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Ramifications of Auto Industry Bankruptcies, Part III

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I am the Harry A. Bigelow Distinguished Service Professor at the University of Chicago Law School where I teach bankruptcy law. I joined its faculty in 1980 and was its Dean from 1994 to 1999. I have also been a visiting professor at Stanford, Harvard, and Yale. I am a fellow of the American Academy of Arts and Sciences, I have served as the Vice Chair of the National Bankruptcy Conference, and I am currently the scholar-in-residence at the American College of Bankruptcy. I have written several dozen articles on bankruptcy and related subjects, and my one-volume overview of U.S. bankruptcy law, *Elements of Bankruptcy*, is now in its fourth edition. I appear at your invitation today to try to draw some general lessons from the recent automobile bankruptcies. I speak as a scholar committed to the effective operation of our bankruptcy system and not on behalf of any individual or group.

The General Motors and Chrysler bankruptcies provide powerful illustrations of how Chapter 11 can give financially distressed companies a second chance. Without Chapter 11 or some similar process, General Motors and Chrysler would likely have gone out of business. The willingness of the federal government to contribute substantial resources was necessary, but not sufficient. In this respect, these cases show the good that modern bankruptcy judges and lawyers are able to do, especially in troubled economic times. Bankruptcy law, however, provides no panacea, only a fighting chance.

Even with a substantially reduced debt burden, the challenges General Motors and Chrysler face are far from over. They have been mismanaged for decades and find themselves in an industry in which there is massive overcapacity. There is no guarantee that either will survive. Much depends on whether domestic automobile consumption rebounds significantly over the next several years and whether these two companies can transform their corporate culture quickly enough in a highly competitive marketplace.

These two cases also underscore the limitations of bankruptcy law in another way. Companies that are insolvent—and General Motors and Chrysler were hopelessly insolvent—cannot meet all of their existing obligations. Bankruptcy can do nothing to change this. No matter what bankruptcy provides, many worthy stakeholders—tort victims, unpaid suppliers, pension funds, dealers, workers—will not be paid in full or at all.

One can try to protect some stakeholders, but this is not without major consequences. Favoring one group necessarily comes at the expense of another,

and legitimate questions can be raised about when it is justified to favor one group over another. Moreover, there are sharp limits on the ability of bankruptcy law to do even this. Most of the firms that fail never file bankruptcy petitions. Indeed, fewer than one percent of financially distressed businesses end up in Chapter 11. Even for companies reorganizing in Chapter 11, merely giving a priority claim is likely to be ineffective. Businesses today have multiple layers of secured debt. The secured creditor enjoys a nonbankruptcy property right that has to be paid first. For these reasons, the best way to protect particular stakeholders is to give them a superpriority lien over other existing stakeholders across the board, inside of bankruptcy and out. Some environmental claims have this feature.

In my own view, tort claims are among those that should be protected with a superpriority lien, but I should emphasize that this view is both controversial and not in the first instance a question of bankruptcy policy. Again, only a law that applies generally whenever the question of priority arises will work. Alternatively, a law, again of general applicability, could require companies to carry sufficient insurance.

Another problem arises with respect to the obligations of a reorganized company to those who suffer harm in the future as a result of products the company made before bankruptcy. On the one hand, it is important to give companies a fresh start, but on the other, tort victims need to have their day in court. These problems have arisen in cases involving everything from asbestos to airplanes. They have been carefully studied and there are sensible, concrete proposals for the treatment of future tort victims that have been put forward by the National Bankruptcy Conference and others. These provide a sensible starting place for legislative reform.

In the balance of my testimony, I want to focus on the particular lessons we can draw from the bankruptcies of General Motors and Chrysler. One must recognize that only massive intervention by the federal government made it possible for the bankruptcy process to give these companies another chance. Both General Motors and Chrysler were experiencing massive and ongoing operating losses. When companies are hemorrhaging cash to this extent, it is generally too late for Chapter 11 to save them in the absence of an extraordinary infusion of outside capital and it is only rarely available. The active participation of the government fundamentally altered the dynamics of these bankruptcy cases—and not always for the better.

