a dividend. The up shot is that a prohibition on cross-liability provisions is likely to destroy value. As long as dividends are legal – and they almost certainly will continue to be – a prohibition on cross-liability provisions will not reduce the opportunistic transfers that can be achieved by dividends but it will destroy the value-creating option of selective enforcement.

To put it another way, allowing these partitions is costless in a world where we already allow dividends. It is unclear why anyone would use cross-liability provisions to transfer value when a dividend is much cheaper. The only opportunity for abuse would be if cross liabilities were allowed in some cases where other transfers such as dividends were not. The key then is to treat them the same. For the most part, fraudulent transfer law does this.

Fraudulent transfer law voids transfers made when a firm is insolvent that are not for true value. The for-value requirement is difficult to measure because there is no market information to compare. This provides the opportunity to hide a dividend or some other transfer in a mispriced premium. But this should only concern us when the firm is insolvent. When the firm is solvent, there is no need to hide a dividend. Hiding a dividend is a way to skirt the constructive fraudulent transfer law that comes into play during insolvency. Perhaps the mispriced premium could also be used to evade a covenant prohibiting dividends. But any party with the sophistication to demand such covenants should also be able to insert a covenant requiring approval of all cross-liability provisions.

All of this suggests that a court should use the insolvency rule as its main guide. It should be skeptical of the value of premiums paid during insolvency. It shouldn't care at all about premiums paid during solvency. This is essentially the current state of the law. Cases often turn entirely on the insolvency question.

If insolvency is shown, the courts place (or should place) a high burden on transferees to show that the value of the premium was paid.¹²⁷ To be clear, the official law does not create a special burden of proof on the transferee here. But I am suggesting that courts sometimes impose one – and they should.¹²⁸ This makes it costly to adopt selective-enforcement provisions when a firm is insolvent; but that is true of many bankruptcy laws. The risk of misbehavior increases as capital diminishes. The law draws a line somewhere to restrict discretion when misbehavior becomes significantly likely. The line is not perfect; but insolvency is a good measure. While there is nothing magic about the line, it is better than the alternatives.¹²⁹ It is easier to measure than other lines as long as we have a reasonable definition. So while the word means different things in different places, here we should use a technical meaning. We need a bright line rule and don't want ex post judging. The key is that the line is the same across the board. If the dividend rule were different from the cross-liability rule, that would create opportunities to structure around rules.¹³⁰

There is one additional takeaway: as we are treating cross liabilities the same as other fraudulent transfers, we need to examine the law on savings clauses. Savings clauses are common in cross-guarantee provisions. Fraudulent transfer law says that transfers not for value will be deemed fraudulent if made by an insolvent entity. The law goes further to say that if the transfer itself makes the entity insolvent, then it will also be deemed fraudulent. Thus, if a cross guarantee makes a solvent entity insolvent, the guarantee can be voided.¹³¹

To get around this, parties often include a clause that states that if the transfer renders the debtor insolvent it will be deemed to be only for the largest amount that would not render the debtor insolvent.¹³² To compare this to divi-

¹²⁷ See, e.g., *In re TOUSA*, 422 B.R. 783 (2009).

¹²⁸ *Id.*

¹²⁹ For a discussion of the role of insolvency as a bright line rule, see Vincent Buccola, *Beyond Insolvency*, 62 Kan. L. Rev. 1 (2013).

¹³⁰ The bright line metric of comparing assets to liabilities would be appropriate here.

¹³¹ See Douglas G. Baird, *One and Half Badges of Fraud*, (work-in progress, manuscript on file with the author).

