The New Corporate Web
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Abstract
Firms often separate assets into distinct entities that have their own legal identity but are commonly owned and together form a large corporate group. When separated in this way, the assets can be financed in discrete bundles to reduce creditors monitoring and enforcement costs. The law-and-economics literature has viewed these legal partitions as either all or nothing. This view is flawed and has led the analysis of corporate groups far astray.

In reality, firms have developed sophisticated legal mechanisms to create precisely tailored partitions. The result is a complex corporate web of interconnected affiliates. For example, an asset that is placed in one legal entity can serve as collateral guaranteeing the debts of another legal entity within the corporate group. This creates a partial legal partition. The assets of the two entities are separate for some purposes but integrated for others. Conventional theories of corporate groups cannot explain the tailored partitions that create today’s corporate web. This article develops a new theory of selective enforcement to fill that gap.

When a debtor defaults on a loan, that default may signal a failure across the entire firm or it may signal a project-specific failure. Tailored partitions provide creditors with a valuable option that allows them to choose between project-specific and firm-wide enforcement depending on the information signal that is provided. In this way, firm-wide risks and failures can be addressed globally while the effects of project-specific risks and failures can be locally contained when necessary.

The concepts of selective enforcement and tailored partitions reveal important implications for legal theory and practice. In addition to providing a cohesive justification for the web of entity partitioning and cross liabilities that characterize much of corporate structure today, the analysis also informs how bankruptcy courts approach a wide range of legal and policy questions from holding company guarantees and fraudulent transfers to substantive consolidation and ipso facto clauses. Outside of bankruptcy, it has implications for defining the contours of fiduciary duties and the default governance rules that apply to the increasing number of different legal entities that define today’s corporate and business structures.
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Scholars have long understood the basic drivers behind corporate groups. Well-developed theories explain the various reasons that an economic enterprise might be divided into many distinct legal entities. 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 eluded scholars. This article begins to develop that theory by introducing the new concepts of tailored partitions and selective enforcement.

Firms separate assets into different legal entities to create value. Legal scholarship on corporate groups has identified various sources of that value. These range from risk partitioning and exit rights to regulatory compliance and tax payments. The value can be captured by placing assets into discrete legal entities with hard boundaries. Common across this scholarship is the unexamined assumption that

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2 Throughout this article, I use the term “firm” in a Coasean sense to indicate an economic enterprise under common control of an entrepreneur. 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”). For simplicity, I use the word to indicate any set of projects or assets that have a common entrepreneur at the top of the hierarchy. Legal entities, on the other hand, are artificial boundaries that define liabilities and claims of or against assets within the firm. Critical to this article is that fact that firms are divided up into legal entities. This distinction was explored and developed by Ed Iacobucci and George Triantis. See Edward M. Iacobucci & George G. Triantis, Economic and Legal Boundaries of Firms, 93 Va. L. Rev. 515, 518–19 (2007) (defining differences between legal and economic theories of firm boundaries).
legal partitions are a binary all-or-nothing choice.\textsuperscript{3} This assumption is unrealistic and has significantly muddied the theoretical waters.

Firms are not faced with the stark choice to partition or not to partition. While legal entities create a meaningful partition, contractual mechanisms can be used to tailor the impact and degree of the partition to create a precise firm structure. Indeed, lawyers create these tailored partitions everyday by combining the use of legal entities with contractual provisions – such as cross guarantees and cross defaults – that create a web of cross liabilities between commonly owned but legally partitioned entities. These tailored partitions create value by allowing the debtor and its creditors to achieve a balance between specialized and general enforcement. Where two projects are partially but not fully related – say with a luxury hotel and a budget hotel – the partitions can be tailored to allow the common risks and failures to be dealt with collectively while containing enforcement of the independent risks and failures.

Recognizing this option changes the analysis of corporate groups. Under conventional models, creditors with no specialized expertise can loan to and monitor the firm as a whole while creditors with expertise can focus on particular projects. This assumes different creditors will specialize in monitoring different projects.\textsuperscript{4} Theories of tailored partitions and selective enforcement, on the other hand, can explain the increasingly common structure where a single


sophisticated creditor\(^5\) has the expertise to both monitor the firm as a whole and to monitor the various projects individually. With tailored partitions, that creditor can loan to each partitioned entity while creating cross-liability provisions. When one entity defaults, the creditor then possesses a valuable selective enforcement option. The creditor can call a firm-wide default or it can selectively waive or ignore some defaults while taking action on others. This allows the creditor to focus remedial action on a specific project.\(^6\)

Thus, in the budget- and luxury-hotels example, imagine that when one hotel defaults it sends the sophisticated creditor one of two signals: 1) managers are generally incompetent and the problems will spread to the entire firm; 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 losses. The second option is valuable because it reduces the significant collateral effects that acting on project-specific signals may have on other projects. These affects are especially high when equity or junior creditors will attempt to gain value through

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\(^5\) Throughout much this article I focus on the dynamic enforcement option available to a single creditor. That is, the same creditor is a lender to both assets and has contracted for cross-liability provisions. It is easiest to demonstrate the value creating course of action that way. The selective enforcement option only creates such value if either 1) creditors actually do consolidate their positions this way in the corporate web or 2) dividing the positions between creditors does not create friction that distorts incentives and destroys the value. I discuss the frictions that may be introduced by multiple creditors below at ____. If those frictions are high enough, we should expect to see creditors consolidating their positions. We do see this. But the exact magnitude merits further empirical examination.

\(^6\) Exactly how selective the creditor’s actions can be will turn on the precise tailoring and design of the partition. I discuss the commonly used designs below at __.
hold up. 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.\(^7\)

The failure to recognize this reality has introduced academic puzzles and complexity that need not and do not exist in the real world. The primary (though certainly not the only) false puzzle stems from a view that corporations undo the effects of entity partitioning by causing affiliated legal entities to agree to cross-liability provisions. Viewing partitions and the cross liabilities as all-or-nothing, scholars have puzzled at why a corporation would partition an entity just to re-integrate it at the next moment. Why create this corporate web when the firm could either partition or not partition?\(^8\)

The concepts of tailored partitions and selective enforcement show that there is no riddle. The question only exists because of the unrealistic assumptions of all-or-nothing partitioning. Once that assumption is relaxed, the answers to this and other questions emerge and reveal major implications for laws of finance and bankruptcy.

In the following sections, I show how tailored partitions can be accomplished and demonstrate that they allow firms to create value by selecting among different enforcement options. This allows a finely calibrated capital structure that reduces the cost of credit. I then discuss the implications this has on our understanding of the laws of finance and capital structure.

**I. Assets, Risk, and Partitions**

In proceeding to show how the all-or-nothing assumption about partitioning has misled scholarship, I focus primarily on the concept

\(^7\) Intuitively, one might think that the second option could be achieved by security interests. But in a world with multiple creditors this will not be the case. See below ____.

of risk partitioning. The separation of unrelated risks is the most commonly identified goal of entity partitions in academic literature. But there are other motivations for partitioning such as creating exit rights,\textsuperscript{9} limiting liability,\textsuperscript{10} and complying with regulations. As I discuss below, for all of these, tailored partitioning allows the firm to choose a precise enforcement option that maximizes the benefit of the partitions while minimizing its cost. But for now I focus on risk partitions.

As a preliminary matter, it is worth noting — as it will come up later — that in the existing literature the ideas of enforcement and monitoring are often conflated. The term monitoring often assumes the ability to enforce. For purposes of the theories presented here, however, it is necessary to separate the two. It is the specific enforcement rights that drive the tailored partitions. I will use the term monitoring to refer to oversight to detect signals of value loss. I will use the term enforcement to refer to action taken in response to those signals.

The risk justification for asset partitions is straightforward. A firm with two unrelated assets will separate them to unbundle the risk. A firm with related assets will keep them together in one legal entity. Choosing the right structure reduces the cost of credit.

Thus, related assets will be integrated to create value. Two oil refineries in Texas can be monitored by one creditor with expertise in the region and the industry.\textsuperscript{11} Some have suggested this creates

\begin{footnotesize}

\textsuperscript{10} See, \textit{e.g.}, Tronox Worldwide LLC v. Anadarko Petroleum Corporation, 450 Bankr. 432 (Bankr. S. D. N. Y. 2011).

economies of scale for monitoring. The point is far from obvious. Separate legal entities can be ignored by a monitor if they want to create the economies that are associated with integration. This is commonplace. On the other hand, there are administrative savings from integration. Full integration will reduce administrative and management costs of maintaining separate legal entities. Likewise writing one loan document is less expensive than two. Separately, there are economies of enforcement. It is cheaper to conduct one rather than two enforcement actions such as a foreclosure or bankruptcy proceeding. And enforcement options could be restricted to only one project if the projects are not integrated.

