Car Trouble

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At the start of 2009, General Motors and Chrysler were bleeding to death.[1] Maintaining either business as a going concern required a massive infusion of capital no one in the private market was willing to provide. Many have questioned the decision of first the Bush and then the Obama administration to spend billions keeping these businesses alive. In this paper, I largely ignore this question. Instead, I focus on the appropriateness, once the decision to support these companies (support will in likelihood cost some tens of billions of dollars) was made, of using bankruptcy and the long-term implications of doing so for corporate reorganizations going forward.[2]

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[1] General Motors, by its own excessively optimistic predictions, was going to burn through $18 billion in cash within a year. General Motors Corporation, *2009–2014 Restructuring Plan Presented to U.S. Department of the Treasury As Required Under Section 7.20 of the Loan and Security Agreement Between General Motors and the U. S. Department of the Treasury Dated December 31, 2008*, Table 12, at 30. Chrysler was losing less, but it was a smaller firm, and, as it was about to shut down production for a number of months due to a massive inventory of unsold cars, it faced less of an immediate need for cash. Chrysler Restructuring Plan for Long-Term Viability, February 17, 2009, at 39.

[2] One can raise, of course, a broad objection to the government's use of the bankruptcy process in both Chrysler and General Motors the bankruptcy process allowed the Obama administration to funnel billions to workers, tort victims, and retirees it could not have provided them directly. The bankruptcy process, in other words, provided a conduit, a means of laundering funds, to a politically powerful constituency that it could not otherwise have paid off. Jim White has been the strongest proponent of this view. My concern, however, is not with this issue, but with the structural implications of these bankruptcies on Chapter 11. One could also say that the voluntary assumption of tort liability on the part of General Motors may

In December, the Supreme Court vacated the Second Circuit's decision in *Chrysler*. The decision was symbolic and largely unnecessary. Some draw from it the suggestion that *Chrysler*—and *General Motors* as well—are bankruptcy's *Bush v. Gore.* They are extraordinary cases, very much like each other, but different from any other. Government intervention on such a scale is not likely to recur and, given their peculiar character, these bankruptcies raise few issues of moment for corporate reorganizations as a general matter. In this paper, I show that this perception is fundamentally wrong. First, the two cases presented radically different challenges for the bankruptcy system. Chrysler and General Motors presented—and were understood to present—altogether two quite different challenges. These two distinct challenges, far from being unusual, are not particularly related to the fact of government involvement and are likely to repeat themselves many times. Together they capture the tension likely to lie at the heart of large Chapter 11 cases going forward.

The bankruptcies of Chrysler and General Motors, quite apart from debates about government intervention in the marketplace, underscore the need to recognize a fundamental shift in large reorganization practice over the last fifteen years. The debate over speedy sales of all the assets of the business as a going concern is over.[3] Sales are now the norm in reorganizations that are anything other than a confirmation of a debt restructuring reached outside of bankruptcy. The debate has shifted to the question of how the sales should be conducted.

Instead of asking whether there should be auctions in bankruptcy, we need to ask how those auctions should be run. Those who control the auction occupy different parts of the capital structure. In some cases, the junior parties control the auction and put the rights of the senior parties at risk, and sometimes it is the other

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have similarly benefited trial lawyers, who were also political favorites. (This is less the case with Chrysler, as it assumed tort liability only for accidents that arose after the sale as a result of activities done before. It is possible that Chrysler would have been liable for these torts in any event.)

[3] *See* Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 Stan. L. Rev. 673 (2003).

way around. Each is subject to its own type of abuse. Bankruptcy has become a problem of designing an auction that minimizes each type of problem.

Chrysler and *General Motors* are emblematic of the two challenges in modern large reorganizations. The first arises when junior investors put seniors at risk and the latter in which the control of the seniors threatens the juniors. The government held the reins in both *Chrysler* and *General Motors*, but what mattered was not that it was the government holding the reins, but rather that it derived its control from its ownership of a particular part of the capital structure. In the first case, we need to worry whether in a world of pervasive going-concern sales bankruptcy's protections for senior creditors are sufficient and in the second whether it does enough for junior creditors.

I. Chrysler

The precipitating event for the bankruptcies of both Chrysler and General Motors was a credit crisis that depressed consumer demand for automobiles. Fifteen million cars and light trucks had been sold in North America every year since 1994, but in the last part of 2008, the annual rate suddenly dropped to less than ten million, a level not seen since the 1960s.[4] A sudden drop of this magnitude had never happened before, not even during the 1930s. As my discussion of General Motors's bankruptcy will make plain, this was not the whole story, but by itself this collapse was quite enough to seal Chrysler's fate.

With the drop in demand, Chrysler had no future as a going concern. Even by the most optimistic accounts, the automobile industry was one in which there was massive overcapacity.[5] Some of that capacity had to go off-line. In a market economy, the capacity that should go off line is the least efficient and the least

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[4] *Id*. at 34 ("decline in SAAR levels in 2008 has been at an unprecedented pace–dropping 5.8 million units from 15.6 million in January 2008 to a 9.8 million monthly annualized rate in January 2009").

[5] J.D. Power and Associates estimates North American utilization at 50% of capacity this year. *See* Denning, *supra* note 5.

valuable and this was Chrysler. Chrysler was making the worst cars and there was no prospect that this would change any time soon. In sharp contrast to Chrysler's previous reorganization in 1980, where Lee Iaccoca's Chrysler had the K-car and the minivan in the wings, Chrysler did not have any new cars in the pipeline.[6] Without cars that could compete on equal terms for some number of years, Chrysler could not survive in a world in which domestic automobile consumption was unlikely to rise to its former level quickly. It is possible at the time that the Bush administration decided to extend credit to Chrysler that there were some who thought otherwise, but no one in the Obama administration thought so.

The question for the Obama administration was not whether to shut Chrysler down, but how to do it. It considered two alternatives. One was to close Chrysler immediately. The other was to allow Chrysler to fail slowly over the course of several years in a way that coincided with Fiat's entry into the U.S. market. With luck, Fiat could make its cars at factories that had been producing Chryslers while taking advantage of part of Chrysler's existing distribution system. A few of Chrysler's old workers might be able to keep their jobs. The Jeep brand name could continue, though likely not the manufacturing operations that were making Jeeps. Some other Chrysler brands might also survive.

The Obama administration ultimately opted for the second option, even though it required several billion dollars and came with no guarantee of success—success being defined as Chrysler slowly morphing into Fiat without many noticing. Success, so defined, depends first on whether the automobile market recovers quickly enough. It also depends on whether Fiat culture and technology can marry well with old Chrysler's culture and technology. Fiat's ambitious plans also assume that the market share of existing Chrysler cars will increase.[7] It is not clear how this is going

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[6] *See* Liam Denning, *Detroit Risks Falling Back Into Temptation*, Wall St. J., Nov. 25, 2009, at C16 (Chrysler to replace only 8.3% of its fleet each year between 2010 and 2013 compared with 11% at GM and 25% at Ford).

[7] Chrysler expects its market share to rise from 9.5% to 13.5% between now and 2013. *See* Denning, *supra* note 6.

to happen, but those in the administration who thought the gamble, however bad, was worth taking persuaded the President to take this course. And the gamble was bad enough and expensive enough that he demanded considerable persuading.[8]

Once Obama opted for this way of liquidating Chrysler, his task force needed to transform Chrysler into a business whose operating losses were small and whose balance sheet was strong enough to allow it to do business on conventional terms for a few years. Neither Fiat's CEO nor any other sane person would accept the burden of running the company even for a short period under other terms. And, of course, as Chrysler had no value as a going concern, no one could expect Fiat to pay a positive price for it. Indeed, the price Fiat demanded was a negative one. Before Fiat would agree to run it, the federal government had to inject billions of dollars into the business and also buy peace with the labor unions and other constituencies. Moreover, Chrysler needed to rid the business of its existing liabilities as well as dramatically alter its dealer network.

