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A REASSESSMENT OF BANKRUPTCY REORGANIZATION AFTER CHRYSLER AND GENERAL MOTORS

BARRY E. ADLER*

ABSTRACT

The descent of Chrysler and General Motors into bankruptcy threatens the chapter 11 reorganization process itself. In each case, a judge approved a transfer of a debtor's assets to favored creditors under circumstances where holders of other claims were denied basic safeguards. Legal reform is required, and proposed here, to assure that aggrieved creditors are granted protection either of the marketplace or of the Bankruptcy Code's creditor democracy provisions. Such reform could help minimize the cost of capital to future debtors.

INTRODUCTION

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

After brief analysis of the Chrysler and General Motors cases, below, and a short description of potentially negative consequences, I comment on how these cases fit into current bankruptcy practice and how courts might disadvantageously extend these precedents. Finally, I offer a proposal for a Bankruptcy Code revision that might curb potential excesses. The proposal is designed to ensure that future bankruptcy courts honor the entitlement for which creditors contract and without which one cannot expect creditors to lend on favorable terms.

* Bernard Petrie Professor of Law and Business, New York University. This article is based on testimony given before the Congressional Oversight Panel's July 27, 2009 hearing on assistance to the automobile industry under the Troubled Asset Relief Program. I thank Douglas Baird, Steve Choi, Tom Jackson, Marcel Kahan, Troy McKenzie, Ed Morrison, Bob Rasmussen, and Mark Roe for conversation that was valuable in the preparation of that testimony and this article. An earlier, working title of this article, "What's Good for General Motors," was inspired by a famous, or infamous, quote of Charles Erwin Wilson, General Motors president and later Secretary of Defense, who testified in 1953 before the Senate Armed Services Committee that "for years I thought that what was good for the country was good for General Motors and vice versa."

I. THE CHRYSLER BANKRUPTCY

The rapid disposition of Chrysler in chapter 11 was formally structured as a sale under section 363 of the Bankruptcy Code.¹ 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. More specifically, 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 of old Chrysler's approximately \$10 billion unsecured obligation to the VEBA (which is a retired workers benefit fund).² So long as New Chrysler remains solvent, this means that at least about half of its obligation to the VEBA will be paid. This, while Chrysler's secured creditors—who held a priority claim on all assets—are to receive only \$2 billion in satisfaction of about \$7 billion in claims, or about 30 cents on the dollar. It may seem, then, that money otherwise 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 may be seen as illegitimate in its diversion of proceeds away from the bankruptcy estate and thus away from the secured creditors entitled to those proceeds.

Appearance can be deceiving, however, and while in fact troubling, the Chrysler transaction is more complicated than it may at first seem. The sale in Chrysler was orchestrated by the U.S. government through the Treasury and a specially created automotive task force. The purchaser in this case was funded primarily by the U.S. government, which had previously advanced \$4 billion in funds from the Troubled Asset Relief Program ("TARP") and, along with the Canadian government, agreed to loan the new enterprise billions more. The governments had political reasons to assure continuation of auto production and toward that end may have been willing to pay more for the assets than they were worth. For purposes of bankruptcy law, then, the question is not whether the government paid the UAW too much, or whether funds were diverted, but whether the process deprived the secured creditors of a return to which the law entitled them. Some of these creditors, albeit a minority, objected to the sale because they

¹ The facts of the Chrysler case reported here are taken from *In re Chrysler*, 405 B.R. 84 (Bankr. S.D.N.Y. 2009), *aff'd*, 576 F.3d 108 (2d Cir. 2009), *vacated as moot*, 130 S.Ct. 1510 (2009). The Bankruptcy Code appears in title 11 of the United States Code.

² Although there is a distinction, legal as well as practical, between the UAW and its VEBA fund for retired union workers, for simplicity of exposition, such distinction is generally ignored in this article.

believed they should have received more and would have but for government intervention.

Proponents of the Chrysler sale defend it on both procedural and substantive grounds. They contend that the secured creditors 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 point to the fact that Judge Gonzalez, who presided over the case, found that the company's assets would have been worth little in liquidation and so the secured creditors should have been satisfied with the return the bankruptcy sale provided them.