On the other hand, integrated assets with unrelated risk make optimal capital structure difficult when asset-specific financing is called for. An oil refinery in Texas and a hotel in New York will be more costly to finance if they are placed in one legal entity. Though the literature focuses on 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 as if there was a partition. But the creditor has little incentive to do that when all enforcement measures will bleed across assets. Thus, reduced enforcement options reduce the incentives for effective monitoring without increasing the direct costs of monitoring.


12 See below at __


14 See, Edward M. Iacobucci & George G. Triantis, *Economic and Legal Boundaries of Firms*, 93 Va. L. Rev. 515 (2007). This is true even with secured lending. See below at__.

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Asset-specific enforcement is difficult within one legal entity because all creditors are subject to the different risks created by each asset. A creditor who specializes in monitoring the oil refinery has to enforce against the firm as a whole when it receives a signal. Likewise, a creditor monitoring the hotel may miss a signal from the oil refinery that affects the value of its loan.

The result is that the integrated firm has a blended capital structure that compromises asset-specific financing. The failure of any one asset will be borne across the entire firm. Creditors must enforce (and, therefore, monitor) risk in both the energy and travel industries or charge a premium for assuming a risk they cannot monitor effectively.\(^\text{15}\)

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.\(^\text{16}\) For example, riskier projects are less likely to be financed with public debt. Likewise, unproven management may need to adopt a structure

\(^{15}\) Enforcement cannot be contained to the creditors monitoring the risky assets. Iacobucci and Triantis develop this point. They also develop the important point that security interests fail to achieve the partitioning necessary to fully unblend the capital structure. Edward M. Iacobucci & George G. Triantis, *Economic and Legal Boundaries of Firms*, 93 Va. L. Rev. 515 (2007). See below at __. The same risk-containment problem exists when both assets are risky but uncorrelated and the monitoring expertise lies with different lenders. Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 Yale L.J. (2000); Henry Hansmann & Reinier Kraakman, *Organizational Law as Asset Partitioning*, 44 Eur. Econ. Rev. 807 (2000); Richard Squire, *Strategic Liability in the Corporate Group*, 78 U. Chi. L. Rev. 605 (2011).

\(^{16}\) “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.” Edward M. Iacobucci & George G. Triantis, *Economic and Legal Boundaries of Firms*, 93 Va. L. Rev. 515, 552-53 (2007).
that includes expert monitors with security interests.\textsuperscript{17} A blended capital structure prevents tailoring in this way. Additionally, managers can more easily cross-subsidize between the projects to serve private interests and all firms will pay for this opportunity (in a higher cost of credit) to divert value unless they can credibly commit not to take advantage of it.\textsuperscript{18}

Because partitioning is assumed to be binary, the model is simpler to understand if one assumes, as most legal scholars do, that the assets are either completely related or not related at all.\textsuperscript{19} This assumption does, indeed, make the point salient and the models elegant. Related assets can be monitored as a group. Unrelated assets can be monitored in separate legal entities by separate creditors. But when the relationship between assets is not all or nothing, the optimal partition will not be all or nothing either. And often partitions will be used even when there is a single creditor monitoring all projects. This is where tailored partitions and the corporate web come into the picture. Rather than thinking about hotels and refineries, analysis should look at 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 an 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 economic downturn. By combining legal entities with cross liabilities, the capital structure creates the option for the creditor to choose the optimal enforcement action in light of the signal received.

Lending lawyers create these tailored partitions everyday. And they do it with cross-guarantees, cross-defaults, covenants and the like.

In the next section, I present a model capital structure to show the mechanism and benefits of a tailored partition and selective enforcement.

**II. Tailored Partitions and Selective Enforcement**

To summarize what is to come, the demonstrative model for tailored partitions will include two assets whose performance will be closely but not completely correlated. Creditors of these assets will face a dynamic enforcement project. Some aspects of management and risk can be monitored jointly. And some information that is produced from monitoring efforts will pertain to the entire firm. It 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 the single asset.

To demonstrate this, I present an example with two assets: 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. The simple point about tailored partitions and selective enforcement can be made by assuming that each quarter a single 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 global incompetence that will spread to the management of other assets, the creditor will want to react by calling a default that can be enforced against both hotels. For signal 3, on the other hand, the creditor will want to contain the default and enforcement to allow it to take enforcement action against the luxury hotel while allowing business on the budget hotel to continue as normal.

The following sections will build up the firm and its capital structure starting with a single asset and a single lender. I will look at 1) a firm with perfectly correlated risks and operational characteristics to demonstrate the value of a legal integration; 2) a firm with perfectly independent risks and characteristics to demonstrate the value of a legal partition; and 3) a firm with partial correlation and partially related characteristics to demonstrate the value of tailored partitions and selective enforcement. But first the foundational set up.

A. The setup.

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 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 track record in the luxury hotel business and banks have lined up to lend to HotelCo.

20 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 dynamic enforcement that I discuss in this section applies equally across these various enforcement options.
We will start with a single-lender structure (which, for now, makes it unnecessary to discuss security interests and priority). HotelCo borrows $1 billion from Bank to finance the project. Bank has long been in the business of financing hotels and offices in Chicago.

The hotel, LuxuryOne is up and running and Entrepreneur is easily making payments to Bank.

As is often the case, the success of one project leads to another. Entrepreneur decides to expand. Entrepreneur 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.

**B. Option 1: Perfect (or High) correlation and integration**

Because option 1 is the conventional case of perfectly (or near perfect) 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 collateral\(^{21}\) for the entire loan. The fact that these are separate hotels contained in one corporate entity is

\(^{21}\) Though I start with one major unsecured creditor and discuss security interests below, the term collateral is still appropriate 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 foreclosure and bankruptcy. Assuming only one major creditor, the unsecured nature of the loan does not significantly alter the availability of these enforcement rights. Additional transaction costs may be incurred in getting the lien judgment, but the real difference is not in enforcement but rather in priority of payment. The secured creditor will be paid first and will reduce the risk of having its claim diluted by subsequent creditors. Those benefits of a security interest are well explored elsewhere.
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 default and take over both hotels. Similarly, Bank has its thumb on the pulse of the 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 of both hotels.\textsuperscript{22} Here we start with the extreme assumption that their long run performance is perfectly correlated. There will be no failure at one property without failure at another.

Neither Bank nor Entrepreneur wants to create a separate 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 completely unnecessary. With the two hotels integrated into HotelCo, she can have one loan agreement, one management team, one tax return, one payroll, and so on. Similarly, she can enter into common contracts more easily. And in the event of a major corporate event, the company can be sold as a unit avoiding the renegotiation of various contracts.\textsuperscript{23}

\begin{itemize}
\item \textsuperscript{23} None of these benefits are absolute. There may be times when legal partitioning is valuable because it eliminates the ability to commonly contract. Thus, legally partitioning may be valuable precisely because it breaks up the firm’s contracts into isolated (and assignable) bundles. See Kenneth Ayotte & Henry Hansmann, \textit{Legal Entities as Transferable Bundles of Contracts}, (2012).
\end{itemize}
Beyond eliminating these administrative transaction costs, the benefits of integration are largely under theorized. Scholarship has primarily accepted integration as the status quo and focused on justifying deviations from there. In passing, the idea of information economies has been suggested as a primary value of integration. But the existence of those economies is not obvious.

Bank has likely achieved economies of scale in information by lending to hotels throughout the city. 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? But regardless of the source of that information, the corporate structure of LuxuryOne and

$^{24}$ 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. That will be part of its cost savings analysis.
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. Similarly, looking at just LuxuryOne and LuxuryTwo, with identical risks and operational characteristics, Bank need only assess Entrepreneur’s competence once.\textsuperscript{25}

Bank may get additional general information about the hotel industry (and thus LuxuryTwo) from monitoring LuxuryOne. But again that information is available regardless of the partition.

Counterintuitively, some have suggested that real information economies from integration are created not when assets are similar but when they are uncorrelated and the investor is seeking diversification.\textsuperscript{26} This suggestion is unpersuasive. These economies result simply from reducing the relatively small transaction costs of documenting two investments rather than one. Any further assumption that legal integration reduces monitoring costs is flawed. Integration would tend to blend information about the unrelated assets. This could be prohibited by a covenant; but the integration will at best be the same as with separate entities. 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 creditor. Most empirical work suggests the opposite.\textsuperscript{27} And in any event, that expertise is not changed by a legal

\textsuperscript{25} 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 the boards could be identical.