¹³² Jessica D. Gabel, *The Terrible TOUSA's: Opinions Test the Patience of Corporate Lending Practice*, 27 Emory Bank. Dev. J. 415 (2011). The specific savings clause in *In re TOUSA* was typical of those used in many agreements and provided:

Each Borrower agrees if such Borrower's joint and several liability hereunder, or if any Liens securing such joint and several liability, would, but for the application of this sentence, be unenforceable under applicable law, such joint and several liability and each such Lien shall be valid and enforceable to the maximum extent that would not cause such joint and several liability or such Lien to be unenforceable under applicable law, and such joint and several liability and such Lien shall be deemed to have been automatically amended accordingly at all relevant times.

dends, imagine that the company issued several incremental dividends throughout a day. All those dividends that were paid before the insolvency materialized would be upheld; all those paid after would be voided. There is no reason to treat guarantees any differently. Savings clauses just draw the line at the exact point at which the parties have priced the ex ante risk of transfer. Again, we cannot change that price by prohibiting savings clauses. If the true purpose of the cross guarantee was to transfer wealth, a debtor could simply make a transfer dollar by dollar until it was insolvent.¹³³

Thus, savings clauses do not increase the incentives for parties to use cross guarantees as means to opportunistically transfer wealth.

The downside of prohibiting savings clauses is introducing great uncertainty and cost to the lending process.¹³⁴ Insolvency can be difficult to measure precisely and a court's measure of it can be difficult to predict with the precision that is required in a world without savings clauses. The same is true of predicting a monetary value for a guarantee that is by nature contingent.¹³⁵ Because invalidation is absolute, a mistake of one cent would change the entire cost dynamic of the deal. Prohibiting savings clauses will require parties to do extreme diligence and, more problematically, to hire expensive experts to document their analysis. This might be worth it if there was some value gained, but here these are just costs imposed. The company can issue value destroying dividends cheaply; but it cannot implement value creating-cross liabilities. Such an approach gets the rule exactly backwards.

C. Bankruptcy and Ipso Facto Clauses

Clauses triggering a cross default from one entity to another raise questions about the bankruptcy code's prohibition on enforcing ipso facto clauses. Clauses

422 B.R. 783, 863 n. 49 (2009).

¹³³ I put to the side here the possibility of proving actual fraud, which would render any transfer voidable.

¹³⁴ See George G. Triantis, *A Tussle with TOUSA: Avoiding Fraudulent Transfers in Intercorporate Guaranties*, in *Annual Review of Insolvency Law*, Janis P. Sarra, editor, Toronto: Carswell, 2009. On the other hand, Douglas Baird has suggested that the cost reductions created by a savings clause might be minimal. See Douglas G. Baird, *One and Half Badges of Fraud*, (work-in progress, manuscript on file with the author). The value or lack thereof is open for debate. The use of these provisions and the practitioners somewhat panicked response to *TOUSA* suggests that there is at least a perception of significant cost reduction that accompany the clauses. Jessica D. Gabel, *The Terrible TOUSA's: Opinions Test the Patience of Corporate Lending Practice*, 27 *Emory Bank. Dev. J.* 415 (2011).

¹³⁵ See Douglas G. Baird, *Beyond Formalism: The Reach of Fraudulent Conveyance Law*, at 14-18 (work-in progress, manuscript on file with the author); Douglas G. Baird, *One and Half Badges of Fraud*, at 8-12 (work-in progress, manuscript on file with the author).

that change the rights a creditor has against a debtor based on the debtor filing bankruptcy (“ipso facto clauses”) are prohibited in some circumstances.¹³⁶ Examples of such clauses might include a contract term that attempts to change the priority for payments to creditors if the borrower files for bankruptcy,¹³⁷ or a term that shortens or terminates the duration of the contract upon filing.

But what if a bankruptcy filing triggers a change in the rights of an affiliated but separate legal entity? Thus, the bankruptcy of affiliate A might shorten or terminate the duration of a separate agreement to which B is a party; or A’s filing might accelerate the payment or change the priority of payments on a separate loan to B. On their face, these terms would not appear to be prohibited ipso facto clauses. In theory, affiliate B need not be in bankruptcy. Where that is true, the bankruptcy court has no power over agreements between B and its creditors. The provision should, therefore, be enforceable if state law allows it.

