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Assessing the Chrysler Bankruptcy

Mark J. Roe
Harvard University

David A. Skeel Jr.
University of Pennsylvania Carey Law School

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Mark J. Roe
*David Skeel**

Chrysler entered and exited bankruptcy in forty-two days, making it one of the fastest major industrial bankruptcies in memory. It entered as a company widely thought to be ripe for liquidation if left on its own, obtained massive funding from the United States Treasury, and exited via a pseudo-sale of its main assets to a new government-funded entity. The unevenness of the compensation to prior creditors raised concerns in capital markets, which we evaluate here. We conclude that the Chrysler bankruptcy cannot be understood as complying with good bankruptcy practice, that it resurrected discredited practices long thought interred in the nineteenth- and early twentieth-century equity receiverships, and that its potential for disrupting financial markets surrounding troubled companies in difficult economic times, if the decision is followed, is more than small.

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INTRODUCTION

The Chrysler Chapter 11 proceeding went blindingly fast. One of the larger American industrial operations entered Chapter 11 and exited forty-two days later. Clearly this speed was propelled by the government's cash infusion of $15 billion on noncommercial terms into a company whose assets were valued at only $2 billion.[1] The influx came at a time when the American economy was sinking, financial institutions were failing, and the government feared that a collapse of the auto industry would have grave consequences for the rest of the economy. Never before had the government used bankruptcy to bail out a major industrial corporation. As a matter of bankruptcy technique, the rapidity of the Chrysler Chapter 11 was a tour de force.

The economic policy and political background is worthy of its own analysis, but we note that level of policy and politics only in passing, when they interact with the Bankruptcy Code. Briefly, Chrysler was a weak producer, making cars that had limited consumer acceptance, in an industry suffering from substantial domestic and worldwide overcapacity. Industries facing such pressure normally need to shrink, and their weakest producers, like Chrysler, are the first candidates for shrinkage.

We focus primarily on the technical structure of the Chrysler bankruptcy under the Code. Did the bankruptcy introduce, or did it magnify, tactics, procedures, and doctrines that would facilitate sound, fast bankruptcies in the future? Or did the Chrysler reorganization reveal defects latent in the Chapter 11 mechanisms? Could the rapid results be obtained in the future

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1. "The Governmental Entities loaned the Debtors at least $4 billion prepetition, and nearly $5 billion postpetition, all of which is a secured debt obligation of the Debtors." *In re* Chrysler LLC (*Chrysler I*), 405 B.R. 84, 108 (Bankr. S.D.N.Y. 2009), *aff'd*, 576 F.3d 108 (2d Cir. 2009), *vacated by* 78 U.S.L.W. 3359 (Dec. 14, 2009). In addition, governmental entities provided $6 billion in secured loans to New Chrysler. *Id.* at 92. Sticklers for form might state that Chrysler did not exit in 42 days, but is still, as of this writing, in Chapter 11. In form, that is correct, but in substance the car operations left Chapter 11 via the sale, 42 days after filing.

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only if the government is willing to flood the bankrupt firm with cash on subsidy-type terms? Was the process sufficiently innovative as to be new? And, if new, is it desirable?

Our overall conclusions are not favorable to the process, results, and portents for the future. The Chrysler bankruptcy process used undesirable mechanisms that federal courts and Congress struggled for decades to suppress at the end of the nineteenth and first half of the twentieth centuries, ultimately successfully. If the mechanisms are not firmly rejected (or forgotten), then future reorganizations in Chapter 11 will be at risk, in ways that could affect capital markets. Although the government's presence commanded judicial deference, its presence is not needed for the defective procedures to be part of future reorganizations. Every reorganization in Chapter 11 can use the same, defective process.

Two creditor groups were sharply cut off in the Chrysler reorganization. Products-liability claimants with claims for damage caused by Chrysler's cars on the road were barred in the reorganization from suing the reorganized Chrysler.[2] And credit markets reacted negatively to the Chrysler reorganization process and results. George J. Schultze, a manager of a hedge fund holding Chrysler debt, said "one reason we went into it was because we expected normal laws to be upheld, normal bankruptcy laws that were developed and refined over decades, and we didn't expect a change in the priority scheme to be thrust upon us."[3] He warned:

> People who make loans to companies in corporate America will think twice about secured loans due to the risk that junior creditors might leap frog them if things don't work out. It puts a cloud on capital markets and the riskiest companies that need capital will no longer be able to get capital.[4]

Warren Buffett worried in the midst of the reorganization that there would be "a whole lot of consequences" if the government's Chrysler plan emerged as planned, which it did.[5] If priorities are tossed aside, as he implied they were, "that's going to disrupt lending practices in the future."[6] "If we want to encourage lending in this country," Buffett added, "we don't want to say to somebody who lends and gets a secured position that that secured position doesn't mean anything."[7]

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2. In the face of continuing complaints after the Chrysler reorganization was completed, Chrysler said it would accept claims for future products-liability lawsuits, but held fast to walking away from lawsuits in place at the time of the reorganization. *Chrysler Revises Stance on Liability*, N.Y. TIMES, Aug. 28, 2009, at B2.

3. Tom Hals, *Chrysler secured creditor to fight "illegal" plan*, REUTERS, May 7, 2009.

4. *Id.*

5. Lou Whiteman, *Buffett warns of Chrysler cramdown ramifications*, THEDEAL.COM, May 5, 2009, http://www.thedeal.com/dealscape/2009/05/buffett_warns_of_chrysler_cram.php.

6. *Id.*

7. *Id.* These were not isolated comments in capital markets. *Cf.* Nicole Bullock, *Painful lessons for lenders in Chrysler debacle*, FIN. TIMES, MAY 7, 2009. Bullock interviewed the financial players:

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Were they right? Were priorities violated?

Perhaps priorities were breached, perhaps not. The most troubling Code-based aspect of the Chrysler bankruptcy is that this is difficult, perhaps impossible, to know from the structure of the reorganization. Yet obtaining that knowledge is one of the core goals of Chapter 11 in practice. Chrysler breached appropriate bankruptcy practice in ways that made opaque both Chrysler's value in bankruptcy and the plan's allocation to the company's prebankruptcy creditors. The requirement in § 1129(a)(8) that each class of creditors consent or receive full payment wasn't used. A market test wasn't used. There was no judicial valuation of the firm. Chrysler went through the motions of selling its principal assets to a newly formed entity controlled by its preexisting principal creditors, a process that has been historically suspect in bankruptcy.

Stunningly, the bankruptcy court did not analyze the § 1129 issues. Indeed, that section—the core of the modern Bankruptcy Code, outlining the conditions the judge must find prior to confirming a plan of reorganization—is not mentioned once in the bankruptcy court's opinion. If the pseudo-sale was a de facto plan of reorganization because it did so much more than simply sell assets for cash, then it was incumbent on the bankruptcy process to assess the deal's terms for consistency with § 1129. If a capable bankruptcy judge does not see fit to mention § 1129 in a sale that determines many reorganization outcomes normally made in Chapter 11 under § 1129, something peculiar is happening. The most obvious hypothesis is that one could not mention it, if one feared that one were witnessing a reorganization that could not comply with § 1129. On appeal, the Second

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> "Given that so much of total borrowing across all asset classes is first lien in nature, the damage that would occur to the economy as a result of higher first lien borrowing costs resulting from lenders requiring a higher return to compensate them for an unknown interpretation of claim priorities could be substantial," says Curtis Arledge, co-head of US fixed income at BlackRock, Inc.
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> . . . .
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> "It is particularly important at this stage of the distressed cycle for lenders to have confidence in pre-existing contracts and rules. We are entering a period of record corporate defaults and the need for bankruptcy financing and financing for distressed companies will only continue to grow," says Greg Peters, global head of credit research at Morgan Stanley.
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> . . . .
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> "People are pretty comfortable with the bankruptcy rules. What they are trying to do in the Chrysler situation is unprecedented," says Jeff Manning, a managing director specialising in bankruptcy and restructuring at Trenwith Securities, the investment bank. "This isn't the way the game is supposed to be played."
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> . . . .
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> . . . Steve Persky, managing director of Dalton Investors, a Los-Angeles-based hedge fund that specialises in distressed debt[,] . . . [says] "Now there is a new risk: government intervention risk[.]" . . . "And it is very hard to hedge."

Id.

Circuit, rather than signaling concern, affirmed the bankruptcy court decision and adopted its analysis.[8]

Worse, the Chrysler bankruptcy in core respects does not look like a simple sale, but a reorganization. The new Chrysler balance sheet remarkably resembles the old one, with only a couple of priorities, involving large dollar amounts, sharply adjusted. Courts will need to develop rules of thumb to distinguish true § 363 sales from bogus ones that are really reorganizations. We take a step toward doing so.

We can hope that the breach of proper practice will be confined to *Chrysler*. But the structure of the deal is not *Chrysler*-specific. Not only did the subsequent *General Motors* opinion rely heavily on *Chrysler*,[9] but other courts and plan proponents will inevitably cite *Chrysler* as precedent.[10] Some already have.

The Chrysler process may have revealed conceptual fault lines in the deeper structure of Chapter 11: the government's presence as a noncommercial lender isn't needed, as a matter of Code structure, for interested players to use the *Chrysler* mechanism. Any coalition of creditors and managers can use the § 363 sale in the same way, if they can persuade a judge to approve their proposed fictional sale.

Hence, *Chrysler* could become the template for the next generation of large scale corporate reorganizations. Even before the Chrysler bankruptcy, Chapter 11 cases were increasingly resolved through § 363 sales that did not always carefully consider § 1129 priority issues. But by blessing an artificial sale that carried over and restructured the bulk of Chrysler's creditors' claims, the Second Circuit's *Chrysler* opinion radically expands this strategy's potential scope. If it becomes the pattern, *Chrysler* could displace the traditional Chapter 11 process, potentially affecting both lending markets and vulnerable nonfinancial creditors adversely.

Its impact will need to be confined. We can hope that the bankruptcy bench and bar come to a consensus view of *Chrysler* as a one-off, sui generis bankruptcy, and we seek here to start us toward that consensus. But because the *Chrysler* techniques resonate enough with prior practice, and can be seen as extreme extensions of that prior practice, effort will be required to reach that consensus.

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8. Ind. State Police Pension Trust v. Chrysler LLC (*In re* Chrysler LLC) (*Chrysler II*), 576 F.3d 108, 118 (2d Cir. 2009) (rejecting concerns about the failure to comply with Chapter 11's protections with the statement that the "bankruptcy court's findings constitute an adequate rebuttal"), *vacated by* 78 U.S.L.W. 3359 (Dec. 14, 2009). How much force is left in the Second Circuit's judgment after the Supreme Court vacated it is yet to be determined. *See infra* text accompanying notes 95–98.

9. *In re* Gen. Motors Corp., 407 B.R. 463, 497–98 (Bankr. S.D.N.Y. 2009).

10. *See* Ashby Jones & Mike Spector, *Creditors Cry Foul at Chrysler Precedent*, WALL ST. J., June 13, 2009, at B1 ("It's going to happen," [Peter Kaufman, president of investment bank Gordian Group LLC, said, questioning the sui generis view]. "The excuse that [the auto cases] are 'special circumstances,' I'm sure [is] right until the next time it's a 'special circumstance.'").

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A roadmap for the Article: in Part I, we outline the structure of the Chrysler bankruptcy, which was effectuated as a § 363 sale under the Code's authorization to bankruptcy courts to sell all or part of a firm, upon the bankrupt's motion, without the creditors' consent. We analyze the best theoretical structure for how § 363 should interact with the rest of the Code, particularly § 1129. Section 363 has the potential to do much good—by repositioning companies quickly in the merger market—and the potential to do much damage, by running roughshod over the rest of the well-honed Chapter 11 structure.

We then in Part II examine the appellate cases, which largely conform to the theoretical structure for § 363 sales that we first outline in Part I. To substitute for the usual creditors' protections of § 1129, courts had developed makeshift safeguards in § 363 sales, requiring adequate valuation, consent, or a genuine market test. In Part III, we show that the Chrysler sale failed to use such checks properly. In Part IV, we demonstrate that while cast as a sale, the Chrysler transaction had so many presale creditors reemerging on the other side of the transfer of its assets to the newly-formed firm that the transaction can, and should, better be characterized as not being a sale to a third party, but as an ordinary reorganization, but one not done in accordance with best Chapter 11 practice. We suggest a rough rule of thumb for courts to sort presumed reorganizations (which need to proceed under alternative Code provisions) from plausible § 363 sales.

Then, after briefly exploring in Part IV how the government might have structured its investment in Chrysler differently and still reached its policy goals without distorting bankruptcy practice, we put *Chrysler* into broader perspective. We speculate in Part V about *Chrysler*'s implications for future bankruptcy practice and remark in Part VI on the similarity of Chrysler's reorganization to nineteenth century reorganizations via the equity receivership. On the positive side, the Chrysler reorganization handled a practical business problem via a sale format as did the equity receivership's reconstruction of the American railroad system. On the negative side, the Chrysler reorganization reintroduced the equity receivership's most objectionable attributes, particularly its casual regard for priority—attributes that the reorganization machinery regularly rejected for more than a century, until now. Before concluding, we speculate on business features that could push toward more Chrysler-like bankruptcies in the future: if major creditor groups increasingly supply not only funds, but also critical goods and services for the debtor's business, *Chrysler* could represent a new direction, one for which Chapter 11 as now constituted is not fully prepared.

The damage will need to be undone. Other courts can, and should, require proper safeguards for sales that substitute for Chapter 11. We outline what those need to be. *Chrysler* needs to be seen as an anomaly, but as of today there's risk that it will not be. Courts need to change direction to handle § 363 sales better than they were handled in *Chrysler* or Congress needs to act.

I. Chrysler's § 363 Problem

A. *The Deal Structure*

The deal's basic structure is straightforward to summarize. Prebankruptcy, Chrysler was a private firm, owned by Cerberus, a large private equity fund. As of the bankruptcy, its two largest creditors were secured creditors owed \$6.9 billion and an unsecured employee benefit plan, owed \$10 billion.[11] It also owed trade creditors \$5.3 billion, and it had warranty and dealer obligations of several billion dollars.[12]

The government created and funded a shell company that, through a § 363 sale from Chrysler, bought substantially all of Chrysler's assets for \$2 billion, giving the secured creditors a return of 29 cents on the dollar. FIAT was brought in to manage the new firm and was given a slice of the new company's stock. New Chrysler (formally: New CarCo Acquisition LLC) then assumed the old company's debts to the retirees, most dealers, and trade creditors. The \$10 billion of unsecured claims owed to the retirees' benefits plan were replaced with a new \$4.6 billion note as well as 55 percent of the new company's stock.