\textsuperscript{26} This is not the same as saying that conglomerates create value. Here the question is whether the conglomerate is legally integrated or partitioned. Edward M. Iacobucci & George G. Triantis, \textit{Economic and Legal Boundaries of Firms}, 93 Va. L. Rev. 515 (2007).

partition. Again, it exists regardless of the corporate structure as long as the manager is at the top of the hierarchy. The only cost benefit of integration is the reduced administrative costs in maintaining fewer legal entities.\textsuperscript{28}

Buried in and implicitly conflated with the idea of information economies is a major driver of real value that integration provides for creditors: economies of enforcement. Monitoring and information economies do not require integration but enforcement economies do. Because the assets are perfectly correlated, Bank knows that any sign of distress at either hotel indicates distress at the other as well. But the defaults that allows Bank to act on these signals may not occur simultaneously. This may be because Bank has taken advantage of monitoring efficiencies involved in lending to related projects (for example, by doing inspections on only one property). It may have observed and documented a default in monitoring of one project and it will be costly or time-consuming to document the same default on the other project.

Alternatively, default triggers may simply materialize at different times.\textsuperscript{29} Bank, therefore, does better when the assets are integrated in

\textsuperscript{28} Another argument for integration may be that it provides deeper protection for a creditor. For example, creditor loans 100 to project A and 100 to project B. If A loses 10 and B gains 10, enforcement against integrated firms leaves creditor whole. Enforcement against separate legal entities, on the other hand, leaves lender down 10. Finance theory tells us this is not a convincing justification for integration. After all, the gain in reduced risk to creditor will be shifted to equity. The cost of capital will remain constant. Franco Modigliani & Merton H. Miller, \textit{The Cost of Capital, Corporation Finance and the Theory of Investment}, 48 Am. Econ. Rev. 261 (1958). Put another way, lender could achieve the exact same expected outcome by loaning to separate entities and then hedging with an investment in equity. \textit{Id}.\textsuperscript{29}

\textsuperscript{29} This is assumed here. It will certainly be true as we relax the assumption of perfect correlation to high correlation. For example, nearly identical projects may experience shocks at different time. A small problem may become apparent at a smaller hotel first even if it is ultimately going to affect both the large and small hotel.
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. Default triggers an investigation. If things turn out to be okay, Bank will often waive the default. If the investigation shows problems, the bank will take action. Bank may waive default in exchange for renegotiated terms or (in the extreme case) call a default and accelerate its debt. Other times the defaults are simply technical violations that allow Bank to act on other non-default signals. Bank may have received a non-default signal and is waiting for a default to act.

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 it needs to wait only until a default occurs with regards to one of the projects. That default allows Bank to exercise its rights globally as to both projects. If, on the other hand, LuxuryOne and LuxuryTwo were partitioned into separate legal entities without cross liabilities, Bank would have to wait for two defaults to exercise full control. LuxuryOne, Inc. might default first making it clear to Bank that it needs to call 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 correlation, waiting for LuxuryTwo, Inc., to default before taking action will force Bank to sit on the sidelines knowing that assets are wasting away. Moreover,


31 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 default makes it risky for creditor to rely on these options alone.

32 I add the “Inc.” to denote when I am referring to the project in its legally partitioned formed. Of course, LLC or some other form might be chosen.
the delay gives management time to take costly gambles with LuxuryTwo during the waiting period. Those gambles will often have negative expected total returns but positive expected private returns to management.\textsuperscript{33} Bank will, therefore, not want LuxuryOne and LuxuryTwo to be partitioned.

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 on one can trigger enforcement rights on both.

Still, when assets are perfectly correlated, there is no enforcement difference between integration and partition with cross liability. And so there is no reason to incur even minimal additional administrative costs of partitioning assets and the transaction costs of negotiating cross-liability provisions. Additionally, the current state of the law makes the enforceability of cross-liability provisions far less than certain. Therefore, without a concrete reason, no one would use partitions plus cross liabilities when integration could accomplish the same thing.

Sometimes, however, partitioning may be required by unavoidable reasons that are unrelated to risk.\textsuperscript{34} For example, a firms doing business in multiple jurisdictions might create separate legal entities to ease compliance with different regulations and tax

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\textsuperscript{33} Jensen, M., and W. Meckling. \textit{Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure}, 3 J. of Fin. Econ. 305 (1976). Management will want to use the integration ex ante to commit to not making these gambles. That commitment will lower its cost of credit. In the absence of an ability to signal type, the commitment is valuable. Alan Schwartz, \textit{Priorities and Priority in Bankruptcy}, 82 Cornell L. Rev. 5201 (1998).

\textsuperscript{34} These may include tax or accounting compliance, jurisdiction rules, or path dependency.
\end{flushright}
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 (and do) see firms combining partitions 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 impacts of the artificial regulation-driven legal partition. The result is a legal partition for regulatory or other purposes with an economic re-integration. As long as the re-integration is not frustrating some other valuable end such as the regulators goal, the cross-liability provision should be viewed favorably. The focus of the remainder of this Part is on more nuanced motivations.

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

**C. Option 2: No Correlation and the benefits of partitions**

35 See Kenneth Ayotte & Henry Hansmann, Legal Entities as Transferable Bundles of Contracts, (2012).

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

37 This point raises questions about proposals for using high risk correlation as a trigger for invalidating cross-liability provisions. Richard Squire, Strategic Liability in the Corporate Group, 78 U. Chi. L. Rev. 605 (2011).
Here, Bank is asked to finance a hotel and an oil refinery. Again this case tracks the conventional literature. 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 the second project be partitioned into a second legal entity.  

Figure 2: Partitions

Bank has an expertise in monitoring luxury hotels. If a refinery is built, financed by another creditor, and housed 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

38 See above at __
alteration. Almost certainly Bank will have a covenant prohibiting HotelCo from undertaking this project without its blessing, which will not be forthcoming. And HotelCo would be foolish not to agree to that covenant as it only gets the best interest rate when it does so.

By partitioning the assets, Entrepreneur can go to a different lender who specializes in oil refineries to get a loan. This lender wants nothing to do with the hotel business. Neither creditor worries about the other project. These benefits of the asset partition have been well explored. With a partition, if OilCo fails, it will have no effect on HotelCo. Bank can focus on monitoring the hotel industry and the lender to OilCo 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. And so it should be surprising if we saw cross-liability provisions adopted in this case.39

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 circumvent the limits that external capital markets have placed on one of the projects.40 The third item in that list is the most concerning.

Incompetent subsidies destroy value. But any transfer or transaction may be the result of incompetence. Rarely does the law provide a mechanism to second guess transactions based on


40 See Edward M. Iacobucci & George G. Triantis, Economic and Legal Boundaries of Firms, 93 Va. L. Rev. 515 (2007);
incompetence alone.\textsuperscript{41} Risk alteration is potentially costly because creditors loan to an entity based on its assets, and the expected risk and return of future projects with 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, it has just changed the risk profile of its business. This doesn’t change the 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 risk alteration is, therefore, priced into every loan.

If A does not receive a premium payment for those liabilities, then A has just transferred to B the market value of that risk reduction. The lenders to A are now protected by a smaller set of assets.\textsuperscript{42} This is the equivalent of a dividend or giving away cash. The law plainly allows those transfers. Again, the risk of such transactions is priced into every loan.\textsuperscript{43}

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

\textsuperscript{41} For example, the business judgment rule in Delaware protects normal incompetence and requires something higher for liability.


\textsuperscript{43} In other circumstances, where the cross liabilities are value creating we might want to allow this value transfer because it significantly reduces transaction costs.
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 value destroying, courts should be especially skeptical in cases where cross liabilities are incurred between entities with uncorrelated risk. Fraudulent transfer law should be relatively strong here.\(^{44}\) Because there is no value creating justification, prohibiting these transactions might be favored. This suggests a justification for the importance the law of fraudulent transfer places on the “for value” requirement. If a market premium is paid for the cross liability then there is no value transfer from one entity to the other and OilCo has not circumvented the costs of external markets because it paid the market price to HotelCo.\(^{45}\)

In any event, a market premium is not likely to have been paid. HotelCo is rarely going to be the lowest cost lender to OilCo. A guaranty from HotelCo to OilCo would be unnecessarily costly. Imagine that the finance market would charge OilCo $100 for a loan guaranty from Lender. Lender, the guarantor, is liquid and has expertise in monitoring refineries. The same guaranty from HotelCo should costs more (say $110). This is because HotelCo has a higher cost of capital than Lender and is not an effective monitor. The differential will materialize as an increase in the capital cost of HotelCo. Now that it is on the hook for OilCo’s debts and it and its creditors cannot efficiently monitor OilCo’s operations, HotelCo’s creditors will charge a higher interest rate to the tune of $110. In our

\(^{44}\) One might even go as far as viewing cross guarantees with a complete lack of correlation as a badge of fraud that could substitute for insolvency.

