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## Chrysler, GM and the Future of Chapter 11

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## **Chrysler, GM and the Future of Chapter 11**

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## Chrysler, GM, and the Future of Chapter 11

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### Abstract

Although they caused great controversy, the Chrysler and GM bankruptcies broke no new ground. They invoked procedures that are commonly observed in modern Chapter 11 reorganization cases. Government involvement did not distort the bankruptcy process; it instead exposed the reality that Chapter 11 offers secured creditors—especially those that supply financing during the bankruptcy case—control over the fate of distressed firms. Because the federal government supplied financing in the Chrysler and GM cases, it possessed the creditor control normally exercised by private lenders. The Treasury Department found itself with virtually the same, unchecked power that the FDIC exercises with respect to failing banks. The Chrysler and GM bankruptcies are cautionary tales about Chapter 11, not about government intervention. It may be time to entertain longstanding proposals for reforming the reorganization process.

Were the Chrysler and GM bankruptcies precedent-setting distortions of long-standing bankruptcy principles, enabled by government intervention? Or were they typical of modern Chapter 11 practice, notwithstanding some unusual features occasioned by government involvement?

Several bankruptcy scholars<sup>1</sup> take the first view, as of course did the dissident secured lenders in the Chrysler bankruptcy.<sup>2</sup> This view implicitly sees a correspondence between the Chrysler and GM bankruptcies and a federal agency receivership. There an agency such as the FDIC can seize a failing bank,

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<sup>†</sup> Harvey R. Miller Professor of Law, Columbia Law School. I received helpful comments from fellow panel participants and audience members at the 2009 Lawrence P. King and Charles Seligson Workshop on Bankruptcy and Business Reorganization.

<sup>1</sup> Mark J. Roe & David A. Skeel, Jr., "Assessing the Chrysler Bankruptcy," working paper (July 31, 2009), available at <<http://papers.ssrn.com>>; Barry E. Adler, Testimony before the Congressional Oversight Panel, Field Hearing on the Auto Industry Financing Program, July 27, 2009, available at <http://cop.senate.gov/documents/testimony-072709-adler.pdf>; Lynn M. LoPucki, Testimony before the U.S. House of Representatives Committee on the Judiciary, Subcommittee on Commercial and Administrative Law (May 21, 2009), available at <http://judiciary.house.gov/hearings/pdf/LoPucki090521.pdf>.

<sup>2</sup> *In re Chrysler LLC*, 576 F.3d 108 (2d Cir. 2009), vacated by *Indiana State Police Pension Trust v. Chrysler LLC*, --- S.Ct. ---, 2009 WL 2844364 (Dec 14, 2009) (No. 09-285) ("2d Circuit Opinion"); Todd Zywicki, "Opinion, Chrysler and the Rule of Law," *Wall St. J.* (May 13, 2009).

transfer good assets and favored debts (to depositors) to a government-owned “bridge bank,” and then distribute the remaining assets to creditors left behind in the receivership estate.<sup>3</sup> Likewise in Chrysler and GM, the federal government used its power as prepetition and DIP lender to influence management, force a sale of good assets and favored debts (to the UAW) to a government-owned entity, and let the court distribute remaining assets to creditors left behind in the bankruptcy estate. The Chrysler/GM cases differ from a federal agency receivership, of course, because of the presence of a judge in those cases. The federal agency receivership is subject to minimal (if any) court oversight.<sup>4</sup> But the standard of judicial review wasn’t much more searching in the Chrysler and GM cases, according to critics. The bankruptcy process, therefore, allowed the federal government to seize and control Chrysler and GM in much the same way that federal agencies can seize and control commercial banks.

It may be correct that these bankruptcies, in practice, differ little from federal agency receiverships. But it is incorrect, I believe, to claim that these bankruptcies differ substantially from the norm in modern Chapter 11 practice.<sup>5</sup> Features of these cases are controversial not because they distort long-standing bankruptcy principles, but rather because they push current practice to an uncomfortable limit. This was made possible by government intervention during an economic crisis. I doubt that these cases have much precedential value because comparable intervention is unlikely going forward.

### **1. An unexceptional bankruptcy?**

Let’s focus on Chrysler, the more controversial of the two bankruptcies. When it entered Chapter 11, its liabilities included secured bank debt,<sup>6</sup> a secured government (TARP) loan,<sup>7</sup> and unsecured claims of suppliers and current and former employees.<sup>8</sup> Equity was held by Cerberus and Daimler.<sup>9</sup> When Chrysler

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<sup>3</sup> See generally Edward R. Morrison, *Is the Bankruptcy Code an Adequate Mechanism for Resolving the Distress of Systemically Important Institutions?*, Temple L. Rev. (forthcoming).

