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CONGRESSIONAL TESTIMONY

Bailouts, Abusive Bankruptcies, And the Rule of Law

Testimony before Judiciary Committee United States House

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The Obama Administration is abusing bankruptcy law to benefit a favored constituency, the United Auto Workers union. This threatens serious consequences:

- Without the discipline of a real bankruptcy reorganization, General Motors and Chrysler may not be able to achieve the reforms that they need to survive and prosper.
- The restructuring plans announced by both automakers are not bold enough. To gain a competitive edge, they will have to cut more dealers loose, put an end to the Byzantine system of work rules that stifles flexibility, and in general, make deeper cuts.
- Selling Chrysler to a shell corporation for the purpose of divesting lenders of their rights is a stunning abuse of U.S. bankruptcy laws that threatens to upend this important resource for troubled companies.
- The "rule of law" means clear, generally applicable laws by which individuals can organize their affairs and which are applied consistently, without respect to status. By favoring a political constituency over individuals with actual legal rights, the Obama Administration has violated a fundamental principle of our constitutional government.
- Striking down contractual rights arbitrarily, merely because they are inconvenient or expensive to the government, raises the costs of making and enforcing agreements across the economy.
- Certain industries and businesses will suffer disproportionately: the automobile industry, heavily unionized industries, corporations that are faltering or undergoing reorganization, and already weakened financial institutions.
- This episode of lawlessness began with legislation, the Emergency Economic Stabilization Act, that many at the time recognized as an illegally unbounded delegation of power from the legislative to the executive branch. It was that act which created the TARP that is now the Administration's slush fund for bailing out its allies and otherwise upsetting economic expectations. That outcome should be no surprise; unbridled discretion breeds unchecked power.
- The bankruptcies of Chrysler and soon General Motors are a microcosm of the lawlessness that threatens our freedom and our prosperity. With its legislative power, Congress can put an end to the bailouts and begin the slow process of unwinding those that entangle us today.

My name is Andrew Grossman. I am Senior Legal Policy Analyst at The Heritage Foundation. The views I express in this testimony are my own, and should not be construed as representing any official position of The Heritage Foundation.

My testimony this afternoon concerns the impact that the abuse of the bankruptcy system to bail out Chrysler and soon General Motors will have on the automobile industry, the rule of law, and the economy. This is an important issue, and I applaud the Committee for taking the time to address it and consider my comments.

Members of this Committee should focus on three points. First, that the U.S. auto industry itself has been harmed by the initiatives of the Bush and Obama Administrations that were meant to save it. Second, that the Obama Administration's abuse of bankruptcy to carry out its initiatives will serve as a precedent for others to sidestep the requirements of America's Chapter 11 reorganization process. The third point is that in rescuing Chrysler and General Motors, the federal government has trampled the rule of law in ways that will prolong our current recession unless Congress acts to rein in the excesses of the Administration's interventionist policies.

The auto industry, like AIG and like many of the banks now scrambling to extract themselves from the government's Troubled Asset Relief Program (TARP), may have been better off had the federal government followed the will of Congress and declined to intervene in their troubles. Though this counterfactual is difficult to prove—we will, of course, never know what would have happened in some alternative scenario—the major issues left unaddressed, or only partially addressed, in the government's reorganization strategy point to this conclusion. So, too, do a surprising number of indicators.

The Detroit-centered auto industry's collapse was the result of deep-seated structural problems that have been decades in the making—not just the recent drop-off in sales. To understand the extent of these problems, some history is required.

The combined market share of the Big Three U.S. automakers has been in decline for more than 35 years, since the oil crisis provided an opening for more fuel-efficient Japanese cars. In the 1980s, with the price of oil down, foreign carmakers gained market share on the strength of their quality, reliability, and prices, and quickly muscled in to the profitable luxury segment of the market. More recently, foreign automakers simply out-innovated their American competitors, investing heavily in smart, fuel-efficient vehicles that Detroit is now struggling to duplicate.

Those failures in management and leadership have been compounded by bad operational and governmental policy. Years of protectionism, such as import restrictions, complex fleet requirements, and regulations that raise costs for foreign producers, shielded the Big Three from competition in vital markets but allowed their creative juices to evaporate. Meanwhile, fat years and government interference allowed the automakers and their workers to put off restructuring their labor agreements, even as foreign competitors opened U.S. plants producing cars with fewer workers working at less cost

and achieving greater quality. By 2008, these "legacy costs" dominated the U.S. automakers' balance sheets, and they spent $20 to $30 more per hour on labor than their competitors, even following minor concessions by the unions, and, due to inflexible work rules, continued to require more hours to produce a vehicle. Well aware of the writing on the wall, the Big Three and the United Auto Workers union demonstrated their cynicism in signing on to untenable labor agreements, under which the companies lose money on most small car sales, under the assumption that the taxpayers will eventually shoulder much of the burden.