\(^{45}\) The risk alteration problem still exits. Therefore, there is a transfer of value from creditors to shareholders. But, as noted elsewhere, that is an unavoidable costs of our financial system and is always priced into a transaction.
example then either HotelCo or OilCo loses out. Either OilCo pays $110 for a guaranty that it could have received for $100. Or OilCo pays $100 to HotelCo and HotelCo incurs an increased cost of capital of $110. Either way, Entrepreneur’s enterprise is out $10. If a market premium was paid, that is likely to be a sign of incompetence or of opportunistic risk alteration. The law is therefore wise to place a heavy burden on OilCo to show that it paid market value for the guaranty when the guaranty results in a loss to HotelCo’s creditors. Indeed, we might prefer a presumptive invalidity of cross guarantees regardless of solvency when correlation is especially low. The one caveat is that it may be hard for a court to create a clear metric for measuring correlation.

Finally, there is one scenario where cross-liabilities of this sort will 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 but cannot convince any lender of the accuracy of that information. In that case, if HotelCo is sitting on uninvested cash or available credit it might be the case that the best investment is the one it has inside information about. These cases should be rare and the law might place a high burden on OilCo to show that HotelCo had valuable private information – which is the same as a high burden of proving that full value was paid.

D. 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. As suggested the lending officer at Bank is perplexed by this option if she relies solely on existing legal scholarship. The risks facing a luxury hotel on the lake shore and an economy hotel near the airport are correlated across some dimensions but quite distinct across others. Much of the
existing theories 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 do with the second best. The costs of partitioning must be borne if they are less than the costs of integration and vice versa.

But this ignores the various 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 signals 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 impact LuxuryOne without impacting 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 night clubs might not have the same value at both hotels.

I focus on Entrepreneur’s management skills. Assume that Bank still has the expertise that it takes to monitor both projects. This is

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46 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.
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. While a company may be sloppy in separating there assets, it cannot be sloppy if a bank demands books under a covenant. 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. In other cases, the firm will look for a default to act on an unrelated signal. I begin with the first scenario.

As a starting point, Bank’s ability to demand that it get accurate separate books and records for each project is a weak argument in favor of partitioning. Under certain circumstances, Entrepreneur may have an incentive to obscure signals about her incompetence on a given project. Moving assets from one project to another may accomplish this smokescreen. Entrepreneur will covenant not to do this under either structure, but it will be (at least marginally) easier to do it under one entity. The relative ease comes in defending against

47 Michael R. Roberts & Amir Sufi, *Control Rights and Capital Structure: An Empirical Investigation*, 64 J. Fin. 1657, (2009). That is to say not to say that banks always demand separate books and records. They do not. There may be better (more cost-effective) signals from another monitoring activity.

48 Signal 1 will never trigger a default.

49 Edward M. Iacobucci & George G. Triantis, *Economic and Legal Boundaries of Firms*, 93 Va. L. Rev. 515 (2007); Adam C. Kolasinski,
claims of fraud. Funds that become commingled within an entity will likely be easier to defend ex post as mere incompetence rather than outright fraud. The incompetence argument can be made even when funds are smuggled across legal boundaries; but there will be more hoops that will need to be intentionally jumped through in the partitioned world. For example, moving money from HotelCo’s account one to HotelCo’s account two may be viewed differently than moving money from LuxuryOne, Inc.’s account to EconoRoom, Inc.’s account.

Still, I label this weak support. The hoops implicit in a partition can be created (at least roughly) by contract as well. Partitions may be bundles of contract provisions requiring exact asset accounting, but a contract could be written (perhaps at some administrative expense) to approximate that bundle. Thus, entity partitioning that is created to deter criminal fraud will likely miss the mark. In most cases, it will be superfluous of covenants. And in the cases where fraud is occurring, it is not at all clear that the extra hoops will deter someone who has already accepted the more significant expected costs of 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 from the reports. If it receives signal 1 from both projects, it does nothing. It does not matter how the partitions are structured. If it receives signal 2 from both projects, it enforces against both projects. The partition structure might matter, but not in most cases.

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. Signal two tells it about EconoRoom as much as about LuxuryOne and the maximizing response is to call its loans before the

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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 defaults. Bank cannot preemptively intervene the way it could if the entities were integrated. In the meantime, EconoRoom may be depreciating in value and management and equity will have increased 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. This essentially captures the world where Entrepreneur has proved to be a successful manager of luxury hotels but an incompetent manager of budget lodgings. Here, Bank wants to enforce only against EconoRoom and leave entrepreneur to run LuxuryOne.

The facts as we have assumed them to this point might allow Bank to do this in a world of no partitioning. This is where other creditors come into the picture. Few firms have one creditor.\(^5\) Multiple creditors complicate the world of no partitioning. If Bank is unsecured and wants to take action against the EconoRoom project, it cannot do so if the projects are commonly owned. Any enforcement action by an unsecured creditor will be against the legal entity as a

\(^5\) 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 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 & Anthony J. Casey, No Exit? Withdrawal Rights and the Law of Corporate Reorganizations, 113 Columbia L. Rev. 1 (2013).
whole.\textsuperscript{51} If Bank pushes HotelCo into bankruptcy, the entire entity is brought in. This raises numerous problems for Bank. Bank wants LuxuryOne to continue to operate but wants to liquidate EconoRoom. If Bank’s enforcement efforts lead to bankruptcy, Entrepreneur has exclusive control of the decision to file and of the plan. She may be able to use that power to extract value from Bank. Even worse, the other junior creditors of HotelCo can become obstacles to the restructuring. Similarly, 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, junior creditors or other parties who do business exclusively with LuxuryOne may now have bankruptcy objections or strategic hold up 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. The junior creditors of EconoRoom can try to extract value from Bank, but their actions will be limited to EconoRoom. The legal partition facilitates this. At the foundation, this is nothing more than a restatement of the traditional justification for partitioning risk. The crucial point is that this justification also exists with partial correlation, and can be satisfied by tailored partitions.

Additionally, Bank may wish to enforce its rights without dealing with a bankruptcy. But 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 senior creditor may accelerate a loan and sweep all cash collateral. This lack of liquidity will cause breaches throughout the debtor’s business. In

this way Bank’s action in response to the failure of EconoRoom provides other creditors the possibility of pushing HotelCo into default and bankruptcy. This can impose costs on Bank who must either limit its enforcement options or allow other creditors to get involved and potentially extract value from it.

The problems are different but just as significant when Bank is a secured creditor. Bank may view its security interest in EconoRoom as a 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 agreement as well. Any one of the creditors\textsuperscript{52} 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 creditors\textsuperscript{53} can then use the procedural levers of bankruptcy to extract value from Bank.

When Bank threatens foreclosure of EconoRoom, Entrepreneur (or a junior creditor) may suggest that it will take (or push) HotelCo into bankruptcy.\textsuperscript{54} A game of chicken ensues. Bankruptcy may reduce the value of LuxuryOne for all involved or it may simply impose transactions costs on Bank. With this threat Entrepreneur may be able to extract value from Bank when it threatens foreclosure on EconoRoom.

\textsuperscript{52} Technically the code will require three creditors, but that is rarely a meaningful obstacle.

\textsuperscript{53} I am assuming that management is included with the Entrepreneur.

\textsuperscript{54} Bankruptcy creates all kinds of opportunity for strategic maneuvering. For example the termination of derivative accounts could destroy value and liquidity. See Kenneth Ayotte & David A. Skeel, \textit{Bankruptcy Law as a Liquidity Provider}, (forthcoming, 2013) for more on liquidity and how bankruptcy might resolve hold up based on liquidity problems in bankruptcy.
These strategic maneuvers are fewer when the entities are legally partitioned. When bank threatens to enforce against EconoRoom to liquidate or take over, the best Entrepreneur or junior creditors can do is threaten a bankruptcy vis-à-vis EconoRoom. 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.

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. 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.

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 file bankruptcy not assets. Thus, the only way to sell EconoRoom free and clear is to take HotelCo with LuxuryOne along for the ride into bankruptcy. Again the various procedural hold-up maneuvers and costs of bankruptcy emerge. Partitioning allows Bank to avoid that problem.

Creditors may also wish to limit their enforcement actions to 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.


Finally, bankruptcy is much simpler when the assets are more confined. In the extreme there are the streamlined single asset bankruptcies.