<sup>4</sup> See, e.g., *James Madison Ltd. by Hecht v. Ludwig*, 82 F.3d 1085 (DC Cir. 1996).

<sup>5</sup> The same view is espoused in a contemporaneous working paper by Stephen Lubben, *No Big Deal: The GM and Chrysler Cases in Context*, Am. Bankr. L. J. (forthcoming 2009).

<sup>6</sup> First lien secured debt amounted to about \$6.9 billion. Motion of Debtors and Debtors in Possession, Pursuant to Sections 105, 363 and 365 of the Bankruptcy Code and Bankruptcy Rules 2002, 6004 and 6006, for (I) an Order (A) Approving Bidding Procedures and Bidder Protections for the Sale of Substantially all of the Debtors' Assets ..., *In re Chrysler LLC, et al.*, Case No. 09-50002, at 7 (Bankr. SDNY May 3, 2009) (“Sale Motion”) [Docket No. 190].

<sup>7</sup> *Id.*, at 8.

<sup>8</sup> About \$5.3 billion was owed to trade creditors, *id.*; at least \$4.5 billion was owed to the VEBA, *id.*, at 18; and around \$9 billion was owed to underfunded pension plans, Motion of Debtors and Debtors in Possession for Entry of an Order Authorizing Chrysler LLC to Enter into a Settlement ... at 7, *In re Chrysler, LLC, et al.*, Case No. 09-50002 (Bankr. SDNY May 19, 2009) [Docket No. 1114].

<sup>9</sup> Affidavit of Ronald E. Kolka in Support of First day Pleadings, Kolka Affidavit, at 17, *In re Chrysler, LLC, et al.*, Case No. 09-50002 (Bankr. SDNY April 30, 2009) [Docket No. 23] (“Kolka Affidavit”).

exited, the secured bank debt had been wiped away. Other liabilities, including the unsecured claims of suppliers and current and former employees, remained on the firm's balance sheet.<sup>10</sup> Equity was now held by Fiat, employees (through the VEBA), and the U.S. and Canadian governments.<sup>11</sup>

This is a reorganization with a twist. Creditors with highest priority—secured bank lenders—were cashed out, nonconsensually, at 29 cents on the dollar (they were paid \$2 billion).<sup>12</sup> How can a reorganization cash out non-consenting senior lenders at less than par while offering full repayment to junior creditors such as suppliers and employees?

This was accomplished, critics say, through a § 363 sale that circumvented the traditional safeguards of § 1129. On paper, the sale process was ordinary: it auctioned Chrysler's assets, fetched a \$2 billion high bid, and then distributed the proceeds to senior lenders pursuant to absolute priority.<sup>13</sup> Junior creditors received nothing from this process. Their payments came instead from the purchaser (the "New Chrysler"), which decided that payments to these creditors served its economic and social objectives.<sup>14</sup>

In reality, critics argue, the sale process was defective in three respects. First, there was no meaningful valuation of the firm prior to sale approval. Without it, we cannot be sure that senior lenders received at least what they would have recovered in a liquidation. This "liquidation baseline" is guaranteed in a traditional reorganization plan<sup>15</sup> but wasn't taken seriously in Chrysler's § 363 sale. To be sure, the company's expert witness put forth two valuations, the second of which ranged from \$0 to less than \$1.2 billion,<sup>16</sup> suggesting that the senior lenders received more than what their claims were actually worth. Though some senior lenders objected to the valuation, they neither rebutted it nor offered evidence of their own.<sup>17</sup> Maybe the objectors were constrained by the court's accelerated schedule. Maybe not. For many months, everyone was aware that Chrysler was deeply distressed and likely to enter bankruptcy.<sup>18</sup> And more than 20 days passed between approval of the bidding procedures on May

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<sup>10</sup> 2d Circuit Opinion, *supra* note 2, at 111-12; *see also* U.S. Treasury Department, "Obama Administration Auto Restructuring Initiative: Chrysler-Fiat Alliance," press release available at [www.ustreas.gov/press/releases/tg115.htm](http://www.ustreas.gov/press/releases/tg115.htm).

<sup>11</sup> 2d Circuit Opinion, *supra* note 2, at 111-12.

<sup>12</sup> 2d Circuit Opinion, *supra* note 2, at 117 n. 9.

<sup>13</sup> *Id.*

<sup>14</sup> Opinion Granting Debtors' Motion Seeking Authority to Sell, Pursuant to 11 U.S.C. 363, Substantially All of the Debtors' Assets at 22-23, *In re Chrysler LLC, et al.*, Case No. 09-50002 (Bankr. SDNY May 31, 2009) ("Bankruptcy Court Opinion"); 2d Circuit Opinion, *supra* note 2, at 118.

<sup>15</sup> 1129(a)(7).

<sup>16</sup> Bankruptcy Sale Opinion at 18-19.