The most striking feature of these Chapter 11s was their speed. Section 363 of the Bankruptcy Code allows the judge to approve the sale of a business's

assets outside of the ordinary course of business. In General Motors and Chrysler, this mechanism was used to sell the businesses as going concerns to a new entity created by, or, in the case of Chrysler, with the cooperation of, the federal government within the course of a few weeks.

Going-concern sales are common in large Chapter 11 cases. Over half of all large Chapter 11 cases now involve sales of one kind or another. In principle, this is a salutary development. A sale often converts an unwieldy and illiquid asset into cash that can be readily divided among the various stakeholders according to their legal entitlements. A sale can provide the best way to maximize the value of the assets. Even when a reorganization provides a better alternative, the *possibility* of a sale improves the process as it tends to keep everyone honest. A cash bid of a company for \$100 makes it impossible for one of the competing claimants to argue that it is worth less.

But we need to ensure that the sale process is conducted in such a way that ensures that the firm is sold for top dollar. Companies that are put up for sale are often in severe financial distress. They are melting ice cubes, and those in control of the process assert that they are willing to pump new money into the company to keep it alive only if the sale is done quickly to a buyer they have already identified. The danger that the business will not have enough cash to stay open puts enormous pressure on the judge to move the case quickly.

Without appropriate procedures, there is a risk that too many §363 sales are fire sales that work to the advantage of those in control, not to the stakeholders as a group. The Bankruptcy Code itself offers no guidelines beyond a general requirement of notice and a hearing. Courts have begun to develop procedures. These, in conjunction with the rule-making process, might be sufficient to create procedures that ensure that these sales do in fact yield top dollar. If they do not, it may make sense for Congress to revisit this issue and ask whether procedures and protections for going concern sales should be explicitly addressed in the Bankruptcy Code.

There is another danger to which attention needs to be given. The sale itself should not dictate the distribution of the proceeds of the sale. The distribution of proceeds should recognize the existing rights of the various stakeholders. The procedures for the confirmation of a Chapter 11 plan of reorganization set out in §1129 are designed to do this. The sale should not short-circuit them. The sales that were conducted in both Chrysler and General Motors, however, were troubling over this dimension.

The newly created entities that bid on the assets of Chrysler and General Motors agreed to take on some obligations of the old company. This itself seems unobjectionable in theory. If a new buyer decides to pay some obligations and not others, it should be free to do so. As a buyer, the assets belong to it, and it should be free to do whatever it wants with them. All that matters is that this buyer has produced the top bid after the company has been fully marketed. But the plan of a buyer to pay existing obligations becomes problematic if, at the same time, the freedom of action of other bidders is limited. For this reason, a buyer's decision to continue the debtor's relationship with some stakeholders, but not with others, has always been treated with suspicion.

In both Chrysler and General Motors, the bankruptcy judge approved sale procedures that narrowly limited the form of the bid. They required that the bidder agree to assume the same burdens the government-created entity was willing to assume.¹ By insisting that each bidder commit to pay specified claimants specified amounts, the sale procedures effectively dictated the distribution of assets. A buyer who takes a \$10 company free and clear will bid \$10 for it. But a buyer of the same company who is required to assume \$6 in obligations will bid only \$4. If the \$6 goes to a different stakeholder, then the process not merely converts the assets into cash, but also dictates how the cash is distributed. It becomes both a sale and a *sub rosa* plan. Those who lose out (those forced to share in proceeds of \$4 instead of \$10) enjoy none of the protections of Chapter 11 plan process.

In both the Chrysler and General Motors bankruptcies, the courts tolerated highly restrictive sales procedures in large part because they did not think it made a difference. It seemed to them unlikely another bidder would emerge even if different rules were in place. The sorry condition of the companies, the illiquidity of the current credit markets, and the strong desire of the federal government to dictate the outcome were sufficient to chill competing bids, regardless of the procedures. Importantly, the judges found that, in the absence of the proposed sale, a liquidation was inevitable and objecting creditors would do worse in a liquidation than they were doing in connection with the proposed sale.