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

Figure 3: Tailored Partitions
All of this allows precise ex post a balancing. 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 one creditor has the option for tailored enforcement. If many creditors had cross-liability provisions, any project-specific default would trigger hold-up opportunities and the selective-enforcement option would be worthless. Not surprisingly, major creditors often prohibit the debtor from including cross-liability provisions in loans or agreements with other creditors or they restrict those provisions to immaterial loans.

E. A further aside about security interests

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 dynamic enforcement benefits of tailored partitioning.

Cross-liability provisions in security agreements can trigger global enforcement rights. A default on payment of a loan secured by LuxuryOne can certainly create a default on a separate loan secured by EconoRoom if the loan agreement 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 Banks ability to contain its enforcement action to just one asset.

As Triantis and Iacobucci pointed out, the true value of a legal partition can be traced largely to the “legal personality” of the corporate entity. The key is that enforcement actions are taken

against legal persons. 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.\textsuperscript{58}

Thus, a security interest in LuxuryOne creates specific priority rights in that asset. But any legal action other than foreclosure will be taken against\textsuperscript{59} 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. Thus, in a structure with security interests but no legal partitions, any bankruptcy involving LuxuryOne will by necessity involve EconoRoom.\textsuperscript{60} 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 – even those who are secured by EconoRoom. For example, if Bank forecloses and sells LuxuryOne, any other 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 the one that provides tailoring across all remedies.

\textbf{III. Selective Enforcement in Action and the Implications for Practice}

The usefulness of a theory of tailored partitions and selective enforcement is that it can be applied to increasingly complex and

\textsuperscript{58} Edward M. Iacobucci & George G. Triantis, \textit{Economic and Legal Boundaries of Firms}, 93 Va. L. Rev. 515 (2007) (“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.”)

\textsuperscript{59} See above.

\textsuperscript{60} Edward M. Iacobucci & George G. Triantis, \textit{Economic and Legal Boundaries of Firms}, 93 Va. L. Rev. 515, 533-34 (2007).
varied to understand what motivates the agreements that form today’s corporate webs and how the law should view them.

**A. Cross Guarantees and Cross Defaults differentiated**

The above analysis has assumed the cross-liability provision as a straightforward cross guaranty. Notably, virtually every-cross guaranty provision will have a cross-default provision accompanying it. This may be explicit in the loan agreement. The agreement will often define “Borrowers” to include all entities and later include a provision noting that a default of any Borrower is a default by all Borrowers or that all borrowers are jointly and severally liable for all indebtedness.61

Even without such language a cross-default provision is implied in the terms of the guaranty as a practical matter. Imagine a contract that included a cross guaranty but did not include a cross-default provision. If entity A defaults on its loan, the creditor has the right to accelerate the debt of entity A. A borrower will rarely be able to pay its debt in full unless it can refinance immediately.62 From there the creditor can go after B for the cross guaranty of the full debt. Again B is unlikely to be able to pay the debt in full and so it will be in default on its guaranty. This immediately due indebtedness will always trigger a default on B’s other loan directly as well – not because of A’s default but because B has now incurred debt that makes its payment

61 For example, the agreement might provide:

> Each Borrower hereby agrees that it is jointly and severally liable for, and absolutely and unconditionally guarantees to the Agent and the Lenders, the prompt payment when due, whether at stated maturity, upon acceleration or otherwise, and at all times thereafter...

62 Refinancing is unlikely to be an option at a favorable interest rate. If it were worth it for an outside lender to lend at an equivalent interest rate, it is unlikely that a rational inside lender would have forced the default in the first place.
of the other loan impossible. The contractual mechanism is different. But the practical effect is the same as a cross-default.

In the above scenario, the creditor started by calling a default against A and then calling the cross default against B. 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. The parties may, however, contract around this rule. The contract may provide that the creditor 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 guaranty of payment where the enhanced option is a guaranty of collection.

While guarantees implicitly include defaults, the converse is not true. A cross-default provision may exist without any accompanying cross guaranty. A creditor pays for a cross-guaranty provision (by way of collecting a reduced interest rate) and pays less for a cross-__

63 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 guaranty is being adopted. Because there is some uncertainty on the default rule, lending lawyers tend to include very precise language even making it clear that the guaranty is an absolute guaranty of payment.

64 See note __ below for the relevant contract language.

65 A cross-default provision may look like this:

[Defining default 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).
default provision on its own. The cross-default provision costs less because it creates an enforcement option against B without creating any priority rights or even any additional debt liabilities. Equity and other creditors are affected not by a change in the amount of liability but by a change in the triggers for default. Creditors may therefore opt for a cross-default provision without guarantees when they don’t expect to gain value from the additional enforcement rights that are created by the guarantee.

Using the tailored enforcement models above, we can predict when this will be the case. When the signal provides correlated information about management but not about the assets, the lender may seek to exercise control by calling a default without collecting on the guaranty. When that signal is significantly more likely than a signal about the correlated value of assets, the lender may choose to insert only a cross-default provision. This allows the optimal amount of tailored enforcement without requiring it to pay the full price of the cross guaranty. It keeps the assets separate but allows related enforcement.

This scenario is likely to occur when the risk associated with the assets themselves is not closely related, but they are commonly managed. There are some costs to this structure, namely calling the default may still trigger junior creditor rights on the asset. Thus, calling a cross-default is more valuable when there are fewer creditors of the entity providing the cross-default provision. Similarly, the cross default will be more valuable when that entity is likely to be over secured. When the lender is significantly over secured, calling the cross default will provide it negotiation leverage but the rights it will trigger in junior creditors are less likely to affect the value of its loan. For example, if the junior creditors force a bankruptcy, the over secured lender should be able to stay on the
sidelines relying on adequate protection. Of course that protection is less certain as the margin of over security gets smaller.66

When the cross-defaulting entity is likely to have many creditors or be only marginally over secured (or under secured) there are alternative structures available to allow selective enforcement against management when assets are otherwise stable – these are discussed in the next part.

66 The over security does not eliminate the lender’s ability to gain leverage. Its threat of acceleration can bring the business to a halt or impose significant costs on management or equity. This power can be used to punish management when it defaults. This may provide state contingent penalties that create incentives to avoid default. This can be a substitute for monitoring. Patrick Bolton & David S. Scharfstein, Optimal Debt Structure and the Number of Creditors, 104 J. Pol. Econ. 1, 5–8 (1996); Douglas G. Baird & Anthony J. Casey, No Exit? Withdrawal Rights and the Law of Corporate Reorganizations, 113 Columbia L. Rev. 1 (2013).
B. Holding company guarantees and stock pledges

One very common structure in lending today is a guaranty of subsidiary debt from a parent holding company whose only asset is its equity in the subsidiaries:

Figure 4: Equity Guaranties/Stock Pledge

Again under existing theories one might puzzle at this structure. Why has the debtor created all of these separate entities only to cross guaranty all of the partitions away? Moreover, what value is a security
interest in equity of the subsidiaries? After all, that is usually the second 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 again that one likely signal is that management is incompetent but that assets are fine. But now imagine that this is not the only likely signal. Other signals could suggest that all assets are losing value or that one of the assets is losing value. Because all of these are possible signals, using a cross default without a guaranty is not an option. Moreover, if we assume that there are several junior creditors of each operating entity, cross defaults between the operating companies carry the risk of triggering their hold-up rights.

This is where the equity guaranty comes in. By combining the equity guaranty with the operating company’s 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 also includes another option: calling a default on parent alone. The affect here is an immediate foreclosure right on the equity of 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 creditor at the time of the loan along with executed instruments of transfer, irrevocable proxies, and acknowledgement of equity interest registration page. These documents together are drafted with the purpose of transferring control and voting rights (and allowing the replacement of directors) instantaneously upon default or notice of default.67

67 The temporary restraining order in Madison Capital Funding LLC v. Homeorganizers, Inc. 10-CH-10531 (Cook County Illinois Circuit Court March 16, 2010) gives an example of how these provisions are intended to work. For example, the agreement included this clause:
The major creditor does not get any liquidation right over the subsidiaries assets when it calls a default, but it also triggers no rights of junior creditors of those subsidiaries. The operating companies continue with business as usual, but with the major 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 takeover 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 guaranty. Given this rationale, it is

If an Event of Default shall have occurred and is continuing and Agent shall give notice of its intent to exercises such rights to the relevant Grantor... (ii) and all of the Investment Property [i.e. the Pledged Equity] shall be registered in the name of the Agent or its nominee, and Agent or its nominee may thereafter exercise all voting and other rights pertaining to such Investment Property

In that case, Madison Capital, the major creditor, sent a notice to the borrowers containing the following: 1) notice of ongoing default with; 2) notice of its exercise of voting rights; 3) written consents showing its votes to remove all directors and elect a sole director chosen by the creditor to replace them; and 4) notice of the express instruction that no officer shall take any action outside of the ordinary course without approval from the new director. Madison Capital then immediately brought an action in state court seeking a restraining order to prevent the “old” board or management from attempting to file for bankruptcy. Id. The motion was granted. Id. The parties shortly after reached a compromise that allowed for bankruptcy filing to facilitate a sale that would pay the creditors in full. The filing occurred on April 8. The company was sold in bankruptcy (to a fund that included management) and the Madison Capital (the major lender) was paid in full. 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. Consistent with the analysis above, the assets of the operating companies did not appear to be in losing value and the creditor’s action appeared to be aimed at taking control to oust management or sell the business. At the time of bankruptcy, the operating companies in fact were experiencing record sales at the time of filing. Id.
again not all surprising that the lenders often include a covenant that explicitly prohibits the parent company from having any other creditors. Indeed, the covenants\textsuperscript{68} will go as far as prohibiting the company from doing anything at all (beyond the administrative tasks required to exist as a holding company).