<sup>17</sup> *Id.*, at 18; 2d Circuit Opinion, *supra* note 2, at 118.

<sup>18</sup> *See, e.g.*, Indicative Summary of Terms for Secured Term Loan Facility (Dec. 19, 2008), <http://www.treas.gov/press/releases/reports/chrysler%20final%20term%20&%20appendix.pdf> (outlining conditions for government loans to Chrysler); Obama Administration: New Path to Viability for GM & Chrysler (Mar. 30, 2009), <http://www.treas.gov/initiatives/eesa/AIFP/fact-sheet.pdf> (imposing 30-day deadline to reach an agreement with Fiat).

5, 2009, and the court's hearings to approve the sale on May 27-29.<sup>19</sup> Put differently, although the Chrysler bankruptcy moved at a record pace, creditors have faced comparable time pressure in ordinary Chapter 11 cases and still been able to perform credible valuations. Prepackaged and prenegotiated cases, in particular, move at rapid speed. During 2005, for example, the median case lasted only 49 days; the median case lasted only 43 days in 2007.<sup>20</sup>

A second defect, according to critics, was the absence of adequate consent from senior lenders. Had this case gone through traditional reorganization, Chrysler would have needed consent from senior lenders holding two-thirds of the value of claims in the same class. Such consent was missing in the § 363 sale. Yes, it was approved by lenders holding about 70 percent of secured claims,<sup>21</sup> but these lenders were effectively wards of the state because they had recently received federal TARP funds.<sup>22</sup> The federal government was steering the § 363 sale (through its power as DIP lender), had a controlling interest in the likely purchaser at the sale, and had indirect control over the only class of creditors that could block the sale process. With the federal government on both sides of the proposed sale, critics argue, TARP recipients had very different interests from non-TARP recipients. In a traditional reorganization, the argument goes, the two groups of secured lenders would have been separately classified and given separate opportunities to vote on a plan. The bankruptcy court should have demanded the same kind of consent in the § 363 sale and permitted the sale only with approval from a super-majority of both TARP and non-TARP lenders.

The implicit assumption here is that § 1129's requirements for plan confirmation are applicable in § 363 sales as well. It is well-established that a § 363 sale cannot short circuit § 1129's rules governing distribution of property of the estate to creditors. The terms of the sale, for example, cannot dictate the distribution of sale proceeds to particular creditors in violation of § 1129 priorities.<sup>23</sup> It cannot lock-up the votes of creditors with respect to a forthcoming plan of reorganization (a violation of §§ 1126 and 1129 voting rules).<sup>24</sup> And it cannot dictate the distribution of non-cash sale proceeds to different classes of secured creditors while simultaneously terminating their replacement liens in the proceeds (potentially a violation of § 1129's absolute priority rule).<sup>25</sup> This caselaw, however, is concerned with § 363 sales that do more than just auction the firm's assets to the highest bidder. It deals with sales that make an end-run around § 1129 by specifying post-sale procedures or distributions.

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<sup>19</sup> Bankruptcy Sale Opinion, at 11-12.

<sup>20</sup> These statistics are produced by Lynn LoPucki's WebBRD database, available at [http://lopucki.law.ucla.edu/bankruptcy\\_research.asp](http://lopucki.law.ucla.edu/bankruptcy_research.asp).

<sup>21</sup> Kolka Affidavit at 5.

<sup>22</sup> See, e.g., Brief for Appellants Indiana State Police Pension Trust, et al., at 12, Case No. 09-2311 (2d Circuit June 4, 2009) ("The Treasury Department negotiated with the First Lien Lenders led by the Administrative Agent, [JP Morgan], for a recovery of only \$2 billion. ... JPM received tens of billions of dollars of TARP funds from the Treasury and, therefore, was in no position to negotiate against the Treasury."); "Statement from Non-Tarp Lenders of Chrysler," Wall St. J. (April 30, 2009).

<sup>23</sup> *In re Braniff Airways, Inc.*, 700 F.2d 935, 940 (1983).

<sup>24</sup> *Id.*

<sup>25</sup> *In re Westpoint Stevens, Inc.*, 333 B.R. 30 (2005).

By contrast, § 1129 has little or no application to § 363 sales that are sales and nothing more. If the sale is motivated by valid business concerns;<sup>26</sup> if assets are sold through a non-collusive<sup>27</sup> auction process<sup>28</sup> that yields a fair price<sup>29</sup>; and if proceeds are subsequently distributed through the traditional reorganization process, there are no § 1129 concerns. To be sure, at least one circuit court has held that a bankruptcy court can apply § 1129 requirements to a § 363 sale if an objector shows that it is being denied protections that it would enjoy in a traditional reorganization.<sup>30</sup> But the objector must show that the sale process reduces the objector's recovery or other tangible benefits relative to what it would receive in a reorganization.<sup>31</sup> It is not enough to show that different procedures (such as classification and voting) applying in 363 sales than in reorganizations.

