U.S. House of Representatives
Committee on the Judiciary
Subcommittee on Commercial and Administrative Law

Hearing on
Ramifications of Auto Industry Bankruptcies

Prepared testimony of Lynn M. LoPucki
Security Pacific Bank Professor of Law, UCLA Law School
Phone (310) 794-5722
lopucki@law.ucla.edu

Thursday, May 21, 2009
12:00 pm
Room 2141 Rayburn Office Building

Chrysler Corporation has already filed under Chapter 11 of the bankruptcy code and General Motors is widely expected to do so prior to June 1. The immediate purpose of Chapter 11 is to save financially troubled companies and by doing so to save jobs. The larger purpose is to assist in deleveraging companies in a fair and orderly manner in times of financial crisis. A financial crisis of the nature the country now faces is what Chapter 11 was designed to address. Yet the prevailing belief, both inside and outside government, seems to be that Chapter 11 cannot be relied upon. It is too complex, too slow, too expensive, and sends too negative a message about the filing company. As a result, both Chrysler and GM are attempting to use Chapter 11 in a manner for which it was not designed.

Chapter 11 Procedure

The ordinary course of a Chapter 11 case is for the company to file a petition with the appropriate bankruptcy court, propose a comprehensive plan of reorganizations, make extensive disclosure to creditors and other stakeholders regarding the company's financial condition, allow the creditors to vote on the plan, and then seek confirmation of the plan by the court. If management seeks to modify or reject a collective bargaining agreement, the bankruptcy code requires management to bargain in good faith – after filing the case. If no agreement is reached, the company is entitled to reject agreement if rejection is necessary to complete the reorganization. The Chapter 11 plan process ordinarily takes from one to two years, and in some cases can take longer. In a traditional Chapter 11, the company remains "in bankruptcy" during that entire time.

Much of the effort and the controversy surrounding the GM and Chrysler bankruptcies result from the efforts of GM and the United States Treasury to shorten the time that the companies would be under the jurisdiction of the bankruptcy court. GM and Chrysler have strategies that will enable both to emerge within thirty to sixty days of the day each entered

bankruptcy. In both cases, the strategy is to sell the company – essentially to the government – pursuant to section 363 of the bankruptcy code.

The intended consequences of the bankruptcies are (1) to keep both companies operating, at least temporarily, (2) to keep a substantial portion of the companies' workforces employed, (3) to avoid a domino effect in which the collapse of GM and Chrysler might take down those companies suppliers and dealers, (4) to minimize the costs to the government of achieving these goals. I believe that the GM-Chrysler-government bankruptcy strategy will succeed in achieving these goals.

There are, nevertheless, problems with the manner in which the bankruptcy system is functioning in these cases.

1. Participation in the proceedings. Chrysler and GM are Detroit companies. Their suppliers and employees are concentrated in the Detroit area. Yet the Chrysler case was, and the GM case is expected to be, filed in New York. As a result, the opportunity for many suppliers, employees and members of affected communities to participate in the cases is sharply limited.

The bankruptcy venue statute, 11 U.S.C. §1408 allows large, public companies to choose the courts in which they file. Forum shopping – choosing a court for one's own advantage – is rampant in large bankruptcy cases. At minimum, it creates the appearance of impropriety. About seventy-five percent of all large, public companies filing bankruptcy in the United States since 2006 have filed in a bankruptcy court other than the one with jurisdiction at the company's headquarters. About seventy percent of all large, public company filings are made in just two bankruptcy courts: Delaware and New York.

The drafters of the current rules intended that if a company filed in a legally permissible, but less than ideal venue, the court should transfer it to the ideal venue. 11 U.S.C. § 1412. That remedy has not be effective. No bankruptcy court has ever transferred a billion-dollar-or-more case, except at the request of the company that initially filed it. Instead, some bankruptcy courts are competing to attract cases.

2. Bias in favor of managers, professionals, and DIP lenders. The managers control the choice of a bankruptcy court. The company's bankruptcy professionals influence that choice, as do the lenders who finance the bankruptcies (the "DIP lenders"). In the Chrysler case, the government is the DIP lender and it, rather than Chrysler, was the first to announce the choice of the New York court. Courts attract cases because they appeal to these three parties (the "case placers"). One result is the widespread perception that the courts most successful in attracting cases are biased in favor of the case placers.

