

Chrysler Reflects Modern Reorganization Practice

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The legislative history of chapter 11 describes its goals as follows: “The purpose of a business reorganization case, unlike a liquidation case, is to restructure a business’s finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders.”¹ In our view, chapter 11, as it is practiced today, is meeting all of those goals with the exception, in most cases, of preserving value for equity.²



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The cornerstone of reorganization practice in reaching the above goals is that chapter 11 allows the stakeholders to realize value closer to going-concern than liquidation. For example, assume that company A has a liquidation value of \$50 million and a going-concern value of \$100 million. The benefit of having a reorganization option in the Bankruptcy Code rather than simply a liquidation option is abundantly clear. In addition to the social and economic good of preserving jobs, relationships with suppliers and customers, goodwill, etc., the economic benefits (certainly in this hypothetical) are undeniable: \$50 million of additional value, or at least some portion thereof, is preserved by maintaining the debtor as a going-concern until its restructuring or sale.

The liquidation value of the debtor is usually distributed to stakeholders in accordance with their statutory priorities.³ This leaves open the question of which stakeholders share in the delta between going-concern value and liquidation value (the “Delta”). Prior to 1979, under the Bankruptcy Act, most debtors would file a chapter XI to facilitate their restructuring

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in part because old equity would often retain some portion of the Delta. Chapter XI had no absolute-priority rule, and the debtor possessed the exclusive right to file a plan. In this hypothetical, the debtor might propose a plan offering \$75 million in value to its creditors. The creditors, of course, would seek to recover \$100 million, not \$75 million. However, faced with the possibility of the debtor ceasing operations, converting the case to chapter VII and a trustee realizing liquidation value, the creditors would ordinarily prefer the \$75 million plan over the \$50 million liquidation. In the hypothetical, \$25 million of the Delta might be retained by old equity. In contrast, chapter X was designed for large, publicly held companies and the absolute-priority

diminished because of enhanced concepts of the debtor’s fiduciary duty to creditors. Additionally, while no trustee is automatically appointed, enhanced creditor control is having nearly the same effect over the chapter 11 process. In addition to other control mechanisms, it is even common for the lenders to insist that the debtor appoint a chief restructuring officer who takes some control out of the hands of the debtor’s traditional decision-makers. Since chapter 11 provides a lesser opportunity for economic survival to the very people making the decision of whether to file, it is not surprising that there are fewer chapter 11 cases being filed than would be anticipated given the state of the economy.⁵ Therefore, by the time a company reaches the decision to file under chapter 11, it is so far over-leveraged and has so little viability that a quick § 363 sale is the only rational alternative. The decision for the lender is whether to fund the chapter 11 proceedings. If the costs of these proceedings are less than the Delta, it only makes sense to allow the company to sell the assets

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rule was strictly enforced; a trustee was appointed at the beginning of the case, and there was no plan exclusivity for the debtor. With a strict enforcement of the absolute-priority rule, the likelihood of old equity receiving value was substantially reduced. As a result, by 1978, few companies filed a chapter X, and even large publicly held companies often filed chapter XI. Chapter X was devastating to the economic interests of the very parties that decided whether to file.⁴

With the passage of the Bankruptcy Code, Congress decided to merge chapters XI and X into a new chapter: 11. However, chapter 11 has now taken on many attributes of old chapter X, and much like the old chapter X, it is not being utilized as a reorganization vehicle as often as one might expect. The debtor’s plan exclusivity is limited in time, and the absolute-priority rule is paramount, unless most creditors agree to a different treatment, which they are increasingly unlikely to do. Further, the threat of the debtor liquidating has been

through a chapter 11 as soon as possible, thus reducing the costs of the proceedings.⁶ The sale may be the most efficient way to maximize creditor recoveries and should be considered separately from the issue of distribution of the proceeds, which more directly implements the more-stringent confirmation rules.

However, sometimes the sale terms do impact distribution issues. The court must ensure that the constituents’ rights are being respected. This is similar to the issues raised with respect to pre-plan settlements, which by their terms vary from the absolute-priority rule. In *Iridium*, the Second Circuit held that while the absolute-priority rule was extremely important

⁵ This is not the only factor that is leading to fewer chapter 11 cases being filed. For example, for lenders to push a company to the precipice makes little sense when collateral values are low. Further, it makes no sense for regulators to be as strict as they have been in the past because it would be irrational for the government to provide an institution with \$30 billion to preserve itself on Tuesday, and then on Wednesday force the write-down of \$60 billion of questionable loans. Some commentators believe that the cost of filing under chapter 11 also reduces its use. That is not to say that there have not been chapter 11 cases, only that it would have been reasonable to expect a far greater number of filings than have occurred given the severity of the recession. This is particularly true with respect to traditional chapter 11 cases (reorganizations rather than prepacks and quick sales).

⁶ There are certainly some “real” reorganizations that take place, as well as prepacks, which in essence utilize the chapter 11 process to complete out-of-court restructurings. However, the predominance of reorganizations that are merely foreclosures for the benefit of lenders cannot be denied.