Priority seemed violated. Unsecured retiree claims were promised well over 50 cents on the dollar, along with control of the New Chrysler, and unsecured trade creditors were promised full payment. The secured creditors, however, were getting 29 cents on the dollar, and future products-liability claims relating to Chrysler cars already on the road would receive nothing at all under the plan, as the pseudo-sale made no provision for them. Claims could be brought against only Old Chrysler, which was expected to soon have no assets.

In an ordinary bankruptcy, the structure would be prima facie improper. The secured creditor would get the value of its security—here perhaps \$2 billion—and its unsecured deficiency claim of nearly \$5 billion would be paid proportionately with the other unsecured creditors. But this was not an ordinary bankruptcy, because the government was lending on noncommercial, policy-oriented terms. The United States Treasury and the government of Canada had lent roughly \$4 billion to Chrysler prior to bankruptcy, and then agreed to provide \$5 billion to fund the bankruptcy, and another \$6 billion in exit financing.[13] Some of the excess promised to the retiree trust was surely spilling over from the government's concessionary lending. The difficulty—the core Chrysler bankruptcy problem—is that the bankruptcy process failed to reveal how much. Its structure was consistent with several sharply differing real results. Maybe the retirees' payout came solely from the government's new money as funneled

11. Affidavit of Ronald E. Kolka in Support of First Day Pleadings ¶¶ 27, 39, *In re* Chrysler LLC (*Chrysler I*), 405 B.R. 84 (S.D.N.Y. 2009) (No. 09 B 50002 (AJG)), 2009 WL 1266134 [hereinafter "Kolka Affidavit"].

12. *Id.* ¶¶ 30, 35.

13. *Chrysler I*, 405 B.R. at 92, 108.

through New Chrysler, maybe some of it came from the prior secured creditors, maybe the deal created unusually lucrative synergies, or maybe the government even subsidized the secured creditors as well. It's impossible to tell because the process was opaque, with none of the standard mechanisms used to validate the process: a judicial valuation, an arm's-length bargained-for settlement, or a genuine market test.

Simply stated, although the secured creditors received $2 billion on their $6.9 billion claim, there is nothing in the *structure* of Chrysler's bankruptcy process inconsistent with the proper number for the secured being not $2 billion, but $5 billion, or $1 billion. Or zero. Whoever won and whoever lost, the process was a defective one, because it was one unlikely to reveal whether the Chrysler bankruptcy adhered to basic priorities.

B. *The § 363 vs. § 1129 Problem: Concept*

Section 363 of the Bankruptcy Code authorizes the debtor to sell assets out of the ordinary course of business at any point in the bankruptcy case, upon obtaining the bankruptcy court's approval. The section is short, with no conditions other than that there be a hearing. But § 1129—arguably the core of Chapter 11—requires that, before the court approves a plan of reorganization, it ascertain that the plan complies with the usual priorities, absent creditor consent to a plan deviating from those priorities.[14]

In a simple sale, these two sections do not conflict. The debtor sells, say, a subsidiary that the firm cannot manage well and that's deteriorating in value. The asset leaves the debtor's estate, but cash comes back in. The cash for the sale is then available to all of the prebankruptcy creditors, who can thereafter litigate, negotiate, and jockey among themselves over priority, over whether any of them are entitled to receive interest payments, over whether any received preferential transfers prior to bankruptcy that must be returned, whether one should be equitably subordinated to another, and so on.

A complex sale, however, can determine priorities and terms that the Code is structured to determine under § 1129, and is not structured to determine under § 363. For example, consider the possibility that in addition to the sale, some prebankruptcy creditors come over to the purchasing firm, but others do not. The purchaser buys the debtor's principal operating subsidiary, say, and agrees to pay one of the subsidiary's creditors in

14. Section 1129 priorities contemplate that secured creditors obtain the value of their security, that unsecured creditors be paid before stockholders, that intercreditor contractual priorities be respected, and that creditors at the same level obtain the same proportion of their claim paid. Creditors can consent to deviations from priority, via a vote of the affected creditor class. An individual creditor can sometimes upset a class-approved deal via § 1129(a)(7), which requires that any nonconsenting creditor receive as much under the plan as the creditor would get if the debtor were liquidated under Chapter 7. For those unfamiliar with the basic priority structure of § 1129, it is outlined in bankruptcy casebooks and treatises. *See, e.g.*, Mark J. Roe, Bankruptcy and Corporate Reorganization 87–117 (2d ed. 2007); Elizabeth Warren & Jay Lawrence Westbrook, The Law of Debtors and Creditors 396–402 (6th ed. 2009).

full, but not pay its other creditors anything. Some of the subsidiary's dealers are terminated, left behind, and have damage claims left unpaid by the old company, but others move over to the purchaser and remain in operation. The purchaser agrees to assume some of the subsidiary's ongoing warranty claims, but not its current collection of lawsuits or its liability for previously sold products that turn out to be defective. Or, the purchaser earmarks some of the consideration used in the sale as being usable by only a particular set of previous creditors of the subsidiary.

All these sales terms would then determine core aspects that would normally be handled under § 1129, with disclosure, voting under § 1129(a)(8), and if voting fails, via a judicial cram-down under § 1129(b).[15] If the restructuring is done via § 363, courts need to resolve how to reconcile such sales with § 1129.

The simplest reconciliation would be to bar such sales that determine core Chapter 11 terms, on the theory that § 363 cannot be allowed to eat up the rest of Chapter 11. Section 363 would be limited to simple sales of assets for cash. Congress intended, in this view, that the Chapter 11 proceeding end with the bankruptcy judge going through the long, precise § 1129 checklist for compliance, typically including full disclosure of the company's business operations and the impact of the plan on the creditor groups, with creditors thereafter voting and the judge evaluating the plan.

But that kind of formalistic reconciliation isn't good enough for two reasons, one theoretical and one practical. The theoretical one is that every sale affects the § 1129 bargaining. Behind the § 1129(a)(8) process is the "what if" alternative—what if the parties cannot bargain to a settlement? If they cannot settle, the judge can cram the plan down, but that cram-down ultimately needs a judicial valuation of the firm and its claims, a process that is usually thought to be highly inaccurate. By reducing the valuation uncertainty, a sale affects the reorganization, but beneficially if the sale value is proper.[16]

The second, practical problem with rejecting all sub rosa plans as not being good enough is quite important: a sale is too attractive a business disposition for many bankrupts to give up. Bankrupt companies come disproportionately from declining industries that should shrink. An excellent way for a declining industry to consolidate capacity is via merger, so that the strongest parts of each partner can be molded together. And bankrupt firms, if poorly managed, can be repositioned to be managed by a better managerial team. If a few terms have to be handled in the § 363 sale that

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15. The judge can cram the plan down on objecting creditors by finding that the objecting creditors obtained their due under a § 1129 plan, thereby allowing the judge to confirm the plan, notwithstanding the creditors' dissent.

16. *See, e.g.*, Walter J. Blum, *The Law and Language of Corporate Reorganization*, 17 U. CHI. L. REV. 565, 572 (1950) ("[Reorganization value] is a fictional value . . . . It is set by the estimates of persons who are not standing back of them with a willingness to invest their own funds."); Kerry O'Rourke, *Valuation Uncertainty in Chapter 11 Reorganizations*, 2005 COLUM. BUS. L. REV. 403, 427 (2005); Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527 (1983).

would ordinarily be handled under § 1129, then courts, and bankruptcy doctrine, should find a way to accommodate the quick sale, but without scuttling the entire § 1129 structure of protections and priorities. One potential negative fallout from the Chrysler bankruptcy is that the eventual push back to its casualness in handling priority could become an attack on § 363 in its entirety, as opposed to its specific implementation. If sales were sharply curtailed, instead of conditioned and properly structured, then bankruptcy would be set back. As a matter of bankruptcy policy, we should want sales that reposition the bankrupt's operations quickly and well. We do not want those sales to strongly violate priority expectations.

But fast sales with some priority determinations can be reconciled. The court can identify the offending feature of the § 363 sale and ascertain whether it's small and whether the priority determination would have passed muster under § 1129. For example, if a single creditor objects to the sale, because some prior creditors are going over to the new entity, the court can determine that the creditor received liquidation value (§ 1129(a)(7)) and that the creditor class to which the dissenter belongs properly consented to any deviation in priority in allocation of the going concern value (§ 1129(a)(8)). If a class consented overall but a dissenter would clearly be getting liquidation value, then the court could determine that even though the sale had aspects of a sub rosa plan, those features if done above-board would still have permitted plan confirmation under § 1129.

II. The Pre-*Chrysler* Appellate Cases

Overall, the prior appellate cases conformed to the concepts laid out above. Bankruptcy law, based on leading 1980s decisions in the Second and Fifth Circuits, was largely in good shape doctrinally before *Chrysler*. These decisions established that there must be an appropriate business justification for the sale, as exemplified by a business emergency or a deteriorating business situation best handled by a sale; the sale cannot be a sub rosa plan of reorganization that de facto determines core terms more properly determined under § 1129 via its creditor protections; and if the plan does determine core § 1129 features, it can do so only if the court fashions a makeshift safeguard—a substitute that's overall consistent with the mandates of § 1129.

A. *Reconciling § 363 Sales with § 1129 Protections*

Prior to the modern Bankruptcy Code, asset sales were allowed only when the asset was wasting away. In *In re Lionel Corp.*, the Second Circuit freed Code sales from that restriction, but firmly stated when rejecting the proposed sale in the case that, although "the new Bankruptcy Code no longer requires such strict limitations on a bankruptcy judge's authority to order disposition of the estate's property . . . it does not go so far as to eliminate all constraints on that judge's discretion."[17] The court established the modern test for approving a § 363 sale: "The rule we adopt requires that a judge determining a § 363(b) application expressly find from the evidence presented before him at the hearing a good business reason to grant such an application."[18] And, importantly for the Chrysler reorganization, the court in *Lionel* also stated that:

> [I]t is easy to sympathize with the desire of a bankruptcy court to expedite bankruptcy reorganization proceedings for they are frequently protracted. "The need for expedition, however, is not a justification for abandoning proper standards."
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> . . .
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> In fashioning its findings, a bankruptcy judge must not blindly follow the hue and cry of the most vocal special interest groups; rather, he should consider all salient factors pertaining to the proceeding and, accordingly, act to further the diverse interests of the debtor, creditors and equity holders, alike.[19]

While the *Lionel* decision evinces skepticism toward the § 363 sale, in time courts became more comfortable with sales, partly because they make so much business sense for a failing business and partly because the general merger market deepened and thickened in the 1980s. Such sales became frequent in Chapter 11.[20]

By relaxing the standard for a § 363 sale, the courts introduced the risk that § 363 could be used to circumvent the carefully crafted Chapter 11 protections emanating from § 1129. The court addressed this issue in *In re Braniff Airways*, stating that "[t]he debtor and the Bankruptcy Court should not be able to short circuit the requirements of Chapter 11 for confirmation of a reorganization plan by establishing the terms of the plan *sub rosa* in connection with the sale of assets."[21]

The *Braniff* court concluded that the proposed sale before it—which would have distributed travel coupons, promissory notes, and a share of profits in specified amounts to different groups of creditors—was a de facto plan of reorganization, explaining that "[w]ere this transaction approved, and considering the properties proposed to be transferred, little

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17. Comm. of Equity Sec. Holders v. Lionel Corp. (*In re* Lionel Corp.), 722 F.2d 1063, 1069 (2d Cir. 1983).

18. *Id.* at 1071.

19. *Id.* (quoting Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson, 390 U.S. 414, 450 (1968)).

20. *See* Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673 (2003); Douglas G. Baird, *The New Face of Chapter 11*, 12 AM. BANKR. INST. L. REV. 69, 73 (2004) ("[S]ales are now part of the warp and woof of [C]hapter 11 practice. Of the 10 largest [C]hapter 11s of 2002, eight used the bankruptcy court as a way of selling their assets to the highest bidder, whether piecemeal or as a going concern."); *cf.* Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Fire Sales*, 106 MICH. L. REV. 1, 24–25 (2007) (sharply criticizing sales).

21. Pension Benefit Guar. Corp. v. Braniff Airways, Inc. (*In re* Braniff Airways, Inc.), 700 F.2d 935, 940 (5th Cir. 1983).

would remain save fixed based equipment and little prospect or occasion for further reorganization. These considerations reinforce our view that this is in fact a reorganization."[22] Courts continue to reaffirm and interpret the *Braniff* standard.[23]

In 2007, the Second Circuit, in *In re Iridium Operating LLC*, affirmed the same standard, barring a bankruptcy transaction because of its similarity to sale cases "if [the sale] would amount to a *sub rosa* plan of reorganization . . . based on a fear that a [bankrupt] will enter into transactions that will, in effect, 'short circuit the requirements of [C]hapter 11 for confirmation of a reorganization plan.'"[24] Equally importantly, the Second Circuit emphasized the importance of ascertaining compliance with the statute's priority requirements:

> [W]hether a particular settlement's distribution scheme complies with the Code's priority scheme must be the most important factor for the bankruptcy court to consider when determining whether a settlement is "fair and equitable" . . . . The court must be certain that parties to a settlement have not employed a settlement as a means to avoid the priority strictures of the Bankruptcy Code.[25]

Although courts regularly indicate the impermissibility of sub rosa plans, they do not bar all plans that make § 1129 determinations in the § 363 sale. The sale may go through, but only if an appropriate, even if makeshift, protection is used to substitute for the forgone conditions to plan confirmation. The court states in *In re Continental Air Lines*:

> [W]e hold that when an objector to a proposed transaction under § 363(b) claims that it is being denied certain protection because approval is sought pursuant to § 363(b) instead of as part of a reorganization plan, the objector must specify exactly what protection is being denied. If the court concludes that there has in actuality been such

22. *Id.*

23. Clyde Bergemann, Inc. v. Babcock & Wilcox Co. (*In re* Babcock & Wilcox Co.), 250 F.3d 955, 960 (5th Cir. 2001) ("*Braniff* stands . . . for the proposition that the provisions of § 363 permitting a trustee to use, sell, or lease the assets do not allow a debtor to gut the bankruptcy estate before reorganization or to change the fundamental nature of the estate's assets in such a way that limits a future reorganization plan."); *see also* Craig A. Sloane, *The Sub Rosa Plan of Reorganization: Side-stepping Creditor Protections in Chapter 11*, 16 Bankr. Dev. J. 37 (1999) (surveying cases through 1999).

24. Motorola, Inc. v. Official Comm. of Unsecured Creditors (*In re* Iridium Operating LLC), 478 F.3d 452, 466 (2d Cir. 2007) (quoting *In re Braniff Airways*, 700 F.2d at 940). Two years earlier, the Southern District of New York rejected a sale, stating that "it is well established that section 363(b) is not to be utilized as a means of avoiding Chapter 11's plan confirmation procedures. Where it is clear that the terms of a section 363(b) sale would preempt or dictate the terms of a Chapter 11 sale, the proposed sale is beyond the scope of section 363(b) and should not be approved under that section." Contrarian Funds, LLC v. Westpoint Stevens, Inc. (*In re* Westpoint Stevens, Inc.), 333 B.R. 30, 52 (S.D.N.Y. 2005).