3. The truncation of the Chrysler and GM bankruptcies. The use GM and Chrysler are making of bankruptcy code section 363 is legally questionable. A company that has a good business justification for selling all of its assets without going through the plan process outlined above is permitted by law to do so. But if the transaction is not really a sale or effects a "sub

rosa plan" the transaction is improper and should not be approved. Chrysler and GM are in form selling their companies, but in economic reality are not. Fiat is not buying Chrysler (it pays nothing at all in the transaction) and the government is not buying GM (it is reorganizing GM by turning creditors into shareholders). These are sales with no real, arms-length buyers to negotiate terms and fix prices, and the transactions are occurring in economic conditions unlikely to produce competing bids.

4. Future reorganizations. Most reorganizing companies suffer from lengthy stays in Chapter 11. They would prefer to have what Chrysler and GM are having – buyer-less 363 sales that will permit them to exit bankruptcy in 30-60 days. Once the Chrysler and GM sales have been approved, other bankrupt companies will strategize to achieve the same result. For example, a bankrupt company with no buyer may propose to sell to a newly created entity in return for all of the stock of that entity. A bankruptcy court that approved such a sale, would immediately attract large numbers of large cases.

Such sales are sufficiently common in United Kingdom bankruptcies to have a name – "phoenix sales." They may, if properly regulated, represent a better way to reorganize companies. The danger, however, is that they will be implemented by clever lawyers and competing bankruptcy courts without regulation or even appropriate examination. In the current forum-shopping environment, any importantly pro-management practice that is accepted in even a single bankruptcy court, can quickly become the norm.

5. The termination of auto dealerships. Both Chrysler and GM intend to terminate substantial numbers of their dealers. The effect of terminating a dealership while in bankruptcy is the same as the effect of terminating it immediately prior to bankruptcy: the company becomes liable to the dealership for money damages. But if the company has filed a bankruptcy case, the dealers claims for those damages share pro-rata with other general creditors. In Chrysler, general creditors will receive no payout at all. In GM, general creditors will probably receive only a few cents on the dollar. Thus, the effect of bankruptcy is to pretty much nullify the dealers' contract rights.

The bankruptcy court is likely to allow Chrysler to terminate whatever dealers it may choose. Terminated dealerships are likely to close, thus eliminating the jobs of their employees. The Chrysler National Dealer Council, a trade organization representing Chrysler dealers, has filed a statement with the bankruptcy court in opposition to that grant of authority. Their argument is essentially that even weak dealers are not a burden on Chrysler because they pay their own way. The issue they raise, like so many others, is within the discretion of the bankruptcy court, and so possibly compromised by competition-induced, pro-management bias. I have not conducted the study necessary to know whether the Council is correct, but it is certainly something that the bankruptcy court, Chrysler, and the government should consider if they have not done so already.

6. Effect on future lending. Some have expressed concern that the harsh treatment of the secured lenders in Chrysler and the unsecured bondholders in GM will affect willingness to

extend credit to large, public companies in the future. At least in the case of the secured lenders, I agree that the treatment was harsh, but I am skeptical that the Chrysler and GM cases alone will have much effect on future willingness to lend. These are extraordinary times. The government is rescuing GM and Chrysler because they are "too big to fail." Whether the harsh treatment has or will result in an actual, substantial reduction in the creditors' recoveries is not clear. I think these events should, and will, be regarded as unique. If, however, future cases follow the phoenix model without effective regulation, I believe that creditors will have cause to, and will, react by constricting their lending.

7. Asbestos and products liability litigation. Those with products liability claims against GM and Chrysler are general, unsecured creditors. If they win judgments, they, like other unsecured creditors, will be paid only a few cents on the dollar (GM) or nothing at all (Chrysler) in the bankruptcy cases. If GM or Chrysler have liability insurance, they may be able to achieve recoveries from that source.

8. Professional fees. Bankruptcy professional fees are a continuing problem. The cost of reorganizing a large public company rose by 10% per year from 1998 through 2007. Because those who employ the professionals are spending other peoples' money, bankruptcy law requires that the professionals keep time records, apply for their fees, and receive only the amounts awarded by the courts. My colleague, Joseph Doherty, and I recently released a study, *Routine Illegality in Bankruptcy Court Fee Practices*, showing that in large, public company cases, the bankruptcy courts have adopted numerous practices that are in clear violation of the bankruptcy code and/or rules. These practices allow some fees to be paid without application or award, allow most fees to be paid prior to application, and allow applications that do not make statutorily required disclosures. The study and supporting evidence is available from this UCLA website. http://www.law.ucla.edu/erg/pubs The study will be published in the American Bankruptcy Law Journal in August.

The United States Trustee, a division of the Department of Justice, is the government agency is charged with monitoring and commenting on fee applications. It has, to date, had no comment on the study. I hope that this subcommittee, or a member, will request comment from the United States Trustee.