The New Corporate Web

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Integrated Firms

Figure 1: Integration

Integrated Firms

Diagram Description:
Risk Partitioned Firms

Figure 2: Partitions

- Creditor 1
- Oil
- Hotel
- Debt
- Creditor 2
- Debt
- A
- B
- $
Withdrawal rights, Securitization, etc.
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Figure 2: Partitions

- Creditor 1
- Creditor 2
- Major Lender
- Hold Co
- P

- Similar Projects
The Setup

• Major creditor is monitor
  – Not specialized to one project
  – Specialized to the firm as a whole

• Lender receives signals from monitoring
  – Global failure
  – Local failure
  – No failure
  – Key point: Failures can happen without triggering a default
Benefits of Partition

Period 1
- Two Loans:
  - Equal Risk at lending (but not correlated)

Period 2
- Loan 1 risk goes down.
- Loan 2 risk goes up.
- Alternative lending opportunities have better return than Loan 2 but worse than Loan 1.
- Borrower in default
- What should lender do?
- Default Loan 2 and not Loan 1
- Note: Defaulting Loan 1 to collect on losses for loan 2 would be irrational here (akin to sunk cost fallacy)
Specific Enforcement

- Enforcement triggers rights in other creditors of an entity
  - Rights are against legal entity
  - Even with security interest
- Partitions determine
  - Who can challenge foreclosure sale?
  - Who can trigger bankruptcy?
- Creditors create hold-up threat against all assets
  - More assets in entity = larger surplus from which to extract ransom
Benefits of Partition (cost of integration)

Figure 2: Partitions

- **Low Risk**: Creditor 1
- **In Default**: Creditor 2
- **Hold Co**: Major Lender

Arrows indicate connections:
- **Debt**: From Creditor 1 to Major Lender
- **Challenge foreclosure sale, involuntary bankruptcy, objections, etc**: From Major Lender to Creditor 2
Costs of Partition

Same Loans
Period 2
• Loan 2 is in default. Default signals global risk.
• Loan 1 not in default.
  – Why?
  – Not perfect correlation across time and size.
  – Monitoring efficiencies.
  – Incomplete contracts.
• Lender wants to default both loans.
• This is true even if Loan 1 is perfectly solvent.
  – As long as the risk adjusted return is lower than its alternatives
  – Or if Lender can create value by exercising control
• What should lender do?
• Default all loans
• Cannot do this with partitions but no cross liabilities.
Global Enforcement with Partitions

• Requires two defaults
• That requires double monitoring of the same thing
  – Becomes cumbersome as we increase to dozens of entities
• Procedural costs
• Defeats any benefit from differentially timed signals.
Figure 2: Partitions

Costs of Partition (Benefits of Cross Liability)

**Bad Management**

**Imminent Default**

**In Default**

Debt

$
Selective Enforcement

• Need a system that allows for general enforcement in response to global signal
• Need a system that allows for targeted enforcement for local signal.
• Neither total partition nor total integration accomplishes that.
Example from Real Life

• Madison Capital/Home Organizers
• Borrower: Claimed lender “unexpectedly” called all loans due
• Media: Record revenues. No financial problems.
• Lender’s Lawyer:
  – “Tons of busted covenants”
  – Litigation with preferred shareholders
  – “We couldn’t wait around for years while that played out”
  – “Default letter had a page and half single spaced list of defaults”
  – “Should we sit on our hands with our thumbs up our *** while the manager tanked the business?”
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PAID IN FULL

Figure 2: Partitions

Creditors ($1 million)

CBD

Major Lender ($50 million)

CLW

Creditors ($1 Million)

Debt

$
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• So what?
• Equity Guaranties
• Good Faith Filing (GGP)
• Substantive consolidation (Owens Corning)
• Ipso Facto Clauses (Lehman)
• Fraudulent Transfer/Savings Clauses (TOUSA)
• Post Petition Interest (ResCap)
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Figure 2: Partitions
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Figure 2: Partitions

The diagram illustrates the relationships between debtors and creditors in a corporate web. The diagram shows:

- **Hold Co**: A holding company
- **P**: A party or a group of parties
- **A** and **B**: Entities
- **Major Lender**: A major lender to the entity A
- **Creditor 1** and **Creditor 2**: Creditors

The diagram includes arrows indicating the flow of debt and payment between these entities.
Examples from Real Life

• Giordano’s Pizza
• Pizza business was fine
• Real Estate in Florida was a disaster
• Lender had no interest in foreclosing on pizza places
• At first, Lender’s Laywer wanted local enforcement
  – Why tank the pizza business?
• Problem: No partition
  – Previous workout of distress entangled everything
  – “Getting bigger better collateral package may have seemed like the right thing at the time (that’s my speculation). It wasn’t. But when the bankruptcy lawyers got there it was too late.”
• Had to enforce globally. Huge hold-up problems as debtor was basically gonna tank the whole thing.
• But, then they received another signal
  – Soveriegn Citizens
  – F.R.A.U.D.S – Federal Reserve Accounting Unit Denominators
  – Death threats
• At this point global enforcement seemed the right way to go
• But a leak-proof holdco equity guarantee would have been better.