\textsuperscript{68} An agreement might make it a default if

(a) Holdings [the holding company] 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 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 (including cash (other than cash received in connection with dividends made by the Borrower in accordance with Section 7.6 pending application in the manner contemplated by said Section) and cash equivalents) other than the ownership of shares of Capital Stock of the Borrower; or

Another form might include these terms:

Under representations and warranties:

\textit{Section \_\_\_ Status of Holdings}. Holdings has not engaged in any business or incurred any Indebtedness for Borrowed Money or any other liabilities (except in connection with the Footprint Acquisition, its formation, incurrence of the Subordinated Debt on the Closing Date in favor of the Subordinated Lenders, its guaranty of such Subordinated Debt, the Term Loans and its guaranty set forth herein).

Under negative covenants:

\textit{Section \_\_\_ Holdings}. Holdings shall not engage in any trade or business, or own any assets (other than the capital stock of the Borrower) or incur any Indebtedness for Borrowed Money other than the Term Loans and in connection with Subordinated Debt in favor of the Subordinated Lenders.
The simplified model above is just the tip of the iceberg. Tailoring can create multiple levels with various iterations and options the creditor can choose from. For example the following structure might be used:

```
Parent
   Equity↓
Subsidiary HoldCo
     Equity↓ Equity↓ Equity↓
Operator Co. 1  Operator Co. 2  Operator Co. 3
```

The loan proceeds would go to the three operating companies with cross guarantees or stock pledges from all entities. Upon receiving a signal and a default trigger from Operating Co. 1, the creditor could chose 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 Subsidiary Hold Co. 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 creditor could enforce against the assets of 1 & 2 or the equity of 1 & 3.

C. Bankruptcy Remote Subsidiaries
   [Implications of theory to be added; these structures can be viewed as an extreme version of tailoring and selective enforcement]

D. [Add section on multiple lenders and the differences between cross defaults and cross acceleration clauses]

E. Contract Interpretation: Types of Guaranties
As mentioned above the default rule for guarantees is more often for them to be guarantees of payment rather than collection. But that can be limited to a guaranty of collection by specific language in the contract. That limitation would require the lender to go after the primary borrower first. Because the baseline\textsuperscript{69} rule is not settled in every jurisdiction, lending lawyers often include very precise language to insure that they are agreeing to a guaranty of payment.\textsuperscript{70}

\begin{quote}
69 Because of potential confusion between a default contract rule (the rule that applies when the language is silent) and a contract default rule (a contractual provision identifying a default on the loan) I call the former the “baseline rule.”

70 An example of such language might include the following:

This guaranty hereunder \textit{is a guaranty of payment and not of collection}. Each Guarantor \textit{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.

Additional language might provide:

Borrowers and Holding . . . unconditionally and irrevocably guarantees jointly and severally . . . the due and punctual \textit{payment} of all present and future Obligations[, etc.] . . . including, but not limited to, \textit{the due and punctual payment of principal of and interest on the Notes}, the Reimbursement Obligations, and the due and punctual payment of all other Obligations now or hereafter owed by Holdings and the Borrower under the Loan Documents . . . in each case as and \textit{when the same shall become due and payable, whether at stated maturity, by acceleration, or otherwise}, according to the terms hereof and thereof . . . In case of failure by the Borrower or Holdings or other obligor punctually to pay any Obligations[, etc.] . . ., each Guarantor hereby unconditionally agrees to make such payment or to cause such payment to be made punctually as and when the same shall become due and payable, whether at stated maturity, by acceleration, or otherwise, and as \textit{if such payment were made by the Borrower, Holdings or such obligor.}
\end{quote}
The theory presented above might suggest a different baseline rule and perhaps stricter altering rules. The right to enforce a guaranty against a non-defaulting guarantor while not pursuing remedies against the primary borrower creates a significant risk of opportunistic behavior.

For example, entity and A and B might both be completely solvent. Assume that entity B is highly profitable and equity is receiving a high return on their investment in B. But B’s operations are very sensitive to disruption. A bankruptcy proceeding or foreclosure could devastate business. A lender could gain significant leverage by calling a default and threatening to accelerate its loan. The acceleration could shut B down. Equity or management will likely be willing to pay the lender off by means of favorably renegotiated terms or other side payments. With a cross-guaranty of collection B could prevent this outcome by meticulously following the covenants in B’s loan. A default by A (because it is solvent) will simply lead to a bankruptcy or foreclosure of A. Lender will be made whole on its loan to A and B will never be affected.

A cross-guaranty of payment is different. If A is in technical default, lender could call that default on B and accelerate both loans against A. In this way, lender has the option to enforce technical defaults against the entity that will pay the most to avoid acceleration of debt. Lender may even call a default against B for violations by A when it never would have thought to call that default against A even without the cross default to B. Management, therefore, must meticulously adhere to covenants for both entities even if it would not otherwise worry about the technical covenants with regard to entity A. This also allows the major creditor to ex post selectively favor certain junior creditors of one entity over those of another. The lender is likely to exercise this option to minimize objections and administrative costs. That may provide an incentive for junior

Because the guaranty of payment provides this extra option for opportunistic behavior, it may be surprising that the law requires parties to explicitly opt out of that type of guaranty. If the rule were the other way around, the court could have some confidence that that the risk was priced into the original transaction. Debtor will have charged the lender for the risk of opportunistic enforcement. But the implication of an explicit agreement and payment of the premium for that opportunity suggests that the costs created by risks of opportunistic behavior are offset by a greater value created in providing for selective enforcement. That value might be created where the signals of default from A are very likely to send a signal about the management of B. For example, A might be easily solvent while B is undercapitalized. A signal from A of mild incompetence might suggest a risk on B that does not exist for A and make it valuable for lender to enforce against B to prevent the destruction of enterprise value.

But the option to go after B first may alternatively be an extreme state-contingent penalty that substitutes for monitoring. The value that can be destroyed at B creates a hostage of sorts that gives management an incentive not to default on A.\footnote{72}{Douglas G. Baird & Anthony J. Casey, No Exit? Withdrawal Rights and the Law of Corporate Reorganizations, 113 Columbia L. Rev. 1 (2013); Patrick Bolton & David S. Scharfstein, Optimal Debt Structure and the Number of Creditors, 104 J. Pol. Econ. 1, 5--8 (1996).} In that sense it looks suspect. Unlike other discrete and tailored exit rights that are created by entity partitions, the penalty here will be borne largely by creditors rather than management. Moreover, the ex post preference for other
creditors here is more malleable and less predictable than other mechanisms.\textsuperscript{73}

Alternatively, A and B might be intertwined business where the success of one affects the success of the other. For example A might be a supplier to B. But cross defaults on the supply agreement might come close to the protection of a cross-guaranty of payment.\textsuperscript{74} Courts may not worry about the default rule because the parties will weigh the likelihood of these various scenarios, the value created and destroyed, and other alternative protection. But we can only be confident that they did so when the contract states their intent clearly. In the end, it may be empirically the case that these mechanisms create enough potential for abuse and confusion (exerting costs on other parties who have high search costs) to warrant a default for guaranty of collection with hard altering rules. For example, a guaranty of payment could require a filing similar to a security interest or the consent of independent directors or major vendors. On the other hand, the problem may not be common enough in practice to warrant action.\textsuperscript{75}

\section*{F. 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 that change the rights a creditor has against a

\begin{flushleft}

\textsuperscript{74} A final possibility is that a cross-guaranty of payment simply saves the administrative cost of going against A when the creditor knows that A cannot come close to satisfying the guaranty but B can.

