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GM and Chrysler: The Chapter 11 Solution

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After U.S. Government "bailout" loans, days of congressional hearings and months of speculation about "too big to fail" or the "cascading" effect throughout the supply chain, GM and Chrysler both filed for protection under chapter 11. Here's why chapter 11 made sense.

Power to Reject Contracts

Perhaps the primary reason a chapter 11 filing made sense for GM and Chrysler is the power to reject executory contracts (including dealer agreements) and collective bargaining agreements (union contracts) under §§365 and 1113 of the Bankruptcy Code, respectively. These provisions make it relatively cheap and easy for a debtor to rid itself of "burdensome" contracts. Section 365 gives the debtor a virtually unfettered right to assume, or reject, an executory contract. It is simply a business decision by management exercised as part of management's "business judgment," approved by the bankruptcy court. Rarely does a bankruptcy court challenge the exercise of a debtor's business judgment, particularly in absence of key creditor objections. Thus, rejecting a contract can be easy.

The rejection of an executory contract is treated as a breach of contract by the debtor. However, the damage claim arising from the debtor's breach of contract is deemed to be a prepetition general unsecured claim. Since prepetition general unsecured claims rarely have material value (*i.e.,* usually receive pennies on the dollar), the cost to the debtor of rejecting an executory contract is minimal.

As the U.S. auto industry attempts to right-size itself in response to declining sales and market share, reducing the dealer network is, unfortunately, a necessary step. Section 365 of the Bankruptcy Code is the perfect tool for this purpose.

As with §365 relating to dealer agreements, §1113 is a powerful tool for dealing with union contracts, which are treated similarly to executory contracts. Section 1113 provides that a debtor can reject a union contract if the union refuses to accept modifications to the contract necessary to permit reorganization and assures that all creditors, the debtor and the affected parties are treated fairly and equitably. Although collective bargaining agreements are treated specially by the Bankruptcy Code (beyond the scope of this article), the result is essentially the same: Debtors can reject collective bargaining agreements relatively cheaply and easily, as indicated above. With GM and Chrysler, it appears that political forces tempered the full power and impact of §1113 as it relates to the union contracts. In these cases of unprecedented government intervention, it appears that while modifications were made to the union contracts to reduce costs, the unions have ended up owning a substantial equity stake in the new entities.

Without §§365 and 1113, debtors would be required to terminate contracts under various state and federal laws including labor laws, franchise laws, dealership laws and state contract laws. This would be an overwhelming task, as virtually every state's laws would be involved and litigation would almost certainly be required. It could take years and incredible financial resources to terminate contracts without §365 of the Bankruptcy Code—which is neither cheap nor easy.

Power to Write Down Secured Debt

Another reason why chapter 11 made sense relates to the Bankruptcy Code's treatment of secured debt. Recent headlines reported that GM and Chrysler's major creditors took substantial "haircuts" regarding the indebtedness owed to them. In particular, with GM, the bankruptcy court found that even though the secured debt was approximately $50 billion, the liquidation value of the GM assets was between $6 billion and $10 billion. Also, the Chrysler secured lenders received only 29 percent of their claims. The reason why secured lenders can be compelled to accept less is §506(a) of the Bankruptcy Code, which provides that a creditor is secured only to the extent of the value of its collateral. Thus, if a creditor is owed $100, but its collateral is worth $50, the creditor is a "secured" creditor in the amount of $50, and a general unsecured creditor for the remaining $50. In a plan of reorganization, a debtor would be required to pay or provide adequate protection for the "secured" claim, but could treat the unsecured claim like all other unsecured claims. Another motivation may have been the leverage of the U.S. Treasury Department as many of the lenders were TARP (Troubled Asset Relief Program) participants. Interestingly, one non-TARP secured lender to Chrysler, the Indiana State Teachers Retirement Fund, objected to the Chrysler settlement.

Thus, if a business' asset values have declined, §506(a) (in the context of a chapter 11 plan) allows a debtor to write down the assets to the fair market value of the assets. Until the onset of the current economic crisis, §506(a) was not often used, because there had not been a marked decline in asset values. In the current circumstances, a material portion of our global economy's assets are being revalued downward. This will precipitate debtors in chapter 11 seeking to write down secured debt under §506(a). To be sure, there are other dynamics that will impact the debtor's use of §506(a) as a tool to write down debt. For example, the debtor's prepetition lender is often the debtor's chapter 11 and exit lender. Thus, lenders may be able to "negotiate" the secured debt write-down. (The secured creditor's right to have its claim treated as fully secured under §1111(b) is beyond the scope of this article.)

Power to Sell Assets Free and Clear of Liens

One more reason chapter 11 was the best option for GM and Chrysler is §363 of the Bankruptcy Code, relating to sales of assets. In a nonbankruptcy setting, if a debtor wants to sell assets, it must comply with the laws of each jurisdiction where assets may be located. Moreover, usually assets are encumbered by liens, such as security interests of lenders, tax liens, possessory liens, etc. The respective rights of parties' competing interests must be resolved prior to sale, which will likely require litigation and very often results in a non-unified, piecemeal sale of assets. By the time the parties' respective rights are adjudicated, the operating losses have likely eroded the asset values substantially.

Section 363, by contrast, allows a debtor to sell assets, including substantially all of its assets, free and clear of liens, with the liens attaching to the proceeds of sale. This eliminates the need to adjudicate the rights of various parties in the assets prior to sale.

Moreover, §363 allows for a quick sale of assets to avoid further operating losses and hopefully achieve maximum value for the assets. The procedure is straightforward. The debtor files a motion to sell, usually subject to higher and better bids, and subject to specified "bidding procedures." Ideally, there is a stalking-horse purchaser that sets the floor price for the assets. Debtors are usually willing to reimburse the stalking-horse bidder its expenses, and pay a "break-up" fee if another party out-bids the stalking-horse purchaser. The §363 sale often culminates in an "auction" where topping bids are received. Once the "best" bid is selected, bankruptcy courts almost always approve the sale as the exercise of the debtor's business judgment. All of the liens or competing interests with respect to the assets sold are transferred to the proceeds of the sale. Further, §363(m) provides that unless the order authorizing the sale is stayed pending appeal, the reversal or modification of the sale order does not affect its validity if the purchaser is "in good faith." The allocation of sale proceeds among the competing interests is often contentious and ends up in litigation. However, under §363, the assets have been sold, further operating losses avoided, and presumably the best possible value achieved. In the cases of GM and Chrysler, both "debtors" were able to obtain quick bankruptcy court approval of §363 sales.

Conclusion

The tools of chapter 11, specifically §§365 and 1113 (rejection of contracts), 506(a) (write-down of secured debt) and 363 (sale of assets), made chapter 11 the ideal solution for GM and Chrysler. Both automakers have successfully used these provisions in their chapter 11 proceedings. These tools have been providing and will continue to provide struggling businesses in all industries substantial incentive to choose chapter 11 as a business strategy to restructure, reorganize, and liquidate business operations and their assets.