Nevertheless, the question of whether other bidders might appear and provide different alternatives is one that the marketplace is supposed to

¹ In Chrysler, the court did provide that the debtor could deem other bids qualified after consultation with the UAW, but the debtor had neither the obligation nor the incentive to do so.

answer. The judges could have done more to test the waters and there would have been little cost in opening up the process more, as the judge in Delphi has been willing to do. When process is neglected, rights of stakeholders are inevitably compromised, as is their ability to sit at the negotiating table and be heard. The special circumstances of the automobile cases may mean that these circumstances are not likely to be repeated and no special legislation is required, but the procedures followed in these cases should not become the norm. Reform of Section 363 is appropriate should such practices persist.

In thinking about legislation affecting going-concern sales, however, it is important to distinguish between the procedures designed to maximize asset value and restrictions on the ability of firms in bankruptcy to give buyers good title. Granting a buyer clean title is the principal virtue of having the sale in the first place, and it is the device that ensures that the company is sold for top dollar. Those who buy in bankruptcy auctions will not pay for the same asset twice. If a firm is worth \$10 when sold free and clear, it will bring the creditors as a group \$10 only if the proper procedures are in place. If the law were changed to require that the buyer assume a \$3 obligation, then the sale proceeds will be only \$7. The effect of imposing limits on the title that can be conveyed is not to benefit the creditors as a group, but merely to alter the way in which the value of the underlying assets is divided among them. Allocating the sale proceeds is utterly different from ensuring that they are as large as possible. One should not confuse the size of the slices with the size of the pie.

Limiting the ability of the debtor to convey good title will also make sales relatively less attractive and hence less likely. The effect in the end may not even be to alter priorities, but simply to leave everyone with less.

By the conventional understanding, debtors in bankruptcy can reject franchise agreements just as they can reject other executory contracts. The effect is to put dealers in the same position as other stakeholders—such as investors, tort victims, and suppliers. This rule likely works to the advantage of the debtor going forward. To compete in any market, manufacturers must have an effective way of distributing their products. Regardless of whether a manufacturer distributes a product itself or outsources distribution to a third party, the less efficient the distribution system, the harder it will be for the manufacturer to compete. If a distributor is located in the wrong place, is the wrong size, or provides an inferior package of services, the manufacturer's position in the marketplace suffers. It does not matter whether the manufacturer pays the distributor or the distributor pays the manufacturer.

The distribution system in place for the automobile industry has remained essentially unchanged for decades. Even if it made sense in the 1950s when the industry was far less competitive and these firms enjoyed far larger market shares, it would be surprising if it still made sense today.

One can argue, however, that this understanding of the law governing franchisees is wrong as a matter of bankruptcy policy. Unlike other claimants, auto dealers are protected by specific state and federal laws. These make their rights different from those who enter ordinary contracts with the debtor. That these laws came into being in an utterly different and far less competitive market is, under this view, irrelevant. These dealership laws must be obeyed until they are changed. In principle, bankruptcy should provide no special break from government regulations, no matter how ill-advised they might be or how much they undermine a company's ability to survive as a going concern. Under this argument, debtors in bankruptcy must play by the same rules as everyone else.

Whether this argument justifies a fundamental shift in the treatment of executory contracts under the Bankruptcy Code outside the context of these cases is best left to another day. The involvement of the federal government in these two cases alters the dynamic significantly. While providing special protection for the dealers will likely decrease somewhat the chances that the companies will survive, its principal effect is merely to reduce the value of the government's stake in the companies as restructured. Put differently, a law protecting automobile dealers in these cases is, in the main, an indirect subsidy of the dealers by the federal government. It may or may not be a good idea, but it is quite different from what goes on in other bankruptcies.

In summary, these two cases raise a number of problems, most arising by virtue of the role the government played. One can fault the particulars and one must ensure that the infirmities that existed in these cases—principally the procedures used in conducting the §363 sale—are not replicated elsewhere. At the same time, however, it should be recognized that the large role that the government played was the result of its perception—correct in my view—that only aggressive use of the bankruptcy process on its part would allow either of these companies to survive in a form that would minimize the cost to the U.S. taxpayer of keeping them alive.