Even putting aside § 1129's application to § 363 sales, it is unclear whether the divergent interests of TARP and non-TARP lenders would have required separate classification in a traditional reorganization. It is not uncommon for a creditor in one class to obtain a controlling voice in another class in order to influence the bankruptcy process, usually via claims trading.<sup>32</sup> Indeed, a DIP lender frequently occupies multiple classes because it extended secured financing

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<sup>26</sup> *In re Lionel Corp.*, 722 F.2d 1063, 1071 (2d Cir. 1983) ("The rule we adopt requires that a judge determining a § 363(b) application expressly find from the evidence presented before him at the hearing a good business reason to grant such an application."). See also *In re Continental Air Lines, Inc.*, 780 F.2d 1223 (5<sup>th</sup> Cir. 1986); *Stephens Indus., Inc. v. McClung*, 789 F.2d 386 (6<sup>th</sup> Cir. 1986).

<sup>27</sup> 11 U.S.C. § 363(n) ("The trustee may avoid a sale under this section if the sale price was controlled by an agreement among potential bidders at such sale, or may recover from a party to such agreement any amount by which the value of the property sold exceeds the price at which such sale was consummated....")

<sup>28</sup> F.R. Bankr. Proc. 6004(f)(1) permits public or private auctions.

<sup>29</sup> *In re Wintz Companies*, 219 F.3d 807 (8<sup>th</sup> Cir. 2000) (Stating that bankruptcy courts have "ample latitude to strike a satisfactory balance between the relevant factors of fairness, finality, integrity, and maximization of assets."); *In re Abbotts Dairies*, 788 F.2d at 149; *In re Willemain*, 764 F.2d 1019, 1023 (4<sup>th</sup> Cir. 1985).

<sup>30</sup> *In re Continental Air Lines, Inc.*, 780 F.2d 1223, 1228 (5<sup>th</sup> Cir. 1986) ("[W]hen an objector to a proposed transaction under 363(b) claims that it is being denied certain protection because approval is sought pursuant to 363(b) instead of as part of a reorganization plan, the objector must specify exactly what protection is being denied. If the court concludes that there has in actuality been such a denial, it may then consider fashioning appropriate protective measures modeled on those which would attend a reorganization plan.").

<sup>31</sup> See, e.g., *In re Torch Offshore, Inc.*, 327 B.R. 254 (Bankr. E.D. La. 2005) (denying an objector's complaint because it failed to show that it would enjoy greater benefits in a reorganization); *In re Condere Corp.*, 228 B.R. 615 (Bankr. S.D. Miss. 1998) (although objectors pointed to lack of a disclosure statement and voting prior to 363 sale, court denied objection because debtor a disclosure statement would be filed and voting would occur after the sale).

<sup>32</sup> See, generally, Paul M. Goldschmid, Note, *More Phoenix than Vulture: The Case for Distressed Investor Presence in the Bankruptcy Reorganization Process*, 2005 Colum. Bus. L. Rev. 191. Well-known examples include *Figter, Ltd. v. Teachers Insurance & Annuity Ass'n*, 118 F.3d 635 (9<sup>th</sup> Cir. 1997); *In re Westpoint Stevens*, 333 B.R. 30 (SDNY 2005); and *In re FiberMark, Inc.*, No. 04-10463 (Bankr. D. Vt. Aug. 16, 2005).

prior to the bankruptcy filing.<sup>33</sup> It may have even purchased unsecured claims before or after the filing. Through its position in multiple classes, the lender can exert great leverage over the bankruptcy process. The federal government was in much the same position in Chrysler. It was a DIP lender who had previously extended prepetition loans; it exerted control over other classes through its TARP lending. The only distinctive feature here is that the government used TARP lending, rather than claims trading, to exert control over multiple classes.

Critics point to a third defect in Chrysler bankruptcy: the assets were sold without a market test of their value because the bidding procedures discouraged third party bidders from participating. Originally, the procedures permitted only “qualified bids,” defined as those that would assume the same unsecured debts (especially the VEBA) that the government’s bid would assume.<sup>34</sup> Later the procedures were amended to permit non-qualifying bids, but gave the federal government and the UAW authority to review these bids prior to acceptance. These auction procedures, critics show, distorted the process.<sup>35</sup> They signaled to potential bidders that the federal government had skewed the process and would stifle competing bids. We therefore have no idea whether the \$2 billion winning bid approximates the fair market value of the assets.