In principle, an argument that the price was fair is, of course, a reasonable defense of the sale. And the judge may well have been correct that the price was fair. But there was no market test of this proposition because Judge Gonzalez 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. There was an exception to this restriction for specially approved bids, but noncompliant bids were not entitled to information about the company that qualified bidders could access and, by the court's order, the UAW had to be consulted before a noncompliant bid would be approved. (Although the court might have simply abandoned the restriction if presented with an attractive enough offer, presumably the restriction was put in place because it was to have some effect.)

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 recession-driven 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. 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 grounds that quick action was required to preserve the company's going concern value and that Chrysler was, in any case, effectively on the market over the years it declined toward bankruptcy. But it is not certain that delay would have been excessively costly, or even that the company possessed any going concern value to protect. In any case, the restrictions placed on the bidding process do not appear to be sensible regardless of the sale's timing. The finality of bankruptcy might have attracted a bidder who did not appear

earlier, and such a bidder might have been dissuaded by the requirement that it assume favored liabilities. The sale restrictions 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.

There is yet another wrinkle. In the Chrysler bankruptcy, the United States government possessed significant leverage as perhaps the only available lender to the debtor in bankruptcy (referred to as the "Debtor-in-Possession" or "DIP"). And it is possible that in the absence of DIP finance, the value of Chrysler's assets would have deteriorated prior to sale. But the fact that a lender—even a needed lender—wants a quick sale with conditions attached does not imply that the debtor should make the requested concessions. Indeed, as discussed below, a court's unwillingness to have the debtor buckle under may increase the debtor's bargaining position and thus the return to the estate.

All told, despite the argument that the debtor was served by a quick, bidder-restricted sale, approval of such a sale over dissent runs afoul of the Supreme Court's admonishment, 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."³ The sale in *Chrysler* was not sufficiently tested by competitive choice.

Viewed another way, the approved transaction was not a sale at all, but a disguised reorganization plan, complete with distribution to creditors including on the workers' claims. In this light, the secured creditors' objection was to the fact that the approved transaction—a de facto reorganization plan—illegitimately distributed assets inconsistently with the priorities established under the Bankruptcy Code.⁴

³ Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 458 (1999). In *North LaSalle Street*, the pre-bankruptcy shareholders of an insolvent debtor in bankruptcy offered to pay for a continuing equity interest in the reorganized entity. When a creditor protested, the shareholders asked the bankruptcy court to affirm the exchange over the objection. The Supreme Court ruled that even if the bankruptcy judge believed the price offered to be a fair, the court lacked the authority to approve the transaction absent a market test of the price. The Bankruptcy Code provisions in the case were not entirely the same as those at issue in the Chrysler or General Motors case, but the principle applies equally well.

⁴ As well summarized by Mark Roe and David Skeel, courts will refuse to approve some sales of all or substantially all of a debtor's assets on the ground that such a sale can be an improper de facto reorganization. See Mark J. Roe & David A. Skeel, *Assessing the Chrysler Bankruptcy* (Harvard Public Law, Working Paper No. 09-42, 2009), available at <http://ssrn.com/abstract=1426530>. Although the emphasis in this article is on the distribution of value among creditors rather on the propriety of a sale in the first instance, the case law addresses the latter issue. Under the law, the proponents of an all or almost all asset sale must demonstrate a business reason to hold a sale rather than reorganize the debtor in the traditional way, with assets in place. See, e.g., *Motorola v. Official Comm. of Unsecured Creditors (In re Iridium Operating)*, 478 F.3d 452, 466–67 (2d Cir. 2007); *Comm. of Equity Sec. Holders v. Lionel Corp. (In re Lionel Corp.)*, 722 F.2d 1063, 1071 (2d Cir. 1983). This was true in *Chrysler* itself, where the bankruptcy court (as well as the court of appeals) was satisfied that there was a valid business reason for the section 363 sale. In this article, I don't question whether the business justification requirement was satisfied in the Chrysler or the General Motors case. This is so simply because I think that the requirement is ill-advised. In my view, an unconditional auction designed to achieve the highest return for the bankruptcy estate should