25. *In re* Iridium, 478 F.3d at 464.

> a denial, it may then *consider fashioning appropriate protective measures modeled on those which would attend a reorganization plan*.[26]

A commentator summarizes the cases as follows:

> [A] debtor [must] establish four elements: (1) a sound business purpose justifying the sale of assets outside the ordinary course of business, (2) accurate and reasonable notice provided to interested persons, (3) a fair and reasonable price obtained by the debtor, and (4) a good faith sale without offering lucrative deals to insiders.[27]

Keep in mind the cautionary indication about "lucrative deals to insiders," because the Chrysler sale could be interpreted as a lucrative deal to nonstandard insiders (the standard ones being management and controlling stockholders; the nonstandard ones being creditors who de facto controlled Chrysler), one that the judge would ordinarily want to examine carefully.

When a firm sells nearly all of its assets to a shell company that assumes many but not all of its prior liabilities, we are not seeing a valid sale solely to benefit creditors as a group. Instead, the sale is a de facto reorganization plan, which courts had previously regularly rejected as requiring makeshift remedies to ensure that the § 1129 standards to confirmation were not violated.

B. *Makeshift Remedies that Validate Priority*

Three makeshift safeguards can reconcile a § 363 sale with core protections of § 1129: judicial valuation, creditor consent, and a contested auction.

1. *Judicial Valuation and Priority Determination*

The most straightforward, but most cumbersome, makeshift remedy would be for the bankruptcy court to hear valuation evidence, ascertain priorities, and determine whether the plan conformed to what would have been distributed had the plan gone through § 1129(b). Valuation, though, is not a favored process, partly because judicial valuation is itself often seen to be inaccurate and slow[28] and, accordingly, courts rarely rely on valuation alone.

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26. Institutional Creditors of Cont'l Air Lines, Inc. v. Cont'l Air Lines, Inc. (*In re* Cont'l Air Lines, Inc.), 780 F.2d 1223, 1228 (5th Cir. 1986) (emphasis added); *cf. In re* Crowthers McCall Pattern, Inc., 114 B.R. 877, 885 (Bankr. S.D.N.Y. 1990).

27. Scott D. Cousins, *Chapter 11 Asset Sales*, 27 DEL. J. CORP. L. 835, 839–40 (2002). Multiple circuits have explicitly required that these conditions be satisfied prior to a § 363 sale. *Id.*

28. *See* H.R. REP. NO. 95–595, at 227 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6186–87; H.R. DOC. NO. 93–137, pt. 1, at 256 (1973).

2. *Class Consent*

Section 1129(a)(8) allows plans to deviate from absolute priority, if the impaired class consents, by a vote of two-thirds in dollar amount and more than one-half in the number of claims. Few modern reorganizations reach a bargaining impasse—eventually the classes usually make a deal. The concept behind the consent procedure is that value may be uncertain and parties often compromise their claims to get a deal done so that the business can move on. The court can look to whether the creditors consented to the terms of the plan in a way that would pass muster under § 1129.[29]

But that consent must be valid and in good faith, i.e., not distorted by severe conflicts of interest, as § 1126(e) states that "the court may designate any entity whose acceptance or rejection of such plan was not in good faith."[30] That lack of good faith exists if a claim holder is acting "in aid of an interest other than an interest as a creditor."[31]

3. *A Market Test*

The main safeguard in most § 363 sales comes from the bidding rules that facilitate an auction, or some lesser market test of the sale. In 2006, the Southern District of New York posted general guidelines for bankruptcy sales.[32] These guidelines—which require that bidders be given access to relevant information, that the debtor market the property adequately and show that the price received will be "the highest or best under the circumstances," and that the insider status of any buyer be disclosed—appear to be consistent with the practice in other courts as well.[33]

Courts usually agree to a sale, but often stretch out the auction's time frame, during which they remove problematic provisions from the debtor's proposed bidding procedures and give the creditors' committee an opportunity to investigate and to object to any problems with the proposed sale. In the *Lifestream Technologies* bankruptcy, for instance, the parties requested that the § 363 sale be conducted shortly after the case was first filed. The judge refused the request, which induced the parties to renegoti-

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29. *See* David Arthur Skeel, Jr., *The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases*, 78 VA. L. REV. 461, 497–501 (1992) (recommending that such consent be required).

30. 11 U.S.C. § 1126(e) (2006).

31. *In re* Allegheny Int'l, Inc., 118 B.R. 282, 289 (Bankr. W.D. Pa. 1990) (quoting *In re* P-R Holding Corp., 147 F.2d 895, 897 (2d Cir. 1945)); *see also In re* Dune Deck Owners Corp., 175 B.R. 839, 845 (Bankr. S.D.N.Y. 1995); *cf. In re* Iridium Operating LLC, 478 F.3d 452, 465 (2d Cir. 2007) (emphasizing that only a single creditor objected).

32. *In re* Adoption of Guidelines for the Conduct of Asset Sales, General Order M-331 (Bankr. S.D.N.Y. Sept. 5, 2006), *available at* http://www.nysb.uscourts.gov/orders/m331.pdf.

33. *Id.* at 7.

ate the terms of the sale.[34] As the Supreme Court said in an analogous setting in *203 North LaSalle*: "Under a plan granting an exclusive right, making no provision for competing bids or competing plans, any determination that the price was top dollar would necessarily be made by a judge in bankruptcy court, whereas the best way to determine value is exposure to a market."[35]

III. The Chrysler Sale

The Chrysler sale violated all of these principles. The § 363 sale determined the core of the reorganization, but without adequately valuing the firm via § 1129(b), without adequately structuring a § 1129(a)(8) bargain, and without adequately market testing the sale itself. Although the bankruptcy court emphasized an emergency quality to the need to act quickly, stating that "if a sale has not closed by June 15th, Fiat could withdraw its commitment,"[36] there was no immediate emergency. Chrysler's business posture in early June did not give the court an unlimited time to reorganize, but it gave the court weeks, not just a few days, to sort out priorities, even if in a makeshift way.

That core terms to § 1129 were determined should not be in doubt, although neither the bankruptcy court nor the Second Circuit indicated that they grasped this basic fact of the Chrysler reorganization and, hence, failed to fully analyze its import. The sale terms effectively determined the consideration to Chrysler's secured creditors and its ongoing products-liability claims. It promised the retirees' VEBA a payment of $4.6 billion and made them substantial owners of the New Chrysler.[37] The sale did much more than just move Chrysler's assets to a new owner for cash. Because it also decided which creditors would get paid and how much they'd be paid, the Chrysler sale was a sub rosa reorganization plan. The only serious question is whether the makeshift procedures the judge used adequately substituted for a real § 1129 confirmation. In most cases the answer is clearly no, because no substitute was attempted. For a few features, a partial substitute was employed—such as a market test—but was inadequate.

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34. *See, e.g.*, Debtor's Supp. Brief in Support of Motion for Order Pursuant to Section 363 of the Bankr. Code, *In re* Lifestream Techs., Inc. (Bankr. D. Nev. Dec. 5, 2006) (No. BK-S-06-13589 BAM) (noting that principal lender agreed to give 25 percent of any overbid to unsecured creditors and to extend the auction for four additional weeks).

35. Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 457 (1999).

36. *Chrysler I*, 405 B.R. at 96–97.

37. *Id.* at 92. VEBA is the acronym for the trust that handles the retiree health benefits—the voluntary employees' benefit association.

A. *Valuation*

Had the judge determined after a contested valuation hearing that the value of Chrysler's automotive assets that secured Chrysler's $6.9 billion secured loan was $2 billion and that nothing further was allocable to the unsecured $4.9 billion deficiency[38] (and had the judge done the same for the other creditors left behind, such as the products-liability claims), then the court would have found a plausible makeshift alternative. The courts could have said that a cram-down under § 1129(a)(7) and § 1129(b) would have led to the secured creditors getting $2 billion, so that the sale, although determining core terms under § 1129, was not defective.

Chrysler did present a valuation to the court, with the liquidation value centered near $2 billion, although with a range that went as high as $3.2 billion, with a predicted net recovery of up to $2.6 billion for the secured creditors.[39] The range was wide enough to suggest that even Chrysler's valuation experts saw it as possible that a liquidation could yield appreciably more than $2 billion, despite the understandable tendency of expert financial opinions in bankruptcy to trend toward the client's interest.[40] Chrysler's original numbers could have indicated to the court that it would need to be cautious if it allowed Chrysler's self-valuation to stand as the court's makeshift valuation.

Shortly before the hearing on the proposed sale, Capstone, Chrysler's financial advisor, revised its valuation downward (to 0–$1.2 billion), pointing to a decrease in Chrysler's cash, a general decrease in car sales, and Chrysler's unprofitability as warranting the adjustment.[41] The court considered no other valuations.

The court did not give the objecting creditors time to present an alternative valuation from their experts or require that such a valuation be subsidized by the bankruptcy estate as Chrysler's was, although the objecting creditors could have anticipated prior to Chrysler's filing that there would be a valuation contest and borne the expenses of getting their own valuation. Such valuation contests are notoriously difficult, as each party comes to court with experts sporting a number remarkably supportive of the client's interests. But that's the system we're saddled with, and judges

38. Or decided that the security was worth less and the difference was the portion allocable for the deficiency claim.

39. The valuation submitted by Chrysler's experts gave a range of $900 million to $3.2 billion, with a likely recovery to the first liens of between $654 million and $2.6 billion. *See* Motion of Debtors and Debtors in Possession, Pursuant to Sections 105, 363 and 365 of the Bankruptcy Code and Bankruptcy Rules 2002, 6004 and 6006, *Chrysler I*, 2009 WL 1227661.

40. *E.g.*, *In re* New York, New Haven & Hartford R.R., 4 B.R. 758, 773 (D. Conn. 1980) ("The parties urge acceptance of the valuation procedures . . . which best conform to their views of the applicable law and which, coincidentally, establish the most favorable standing with respect to their own cause.").

41. *Chrysler I*, 405 B.R. at 97.

have done the best they can under the circumstances. Here, though, the judge saw evidence from only one side's expert.[42]

Yet in retrospect, this aspect of the reorganization may be the best justification for judicial approval of the sale: the proponents presented valuation evidence and the objecting creditors did not. The objecting creditors indicated that they lacked time to do so, but regardless, the litigation posture at the time of the judge's decision was that a single valuation was available to the judge and it stood unrebutted by better evidence.[43]

B. *Consent*

Sale proponents could analogize to § 1129(a)(8) consent, positing that, parallel to that section, the Chrysler deal had the secured creditors—the creditors entitled to the proceeds from the sale of the assets—consenting de facto to the sale.

On the surface, there was a favorable informal vote. While the creditors initially objected strongly in negotiations with the U.S. Treasury, four major creditors—Citigroup, J.P. Morgan Chase, Goldman Sachs, and Morgan Stanley—holding 70 percent of the dollar amount of the claims eventually acceded to the $2 billion number.[44]

The difficulty with crediting such a vote as informally satisfying § 1129(a)(8) is that these creditors were beholden to the U.S. Treasury, which was emerging as Chrysler's principal creditor, and the Federal Reserve, not just as their regulators, but as the banks' key financial patrons via the government's bank-rescue program. The four banks had recently received $90 billion in investments from the Treasury.[45] Their vote was sufficiently tainted under § 1126(e) to be a bad-faith vote, which would require that the tainted voters either be classified apart from the creditors not beholden to the Treasury or that the tainted votes just be dropped in calculating whether the class consented.

There's another, more severe, way to look at the big banks' votes. One or more of these banks could plausibly be viewed as controlled by the U.S. Treasury at the time. Not only did they depend on the Treasury for financing, but serious talk had it that major banks, particularly Citigroup, would need to be nationalized. Bank executives had reason to be wary, as Treasury-induced management changes or compensation mandates were being discussed. Senior bank management had good reason not to annoy the Treasury.

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42. *Id.* The problem may lie with the plan opponents. They did not have their own valuation ready to put before the judge in the first week of bankruptcy, as the plan proponents did.

43. The dissenting creditors did, however, contest the credibility of the valuation and the advisory-opinion author's incentives. *See* Brief of Appellants Indiana State Police Pension Trust et al., at *15–19, *Chrysler II*, 2009 WL 1560029 ["Brief of Indiana State Police Pension Trust"].

44. Neil King, Jr. & Jeffrey McCracken, *USA Inc.: U.S. Forced Chrysler's Creditors To Blink*, WALL ST. J., May 11, 2009, at A1.

45. *Id.*

If the Treasury was a controlling person of one or more the major banks, how should we look at the banks' consent? We'd then have to see Chrysler's major bankruptcy lender as controlling the votes of Chrysler's major prebankruptcy creditors, on a plan the lender itself designed. Normally this conflict is reason for serious concern—one that's too large to keep the various minority creditors in the same voting class as the four major banks. The classes would need to vote separately on whether to accept the reorganization plan proposed by the conflicted players and, then, without class consent, no plan could be confirmed without a judicial determination under § 1129(b) that priorities had been complied with.

The principal prebankruptcy bank lenders and the government, as both debtor-in-possession and exit-finance-lender, were too tightly related at the height of the financial crisis to be fully independent actors. De facto, the same party controlled the purchase and the sale. As such, with the same player on both sides of the sale, the best result conceptually would be to view the lenders' votes as tainted under § 1126 (and therefore excluded) or to separately classify the conflicted lenders' prebankruptcy loans from the others.'[46]

That § 1126 is designed to police these kinds of conflicts is clear both from the legislative history and from prior case law. In the House Report, lawmakers emphasized that the votes of creditors who have conflicting interests should be excluded, and explicitly disapproved of a case that had upheld a creditor vote outside of bankruptcy, despite an apparent conflict.[47] If a claimant acted "in aid of an interest other than an interest as a creditor," as a well-known case puts it,[48] or had some "ulterior purpose" for its approval or disapproval, in the words of the leading treatise,[49] its vote

46. Business-media hype about government pressure on the lenders to accede to the government's plan is beside the point. *See, e.g.*, Michael J. de la Merced, *Creditors Opposing Chrysler's Overhaul Plan End Alliance*, N.Y. Times, May 9, 2009, at B2. While not admirable if the acts occurred, such pressure isn't needed to make the case that a conflicted vote was in play. That some pressure was put on the banks is clear. While the administration may wisely have not explicitly reminded the banks, "[l]awmakers weren't so shy. Rep. Gary Peters [D-Mich.] . . . wrote to the bank CEOs listing their [bailout] loans and asking them to extinguish most of Chrysler's debt." King & McCracken, *supra* note 44. These considerations could also have discouraged the banks from proposing alternatives to the government's favored transaction. Since the big banks were unpopular then, they had a conflicted position even *without* the government in play, as they had reason not to be tough with Chrysler, its operations, and its employees, to reduce the chance that public opinion would turn further against the big banks.

