The Consolidated Howell Companies

Big Bank NA is contemplating a US$1 million unsecured loan to a single company in the Howell Group, a conglomerate that manufactures pleasure boats, manages a cruise line and sells widgets. Due diligence on the Howell Group to date reveals the following information. The parent company is Thurston Howell Company, a Delaware corporation ("THC"). It has issued and outstanding 100 shares of common stock, representing all the capital stock of THC. THC shares are owned by Gilligan, Skipper, Ginger, Mary Ann and Professor, 20 shares each. THC owns 100 shares of common stock of Mrs. Howell Inc, a Delaware corporation ("MHI"). The summary consolidated financial statements of the Howell Companies disclose assets with a book value of US $3 million, long-term debt of US $1 million and short-term liabilities of US $500,000.

1. Assume you are the chief credit officer for Big Bank. Would you prefer to lend money to Thurston Howell Company or Mrs. Howell Inc?

a. Thurston Howell Company because it owns the shares of Mrs. Howell Inc, a potentially valuable asset.

b. Mrs. Howell Inc because Mrs. Howell is the brains behind the Howell family fortune (and good management should be important to a creditor).

c. Loan half the money to Thurston Howell Company and half the money to Mrs. Howell Inc in order to balance out the risk.

d. Mrs. Howell Inc because a claim against assets of a subsidiary is a direct claim.

e. More due diligence must be conducted on the Howell family of companies to make an informed lending decision.

2 Assume that THC is a pure holding company (i.e. its only assets are shares of stock). You know that THC borrowed the outstanding long-term debt. A Big Bank NA loan to MHI will be supported by assets valued at what dollar amount?

a. Assets with a market value of US$3 million.

b. Assets with a market value of US$2.5 million.

c. Assets with a book value of US$1.5 million.

d. Assets with a book value of US$3 million.

e. Assets with a book value of US$2.5 million.

3 Assume that: (i) the existing US$1 million long-term debt is the sole obligation of THC, (ii) the short-term debt is the sole obligation of MHI and (iii) THC is a pure holding company. Identify the priority of claims if the new loan from Big Bank is made to THC.

a. The debt of Big Bank is senior to the short-term debt.

b. The debt of Big Bank is senior to the existing long-term debt.

c. The short-term debt is senior to the existing long-term debt and pari passu with the debt of Big Bank.

d. All the debt is pari passu because on the facts as stated THC must have contributed the proceeds of the long-term debt to MHI (which contribution creates a basis for substantive consolidation).

e. The existing long term debt and the new debt from Big Bank are pari passu, with the short-term debt being senior to both.

4. Answer question 3 on the assumption that the new loan from Big Bank is made to MHI.

5. What would happen to the different priority structures you identified in questions 3 and 4 above if THC caused MHI to be merged with and into it, with THC as the surviving corporation? With MHI as the surviving corporation?

6. What would happen to the different priority structures if THC formed two new subsidiaries, keeping MHI to run the cruise line but transferring its widget manufacturing assets to Professor Inc. and its boat manufacturing operations to Skipper Inc.? How did you know the identity of THC's subsidiaries in the first place?

7. What would happen to the different priority structures if MHI (and, if applicable, Professor Inc. and Skipper Inc.) guaranteed the debt owed to Big Bank? The other creditors? Would you have any concerns about the enforceability of any of these guarantees? Explain. How would any of these guarantees differ from guarantees of the debt provided by the five shareholders of THC?

8. What would happen to the various priority structures if THC merged into another highly leveraged company, Risky Corporation, which had outstanding $10 million in secured debt owed to Vulture Ventures LLC?

9. What would happen to the various priority structures if THC decided to provide security interests to its other long term debt, with secured guarantees from any and all of its subsidiaries?

10. In light of the foregoing answers to questions in 5, 6, 7, 8 and 9 what sorts of covenant restrictions might you impose on THC and its subsidiaries to protect Big Bank? In what ways would Big Bank feel more protected if its loan to THC/MHI were secured instead of unsecured?