Analysis turns next, then, to whether the objecting secured creditors 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 section 363 sale.⁵ 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. And, again, the judge's valuation may have been correct. What this argument overlooks, however, is that chapter 11 contains rules—sometimes called creditor democracy provisions—designed 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 section 1129(b) of the Code and govern the confirmation of reorganization plans.⁶ 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.⁷ 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.⁸ 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 creditors attempted to invoke the protection against unfair discrimination. Whatever the judge might deem to be the liquidation value of their collateral, section 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 portion. The secured portion is equal to the judicially determined value of the collateral while the unsecured portion is equal to the deficiency claim. The secured creditor objectors to the Chrysler sale based a legal

always be permitted; I would not interpose the vague obstruction of business justification. As explained in the text, my concern with the Chrysler and General Motors cases is that there was no such auction. *See also infra*, note 15 and accompanying text.

⁵ For a similar analysis, which reaches many, though not all, of the same conclusions, see generally Roe & Skeel, *supra* note 4.

⁶ In addition to 11 U.S.C. § 1129(b), see § 1129(a)(8).

⁷ *See, e.g., In re Grandfather Mountain Ltd. P'ship*, 207 B.R. 475, 486 (Bankr. M.D. N.C. 1996) (describing fair and equitable requirement for plan confirmation); *In re Gregory Boat Co.*, 144 B.R. 361, 364–65 (Bankr. E.D. Mich. 1992) (referencing section 1129(b) and explaining "fair and equitable" requirement).

⁸ *See, e.g., Heritage Org.*, 375 B.R. 230, 312 (Bankr. N.D. Tex. 2007) (generally discussing requirement that plan not discriminate unfairly); *In re Simmons*, 288 B.R. 737, 744–53 (Bankr. N.D. Tex. 2003) (describing legislative history behind and contours of unfair discrimination test).

challenge on the treatment of their deficiency claims. Deficiency claims, like the UAW claims, are general obligations. Yet while the sale and distribution approved in *Chrysler* paid the deficiency claims nothing, it paid the UAW claims with assets worth 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. 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 creditors accepted the distribution.⁹ 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, in a formal reorganization, the judge might have been obliged to disallow TARP lender votes in favor of the government-sponsored plan or to separately classify the TARP lenders' claim,¹⁰ thereby giving the dissenters control over their own class and, perhaps, the right to veto the UAW distribution as unfairly discriminatory. The plan proponents can also argue that the payment to the VEBA was not as a distribution on account of an unsecured claim at all, but rather a 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 was necessary in the midst of a great recession. 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 vote disqualification or 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 creditors' loan agreement that arguably granted an agent of the creditors the right to sell their collateral on behalf of the group. According to this argument, because the creditors' agent was obliged to represent the secured creditor majority that favored the sale, the agent properly consented to the transaction on behalf of all

⁹ 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. See 11 U.S.C. § 1126 (2006).

¹⁰ See 11 U.S.C. §§ 1126(e); 1122. See, e.g., *In re Figter, Ltd.*, 118 F3d 635, 639 (9th Cir. 1997) (observing that a creditor's vote can be disqualified on the basis of bad faith if the creditor has an "ulterior motive").

secured creditors. Judge Gonzalez agreed and approved the sale, despite the lack of an unconstrained 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 secured creditors 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 the holding on this point may be correct. But even if the judge properly interpreted state law, *Chrysler* remains an unsettling precedent because approval of a sale of assets under section 363 is not limited to a case where the affected parties consent.¹¹ 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.¹² Moreover, a section 363 sale of a debtor's assets may occur over the objection of unsecured creditors who object to the sale because they 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 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 the potential for 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 debt. 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*, and the essentially identical holding in the General Motors case, discussed next, one might expect future firms to face a higher

¹¹ As revealed, *supra* note 1, the Second Circuit's opinion that affirmed the Chrysler bankruptcy court decision was vacated by the Supreme Court, thus perhaps diminishing the influence of the bankruptcy case as precedent. Nevertheless, other courts may well rely on the case. As described in Part II, *infra*, the court in the General Motors case already has so relied.