¹ H.R. Rep. No. 95-595, at 220 (1978).

² This, of course, is a broad generalization, and there are cases in which it is possible to reorganize a company and preserve value for old equity; that, however, is not the predominant outcome of chapter 11 cases today.

³ See 11 U.S.C. § 1129(a)(7)(A).

⁴ See Richard E. Mikels and Peter S. Kaufman, “Balancing Creditor and Equity Interests Provides Incentive to Utilize Chapter 11 for Mutual Benefit,” *ABI Journal*, December/January 2004.

and would ordinarily be followed, it is not a *per se* rule but rather one that leaves room for the court's discretion in evaluating a Rule 9019 pre-plan settlement.⁷

The *Chrysler* case reflects current policies and procedures of chapter 11. While other cases could be chosen as examples, none would better establish this point than *Chrysler*, particularly in light of the economic and political objections to the process. Let's analyze the *Chrysler* case and why it is in line with current bankruptcy practice.

1. *The Chrysler case was thought by many (including the authors) to be essential to the U.S. economic recovery.* Therefore, through the use of Troubled Asset Relief Program (TARP) funds, debtor in possession (DIP) financing and a commitment for post-sale lending, the government was in the uncharacteristic role of a lender. Over recent years, DIP lenders have taken an ever-increasing role in determining the direction and outcome of chapter 11 cases.⁸ The fact that the government found itself acting like a DIP lender when it in fact *was* a DIP lender is hardly surprising. In fact, since it was the taxpayer's money that was doing the funding, it might have been considered irresponsible if the government took a more limited role than would the ordinary DIP lender. In the ordinary chapter 11 case, the lenders would have been the party providing the DIP financing and thus would have had the correlating leverage. Instead, those lenders refused to provide funding and the government became a lender of last resort to avoid the damage that would have been caused by a permanent shutdown of Chrysler. The lenders could not have been shocked that they were unable to exercise the same control as if they were providing the ongoing financing.⁹

2. *The absolute-priority rule only arises in the context of a cramdown, which only arises when a class rejects the plan.* The class is deemed to accept a plan by a two-thirds vote in amount and half in number of the claims of the class voting. In this case, at the time of the filing, about 80 percent in amount and more than 50 percent in number of the

lender class had accepted the proposal. Were the proposal a plan rather than a sale, the issue of absolute priority would have never even arisen. Therefore, the issues relating to the sharing of value by lower-priority constituencies would never be implicated even if the likelihood of success were put at risk by requiring a plan process.

3. *In the days surrounding the Chrysler filing, many commentators argued that favoring the union over more senior creditors was an indication of political corruption and a disruption of traditional bankruptcy principles.* "The Administration is advancing its own social and political agenda," argued a *Wall Street Journal* editorial. "That explains why the government is giving 55 percent of the new Chrysler to the UAW's retiree-benefit trust, a junior creditor, while those ahead of the trust in line get a mere 30 cents on the dollar."¹⁰ "Upsetting [the] fixed hierarchy among creditors is just an illegal taking of property from one group of creditors for the benefit of another," one critic concluded, "which should be struck down on both statutory and constitutional grounds."¹¹

However, it is not uncommon for certain critical creditors to be paid out of their technical order. Similarly, it is common for a buyer to assume certain obligations that it believes are important for its success. For example, the common-warranty claims are technically behind the lenders, but in *Chrysler*, everybody understood they had to be honored if New Chrysler had any hope of surviving. Likewise, the very fragile supply chain had to be protected and maintained. If it were not, New Chrysler could not have survived, and neither could have General Motors (and perhaps other car manufacturers using the same suppliers, for that matter). In fact, if the supply chain were not maintained, the ultimate impact on the economy could have exceeded that of Lehman Brothers. The authors are unaware of any huge debate about the honoring of warranties or the protection of the supply chain as constituting a breakdown of the legal system. Indeed, the practice of paying critical vendors before higher-priority stakeholders in order to avoid a disruption in service is common in New York and Delaware—popular venues for large, corporate bank-

ruptcies. However, people were extremely distraught over the fact that the union was being preferred in some fashion.

While the distinction is not entirely clear, except on political or at least philosophical grounds, there are reasons for the result. A labor contract can be assumed or rejected. Presumably, the labor contracts could have been assumed and assigned to New Chrysler, making all amounts due a continuing obligation. Under a plan, those claims and the contracts would have to be satisfied in full, as is the case with all assumed contracts. Critics can argue that the government or New Chrysler was not forceful enough in the negotiations or that political considerations led to a deal that was "too rich" for the union, but a deal of this nature is not unusual in bankruptcy practice.¹² After all, New Chrysler had to reach some arrangement with the union in order to provide for future operations. Additionally, the authors question how overly rich the deal was for the union. It received stock in New Chrysler and a 13-year payout, both of which only have value if New Chrysler were to succeed. At the time, the likelihood of New Chrysler being successful over the long haul was far from certain. Twenty-nine cents in cash might have been a better bargain than stock in New Chrysler and a "hope note." Making the labor recovery contingent on New Chrysler's success seems a reasonable result that matches incentives quite nicely.

