

TESTIMONY OF DAVID A. SKEEL, JR.

Judiciary Committee  
U.S. House of Representatives  
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Good afternoon, Chairman Conyers, Ranking Member Smith and members of the committee. I am David Skeel, Professor at the University of Pennsylvania Law School. It is a great honor to appear before you.

I'd like to make two basic points in my opening remarks. First, our bankruptcy laws are well designed to handle the financial distress of Chrysler and General Motors, and to facilitate their restructuring. Second, the administration's handling of the Chrysler bankruptcy and its apparent plans for GM have violated the basic rules of bankruptcy in ways that could have dangerous consequences. Let me briefly expand on each of these points.

First, our bankruptcy laws—in particular, Chapter 11—are well designed to successfully restructure the automakers. There is a widespread misconception that bankruptcy means the death of a business. In many countries this would accurate, but the American bankruptcy laws are uniquely designed-- as they have been since corporate reorganization was first devised over a century ago-- to preserve and restructure viable enterprises like the carmakers. (The history is described in detail in David

A. Skeel, Jr., *Debt's Dominion: A History of Bankruptcy Law in America* (2001)).

The first major mistake with the carmakers was waiting so long to consider the bankruptcy option. General Motors lost \$20 billion last year. The company surely would have lost less, and would be much further along in its efforts to restructure, if its former management had not refused to plan for or even consider the possibility of bankruptcy until late last year. The arguments GM's management made for avoiding bankruptcy—such as the claim that customers would refuse to buy the cars of a company in bankruptcy-- were never plausible.

In my view, the decision finally to use Chapter 11 has thus been a good and overdue decision.

But the administration's handling of the bankruptcy process has been deeply problematic. This is the second of my two points.

In a case like Chrysler, the parties ordinarily would negotiate over the term of a proposed reorganization plan, and then each class of creditors or shareholders would vote whether to approve the plan. Rather than use the traditional process, the administration has structured Chrysler's bankruptcy as a sham sale of most of Chrysler's assets to a new entity called New

Chrysler for \$2 billion. The goal of this strategy seems to be to circumvent the voting process and to alter the ordinary rules of priority.

Under the usual priority rule—known as absolute priority—senior lenders are entitled to be paid in full before lower priority creditors (including employees) receive anything. The sale in Chrysler undermines the rights of the senior lenders by setting an artificially low sales price that will give them less than 30% of what they are owed, while promising a substantial recovery to lower priority creditors.

I believe the auto task force and the administration genuinely believe that their plan is the best strategy for restructuring the American auto industry and making it profitable again. But they have distorted the bankruptcy rules to achieve this result. Ironically, they have done so by resurrecting a strategy—the sham sale—whose potential abuses the reformers of the New Deal era—your predecessors—thought they had stamped out more than seventy years ago. (This point is discussed more fully in David Skeel, “Why the Chrysler Deal would horrify a New Dealer, available at <http://www.american.com/archive/2009/may-2009/why-the-chrysler-deal-would-horrify-a-new-dealer>).

The Chrysler strategy could have at least two very dangerous consequences.

First, the subversion of the basic priority rules could seriously interfere with lenders' willingness to extend credit to troubled corporations. Senior lenders have been burned in Chrysler; they will take steps not to be burned again. Lenders will be especially reluctant to make loans to any company that might be the subject of government intervention, such as the suppliers to the auto industry. The administration's misuse of the bankruptcy process in Chrysler may make it more difficult for these other companies to survive on their own, and could make government help more necessary than it otherwise would be. More generally, the unsettling of the priority rules could appreciably increase the cost of borrowing for any company that is in financial distress in the coming years.

Second, the Chrysler sale sets a dangerous precedent. In future cases, the insiders of a company that files for bankruptcy will be able to propose a similar sham sale that benefits favored creditors at the expense of disfavored creditors. There already are reasons to worry about bankruptcy sales that are proposed by insiders. But the Chrysler precedent goes well beyond anything that previously would have been thought possible.

I don't believe that the sham sale in Chrysler will be treated as an extraordinary, one time event. Much like the Bush v. Gore decision by the Supreme Court, it will influence cases in the future.

In sum, I believe that our bankruptcy laws are well designed for a restructuring of the troubled carmakers. But it is very dangerous for the administration to distort the bankruptcy laws to achieve its preferred outcome.

THANK YOU.