The critics envision an auction procedure that hasn’t been tainted by the parties in interest, but that kind of procedure is rarely seen in practice. It is instead common for auction procedures to favor the stalking horse bidder, which was precisely the role of the federal government in Chrysler’s bankruptcy.<sup>36</sup> That, of course, doesn’t rule out the possibility that Chrysler’s

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<sup>33</sup> See Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, J. Legal Analysis (forthcoming 2009) (analyzing large Chapter 11 filings during 2001 and finding that two-thirds of DIP lenders were prepetition secured lenders).

<sup>34</sup> Motion of Debtors and Debtors in Possession ... for (I) an Order (A) Approving Bidding Procedures ..., Exhibit A to Bidding Procedures Order at 4-6, *In re Chrysler, LLC, et al.*, Case No. 09-50002 (Bankr. SDNY May 3, 2009) [Docket No. 190].

<sup>35</sup> Bankruptcy Sale Opinion at 38-39.

<sup>36</sup> See, e.g., Corinne Ball & John K. Kane, “How to Handle Corporate Distress Sale Transactions,” ALI-ABA Presentation (Oct. 23-24, 2008) (“A ‘qualified bid’ could require a significant cash deposit, that the scope of the bid be substantially equivalent to the scope of the stalking horse bid, a signed purchase agreement (including final schedules, which may be very difficult to prepare), no financing or other non-regulatory conditions, no break-up fees, and stiff overbid requirements.”); Ronald L. Leibow, et al., “Distressed Asset Sales: Selling and Acquiring Assets from the Debtor Estate,” PLI Presentation (March-April 2005) (“Qualified Bid requirements typically require a significant cash deposit, terms on substantially the same basis as the stalking horse bid, a signed purchase agreement which is irrevocable until the assets are sold, and a purchase price that exceeds the stalking horse bid by a specified amount (usually the break-up fee and expense reimbursement combined.”); Harvey R. Miller, “Assets Sales Pursuant to Section 363 of the Bankruptcy Code,” PLI Presentation (Sept. 2003) (“A qualified bid is a bid from a qualified bidder which meets certain qualifications, typically including requirements that the bid: (a) provides for consideration greater than the overbid and initial overbid amounts, (b) has substantially the same terms and conditions as the stalking horse agreement; and (c) is accompanied by satisfactory evidence of committed financing or other ability to perform.”).



assets were sold at fire sale prices. Critics think this is likely based on two features of New Chrysler's capital structure: (1) its debt-asset ratio and (2) the composition of its unsecured claims.

The bankruptcy auction pegged New Chrysler's asset value at \$2 billion. The company, however, will owe the federal government \$6 billion in secured debt and about \$17 billion to unsecured creditors. Even if the government debt is forgiven, New Chrysler will never fulfill its promises to the VEBA and other unsecured claimants unless its future asset value exceeds \$17 billion. Either the New Chrysler is destined to go bankrupt, or the assets are worth far more than their valuation during the bankruptcy – and far more than the \$2 billion they actually fetched at auction.

There are at least three problems with this logic. First, it's unclear what the assets will be worth once Chrysler's operations are rationalized and integrated with Fiat's. Second, the promises to the unsecured creditors may be credible because the government—not New Chrysler—intends to honor them. It seems clear that the government's investment in Chrysler is meant to do much more than save that company: it is meant to help stabilize an entire industry. Chrysler is a conduit for achieving this policy goal. Third, and most importantly, the critics' hypothesis implies that the government's \$2 billion bid for Chrysler's assets was far, far below their fundamental value. Why, then, did we not see competing bids? It seems unlikely that a financial institution, such as a foreign hedge fund, would have looked askance at a massive arbitrage opportunity merely because the bidding procedures favored the government's bid.

Critics also point to the composition of the unsecured claims. New Chrysler assumed the prepetition claims of Old Chrysler. How do we know whether these prepetition claims are being assumed because New Chrysler needs to maintain an ongoing relationship with the claimants (and promote labor peace) or because it is favoring the claimants at the expense of senior lenders? We don't know. But the same question could be asked—and given the same uncertain answer—in many § 363 sales. It is common for a purchaser to assume prepetition liabilities. American Airlines assumed \$3.5 billion of TWA's debts, most of which arose from aircraft leases.<sup>37</sup> Hilco and Gordon Brothers assumed Sharper Image's prepetition liabilities arising from unexpired real estate leases and other executory contracts.<sup>38</sup> Wilbur Ross's International Steel Group assumed the environmental liabilities and certain obligations to salaried and hourly employees of Bethlehem Steel.<sup>39</sup> Were these obligations assumed for legitimate business reasons, or did they divert value from senior creditors?

The foregoing observations suggest that the Chrysler bankruptcy was indeed unexceptional. The bankruptcy is controversial not because it departed from long-standing principles, but rather because government intervention pushed

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<sup>37</sup> American Airlines 10-K (Dec. 31, 2000).