\textsuperscript{75} Guarantees of payment are common. It may be that they are just assumed to be the case and few people would every expect deviation from the default. And it is not clear how often they are enforced any differently than guarantees of collection. The question merits further empirical study.
\end{flushleft}

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debtor based on the debtor filing bankruptcy are prohibited. But what if a bankruptcy filing triggers a default of an affiliated but separate legal entity? Thus, the bankruptcy of affiliate A might trigger a default of the loan agreement between lender and affiliate B. On its face this would not appear to be a prohibited ipso facto clause. In theory affiliate B need not be in bankruptcy and thus the provision should enforceable if state law allows it. Similarly, if affiliate B were truly a separate firm owned by an outsider, the law would respect those clauses. Thus, it might be thought that the clause was valid even when both A and B are in bankruptcy together. One bankruptcy judge has opined on this matter three times in major cases and come to the opposite conclusion.76 Douglas Baird and I suggested that this outcome might not be justified.77 Looking at things with the new corporate web in mind may, however, reveal further nuance.

Selective enforcement has value. And we should try to encourage that value creation where it does not otherwise complicate other aspects of the system. That is why we do not worry as much about the use of the corporate web to shift value because the system already allows that through dividends and other transfers. The use of the corporate web creates no new opportunity for parties to act opportunistically.

The same is not true with ipso facto clauses. If entities are separated and then the partition is tailored with cross liabilities, it is possible for a debtor and creditor to create a tailored partition for the sole purpose of getting around the law’s prohibition on ipso facto clauses. They will use tailored partitions – knowing that they will


always opt to enforce against the entire firm – just to have rights that are triggered by the filing. By combining a web of cross guarantees and cross defaults with entity partitions, a lender could push an entire enterprise into bankruptcy (as if it were one legal entity) but then enforce certain rights that were triggered only by means of the bankruptcy filing. Creditor can loan to entity A. Have entity B cross guaranty the loan. And then include a term that changes priority or other rights in A when B files for bankruptcy. This is functionally no different than having one large entity with a prohibited ipso factor clause in place. As long as we think the prohibition on ipso facto clauses is appropriate this should trouble us. The rule is avoided, and doing so creates unnecessary costs – much a like a tax shelter.

The solution might be to prohibit the use of these clauses in a world of global enforcement. That is if the major 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 the use of those clauses still allows a party to create the value of selective enforcement but eliminates the use of tailored partitions to simply get around the law.\(^78\)

The prohibition need not apply only when the major creditor enforces globally. When the entities are sinking together in a way that the major creditor cannot avoid, we are in a world where the cross guarantees are implicated and global enforcement is the de facto path. The major creditor’s option for selective enforcement only exists when one entity is still viable. Thus, the protection of that right is not in the enforcement of ipso facto clauses but rather in the court’s determination of good faith filing.

\(^78\) This evasion is different than the tailoring discussed above and in my previous work. Tailoring to simply avoid a provision with no other reason should be viewed skeptically. Perhaps the tests applied to tax shelters are the same tests we might think of in this context.
Viewed this way, most rights created by cross-liability provisions on loans with a right of acceleration will be subject to the prohibition on ipso facto clauses. This is true because the use of the clause will itself reflect the creditor’s option to enforce globally. This may have been the rationale driving the bankruptcy court’s decisions in the Lehman and Charter cases.

On the other hand, clauses that can be exercised consistent with local enforcement should generally be respected. For example, where A is a critical supplier to its affiliate B, it would be common to see a clause that terminates a loan or other agreement that A is a party to upon B’s bankruptcy filing. As long as the party calling the default on A is not the same party causing B’s bankruptcy, opportunistic behavior is not a major concern. Still the similar outcome could be achieved by a default provision triggered by a breach of an intragroup supply agreement between A and B. It might also be appropriate to respect those clauses when affiliate A is not forced into bankruptcy with B but not enforce them when it is.

This would protect the partitioning value of these contracts but eliminate the opportunity for strategic evasion of the bankruptcy code.

G. 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. That said, dividends may add value ex ante by providing 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 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 any prohibition on cross-liability provisions will destroy value. As long as dividends are legal – and they almost certainly will be – the prohibition 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. Any misbehavior using these can be recreated with 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 very 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 fraudulent transfer law that only applies 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.79

The takeaway is that a court should use the insolvency rule as its main guide.80 It should be skeptical of the value of premiums paid during insolvency. It shouldn’t care at all about premiums paid

79 But see the Dynegy case.
80 With the possible exception discussed above for completely uncorrelated projects.
during solvency. This is essentially the current state of the law. Cases usually 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.\(^8\) 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 likely better than the alternatives.\(^8\) 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. Again 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 than the cross-liability rule that creates opportunities to structure around rules.\(^8\)

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-guaranty 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 solvent entity becomes insolvent because of a cross guaranty, the guaranty is voided.

To get around this, parties include a clause that states that if the transfer renders the debtor insolvent it will be deemed to be only for

\(^8\) See, e.g. *In re TOUSA.*

\(^8\) See Buccola, *Beyond Insolvency,* (forthcoming 2014).

\(^8\) The bright line metric of comparing assets to liabilities would be appropriate here.
the largest amount that would not render the debtor insolvent.\textsuperscript{84} To compare this to dividends, 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 can not change that price by prohibiting savings clauses. If the true purpose of the cross guaranty was to transfer wealth, the debtors could simply make transfer dollar by dollar until it was insolvent.\textsuperscript{85} It is illogical to allow the transfers when they create no value but not when they have a major value creating potential.

By allowing savings clauses and setting the line at insolvency, the law avoids incentive for parties to use cross guarantees as means to opportunistically transfer wealth (because cheaper legal means exist).

The flip side of prohibiting savings clauses is introducing great uncertainty and cost to the lending process. 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. Because invalidation is absolute, a mistake of one cent would change the entire cost dynamic of the deal.\textsuperscript{86}

\textsuperscript{84} The savings clause in \textit{In re TOUSA} 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.

\textsuperscript{85} I ignore here the possibility of proving actual fraud.

\textsuperscript{86} George Triantis, \textit{A Tussle with TOUSA: Avoiding Fraudulent Transfers in Intercorporate Guarantees}, Annual Review of Insolvency Law (2009).
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.

H. Good Faith Filing

For the selective enforcement option to have value, it must be
real. A great deal of importance rests on the rules of good faith filing.
The major creditor must truly have an option to selectively enforce its
covenants. The takeaway then is that when the 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.
Neither the junior creditors nor equity of A should be able to use the
default event of A to justify the bankruptcy filing of B. This is why the
major creditor will often prohibit any other loan from having a term
that causes a cross default because of a default of the major creditor’s
loan.

On the other hand, when a major creditor opts for global
enforcement, many other complications are introduced. The courts
must decide whether to treat the entire enterprise as one legal entity
or as many. The cross guarantees are in place and will be respected.
But the questions remain of whether or not the bankruptcy court
needs to untangle all other intragroup claims and liabilities. The debt
of affiliate A to affiliate B will be a factor in determining the payouts
for the creditors of A and B.

The preference of the major creditor with the selective
enforcement option need not worry us. The default rule can be priced
into the original loan, and the practice of these lenders suggests this
point is of little ex ante importance to them. That is to say, the court
need not worry about the major creditors’ interest in treating the entities separate once they have moved to enforce globally. The real value to the major creditor is the selective enforcement option, not the separateness of the assets. This is evident in the contract terms and in the monitoring behavior of these creditors. But, on the other hand, forcing these creditors to accept the separateness is of no great moment either. That separateness exists because of the selective enforcement option and can be baked into the price of that option.

The impact on other creditors is, however, more complicated. It raises important questions about substantive consolidation as discussed in the next section.

I. Substantive Consolidation

Perhaps the thorniest and most important issue that the corporate web poses for bankruptcy law is substantive consolidation. When large firms enter bankruptcy they often do so as one enterprise. That is, the affiliated entities file at the same time. The first move is to administratively consolidate the cases. That is easy enough. Each debtor files a separate bankruptcy because the black-letter rule is that legal entities enter bankruptcy not economic firms. But the issues in each case will be related and overlapping. Administrative consolidation allows for one bankruptcy court to hear these cases on a consolidated basis.

But in theory the legal boundaries of each entity must be respected. The judge cannot ignore intragroup transfers and liabilities. In large cases, this can be a daunting task. And it becomes almost impossible when the debtor and the major creditors (the ones with the selective enforcement option) have ignored the legal entities and treated the enterprise as one entity along the way.