Bankruptcy seemed a useful way to bring about all of this. After cutting a deal with the unions, the Auto Task Force arranged for Chrysler to file a bankruptcy petition. At the same time, it injected cash from TARP into a new subsidiary of Fiat called New CarCo. Fiat put in no cash of its own. New CarCo appeared on the first day of the case with a $2 billion bid to buy the assets of Chrysler free and clear of any existing claims, including secured claims, as well as any obligations to the old dealers. As long as the judge approved the sale procedures and no competing buyer appeared, New CarCo would become the owner of those assets of Chrysler that were useful to Fiat. The plan of having Chrysler taken over by Fiat and then slowly morphed into it could be executed.

This tactic of finding a buyer before a bankruptcy who is willing to assimilate the assets of a losing buyer into its own is a familiar theme of large reorganizations. It is unusual that a third party will pay a buyer to make its bid, but the dynamics are

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[8] Austan Goolsby recommended this course of action to Obama, who took it seriously enough to schedule an evening meeting to discuss it at length. *See* Steven Rattner, *The Auto Bailout: How We Did It*, Fortune (October 2009).

not otherwise especially different from the case in which the existing managers find a buyer who is willing to buy the business. The challenge for the court in such cases in one of ensuring that the sales process is one that respects the rights of those who are not in control of the debtor and who object to the sale. This plan had the effect of leaving out in the cold both tort victims who suffered injuries before the bankruptcy petition and dealers Chrysler no longer wanted. The secured bondholders were paid only thirty cents on the dollar. Each of these parties appeared and objected. Putting to one side the question of whether such an intervention made sense as a matter of economic policy, we need to ask whether bankruptcy norms were violated in the process: Did anyone get paid who should not have been? Was there anyone who did not get paid who should have been?

The question with respect to the existing tort victims is easy as matter of existing law. Tort claims are ordinary general claims that take a back seat to those of secured creditors. If there is not enough to pay the secured creditors, the tort victims are not entitled to anything. The priority rule could, of course, give tort victims a superpriority lien. This would not make bankruptcy or reorganization more difficult. The obligation to pay tort victims would affect only the distribution of the firm's assets. While the costs of adjudicating tort liability may be substantial, these are costs that exist outside of bankruptcy, as well as inside. In the extreme case, superpriority tort liens may themselves exceed the value of the firm, but this means only that the costs of administering the bankruptcy will be borne by the tort victims. The process can be administered even in these circumstances. If any changes were required in the Bankruptcy Code to accommodate superpriority tort liens, they would be modest.

Priorities among creditors, however, are best left to nonbankruptcy law. The crucial issue with respect to tort law is not in the first instance a question of priorities, but rather the challenge of ensuring that tort liability is sensibly defined in the first instance. Tort law should hold firms liable only for acts that impose unreasonable costs on others. If it does only this, it will not limit desirable investments. Investors will ensure that firms take sensible precautions, and they will adjust the terms of their investments to take account of potential tort liability. Of course, it is a matter of concern if tort liability is not sensibly defined and deters behavior on the part of firms that is socially desirable, but this is a consequence of the substantive law being wrong, not the superpriority. More to the point for purposes of this paper, there is nothing about leaving tort victims with nothing that is peculiar to the government's involvement in the case.

The automobile dealers argued that the decision to terminate their dealerships made no economic sense. Car manufacturers do not subsidize them. If they are losing money from running an inefficient operation, it is their money that is being lost. Chrysler was using bankruptcy, they claimed, to settle old scores, rather than improve its bottom line. Of the two Rhode Island Jeep dealers, Chrysler choose to terminate the more profitable one, albeit one that had sued Chrysler in the past.

The question of whether a particular dealer is being subsidized, however, is quite beside the point. Every manufacturer needs a way of bringing its product to market. For some, the strategy involves finding independent retailers. For some, there is complete vertical integration. For others, it is a mixture of the two. The optimal distribution mechanism may change. Microsoft, for example, is creating its own retail outlets for the first time. Regardless of the organizational structure, a manufacturer needs to have sales outlets in the right sized facilities, run by the right people, located in the right places.

Chrysler's dealer network was put in place in a different era. In 2009, it was completely out of step with what Fiat needed. Even if it could free itself of deeply embedded norms, state and federal franchise laws made it hard to restructure the distribution channel. Once established, dealers can be terminated only for cause. Radically different channels for selling cars—such as through the Internet without any dealer intermediation—are not possible.

Chrysler argued that bankruptcy law allowed it to terminate the franchise agreements it no longer wanted, something eminently sound as a general policy matter. Locking an industry into a hopelessly inefficient method of distribution in the age of Walmart makes little sense. Car manufacturers should be able to experiment with different ways of selling their goods just like computer makers. But this kind of policy is not what bankruptcy is supposed to second-guess. Bankruptcy is supposed to take state law as it finds it.

As a matter of existing law, however, the issue is thought straightforward. Dealerships are executory contracts that can be rejected and the judge accepted the conventional wisdom. The dealers might have been able to press their case more forcefully than they did. One can imagine that Chrysler had not merely entered into a contract with the dealers governed by state regulations, but had conveyed a property right as well. Chrysler had not only promised to keep delivering cars at a specified price, but also conveyed a right to use the Chrysler name/brand in a particular geographic area. Chrysler's promise to deliver cars and the dealers' promise to pay for them were future obligations that formed an executory contract that Chrysler could reject. But the conveyance of Chrysler's intellectual property, if that is an accurate depiction of the transaction, is not something it should be able to reacquired through rejection. If I sell you an oil well, promise to service it every year for 10 years in exchange for $1000 per service, and then file for bankruptcy, I can reject the service portion of our contract on the ground that the market price for oil well service is now $2000. But I cannot get the oil well back. Whether the franchises were purely contractual or contractual coupled with the conveyance of a property interest itself requires closer examination than any of the parties may have given it. This question, however, illustrates a long-standing tension in bankruptcy law and the way that the treatment of executory contracts is, as a general matter, one of the worst flaws in the Bankruptcy Code. The judge here broke no new ground in allowing these dealerships to be terminated.

It might seem that the way that secured creditors were treated was what was most seriously wrong in *Chrysler* and that it was a product of government intervention. Secured creditors are supposed to be paid in full before those junior to them get paid anything. This is bankruptcy's absolute priority rule. Put in place first in the 1930s, it has become one of bankruptcy's central precepts.[9] But it is not at all clear that the absolute priority rule was violated.

In the first instance, the secured creditor's right to absolute priority, like any other right, is one that can be waived. This seems to have happened here. Secured creditors in *Chrysler*, as a group, consented to the Task Force Plan. As in most large financings, the secured creditor in *Chrysler* was not a single financial institution, but rather a consortium of lenders who had joined forces. Over ninety percent of the consortium in *Chrysler* agreed to accept the government's offer of $2 billion. They told the administrative agent not to block the sale, and he followed their instructions.

For their objection to stand at all, the small minority of the consortium who opposed the transaction needed to explain why they were not bound by the agreement among the secured creditors that provided, among other things, they appointed an administrative agent and directed him to follow the wishes of the majority in deciding whether to block the sale.[10] They asserted that the sale implicated a clause that prevented "waivers, amendments, supplements or modifications" to the loan agreement without their consent. Whether their argument had merit or not, the argument does not implicate bankruptcy policy. The mistake, if there was one, is the quotidian one of a judge misconstruing a contract.