<sup>38</sup> Asset Purchase Agreement between Sharper Image Corporation and a Joint Venture of Hilco Merchant Resources, LLC, Hilco Consumer Capital, LLC, Gordon Brothers Retail Partners, LLC, and GB Brands, LLC (May 29, 2008).

<sup>39</sup> Asset Purchase Agreement by and among International Steel Group Inc., ISG Acquisition Inc., Bethlehem Steel Corporation, and the other sellers named herein (March 12, 2003).

those principles to their limit, showing vividly the power wielded by the DIP lender and the pliability of the modern Chapter 11 process.

## **2. Outer limits of Chapter 11: Bankruptcy as federal agency receivership**

What is unique about the Chrysler bankruptcy is the role of the government as prepetition and DIP lender during a credit crisis. Like any prepetition or DIP lender, the government could impose exacting terms on Chrysler and thereby dictate the course of its distress and bankruptcy. The credit crisis meant that the government held a near-monopoly over the provision of credit, thereby cementing its influence.

This influence transformed the Chrysler bankruptcy into a process resembling a federal agency receivership. Through prepetition loans, the federal government imposed strict deadlines for restructuring and sale of Chrysler's assets. It also obtained power to trigger Chrysler's bankruptcy filing. These powers resemble those possessed by federal agencies, such as the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC), which supervise commercial banks and can impose a receivership if a bank's financial condition deteriorates.<sup>40</sup>

Once Chrysler's bankruptcy was triggered, the government maintained control over the manufacturer via the DIP loan. Loan covenants gave Treasury powers commonly seen in modern Chapter 11 cases:<sup>41</sup> Chrysler was ordered to comply with a weekly budget of receipts and disbursements; it was forbidden to change management or exceed limits on cash disbursements, indebtedness, extensions of credit or other investments, and investments in financial derivatives; and it was forbidden from exercising certain rights in bankruptcy, such as seeking an extension of the exclusivity period.<sup>42</sup> More importantly, loan covenants required Chrysler to obtain approval of acceptable auction bidding procedures within one week of the bankruptcy filing, to obtain approval of a 363 sale within 40 days of the filing, and achieve other "Case Milestones."<sup>43</sup> Also, a default would occur under the DIP loan if secured lenders either (a) objected to the price offered at the 363 sale or (b) made a credit bid at the auction. In the event of default, Treasury had typical remedies: it could terminate the loan commitment, demand immediate repayment, and compel Chrysler to sell assets in order to repay the DIP loan.<sup>44</sup> These remedies could be exercised without court order. Put differently, no automatic stay would exist in the event of default.

The terms of the DIP loan allowed Treasury to dictate the course of the bankruptcy process in much the same way that government agencies can dictate the course of a bank receivership. A federal receiver has broad power to seize a

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<sup>40</sup> See generally Jonathan R. Macey, Geoffrey P. Miller, & Richard S. Carnell, *BANKING LAW AND REGULATION* ch. 8 (2d ed. 2001).

<sup>41</sup> For a survey of typical DIP loan covenants, see Ayotte & Morrison, *supra* note 33. See also Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. Penn. L. Rev. 1209 (2006) and David Skeel, *Creditor's Ball: The 'New' New Corporate Governance in Chapter 11*, 152 U. Penn. L. Rev. 917 (2003) for discussion of the control exerted through DIP financing loans.

<sup>42</sup> 51-58.

<sup>43</sup> *Id.*, at 59-60.

<sup>44</sup> *Id.*, at 62-63.

depository institution, change its management, and sell, liquidate, or reorganize its operations.<sup>45</sup> To be sure, Treasury could not unilaterally seize Chrysler in the same way that the OCC or FDIC can seize a failing bank. Because depository institutions are chartered by state or federal governments, they are subject to government supervision and seizure in the event of insolvency. They can be seized without prior notice or hearing.<sup>46</sup> Although a court can review an agency's decision to appoint a conservator or receiver, the deferential standard of review asks only whether statutory grounds existed for the appointment based on the administrative record<sup>47</sup> or, equivalently, whether the decision was "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law."<sup>48</sup> Once a bank is placed into receivership or conservatorship, there is no judicial oversight of subsequent decisions to sell assets, close the institution, or merge it with another bank.<sup>49</sup>

Treasury, of course, would trip numerous constitutional limits—particularly the Due Process and Takings Clauses—if it unilaterally seized control of Chrysler before or after it entered bankruptcy. But these limits are easily navigated. A simple solution is to offer aggrieved parties a right to sue under the Tucker Act for compensation. That was the government's approach when it intervened in the railroad bankruptcies of the early 1970s, ordered them to continue unprofitable operations until their assets were transferred to a new state-run corporation (Conrail), and compensated creditors with securities in the new Conrail corporation. The Supreme Court held that, if a taking occurred here, it was not an unconstitutional taking because the aggrieved parties could bring suit under the Tucker Act.<sup>50</sup>

But there is an even simpler way to navigate constitutional limits, as the Treasury showed in Chrysler: the government can leverage the ordinary powers of a pre- and post-petition lender to control the debtor's operations as well as the bankruptcy process. No due process or takings issues arise because the government obtains control via contract.