¹² The Bankruptcy Code's provisions for a sale of assets free and clear of interests in those assets are poorly drafted and internally inconsistent. On one reading, property cannot be sold free of liens unless the sale proceeds are sufficient fully to satisfy those liens. On another reading, there is no such requirement. See 11 U.S.C. § 363(f) (2006). See, e.g., *In re PW LLC*, 391 B.R. 25, 40–41 (B.A.P. 9th Cir. 2008) (describing varying judicial interpretive approaches).

cost of capital,¹³ thus dampening economic development at a time when the country cannot well afford impediments to growth.

II. THE GENERAL MOTORS BANKRUPTCY

Chrysler was a blueprint for the General Motors bankruptcy, which, like that of Chrysler, included a sale of the debtor's assets to an entity that assumed unsecured obligations owed its workers or former workers.¹⁴ In General Motors' case, 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 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 *Chrysler*, the sale was to take place quickly, within weeks, and the sale procedures required that, absent special exemption, any bidder who wished to compete with government-financed entity 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 *General Motors* 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 *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 may have come. 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 government 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 were substantial—including about \$27 billion in unsecured bonds alone—the GM bankruptcy estate received 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 assets not tendered to New GM, may well exceed any bid—net of the secured claims—that GM could have received from anyone else for the GM assets.

Still, just as in *Chrysler*, the approval of a restricted bid process establishes a troubling precedent, one that went unnoticed, or at least unnoted, by the court. In

¹³ Although, I am unaware of empirical support for the claim that the Chrysler and General Motors cases will increase the cost of capital to corporate debtors, the cases are still new and it is not clear whether they will be extended, a topic to which I return in Part III, *infra*.

¹⁴ The facts of the General Motors case reported here are taken from *In re General Motors Corp.* 407 B.R. 463 (Bankr. S.D.N.Y. 2009).

his opinion approving the GM sale, Judge Gerber addressed the objections of some unsecured creditors and made 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 . . . [sale and purchase agreement] 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.¹⁵

This passage may be persuasive on its face. However, Judge Gerber ignored the constraints within the sales procedure, which, like those in *Chrysler*, may have discouraged a potentially higher bid by a prospective purchaser who had not time to put a bid together or who was unwilling to make the same concessions to the UAW that the government-sponsored purchaser was willing to endure. Thus, there is the theoretical possibility that the process impermissibly transferred asset value from the company's other creditors to the UAW. As in *Chrysler*, this is merely a theoretical possibility. But, the case stands as precedent that might cause later lenders to doubt whether future debtors will be forced to live up to their obligations. And as also noted above, wary lenders are inhospitable to economic development.

III. PAST AS PROLOGUE

Against these or similar criticisms of the Chrysler and General Motors bankruptcy cases, two defenses have been raised, each in tension with the other. The first defense is that *Chrysler* and *General Motors* broke no new ground. The second is that *Chrysler* and *General Motors* are so unusual as not to matter. I address each of these claims in turn.

As noted above, in each of the two automaker cases, government as sponsor of the sale was also a significant lender to the bankrupt debtor. And as Ed Morrison has observed in his contribution to this debate, it is common for such a lender—a DIP lender—to impose its will on the bankruptcy process.¹⁶ Particularly, where a debtor has few or no unencumbered assets to offer a prospective DIP lender, a dominant pre-bankruptcy secured creditor may be the bankrupt debtor's only source of affordable, needed funds and this position can provide such a creditor great influence, enough to dictate the terms of a sale even over the dissent of other creditors. The terms so imposed, moreover, may at times include a quick sale and

¹⁵ *Id.* at 495–96. For a discussion of de facto reorganization doctrine, see also *supra*, note 4.

¹⁶ Edward R. Morrison, *Chrysler, GM, and the Future of Chapter 11* (Columbia U. Sch. of Law, Working Paper No. 365, 2009).

the requirement that competing bidders assume whatever liabilities the secured lender wants assumed and for whatever reason. Against this background, *Chrysler* and *General Motors* may seem more part of the current landscape than a startling new development.