Once the secured facility's controlling lenders had repaid the Treasury, their renewed freedom to move independently of government opinion was noticed. Robin Sidel, *Loan Paid, J.P. Morgan Swagger Returns*, Wall St. J., July 15, 2009, at C1 ("J.P. Morgan Chase & Co., freed from the government's strictures after repaying $25 billion in federal money, is back to playing hardball [with the government].").

47. H.R. Rep. No. 95–595, at 411 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6367; *see also In re* Dune Deck Owners Corp., 175 B.R. 839, 845 n.13 (Bankr. S.D.N.Y. 1995).

48. *In re* Allegheny Int'l, Inc., 118 B.R. 282, 289 (Bankr. W.D. Pa. 1990) (quoting *In re* P-R Holding Corp., 147 F.2d 895, 897 (2d Cir. 1945)).

49. 7 Collier on Bankruptcy ¶ 1126.06[1] (Alan N. Resnick & Henry J. Sommer eds., 15th ed. rev. 2009); *cf. In re* Holly Knoll Partnership, 167 B.R. 381, 385 (Bankr. ED. Pa. 1994) (favorably quoting similar statement in prior edition of Collier on Bankruptcy).

should not be included.[50] True, courts do not treat every conflict of interest as bad faith, and bankruptcy courts have been more lax than tough in policing conflicts. But if the big banks' approval of the Chrysler sale was motivated by factors other than their interests as creditors, some courts would have, and should have, disqualified their votes for Chapter 11 purposes or separately classified the two creditor groups.

Although the bankruptcy court considered consent, it did so in a different context and misunderstood the full range of reasons for it to have been wary of the majority banks' consent as binding the minority creditors.[51] Because the creditors were acting of their own volition and were not mere alter egos of the Treasury, the bankruptcy court asserted, their consent was real and not a capitulation due to pressure.[52] That instrumentality, alter-ego standard, if met, would indeed have been *sufficient* to disqualify the tainted vote, but wasn't a necessary hurdle. The court needed to have considered that a calculating creditor could have possessed the capacity to reject the Treasury's plan, but still cast a severely tainted vote, if the creditor understood that to do so would jeopardize other ongoing rescue arrangements, discourage regulatory forbearance, and constrict cash conduits from the Treasury worth more to it than fully contesting the Chrysler plan.

While the court said no one brought forth evidence that the banks decided due to their conflicted position—that the conflict was mere speculation—this is a weak, possibly naïve standard here. Wiser judging can be found in analogous state corporate-law conflict decisions. When a board

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50. For a succinct history of the good faith provision, see Patrick D. Fleming, *Credit Derivatives Can Create a Financial Incentive for Creditors to Destroy a Chapter 11 Debtor: Section 1126(e) and Section 105(a) Provide a Solution*, 17 AM. BANKR. INST. L. REV. 189, 200–09 (2009).

51. While we focus here on § 1129(a)(8)-based consent as a basis for approving the sale, the *Chrysler* court considered the ostensible consent of Chrysler's senior creditors in deciding whether to release their liens pursuant to § 363(f)(2) when the assets moved over to New Chrysler; if not, New Chrysler would be subject to the liens. Consent was considered under the senior creditors' loan agreement, which arguably allowed the creditors' agent—JP Morgan Chase, as it happens, one of the major lenders—to release collateral and sell it, even without the consent of the creditors. First, the court understood that a threshold issue was whether there was a valid sale. (It concluded that there was and that there was no sub rosa plan embedded in the sale—mistakenly in our view.) The court then wondered whether it had jurisdiction to resolve any intercreditor, state-law-based dispute and offered the no-evidence-of-being-incapable-of-resisting-the-Treasury standard indicated in the text. It viewed the creditor class as a single creditor, with its agent consenting. Hence, it didn't need to look behind that agent's consent and even wondered whether it had jurisdiction to do so. But the dissenting creditor argued that the agreement required each affected party to consent to a release of collateral.

Even if the agent's consent sufficed under the loan agreement, however, once the sale is a sub rosa plan because it de facto determined distributions, case law demands that the § 363 sale either be abandoned (*Braniff*) or comply with § 1129 (*Continental*). Creditors would vote by their dollar claims and individually under § 1129(a)(8) (the agent would *not* cast the sole vote on behalf of the creditor class), with those votes subject to § 1126(e) exclusion, and individual creditors would have § 1129(a)(7) rights. The § 363 result removes the collateral from the bankrupt estate under § 363(f), if the sale itself is otherwise proper, but neither validates the transaction's other terms nor justifies the treatment of the products-liability and other claims left behind in Old Chrysler.

52. *Chrysler I*, 405 B.R. at 103–04. More precisely, it concluded that the evidence to the contrary—that the banks lacked volition—was speculation.

litigation committee decided not to pursue a remedy in derivative litigation, the corporate law court examined the conflicts afflicting a Stanford law professor on the board committee. The court saw the benefits the company and its other directors could have, and had, provided the director's university. The judge did not, as the Chrysler judge appears to, look primarily for a money trail leading to the professor's bank account. Nor did the corporate law judge view the conflict as speculative, one needing evidence of actual pressure from inside interests on the professor to favor his board colleagues and alma mater. The judge saw a conflict, knew that the pressure and conflict could be inside the director's head and, hence, concluded that the director's actions were not entitled to deference.[53]

So it was in *Chrysler*, in all but the judge's conclusions. No one should have had to show either a money trail running to the controlling banks from the U.S. Treasury or explicit pressure via a smoking-gun memo, email or phone call to the banks. That the banks might have overcome their conflict is surely true, but equally surely not good enough for the court to dismiss the conflict as speculative. All the judge needed to know was that the conflicts were severe—and quite possibly inside the heads of the decision makers at Citibank and the others then dependent on the U.S. Treasury—to conclude that the court had before it a serious § 1126 problem. The notion that the level of conflict of interest needed to be taken seriously under § 1126 was one that the banks lacked any will of their own—that they were mere instrumentalities—is too low a standard.

Best view: the class consent was inadequate to bind the dissenters under § 1129(a)(8).

C. *The Market Test*

An alternative to a judicial valuation or a bargained-for result is a market test. If Chrysler were put up for sale in a suitable market and no one bid more than $2 billion, then that plausibly was its value. Creditors would have had their makeshift substitute, and the § 363 sale would have been proper. The courts' deference to the sale proponents' weak market test was the single most disturbing feature of the Chrysler bankruptcy. Because the ostensible consent was at least tainted and perhaps inadequate, because judicial valuation assessments are inherently difficult, and because the deal was more a reorganization than a true sale as Part IV, next, shows, the market test was the key way by which the Chrysler plan could have fully justified itself, removing the taints. But it did not.

There was a market test of the Chrysler plan, but unfortunately no one could believe it adequately revealed Chrysler's underlying value, as what was put to market was the sub rosa plan itself. Chrysler and the government asked the court to permit the firm to be marketed only *with* multiple prebankruptcy claims on Chrysler intact, including the United Automotive Workers' ("UAWs") retiree claims. But that's exactly what was at stake:

53. *In re* Oracle Corp. Derivative Litig., 824 A.2d 917 (Del. Ch. 2003).

whether Chrysler's assets were more valuable without those claims. The bankruptcy court turned down the objecting creditors' request to market the assets alone.[54]

Here is the weakest link in the government's and Chrysler's case. They argued that the firm was worth no more than $2 billion. As such, they should not have stymied the Chrysler creditors from seeking to sell the assets for more than $2 billion, as they—the government and Chrysler—believed that the creditors would fail.

The government and Chrysler argued that they had scoured the world for a bidder for Chrysler and had found only one, FIAT.[55] But they were marketing variants of the bankruptcy plan actually used, one that didn't separate Chrysler's assets from its largest preexisting liabilities. As such, their efforts were efforts to market the plan they preferred, not the alternative plans the Code requires the court to test.[56]

And the Chrysler bankruptcy bidding procedures discouraged competing bids—and, indeed, no competing bid was received. Bankruptcy courts do often require that bids be "qualified," but they do so mainly to screen out frivolous bids and to encourage bids that improve on the bid from the initial, stalking horse bidder (who typically wants to deter others from bidding, a motivation that induces courts to police proposed conditions).[57]

The Chrysler qualifications went much further than deterring frivolous bids. To be deemed "qualified" in the Chrysler bankruptcy, a bid had to, among other things, conform substantially to the terms set out in the Treasury's proposed Purchase Agreement. Bidders were bound by the government's deal, which included agreeing to take on Chrysler's collective-bargaining agreements and much of its prebankruptcy debt but not the $6.9 billion secured facility and the ongoing products-liability claims.

Bidders were not free to bid on Chrysler's assets alone, nor were they readily able to bid on other configurations of a reorganized Chrysler. A

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54. Order, Pursuant to Sections 105, 363 and 365 of the Bankruptcy Code and Bankruptcy Rules 2002, 6004 and 6006, at 18, *Chrysler I*, 2009 WL 1360869 ["Order Approving Bidding Procedures"].

55. Motion of Debtors and Debtors in Possession, Pursuant to Sections 105, 363 and 365 of the Bankruptcy Code and Bankruptcy Rules 2002, 6004 and 6006 at ¶ 46, *Chrysler I*, 2009 WL 1227661 ["Motion of Chrysler to Approve Bidding Procedures"].

56. General Order M-331 [of the Southern District's Bankruptcy Court], *supra* note 32, at 3 (Bidding procedures "must not chill the receipt of higher and better offers . . . ."); *see also In re* President Casinos, Inc., 314 B.R. 784, 786 (Bankr. E.D. Mo. 2004) ("Structured bid procedures should provide a vehicle to enhance the bid process and should not be a mechanism to chill prospective bidders' interests."). More generally, as the Supreme Court has said, "the best way to determine value is exposure to a market." Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 457 (1999). That implies a real exposure to the market, not one designed to chill market reaction.

57. Qualified bid requirements aim to "eliminate potential overbidders who are not serious about purchasing the debtor's assets, ensure the sale can be rapidly closed if an overbidder should purchase the assets, and ensure that the net purchase price is higher than the original bid should overbidding occur." Ronald L. Liebow, Steven F. Werth, N. Lynn Hiestand, Jeffery Steinle, and Alexa Palival, *Distressed Asset Sales: Selling and Acquiring Assets from the Debtor's Estate,* Practicing Law Institute Commercial Law and Practice Handbook Series, PLI Order No. 5989, at 85, 87 (Mar.-Apr. 2005).

nonconforming bid would be considered only if the debtor, after consulting with creditors, the Treasury, and the UAW, accepted it as qualified. While one must assume that had a party, sua sponte, come into the court with a competing bid on differing terms, the court would not have ignored the bid, nothing in the court's approval of the bidding procedures indicated that the court would welcome such a bidder offering a check for the assets alone. Bids proposing alternative configurations of the UAW and VEBA obligations were discouraged or, more realistically, barred. Even if an outsider valued the assets alone at more than $2 billion, it had to know that neither the court nor the central parties would allow those assets to be pried loose.[58]

This is a serious defect in the bidding procedures. First, with the government having committed itself to rescuing Chrysler, bidders who contemplated buying pieces of Chrysler—the Jeep product line, for example, or piecemeal equipment or Chrysler's new $1 billion car-body stamping plant—had to know that they were not competing with a commercial bidder who realistically could be outbid. Since the Treasury would not be outbid, why should a commercial bidder bother to study the company carefully enough to place a bid? Given this baseline, getting a valid bidding process for Chrysler was not going to be easy, but the court too readily accepted Chrysler's, the government's, and the UAW's preferences that there not be a serious bidding process at all. With the Treasury and the UAW as parties who would evaluate the bids under the court-approved procedures, the court signaled that there would not be a substantial, serious bidding process, thereby chilling whatever outside interest existed in alternative configurations. Conditioning that outside bids be acceptable to the Treasury and the UAW was peculiar, or at least nonstandard. Sales in which a single entity is both lender and bidder, as was the government in *Chrysler*, warrant special vigilance, such as a robust market test, not a weak one.[59]

This auction defect extended back to the prebankruptcy marketing: since bidders knew that the government had a structure in mind—keeping Chrysler's operations and employment as intact as possible—bids for the assets alone, or with a different labor configuration, would not have been forthcoming. The problem has its analogue in more usual bidding informational problems: if insiders have better information, outsiders have reason to fear that if they value the firm more highly than insiders, they'll overpay. So they do not investigate and bid in the first place. Here the insiders had not just better information, but policy goals that made a wide range of Chrysler's potential sales configurations unacceptable to those that the court allowed to control the firm's disposition.

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58. The Chrysler auction differed starkly in this respect from the sale of TWA's assets to American Airlines, which some have cited as an analogue to *Chrysler*. The bidding procedures in TWA explicitly invited "alternative transactions" and bids for any part of the company. *In re* Trans World Airlines, Inc., No. 01-00056(PJW), 2001 WL 1820326, at *6 (Bankr. D. Del. Apr. 2, 2001).

59. *See, e.g.*, Kenneth Ayotte & David A. Skeel, Jr., *An Efficiency-Based Explanation for Current Corporate Reorganization Practice*, 73 U. Chi. L. Rev. 425, 465-67 (2006).

Moreover, with the court accepting the proponents' request that Chrysler be sold quickly, outside bidders were given little more than a week to place bids, which did not make for easy due diligence or financing. Bidders were required to put down a cash deposit of 10 percent of the purchase price proposed. Chrysler reserved "the right, after consultation with the Creditors' Committee, the U.S. Treasury and the UAW, to reject any bid if such bid" was "on terms that are materially more burdensome or conditional than the terms of the Purchase Agreement."[60] The Purchase Agreement stated the terms to be accorded the majority of Chrysler's prebankruptcy debts. The reality was that the deal as proposed was going forward.

A good market test could have validated the § 363 sale process, but *Chrysler* lacked one. True, even a workable market test is not a cure-all. It will never perfectly ensure that a company receives top value for its assets, and there are inherent defects in any auction. And it does not by itself resolve the plan-determination issues of how the sales proceeds would be distributed. These issues were particularly acute for Chrysler because its bidding plan largely determined the distribution in the Chrysler Chapter 11. But the bidding structure in Chrysler was far removed from a genuine market test that could validate the actual § 363 sale that occurred.