Substantive consolidation is the legal mechanism to ignore the legal boundaries and treat all entities as one. This remedy is considered extreme, and the technical rule is that it should happen
rarely.⁸⁷ The reality is that judges often gray the lines between entities on the margin⁸⁸ and reorganization plans that consolidate assets and liabilities are often approved.⁸⁹ But in theory (at least) a creditor who was harmed by consolidation could hold up the whole process.

That creditor will claim that it relied on the entity partitions in making its loan. As a result, it will claim that any intragroup debts must be reconciled before payments can be ascertained. The unwinding can be immensely costly if the web is of significant complexity. The problem becomes even more intractable when various small creditors are arguing on both sides of the issue. One creditor may argue that it relied on the legal partitions while another may argue that the enterprise was so commingled that it would be unjust to separate the assets. This is akin to a traditional veil piercing or enterprise liability argument.

An easy solution does not present itself. A default rule for substantive consolidation will place a cost on junior creditors that may not be offset elsewhere. In a world where all corporate webs are consolidated in bankruptcy, the junior creditor will be forced to examine the entire corporate group to assess the risk of the loan. This eliminates the information and enforcements benefits of asset partitioning.

In that scenario the creditor will either incur the costly research – which will result in an increased interest rate – or simply raise the interest rate to account for the uncertainty inherent in lending in a world with such a default rule. Either way this increases the cost of

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⁸⁷ See In re Owens Corning, 419 F.3d 195, 215 (3d Cir. 2005).
credit and presents a suboptimal outcome if an alternative rule could be devised to avoid that creditor’s need to research or take on that risk.

Moreover, it exacerbates the risk alteration problem. A junior creditor who incurs the research to ascertain the scope of the corporate group has no guaranty that the group will not change in the future. The creditor will have to incur (and charge for) the additional information cost on an ongoing bases or further increases its interest rate to account for the chance of future changes.

Covenants might be put in place to prevent changes in the corporate group. But those covenants might not be enforceable in bankruptcy. More importantly, they will be very costly. Such a covenant if it was placed in all agreements with all creditors would prevent a debtor from changing its structure in the future if selective enforcement becomes valuable. The cost of renegotiating with every creditor would be prohibitive.

On the other hand, a default rule of no consolidation is also problematic. The cost of untangling enormous webs will sap value from large bankruptcy estates. Additionally, any creditors who rely on the commingled nature of the legal entities will incur costs ex post. Again the expectation of these costs will raise the ex ante cost of financing. And the cost of maintaining perfect records ex ante may be equally wasteful.

The concepts discussed above may provide a way out. To get to the heart of the matter: the corporate web creates value through selective enforcement but it destroys value by making information opaque. Assuming we cannot have our cake and eat it too, the optimal solution is one that allows the selective enforcement option only when the value exceeds the cost. To get to that point is simple: the party receiving the benefit must bear the cost.

To put it another way, the information opaqueness is a price of the selective enforcement option and so it should be baked into the
overall price of that option. To do this, a court need only place the liability for information opaqueness on the major creditor.

Thus, if a corporate web is created and obscures information to other creditors, the major lender must indemnify them. After bankruptcy is filed, if a junior creditor relied on the separate legal entities then the major creditor must make it whole. If on the other hand a junior creditor relied on the commingled nature of the assets, the major creditor must make it whole. In this way, the reliance costs of junior creditors is born by the major creditor who will in turn charge for that when it contracts for the enforcement option. The debtor will of course pay an increased interest rate. If the expected cost of reliance is higher than the benefit of the corporate web, then the interest rate will be lower for a loan with no corporate web and vice-versa. Thus, the corporate web will only be created when the benefit of the selective enforcement option exceeds the information cost to other creditors.

But what if the best outcome is not indemnification or no web? There may be cases where the debtor can actually keep its books pristinely separate at low relative cost such that no reliance on commingling by junior creditors would be reasonable. In that case, the major creditor should not indemnify the junior creditors. Imagine then a safe harbor rule that says the major creditor is not liable for the reliance if 1) the debtor kept meticulous books and 2) there was a disclaimer of enterprise liability in agreements with all creditors. The senior creditor would then face a choice: incur the cost of monitoring the meticulous separation of entities or indemnifying the reliance costs. Again, the major creditor will choose the less costly alternative and we will arrive at the optimal outcome.

The takeaway is that where a creditor with a selective enforcement option opts for firm-wide enforcement, there is no harm

90 Note that a disclaimer alone is not enough because it presents opportunities for ex post alteration that will distort prices and costs.
treating the firm as one entity and disregarding intragroup transfers. But where the creditor selects project-specific enforcement, the court should respect that. This places a large importance on good faith filing rules. Separately, though the court must deal with other creditors. Where a major creditor opts for a selective enforcement option in its loan agreement, it should bear the burden of showing that other creditors did not rely on the integration or the partition. Thus, if a junior creditor relied on integration to its detriment, the payment for that reliance comes for the major creditor. The same is true for junior creditors who relied on partitions. The key is that there is some confusion created by this structure. But we want to allow the tailored partition when it is valuable. By forcing the major creditor to pay for the confusion created, it will internalize that confusion and it will be priced into the original transaction. This produces the best outcome. In practice, something of this sort happens – lenders often force the borrower to take a reserve\textsuperscript{91} for the chance that a partition will not hold.

Note that this is not the equivalent of substantive consolidation or veil piercing. It is not the estate of any one entity that is supplying the protection to the small creditor who relied, but rather the major creditor. The claims of junior creditor on affiliate A do not impact the claims of junior creditor on affiliate B. The court can consolidate for convenience and then have any relying creditors paid by the senior creditor. If however the senior creditor forced the meticulous book keeping with a notice, then the court can refuse consolidation and award no indemnification.

When there is no global enforcement, the reliance costs of the junior creditors might still be at issue. But selective enforcement can still be respected while indemnifying the reliance costs of other

\textsuperscript{91} The reserve is essentially a substitute for a higher interest rate plus indemnification. The difference, however, is that it only has value in the non bankruptcy enforcement context.
creditors. As a doctrinal matter this is a state law question of veil piercing. But the same reasons that suggest a major creditor might indemnify junior creditors in bankruptcy cases where books are not meticulously kept would apply here as well. The result would be that a claim against entity B that was not fully paid in the bankruptcy would convert to a claim against the major creditor – this would be adjudicated separately from the bankruptcy.\textsuperscript{92}

The one objection to all of this is that the junior creditors will always claim reliance either to play the lottery or to extract a nuisance payment. Perhaps this is of no concern given the safe harbor available to the major creditor. Otherwise, the key would be setting the pleading burden at the right level. This can be assessed by traditional evidentiary analyses and by comparing the likelihood of hold up the likelihood of a false negative at the pleading stage.

### J. Structural Priority, Withdrawal Rights, and Other Partitions

Finally, 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 impacts 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

\textsuperscript{92} The difference between such a rule and the current rule would essentially be a lowering of the burden of proof for veil piercing and enterprise liability in these particular cases.
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. But that substitute is most necessary and effective when it allows creditors to withdraw a stable asset that is easily monitored or has a high outside value in response to a failure with regard to a complementary but hard to monitor asset. This is valuable 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 major creditor on all relevant assets and those assets have been connected by cross guarantees. Moreover, when withdrawal rights have a two way option they are more likely to be subject to abuse and to create costly confusion. The takeaway is that withdrawal rights should be respected 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 meticulously kept for the withdrawable entity. It should also expect the creditor of that entity not to be the major creditor of the core entity of the enterprise.

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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 overlapping of cross-liability provisions will be the keystone in this inquiry. And the presence of a central major creditor will likely be likely (though not absolute).

In summary, structural priority can generally be respected (with the reliance indemnification as an exception); withdrawal rights can be respected when the separation is fully respected and the creditor is not on both sides of a cross liability provision; selective enforcement should be respected in the filing decisions, but the major creditor can bear the burden and cost that are created by a corporate web that does not fully respect the legal separation.

IV. Conclusion

Law-and-economics literature of corporate groups has spent the last four decades dissecting full partitions and groups that were identified in the 1970’s and puzzling over incremental changes thereto. Meanwhile on the ground, the new corporate web has emerged and begun to evolve. 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, the new corporate web divides partially related assets in a tailored fashion to create selective enforcement options for a central creditor. That creditor specializes in monitoring enterprises as a whole. But its special expertise includes its experience in using the selective enforcement options to maximize monitoring value by calibrating enforcement responses precisely to the signals that trigger enforcement.

The fact that these arrangements are routine in secured lending transactions and that so much attention and organizational efforts
focus on them provides further evidence to support theories of senior and major creditors as primary monitors.  

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, substantive consolidation, equity guaranties and stock pledges, good faith filing and the like should not ignore the important reality of the new corporate web.

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