Similarly, if affiliate B were truly a separate firm owned by an outsider, the law would certainly respect those clauses. Thus, it might be thought that such a clause was valid even when A and B are affiliates in bankruptcy together. One bankruptcy judge, James Peck, has opined on this matter three times in major cases and come to the opposite conclusion.¹³⁸ Elsewhere, I have suggested that that outcome might not be justified.¹³⁹ Looking at things with the new corporate web in mind, however, reveals further nuance to support Judge Peck’s position.

In *Charter Communications*, the secured lender wanted to invoke the bankruptcy filing of Debtor A to irreversibly accelerate hundreds of millions of dollars of debt of an otherwise solvent affiliate, Debtor B. Debtor B wanted to reinstate (and decelerate) its loan. The bankruptcy code allows for this if Debtor B can cure all defaults that were not triggered by *ipso facto* clauses.¹⁴⁰ The parties agreed that the default – Debtor A’s filing – could not be cured. The question was whether it was triggered by an ipso facto clause.¹⁴¹

¹³⁶ 11 U.S.C. §§ 365(b) & (e), 541(c), and 363(l). Some courts have held that the code provides a general prohibition on ipso facto clauses. Other courts have read the code narrowly to prohibit the clauses in specific contexts (enforcing executory contracts, defining property of the estate, and determining the trustee’s power to use that property of the estate). Compare *In re AMR*, 730 F.3d 88 (2013), with *In re W.R. Grace & Co.*, 475 B.R. 34, 154 (D. Del. 2012).

¹³⁷ See *In re Lehman Brothers Holdings Inc., et al.*, Case No. 08-13555 (Bankr. S.D.N.Y. 2008).

¹³⁸ *JPMorgan Chase Bank v. Charter Commc’ns Operating, LLC* (In re Charter Commc’ns), 419 B.R. 221 (Bankr. S.D.N.Y. 2009); *Lehman Bros. Special Fin., Inc. v. BNY Corporate Trustee Servs.* (In re Lehman Bros. Holdings Inc.), 422 B.R. 407 (Bankr. S.D.N.Y. 2010).

¹³⁹ Baird and Casey, *supra* note 3.

¹⁴⁰ 11 U.S.C. § 1124(2) (2006) (setting forth requirements for reinstatement).

¹⁴¹ *Charter Commc’ns*, 419 B.R. at 250.

Abstracting from the doctrinal dispute, it is worth noting that acceleration of affiliate debt is a sure sign that the lender has gone down the path of firm-wide enforcement. Acceleration is a way to get out of an investment and, unless it is for a trivial amount, it will always lead to a restructuring or liquidation of some sort. The lender in *Charter Communications* did not want to see Debtor B survive and continue making payments. It was calling due hundreds of millions of dollars of debt from all entities and then claiming that because of the entity partition it could avoid reinstatement on its investment. If the entities had been integrated that would have been prohibited. Lender was essentially treating the entities as integrated for all purposes other than the code's prohibition on ipso facto clauses.

This strategic positioning in *Charter Communications* counsels in favor of a finely crafted rule that protects selective enforcement without providing an opportunity for creditors and debtors to use partitions just to avoid the application of the bankruptcy code. If we absolutely respect the partition, any lender, knowing that it will always opt to enforce against the entire firm, can use cross-default triggers across entities in place of a prohibited ipso facto clause within one entity. A lender can loan to entities A and B, have each entity cross guarantee the loan of the other entity, and then include a term that changes priority or other rights in A when B files for bankruptcy (and the other way around). When A and B file bankruptcy together, this is functionally no different than having one large entity with a prohibited ipso facto clause in place. As long as the prohibition on ipso facto clauses is appropriate,¹⁴² this is troubling. The rule is avoided, and doing so creates unnecessary transaction costs – much like a tax shelter.

On the other hand, clauses that can be exercised consistent with project-specific local enforcement create real value and the law should respect them. For example, where A is a critical supplier to its affiliate B, it would be common to see a clause that changes the terms of a loan or other agreement to which B is a party upon A's bankruptcy filing. A lender might increase the interest rate on B to account for the added risk that it may lose its critical supplier. Or a counterparty to another agreement might demand additional assurances of the future performance of B's obligations. It would be appropriate to respect those clauses when affiliate B is not forced into bankruptcy with A but not enforce them when it is. Once B is in bankruptcy local enforcement is no longer an option.