4. *While some may argue that chapter 11 cases should culminate in confirmed plans rather than quick sales, that horse has left the barn long ago.* Over the past few years, most "successful" chapter 11 cases have included § 363 sales. Certainly, a case with the economic significance of *Chrysler* is unlikely to be the case where that common practice is challenged. In light of the past 15 years' experience, with sales having become increasingly predominant, it would have been surprising if any other decision had been reached.

5. *Many commentators, particularly political commentators, raised the issue of whether Chrysler represented the government violating the rule of law.* A *Wall Street Journal* article claimed that "the Obama administration's behavior in the Chrysler bankruptcy is a pro-

⁷ See *Motorola Inc. v. Official Comm. of Unsecured Creditors (In re Iridium Operating LLC)*, 478 F.3d 452 (2d Cir. 2007).

⁸ Some DIP loans require control items like identity of management, tight benchmarks toward a sale and automatic relief from stay, among others. Some commentators would criticize the level of control that is being exercised by lenders today. However, it is unrealistic to expect that this level of control would be rolled back in a case where the entire financial system was at stake.

⁹ Chrysler did not pay the lenders; rather, it was the government who directly or indirectly paid them. At the filing, 80 percent in amount were in favor and 20 percent felt that the taxpayers should dig deeper to bail them out. While their point of view is understandable (after all, they do have investors to answer to), it is perplexing why they received so much sympathy from the business press.

¹⁰ "Chrysler Goes to Court," *The Wall Street Journal*, May 4, 2009, <http://online.wsj.com/article/SB124113484242375207.html?KEYWORDS=Chrysler+Goes+to+Court>.

¹¹ Richard A. Epstein, "The Deadly Sins of the Chrysler Bankruptcy," *Forbes*, May 5, 2009, www.forbes.com/2009/05/11/chrysler-bankruptcy-mortgage-opinions-columnists-epstein.html.

¹² It was the Retiree Medical Benefit Trust that actually received the stock and note. However, whether the union-related contracts were rejected and new contracts entered into, or the union-related contracts were assumed and modified to realize necessary concessions, consideration had to flow to the employees in some form.

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found challenge to the rule of law,”¹³ which induces the “fleecing [of] lenders to pay off politically powerful interests, or governmental threats to reputation and business from a failure to toe a political line.”¹⁴ Such governmental acts are Machiavellian in nature, argued a *Financial Times* article.¹⁵ Further, it was argued that “by stepping over the bright line between the rule of law and the arbitrary behavior of men, President Obama may have created a thousand new failing businesses. That is, businesses that might have received financing before but that now will not, since lenders face the potential of future government confiscation.”¹⁶

The controversy about the rule of law arises because the policies of chapter 11 conflict with the usual policies of the law. Under normal circumstances,

the rule of law strongly favors sanctity of contract. A capitalist society certainly has an interest in ensuring that people are comfortable entering into contracts. They will only do so if they have the expectation that the other party will comply with its obligations and that the legal system will support the complaining party if the counterparty breaches. However, in insolvency, the usual favoring of sanctity of contract has to be modified to account for a directly competing policy: Society benefits when a company is able to restructure and maintain operations rather than liquidate. This approach is designed to save jobs, preserve going-concern value and avoid the loss of productive resources, and it ultimately allows for payments to levels of creditors (and perhaps even equity-holders) that would not share if only liquidation values were realized.

However, to accomplish reorganization, the usual rules must be altered. People cannot be paid in strict compliance with their contracts because there is not enough value to go around to all of the constituencies in the manner that

was originally contemplated. Therefore, a complicated set of rules has been devised that attempts to provide the flexibility necessary to accomplish reorganization while providing various forms of protection to the parties whose rights are altered. This is not a violation of the rule of law, but rather the implementation of different rules of law, which are designed to apply only in the case of financial distress.

Chrysler represents chapter 11 as it is practiced today. It accomplished all of the goals of chapter 11 as stated in the legislative history quoted in the first paragraph except, as is so common today, providing a return to old equity. *Chrysler* is a good example of a successful modern chapter 11 case: The sale approach was utilized in an effort to maximize value; New Chrysler was given the opportunity to succeed into the future while maintaining significant employment and providing a lifeline to many suppliers and dealers; and an economic catastrophe was avoided in an economy that could not have absorbed the loss of Chrysler at that particular point in time. ■

¹³ Todd J. Zywicki, “Chrysler and the Rule of Law,” *The Wall Street Journal*, May 13, 2009, http://online.wsj.com/article/SB124217356836613091.html?utm_source=newsletter&utm_medium=email&utm_campaign=rcp-today-newsletter.

¹⁴ *Id.*

¹⁵ Francesco Guerrera, “On Wall Street: Chrysler Saga Sets Dangerous Precedent,” *FT.com*, May 1, 2009, www.ft.com/cms/s/0/f4d04d3e-3675-11de-af40-00144feabdc0.html.

¹⁶ Zywicki, *supra*.

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