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<sup>45</sup> See generally, Morrison, *supra* note 3.

<sup>46</sup> See, e.g., 12 U.S.C. § 191 (stating that the "Comptroller of the Currency may, without prior notice or hearings, appoint a receiver for any national bank" if grounds for appointment of a receiver exist), § 203(a) (giving OCC same power with respect to appointment of a conservator).

<sup>47</sup> See, e.g., Franklin Savings Ass'n v. Director, Office of Thrift Supervision, 934 F.2d 1127 (10<sup>th</sup> Cir. 1991) (interpreting the phrase "on the merits" in 12 U.S.C. 1464, governing receiverships and conservatorships for savings associations, and explaining that "[r]eview 'upon the merits' simply means the district court's decision to either dismiss the action or remove the conservator should be based upon the merits of the action (i.e., whether statutory grounds for the appointment of a conservator exist), rather than on procedural or policy oriented grounds."). See also Woods v. Federal Home Loan Bank Bd., 826 F.2d 1400 (5<sup>th</sup> Cir. 1987) (same); Guaranty Savings & Loan Ass'n v. FHLBB, 794 F.2d 1339 (8<sup>th</sup> Cir. 1986) (same).

<sup>48</sup> 12 U.S.C. 203(b)(1). Courts have interpreted the phrase "on the merits" to imply this standard of review. See, e.g., Woods, 826 F.2d at 1408-09.

<sup>49</sup> Judicial review is available for the decision to impose a receivership, but not for its conduct. See, e.g., James Madison Ltd. By Hecht v. Ludwig, 82 F.3d 1085 (DC Cir. 1996).

<sup>50</sup> Blanchette v. Connecticut General Insurance Corps., 419 U.S. 102 (1974).

Moreover, the terms of the Treasury's DIP loan—and the absence of alternative sources of liquidity—meant that judicial oversight would matter little to the course of the case. If Chrysler were not sold within the time and on the terms set out in the covenants, Treasury could withdraw financing and force immediate liquidation (and Fiat might walk away). That reality was clear to the bankruptcy judge.<sup>51</sup>

These observations suggest that the Chrysler bankruptcy was radical because it showed how standard Chapter 11 practices can, when harnessed to government action, mimic procedures that are used to seize insolvent banks.<sup>52</sup> The Chrysler bankruptcy did not distort existing precedent. It pushed precedent to its limit.

### 3. The future of Chapter 11

The Chrysler and GM bankruptcies may typify modern Chapter 11, but should we have a bankruptcy process that works this way? Modern Chapter 11 could offer the worst of both worlds. It is not merely a traditional reorganization procedure in which debts are restructured or reduced and equity is redistributed to existing creditors. That process has long been criticized as one that is vulnerable to the biases of judges and to jockeying and holdup by creditors and equityholders.<sup>53</sup> Eastern Airlines has long been the poster-child for these problems.<sup>54</sup> Nor is the modern Chapter 11 merely a speedy auction in which firms are routinely sold off. That process has likewise been the object of much criticism because it can prematurely expose a firm to the market, generate fire-sale prices with correspondingly low returns to unsecured creditors, and yield a (temporary) misallocation of resources.<sup>55</sup> Modern Chapter 11 is instead a

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<sup>51</sup> See, e.g., Bankruptcy Sale Opinion at 17-18 (“... delay may vitiate several vital agreements negotiated amongst the Debtors and Various constituents. Thus, approval of the Debtors’ proposed sale of assets is necessary to preserve some portion of the going concern value of the Chrysler business and to maximize the value of the Debtors’ estates. ... The Governmental Entities, the funding sources for the Fiat Transaction, have emphasized that the financing offered is contingent upon a sale closing quickly. ... Thus, the Debtors were confronted with either (a) a potential liquidation of their assets which would result in closing of plants and layoffs, or (b) a government-backed purchase of the sale of their assets ...”).

<sup>52</sup> Bank receiverships differ from the bankruptcy process along another dimension: when the FDIC intervenes, it is pursuing an explicit policy to minimize cost to the deposit insurance fund. See generally FDIC, *MANAGING THE CRISIS: THE FDIC AND RTC EXPERIENCE* Ch. 2 (1997). Although different policy goals animated the Chrysler bankruptcy—the Treasury acted to minimize costs to auto industry workers and suppliers—they yielded similar outcomes. The FDIC prioritizes the claims of depositors; the Treasury prioritized the claims of workers and suppliers (relative to prepetition secured debt).

