"IT'S ALL JUST A LITTLE BIT OF HISTORY REPEATING:" AN EXAMINATION OF THE CHRYSLER AND GM BANKRUPTCIES AND THEIR IMPLICATIONS FOR FUTURE CHAPTER 11 REORGANIZATIONS

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I. INTRODUCTION

During the summer of 2009 Chrysler and General Motors ("GM") filed for bankruptcy protection. The bankruptcies of these two companies, while not as earth shattering as the Lehman Brothers bankruptcy or the subsequent TARP program, were nonetheless significant indicators of the large impact that the 2008 Recession had made on the United States economy. Two major car manufacturers that for decades had been engines of growth in the United States economy were now suddenly faced with the humiliating process of going through a Chapter 11 restructuring. GM and Chrysler, however, are not the first major corporations to go through Chapter 11, nor are they likely to be the last.

Once the firms filed for bankruptcy, they were sold to a new company pursuant to section 363(b) of the Bankruptcy Code,[1] a process remarkably similar to that used in many smaller-scale bankruptcy proceedings. Section 363(b) is attractive for both bankrupt companies and investors. It is attractive to bankrupt companies because it provides a quick method of ending the uncertainty of bankruptcy. It is attractive for new investors because it provides purchasers with the

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1. 11 U.S.C. § 363(b)(1) (2009) gives the trustee or debtor-in-possession the power to "use, sell, or lease, other than in the ordinary course of business, property of the estate" after following notice and hearing procedures.

ability to buy the assets of the bankrupt company without incurring any liabilities that had been associated with the asset prior to bankruptcy, and to cherry-pick which of an estate's assets are included in the sale.[2] As a result of this attractiveness, Section 363 sales have become so commonplace that two prominent bankruptcy scholars declared that large scale reorganizations are a thing of the past.[3] However, GM and Chrysler, unlike the standard Section 363 sale, provoked significant outcry from the corporate world. Immediately after the sales took place, bankruptcy commentators began discussing how such sales might be illegal,[4] but also forewarned that if these sales were in fact legal they created a horrible precedent that circumvented the carefully wrought procedures of the bankruptcy code.[5]

Following this initial outcry over the Section 363 sales, scholars continued to write about and discuss the GM and Chrysler bankruptcies. Almost all of the academics that have discussed the sales have been opposed to them, and generally fall into two different groups. In the first group are academics that view the General Motors and Chrysler bankruptcies as significant deviations from the standard bankruptcy practice. These scholars often focus on the bidding procedure that was used in the Chrysler bankruptcy and how it was virtually impossible for any other bidder to successfully challenge the government-sponsored bid.[6] Other academics who view the sale as a bellwether event focus instead on the distribution of the proceeds, and argue that because the sale determined the distribution of assets, once a plan was confirmed it constituted a *sub rosa* plan of reorganization.[7]

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2. *See* Bryant P. Lee, *Survey: Chapter 18? Imagining Future Uses of 11 U.S.C. § 363 to Accomplish Chapter 7 Liquidation Goals in Chapter 11 Reorganizations*, 2009 COLUM. BUS. L. REV. 520, 525.

3. Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 752 (2002).

4. *See* Zach Lowe, *GM and Chrysler: The End of Bankruptcy as We Know It*, AM. LAW, July 9, 2009, http://www.law.com/jsp/article.jsp?id=1202432107397&thepage=1 (discussing Professor Lynn LoPucki's criticism of the sale).

5. Mark J. Roe & David A. Skeel, *Assessing the Chrysler Bankruptcy*, 108 MICH. L. REV. 727, 751 (2010).

6. *See, e.g.*, Barry A. Adler, *A Reassessment of Bankruptcy Reorganization After Chrysler and General Motors* (N.Y. Univ. Ctr. For Law, Econ. & Org., Working Paper No. 10-04, 2010), *available at* http://ssrn.com/abstract=1530011.

7. *See, e.g.*, Roe & Skeel, *supra* note 5, at 12.

The second group of scholars, while also opposed to the sales, focuses instead on what they consider to be the ordinariness of the sales.[8] Scholars in this group argue that the sales are remarkably similar to the standard section 363 sales that occur in the typical Chapter 11 bankruptcy, in that the secured creditors of GM and Chrysler were able to use their power in order to force the sale of the companies.[9] This argument mirrors the frequent opposition to section 363 sales that focuses on the role of secured creditors, "Debtor In Possession" (DIP) lenders, and management in forcing a sale early in the bankruptcy process.[10]

The argument made herein is similar to that made by the second group of bankruptcy scholars, except that this Note takes a slightly different approach by analyzing the sales through a longer historical prism of bankruptcy practices in the United States. Viewed within this context, this Note argues that the GM and the Chrysler section 363 sales are not anomalies, but are rather part of two phenomena that have existed throughout the history of bankruptcy in the United States. First, the ability of management and influential creditors to take control of the restructuring process. Second, the inability of Congress to create bankruptcy laws that successfully curb this behavior of managers and creditors and protect less influential creditors. This Note concludes that the underlying cause of these two trends is related to the collective action and governance problems inherent in bankruptcy.

In discussing these trends, Section II traces the historical development of the bankruptcy code from the equity restructurings of the nineteenth century through the promulgation of the Bankruptcy Code of 1978, and focuses in particular on the role of insiders and influential creditors in the bankruptcy process. Section III focuses on the role that these trends have played in shaping bankruptcy outcomes during various peri-

8. *See* Stephen J. Lubben, *No Big Deal: The GM and Chrysler Cases in Context*, 83 AM. BANKR. L.J. 531, 535-538 (2010) (comparing the GM and Chrysler sales to typical secured creditor driven § 363 sales and arguing that the same process was driving the sales).