The dissident secured creditors argued further that the vote of the majority was tainted. Those who approved the sale had received TARP funds. Hence, one can argue, they were not consenting in order to maximize the value of their secured claim, but rather because they feared repercussions elsewhere if they refused to do

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[9] *See* Case v. Los Angeles Lumber Products, 308 U.S. 106 (1939). It is sometimes asserted that the absolute priority rule has deeper roots. This is wrong. *See* Douglas G. Baird & Robert K. Rasmussen, Boyd's *Legacy and Blackstone's Ghost*, 1999 Sup. Ct. Rev. 393.

[10] 405 B.R. at 101. As I discuss below, secured creditors control whether a sale takes place to a third party by the device of credit-bidding. Ensuring that this right exists, not an issue in Chrysler, is an important element of protecting secured creditors when those junior to them are in control.

the government's bidding. It is hard to have much sympathy for this argument either. First, the minority investors were not babes in the woods when they agreed to be bound by what their fellow investors decided. They should never have thought that J.P. Morgan was going to do anything other than follow its own self-interest if the deal went sour. They should not have thought J.P. Morgan would have a fiduciary duty to other investors of the class. Majority shareholders owe some duties to minority shareholders, but creditors do not. I have argued elsewhere that this distinction is unsound.[11] But it should come as no surprise to a creditor that J.P. Morgan would promote its own financial interests in deciding whether to consent to a sale and it was incumbent on them to bargain for a different contract if they wanted one. They signed a deal in which they hoped that J.P. Morgan's interests would align with their own. That J.P. Morgan looked with favor on a sale to a party with whom it was otherwise aligned was one of the risks that it took. Even if J.P. Morgan and the other lenders broke their obligations under the loan agreement in their instructions to the administrative agent, the minority investors' gripe is with them, not with the bankruptcy court. Their remedy would seem to be a state-court contract action.

There seems to be nothing special about the buyer in question being the federal government. The question about the duties investors in the same slice of the capital structure owe each other, but the received wisdom is that the problem is at bottom one of contract. The problem that investors face in coordinating their actions with one another does not implicate bankruptcy process beyond making it important that bankruptcy judges enforce contracts as written, something they are generally inclined to do.[12] Modern bankruptcy judge is not likely to be biased against one or the other in assessing a battle between investors at the same priority level.

Even if the secured creditors as a group had not consented, it is not obvious that anything is amiss. To be sure, New CarCo was planning to make payments to retiree

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[11] See Douglas G. Baird and M. Todd Henderson, Other People's Money, 60 Stan. L. Rev. 1309 (2008).

[12] See, e.g., In re Metaldyne Corp., 409 Bankr. 671 (Bankr. S.D.N.Y. 2009).

pension funds and various suppliers. Indeed, it later even assumed Chrysler's tort liabilities. But New CarCo was never in bankruptcy. Chrysler, the debtor that filed the bankruptcy petition, gave everything it had to the secured creditors. It did not pay its general creditors anything. It sold its assets for $2 billion in cash. The absolute priority rule required that all of it go to the secured creditors and it did.

It is not obvious why Chrysler's secured creditors should be able to complain that a completely different entity is giving money to some who also happened to be creditors of Chrysler. I owe you a bunch of money, and you have a security interest in everything I own. My only asset is a Van Gogh. I file for bankruptcy and the trustee puts my painting up for sale. And there are two bidders. One bids $1 million. He is going to put the Van Gogh above his sofa. The other bids $2 million. He is a loving son who hopes to give it to his mother so she can put it above her sofa. Confronted with these two bids, it would seem that my bankruptcy trustee should take the $2 million bid. It would seem completely irrelevant whether the mother is also a general creditor in my bankruptcy. She is receiving the asset because she has a loving son who was the high bidder, not because she was my general creditor. Creditors of a seller should not care how the assets being sold are going to be used, nor how sentimental, generous, or stupid the buyer is. They should just pick the highest bidder.

The same is arguably the case with the government and New CarCo. New CarCo offered to pay more for Chrysler's assets than anyone else. The secured creditors should count their good fortune. Chrysler had no value as a going concern and was worth, if you believed the experts, less than $2 billion if liquidated. Far from receiving less than their collateral was worth, the secured creditors were receiving more. You have to expect that someone who is paying you too much will pay others more than they deserve as well. Usually when you find a buyer who offers you more than he should, you don't complain that he is being unnecessarily generous to others. You take your money before he recognizes his idiocy.

Of course, one can argue that the willingness of the Obama administration to invest billions of dollars in a business that had no value as a going-concern made no sense and has the effect, over the long-term, of distorting investment decisions. But the distortion here arises from giving the secured creditors too much, not too little. It makes them too inclined to invest in declining industries. The complaint that the government intervention discourages investors in a particular industry gets things backwards.

The principal obligations New CarCo assumed were to funds that supported Chrysler's retiree benefits. There is a second way to justify these. The retirees may have been paid not because the government wanted to bestow largess on them nor because they were prepetition creditors, but because their friends had the ability to shut the firm down postpetition. Unlike some other unions, the UAW protects its retirees, and it might not have been possible to run Chrysler as a going concern without cutting a deal with the UAW. In theory, one could hire replacement workers and obtain sufficient police protection so that they could cross picket lines. But police might not be enthusiastic about doing that sort of work. One might be better off shutting the firm down and selling off its assets piecemeal.

Let's assume that Chrysler would be worth $5 billion in a world without the UAW, but the UAW can credibly threaten to shut it down unless $3 billion is paid to the retiree benefit fund. How much is Chrysler worth as a going concern? In the counterfactual *Twilight Zone* world in which the UAW does not exist, the firm is worth $5 billion, but on Planet Earth, it is worth only $2 billion. The need to pay the retirees $3 billion is a cost of doing business—no different from the money needed to pay what might seem high prices for zoning variances, concrete, or garbage collection.[13] Every buyer takes these into account in making a bid. A rational buyer pays $3 billion not on account of the prepetition debt, but to receive postpetition services. The debtor's senior creditors cannot complain that others are being paid for something that they neither own nor control.

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[13] There is nothing new here. Dangerfield makes the same point. See http://www.youtube.com/watch?v=YlVDGmjz7eM&feature=related (noting the need to account for such expenses as costs of business much like any other).

The deal the government cut with the UAW might have been the deal anyone would have had to cut to keep the business running. It was not behaving any differently from a private, wealth-maximizing bidder buying the same asset. As when the government is simply bestowing largess, the secured creditors seem to have no grounds for complaint. All that should matter is that the sale process was done in a way that brought the highest bidder.

The story, however, is more complicated. The government demanded that Chrysler shop the company extensively before settling on Fiat, but less clear is how much it required Chrysler to explore a piecemeal sale of the assets. The rule of thumb when you liquidate a company is that you realize ten percent of book value. It might not seem like much, but in the case of Chrysler, it would be more than twice New CarCo's bid. Creditors should not much care who the buyer happens to be or what plans the buyer has for the assets, but they should care about ensuring that the sale brings top dollar. They should be able to object to a sale of the business as a going concern, if more could have been realized by selling it off in pieces.

Chrysler owned a lot of real estate. At least in Jeep, it had a valuable trademark. Its transmission business was well respected. There were accounts receivable in the billions of dollars. These various assets may not be worth even 10 cents on the dollar. Real estate values have plummeted and land used for manufacturing is often a toxic waste site that has a negative value. A Chinese company might not be willing to pay much for the Jeep brand name if it feared that a hostile Congress might not allow the cars to be imported. Many of the accounts would prove uncollectable if Chrysler shut down as Chrysler's liquidation would likely trigger a liquidation of the account debtors. A promise from a Chrysler dealer is likely worth even less than Chrysler's own promise. Nevertheless, even though Chrysler had a negative value as a going concern, a piecemeal sale of assets would likely fetch a positive price. Hence, the question was not whether New CarCo was paying a fair price for Chrysler as a going concern. Subject to this condition, any positive price would be fair. The proper question rather is whether the amount bid exceeded the value of Chrysler if broken up piecemean.