<sup>53</sup> See, e.g., Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. Legal Stud. 127 (1986).

<sup>54</sup> Lawrence A. Weiss & Karen H. Wruck, *Information Problems, Conflicts of Interest, and Asset Stripping*, 48 J. Fin. Econ. 55 (1998).

<sup>55</sup> See, e.g., Andrei Shleifer & Robert W. Vishny, *Liquidation Values and Debt Capacity: A Market Equilibrium Approach*, 47 J. Fin. 1343 (1992); Todd C. Pulvino, *Do Asset Fire Sales Exist? An Empirical Investigation of Commercial Aircraft Transactions*, 53 J. Fin. 939 (1998).

combination of both. The outcome—a traditional reorganization or a speedy auction—depends on the bargaining power of the various constituents. A powerful DIP lender can push for a speedy sale, as it did in the Chrysler bankruptcy, possibly at the expense of other creditors. Junior creditors can push back and delay the bankruptcy process in hopes of at least a small recovery.<sup>56</sup>

Instead of a bankruptcy process that is vulnerable to creditor jockeying or one that is vulnerable to fire sales, modern Chapter 11 is a process vulnerable to both problems. Recent scholarship highlights this “worst of both worlds” phenomenon. For example, one study shows that a Chapter 11 is more likely to end in a sale when secured lenders are oversecured and therefore unconcerned about the risk of a fire sale.<sup>57</sup> Sales are significantly less likely when a firm has no secured debt and when secured claims exceed the value of the firm’s assets. Another study suggests that the recoveries of unsecured creditors are substantially lower when a firm is sold off through § 363 than when it is reorganized.<sup>58</sup>

To be sure, our system may not be as costly as it seems. Some studies have found that the bankruptcy process is no more costly than comparable change-of-control transactions,<sup>59</sup> that the costs of this process are small compared the costs of financial distress generally,<sup>60</sup> and that firms in bankruptcy are no less efficient in allocating productive resources than firms operating outside bankruptcy.<sup>61</sup> Then again, it is difficult to disentangle the costs of our bankruptcy system from the costs of financial distress generally, because the law affects the resolution of distress in or out of court. And one recent study suggests that the expected cost of financial distress may be as high as 4.5% of the pre-distress value of the firm’s assets.<sup>62</sup>

If the inefficiencies in our modern Chapter 11 process are significant, it makes sense to consider alternatives. Once it was common for scholars to propose alternatives. The 1980s and 1990s saw proposal after proposal issued by Mark Roe,<sup>63</sup> Douglas Baird,<sup>64</sup> Lucian Bebchuk,<sup>65</sup> Robert Rasmussen, and others.<sup>66</sup> The

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<sup>56</sup> See Lawrence Weiss & Vedran Capkun, “Bankruptcy Resolution: Priority of Claims with the Secured Creditor in Control,” working paper (2007) (available at <http://law.bepress.com/cgi/viewcontent.cgi?article=1929&context=alea>) (showing that that absolute priority was violated in favor of unsecured creditors in 28% of cases filed by publicly-traded corporations between 2002 and 2004).

<sup>57</sup> Ayotte & Morrison, *supra* note 33.

<sup>58</sup> Lynn M. LoPucki, *Bankruptcy Fire Sales*, 106 Mich. L. Rev. 1 (2007).

<sup>59</sup> Frank H. Easterbrook, *Is Corporate Bankruptcy Efficient?*, 27 J. Fin. Econ. (1990).

<sup>60</sup> Gregor Andrade & Steven N. Kaplan, *How Costly is Financial (Not Economic) Distress? Evidence from Highly Leveraged Transactions That Became Distressed*, 53 J. Fin. 1443 (1998).

<sup>61</sup> Vojislav Maksimovic & Gordon Phillips, *Asset Efficiency and Reallocation Decisions of Bankrupt Firms*, 53 J. Fin. 1495 (1998).

<sup>62</sup> Heitor Almeida & Tomas Philippon, *The Risk-Adjusted Cost of Financial Distress*, 62 J. Fin. 2557 (2007).

<sup>63</sup> Mark Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 Colum. L. Rev. 527 (1983)

<sup>64</sup> Baird, *supra*, at note 53.

proposals were attacked, and largely abandoned, at a time when some observers felt that Chapter 11 actually worked pretty well. Times have changed. It may be time to take the proposals seriously.

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<sup>65</sup> Lucian Arye Bebchuk, *A New Approach to Corporate Reorganizations*, 101 Harv. L. Rev. 775 (1988).

<sup>66</sup> E.g., Philippe Aghion, Oliver Hart, & John Moore, *Improving Bankruptcy Procedure*, 72 Wash. U. L. Q. 849 (1994).