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**WRITTEN STATEMENT**

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**TO:** Congressional Oversight Panel  
**FROM:** Barry E. Adler  
the Charles Seligson Professor  
New York University School of Law  
**SUBJECT:** AIFP Hearing (Revised Statement)  
**DATE:** August 5, 2009

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The following is a summary of my perspective on the recent Chrysler and General Motors bankruptcies. The summary includes a description of how I believe the government influenced the process. I also suggest legislation that would address what I perceive as faults in the case procedures.

The recent bankruptcy cases of Chrysler and General Motors were successful in that they quickly removed assets from the burden of unmanageable debt, but the price of this achievement was unnecessarily high because the cases established a precedent for the disregard of creditor rights. As a result, the automaker bankruptcies may usher in a period where the specter of insolvency will increase the cost of capital in an economy where affordable credit is sorely needed.

After brief analysis of the Chrysler and GM cases, below, I offer a proposal for an amendment to the Bankruptcy Code. The proposal is designed to ensure that future bankruptcy courts honor the entitlement for which creditors contract and without which one cannot expect them to lend on favorable terms.

### ***The Chrysler Bankruptcy***

The rapid disposition of Chrysler in Chapter 11 was formally structured as a sale under §363 of the Bankruptcy Code.<sup>1</sup> While that provision does, under some conditions, permit the sale of a debtor's assets, free and clear of any interest in them, the sale in Chrysler was irregular and inconsistent with the principles that undergird the Code.

The most notable irregularity of the Chrysler sale was that the assets were *not* sold free and clear, but rather the purchaser, "New Chrysler"—an affiliation of Fiat, the U.S. and Canadian governments, and the United Auto Workers ("UAW")—took the assets subject to specified liabilities and interests. Notably, New Chrysler assumed about \$4.5 billion of Chrysler's obligations to, and distributed 55% of its equity to, the UAW's voluntary beneficiary employee association ("VEBA") in satisfaction, perhaps full satisfaction, of old Chrysler's approximately \$10 billion unsecured obligation to the VEBA (which is a retired workers benefit fund).<sup>2</sup> So long as New Chrysler remains solvent, this means that at least half of its obligation to the VEBA will be paid. This, while Chrysler's secured bondholders are to receive only \$2 billion in satisfaction of about \$7 billion in claims, about 30 cents on the dollar. That is, money that might have been available to repay these secured creditors was withheld by the purchaser to satisfy unsecured obligations owed the UAW. Thus, the sale of Chrysler's assets was not *merely* a sale, but also a distribution of the sale proceeds seemingly inconsistent with contractual priority among the creditors.

To be sure, the situation is more complicated than may first appear. The purchaser in this case was funded primarily by the U.S. government, which had previously advanced \$4 billion in TARP funds and, along with the Canadian government, agreed to loan the new enterprise billions more. The government had political reasons to assure continuation of auto production and toward that end may have been willing to pay more for the assets

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<sup>1</sup> The Bankruptcy Code appears in Title 11 of the United States Code.

<sup>2</sup> Although there is a legal distinction between the UAW and its VEBA fund for retired union workers, for simplicity of exposition, the distinction is generally ignored in this statement, which sometimes treats as interchangeable payments to the UAW on account of its claims in bankruptcy and transfers to the VEBA.

than they were worth. For purposes of bankruptcy law, then, the question is not whether the government paid the UAW (or holders of other assumed obligations) too much, but whether the process deprived the secured bondholders of a return to which the law entitles them. Some of these bondholders, albeit a minority, objected to the sale because they believed they should have received more and would have but for the orchestration of the sale by the U.S. Treasury and automotive task force.

Proponents of the Chrysler sale argue that the sale was proper despite the protests. They contend that the secured bondholders who objected to the sale were a minority of such creditors and as a minority lacked standing to complain, a point to which I return below. More fundamentally to the bankruptcy analysis, the proponents of the transaction insist that the company's assets would have been worth little in liquidation and so the secured bondholders should have been satisfied with the return the bankruptcy sale provided them. But there was no market test of this proposition because Judge Gonzalez, who presided over the Chrysler case, permitted only days for a competitive bid to challenge the proposed sale and restricted bids to those that were willing to have the bidder assume specified liabilities, including Chrysler's obligation to the VEBA.<sup>3</sup> (There was an exception to this restriction for specially approved bids, but by the court's order, the UAW had to be consulted before a noncompliant bid would be approved.)