Chrysler did pay a valuation expert who, in return for a fee of $10 million, said that, if liquidated, Chrysler would be unlikely to yield more than $2 billion after the costs of the sale were taken into account. But the amount someone would pay to acquire Chrysler's assets with the intent to liquidate them is not a question that should be left to expert testimony. It should be tested by the market.

In short, the key question in Chrysler is not that there was a sale, but enough was done to look at sales that took different forms.[14] The government had Chrysler propose bidding procedures that defined as a "qualified bid" only those that assumed the obligations that New CarCo was planning to assume. Many of these, such as promises to retirees, made sense if the business was continuing as a going concern. The debtor could consider nonqualified bids in the exercise of its fiduciary duty only after consultation with both the U.S. Treasury and the UAW. This falls somewhat short of affirmatively welcoming liquidating bids. The failure of the bankruptcy judge to insist that liquidating bids be entertained in these cases contrasts sharply with practice elsewhere. For example, the judge in the *Sun Times* bankruptcy insisted (over objection) that liquidating bids be entertained. He did not expect any and none appeared, but he wanted to cut square corners.

Chrysler is emblematic of a larger class of cases in which the junior creditors are in control and one needs to ensure that the sale procedures protect the senior creditors. This may not be that hard. Protecting senior creditors, at least those who are careful about how they write their contracts with each other, may need to go no further than ensuring that it is easy for them to credit bid and the provision of the Bankruptcy Code allowing for asset sales, §363, does exactly this. .

It is not possible to sell a company under §363 to anyone for less than the amount of the secured creditor's claim over its active objection. Let us assume that the secured creditor is owed $10. The debtor has found a stalking horse bidder who is offering $2. At this point, the secured creditor can simply go to a bank, borrow $10

[14] Barry Adler, Mark Roe, and David Skeel have made this point. *See* Barry E. Adler, *What's Good for General Motors* (NYU Law School, October 3, 2009); Mark J. Roe & David Skeel, *Assessing the Chrysler Bankruptcy* , 108 Mich. L. Rev. 727 (2010).

for a day and use this money to bid $10. Unless someone offers enough cash to pay the secured creditor in full, it will be the winning bid. The secured creditor will have to turn over $10, but it will receive this money back immediately. As the senior secured creditor, the absolute priority rule entitles it to all the proceeds of the sale up to the amount it is owed. It can then return the $10 to the bank. At this point, the secured creditor has its collateral and is not out of pocket anything. To prevent this from happening, a competing bidder must be willing to offer more than the secured creditor is owed.

The barrier that the secured creditor faces in protecting its interests consists of transaction costs. To minimize these, the Bankruptcy Code does not even require the secured creditor to put up any cash in a §363(b) sale. It can simply bid the amount of its claim (and avoid the transaction costs and potential liquidity constraints associated with obtaining a day loan).

The ability to credit bid may fall short of giving secured creditors who lack control over their debtor complete protection. First, secured creditors need to be able to act collectively. When the most senior tranche is not a single creditor, but a diverse set of creditors who are constantly trading in and out of the case, it may be hard to devise a mechanism that allows them to act as one. Even though they occupy the same place in the capital structure, a hedge fund, a bank, or a special purpose vehicle securitizing the claim can have radically different objectives.

In addition, credit bidding protects the most senior tranche only if the threat is credible. Among other things, the secured creditor must have the ability to take over the assets in the event that it proves to be the high bidder. Not only must a mechanism allow someone competent to run the operation, but doing this even for a short period of time (to allow, for example, a piecemeal sale) may require cash. The various claimholders may be more or less able to contribute the cash.

In equilibrium, of course, investors should be able to sort through these problems. But as the last credit crisis showed, this has not happened yet. In the end, what is most telling in *Chrysler* is the challenge investors have in coordinating their own actions, not in the failure of the bankruptcy system to enforce the bargain that creditors strike among themselves.

But the ability to bid provides an effective backstop only to the extent that the Bankruptcy Code facilitates it. Developments after *Chrysler* have put the matter in doubt. While credit-bidding is a right explicitly granted to secured creditors in §363, sales can also be conducted under §1129, where the right to credit bid is less clear. The most recent case—recently decided by the Third Circuit—involves the *Philadelphia Inquirer*. The secured creditor is owed hundreds of millions. No one thinks the company is worth more than $60 million and everyone agrees that there should be a sale and that the secured creditors should get every additional penny that is raised through the sale.

The managers, however, have found a stalking-horse bidder who has agreed to keep on them on. Its bid gives the senior creditors some land and some $30 million in cash. The senior lenders would rather just take their collateral and throw out the existing management. In principle, the senior lender could just make a higher bid, but the senior lender is a consortium of several dozen financial institutions and hedge funds. They have found themselves unable to make a cash bid. Taking advantage of this, the debtor has proposed a plan of reorganization in which a sale is part of the plan, not under §363.

The Third Circuit held that a sale conducted under a plan does not have to give the secured creditors a right to credit bid.[15] Fifth Circuit has found it similarly unavailable.[16] Both courts engaged in a rather formal exercise of statutory interpretation. Section 1129 is written in the alternative and allows the debtor to propose a plan in which the secured creditor is given, in lieu of its right to credit bid, the indubitable equivalent. Given that credit-bidding allows the secured creditor to gain control over the asset and any other plan necessarily gives it something less, it is mystifying how any plan could provide it with the "indubitable equivalent."

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[15] *In re* Philadelphia Newspapers, LLC, 599 F.3d 298 (3d Cir. 2010).

[16] *In re* Pacific Lumber Co., 584 F.3d 229 (5th Cir. 2009).

The contrary argument that carried that day rested merely on the language of the statute. Given that it was written in the alternative, *some* plan must provide the indubitable equivalent of credit bidding. The debtor should be entitled to show its plan passes this threshold and a conclusive presumption against the plan is therefore inappropriate. As a matter of narrow and literal statutory interpretation, the argument has some force, but it otherwise has little to recommend it.[17]

In addition to ensuring that creditors that find themselves in the position of the creditors in *Chrysler*, we must also worry about those cases in which the senior creditors are the ones with control. Here again, we need to confront the question whether the procedures are in place that bring top dollar for the company. When the party in control is the senior creditor, the problem is similar, but the dynamics altogether different.

In these cases, the senior creditors are the ones who enjoy the upper hand. The ability to credit bid combined the combined with control poses a threat to the rights of junior investors, at least in those cases in which it is not self-evident that they are out of the money. How to protect junior investors in these circumstances is an issue that has long been on concern to the law of corporate reorganizations and this was the problem that arose in *General Motors*. The difficulties it faced, however, were altogether more complicated than those of *Chrysler* and requires first some perspective.

II. Innovation, Market Structure, and Economic Distress

The modern automobile goes back to the Model T. The image some have of the Model T is Jedd Clampet and *The Beverly Hillbillies*—a rickety contraption held

[17] Circuit Judge Ambro makes this point ably in his dissent, drawing on Vincent S.J. Buccola & Ashley C. Keller, Credit Bidding and the Design of Bankruptcy Auctions, available at http://papers.ssrn.com/sol3papers.cfm?abstract_id=1545423.

together by bailing wire and chewing gum. That is fundamentally wrong.[18] The Model T was a tough, durable car. Quite a few are still running. More importantly, it was a great technological break-through that introduced a design that became the template that lasted until the 1970s.[19] The Model T's genius lay in its simplicity. Instead of a carriage on wheels with a motor attached, the car consisted of three elements: the frame, an encased drive train, and the body. The ability to change the body design and interior finishings allowed for the production of cars that looked quite different, but were fundamentally the same.[20]

In the decades after Henry Ford, the icon of automotive innovation was Harley Earl, who reigned at General Motors from the 1930s through the 1950s. General Motors featured him in its advertising even in this decade. Earl was born in Hollywood and started his career designing custom bodies for Tom Mix and Fatty Arbuckle. He brought style, not technical knowhow. Differentiation among his cars came from adornments, not technological innovation. The guts of the cars remained essentially the same and their engineering straightforward. A mechanically inclined high school student could pretty much repair any car in his own garage.