The Big Three are also burdened with obsolete and expensive business structures. All are top-heavy with management and bureaucracy, compared to other manufacturing industries. They are also bogged down by too many nameplates that, due to state franchising laws, cannot easily be folded into other brands. As of December, General Motors manufactured and marketed automobiles under eight brands in the United States, including Chevrolet, Saturn, Pontiac, and Buick, in a market where few customers perceive any significant difference among them. Their antiquated and bloated dealership structures also prevent the Big Three from instituting modern and more flexible inventory-management practices and selling cars over the Internet.

In late 2006, shortly before the current economic slowdown, Ford separated itself from its two domestic rivals. Its new management team, led by former Boeing executive Alan Mulally, recognized both that the company needed a top-to-bottom revamp and that, without extraordinary commitment, this restructuring would probably fare no better than the many others Ford had undertaken over the decades. To commit itself to a major, years-long overhaul, Ford mortgaged its assets to the hilt, raising $23.6 billion to reorganize, develop new cars and technologies, and free itself of many of the legacy costs that sapped its competitiveness.

Already weakened by years of bad business decisions, the Big Three were hit hard by high fuel prices and then the economic slowdown. Though sales are down across the industry, buyers' interest in the Big Three's fleets has plummeted. For the first time in history, Detroit's share of the U.S. market dipped below 50 percent in 2008 and has fallen further since.

Ford, to date, has had the wherewithal and the resources to ride out the recession and weak auto market. General Motors and Chrysler, however, have not, and so late last year asked the federal government to give them the money needed to undertake the sort of reorganization already well underway at Ford.

The usual process for accomplishing this type of restructuring is bankruptcy—specifically a Chapter 11 filing. Under Chapter 11, bankruptcy affords companies that have hit hard times a fresh start and a chance to reorganize to take better advantage of their assets. Dire claims that bankruptcy is somehow equivalent to the end of a business—for example, some claimed that bankruptcy would imperil the employment of all of an automaker's workers—are simply incorrect. Instead, the reorganization process provides unique flexibility to unlock the fundamentally sound productive capabilities of a

faltering business by freeing it of many obstacles to success, such as unviable contracts, crushing debt, and poor management. Reorganization is the usual tonic for businesses, like the Big Three, that need to adjust quickly to new economic realities but are, at their cores, sound, productive, and potentially profitable.

Yet after Congress declined to bail out General Motors and Chrysler, the Bush Administration and then the Obama Administration acted to accomplish the same end, drawing on funds that had been appropriated to shore up financial institutions under the TARP.

Bankruptcy has been, with Chrysler, and probably will be, with General Motors, a part of this process. As explained further below, the Obama Administration's Automotive Task Force (ATF) developed a plan to use several provisions of the bankruptcy code while evading most of its requirements. In this way, it could bail out Chrysler and General Motors for far less money than would otherwise be required—essentially by forcing others to pay for much of it—without relinquishing its effective control of either company or forcing favored constituencies, unions chief among them, to accept serious concessions.

The result is that neither company will go through the full Chapter 11 restructuring process but only, in the words of various Administration officials, a "quick dip" or "surgical bankruptcy." Thus, both will forgo the essential discipline of the Chapter 11 process, its narrow focus on finances and sustainability, that has made it so successful. Altering or evading this essential focus reduces the likelihood of achieving the goal: rehabilitating a business that has suffered financial failure and restoring it to profitability and, over the longer term, success.

Given the deep-seated nature of these companies' problems—how long they have persisted, how much they cut to the core of their businesses—it is obvious that meek efforts will not suffice. Yet, aside from the billions of taxpayer dollars being committed to them, meekness, rather than discipline, buttressed by tough talk characterizes the Obama Administration's approach. The result is that heavily touted reforms are less aggressive than could be expected in an ordinary bankruptcy reorganization. This imperils both companies.

One example is the rationalization of dealer networks. Both General Motors and Chrysler recently announced plans to sever their ties with some of their dealerships. Chrysler, relying on a provision of bankruptcy law that allows the setting aside of contracts, will drop 800 of its dealers, about a quarter of its total network, leaving about 2500. General Motors, meanwhile, notified 1,100 of is 6,000 dealers that their contracts will not be renewed next year; it hopes to cut another 900 to 1,300 dealers over the next few years, reducing its total to 3,600 to 4,000. Further reductions could come from attrition and consolidation.

These are, unambiguously, steps necessary to the survival of both automakers, but there is a real question as to whether they are enough. Even with the cuts, neither

company will come close to matching Toyota's much-envied statistic of 1,100 car sales per dealer, per year, on average. If it meets its most aggressive goals, General Motors will still have, relative to that standard, an excess of 1,800 dealers. The result is that overhead and marketing expenses will remain too high, that dealers in some markets may face cannibalizing competition from cross-town rivals, and that many dealers will not be able to invest the money necessary to improve customer experience.