The solution is therefore to prohibit the use of cross-entity ipso facto triggers as part of firm-wide enforcement but allow them when they are part of project-

¹⁴² Not everyone agrees that the prohibition is appropriate. Alan Schwartz and Yeon-Koo Che provided the first in-depth analysis of the dynamic that must play into any calculus of the value of an ipso facto prohibition and concluded that the prohibition is inefficient. See Yeon-Koo Che and Alan Schwartz, *Section 365, Mandatory Bankruptcy Rules and Inefficient Continuance*, 15 *J. Law Econ. and Org.* 441 (1999).

specific enforcement. If the primary creditor is using cross-liability provisions in a way that pushes the entire firm into bankruptcy, then we should not allow it to turn around and pretend it is acting against these entities individually. Prohibiting this particular use of the clauses still allows for selective enforcement but eliminates the use of tailored partitions to simply get around the law.¹⁴³

Such a rule need not be limited to instances where the primary creditor has turned to firm-wide action by choice. When the entities are sinking together in a way that the primary creditor cannot avoid, we are in a world where the cross guarantees are implicated and firm-wide enforcement is the de facto path. The primary creditor's option for selective enforcement only exists when one entity is still viable. Once both entities have filed for bankruptcy, the option has no value. Thus, the protection of the option is not in the enforcement of ipso facto clauses but rather in the court's determination of good faith filing.¹⁴⁴ If viable entities are prohibited from filing bankruptcy, the project-specific enforcement option is preserved and none of the ipso facto clauses governing the viable entities' obligations are subject to bankruptcy law with its prohibition on those clauses.

Judge Peck's reading of the bankruptcy code in *Charter Communications* and *Lehman* provides for this outcome. He suggests that a clause that is triggered by the filing of bankruptcy by any affiliated debtor is a prohibited ipso facto clause. This is narrower than it first appears. Because there is no state law prohibiting ipso facto clauses, any entity that has not filed for bankruptcy cannot rely on the bankruptcy code for protection. Thus, only simultaneous bankruptcies¹⁴⁵ will trigger the prohibition.¹⁴⁶

¹⁴³ This evasion is different from the tailoring discussed above and in my previous work. Tailoring to simply avoid a provision with no other reason should be viewed skeptically. *Cf. In re Integrated Telecom Express, Inc.*, 384 F.3d 108 (3rd Cir. 2004). Perhaps the tests applied to tax shelters are the same tests we might think of in this context. *See, for example, Klamath Strategic Investment Fund v. United States*, 568 F. 3d 537, 544 (5th Cir. 2009); 26 U.S.C. § 7701.

¹⁴⁴ See above at ____.

¹⁴⁵ There may be the need for further inquiry when there are close-in-time filings that are not simultaneous. How does one determine if the filings are part of one enforcement or separate subsequent events? *See In re Lehman Bros. Holdings Inc.*, 422 B.R. 407 (Bankr. S.D.N.Y. 2010) (the sequential filing of affiliates within weeks was deemed part of one singular filing event).

¹⁴⁶ Judge Peck's reading of the statute was novel. It is not uncommon, however, for the expert and pragmatic bankruptcy bench to stretch the Code's language a little to find the right outcome. Douglas G. Baird and Anthony J. Casey, *Bankruptcy Step Zero*, 2012 S. Ct. Rev. 203.

IV. Limitations on and Critiques of the Selective Enforcement Theory

A. Creditor Opportunism

The greatest danger posed by selective enforcement is creditor opportunism. An unconditional cross-guarantee of payment gives a primary creditor the option to enforce a covenant selectively against any one entity within a corporate group. The target entities need not even include the defaulting entity. This provides an ex post opportunity for primary creditors to use a hold-up threat to extract value.