Given the constraint on bids, it is conceivable that the liquidation value of Chrysler's assets exceeded the company's going-concern value but that no liquidation bidder came forward because the assumed liabilities—combined with the government's determination to have the company stay in business—made a challenge to the favored sale unprofitable, particularly in the short time frame afforded. It is also possible that, but for the restrictions, there might have been a higher bid for the company as a going concern, perhaps in anticipation of striking a better deal with workers.<sup>4</sup> Thus, the approved sale may not have fetched the best price for the Chrysler assets. That is, the diversion of sales proceeds to the assumed liabilities may have been greater than the government's subsidy of the transaction, if any, in which case the secured creditors would have suffered a loss of priority for their claims. There is nothing in the Bankruptcy Code that allows a sale for less than fair value simply because the circumstances benefit a favored group of creditors.

Against this criticism, the sale is defended on the ground that quick action was required to preserve the company's going concern value, but it is not certain that company's going concern value exceeded its liquidation value. Moreover, restrictions placed on the bidding process do not appear to be sensible even given a time constraint. The sale served the government's desire to assure continuation of the company and to protect the union's interest, but it is not apparent that the sale was designed to maximize the return to the bankruptcy estate and there seems no legitimate reason to have restricted

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<sup>3</sup> The bankruptcy court opinion in Chrysler appears at 405 B.R. 84 (Bankr. S.D.N.Y. 2009).

<sup>4</sup> Note that these restrictions would have prevented credit bidding even if the secured bondholders had collectively desired to make such a bid because the required assumption of liabilities effectively eliminated the secured lender priority that is necessary for a credit bid.

bids based on the bidders' willingness to assume favored liabilities. The approved sale, therefore, ran afoul of the Supreme Court's admonition, in the analogous case of *North LaSalle Street*, that a court should not settle a valuation dispute among parties with a determination "untested by competitive choice."<sup>5</sup>

Viewed another way, the approved transaction was not a sale at all, but a disguised reorganization plan, complete with distribution to preferred creditors. In this light, the secured bondholders who objected to the sale and distribution did not necessarily have a complaint with the amount paid (by the government) for the assets. Indeed the objecting creditors may well concede that the amount paid *to the UAW* was quite high; they objected to the distribution, which favored others at their expense. That is, the objection was to the fact that the approved transaction distributed assets inconsistently with the priorities established under the Bankruptcy Code.

Analysis must turn next, then, to whether the objecting secured bondholders could have blocked the transaction had the distributions in the case been subject to the rules prescribed by Chapter 11 rather than as part of a §363 sale. One who would defend the approved transaction would say "no," relying again on the contention that the liquidation value of Chrysler was so small that the secured creditors received at least their due from the sale, an amount that the judge deemed satisfactory. What this argument overlooks, however, is that Chapter 11 contains rules designed precisely to protect creditors from a judicial determination with which the creditors disagree. When Judge Gonzalez approved the Chrysler sale, he stripped these protections from the secured creditors.

More specifically, the Chapter 11 rules that shield creditors from judicial error are called "fair and equitable" and "no unfair discrimination" provisions, which appear in §1129(b) of the Code and govern the confirmation of reorganization plans. The requirement that a reorganization plan be fair and equitable means that if a class of claims objects to the distribution under the plan, the plan may not be confirmed if the objecting class is not paid in full while a lower-priority class receives anything under the plan. The requirement that a plan not discriminate unfairly means that if a class of claims objects to the distribution under the plan, the plan may not be confirmed if a class of equal priority receives a higher rateable return under the plan. When applicable, these provisions prevent confirmation *even if* a judge is convinced that the claims in the dissenting class are receiving at least what they would receive in liquidation. Whether the dissenting class believes that the judge is mistaken as to the true liquidation value of the firm or merely demands its share of what it believes to be a firm's going concern surplus over liquidation value, the class can decide for itself whether to accept the plan.

In Chrysler, the dissenting secured bondholders attempted to invoke the protection against unfair discrimination. Whatever the judge might deem to be the liquidation value of their collateral, §506 of the Bankruptcy Code bifurcates an undersecured claim—a claim that exceeds the value of its collateral—into a secured portion and an unsecured

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<sup>5</sup> Bank of America v. 203 North LaSalle Street Partnership, 526 US 434, 458 (1999).

portion. The secured portion is equal to the judicially determined value of the collateral; the unsecured portion is equal to the deficiency claim. The secured creditor objectors to the Chrysler sale based a legal challenge on the treatment of their deficiency claims. A deficiency claim, like the UAW claims, is a general unsecured obligation and these claims have the same priority. Yet while the sale and distribution approved in Chrysler paid the deficiency claims nothing, it paid the UAW claims with billions of dollars. This, the objectors argued, is an unfair discrimination that would have rendered unconfirmable a formal reorganization plan and should have rendered illegitimate what they saw as a de facto reorganization embodied in the sale and distribution.