This may be so. *Chrysler* and *General Motors* may be just prominent examples of how chapter 11 can be manipulated to deprive dissenting creditors of (what should be) their entitlement to either a market test or process protections afforded by the Bankruptcy Code's reorganization provisions. But this observation does not make such manipulation more palatable. If the law were clear that a court could not approve an undeserved payment or distribution to anyone, not even a DIP lender or its designee, the lender would have no incentive to withhold needed funds if the debtor offered a merely fair price for the loan. Bankruptcy policy is not served when a DIP lender uses a monopoly position as financier to capture the benefits of the bankruptcy process' value-enhancing provisions such as the automatic stay and the authority to sell assets free and clear of liens. A DIP lender should be afforded an ordinary return on its post-petition investment, but there is no apparent reason it should receive more.¹⁷

While judicial approval of a process susceptible to diversion of value may have occurred before, *Chrysler* and *General Motors* are prominent examples, cases where the issue of diversion was presented front and center rather than buried in approval of an obscure sale order. The process approved in these cases, or other processes that may deprive creditors of their entitlements, may now become more common.¹⁸

This said, it is tempting to dismiss the *Chrysler* and *General Motors* bankruptcy cases as *sui generis*. Prompted by the political pressures created by the recession and financial crisis, the government insinuated itself into the process with cash in hand, and it may be that the cash was sufficient to pay everyone at least its due. The dissenters may have been greedy, not victims. And if the judges saw things this way, they may have been willing to approve a process that would not have survived their scrutiny under ordinary circumstances. But even if this is all true, the cases establish a precedent that could undermine the bankruptcy process in the future, even if the government recedes from the scene.

Consider the following illustration, where the government as lender or purchaser is nowhere to be found. Imagine a simple firm, Debtor, with only two

¹⁷ An ordinary return to a DIP lender or its designee might include a breakup fee to compensate an initial bidder for the cost of its offer should a competitive auction result in the sale of the debtor's assets to someone else. *See, e.g., id.* But a court's approval of a breakup fee should be based on the cost to the initial bidder and the court should not be permitted to approve a fee of any amount merely by finding that the price offered by the initial bidder is, in the court's view, the best available option. Under this approach, even a recharacterization of the assumed liabilities in *Chrysler* and *General Motors* as breakup fees fails to provide a basis for approval of the sales in those cases.

¹⁸ *Cf. In re Philadelphia Newspapers, LLC*, 599 F3d 298 (3d Cir. 2010) (denying secured creditor right to credit bid). This case does not rely on *Chrysler* or *General Motors*, and presents different issues, but may be part of a trend toward judicial disregard for the bankruptcy processes that protect priority.

creditors, each unsecured: Supplier, owed \$60, and Bank, owed \$20. After Debtor runs out of working funds and files a bankruptcy petition, Bank uses information it possesses as a lender quickly to formulate and extend a \$40 offer for all of Debtor's assets (which Bank intends to resell). Bank contends that this is the best offer Debtor is going to get and argues that if Debtor does not accept the offer immediately Debtor will have no choice but to liquidate piecemeal for \$10. The court agrees and approves the sale over Supplier's objection even though there is no auction or other market test for the value of the assets. After the sale, Debtor moves through the ordinary bankruptcy process and distributes the \$40 proceeds ratably between Supplier and Bank, with \$30 to Supplier and \$10 to Bank.

As long as the court is correct to accept Bank's valuation, the sale and the distribution are appropriate. But what if the court is wrong? Assume that Debtor's assets are worth \$60. In this case, Supplier should receive \$45 and Bank \$15. But the sale and distribution approved by the court has different consequences. Instead, Bank pays \$40 for assets worth \$60 (i.e., gains \$20) then receives a \$10 distribution from Debtor's bankruptcy estate, for an effective total distribution of \$30, half the true value of Debtor's assets, twice the amount to which it is entitled. All this while, as a formal matter, it is correct to say, as the courts did in *Chrysler* and *General Motors*, that the sale proceeds were distributed among the creditors in accordance with priority. The problem, of course, is not with the distribution of sale proceeds received; the problem is with the diversion of value to the purchaser, which paid the estate too little and thus, in its role as a creditor, received too much. This is Supplier's complaint in this illustration and the essence of the dissenting creditors' complaint in *Chrysler* and in *General Motors*.