There is very little in the credit agreements that protects against this. Some facilities include onerous covenants that put debtors in technical default very easily if a creditor wants to extort value. Relationships and repeat-play dynamics play a stronger role in preventing this. It is common for a primary creditor or creditor group to be headed by a relationship bank that has a history with the debtor. This provides the creditors with useful information about the loan prospects but it also provides the debtor with useful information about the likely behavior of the creditors. Additionally, the lender world is not enormous. Banks have reputations and are repeat players with particular debtors and within industries. And they compete for debtors' business. A creditor who has a reputation for being trigger-happy with defaults is not likely to be a favored candidate for a company shopping its primary debt. Nor are other creditors likely to favor that creditor's involvement as a primary creditor.¹⁴⁷ The result is that a debtor's cost of capital will likely increase if it brings on a primary creditor with a reputation for opportunistic behavior.

If anything, the banks who tend to be primary lenders with the selective-enforcement option are a check on some general creditors (such as hedge funds) who swoop in when the company is in distress.¹⁴⁸ Those funds have less need for a market reputation as they can buy into the distressed debt market without the consent of other stakeholders. The primary creditors can use the selective-enforcement option to avoid broad enforcement actions that might cause the contagious spread of distress that triggers the power among those investors.¹⁴⁹

¹⁴⁷ See Anthony J. Casey and M. Todd Henderson, *The Market Production of Corporate Control*, (work in progress) (exploring the informal banking relationships that allocate control over corporations and noting that some banks will be pushed out of an industry for opportunistic or incompetent use of covenant defaults).

¹⁴⁸ Jonathan C. Lipson, *supra* note 48 (exploring the opportunistic behavior of distressed investors).

¹⁴⁹ There is also a natural check inherent in having layers of debt held by different powerful investors. See Anthony J. Casey, *Auction Design For Claims Trading*, 22 ABI L. Rev. 133, 140 (2014) (noting that competition among multiple stakeholders with private

In cases where the restraints on primary creditor opportunism are weak, the market has an additional tool at its disposal: the covenant-light loans. Fears of lender opportunism may explain the increasing trend in the last ten years toward their use. Reducing the strength of covenants limits creditors' ability to act opportunistically but it also limits their valid enforcement options. Lenders competing to make a loan might reduce the number of covenants in an agreement to entice the debtor to borrow from them. It may be that debtors demand covenant-light loans in particular when they do not have a longstanding trust relationship with a creditor. The data on whether this is actually the case is murky.¹⁵⁰

In the end, there is no bulletproof way to avoid creditor opportunism. But given the dynamics at play – including relationship lending, opportunism among more junior creditors, reputational considerations, and the option to demand covenant-light loans – primary creditors with a selective-enforcement option are likely to do more to reduce the costs of creditor opportunism than to increase them.

B. Differentiating Motives

The claim of this article is that the puzzle of the corporate web can be explained in many cases by an analysis of tailored partitions as a means to create selective-enforcement options. I do not claim, however, that all partitions and cross liabilities are attempts to create selective-enforcement options. As I note throughout, firms face all kinds of pressures to partition assets. Tax regulations, path dependency, accounting regulations, jurisdictional rules, and the like might also be driving partitions. But these explanations cannot account for the majority of large firms that go into bankruptcy with massive corporate webs divided by legal entities and connected by cross-liability provisions. Indeed, the puzzle for academics has been coming up with an explanation for these partitions that cannot be explained by jurisdiction, tax, or other regulatory reasons. For example, one can be certain that Kodak's foreign subsidiaries were partitioned for independent reasons. But those were not the subsidiaries connected by cross guarantees who filed bankruptcy petitions together. Regardless of the foreign entities, we need an explanation for what was going on with the 16 domestic entities that filed for bankruptcy in the Southern District of New York.

One challenge all of this raises is that it may be difficult to distinguish between tailored partitions that are creating selective-enforcement options and

information and different interests can provide checks on certain types of opportunistic behavior).

¹⁵⁰ See Anthony J. Casey and M. Todd Henderson, *The Market Production of Corporate Control*, (work in progress) (collecting sources).

those that exist for other reasons. Along the way, I have suggested several characteristics (for example the presence of one major creditor to all entities) that may be indicative. But the question merits future treatment both theoretical and empirical. As the literature on entity partitioning matures, the ability to differentiate the various motivations behind those partitions will be invaluable to courts and scholars in determining the appropriate policy implications for a specific case.