If the economy, and car sales, recover, both companies will find it tough to make further cuts. Outside of bankruptcy, both will be, once again, subject to restrictive state franchising laws that heavily penalize closures. For example, when General Motors shut down one underperforming and duplicative brand, Oldsmobile, in 2004, it had to pay dealerships over $1 billion in "financial assistance" to avoid lawsuits and is still, 4 years later, embroiled in litigation from former Oldsmobile dealers who declined to accept assistance or settle their claims. The costs could be even greater for cutting loose multiple-brand dealers.

There is also concern about which dealers are being cut and whether they are the right ones to go. As wards of the state, both automakers face intense pressure to make decisions that reduce political friction, rather than those that maximize economic gain. It would be difficult to believe, considering the ATF's deep involvement in both companies' plans, as well as the power of certain Members of Congress, that no political pressure was brought to bear and that all decisions were made entirely on the merits.

Unfortunately, such pressure, and such doubt, will accompany every decision made by General Motors and Chrysler in the months ahead. Some, for example, speculate that General Motors and Chrysler threw their support behind President Obama's new emissions and fuel efficiency standards at the behest of his Administration.[1] No doubt politics played some role in transforming the automakers' former intransigence on the issue.

As with dealers, both companies have begun the process of culling underperforming brands from their stables to reduce expenses and improve focus. Again, this is a necessary step, but questions remain as to whether it is enough. Does Chrysler need both the Chrysler brand and Dodge? And while General Motors was right to retire Pontiac, and Cadillac maintains its allure, does it need Chevrolet, Buick, and GMC, or do further opportunities to cut brands, and costs, exist? These questions could be answered in a regular Chapter 11 case, but outside of that context, there's little to guide the inquiry. Some industry analysts, however, have maintained for years that these extra brands only add costs and distraction, not value.

[1] *See* Jake Tapper, Arnold Hypothesizes POTUS Told U.S. Automakers to Go Along with New Enviro Regs for Federal $, May 19, 2009, http://blogs.abcnews.com/politicalpunch/2009/05/arnold-hypothes.html.

And once again, trimming brands in future years will be a difficult, expensive effort, due to the same state laws that make it hard to cut loose dealers. Efficiencies forgone now, during restructuring, may not be available in the future.

Labor is another area where the concessions made, though a big step in the right direction, may be insufficient to put General Motors and Chrysler on a level playing field with their competitors. At this moment, General Motors is locked in negotiations with the United Auto Workers, but Chrysler completed a deal with the union shortly before it entered bankruptcy. The new agreement will, in theory, eventually put hourly costs in line with those of the foreign automakers, known as "transplants," who build cars in the United States. It also trims benefits a bit (e.g., vision, dental, prescriptions for Viagra), reforms overtime calculations, and consolidates some skilled trades to reduce the complexity of work rules.

Some issues, however, were not fully addressed by the new agreement. Current employees, for example, will not be asked to take cuts in their base wage rates until at least 2011, if at all. At that point, the company and the union will enter into binding arbitration with the stated goal of equalizing "all-in" hourly wages with those of the transplant automakers. That agreement could potentially push equalization even further into the future; if auto sales have recovered by then, Chrysler may not be in a position to demand that its workers accept more cuts. The agreement also requires the automaker to continue making payments to the union-run Voluntary Employee Beneficiary Association (VEBA) that provides health benefits to retirees and their families. Those payments will total $9.2 billion. Benefits for laid-off workers will also remain unusually generous. Some workers will be eligible to receive payments covering 50 percent or more of their gross pay for up to 2 years after being laid off. Given the need to shrink operations, this stands to be a significant expense.

Work rules also remain a barrier to competitiveness. The agreement does make some significant improvements to these Byzantine arrangements that govern nearly every facet of automobile production, but they will still reduce flexibility and efficiency, while imposing a bureaucratic, union-mediated process on all employer-employee relations that is expensive, time-consuming, and morale-sapping—for both sides. A better, though perhaps unlikely, outcome would have been scrapping plant-level work rules in favor of the more flexible approach taken at New United Motor Manufacturing (NUMMI), a Toyota and General Motors joint venture in California that regularly wins awards for its innovation and productivity. That approach is based on the one used at all of Toyota's facilities and is similar to those employed by other transplant automakers. This shortcoming alone leaves Chrysler, and almost certainly General Motors under its forthcoming agreement, at a major competitive disadvantage.

Also detrimental to General Motors and Chrysler is the difficulty that they will have accessing capital and debt markets. Lenders know how to deal with bankruptcy—it's a well understood risk of doing business. But the tough measures employed by the Obama Administration to cram down debt on behalf of the automakers were unprecedented and will naturally make lenders reluctant to do business with these

companies, for fear they could suffer the same fate.[2] Even secured and senior creditors, those who forgo higher interest rates to protect themselves against risks, suffered large, unexpected losses. So nothing that either company can offer, no special status or security measure, can fully assuage lenders' fears that, in an economic downturn, they could be forced to accept far less than the true value of their holdings. At best, if General Motors and Chrysler have access to debt markets at all, they will have to pay dearly for the privilege. At worst, even high rates and tough covenants will not be enough to attract interest.