There is merit in the dissenters' argument.<sup>6</sup> To be sure, proponents of the pro-UAW distribution can argue that the right to veto a plan on the basis of unfair discrimination is a class-based right—not available to individual dissenters within an accepting class of claims—and that a large majority of the secured bondholders accepted the distribution.<sup>7</sup> But the accepting secured creditors were largely recipients of government TARP funds and thus arguably beholden to the government, which engineered the distribution to the UAW. Therefore, under §1122 of the Bankruptcy Code and relevant precedent, in a formal reorganization, the judge might have been obliged to classify the TARP lenders separately from the non-TARP bondholders, thereby giving the dissenters control over their own class and, perhaps, the right to veto the UAW distribution as unfairly discriminatory. Against this unfair discrimination contention, plan proponents can argue further that the payment to the VEBA not as a distribution on account of an unsecured claim at all, but rather as prospective expense that assured the company a needed supply of UAW workers, with the union thus portrayed as a critical vendor of labor. However, even if one assumed that the automaker's value was greater as a going concern than in liquidation, one wonders whether so large a transfer to its labor force would have been necessary in this depressed economy. In any case, because the court characterized the transfer of assets from Chrysler to New Chrysler as a sale rather than as reorganization, it didn't need to reach the classification issue or the critical vendor issue. Consequently, this characterization improperly denied the dissenters the chance at the full protections of the Bankruptcy Code.

The foregoing assumes that the dissenting secured creditors had standing to object to the proposed, and ultimately approved, sale of Chrysler's assets. As noted above, proponents of the sale argued that the dissenters, as a minority of the secured creditors, lacked such standing. The proponents pointed to a provision of the secured bondholders' credit agreement that arguably granted an agent of the bondholders the right to sell their collateral on behalf of the group. According to this argument, because the bondholders'

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<sup>6</sup> Many courts agree that a de facto reorganization plan is improper. See, e.g., *In re Westpoint Stevens Inc.*, 333 B.R. 30 (S.D.N.Y.2005); *Pension Benefit Guar. Corp. v. Braniff Airways, Inc.*, 700 F.2d 935 (5th Cir. 1983). There is significant disagreement, however, over what constitutes a de facto reorganization plan. De facto reorganizations are further discussed below.

<sup>7</sup> Section 1126 of the Bankruptcy Code provides that a class of claims accepts a plan if a majority of claim holders, holding at least two-thirds of claims by amount, accepts the plan.

agent was obliged to represent the bondholder majority that favored the sale, the agent properly consented to the transaction on behalf of all bondholders. Judge Gonzalez agreed and approved the sale, despite the lack of a true auction, in part because, in his opinion, given the agent's consent, there was no objection. The judge rejected the dissenters' claim, among others, that the influence of the TARP lenders among the bondholders tainted the agent's authority.

Whether Judge Gonzalez was correct to rule that the secured creditor dissenters should be deemed to have consented to the sale of their collateral is a matter of state contract law rather than bankruptcy law. But even if the judge correctly interpreted state law, Chrysler remains an unsettling bankruptcy precedent because approval of a sale of assets under §363 is not limited to a case where the affected parties consent. Some courts permit a sale free and clear of liens despite the objection of a secured creditor who will not be fully repaid by the proceeds.<sup>8</sup> Moreover, a §363 sale of a debtor's assets may occur over the objection of an unsecured class of claims, one that disputes the efficacy of a sale because the creditors believe they would, despite their lack of priority, receive a better distribution if the sale is disallowed. (Indeed, in Chrysler itself, there were unsecured creditors—tort claimants, e.g.—who objected to the sale on other grounds and may have had a valid argument, as a class, on this ground as well.) Thus, given the holding in Chrysler, if a sale of a firm's assets is to occur without a market test, there remains the opportunity for courts to approve a de facto reorganization plan that fails to protect creditor entitlements even over the objection of the disadvantaged creditors.