D. *The Emergency—How Immediate?*

Lionel requires that sales be made only if there is a valid business purpose. The posture of the Chrysler case seemed to rely on the business emergency—Chrysler would, it was said, be forced to liquidate shortly after June 15 if the sale to FIAT did not close by then. Indeed, plan proponents in places seemed to rest solely on an emergency standard as sufficient in itself to justify cutting § 1129 priority corners and doing so quickly,[61] despite that *Lionel* had the emergency justifying a business purpose for a sale, but *not* justifying ignoring priority. The proponents' aggressive interpretation is one that courts had not previously promulgated.

Much was made early in June of the fact that FIAT had agreed to purchase Chrysler's core on June 15. This was portrayed as providing both the business justification for the sale—a buyer who might turn the company around—and the pressing need to approve that sale immediately, because any stay to the proceedings that went past June 15 jeopardized the sale.

But the emergency status was greatly exaggerated, with the threat that Chrysler would promptly liquidate if the FIAT deal did not go forward on June 15 implausible. To understand why the liquidation threat was overplayed—which seemed to move the courts both in quickly approving the

60. *Chrysler I* Order Approving Bidding Procedures, *supra* note 54, at *6, *20.

61. Brief for Debtors-Appellees Chrysler LLC, et al., *Chrysler II*, 2009 WL 1560030, at *22–24.

sale and in not staying its closing for a closer look—we need to follow the money in the Chrysler deal.

While a deadline from a typical purchaser who is providing, say, $2 billion in fresh money is something bankruptcy courts must take very seriously, Chrysler was *not* in that situation and FIAT was *not* that kind of cash purchaser. The cash came from the U.S. Treasury, not from FIAT.

Without FIAT, Chrysler and the Treasury could have used the GM template, without a figurehead outsider as a purchaser that provides no cash. Moreover, FIAT's chief executive conceded that FIAT would never walk away from the deal.[62] And why would it? It was not asked to pay anything.

The Treasury could have pulled the plug, not FIAT. But the Treasury was not about to. While the judge stated a fear that the Treasury would walk if the June 15 deadline were missed, one wonders how credible this fear was, when the Treasury was a major architect of the plan and was simultaneously actively preparing an analogous reorganization of General Motors.[63]

If Chrysler's operations were like the melting-ice-cube metaphor that's been used in this setting[64]—about to collapse and only the sale could allow any value to be obtained—then a court would have to weigh competing considerations. Since Chrysler had already shut down its plants due to weak demand, a limited delay was unlikely to affect production.[65] Chrysler did not have all the time in the world, but there was sufficient time—weeks, maybe a month—for the courts to fashion the makeshift checks that prior case law demanded, to confirm that the plan complied with § 1129 and, if it did not, to induce the parties to reshape the plan.

Moreover, the emergencies in the past have been judicially cited to support a § 363 sale instead of a full-scale § 1129 reorganization, but *not* to support the idea that no protections, makeshift or substantial, are needed in a

62. *See, e.g.*, Serena Saitto, *Fiat Will 'Never' Walk Away From Chrysler, CEO Says*, BLOOMBERG.COM, June 8, 2009, http://www.bloomberg.com/apps/news?pid=20601087&sid=aS_6UyCqIJmA. The record before the court included the concession.

63. *See, e.g.*, David E. Sanger & Bill Vlasic, *Chrysler's Fall May Help Obama to Reshape G.M.*, N.Y. TIMES, May 2, 2009. The Treasury itself, and not FIAT, created the June 15 deadline in its DIP financing. If it wanted to extend a few weeks, while the plan was adequately vetted under § 1129 for compliance, it could have. FIAT would, the indicators strongly suggest, have waited. Given that the Treasury was sponsoring the Chrysler rescue, it's unlikely it would have walked away disgruntled if it had to wait a few more weeks for a real auction. Still, alternate scenarios had uncertain outcomes if the delay got out of hand: one economic advisor, who opposed any Chrysler bail-out, believes that without FIAT the government would not have bailed Chrysler out. Ryan Lizza, *The Political Scene—Inside the Crisis*, THE NEW YORKER, Oct. 12, 2009, 80, 95.

64. *E.g.*, *In re* Summit Global Logistics, Inc., 2008 Bankr. LEXIS 896 at *31 (Bankr. D.N.J. Mar. 26, 2008); *see also Chrysler II*, 576 F.3d at 114 ("[A]n automobile manufacturing business can be within the ambit of the 'melting ice cube' theory . . . .").

65. *See, e.g.*, Michael McKee, *Chrysler Bankruptcy May Not Dent Economy as Cutbacks Were Set*, BLOOMBERG.COM, May 5, 2009, http://www.bloomberg.com/apps/news?pid=20601110&sid=aOofvGXOZKk4 ("[Due to weak demand,] Chrysler probably would have had to shut down temporarily anyway, said Mark Zandi, chief economist at Moody's Economy.com . . . . Chrysler, which filed for the fifth-biggest U.S. bankruptcy last week, already had been . . . closing factories because of the industry's slump.").

sale that determines core priorities. If courts come to accept this argument, they should understand that they're breaking new—and dangerous—ground. *Continental* makes clear that creditors are entitled to some remedy, but neither the *Chrysler* bankruptcy court nor the Second Circuit came to grips with either that opinion or the underlying importance of respecting § 1129.

* * *

For *Chrysler* to comport with prior case law, the § 363 transaction could not have been a sub rosa plan of reorganization, as it was. A business emergency justifies a sale, perhaps even a speedy one, but has not until now justified abandoning basic creditor protections and priority. Terms that ordinarily are resolved under § 1129 should not have been resolved in the § 363 sale, unless the process provided satisfactory, even if makeshift, substitutes.

But this was not done. The market test was one that could not have elicited suitable bids, because it was set to replicate the deal then at hand, the one already engineered by the insiders, when the very question was whether creditors could have obtained more money via a different deal. Some core problems could have been seen as substantially remedied by the consent of much of the senior creditor class. But the consenting majority was largely dependent on the U.S. Treasury's good graces at the time, to the point that they—the Treasury and the consenting banks—should have been seen as nearly alter egos. This leaves only the valuation, which is the least favored of the makeshift remedies, and consisted only of Chrysler's own valuation. It's the best justification, even if it's a weak one, for the sale.

IV. Was Chrysler Reorganized or Sold?

In Part III, we saw that prior decisions soundly held that a § 363 sale that determines § 1129 results is a sub rosa plan. In such settings, the bankruptcy court must either reject usage of § 363 or find that the sale would have complied with § 1129. Since *Chrysler* failed to comply here, it's a dangerous precedent. Prior cases analyzed genuine sales, and we have thus far analyzed *Chrysler* as if the company were genuinely sold. But it is far from clear that the Chrysler transaction was a sale. We need to examine the possibility that there was *no* real third-party sale, that at its core *Chrysler* was a reorganization.

Indeed the best view is that Chrysler was *not* sold; it was reorganized.

A. *The Case That Chrysler Was Reorganized, Not Sold*

1. *Old Chrysler's Mandates to New Chrysler*

First off, this inquiry relates to a weak justification for the sale that views the assets as having been sold cleanly to New Chrysler, without Old Chrysler's debts, but with New Chrysler then sua sponte picking up obligations to some, but not all, of Old Chrysler's creditors. This idea represents the kind of formalistic thinking that courts usually reject. Yet the bankruptcy judge said that "the UAW, VEBA, and the Treasury are not receiving distributions on account of their prepetition claims. Rather, consideration to these entities is being provided under *separately-negotiated* agreements with New Chrysler."[66] Even if some of these claims needed to be picked up by the surviving entity in *Chrysler* as a business matter, it's an uphill argument that these claimants were not receiving distributions on account of their prepetition claims. Were it not for the creditors' prepetition claims on Old Chrysler, New Chrysler would not have picked up and promised to pay those creditors.

The business trade-offs are clear in the debt carryover, but the bankruptcy policy considerations are hard to evaluate: Yes, Chrysler needed its suppliers and it needed peace with the UAW—consider airline restructurings where the airlines pick up frequent flyer obligations so as not to disrupt relationships with customers. But it's hard to conclude without analysis that these players received their distributions from New Chrysler alone, and that their distributions were not on account of their prebankruptcy debts that Old Chrysler owed them. These New Chrysler payment promises look like reorganization decisions, not an arm's-length purchaser's independent decisions.

Consider key Chrysler terms that should raise eyebrows as to whether New Chrysler's decision was really spontaneous. One, Old Chrysler *required* that New Chrysler pick up Old Chrysler's core obligations to trade creditors, the UAW, and the VEBA facility.[67] The major $4.6 billion note plus stock ownership for Old Chrysler's VEBA obligations oblige New Chrysler to pay Old Chrysler's obligations to *inactive* employees, but it's the *active* employees that New Chrysler needs for its operations and the multibillion-dollar VEBA plan excluded active employees. The VEBA payout, as well as the requirement that New Chrysler pick up all obligations to Old Chrysler's trade creditors, was explicitly required of New Chrysler in the Master Transaction Agreement between Old and New Chrysler. Explicitly requiring that pickup hardly indicates an arm's-length sale, with the buyer then deciding on its own which players' interests it needed to assuage to move forward. Why did the legacy players and trade creditors need to *require* this, if it were in New Chrysler's own interest, expressed sua sponte?

And, two, Old Chrysler's Official Committee of Unsecured Creditors *approved* the assets' sale to New Chrysler. But why would they approve a sale *none* of whose proceeds would go to the creditors they represented?

66. *In re Chrysler I*, 405 B.R. at 99 (emphasis added). The Second Circuit truncated its discussion of this crucial issue, saying only: "As Bankruptcy Judge Gonzalez found, all the equity stakes in New Chrysler were entirely attributable to *new* value—including governmental loans, new technology, and new management—which were not assets of the debtor's estate." *Chrysler II*, 576 F.3d at 118. While it's easy to attribute the FIAT stock interest as arising from new value, it's not easy to see the 55 percent VEBA stock ownership as arising from new value as opposed to past services to Old Chrysler.

67. *See* Motion of Chrysler to Approve Bidding Procedures, *supra* note 55, at Exhibit A: Master Transaction Agreement among FIAT S.p.A., New CarCo Acquisition LLC, Chrysler LLC and the other Sellers identified herein.

The cash was going just to Old Chrysler's secured creditors; *nothing* from the sale was going to the unsecured. The answer is obvious but unhelpful to viewing Chrysler as sold and not reorganized: the committee knew what was coming to them from New Chrysler, because the transaction agreement required it. The post-"sale" structure required by the Chrysler Master Transaction Agreement indicates it was de facto a plan of reorganization—not an arm's-length sale.

2. *The Before-and-After Resemblance*

This nonsale possibility shows a deeper disturbance in the Chrysler Chapter 11 beyond it being a sub rosa sale. Perhaps the Chrysler transaction should not even be seen as a sale, because Chrysler was not really sold to a third party. Quite plausibly, it should be collapsed into a simple before and after. If so collapsed, it was a reorganization that failed to comply with § 1129, not a § 363 sale.

It's a basic principle that courts will not countenance a series of steps that in isolation are defensible, but that when strung together change the fundamental character of the transaction. *Gleneagles* illustrates how bankruptcy courts take transactions comprised of plausible steps and evaluate them by comparing the end result with the initial position, particularly when the initial players knew what the end result would be.[68] In *Gleneagles*, a cleverly designed leveraged buyout left the target insolvent. No single step in the transaction violated fraudulent conveyance law. But the Third Circuit compared the final to the initial structure, added that all active parties knew where the deal was going, and held the transfer to be a fraudulent conveyance.[69]

Chrysler is similar: The final structure has most prebankruptcy assets and creditors in place in New Chrysler, with a few, most notably the secureds and the products-liability claims, left behind in a weak Old Chrysler shell that had seen its best assets (and most of its liabilities) go. While some steps could have stood on their own, alone, had there been no more, the totality is that Old Chrysler was reorganized in Chapter 11 via a pseudo-sale to a shell company controlled by those who controlled Old Chrysler. It's no more a sale than if you move your wallet from your coat pocket to another pocket and drop a few dollars along the way; you haven't sold or bought anything. *Chrysler* was a de facto reorganization, not an arm's-length sale.

A before-and-after look at Chrysler's balance sheet illustrates.[70] On the asset side, New Chrysler ended up with the bulk of the assets of the

68. United States v. Tabor Court Realty Corp., 803 F.2d 1288 (3d Cir. 1986), which is typically referred to as *Gleneagles*, its lower court name.

69. *Id.* The older, classic case invoking the principle is *Pepper v. Litton*, 308 U.S. 295, 305 (1939).

70. For a transaction summary, see Motion of Chrysler to Approve Bidding Procedures, *supra* note 55, ¶ 58; for full details, see *id.*, Exhibit A. *See also* Kolka Affidavit, *supra* note 11. FIAT did not receive 35 percent of the New Chrysler stock right away, but a smaller amount, with the

prebankruptcy Chrysler—the Chrysler, Dodge, and Jeep vehicle lines, as well as most of its factories. It will continue to assemble and sell the same vehicles, at the same factories, and under the same names. Most employees are being kept on at the same locations.

The asset continuity is unremarkable. A sale of the firm in its entirety moves the assets to a new entity. It's the liability side of the balance sheet that's troubling for the assertion that the sale didn't distribute value to the prebankruptcy creditors on account of their prebankruptcy debts. It's troubling because the liabilities of the New Chrysler are substantially those of the Old Chrysler. The trade credit stays the same, the warranty and dealer liabilities remain the same, the underfunded pensions remain the same, and the VEBA obligations are still there although transmuted. Mergers often have liabilities traveling with the assets, but few would assert that the buyer is picking up those liabilities sua sponte. They pick them up because the seller makes the debt assumption part of the deal.

Old Chrysler		**New Chrysler**	
Secured Debt		Secured Debt	
First Lien	$6.9 B		
Second Lien (prior shareholdrs)	$2 B		
Third Lien DIP (government)	$4.5 B	Government	$6 B
Unsecured Debt		Unsecured Debt	
TARP Loan	$4 B		
Trade Debt	$5.3 B	Trade Debt	$5.3 B
Warranty and Dealer	$4 B	Warranty and Dealer	$4 B
Underfunded Pensions	$3.5 B	Underfunded Pensions	$3.5 B
VEBA Obligations	$10 B	VEBA Note	$4.6 B
Shareholders' equity		Shareholders' equity	
Cerberus		VEBA	55%
		FIAT	35%
		U.S. Treasury	8%
		Canadian government	2%

But in bankruptcy, § 1129's priority rules bar lower-ranking creditors from receiving anything "on account of" their claims, as the *Chrysler* judge indicated, unless senior creditors are paid in full and unless similarly ranked creditors are paid ratably.[71] In *Chrysler*, the court sidestepped this core Chapter 11 requirement by claiming that New Chrysler picked up the prebankruptcy liabilities of its own, independent volition and not on account of the debts Old Chrysler owed. That an arm's-length buyer would have volunteered to pick up all of nearly $20 billion of legacy obligations for the goodwill involved seems a practical, although not a logical, stretch. (If the buyer needed the UAW's goodwill and acquiescence, it might

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difference to be given later if targets are met. Because the numbers in the balance sheet in the text have been widely reported, we have kept these as is.