All of this started to change in the 1970s. Instead of a separate frame and body, unibody construction became the norm. The parts of each became much more integrated. In the 1980s, electronics took over cars. In the 1990s, new materials increasingly replaced sheet metal. Machines that had been not significantly more complicated than the Model T became sophisticated creatures of high technology. We can romanticize the cars of the past, but cars today are better, across all dimensions.

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[18] Among other things, Jedd did not drive a Model T, but rather a 1922 Oldsmobile.

[19] *See* Robert Lacey, Ford: The Men and the Machine 94 (1986).

[20] Lee Iacocca's sporty 1964 Mustang was a triumph of styling. Its Taunus V4 engine was from Ford Germany, while the Ford Falcon and Ford Fairlane were the source of the chassis, suspension, and drive-train components.

These changes were bad news to General Motors. The demand for new cars came from the need to replace old cars.[21] Because new cars were better built and more reliable, they lasted longer and needed to be replaced less often. As a result, everything else being equal, the demand for new cars goes down. Even if their market share remained the same, total sales at General Motors were likely to diminish.

Technological change brought another shift that disadvantages manufacturers such as General Motors that is committed to an existing infrastructure: The optimal size of the automobile company became smaller. Improved technology often leads to more vertical integration, such as the efficiencies brought about by Walmart's sophisticated computer-driven supply chain. We saw this in the automotive industry with the introduction of the Model T. Ford transformed itself from a firm that bought virtually all its components from the outside into its giant River Rouge works, in which iron ore entered at one end and cars emerged at the other.[22] Alfred Sloan worked a similar change at General Motors.[23]

But technology can push in the opposite direction, and this has been the recent history of the automobile industry.[24] We are in an era of massive vertical deintegration. General Motors is soon to have only 31,000 hourly workers, almost an order of magnitude smaller than what it used to have. Chrysler's workforce has shrunk by comparable amounts.

To be sure, some of the reduction comes from declining production and some from increased automation, but that is only part of the explanation. The workforce has become smaller largely because the amount of outsourcing has increased.

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[21] With more cars in this country than licensed drivers, the domestic market is close to being saturated.

[22] For its first model, the Ford Motor Company spent $384 on components and $20 on assembling them. *See* Lacey, *supra* note 19, at 70.

[23] *See* Alfred P. Sloan, Jr., My Years with General Motors (Doubleday 1963).

[24] *See* James P. Womack, Daniel T. Jones & Daniel Roos, The Machine That Changed the World (2007).

Instead of having a supplier make a particular instrument, today's supplier manufactures the entire dashboard. Instead of finding a supplier to provide the fabric for the seat covers, today's efficient car company will have an outsider make the entire seat assembly. These much more substantial components are brought together in an assembly plant that, if optimally designed, is much smaller than its predecessors.

Moreover, as cars have become more complicated, relevant design and manufacturing expertise is less likely to be found in-house. Supporting a large team of engineers in-house make sense when changes are slow and incremental. In such a world, a shift from one model to another might require a large investment in new dies to stamp out different pieces of sheet metal, but designing these pieces of metal required no additional talent or expertise. All Harley Earl's design team needed was modeling clay. Today, someone who wants to produce a new car requires expertise that is likely to be located outside the firm. At the same time there is a greater need for outside expertise, computer-assisted design has made it easier for designs and information to be traded at a distance.

A car company invests in a number of car projects and enjoys its profits from those that prove successful in the marketplace. Gone are the days in which consumers are loyal throughout their lives to a particular carmaker and demand for each can be confidently predicted from one year to the next. Crucial to the success of a car company today is having a number of models in production that are successful in the marketplace and having a number of others in the pipeline. If a car company does not have this, it has few advantages relative to a new entrant, and none relative to an established firm with successful models.[25] Moreover, in this environment, it is important to have the ability to ramp up production when a model proves successful and ramp it down when it does not.

[25] A caveat to this is the need to have some distribution system in place. This is in large part the result of legal rules that limit the ways in which cars can be distributed. Saturn, for example, had value only because of the possibility that a new automobile manufacturer would want its distribution network.

America's comparative advantages change over time and, at some point, it ceases to have any comparative advantage in making a particular type of product. This has happened in the case of televisions, but it has not yet happened with cars. Cars, at least the larger ones, can still be profitably designed and manufactured in this country. Some of Toyota's most successful products, such as the Tundra, are designed in this country by engineers who began their careers at General Motors, Ford, and Chrysler. The question was not whether there will be American car companies, but rather whether, given these changes, they will include General Motors.

At the time of the sudden collapse in demand for automobiles, General Motors was making its best cars ever. Some models, such as the Malibu, were competitive, and there were new cars in its pipeline. Some were promising even though others, such as the Volt, would never bring any profits. But General Motors had to solve a number of problems if it was to compete successfully against other American car companies.

General Motors had collective bargaining agreements that were hopelessly out of step with existing conditions. Standing alone, they were not an insurmountable problem. The contracts themselves were of relatively recent vintage, and experience in the steel industry showed that unions were willing to make drastic changes in their contracts if the survival of the business turned on it.

The collective bargaining agreements were symptomatic, however, of a much bigger problem. The work rules in General Motors's collective bargaining agreement was merely one manifestation of a much larger problem—deeply embedded norms that were out of step with what it took for a modern automobile company to be successful. That problem would not go away with a different collective bargaining agreement. It was part of a culture in which the way everything was done assumed a method of production that had long passed. General Motors was saddled with an infrastructure that was too large. Everything from its factories to its executive offices was excessive given the optimal amount of outsourcing.

Compounding this problem, General Motors's infrastructure was premised on the idea that it made sense for one company to produce a complete line of cars. ("A car for every purpose and every purse," as Alfred Sloan used to say.) This was easy when cars shared a common platform and many common components. But as cars become increasingly sophisticated, one can no longer make many models with just a few platforms. Firms possessed different competences that change over time. No one firm can be confident that, over time, it will remain adept at building competitive cars at every price point.

General Motors was now best at building large, technically sophisticated cars. Smaller and less complicated cars put a premium on cheap, relatively unskilled labor. Freed of constraints, General Motors might not even make small cars domestically. Unfortunately, this segment of the market is now the one in which there is the greatest demand. Legal regulation compounds the problem. The CAFE standards put in place in the 1970s had a nice virtue. Instead of micromanaging car companies, regulators told them the average fuel economy they were to have across their entire fleets. In a world in which the Big Three made all the cars and each made cars of all types, they bore the burden of making the trade-offs. In a world in which there are more and different players making different kinds of cars, this burden falls disproportionately hard on those like General Motors whose comparative advantage is making bigger cars.

In short, at the start of this year, General Motors was in terrible shape, even without its legacy costs and collective bargaining agreement. Nevertheless, the disconnect between General Motors's CEO Rick Waggoner and the world around him was completely understandable. Like many managers, he measured the state of General Motors relative to its condition at the time he took the helm. By any measure, the General Motors of 2009 was better than the General Motors of 2000. Waggoner could not believe he could change as much as he had and still have a company that was hopelessly uncompetitive.

General Motors's ability to survive over the long term remains unclear. It requires a wholesale change of well-entrenched norms and a dramatic rescaling of its infrastructure. Even with these substantial modifications, its survival depends on a relatively quick return to historic levels of domestic demand for automobiles as well as the ability to shrink every aspect of its operations dramatically.