Impaired access to debt and capital will stymie future restructuring, investment, and growth, reducing the likelihood that either company will fully rebound and, beyond that, prosper. There is the risk that this will lead to further government intervention, using taxpayer funds; rather than the lender of last resort, the federal government could become the first, and only, option.

Finally, there is the stigma of having accepted government funds. For months, auto executives asserted that consumers would not purchase cars manufactured by a company in bankruptcy. Poll after poll, however, showed that fear to be overblown, especially as consumers came to know more about the restructuring process. Meanwhile, as auto sales plummeted, General Motors and Chrysler lost the most, as Ford, the holdout, snatched their market share. There is a stigma to taking taxpayer dollars that, according to polls, is far worse than any attached to filing for bankruptcy. Fully 72 percent of those surveyed nationwide say they are more likely to purchase a Ford product because the company has not taken government money.[3] A Rasmussen poll found that 88 percent of Americans would prefer to buy a car from an automaker not receiving government aid.[4] And many articles published in newspapers and online have quoted individuals once devoted to GM brands or Chrysler (known as "Mopar" fans, after the company's auto-parts division) whose loyalty is now defunct—or shifted to Ford.

These downsides prove—as much as is possible at this time—that aggressive government intervention has had a negative effect on both Chrysler and General Motors, relative to the usual alternative, a regular bankruptcy, even one with some degree of debtor-in-possession financing provided by or (even better) merely guaranteed by the federal government. There is every reason to believe that unexceptional bankruptcies, though taking longer and demanding greater sacrifice, would have left both companies on firmer competitive footing. But for mostly political reasons, that is not what the Obama

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[2] There is some evidence that this is already happening. See, e.g., Eric Berman, *State to No Longer Invest in Federal Bailout Recipients*, WIBC News, May 20, 2009, http://www.wibc.com/news/Story.aspx?ID=1094872 (describing how Indiana's State Treasurer ordered the managers of the state's investment funds, such as pensions, "not to buy any more bonds from Chrysler, GM, or banks covered by the bailout").
[3] Bill Vlasic, *Choosing Its Own Path, Ford Stayed Independent*, N.Y. TIMES, April 8, 2009, at B1.
[4] Ken Bensinger, *GM, Chrysler sales hurt by mixed messages*, L.A. TIMES, March 29, 2009.

Administration chose to do. That it chose, however, to rely on portions of the bankruptcy code to implement its bailout plan raises concerns that it may have, in the process, altered that body of law.

Specifically, the Obama Administration's abuse of bankruptcy to carry out its initiatives could serve as a precedent for others to sidestep the requirements of the Chapter 11 reorganization process, thereby undermining what has been an extraordinarily successful tool to turn around troubled enterprises.

America's Chapter 11 process has been a model for the rest of the world. As one recent article describes, China's new bankruptcy law, its first, allows for reorganization of insolvent businesses and the "cramdown" of their debts, very closely tracking the U.S. model.[5]

Its success can also be judged in statistical terms. A recent article from Elizabeth Warren and Jay Lawrence Westbrook analyzes data from thousands of bankruptcy cases involving both small and large businesses.[6] They found that, among companies that, entering bankruptcy, had a plausible chance of reorganizing, between 65 percent and 72 percent were able to confirm a reorganization plan to exit bankruptcy.[7] And the rate is likely higher for larger firms.[8] This is an encouraging statistic, considering that all of these businesses had reached the point of insolvency or illiquidity at the time that they entered bankruptcy.

Warren and Westbrook also found that bankruptcy proceeds at a quick pace in most cases; the typical case is resolved in about 9 months.[9] While firm size is a factor, larger businesses only took an average of 4 months longer than smaller businesses.[10] And by 24 months, they report, nearly all cases were resolved.[11]

They summarize their findings thusly:

> These data expose the heart of the efficiency question: is successful reorganization a rarity, available in a relatively small number of cases? Are the benefits of Chapter 11 achieved only at the expense of long delays? Our data...show that confirmation rates jumped to two-thirds or more among larger debtors, debtors that were able to survive the first nine months in bankruptcy, and debtors who at least proposed a plan to reorganize. The data reveal that the

[5] Michael Burke, Wei Cui, & Paul Jones, *International Legal Developments in Review: 2006: Regional & Comparative Law*, 41 INT'L L. 777, 784-787 (2007)
[6] Elizabeth Warren & Jay Lawrence Westbrook, *The Success of Chapter 11: A Challenge to the Critics*, 107 MICH L. REV. 603, 607 (2009).
[7] *Id*. at 617-18.
[8] *Id*. at 635-37.
[9] *Id*. at 629.
[10] *Id*. at 637.
[11] *Id*. at 629.

cases—both those that exit the system and those that confirm plans of reorganization—moved at a lively pace.