We can say a little at this time about distinguishing some potential motives. Selective enforcement, withdrawal rights, and structural priority are all different things that may drive partitions. Structural priority is created whenever entities are partitioned. It is fairly easy to identify the effects of structural priority and to understand its impact on a claim. But it will rarely be clear whether structural priority is the purpose and intent behind a partition or just a known incidental effect of it. Because the intent is hard to ascertain but the effects are easy to identify, it should generally be respected. Nothing about respecting structural priority necessarily affects the value of withdrawal rights or selective enforcement. And carefully written cross-guarantees, subordination agreements, and other side agreements could actually eliminate structural priority if the relevant parties were determined to do so. There is, therefore, no obvious value in any rule that eliminates structural priority.

Withdrawal rights are more complicated. As I have developed elsewhere, they create a powerful substitute for monitoring.¹⁵¹ That substitute has value especially when there is a risk of management misbehavior or there are major obstacles to monitoring a particular asset or a particular creditor is bad at monitoring.

The key characteristics of withdrawal rights are that they go in one direction. The value does not exist when a creditor is the primary creditor on all relevant assets and those assets have been connected by cross guarantees. Moreover, when entities on both sides have withdrawal rights, the rights are more likely to be subject to abuse and to create costly confusion. Withdrawal rights should, then, be favored when they protect a peripheral creditor and run in one direction without bilateral cross guarantees.

In those cases, the separate entity should be treated like a third party. But this also means that it must have been run like one. The creditor with the withdrawal right may not be able to monitor performance but it must monitor the separateness of the entities to ensure its withdrawal right is worth something and is visible to the world. The court then can expect that when a partition is created for withdrawal-rights purposes the assets and liabilities will not be commingled and the separate books will have been meticulously kept for the withdrawable entity.

¹⁵¹ Douglas G. Baird and Anthony J. Casey, *No Exit? Withdrawal Rights and the Law of Corporate Reorganizations*, 113 Columbia L. Rev. 1 (2013).

It should also expect the creditor of that entity not to be the primary creditor of the core entity of the enterprise.

In these ways, a withdrawal partition can be differentiated from a selective-enforcement partition. On a more grand scale, this suggests that the treatments discussed above should be limited to cases where the selective-enforcement option is at play. The presence of tailored partitions by way of overlapping of cross-liability provisions will be the key in this inquiry, as will the presence of a central primary creditor, syndicate, or common group of creditors.

Conclusion

Law-and-economics literature of corporate groups has spent the last four decades dissecting the full partitions and groupings that were identified in the 1970's and puzzling over incremental changes thereto. But assets today are not simply partitioned when they are completely unrelated. And they are not always partitioned to facilitate monitoring by distinct specialized creditors.

Instead, in many cases, firms divides partially related assets in a tailored fashion to create selective-enforcement options for a central creditor. That primary creditor specializes in monitoring the enterprise as a whole. But its special expertise includes its experience in using the selective-enforcement options to maximize monitoring by calibrating ex post enforcement responses precisely to the signals that ultimately trigger enforcement.

Incidentally, the fact that these arrangements are routine in major bank lending transactions and that so much attention and organizational effort focus on them provides further evidence to support theories of senior and primary creditors as central monitors.¹⁵²

From a forward-looking perspective, this phenomenon provides valuable insight into some of the most pressing questions in bankruptcy today. While the analysis above is preliminary and must be empirically tested, further analysis of fraudulent transfers, equity guarantees and stock pledges, good faith filing, and the like should not ignore the important reality of the new corporate web.

¹⁵² Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 *Yale L.J.* 49, 56 (1982)

Appendix: Specific Provisions

A. Cross Defaults/Cross-Guarantees

A cross guarantee is a promise that one entity will pay the debts of another entity. A cross-default provision is merely a provision that says that a loan will go into default if the borrower defaults on another loan. When used across entities, a cross-default provision will cause the default of any debt of one entity to default the major loan of another.