71. 11 U.S.C. § 1129(b)(2)(B) (2006). Similarly, consider the analogous transaction, prepetition. If the bankrupt-to-be sold assets in a prebankruptcy transaction that required the buyer to assume some of the bankrupt's debts, the other creditors could in the ensuing bankruptcy avoid that transfer as being a preference and recover the transferred assets for the benefit of all creditors.

indeed have had to buy it; an auction could have better revealed how much that would cost.) Since the bidding procedures did not allow alternative bid packages, one suspects that the insiders feared that some bidder might have bid for the assets and sought to make a different deal with the UAW.

Overall, the major difference on the liability side between prebankruptcy Chrysler and the postbankruptcy New Chrysler is that the senior lenders' deficiency claim, the products-liability claims, and the prior owners' claims and interests were wiped out and the government came in to fund the New Chrysler. New Chrysler picked up about $20 billion of Old Chrysler obligations, sua sponte, in the bankruptcy court's analysis, as illustrated in the chart above.

3. *A Rule of Thumb to Sort Legitimate § 363 Sales from § 1129 Reorganizations*

Bankruptcy courts will need appellate guidance on what really constitutes a reorganization that's hidden inside a defective § 363 sale. Consider a spectrum. At one end, the old firm is sold for cash in a straightforward, arm's-length sale to an unaffiliated buyer who wins the company in an open auction against other third-party bidders. It's a prime candidate to be a legitimate § 363 sale and should presumptively be respected as one.

At the spectrum's other end, the bankrupt firm's operations are transferred to insider creditors who obtain control by bidding their prebankruptcy loans in a pseudo-sale without an arm's-length bidder and with the new capital structure substantially drawn from the old one. That transaction isn't a § 363 sale; it's a reorganization that needs to comply with § 1129.

How about transactions in the middle? A § 363 purist would insist that only arm's-length cash sales get to use § 363; all others must proceed under § 1129, with its disclosure, classification, voting, and priority protections for creditors. And the purist's bright-line test would be the easiest to administer. Flexible courts will see cases in the middle of the spectrum and consider whether they're so much like the arm's-length cash sale that they should proceed under § 363 anyway without the weight of § 1129: an arm's-length sale, for example, that determines a few minor, secondary priority issues involving small numbers might as well go ahead, a court looking to clear its docket might conclude. For those with minor deviations, § 363 should be available, with complaining creditors accorded *Continental*–style makeshift remedies.

The problem of administrability, if we abandon the purist's position, is for appellate courts to devise a rule of thumb to flag transactions to be wary of, because they are too far away from arm's-length sales for cash. A rough rule is this stark, two-prong, either-or test: if the post-transaction capital structure contains a majority of creditors who had constituted more than half of the old company's balance sheet, while the transfer leaves significant creditor layers behind; or if a majority of the equity in the purportedly acquiring firm was drawn from the old capital structure, then the transaction is too much more than a cash sale to be entitled to § 363 treatment. It is presumptively a reorganization, not a bona fide sale.[72]

In *Chrysler*, nearly 80 percent of the creditors in the new capital structure were from the old one and more than half of the new equity was held not by an arm's-length purchaser, but by the old creditors.[73] The extent to which New Chrysler took over claims from Old Chrysler contrasts to prior § 363 cases.[74] Prior § 363 sales had some prebankruptcy debt tag along, but our understanding is that Chrysler's tag-along was much higher than usual.

Chrysler was reorganized, not sold.

B. *Consequences of a Nonsale: Valuation Inconsistencies*

Looking at Chrysler as not truly sold brings other shortcomings of the *Chrysler* analysis into focus, because Chrysler's and the governments' valuation arguments had potential internal inconsistencies that the courts never addressed. First, the implicit preexisting value of Chrysler and the governments' cash infusion seems disproportionate. Chrysler was contributing $2 billion in value to the new firm, while the government was investing $15 billion. These numbers suggest more than a simple rescue.

Second, New Chrysler's balance sheet shows it supporting nearly $20 billion of old debt; someone must have thought that the reorganized Chrysler could provide value well in excess of the $2 billion assigned to its assets in the § 363 sale.

Third, although the favored treatment of the employee retirement claims seems to come from the governments that were subsidizing the firm—justifying any priority deviation if the American and Canadian governments were paying for it—the structure is more complex. The governments' claims come first in New Chrysler's capital structure, *before* the retirees' claims. If the retirees' claims have value, then either the governments see going concern value in Chrysler well beyond their own contributions, or the governments are really making an equity investment, in that they plan to forgive their loans eventually, to the benefit of the employees.

72. The presumption could be rebutted, with the judge turning to process. If, say, an old creditor bids for the firm in a § 363 sale and wins in an open, contested, and clean auction without bidding preconditions and with true arm's-length bidders, then the judge should consider the presumption rebutted: there's been an open auction and the old creditors bid the firm away from outsiders.

73. The back-of-the-envelope calculation is this: Chrysler's old balance sheet had $40 billion in debt. Creditors with $30 billion of that debt reappear largely intact in the New Chrysler's balance sheet. A few gave new value, most did not.

74. When a bankrupt TWA sold its assets to American Airlines in 2002—a sale thought to represent a Chrysler precedent—American assumed most of TWA's pension obligations and the capital leases on its airplanes, as well as $638 million of its trade debt. But a large portion of its trade debt was not assumed, American did not pick up TWA's other unsecured debt, and TWA's creditors and shareholders did not receive any stock. For discussion of two other cases sometimes mentioned as similar to Chrysler, see *infra* note 79.

And, if a future reorganization is needed so that Chrysler can restructure the new and the carried-over debts, then the transaction would not comply with § 1129(a)(11), which requires that the judge find the plan not likely to be followed by a future reorganization of the debtor. To be sure, this section is not core to the § 1129 plan-confirmation standards and it's not regularly used to strike down plans. And one could formalistically state that Old Chrysler will not need further reorganization other than as contemplated in the plan and it's only Old Chrysler that counts under the plan. New Chrysler is the strong candidate for future reorganization, but, it could be argued, it wasn't subject to § 1129(a)(11). Properly seen, though, it's all one plan of reorganization.

Section 1129(a)(11)'s not-likely-to-be-followed-by-further-reorganization rule requires the judge to confirm that the reorganization plan is likely to handle the bankrupt's operating and financial problems. The Code is looking via § 1129(a)(11) to avoid reorganization recidivism, seeking to resolve a firm's financial troubles as best it can in one proceeding. The only way to interpret the actual deal structure, however, is that either (1) there was value in Chrysler sufficient to pay tens of billions of dollars of unsecured claims (since the government's loans were superior in right of payment and could not be providing much value to those claims) or (2) the inside players expected a future reorganization of New Chrysler that will either wipe out those claims or have the government forgive its claims on the reorganized entity. If the former, priorities were violated. If the latter (which seems plausible), § 1129(a)(11) was violated.

We point this out not because it seems highly likely that such going concern value existed independently of the government's multibillion-dollar rescue, but to demonstrate that the rapid process neglected to uncover logical difficulties with the plan, much less actual valuation difficulties.

Regardless, the capital structure of New Chrysler suggested that there was value in the company for the creditors beyond the $2 billion actually paid them. Under the plan, New Chrysler satisfied the claims owed to retirees in the VEBA facility with a note in the amount of $4.6 billion and a 55 percent equity interest in New Chrysler. The governments financed New Chrysler's operations with $6 billion in senior secured financing. Any returns on the $4.6 billion note and equity owned by VEBA would ordinarily come from earnings beyond those necessary to pay back the governments' loans. The assets that New Chrysler purchased for $2 billion support claims from Old Chrysler of nearly $20 billion. While it's logically possible that the assets were worth only $2 billion, but the going concern could support ten times as much value, that result would not seem a practical likelihood. This capital structure, if it's viable, points to Chrysler having a value above the $2 billion secured benchmark.

However, to assess the sufficiency of the $2 billion payment, the bankruptcy court would have needed to resolve a cluster of priority valuation ambiguities, several of which would have favored the plan proponents, not the lenders, although others would have favored the lenders. Start with the valuation ambiguities that would favor plan proponents. Many preexisting trade creditors were ripe for a critical-vendor priority that would justify paying them in full.[75] And the Code would require that obligations to the retirees not be held in abeyance like other prebankruptcy obligations, but be paid out, under § 1114, during the time it would take to reorganize the company. While these creditors would be paid out of Chrysler's general funds, Chrysler's secured creditors would not, under *Timbers*, be entitled to the time value of delay in realizing on their security, if there were a multiyear Chapter 11 proceeding.[76]

But other offsetting factors would have favored the lenders. First, the § 1114 payments to retirees would have been much less than the billions of dollars transferred over from Old to New Chrysler.[77] Second, some trade creditors would not have qualified as critical vendors.

And, third, a more basic rule would have further favored the financial lenders. Bankruptcy bars "unfair discrimination" in § 1129(b), which is bankruptcy's way of saying that similarly ranked creditors should be paid pro rata, without some grabbing a bigger percentage of their claim than others. Chrysler's secured lenders were entitled to pro rata treatment with unsecured creditors on the unsecured portion of the secureds' claim (the deficiency that their security did not cover). With the lenders receiving nothing for their unsecured deficiency claim, while other unsecured creditors were promised substantial recoveries, this rule seems to have been violated. Other creditors disfavored in the Chrysler transaction, such as the products-liability claimants, could readily assert that they too were victims of unfair discrimination. For those deviations to be allowed, the court would have had to sign on to some larger justification, perhaps one that extended critical vendor doctrine to a labor force needed to run the assembly lines, given the possibility that an angry labor force (which, with the employee retirees, held major claims on Chrysler) would be costly to Chrysler in multiple dimensions.

One can imagine the form such an argument might take: Chrysler may not have been an effective organization without the UAW's agreement; or when one understands the realpolitik that the government would not provide cash without the UAW being roughly satisfied and that a plan that didn't preserve many jobs would not be acceptable to the UAW, then the real range of plans that were viable had limits. Even a purely financial bidder without the government's policy motivations may have decided to

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75. Critical vendors are suppliers that are vital to the debtor's business. Courts permit the debtor to jump them in the payment queue on the theory that disrupting their relationship with the bankrupt would cost the bankrupt more than paying them. *See* Mark A. McDermott, *Critical Vendor and Related Orders:* Kmart *and the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, 14 AM. BANKR. INST. L. REV. 409 (2006).

76. United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs., Ltd., 484 U.S. 365 (1988) (holding that an undercollateralized secured creditor is not entitled to interest payments during the bankruptcy's pendency).

77. The § 1114 bonus to the retirees' claims would cover the period of the reorganization itself, which is typically a two-year affair, not more. And Chrysler's desperate shape could have led the bankruptcy court to reduce the § 1114 payment obligation. 11 U.S.C. § 1114(h) (2006).

keep similar UAW terms for current employees, as it would need a trained labor force and no other was available, and even if it didn't need that labor force, a disgruntled UAW could not have been good for such a bidder.

But the critical vendor analogy seems faint when the major $10 billion carryover was for those no longer working at the auto company. The critical-vendor analogy makes most sense for ensuring that the labor force's ongoing wage rate is adequately preserved and that obligations to the ongoing workers are respected. In prior bankruptcies with powerful labor, auctions were done and bidders made deals with the unions. Bethlehem and LTV are two prominent ones;[78] in both reorganizations the proportion of the claims carried over to the new company was much less than that in Chrysler. Wilbur Ross's International Steel Group picked up a much smaller fraction of Bethlehem's liabilities—less than a third,[79] in contrast to Chrysler's nearly 80 percent—and, in contrast to the Chrysler before- and after-relationship, old Bethlehem did not control the buyer.[80] The Bethlehem and LTV auctions and deal making are suggestive of the limited extent to which the claims on Old Chrysler truly were claims from clearly critical vendors. But without a real auction having been attempted in Chrysler, we don't know whether anyone would promise to pay the full $10 billion to retirees to better motivate current employees and, hence, one cannot be sure whether value came from the lenders instead of just from the government.

Whether all of these ambiguities would have been resolved against Chrysler's lenders if they were fully played out is hard to say. But it is easy to say that the sale did determine the distributional result, demonstrating it was indeed a sub rosa reorganization plan.

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In Part III, we highlighted the fundamental problem with the *Chrysler* opinions: even if the sale were appropriate under § 363, it determined so many plan terms that are typically governed by § 1129 that it was a sub

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78. Robert Guy Matthews, *W.L. Ross Firm to Buy LTV Assets for $125 Million*, WALL ST. J., Feb. 28, 2002, at A6 ("Wilbur Ross, head of the private investment firm bearing his name, said he thinks he could keep the steel mills operating profitably because he won't have to assume all of LTV's [$4.78 billion in] debt. . . . Nor will W.L. Ross pick up LTV's so-called legacy costs—healthcare and other benefits for the company's 85,000 retirees."); Wilbur L. Ross, Letter to the Editor, *Bankruptcy Is a Darwinian Process*, WALL ST. J., June 19, 2009, at A14 ("[When our International Steel Group acquired] Bethlehem Steel and LTV Steel Co. . . . unsecureds got zero and the bankruptcy court actually had terminated retiree health benefits. . . . [Y]et [we] started a VEBA with $50 million and a future profit-sharing formula.").

79. Order Authorizing (I) Sale of Certain of the Debtors' Assets Free and Clear of Liens, Claims and Encumbrances, (II) Assumption and Assignment of Certain Executory Contracts, and (III) Assumption of Certain Liabilities, *In re* Bethlehem Steel Corp. (Bankr. S.D.N.Y. Apr. 23, 2003) (Nos. 01-15288 (BRL) through 01-15302, 01-15308 through 01-15315 (BRL)); Gus G. Sentementes, *Court OKs Bethlehem's Sale to ISG*, BALT. SUN, Apr. 23, 2003, at 1D. While the buyer picked up a smaller chunk of the presale obligations in *Bethlehem*, making it less reorganization-like than Chrysler, the validating auction had some of the same defects as in *Chrysler*.

80. *See, e.g.*, Bethlehem Steel Corporation, 10-Q Quarterly Report 4 (March 31, 2003), *available at* http://www.getfilings.com/o0000909518-03-000316.html.

rosa plan of reorganization, one needing at least makeshift safeguards to test for § 1129 compliance. In this Part we examined a potentially deeper defect—that Chrysler was not really sold via § 363, that the movement from Old Chrysler to New Chrysler was a reconfiguration of the company's operations and liabilities—a reconfiguration that should be viewed as no more and no less than a full-scale reorganization, not a sale.