Those conclusions, however, describe a system that is premised on maximizing the value of an enterprise for (in the case of insolvency) the benefit of its creditors, who wield great control over the process. That is the system that the Obama Administration opted to circumvent.

In a normal case, a business files for bankruptcy and then has an "exclusivity period" of up to 18 months during which it can prepare a reorganization plan to present to its creditors. That plan, under Section 1129 of the Bankruptcy Code, must adhere to the "absolute priority rule," which simply mandates that senior creditors, such as those with security interests, are paid off before junior creditors. Further, creditors who, under the plan, are not paid in full and are slated to receive less than they would in a Chapter 7 liquidation—that is, when the assets of the business are sold off—have a chance to vote, as a class, on whether to accept or reject it.

Taken together, these rules protect creditors' contractual rights and ensure that bankruptcy law is used to promote economic efficiency, rather than for more nefarious purposes, such as enriching favored creditors at the expense of others. This is important because, within bankruptcy, a business has extraordinary power to accept or reject contracts, alter the terms of its debt, and even dismiss debt altogether. Without these rules, bankruptcy could easily be misused to defraud lenders and other creditors.

But Chrysler, which filed for bankruptcy on April 30, will never file a plan subject to the approval of impaired creditors. Though it is taking advantage of bankruptcy to exit contracts, such as with some dealers, and cram down its debt, it gets to skip the requirements of Chapter 11 reorganization thanks to a combination of aggressive lawyering, coercion, and intimidation, all courtesy of the Obama Administration.

The means to evading the law is a provision of the Bankruptcy Code, Section 363(b), which allows the sale of assets of the bankruptcy estate. Relying on that provision, the government arranged a sham sale of nearly the entire company to a newly created "Chrysler" capitalized by the government. The price? $2 billion, all of which would go to secured creditors for senior debt worth $6.9 billion, for a recovery of just 29 cents on the dollar. Meanwhile, one junior debtor, the UAW-administered VEBA, was slated to receive 43 cents on the dollar for its unsecured $11 billion claim, as well as 55 percent of the new Chrysler. In a typical case where senior debt-holders were not paid in full, the UAW, along with other junior creditors, would receive nothing.

In effect, the Administration used Section 363(b) to accomplish a *sub rosa* reorganization of Chrysler, financed in part by Chrysler's former senior debtors. It then transferred a large portion of that value, along with added value from additional bailout funds, to the UAW and Fiat, which is investing some technology, but no money, in its new joint venture with Chrysler.

This is exactly the kind of abuse—stealing from one party to give to another—that the bankruptcy code was designed to prevent.

This is not the first time that Section 363(b) has been used to sell essentially an entire company or its "crown jewel" assets, though it is certainly the most prominent. Courts have been justifiably wary of the practice and carefully scrutinized transactions to ensure that the law was not being abused. In an early case employing this legal "innovation," the Fifth Circuit rejected it outright, writing:

> [T]he district court was not authorized by Sec. 363(b) to approve the [transaction]. In any future attempts to specify the terms whereby a reorganization plan is to be adopted, the parties and the district court must scale the hurdles erected in Chapter 11. See e.g. 11 U.S.C. Sec. 1125 (disclosure requirements); id. Sec. 1126 (voting); id. Sec. 1129(a)(7) (best interest of creditors test); id. Sec. 1129(b)(2)(B) (absolute priority rule). Were this transaction approved, and considering the properties proposed to be transferred, little would remain save fixed based equipment and little prospect or occasion for further reorganization. These considerations reinforce our view that this is in fact a reorganization.[12]

A more recent case stated the concern with Section 363(b) sales even more plainly: "The reason sub rosa plans are prohibited is based on a fear that a debtor-in-possession will enter into transactions that will, in effect, short circuit the requirements of Chapter 11 for confirmation of a reorganization plan."[13] That court went on to state:

> [W]hether a particular settlement's distribution scheme complies with the Code's priority scheme must be the most important factor for the bankruptcy court to consider when determining whether a settlement is "fair and equitable" under Rule 9019 [concerning the settlement of controversies within classes]. The court must be certain that parties to a settlement have not employed a settlement as a means to avoid the priority strictures of the Bankruptcy Code.