In this illustration, an unconstrained auction—one that would not, e.g., require a bidder to assume the debtor's obligation to Bank—would solve the problem because a bidder would offer \$60, foiling Bank's scheme. The problem could also be solved by granting Supplier a veto over the sale to reflect its dominant position in what would be the unsecured creditor (and only) class were the proposed transfer of Debtor's assets to Bank part of a reorganization plan.¹⁹ With neither protection in place, Supplier is left to suffer the consequences of judicial error, which can occur no matter how skilled or well meaning the judge; skilled and well meaning are not synonymous with omniscient.

As Mark Roe and David Skeel observe in their own criticism of the Chrysler bankruptcy, the ability of a court to approve an untested sale at the behest of some creditors over the objection of others without the safeguards prescribed by the Bankruptcy Code returns us to a past centuries' practice referred to as the equity receivership, where it was widely believed that powerful, favored creditors routinely victimized the weak and unconnected.²⁰ *Chrysler* and *General Motors* are a step back and in the wrong direction.

¹⁹ See 11 U.S.C. § 1129(a)(10) (2006).

²⁰ See Roe & Skeel, *supra* note 4, at 35; see also DAVID A. SKEEL, JR., *DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA* 48–70 (Princeton University Press 2001).

IV. PROPOSED REFORM

The Chrysler and General Motors cases are objectionable because they include a sale of virtually all of a debtor's assets under section 363 of the Bankruptcy Code without a market test for the value of those assets. In *Chrysler* and *General Motors*, had the price paid for the assets been properly determined, dissenting creditors would have had no basis for complaint so long as they received a ratable share of the sale proceeds consistent with their priority. In neither case, however, was the price properly determined. It is particularly problematic 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 section 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. As 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.²¹ 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.²² Congress would do well to establish as a minimum procedural safeguard state law requirements for section 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

²¹ This trend is noted in the Second Circuit's affirmation of *Chrysler*. See *In re Chrysler*, 576 F.3d 108, 115 (2d Cir. 2009), *vacated as moot*, 130 S.Ct. 1510 (2009) (citing Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 751–52 (2002)).

²² The recent Delaware Supreme Court case of *Lyondell Chemical Co. v. Ryan*, 970 A.2d 235, 239–42 (Del. 2009) summarizes the current state of the *Revlon* doctrine (though the holding of *Lyondell* addresses only a narrow issue of director liability).

proper part of any sale, and should not be permitted, regardless of applicable state law.

To accomplish these ends, Congress could add to the Bankruptcy Code a new subsection of section 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, any 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 is 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 any amount on account of a claim or interest unless as a result of the sale the purchaser assumes the obligation to pay or pays all claims in full plus interest at the legal rate from the date of filing of the petition; or

(2) no holder of a claim, except a claim that the holder of which will receive on account of such claim cash equal to the allowed amount of such claim plus interest at the legal rate from the date of the filing of the petition 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,²³ 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 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,²⁴ 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 process would include, where

²³ This term is defined by 11 U.S.C. § 101(51D) (2006).

²⁴ 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 use of a hypothetical event would not be unusual for the Bankruptcy Code. *See, e.g.*, 11 U.S.C. §§ 544(a)(1); 547(e)(2). 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.

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 Code²⁵—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.

Finally, under no circumstance could the sale of a debtor's assets be conditioned on a purchaser's willingness to assume some but not all of the debtor's liabilities.²⁶ This practice is illegitimate, and was the crux of the problem in the Chrysler and General Motors cases.

CONCLUSION

There is a saying that one is cursed to live in interesting times. This quip—though trite from overuse and of uncertain origin—applies well to the Chrysler and General Motors bankruptcies. These cases, of iconic companies failing in the midst of a worldwide financial crisis, are no doubt interesting. But the law that they produced may be more curse than blessing. Time will tell.

²⁵ See, e.g., 11 U.S.C. §§ 365(c); 502(b).

²⁶ The provision proposed here is arguably incomplete as it would not protect equity holders, including preferred shareholders, from a sale to or for the benefit of a debtor's creditors as a group. One might be unconcerned about this possibility, because a debtor that could pay its creditors in full should ordinarily be able to avoid bankruptcy. But the provision could, in any case, be revised to address the risk that equity would suffer in this way.