C. *Could the Treasury Have Acted Any Differently?*

Could the United States, once it decided to rescue Chrysler for policy reasons, have structured Chrysler's bankruptcy differently? Was national policy just on a collision course with proper bankruptcy practice?

There were alternatives, albeit imperfect ones. The government could have picked up Old Chrysler's VEBA obligations directly, as the government's Pension Guaranty Benefit Corporation does when a pension plan is terminated. This would have been a different deal, however, because the government is a more creditworthy debtor than the reorganized Chrysler. Making the UAW dependent on the equity value and debt repayment capacity of New Chrysler better aligns its incentives with those of the company, and Chrysler's operations may very well be worth more because the deal cleverly mixes up the UAW's post-sale motivations by making it simultaneously a big creditor, a big union, and a controlling stockholder.

As a second alternative, the government could have offered its subsidy not to Chrysler directly but to qualified bidders, in a way that would have been analogous to the plans discussed to encourage bidding on banks' toxic assets. If done well, that could have elicited a range of bids and terms, yielding a much better market test.

Third, the government could have paid off all of Chrysler's creditors. While expensive, it's not such a profligate possibility, because Chrysler's major secured lenders, which were asked to accept the $2 billion for $6.9 billion deal, were recipients of government rescue money via other channels. A fuller buyout in *Chrysler* would have meant less subsidy elsewhere.[81]

That parallel conduit for money during the financial crisis indicates the irony in the business-political setting. One wonders why the Treasury was tough on Chrysler's lenders in this dimension, while propping them up elsewhere. Three possibilities are in play: Popular opinion had just seen the U.S. Treasury as rescuing wrongdoing Wall Street financiers as much as it was rescuing a weakened financial system. The AIG bonus imbroglio did not assuage public opinion. Hence, the government could have wanted to be seen as tough on financiers and accommodating for blue-collar workers. Chrysler gave it the opportunity to do both. The second possibility is that the Treasury Auto Task Force players were strong deal makers

81. A full buyout would have obviated the bankruptcy distortions, but created other policy problems. Credit markets might have seen a class of large industrial firms as too big to fail, making it privately sensible for credit to flow to those firms rather than to other sectors of the economy.

previously. They continued to make the strongest deal possible for their client, but suddenly found their deal-making prowess enhanced by the muscle of the U.S. Treasury. The third is that the Treasury's Auto Task Force concluded that to persuade the UAW to accept factory closures, layoffs, contract revisions, and a no-strike promise, Chrysler's lead lending group had to suffer visibly serious damage.

V. *Chrysler* as Chapter 11 Template?

Can *Chrysler* be repeated in Chapter 11? Should it be?

Chrysler may be ignored in the future, if it's seen, as it should be, as a one-off, deviant reorganization with heavy government involvement. But in some dimensions, *Chrysler* would be a good template for future reorganizations in Chapter 11. Future Chapter 11s can aspire to Chrysler's forty-two days in bankruptcy. Speed reduces the costly frictions of the bankruptcy process. While nothing as a matter of form precludes *Chrysler*-like speed in future Chapter 11s, the bases for optimism here are limited. The $5.3 billion in trade debt came through the bankruptcy unscathed because the government supported their claims. Labor-agreement restructuring was real but limited. The retirees' claims were readjusted, but not severely. In a typical Chapter 11, financial creditors would not have readily agreed to these terms, making the efforts to renegotiate the financial debts, the trade debt, the retirees' debt, and the labor contract difficult. The government's flooding of the firm with cash made the reorganization possible. Without it, more creditor classes would have been disgruntled and we would have had a more typical bargained-for Chapter 11.

But much of *Chrysler* is potentially pernicious. Regardless of whether the government's involvement helped or hurt the complaining creditors, the *structure* of the court-approved Chrysler transaction is dangerous, in that it permits and in fact contemplates a low regard for ordinary priority, endangering the protections and priority structure of Chapter 11 in future reorganizations. It does so even if the government's subsidies to Chrysler spilled over to help the complaining creditors.

Consider the following hypothetical. BadCo, worth $12 billion, files for bankruptcy, planning to split itself into an OldCo and a NewCo, with OldCo selling its assets to NewCo. Its financial debt consists of a single lending facility. The lending facility authorizes a single agent to act on behalf of the lenders, based on a majority vote of the participating lenders. BadCo owes a long-time vendor $2 billion in back payments for parts and technology that BadCo no longer uses or expects to use again. The supplier is closely associated with some of BadCo's stockholders.

OldCo in bankruptcy proposes to sell all of its assets via § 363 to NewCo. BadCo's old shareholders will own NewCo's stock. Creditors initially resist the sale, but shareholders invite consenting creditors to invest on concessionary terms in another entity BadCo shareholders control. Three-quarters of the creditors (by dollar amount) agree to a $5 billion sale and receive the outside concessionary terms. The prebankruptcy capital structure and the sale to NewCo are illustrated below.

BadCo

$12B assets	$8B secured debt
	$2B prior vendor
	$2B consumers, tort claims
	Common Stock

OldCo

$5B cash	$8B secured debt
	$2B consumer, tort claims
	Common Stock

NewCo

$12B assets	$5B new loan
	$2B prior vendor
	Common Stock

Having obtained 75 percent consent, BadCo asks the bankruptcy court to approve bidding rules and to schedule a hearing to approve the sale two weeks later. The bidding rules require that any competing bid have BadCo's old shareholders receive at least 95 percent of the stock of the entity that acquires the assets and that the obligation to the vendor be assumed. This requirement is explained as necessary to keep stockholder-managers available to run NewCo.

The bankruptcy court approves the bidding rules. No new bidder emerges. At the hearing to approve the sale to the company old stockholders control, the minority pleads that the sale is an impermissible sub rosa plan, one that would fail under § 1129. The products-liability claims are not represented at the hearing. The court rejects the creditors' plea. After all, the judge points out, the creditors consented to the sale, and the minority will be entitled to its share of the proceeds via its claim on OldCo. No bidder emerged to top the proposed deal; the company was shopped before and during bankruptcy. The "sale" is thus fully consistent with Chapter 11, says the court, citing *Chrysler*. A better analysis would acknowledge that it's the bidding rules that prevent a real market test, that equity holders are using § 363 to end-run § 1129, and that this is what the Supreme Court said in *North LaSalle* could not be permitted.[82]

The following table compares § 363 to § 1129 priority distributions:

82. Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 458 (1999).

Outcomes

	Claim	§ 1129(b) Absolute Priority	Chrysler-type § 363 Sale	Portion of § 1129 entitlement paid in the § 363 sale
Financial creditors				
Majority	$6B	$6B	$3.75B+2.25B=$6B[83]	100%
Minority	$2B	$2B	$1.25B	62.5%
Consumers, tort	$2B	$2B	0	0
Prior vendor	$2B	$2B	$2B	100%
Common Stock	Residual	0	$5B-2.25B=$2.75B	Multiple

Chrysler suggests that such a transaction could now be approved. A coalition of creditors, managers, and (maybe) shareholders could present a § 363 deal to the court for approval, and the plan could squeeze out any creditor class. Some creditors could be bought with ancillary consideration and the court would not question their good faith. We are, for now, at risk of seeing a bankruptcy process that's more fully in the individual judge's and creditor coalition's discretion, but, with prior § 363 case law not followed, and § 1129 jettisoned, no standard is in place to guide the judge.

A. *Replication Without Government Funding*

Although *Chrysler*'s positives, such as its speed, cannot be replicated without government money, the negatives can be. The deal structure *Chrysler* used does not need the government's involvement or a national industry in economic crisis. Because the bankruptcy techniques and doctrines used are readily replicable in ordinary bankruptcies, the deal shows fissures and weaknesses in Chapter 11's structure. And the case is already being cited as a precedent. The question is whether the courts will insist on strong makeshift alternatives when a § 363 sale determines core elements of § 1129, or whether it will accept empty ones. *Chrysler* represents the latter; Chapter 11 and prior precedent demand the former.

Three subsequent cases illustrate. In the bankruptcy of Delphi, General Motors' main parts supplier, the judge resisted the initial plan proponents' *Chrysler*-like strategy and insisted on a real market test. Rejecting arguments by General Motors and the government that their preferred buyer, Platinum Equity, was the only acceptable purchaser for Delphi's assets, Judge Drain said, "I don't know what makes Platinum acceptable to GM and why Platinum is unique . . . . Unless I hear more, there's something

83. The $3.75 billion is the majority creditors' pro rata share of the $5 billion sale price (three-fourths of $5 billion is $3.75 billion). The $2.25 billion is the value of the concessionary terms the shareholders give the majority. The shareholders obtain $2.75 billion, some from the tort claimants and some from the minority lenders.

going on here that doesn't to me make sense."[84] "What's so special about Platinum?" he asked. "They're just guys in suits. Why can't the other guys in suits just pay more?"[85] Eventually a new bidder emerged and topped Platinum's bid.[86]

Although the judge's response was encouraging for good bankruptcy practice, Delphi's previous proceedings reveal the risks coming from the *Chrysler* precedent. Proponents of the earlier Delphi plan argued to the court that a § 363 sale fully substitutes for a § 1129 reorganization. But this, while it follows from *Chrysler*, is incorrect. Congress intended with the 1978 Bankruptcy Code that business reorganize primarily via § 1129(a)(8) bargains. If bargaining failed, plan proponents could seek to cram down the plan under § 1129(b)(2), which requires adherence to priority and forbids unfair discrimination. In *Delphi*, the proponents' tactic was, if unable to get a § 1129 plan done because of a priority dispute, to move to § 363 and, *Chrysler*-like, *avoid* a priority determination.[87] *Continental* would not have allowed that; *Chrysler* did.

Moreover, despite the judge's tough language, which has made the rounds in bankruptcy circles, the *Delphi* reality does not firmly reject *Chrysler*. The judge forced a bid of a structure that carried over a very large level of old Delphi creditors to the new Delphi;[88] the buyers were still largely drawn from Delphi's presale creditors. *Delphi* thus in fact *resembled Chrysler* in determining reorganization-type distributions. Although the judge tested the insiders' preferred deal's *price*, the court did *not* see any actual bids for alternative deals that the insiders disfavored.[89]

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84. *See* Editorial, *DIPping Into Delphi*, Wall St. J., June 16, 2009, at A14. The case is *In re Delphi Corp.* (Bankr. S.D.N.Y.) (No. 05-44481 (RDD)).

85. Peter Lattman, *Judge Orders Auction in a Rebuke to Delphi Plan*, Wall St. J., June 11, 2009, at B1.

86. Mike Spector, *Delphi Lenders Poised to Wrest Control of Firm Over U.S. Plan*, Wall St. J., July 28, 2009, at B1.

87. *See* Expedited Motion for Order, *In re* Delphi Corp., (Bankr. S.D.N.Y. July 20, 2009) (No. 05-44481 (RDD)). The motion explained:

> If the Debtors are unable to obtain confirmation of the Modified Plan, the Debtors have committed to seeking approval of the transactions set forth in the Master Disposition Agreement pursuant to a sale under section 363 of the Bankruptcy Code independent of and not pursuant to, or contingent on, any plan of reorganization.

Id. at 7. In contrast, the Circuit Court in *Continental* ordered its district court to reconsider its prior approvals in the case because the court likely lacked statutory authority to approve transactions outside of a reorganization plan "if the [objectors] could have defeated a plan of reorganization containing the [transactions]." Institutional Creditors of Cont'l Air Lines, Inc. v. Cont'l Air Lines, Inc. (*In re* Cont'l Air Lines, Inc.), 780 F.2d 1223, 1228 (5th Cir. 1986); *see also* Sloane, *supra* note 23, at 49 ("[A] transaction that cannot be approved as part of a plan should not be approved outside of a plan.").

88. However, with many assumed liabilities in schedules filed under seal, the full extent of the carryover is not easy to assess.

89. Whether that means that outsiders knew not to bother or that the insiders' deal was the most efficient one is hard to evaluate with neither an § 1129 process nor any actual competing bids on differing terms. And, the *Delphi* testing of the price for the insiders' preferred deal may have

In the bankruptcy of the Phoenix Coyotes NHL team, the debtor argued that *Chrysler* set the precedent for the court to approve a rapid time line because the team was losing money while only one firm offer had been made for the team. The judge dismissed this argument, indicating limits to *Chrysler*'s influence, rejecting the breakneck pace because "the court does not think there is sufficient time (14 days) for all of these issues to be fairly presented to the court given that deadline."[90]

Whatever promising signs can be gleaned from *Delphi* and *Phoenix Coyotes* are offset by the General Motors ("GM") bankruptcy court's invocation of *Chrysler* as controlling law in the Second Circuit. The government used the same template for the § 363 sale in GM as it did in *Chrysler*. As in *Chrysler*, the buyer was not a true third party, the ostensible immediacy to the urgency of the sale was debatable, and the § 363 bidding procedures required that would-be bidders agree to the retiree settlement negotiated by the government and GM. But GM's secured creditors, unlike their counterparts in *Chrysler*, were paid in full. The GM sale was in this dimension thus easier to reconcile with ordinary priority rules than *Chrysler*. It's plausible that the Treasury adjusted to the push back from capital markets and the media criticism that accompanied the Chrysler deal.[91]

But the opinion approving GM's § 363 reorganization relied extensively on *Chrysler*. "Last, but hardly least," the court wrote in rejecting the GM objectors' argument that the sale was a sub rosa plan, "the *sub rosa* plan contention was squarely raised, and rejected, in *Chrysler*, which is directly on point and conclusive here."[92] After relying on the *Chrysler* reasoning in dismissing another objection, the court stated that "we here have a hugely important additional fact. The [Second] Circuit affirmed *Chrysler* . . . 'substantially for the reasons stated in the opinion below.'"[93] "[I]t is not just that the Court feels that it *should* follow *Chrysler*. It *must* follow *Chrysler*. The Second Circuit's *Chrysler* affirmance . . . is controlling authority."[94]

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been incomplete, because the winning bidders credit bid their existing debt. But the judge's widely quoted willingness to accommodate bidders on the proposed deal suggests a testing of the price.

90. *In re* Dewey Ranch Hockey, LLC, 406 B.R. 30, 42 (Bankr. D. Ariz. 2009); *see also* Jones & Spector, *supra* note 10 ("[Chrysler's] restructuring is altering the bankruptcy landscape well beyond the auto industry. Within days . . . a lawyer in the bankruptcy case of the National Hockey League's Phoenix Coyotes invoked Chrysler in trying to push through the speedy sale of the team.").

91. Again, while this might ameliorate the bankruptcy priority situation, it would distort capital markets by expanding expectations that a too-big-to-fail class of industrial firms could easily draw capital away from other sectors of the economy.