There are at least two negative consequences from the disregard of creditor rights. First, at the time of the deviation from contractual entitlement, there is an inequitable distribution of assets. Take the Chrysler case itself, where the approved transaction well-treated the retirement funds of the UAW. If such treatment deprived the secured creditors of their due, one might well wonder why the UAW funds should be favored over other retirement funds, those that invested in Chrysler secured bonds. Second, and at least as importantly, when the bankruptcy process deprives a creditor of its promised return, the prospect of a debtor's failure looms larger in the eyes of future lenders to future firms. As a result, given the holding in Chrysler, one might expect future firms to face a higher cost of capital, thus dampening economic development at a time when the country can least well afford impediments to growth.

### ***General Motors***

Chrysler was a blueprint for the General Motors bankruptcy, which, like that of Chrysler, included a sale of the debtor's valuable assets to an entity that assumed unsecured obligations owed its workers or former workers. In the case of GM, the purchaser, "New GM," owned largely by the United States Treasury, agreed to satisfy General Motors' approximately \$20 billion pre-bankruptcy obligation to the VEBA with

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<sup>8</sup> See *In re PW, LLC*, 391 B.R. 25 (9<sup>th</sup> Cir. BAP 2008), which describes the varying judicial approaches to this question.

a new \$2.5 billion note as well as \$6.5 billion of the new entity's preferred stock, 17.5% of its common stock, and a warrant to purchase up to an additional 2.5% of the equity; depending on the success of New GM, the VEBA claim could be paid in full. As in the Chrysler case, the sale procedures required that, absent special exemption, any competing bidder was to assume liabilities to the UAW as a condition of the purchase. Therefore, once again, there was no true market test for the sale.

The primary difference between the cases, other than much larger size of General Motors, is that in GM there were no objections to the sale by holders of senior-secured claims, which were held by the United States or Canadian governments or were to be assumed by the purchaser. Rather, in the case of General Motors, the United States and, to a lesser extent, Canadian governments were both the sponsors of the asset purchase that favored the UAW and the senior lenders from whose pockets any consequent diversion of value likely came. In particular, the United States Treasury, under TARP authority, lent GM about \$50 billion in a combination of pre- and post-petition secured transactions; the governments assigned these obligations to New GM, which then credit bid for the assets. Some unsecured creditors objected to the transaction. But while the unsecured claims are substantial—including about \$27 billion in unsecured bonds alone—the GM bankruptcy estate will receive between 10% and 12% of the shares of New GM plus warrants for additional shares. The value of these shares and warrants, plus that of other assets not tendered to New GM, may well exceed any plausible bid—net of the secured claims—that GM could have received from anyone else for the GM assets.

Still, just as in the case of Chrysler, the approval of a restricted bid process establishes a dangerous precedent, one that went unnoticed, or at least unnoted, by the court. In his opinion approving the GM sale, Judge Gerber addresses the objections of some unsecured creditors and makes the following observation:

A 363 sale may ... be objectionable as a [disguised reorganization] plan if the sale itself seeks to allocate or dictate the distribution of sale proceeds among different classes of creditors. But none of those factors is present here. The MPA does not dictate the terms of a plan of reorganization, as it does not attempt to dictate or restructure the rights of the creditors of this estate. It merely brings in value. Creditors will thereafter share in that value pursuant to a chapter 11 plan subject to confirmation by the Court.<sup>9</sup>

In this passage, however, Judge Gerber ignores the sales procedure, which, like that in Chrysler, strictly limited the time for competing bids and restricted bidders to those willing to assume significant UAW liabilities. The process thus precluded a potentially higher bid by a prospective purchaser who was unwilling to make the same concessions to the UAW that the government-sponsored purchaser was willing to endure. Thus, there remained the theoretical possibility that the process impermissibly transferred asset value from the company's other creditors to the UAW. This is merely a theoretical

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<sup>9</sup> In re General Motors, Corp. 2009 WL 1959233 (Bankr. S.D.N.Y.)

possibility. As noted above, it may well be that no creditor other than the government secured lenders suffered a loss of priority from the transaction. But the case stands as precedent that might cause later lenders to doubt whether future debtors will be forced in bankruptcy to live up to their obligations. And as also noted above, wary lenders are inhospitable to economic development.

### ***Proposed Reform***

The Chrysler and GM bankruptcy cases are problematic because they include a sale of virtually all of the debtors assets under §363 of the Bankruptcy Code without a market test for the value of those assets. In Chrysler and in GM, had the price paid for the assets been undeniably fair, dissenting creditors would have had no basis for complaint so long as they received a ratable share of the sale proceeds consistent with their levels of priority. In neither case, however, was the price undeniably fair. It is objectionable that in each case the process favored some creditors over others through the assumption of some claims and the consequent relegation of others to receive perhaps inadequate sales proceeds.