General Motors's bankruptcy, like Chrysler's, took the form of an asset sale. The debtor at the time of filing the petition proposes a sale to an identified buyer. The dynamics of the case, however, were altogether different. While Chrysler had no ability to survive as a going concern, regardless of how much money was spent to keep it intact, General Motors had a chance to survive—at a cost that likely exceeded the value of its assets—if it were dramatically transformed. The ability to sell assets in bankruptcy allowed the kind of transformation that was a necessary, though far from sufficient condition for its survival as a going concern.

The General Motor's bankruptcy was unusual in the sense that those who controlled the case wanted a radical redeployment of the assets that may not have put them to their highest and best use. But as long as the amount the government was owed was greater than the value of the assets, its intended use for the assets is not particularly relevant to investors who are being cashed out. The high bidder at an asset sale is entitled to use them as it sees fit. If the government was owed more than the assets were worth, its intended use of the assets does not implicate any bankruptcy policy. The government merely stands in the shoes of any senior creditor that intends a radical redeployment of the assets and wants to use the §363 sales process to effectuate it. The procedural protections needed in both cases are the same.

III. Asset Sales and Senior Creditor Control

At the time General Motors received its first infusion of financial aid in the waning days of the Bush administration, it had relatively little secured debt. As a result, the government's loans, like most loans to financially troubled businesses, were secured. These loans, combined with billions more in debtor-in-possession financing were large relative to the value of General Motor's assets and indeed in all likelihood were greater than the value of these assets. Because the government was both the largest creditor and enjoyed, in essence, a first-priority position,[26] it controlled the bankruptcy process. While *Chrysler* presented the challenge of ensuring the sales process respects the right of senior creditors who do not have control, here the juniors are the ones who lack control and need protecting.

Long past is the day in which the old managers of the business typically called the shots. Long before the bankruptcy petition, secured creditors begin to control the governance of the business.[27] A chief restructuring officer has been put in place and has already told the board that equity will receive nothing and that the sensible course is one in which there is either a consensual restructuring of the debt or a sale of the business. By the time of the bankruptcy petition, the senior secured lenders will have explored the various options and settled on a favored course of action. Among these includes the option of having the managers of the debtor put up the assets for a quick sale in bankruptcy, either to the secured creditor or to some buyer.[28]

The speedy sale that gives little time for rival bids worked to the disadvantage of the dissident secured creditors in *Chrysler*, but in the mine run of cases, it is the device that secured creditors use to the detriment of those junior to them. Because they do not gain from postponing a sale and face all the downside if things go worse than expected, the secured creditors have an incentive to force through a speedy sale. If the firm is worth less what the secured creditor is owed, there is no problem with a sale being conducted under its aegis. We need to worry, however, that the secured creditor is pushing through a speedy and low-valuation sale even when the

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[26] More precisely, the debt that was senior was so small relative to the value of the assets that the creditors who held it were confident of being paid in full and played only a minor role in the reorganization.

[27] *See* Greg Nini, David C. Smith & Amir Sufi, *Creditor Control Rights, Corporate Governance, and Firm Value* (November 2009).

[28] *See* Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. Pa. L. Rev. 1209, 1209 (2006)

assets are worth more than what it is owed.[29] The secured creditor and the managers possess private information not available to anyone else. By binding together, they can suppress information about the value of the business.[30]

When the secured creditors want either to sell the firm or acquire it outright with a credit bid, the bankruptcy judge can be put in an impossible position. Even if the firm does not need to borrow to keep its doors open, the firm can maintain its ongoing operations only if it can continue to use its existing cash reserves to meet the payroll and acquire new supplies. The reserves, however, are subject to the senior secured creditor's security interest. The Bankruptcy Code severely limits the ability of the bankruptcy judge to authorize the use of cash collateral over the secured creditor's objection.[31] The secured creditor appears and asserts that it is willing to authorize the use of cash collateral only if the judge approves the sale on an expedited basis.

Especially when the business is losing money on an operating basis, approving the sale offers the bankruptcy judge the path of least resistance. As the issue surfaces early in the case, the junior creditors will have had little time to organize any opposition. Bankruptcy judges are disinclined to risk shutting the firm down by turning down a motion to which no one has objected. As between having a case disappear from her docket or having it explode into thousands of contentious lawsuits over the wreckage that follows in the wake of a piecemeal liquidation, judges are inclined to favor the former. Judges fear that if they push back too hard, the secured creditor will indeed refuse to finance the business and it will shut down.

Brinkmanship of this sort has become commonplace in bankruptcy court. Conventional game theory models suggest that this bargaining game has multiple

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[29] There is some empirical evidence that this is in fact happening. *See* Kenneth Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11* (Columbia Law and Economics Research Paper No. 321; Northwestern Law & Econ Research Paper No. 08-16) (July 9, 2008), *available at* http://ssrn.com/abstract=1081661.

[30] [Cite Picker].

[31] See 11 U.S.C. §364.

equilibria, including one in which the firm liquidates. Assume that Firm is worth $120 if it remains intact and $30 if liquidated. Bank is the senior creditor and is owed $100. Bank has a choice between two strategies. In one, it proposes a speedy sale (one in which it makes a credit bid of $100 and a cash bid of $10) and simultaneously commit itself to rejecting any subsequent bargaining. In the other, it can ask for a speedy sale on the same terms, but prepare to engage in bargaining in the event that the judge pushes back. Such preparation costs it $10. The bankruptcy judge similarly has a choice between a soft and a tough negotiating strategy.

If the judge adopts the soft strategy, and Bank is indeed committed, the sale goes forward as Bank proposes. Bank receives the firm and the general creditors receive $10. If Bank is willing to bargain and the judge again takes a soft position, the payoffs are the same, but Bank has spent $10 preparing to bargain. If the judge adopts a tough position, and Bank is willing to bargain, Bank ends up with only $100 (and expenses of $10) and the general creditors receive $20. If Bank and the judge both adopt tough strategies, the firm is liquidated. Bank receives $20 (net of expenses) and the general creditors receive nothing.

If we assume judge acts to maximize the recovery of the general creditors, the game has three Nash equilibria—one in which Bank adopts the tough strategy and the judge adopts the soft strategy; another in which Bank is soft and the judge tough; and the last in which the judge adopts the soft strategy with ⅞ probability and Bank adopts the soft strategy with ½ probability.[32]

These different equilibria capture the problems we face. The ex post efficient outcome is the pure strategy equilibrium in which the judge acquiesces and Bank adopts a tough strategy. The problem with this equilibrium, however, is that, while efficient, Bank receives more than the $100 it is owed and the rights of the junior creditors are compromised. The pure strategy equilibrium in which Bank is paid in full is problematic over two dimensions. First, Bank has been forced to bargain and

[32] The existence of a mixed strategy equilibrium is a common feature of games that have this structure, such as matching pennies, chicken, and hawk-dove.

$10 has been lost as a consequence. Second, this rule compromises Bank's entitlements, as it is effectively recovering only $90 (net of costs), when it is owed $100. The mixed strategy equilibrium is the worst of all worlds, as $100 of value is lost.

We need to ask how to change the structure of this game. We want procedures that protect the rights of junior investors. At the same time, they should minimize the costs of the process and try to ensure that the senior creditors are paid in full. It might seem that we have seen all this before.[33] In the 1890s, most of the railroads in the country were insolvent. They had more debt than they could ever hope to repay. There was a huge amount of secured debt and the secured creditors again controlled the reorganization process.