Any court examining the Chrysler transaction would be compelled to reach the opposite conclusion. It is difficult to argue that what Chrysler is undergoing at present is not a reorganization. The Treasury, in fact, refers to the transaction as a "restructuring initiative" and to the new shell company as "the reorganized Chrysler."[14] Further, it

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[12] In Re Braniff Airways, Inc., 700 F.2d 935, 940 (5th Cir. 1983).
[13] In re Iridium Operating LLC, 478 F.3d 452, 466 (2nd Cir. 2007) (internal quotations omitted). The court approved the sale in this case only after it found that the transaction "had a proper business justification and was a step towards possible confirmation of a plan of reorganization and not an evasion of the plan confirmation process." *Id.*
[14] Press Release, Department of the Treasury, Obama Administration Auto Restructuring Initiative
Chrysler-Fiat Alliance, April 30, 2009, *available at*
http://www.ustreas.gov/press/releases/tg115.htm.

describes the time period after the transaction as part of a "restructuring period."[15] Even more clearly, the transaction, unlike a sale to an established entity such as another company, had no economic substance. Finally, the distribution is hardly "fair and equitable;" it upends the Code's priority scheme, with junior creditors faring better than those holding senior claims.

In short, the entire point of using Section 363(b) was to force a very unfavorable plan on (understandably) recalcitrant secured creditors in violation of their contractual and property rights.

Lawyers justified the sale using much the same language as was employed in support of the Section 363(b) sale of Lehman Brother's brokerage unit, just after its parent had filed for bankruptcy, to Barclays Capital. They argued that Chrysler would precipitously decline in value, wreaking havoc throughout the supplier base, and that only a quick sale could prevent that end. Unlike in the case of Lehman, however, there was little evidence to support this claim, just hand-waving.

Under the Bankruptcy Code, creditors can object to a proposed sale. But reminiscent of the Sherlock Holmes tale about "the dog that didn't bark," banks that held the bulk of Chrysler's senior debt, and that were also TARP recipients and so subject to close scrutiny and regulation by the Treasury, declined to do so. Though an anonymous Administration aide told reporters that the White House forbade the use of TARP as leverage over these banks, other creditors saw early on in negotiations that TARP recipients were more willing than non-TARP parties to cut a deal on unfavorable terms.[16] The implication is that, whether they were explicitly ordered to or not, these banks were coerced into supporting the government-backed proposal.

And there were threats, too, after about 20 creditors banded together to form the "Chrysler Non-TARP Lenders Group" and challenge the Section 363(b) sale. This was just days after President Obama had put pressure on those who had rejected the Administration's previous offer, publicly blaming "investment firms and hedge funds" for Chrysler's bankruptcy, claiming that by rejecting the government's deal, they had "decided to hold out for…a taxpayer-funded bailout" and were "hoping that everybody else would make sacrifices, and they would have to make none."[17] (In reality, the hold-outs had offered a compromise plan under which they would receive 60 cents on the dollar, about the same as the UAW.) The group, representing teachers unions, pension funds, and school endowments, among others, moved to delay the sale, and the judge agreed to hold a hearing. But the effort would quickly fizzle, as members deserted the group in the face of death threats, criticism from lawmakers, and according to one prominent attorney, threats from the administration:

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[15] *Id*.
[16] Neil King, Jr., & Jeffrey McCracken, *U.S. Forced Chrysler Creditors to Blink*, WASH. POST, May 11, 2009, at A1.
[17] Remarks of President Barack Obama, April 30, 2009.

> One of my clients," [attorney Tom]Lauria told [radio] host Frank Beckmann, "was directly threatened by the White House and in essence compelled to withdraw its opposition to the deal under threat that the full force of the White House press corps would destroy its reputation if it continued to fight."[18]

After suffering days of abuse, the group folded, ending the leading objection to the sale.[19]

According to news reports, General Motors will follow a similar course at the end of this month, with an anticipated Section 363(b) sale to a new entity that would initially be owned by the federal government.[20] Secured lenders would be paid 28 cents on the dollar, while holders of the company's $27 billion in unsecured bonds would receive a 10 percent stake in the new company. The UAW, meanwhile, would receive $10 billion in cash and up to a 39 percent stake in the "new" General Motors in exchange for its $20 billion in unsecured debt—a far better payout than those to secured lenders and similarly situated bond holders. The government is also expected to take a big ownership stake.

These high-profile precedents threaten to change the nature of bankruptcy for businesses carrying heavy debt loads. Professor Mark Roe, of Harvard Law School, described this risk in a recent column:

> [I]f the current deal becomes a strong bankruptcy court precedent, it'd throw priorities into question generally, because the tactics are easily imitated even without the government as the major player. In Chapter 11 reorganizations going forward, if a coalition of creditors and insiders can convince a judge to use the same structure as the Chrysler judge has provisionally approved, they can freeze out a creditor group who then couldn't call on any of bankruptcy law's normal protections.[21]

Insiders alone, as well, might wish to take advantage of this technique to keep their hold on the business, while dropping debt. Rather than persevere the rigor and

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[18] Michael Barone, *White House puts UAW ahead of property rights*, WASH. EXAMINER, May 6, 2009.

