GM, Chrysler bankruptcies created troubling legacy, legal scholars say

November 10 2010

The Chrysler and General Motors bankruptcy reorganizations represented a sea change in corporate restructuring, one that could portend the end of our current system of bankruptcy reorganization, according to a published article by two University of Illinois experts in bankruptcy law.

Law professors Charles J. Tabb and Ralph Brubaker argue that the legal principles applied in the GM and Chrysler bankruptcies – two of the largest in U.S. history at $83.5 and $39.9 billion, respectively – were misguided, and ultimately have undermined the distributional norms of bankruptcy reorganizations.

"It would be slightly less troubling if GM and Chrysler were just political aberrations, and could be viewed by courts as byproducts of the extraordinary economic and political pressure of preventing two-thirds of the American automotive industry from disappearing," Tabb said. "But that's not the case. These types of bankruptcies have been happening for some time; Chrysler and GM just brought it to the forefront."

Bankruptcy reorganizations traditionally have been effectuated by a Chapter 11 plan of reorganization, with elaborate requirements for disclosure, creditor voting and allocation of stakes among creditors and owners. In GM and Chrysler, however, the reorganization was done not by plan, but by sale.

Tabb and Brubaker warn that the Chrysler and GM bankruptcies both illustrate that there's no clear distinction between reorganization by "plan" and reorganization by "sale" – one can be the precise functional equivalent of the other through sophisticated financial legerdemain.

"The acute danger this presents is that a nominal sale structure could be used to effectuate a purely internal boot-strap reorganization," Brubaker said. "That would distribute the value of the reorganized debtor entity among creditors in a manner that contravenes their relative priority rights in the debtor's assets."

That scenario, which actually came to pass in the GM case, presents the "opportunity for opportunism," according to Tabb.

"What people do when they have leverage over the company is try to get a jump on everyone else," he said. "One of the big risks is that insiders could put deals together for their own benefit and take value in a company away from the stakeholders who have a superior entitlement to them."

According to the article, published in the *University of Illinois Law Review*, the cumulative effect of the Chrysler and GM bankruptcies essentially erases the bedrock "positive law" that has been in existence for at least a century, while simultaneously heralding the death of the fundamental distributive principles that are the essence of bankruptcy law.

When examined from a historical perspective, what transpired in the GM case – and what the Second Circuit's Chrysler opinion sanctions – was precisely what the Supreme Court prohibited in a series of decisions dating back to the late 1800s, the scholars say.

Those decisions ultimately formed the basis for Chapter 11's codification of creditors' priority rights in corporate reorganizations.

"What we're dealing with in bankruptcy is the ultimate satisfaction of creditors' claims," Brubaker said. "So it goes back to a very basic question of what payment rights do creditors have when there's not enough money to go around."

Brubaker, the Guy Raymond Jones Faculty Scholar at Illinois, says the expectation of capital markets in legal history is that repayment rights established by contract are sacrosanct.

"In lending money to an enterprise, creditors can rely on the integrity of rights as established by a contract, and what it means to have collateral and be a secured creditor, which means they'll get paid before the equity holders get paid," he said. "In other words, no one will be able to cut in line and get paid ahead of them."

But when the bill comes due and none of that's true, "then you've undermined the basis on which all of these contracts are made," Brubaker said. "The subsequent danger is that creditors are going to charge a much higher price because of the uncertainty of the enforcement."

According to Tabb, the Alice Curtis Campbell Professor of Law at Illinois, if the enforceability of contracts isn't respected, the foundation of our entire capitalist economy is weakened.

"It undermines the whole premise of commercial economies and the rule of law being so important to economic development," he said. "That's why in developing nations they always bring in experts to preach about the rule of law, because those are the foundations of economic growth."

In bankruptcy proceedings, the authors say that the very nature of

Chapter 11 along with the adversarial system of our justice system tends to elevate so-called extraordinary and exceptional relief – to be granted only when absolutely necessary for a business to successfully reorganize – into business-as-usual.

"You could credibly paint every major corporate bankruptcy as an emergency to some extent," Brubaker said. "In GM and Chrysler, there's no bad guy you could point the finger at and blame. It's the context for this sort of thing to happen without anyone really being at fault or nefarious."

The best remedy, according to Brubaker, is for judges to be extremely skeptical of dire, the-sky-is-falling claims from lawyers.

"What should happen is that you go into court, make an evidentiary showing where witnesses are cross-examined, and the judge makes factual findings in order to gauge a fair estimation of the value," Brubaker said. "The most effective way for judges to figure out if it's essential to the continuation of the business or not is to simply say 'No,' because there's nothing to prevent anyone from saying, after the fact, 'OK, I'm going to pay you in full out of the businesses resources.' So you can potentially discriminate between like-situated parties if there's a fair basis for the discrimination."

Provided by University of Illinois at Urbana-Champaign