Superficially, the dynamic we saw then is the same as now. Judges soon recognized that the people who appeared to credit bid were often the senior secured creditors who controlled the firm. (The case in which the secured creditor used the ability to credit bid to protect itself from a sale orchestrated by the juniors was the exception.) The judges insisted on doing an independent analysis of the business and putting in place what they called an "upset price." What they did was quite similar to the way the judge in *Chrysler* focused on expert testimony about the value of Chrysler if liquidated.

Critics of speedy sales today will likely point to the subsequent evolution of the law. After imposing upset prices, judges in time developed addition protections for junior investors. These led to the reforms of the 1930s, the introduction of the absolute priority rule into bankruptcy, and eventually the Bankruptcy Code of 1978. The existing protections that junior investors enjoy in Chapter 11 evolved out of an effort to ensure that, when the business was sold, especially when it was sold to senior secured creditors, that their rights were protected. In other words, courts today are simply reinventing the wheel.

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[33] Ralph Brubaker, among others, has pointed this out. *Ralph Brubaker, The* Chrysler *and* GM Sales*: § 363 Plans of Reorganization?*, 29 Bankruptcy Law Letter, No. 9, at 12 (Sept. 2009).

The incremental protections being discovered today for sales under §363 will ultimately lead us back to the protections already embedded in the plan confirmation process in Chapter 11. Rather than wait for evolution of these procedures, we should go to its end point at once. We should limit the availability of sales altogether. We should insist that dispositions of the firm as a going concern go through the plan process. Only the narrowest exceptions should exist for the few cases in which the businesses are in fact “melting ice cubes.” The protections built into Chapter 11 are the ones history teaches us are needed to prevent abusive sales. End runs around them are inappropriate. At the very least, the protections junior creditors enjoyed when assets were sold during an equity receivership should remain.

This line of reasoning should be rejected. Today the filing of a bankruptcy petition is a recognition event that collapses future possibilities to present value. This was not the case with the equity receivership. As a result, the dynamics of the two cases were different and the protections that make sense are radically different as well.

Under modern law, the senior creditor has an incentive to push for an immediate sale, while the junior investor wants delay. To return to our example, if there is an immediate sale for $120, Bank receives $100 with certainty. If everyone waits, there is a fifty-fifty chance the firm will be worth $160, and Bank will again be paid in full, but if there is an equal chance the firm will be worth only $80 and Bank will be paid only $80. Thus, while Bank gets $100 if everything is settled today, it realizes in expectation only $90 if there is delay. Junior investors have exactly the opposite incentive. They gain only $20 from an immediate sale, but can expect $30 from delay.

More significantly in terms of system design, the costs associated with an early disposition—the risk of a fire sale[34]—are borne by the junior investors, while the

[34] Of course, at first blush, a fire sale does not lead to an efficiency loss. The investors as a group receive less, but the assets themselves may still be put to their

secured creditors bear the risk of asset depreciation that comes with the delay. It may not be possible to have procedures that ensure a sale for top dollar and at the same time adequately protect the secured creditor's priority position. In theory, of course, the junior investors in our example should be able to offer adequate protection to the secured creditor, as they hold the fulcrum security. (The firm is worth $120 and the secured creditors are owed only $100.) But if the junior creditors face any problems in organizing, it may not be possible. We usually need to make a trade-off between rules that prevent fire sales on the one hand and rules that force junior investors to bear the costs of delay on the other.

Many have proposed elaborate schemes to vindicate absolute priority,[35] but they are not especially apposite in a world in which we increasingly find ourselves—one in which everyone agrees on the wisdom of a sale to the highest bidder and the only question is the sort of procedures under which the sale is to be conducted. If the value of the firm was less than what was owed the secured creditor, there is no need to worry about any of this. But neither the judge nor potential buyers nor the junior creditors possess as much information about the

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best use. An investor with a diversified portfolio is indifferent to sale prices when she is equally likely to be a buyer or a seller. As has been observed often before, there are still potential costs. First, the fire sale may not simply yield a lower price. It may also put the asset in the hands of someone who values it less. *See* Andrei Shleifer & Robert W. Vishny, *Liquidation Values and Debt Capacity: A Market Equilibrium Approach*, 47 J. Fin. 1343 (1992). Second, entrepreneurs may be able to raise less capital in the first instance as investors are undercompensated in bad states of the world. *See* Alan Schwartz, *A Normative Theory of Business Bankruptcy*, 91 Va. L. Rev. 1199 (2005).

[35] *See, e.g.,* Lucian Arye Bebchuk, *A New Approach to Corporate Reorganizations*, 101 Harv. L. Rev. 775 (1988). The great charm of Bebchuk options is that it allows individual junior creditors to buy out the position of senior creditors if they think the firm is worth more than enough to pay them off. But this mechanism depends upon the junior creditors possessing the same private information about the value of the business. Even if they possess the private information, Bebchuk options do them little good if they need to access capital markets to exercise the options. As the information they possess is private and nonverifiable, outsiders cannot rely on it in extending capital to them. *See* Douglas G. Baird & Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 Yale L.J. 1930 (2006).

value of the business as the secured creditor and the managers together. As Randy Picker argues, one of the principal challenges for those administering the sale is ensuring that those in possession of private information about the value of the business are induced to reveal it.[36]

This tension between junior and senior stakeholders is simply not the problem that judges faced in trying to police the players in an equity receivership. The equity receivership had a rule of relative as opposed to absolute priority. One can see how relative priority worked with a variation on the previous example. Bank is once again owed $100. The firm can be sold today. If firm is not sold, there are two possibilities, each appears equally likely. Under one outcome, the firm, as best as anyone on the outside can tell, will be worth $160. Under the other, the firm will be worth only $80. Bank and the junior investors know a little more than anyone else about the value of the firm in good and bad states of the world.

Dealing with such situations is hard in an absolute priority world. The senior investors will press for an immediate sale, while the junior investors will want delay, regardless of which one is value maximizing. Both know which course is value maximizing, but neither can credibly communicate it. The relative priority regime solved this problem. In the equity receivership, the shares of both Bank and the junior investors were fixed at the outset according to their expected value at the time of the bankruptcy petition. In this example, junior investors would receive 1/6th of whatever was realized and Bank the balance.

With their shares fixed, Bank and the junior investors decide jointly on whether to sell the firm or reorganize. Because their claims have been transformed into share against the firm, the tension that would otherwise exists between junior and senior investor disappears. Both now care only about maximizing the value of the business as their relative shares are fixed.

[36] [Cite Picker.]

A regime of relative priority is analogous to the admiralty rule of the general average.[37] If the ship is foundering, those with cargo aboard the ship have their own rights to their own cargo transformed into a pro rata share of all the cargo on the ship. In this regime, the decision about what cargo to throw overboard is separated from the question of who owns it. A regime of relative priority treats a bankruptcy filing the same way. The need for the different investors to work cooperatively justifies ensuring that the reorganization is not a recognition event. At the time of the reorganization, Bank had a claim for $100 and the firm had an expected value of $120. By giving it 5/6ths of the value of the firm, the bankruptcy filing effects no change in the value of its rights against the firm.

Relative priority, of course, does yield different returns for Bank under some conditions than absolute priority.[38] For example consider the case that would arise if Firm were again worth $120, because of the possibility of yielding either $80 or $160. Bank, however, is owed $140. In a regime of relative priority, Bank would receive a share of the company that reflects the probability that it will receive its $140 half the time and only $80 the rest of the time. The expected value of its claim is therefore $110. The firm is worth $120, and Bank receives 11/12ths of the business. In a relative priority regime, the value of its claim against the firm remains constant. Put differently, a relative priority regime is one in which the restructuring preserves the option value of the junior interest, even when that interest would be wiped out if there were a sale or some other event that collapsed all future possibilities to present value.

In a relative priority regime the decision to reorganize does not itself affect the value of any of junior or senior securities. The valuation does not have the same

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[37] Jackson and Scott were the first to invoke the analogy of the rule of the general average in bankruptcy. Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 Va. L. Rev. 155, 164-78 (1989).