[19] One challenge, though, is still pending. The Indiana State Teachers Retirement Fund, Indiana State Police Pension Trust, and Indiana Major Movers Construction Fund have asked the bankruptcy judge to block the sale, arguing that it is "illegal and tramples their rights," nothing more than a scheme to reward creditors the "government deems politically important." Objection of Indiana Pensioners, In Re Chrysler, No. 09-50002 (Br. S.D. N.Y. May 19, 2009), available at http://chapter11.epiqsystems.com/viewdocument.aspx?DocumentPk=8b2f9a28-04cd-4161-b3b6-50fc8e37ef9c.

[20] Chelsea Emery & Tom Hals, *GM bankruptcy plan eyes quick sale to government*, Reuters, May 19, 2009.

[21] Mark Roe, *Stress-Testing Washington's Chrysler Bankruptcy Plan*, FORBES, May 13, 2009.

discipline of the current bankruptcy system, and its inconvenient insistence on fair treatment of creditors, businesses will have another option: arrange a sham sale to a shell company, wiping out debts and other obligations in the process.

If this practice becomes more prevalent, it threatens to disrupt both lending and capital investment across the economy. This consequence is discussed further below.

Just as bad, it promises poor results. Businesses will be washed of their debt, but without realizing the efficiency gains of a real, profits-focused reorganization. Managers regularly overestimate their ability to turn around a failing business, and creditor control in bankruptcy provides an important check on this tendency. Cutting creditors out of the picture will only lead to more business failures, as firms opt to take the easy way out.

Congress should, the next time it takes up bankruptcy reform, study the use, or misuse, of Section 363(b) sales to evade the requirements of the bankruptcy code and frustrate the principles of fairness and rule of law on which it is premised.

It is appropriate here to discuss the rule of law, because in rescuing Chrysler and General Motors, the federal government has trampled it in ways that will hurt our economy.

The “rule of law” means clear, generally applicable laws by which individuals can organize their affairs and which are applied consistently, without respect to status. This was something that the Framers of the U.S. Constitution took very seriously. In three separate clauses of the Constitution—the Contracts Clause, the prohibition on bills of attainder (i.e., legislation that punishes particular individuals, as if they had been convicted of a crime), and the prohibition on *ex post facto* laws (i.e., criminal laws that apply retroactively)—they sought to limit the power of the government they were creating and of the states to intervene in lawful conduct.

James Madison, for one, understood that the temptation to do so would be irresistible otherwise. His explanation in Federalist No. 44 is worth repeating:

> Our own experience has taught us, nevertheless, that additional fences against these dangers ought not to be omitted. Very properly, therefore, have the convention added this constitutional bulwark in favor of personal security and private rights; and I am much deceived if they have not, in so doing, as faithfully consulted the genuine sentiments as the undoubted interests of their constituents. The sober people of America are weary of the fluctuating policy which has directed the public councils. They have seen with regret and indignation that sudden changes and legislative interferences, in cases affecting personal rights, become jobs in the hands of enterprising and influential speculators, and snares to the more-industrious and less informed part of the community. They have seen, too, that one legislative interference is but the first link of a long chain of repetitions, every subsequent interference being naturally produced by the effects of the preceding. They very rightly infer, therefore, that some thorough reform is

wanting, which will banish speculations on public measures, inspire a general prudence and industry, and give a regular course to the business of society.

In this view, the consistent application of law is the assumption behind every other clause of the Constitution, the principle, without which, none life, liberty, and the pursuit of happiness could be secure. It is, thus, a prerequisite to due process and protection against the arbitrary exercise of power—that is, tyranny.

When the rule of law is cast aside, for whatever seemingly pragmatic reason, it impairs the machinery of private ordering, such as contractual rights, that are at the core of our economic freedom and prosperity. The broad enforceability of contracts, tempered by several narrow doctrines of abrogation, makes it possible to conduct economic affairs with strong assurance that other parties will keep their promises or be held liable for failing to do so. In this way, people are able to order their affairs, in employment contracts, insurance contracts, service agreements, and the myriad of other contractual agreements that make modern life possible.

Striking down contractual rights arbitrarily, merely because they are inconvenient or expensive to the government, raises the costs of making and enforcing agreements across the economy by reducing the certainty of all agreements. Madison himself described the slippery slope that would result: The more the legislative branch interferes in private affairs, the more who will demand that it interfere in their affairs, to their advantage, and the less the role private agreements will play in economic life. It is, in effect, a tax on contracting, for more contracts will require a lawyer's hand in drafting to avoid government abrogation. And where that is unavoidable, parties may decline to contract at all, costing the U.S. economy the surplus of their avoided transaction, while others may alter the terms of their agreements to reduce risk but also reward. Still others may shift their business to foreign shores that show greater respect for the rule of law.