Here are two examples of the language that might be used in a cross guarantee:

Guaranty: (a) (i) Each of the Company and each US Subsidiary Guarantor, jointly and severally, hereby absolutely, unconditionally and irrevocably guarantees the punctual payment when due, whether at scheduled maturity or on any date of a required prepayment or by acceleration, demand or otherwise, of all obligations of each other Loan Party and each other Subsidiary of the Company now or hereafter existing under or in respect of the Loan

Guarantee. Each Guarantor unconditionally guarantees, jointly with the other Guarantors and severally, as a primary obligor and not merely as a surety, the due and punctual payment and performance of the Obligations. Each Guarantor further agrees that the Obligations may be extended or renewed, in whole or in part, without notice to or further assent from it, and that it will remain bound upon its guarantee notwithstanding any

A cross-default provision may look like this:

[Defining default of the major loan to occur when any other]:

default shall occur under any Indebtedness for Borrowed Money issued, assumed or guaranteed by Holdings, the Borrower or any Subsidiary aggregating in excess of \$250,000, or under any indenture, agreement or other instrument under which the same may be issued, and such default shall continue for a period of time sufficient to permit the acceleration of the maturity of any such Indebtedness for Borrowed Money (whether or not such maturity is in fact accelerated), or any such Indebtedness for Borrowed Money shall not be paid when due (whether by demand, lapse of time, acceleration or otherwise).

Or this:

[Defining default of the major loan to occur when any other]:

(e) Cross-Default. The Borrower or any Material Subsidiary (i) fails to make any payment when due (whether by scheduled maturity, required prepayment, acceleration, demand, or otherwise) in respect of any Material Indebtedness, or (ii) fails to observe or perform any other agreement or condition relating to any Material Indebtedness, or any other event occurs, the effect of which default or other event is to cause or to permit the holder or holders of such Material Indebtedness to cause, with the giving of notice if required, such Material Indebtedness to become due prior to its stated maturity; provided, however, that an Event of Default under this Section caused by the occurrence of a default with respect to such Material Indebtedness shall be cured for purposes of this Agreement upon the party asserting such default waiving such default or upon the Borrower or such Subsidiary curing such default prior to such party exercising any remedies with respect thereto if, at the time of such waiver or such cure the Administrative Agent has not exercised any rights or remedies with respect to an Event of Default under this Section ___;

B. Cross Guarantees of Payment/Cross Guarantees of Collection

The baseline contract rule in most jurisdictions is that if the contract does not specify otherwise, lender has an absolute guarantee of payment and may enforce against either A or B first. That means when A defaults, the lender can go after B for payment without ever going after A for any payment.

The parties may, however, contract around this rule. The contract may provide that the lender cannot call a default against B without trying to collect against A first. This allows a further tailoring of enforcement. The default rule is known as a guarantee of payment where the restricted guarantee is a guarantee of collection.

Not every jurisdiction has law on point. And in any event the parties in the agreements we are discussing are sophisticated enough to almost always include precise language on which type of guarantee is being adopted. Because there is some uncertainty on the default rule, lending lawyers tend to include very precise language making it clear that the guarantee is an absolute guarantee of payment.

An example of such language might include the following:

This guaranty hereunder is a guaranty of payment and not of collection. Each Guarantor waives any right to require the Agent or any Lender to sue any Borrower or any other Guarantor, or any other Person obligated

for all or any part of the Guaranteed Obligations (each, an "Obligated Party"), or otherwise to enforce its payment against any collateral securing all or any part of the Guaranteed Obligations.

Or:

Guarantee of Payment. Each of the Guarantors further agrees that its guarantee hereunder constitutes a guarantee of payment when due and not of collection, and waives any right to require that any resort be had by the Administrative Agent or any other Secured Party to any security held for the payment of the Obligations or to any balance of any deposit account or credit on the books of the Administrative Agent or any other Secured Party in favor of any Borrower, any Account Party or any other Person.