92. *In re* Gen. Motors Corp., 407 B.R. 463, 497 (Bankr. S.D.N.Y. 2009).

93. *Id.* at 504.

94. *Id.* at 505. The Supreme Court subsequently vacated the Second Circuit's opinion, casting doubt on this portion of *GM*. See *infra* notes 96–98 and accompanying text.

B. *Recommendations*

We can hope that bankruptcy judges will come to see *Chrysler* as flawed, but unique. They should require a better bidding process and attend better to priority. They can be more skeptical of the facts when parties say that the new entity is sua sponte recognizing the bulk of the old entity's debts; this is a strong signal that they are witnessing a sub rosa reorganization plan, designed to avoid § 1129. They could latch onto the fact that in *Chrysler* there was an unrebutted liquidation value study and, if they are faced with a contested valuation, require a more open auction and better makeshift substitutes for the § 1129 protections. Or they might simply say that the government's involvement made *Chrysler* sui generis. Better yet, the courts could develop rules of thumb, such as the dual 50 percent rule we suggested above to cull presumed pseudo-sales from the real ones.

But the Second Circuit's affirmance of *Chrysler* complicates these judicial adjustments by in effect casting doubt on the continued vitality of the sub rosa doctrine. The court called the term sub rosa "unhelpful" and "something of a misnomer." While this would be fine if the court were focusing only on the fact that the terms that are sub rosa are usually visible, the real problem is that the court construed the concept so narrowly as to effectively create a split with the Fifth Circuit, one that in time the Supreme Court or Congress may have to resolve.[95] Reconciling the *Chrysler* results with the sub rosa doctrine is exceedingly difficult: if the *Chrsyler* plan isn't a sub rosa one, it's hard to think of any real-world effort under § 363 that would be a sub rosa plan anymore.

The Supreme Court disposed of the appeal from the Second Circuit by granting certiorari, vacating the judgment below, and ordering the Second Circuit to dismiss the appeal as moot. No consensus in the bankruptcy bar formed immediately after the decision came down as to the significance of the Court's one-paragraph opinion.[96] A plausible interpretation is that the Chrysler sale's status was moot by the time the appeal reached the Court—it was a done deal that could not be undone after the temporary stays were lifted and the assets sold, as they had been.[97] But, not having heard the substantive issues, the Court vacated the judgment below, taking

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95. *See Chrysler II*, 576 F.3d at 117–18. The Second Circuit treated sub rosa analysis as inapplicable so long as the sale "does not specifically 'dictate,' or 'arrange' ex ante, by contract, the terms of any subsequent plan." *Id.* at 118 n.9 (emphasis omitted). That was the announced standard, but a fair reading of the transaction's terms is that *Chrysler* failed to meet even that easy-to-meet standard. One can hope that even in the Second Circuit, bankruptcy courts will use their ample discretion to avoid parallels to *Chrysler*, by incorporating makeshift remedies into § 363 sales. The *Chrysler* opinions unwisely allowed a bidding process that discouraged alternative bidders, and they ignored the protection that would be available under § 1129. But they do not *require* these features in Second Circuit § 363 sales.

96. *Compare US Supreme Court Drops Bombshell "Summary Disposition" Vacating 2d Circuit's Chrysler Decision*, http://www.bankruptcylitigationblog.com/archives/us-supreme-court-cases-us-supreme-court-drops-bombshell-summary-disposition-vacating-2d-circuits-chrysler-decision.html, *with* http://www.creditslips.org/creditslips/2009/12/i-know-its-over-.html.

97. Bankruptcy Code, § 363(m).

away its binding precedential value.[98] Second Circuit bankruptcy courts are no longer bound by *Chrysler* in the way that the GM court said it was bound. The Second Circuit's opinion could continue to have persuasive value, although, as we have indicated, it is not persuasive and, in fact, it represents poor bankruptcy practice.

Given the obstacles to further judicial adjustment, and the possibility that judicial rules of thumb may prove unworkable, Congress may need to amend § 363 to clarify its relationship with § 1129. Only minor adjustments to the language of § 363(b), such as the following (with additions in italics) would be needed, but the substantive implications would be large:

> The trustee, after notice and a hearing, may, *and any party in interest may propose to*, use, sell, or lease, other than in the ordinary course of business, property of the estate. *If such use, sale or lease involves substantial operations of the debtor, it shall be approved only if validated in an open auction that does not materially determine the distribution to claims on and interests in the debtor's property.*

Adopting this or similar language would simplify the task of navigating around the wreckage of § 363 doctrine left by the *Chrysler* decisions.[99]

VI. THE BIG PICTURE

Although we are interested in proper bankruptcy practice for its own sake and for fidelity with the Code, we obviously have other motivations for writing this Article. The opacity of the Chrysler deal gave credit markets a scare, with major investors fearing that priorities were being violated. If that sense persists, creditors would adjust interest rates for companies seen to be at risk of priority warps, or decide not to invest in some marginal companies. That outcome would be unfortunate for the economy.

It's important for courts to reject *Chrysler*, so that we can be better assured that credit markets will continue to function properly for weak firms. If courts readjust away from the Chrysler scenario, in time creditors will forget the *Chrysler* bankruptcy, or remember it as a one-off anomaly. Alternatively, Congress could amend § 363 as we suggest to clarify its scope.

The Chrysler deal was structured as a pseudo-sale, mostly to insiders (in the Chrysler case to the UAW and the government), in a way eerily resembling the ugliest equity receiverships at the end of the nineteenth century. The nineteenth century receivership process was a creature of necessity, and it facilitated reorganization of the nation's railroads and other large corporations at a time when the nation lacked a statutory framework

98. Charles A. Sullivan, *On Vacation*, 43 HOUSTON L. REV. 1143, 1154 (2006).

99. Barry Adler's concept that a § 363 sale should use the state merger and acquisition process should improve the process. Barry E. Adler, A Reassessment of Bankruptcy Reorganization after Chrysler and General Motor 19 (NYU Law, Economics and Organization working paper, Jan. 2010), *available at http://ssrn.com/abstract=1530011*.

to do so.[100] But early equity receiverships created opportunities for abuse. In the receiverships of the late nineteenth and early twentieth century, insiders would set up a dummy corporation to buy the failed company's assets.[101] Some old creditors—the insiders—would come over to the new entity. Other, outsider creditors would be left behind, to claim against something less valuable, often an empty shell. Often these frozen-out creditors were the company's trade creditors.

Northern Pacific Railway Co. v. Boyd[102] is the famous case. Its deal structure resembled the BadCo hypothetical we considered earlier—insiders moved over to the new company in a pseudo-sale, to the detriment of outsiders. It differed from *Chrysler* mainly in that the insider types (the UAW and the government today, some well-positioned bond creditors and shareholders in *Boyd*) differed.

The judicial result in *Boyd*, however, sharply differed from that in *Chrysler*. In *Boyd*, the Supreme Court refused to let the transaction stand, rebuked the lower courts, and instructed them to determine whether priorities were followed before allowing such a sale to go forward that de facto determined lender priority and compensation.[103]

After the *Boyd* decision, insiders could no longer ignore disfavored creditors. But critics continued to worry about the dominant role of insiders—principally Wall Street banks, favored bondholders, and their law firms.[104] In the 1930s, William Douglas oversaw an influential Securities and Exchange Commission study that documented abuses in many large cases.[105] The study led to major reforms that replaced the old receivership practice with judicially overseen reorganization as part of the Chandler Act of 1938.[106] Both before and after the Chandler Act, the Supreme Court insisted that creditors' priorities be respected, most prominently in a 1939 decision that struck down a proposed reorganization that would have given

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100. *See* David A. Skeel, Jr., Debt's Dominion: A History of Bankruptcy Law in America 48–70 (2001).

101. The receiverships were structured as pseudo-"sales" of the company to a portion of its existing creditors and shareholders. Creditor consent was not solicited. The process was devised from ordinary foreclosure sales, with the parties pretending to conduct a foreclosure sale, but in reality effecting a restructuring by selling the assets to a group of the preexisting investors. *Id.* at 56–59.

102. 228 U.S. 482 (1913).

103. *Id.*

104. *See, e.g.*, Jerome N. Frank, *Some Realistic Reflections on Some Aspects of Corporate Reorganization*, 19 Va. L. Rev. 541, 555 (1933) (calling the equity receivership sale "a mockery and a sham"). "A sale at which there can be only one bidder," Frank complained, "is a sale in name only." *Id.*; *see also* William O. Douglas, Democracy and Finance 185 (1940) (concluding that "plans of reorganization were frequently dictated by a single interest—by a closely knit inside group; primarily in the interests of that group").

105. U.S. Sec. and Exch. Comm'n, Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees (1937).

106. *See, e.g.*, Skeel, *supra* note 100, at 109–23.

insiders stock in the new company.[107] The reforms of the 1930s and the Supreme Court decisions of the early twentieth century eliminated the previous artificial sales that were seen as often warping priority, and ensured that creditors' priorities would be respected.

It is ironic that the Supreme Court invested considerable energy in the late nineteenth century and early twentieth century, and the Congress did as well with the Chandler Act, to make sure the priorities were adhered to in a way that the Chrysler reorganization did not require. *Chrysler*, in effect, overturns *Boyd*.

One feature of *Chrysler* that differed from *Boyd* may portend future problems. Major creditors in *Chrysler* were not pure financiers, but were deeply involved in the automaker's production. The company had major trade creditors and the UAW and its retirees were also major creditors. Only the secured creditors were plain vanilla financiers, uninvolved in producing Chrysler's cars. (And even they, in principle, brought the factories and equipment to the negotiating table, since Chrysler's facilities were subject to their security interest.) Chapter 11 is well suited to reorganizing a firm's financial side, with the court and the parties sorting out priorities and then bargaining to a settlement. That's what the 1978 Bankruptcy Code sought to accomplish in a financial world that seemed a simpler one, where all bankruptcy had to do was sort out the financial claims of stockholders and secured and unsecured creditors.

Chrysler then looks to be an extreme version of what was once a nonstandard problem: a § 363 sale in which the debtor's assets cannot easily be sold to a third party, because the value of the assets is enhanced by the continued involvement of key nonfinancial creditors of the company. In these cases, players with similar priorities will not, sooner or later, be treated similarly. But to say this is conceptually possible is not to make it surely so in any particular case before us. There's a tension between ordinary priority rules—which Congress embedded in the Code to *stymie* powerful parties, often insiders, holding out for a better deal—and priority deviations to account for the added value that some value-enhancing parties provide the reorganization. Conceptually resolving that tension between priority and value enhancement still needs to be accomplished.

This tension is another reason why bankruptcy courts need to be vigilant in applying the makeshift remedies in § 363 cases that appellate courts previously had called for. It also suggests that the Chrysler bankruptcy was not necessarily sui generis. Neither the traditional bargaining process nor the § 363 sales process seems well suited to resolve claims when the major creditors are also major parts of the firm's production chain.

When Congress passed the Code in 1978, merger markets were weaker than they became in the ensuing decades. As merger markets deepened, selling divisions or whole firms became more viable in bankruptcy than it had been. The frequency of sales in bankruptcy created tensions between

107. Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106 (1939).

the sales possibilities and the Code's overall structure—tensions that Congress did not have to deal with when the merger market was weaker. We suggest here how to reconcile the benefits of the sales with both the Code's structure and the financial marketplace's legitimate expectations.

Conclusion

Chrysler's operations entered and exited bankruptcy in forty-two days, making it one of the fastest major industrial bankruptcies in memory. It entered as a company widely thought to be ripe for liquidation if left on its own, obtained massive funding from the United States Treasury, and exited through a pseudo-sale of its main assets to a new government-funded entity. Most creditors were picked up by the purchasing entity, but some were not. The unevenness of the compensation to prior creditors raised considerable concerns in capital markets.

Appellate courts had previously developed a strong set of standards for a § 363 sale: the sale must have a valid business justification, the sale cannot be a sub rosa plan of reorganization, and if the sale infringes on the protections afforded creditors under Chapter 11, the court can approve it only after fashioning appropriate protective measures.

The Chrysler reorganization failed to comply with these requirements. Although Chrysler needed to be repositioned, and needed to be repositioned quickly, it had a few weeks, maybe a month, to get the process done right in a way that would neither frighten credit markets nor violate priorities. Chrysler's facilities were already shut down and not scheduled to reopen immediately. FIAT, the nominal buyer, was providing no cash. The party with the money was the U.S. Treasury, and it wasn't walking away.

The plan surely was a sub rosa plan, in that it allocated billions of dollars—the core determination under § 1129—without the checks that a plan of reorganization requires.

The informal, makeshift checks that courts had previously required when there were strong § 1129 implications were in *Chrysler* weak or nonexistent. The courts did not even see fit to discuss § 1129 in their opinions. There was de facto consent from a majority of the bank lenders (although not from products-liability claimants), but that consent came from parties afflicted with serious conflicts of interest. There was a pseudo-market test, not a real one, because the auction process marketed only the reorganization plan itself, when the issue at stake was whether the assets alone had a higher value.

Worse yet, it's plausible to view the Chrysler bankruptcy as not having been a sale at all, but a reorganization. The New Chrysler balance sheet looks remarkably like the old one, sans a couple of big creditors. Courts will need to develop rules of thumb to distinguish true § 363 sales from bogus ones that are really reorganizations that squeeze out one or more creditor layers. We suggest a rough rule of thumb to start with: if the new balance sheet has creditors and owners who constituted more than half of the selling company's balance sheet, but with some creditors left behind, or if a majority of the new equity was drawn from the old capital structure, then the transaction should be presumed not to be a sale at all, but a reorganization. The Chrysler transaction would have failed that kind of a test.

One might be tempted to dismiss the inquiry as needless worry over a few creditors. But we should resist that easy way out. Much corporate and commercial law has to do with the proper treatment of minority creditors and minority shareholders. For minority stockholders, there's an elaborate corporate-law machinery for freeze-outs when a majority stockholder seeks to engineer a transaction that squeezes out minority stockholders. For minority creditors, there's a century of bankruptcy and equity-receivership law designed to balance protection from the majority's potential to encroach on the minority and squeeze them out from their contractual priority against the minority's potential to hold out perniciously. These are neither small nor simply fairness-based considerations: capital markets depend on effective mechanisms that prevent financial majorities from ousting financial minorities from their ratable position in an enterprise. That's what's at stake.

It's in that light that the Chrysler bankruptcy was pernicious. It failed to comply with good bankruptcy practice, reviving practices that were soundly rejected nearly a century ago. Going forward, the extent of *Chrysler*'s damage to bankruptcy practice and financial markets will depend either on congressional action or on how *Chrysler* is construed by other courts, and whether they will limit its application, as they should.