We can predict who will suffer these consequences. The automakers, surely, will have only limited access to financial markets for years to come and pay usurious rates when they are able to borrow. Sadly, Ford will probably suffer the same fate, if to a slightly lesser degree, because the mere fact of its present solvency is not enough to guarantee that lenders' rights will not be gutted at some point in the future.

Quite perversely—or quite appropriately, depending on one's point of view—unionized industries may also see their cost of capital rise, hampering growth and hiring. The Obama Administration's transparent favoritism toward its political supporters in the United Auto Workers Union may lead other unions to demand the same: hefty payouts and ownership stakes in exchange for halfhearted concessions. Lenders know now that the Administration is unable to resist such entreaties. As one hedge fund manager observed, "The obvious [lesson] is: Don't lend to a company with big legacy liabilities,

or demand a much higher rate of interest because you may be leapfrogged in bankruptcy."[22]

Perhaps the most affected will be faltering corporations and those undergoing reorganization—that is, the enterprises with the greatest need for capital. Lending money to a nearly insolvent company is risky enough, but that risk is magnified when bankruptcy ceases to recognize priorities or recognize valid liens. With private capital unavailable, larger corporations in dire straits will turn to the government for aid—more bailouts—or collapse due to undercapitalization, at an enormous cost to the economy. As Warren Buffet opined, "[I] priorities don't mean anything that's going to disrupt lending practices in the future."[23]

Professor Todd Zywicki offers an observation on this point: "Mr. Obama may have helped save the jobs of thousands of union workers whose dues, in part, engineered his election. But what about the untold number of job losses in the future caused by trampling the sanctity of contracts today?"[24]

Financial institutions—enterprises that the federal government has already spent billions to strengthen—will also be affected. Many hold debt in domestic corporations that could be subject to government rescue, rendering their obligations uncertain. It is that uncertainty which transforms loans into impossible-to-value toxic assets and blows holes in balance sheets across the economy.

Finally, there are the investors, from pension funds and school endowments to families building nest eggs for their future. General Motors bonds, like the debt of other long-lived corporations, has been long regarded as a refuge from the turmoil of equity markets. The once-safe investment held directly by millions of individuals and indirectly, though funds and pensions, by far more, are now at risk, which will be reflected in those assets' values.

The effects of abrogating the rule of law are broad and deep. They can be witnessed first-hand in any nation where contracts are unenforceable and the government's rule is arbitrary and absolute. They are also evident in the prosperity of nations:

> [Economists Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny (LLSV)] documented empirically that legal rules protecting investors vary systematically among legal traditions or origins, with the laws of common law countries (originating in English law) being more protective of

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[22] Caroline Salas, *Fund Managers Burned by Obama Now Say They Are Wary*, Bloomberg.com, May 20, 2009.
[23] Interview with Warren Buffet, CNBC, May 9, 2009, http://www.moneycontrol.com/india/news/fii-view/best-dow-sp-returns-were-during-recession-warren-buffet/396389/2.
[24] Todd Zywicki, *Chrysler and the Rule of Law*, WALL ST. J., May 13, 2008, at A19.

> outside investors than the laws of civil law (originating in Roman law) and particularly French civil law countries. LLSV then used legal origins of commercial laws as an instrument for legal rules in a two stage procedure, where the second stage explained financial development. The evidence showed that legal investor protection is a strong predictor of financial development.[25]

Empirical studies also show that the rule of law has an impact on civil society, affecting such disparate variables as entrepreneurship, military conscription, and government control of the media.[26]

In sum, continued disregard of this fundamental principle threatens severe consequences.

This episode of lawlessness began with legislation, the Emergency Economic Stabilization Act, that many at the time recognized as an illegally unbounded delegation of power from the legislative to the executive branch.[27] It was that act which created the TARP that is now the Administration's slush fund for bailing out its allies and otherwise upsetting economic expectations.[28] That outcome should be no surprise; unbridled discretion breeds unchecked power.

What began with Congress can end with it, too. It is time to stop the economic adventurism that marked the last months of George W. Bush's Administration and the first of President Obama's. The bankruptcies of Chrysler and soon General Motors are a microcosm of the lawlessness that threatens our freedom and our prosperity. With its legislative power, Congress can put an end to the bailouts and begin the slow process of unwinding those that entangle us today.

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[25] Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, *The Economic Consequences of Legal Origins*, NBER Working Paper No. W13608, November 2007.
[26] *Id*.
[27] *See, e.g.,* Todd Gaziano & Andrew Grossman, *All Deliberate Speed: Constitutional Fidelity and Prudent Policy Go Hand in Hand in Fixing the Credit Crisis*, Heritage Foundation WebMemo No. 2079, http://www.heritage.org/Research/Economy/wm2079.cfm.
[28] See Andrew Grossman & James Gattuso, *TARP: Now a slush fund for Detroit?*, Heritage Foundation WebMemo No. 2170, December 12, 2008, http://www.heritage.org/Research/Economy/wm2170.cfm.

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