A response to this problem could be a ban on the use of §363 to sell all or substantially all of the assets of a debtor in bankruptcy. Without a sale as a tool for de facto reorganization, a court would be forced to follow the Bankruptcy Code's procedural provisions in an actual reorganization of a debtor and could not easily deprive creditors of the Code's protections. This response would be excessive, however. So long as a sale of a firm's assets is subject to a true market test, a sale may be the best and most efficient way to dispose of an insolvent debtor. Indeed, bankruptcy courts have increasingly, and usefully, conducted all-asset sales. The key is to ensure a *true* market test.

State courts have significant experience in deciding whether a proposed sale of a firm is likely to achieve the best price for investors. Under a line of cases that comprise what is referred to as the *Revlon* doctrine, the Delaware courts have imposed a standard that directors must meet when a corporation is up for sale. While this standard does not require any particular process in every case, the courts have suggested that there is a general obligation for the directors of the firm to hold an auction or conduct some other form of market test if there is a doubt about the true value of the firm.<sup>10</sup> Congress would do well to establish as a minimum procedural safeguard state law requirements for §363 sales of all or substantially all of a debtor's assets, at least where the debtor is large enough to justify the administrative expense of such a process.

In addition, as described above, the requirement that a bidder assume some of a debtor's liabilities dictates the distribution of sale proceeds, and cannot enhance the amount of those proceeds. Therefore, a condition of liability assumption is not a proper part of any sale, and should not be permitted, regardless of applicable state law.

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<sup>10</sup> The recent Delaware Supreme Court case of *Lyondell Chemical Co. v. Ryan*, 970 A.2d 235 (Del. 2009) summarizes the current state of the *Revlon* doctrine (though the holding of *Lyondell* addresses only a narrow issue of director liability).

To accomplish these ends, Congress could add to the Bankruptcy Code a new subsection of §363, one that would provide:

*The trustee may sell property under subsection (b) or (c) of this section only if—*

*(1)(A) where the debtor is not a small business debtor, the sale of all or substantially all of the debtor’s assets complies with the requirements that would be imposed on the debtor by applicable nonbankruptcy law if the debtor were a corporation that was not a debtor and if such corporation’s equity interest were publicly traded and subject to a bid for control; and (B) the process for the sale of such property imposes no condition, whether or not subject to exception, that an offeror agree to assume or pay some but not all claims; or*

*(2) no holder of a claim, except a claim that will receive on account of such claim cash equal to the allowed amount of such claim upon distribution of the property of the estate or as of the effective date of the debtor’s confirmed plan, objects to the sale.*

This provision, if adopted, would not apply to a small business debtor,<sup>11</sup> which cannot be expected to absorb the expense of auctioning its assets, and would have no effect on a debtor that, while too large to qualify as a small business debtor under the Bankruptcy Code, is still small enough that applicable state law would not impose a market test. For large debtors such as Chrysler or GM, however, whether or not publicly traded,<sup>12</sup> the provision would grant any creditor with a claim that will not be paid in full a right to insist on the sort of process that state law would provide shareholders of a solvent firm. This would include, where appropriate, the right to insist on an openly contested auction with ample time for potential bidders to assess the assets on which they may bid. Reliance on applicable state law—a common feature elsewhere in the Bankruptcy Code—would provide a debtor with the flexibility to opt out of an auction or other market test if exigent and unusual circumstances would allow a firm to opt out outside of bankruptcy. Yet, the provision would advantageously prevent a debtor from concluding a sale pursuant to a process that state law would disallow even if a bankruptcy judge believed, perhaps mistakenly, that the sale would be in the interest of the bankruptcy estate. That is, for a large firm, the bankruptcy sale process could not be more permissive than that required by applicable state law. And under no circumstance could the sale of a debtor’s assets be conditioned on a bidder’s willingness to assume some but not all of the

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<sup>11</sup> This term is defined by §101(51D) of the Bankruptcy Code.

<sup>12</sup> The proposed provision is designed to apply and to protect creditors in large, privately held firms just as it would apply to a publicly traded firm. The reference in the proposed provision to a “publicly traded” controlling interest is designed as a hypothetical test that would trigger the applicability of the provision; such tests are common in the Bankruptcy Code. A related provision might be desirable to define “publicly traded” for these purposes, though this term might be plain enough for courts to interpret in context.

debtor's liabilities, as this practice is illegitimate, and was the crux of the problem in the Chrysler and GM cases.