[38] *See* Douglas G. Baird & Robert K. Rasmussen, *Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations*, 87 Va. L. Rev. 921 (2001)

knife-edge character as it does in an absolute priority regime in which a small change in interest rates can affect whether a class is in money or wiped altogether. In our example, for example, if a plan proposed creating an all-equity firm, the court need ensure only that the junior investors are getting one sixth of it. Absence of exact knowledge of the value of the firm affects the option value embedded in junior interests, but not nearly as much in absolute priority regimes. As Tony Casey has pointed out, one can implement a relative priority regime and avoid a judicial valuation altogether by giving the junior creditor a call option with a strike price equal to the value of the senior creditor's claim.[39]

Nor did the courts that handled equity receiverships have to worry about senior creditors pushing for a sale that takes place too soon. In a relative priority regime, senior creditors stand to lose as much from an early sale as the junior creditors. No one stood to gain from an early sale, and, as a result, the sales could be relatively leisurely affairs. Unlike modern firms, railroads were typically cash-flow positive on an operating basis and hence there was not even a need to secure financing to keep the business running.

Relative priority regimes today have few defenders.[40] Nevertheless, we may be selling it short. The relative priority regime was abandoned largely as a result of meddling by a bankruptcy professor at the Yale Law School who was utterly clueless about the advantages that a relative priority regime brought with it. He managed to inveigle his way into the Roosevelt Administration, and we were saddled with the absolute priority rule as a result. This is a familiar story that has been told elsewhere.[41] What matters for our purposes is that the procedural protections that

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[39] See Anthony J. Casey, *The Benefit of the Creditors' Bargain: Option-Preservation Priority In Chapter 11*, 77 U. Chi. L. Rev. ●●● (2010).

[40] Indeed, among law and economics scholars who adhere to the standard Jackson creditors' bargain model, Tony Casey stands conspicuously alone. See Casey, *supra* note 39.

[41] David A. Skeel, Debt's Dominion: A History of Bankruptcy Law in America (2001); Baird & Rasmussen, *supra* note 9.

judges cared about at the end of the nineteenth century have nothing to do with the rules now needed to police sales in bankruptcy.

Indeed, some of the rules developed during that period—in particular looking with suspicion on any plan that leaves some people out in the cold[42]—may be out of step with what is needed now. Assume that the government in General Motors honored obligations to retirees only because it believed that the highest and best use of the company was as a going concern and that this requires a pay-off to the existing workers and, because of pressure from the union, to the retirees. Picking and choosing among creditors is not possible in a relative priority world.

All creditors are entitled to share. Everyone's claim possesses some option value.[43] Requiring payments to everyone as a condition to including some junior parties is harder to justify in an absolute priority regime in which senior creditors are entitled to the entire firm. Their desire to make a transfer is problematic not in its own right. It becomes a problem only if the gift is distorting the mechanism being

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[42] The equity receivership provided initially for returns only to investors who held security interests in assets of the firm and only then if the firm was to keep the assets going forward. An investor whose collateral provided no synergy could not expect to receive any share of the going concern value. Moreover, general creditors received nothing, unless they contributed value to the firm going forward (as the workers may have in *Chrysler* and *General Motors*). Courts wrestled for several decades with the question of whether, in a relative priority regime, these stakeholders should be entitled to a share of the reorganized business as well. The Supreme Court held that they interests had to be taken into account, but did not explain how their shares were to be calculated. *See* Northern Pacific Railway v. Boyd, 228 U.S. 482, 508 (1913) (noting with elaboration that a creditor's "interest can be preserved by the issuance, on equitable terms, of income bonds or preferred stock. If he declines a fair offer he is left to protect himself as any other creditor of a judgment debtor, and, having refused to come into a just reorganization, could not thereafter be heard in a court of equity to attack it.")

[43] *See* 228 U.S. at 507 ("The question must be decided according to a fixed principle, not leaving the rights of the creditors to depend upon the balancing of evidence as to whether, on the day of sale the property was insufficient to pay prior encumbrances.").

used to sell the business, such as by suppressing information held by junior investors who are also insiders.[44]

In a world committed to absolute priority, the bankruptcy judge must police the sale and ensure that it takes place at the right time and under optimal procedures that minimize costs and maximize proceeds. This is a problem that judges did not face during the equity receivership, as none of the players in the process had any reason to push for a sale that was not wealth maximizing. The players had no reason to hide information from each other. They could even hire the same lawyer to represent them.[45]

At this point, we can return to the bargaining game set out above. This game is embedded inside a larger game. The procedures available to sell the assets and the options available to the bankruptcy judge turn in large part on the actions of the secured creditor before the bankruptcy began. We can have two cases in which Bank comes in and proposes to sell the assets for $100 to the same buyer and sets out identical procedures for what someone else must do to make a topping bid, and the two cases can be radically different. Much of the action takes place off-stage. Even if the options available at the time the bankruptcy starts might be the same, the amount realized turns decisively on what has been done before the petition has been filed. If the firm has been shopped and if all the options (including liquidation options) have been completely explored, extensive procedures in bankruptcy are not necessary.

When the options available at the time of the reorganization are likely to be limited, what matters most may be the incentives faced by the parties in the time leading up to bankruptcy. Most obviously, one might consider tying the hands of

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[44] [Cite Picker.]

[45] In the Atchison, Topeka and Santa Fe reorganization, for example, the same firm represented both the first- and second-lienholders simultaneously, and no one seemed to have thought it problematic. I asked one of the partners about the apparent conflict of interest, but he refused to discuss it, invoking the attorney-client privilege.

bankruptcy judges. Imagine, for example, that the legal rule that allowed the bankruptcy judge to authorize a speedy sale only if the firm has been adequately shopped prepetition. If additional resources are needed to keep the firm running while a sale is conducted, the secured creditor can provide them. If the secured creditor is unwilling, the firm may need to be shut down and the eventual liquidation may yield substantially less than the offer on the table at the time of the filing of the petition. Everyone loses, of course, if things come to this. But if the bankruptcy judge's hands are tied, Bank's incentive to force a quick sale disappears. Because Bank no longer has the ability to play of a game of chicken with the bankruptcy judge, Bank has the incentive to ensure that it lays the ground work before the petition is filed. One may doubt, however, whether such hands-tying rules are ever likely to work. Most efforts to adopt of strict policy of never negotiating with terrorists break down.

IV. Conclusion

Chrysler and *General Motors* expose foundational issues in the law of corporate reorganizations, but the issues are not what they appear. One can fault the bankruptcy judges in these cases for not insisting on more procedures and in particular for not insisting that liquidating bids be affirmatively welcomed, but it would not likely have affected the outcome in *Chrysler* and would have been entirely symbolic in the case of *General Motors*.

As long as we remain committed to the absolute priority rule, the central question is one of designing a mechanism that induces everyone, before the filing and afterwards, to take steps that ensure that the firm is sold for top dollar. In the end, the choice is not be whether we regulate sales more, but how we do it, principally whether we leave it to rule-making or case-by-case decisionmaking. This turns on the question of how much the hands of a bankruptcy judge can be tied without interfering with her ability to manage the case.[46]

[46] A hands-tying strategy could be implemented either through rule-making or legislative action.

What about the many billions taxpayers have invested in Chrysler and General Motors? How much of it will be recovered? Most everything turns on what happens to domestic automobile consumption. If it remains at ten or eleven million, taxpayers are unlikely to recover much. If it rises back to fifteen million units a year, a place where it was for years and years before the current crisis, General Motors will likely survive, at least over the medium term. Taxpayers will make a substantial recovery. If the return is quick enough, even Chrysler might be able to pay something back.