9. *Id.*

10. *See generally* George Kuney, *Hijacking Chapter 11*, 21 EMORY BANKR. DEV. J. 19 (2004) (discussing the role that secured creditors and managers play in distorting the Chapter 11 process and providing themselves value at the expense of unsecured creditors).

ods in the history of bankruptcy, and uses the Chrysler and GM bankruptcies as examples of the modern impact of these trends. Section IV discusses the implications of increased secured creditor and insider power over the fate of bankrupt companies for the stakeholders in a bankruptcy. Finally, Section V concludes by briefly discussing some potential methods of curbing secured creditor and insider power in bankruptcies and why the power of the constituencies will continue to plague insolvency law.

II. HISTORICAL DEVELOPMENT OF THE BANKRUPTCY CODE

A. *Equity Receivership*

Article I, Section 8 of the Constitution gives Congress the power to establish national laws regarding bankruptcy.[11] However, Congress was slow to establish a uniform code, and during the nineteenth century, investors in search of a successful method to restructure companies turned to the ad hoc solution of equity receiverships.[12] Equity receiverships were necessary because of the massive expansion of railroads in the nineteenth century. This expansion was highly decentralized, resulting in some areas being served by multiple railroads while just one railroad would serve others.[13] This uneven expansion led railroads to attempt to charge higher prices in underserved markets and lower prices in the more heavily served markets.[14] However, this bifurcated pricing was eliminated by regulations that limited what railroads could charge in underserved markets.[15] This combination of market forces and regulation left many railroads unable to charge a price sufficient to earn a profit or service debt.[16]

The financial distress of railroads posed a unique problem for creditors because although the creation of railroads

11. U.S. CONST. art. I, § 8, cl. 4.

12. *See* DAVID A. SKEEL, DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA 50-51 (2001).

13. *Id.*

14. *Id.*

15. *Id.*

16. *Id.*

was a very capital-intensive endeavor,[17] the materials used in creating railroads could not be easily transformed to serve other purposes.[18] Moreover, due to the high costs involved in creating railroads, there was no possibility that one person or entity could amass sufficient capital to buy a railroad as an economic entity.[19] This made railroads ill-suited for what little insolvency law existed at the time — laws which focused purely on liquidation rather than restructuring.[20] Instead, these creditors made use of the common law doctrine of equity receivership as a method for preserving the railroad while it was restructured. The doctrine of equity receivership was designed to temporarily preserve the property of a debtor while creditors were at the same time foreclosing on the property. The creditors, while still using the "magic words of foreclosure law," were able to use a body of law aimed at liquidation to restructure the insolvent corporations.[21]

Creditors manipulated the process of equity receiverships in order to achieve their desired outcome of restructuring the company. By using equity receiverships, creditors were able to use a process designed for foreclosing on assets to achieve a fundamentally different outcome of rehabilitating companies. Therefore, when the railroad initially faced trouble, a creditor would go to court and request that it be appointed as a receiver, which nominally shifted control of the company's assets from the debtor to the receiver.[22] This receivership actually served as an early version of the automatic stay and stopped other creditors from being able to reach the railroad's assets. Once the receiver was appointed, the investment banks that had initially underwritten the bonds and common stock of the railroad would form protective committees, and these committees would then represent the investment banks' interests in

17. *See id.* (discussing the capital intensive nature of railways, and the fact that because of the costs of upkeep railways would run at a loss simply to generate some money towards the upkeep of the tracks).

18. Baird & Rasmussen, *supra* note 3, at 158.

19. *Id.*

20. SKEEL, *supra* note 12, at 54.

21. *Id.* at 57.

22. *See* Charles Jordan Tabb, *The History of the Bankruptcy Law in the United States*, 3 AM. BANKR. INST. L. REV. 5, 22-23 (1995) (describing the process that occurred once a receiver was appointed).

subsequent negotiations.[23] The committees negotiated with each other and with the railroad's management to determine the new capital structure of the corporation.[24] Once the committee or committees had reached an agreement with management, they would file a "foreclosure bill" with the court, whereby they would use their underlying securities to "purchase" the railroad. However, the foreclosure merely changed the name of the corporate parent while the same management, shareholders and secured creditors continued to control the railroad company.[25]

At first glance, this process appears similar to the current Chapter 11 process, and it includes many of the same elements as Chapter 11 proceedings, such as the automatic stay,[26] Creditor's Committee,[27] and approval of a consensual plan of reorganization.[28] However, there are a number of factors that make this process of equity receivership more similar to a section 363 sale than to a traditional Chapter 11 restructuring. First, all of the negotiations were conducted between the management of the railroad and the investment banks (typically J.P. Morgan or Kuhn, Loeb) that had initially underwritten the railroad's bond or share offering.[29] These banks would take physical possession of the securities from their holders allowing them complete control over the negotiations and the right to vote the shares.[30] Moreover, courts helped bolster the committee's power by establishing "upset prices," which were the lowest prices that the court would accept for the insolvent company.[31] These upset prices, while nominally designed to

23. SKEEL, *supra* note 12, at 56.

24. *Id.* at 58.

25. *Id.* at 59.

26. 11 U.S.C. § 362 (2009) creates the automatic stay in modern bankruptcy proceedings. As a result of this section any attempt to continue a preexisting action against a bankrupt company or to enforce a preexisting judgment against the company is stayed during the pendency of the bankruptcy.

27. *Id.* § 1102 (mandating that the trustee appoint a committee of unsecured creditors to represent similarly situated creditors).

28. *Id.* § 1126 (describing the procedures that will be used to determine whether or not creditors have accepted or rejected a plan of reorganization).

29. SKEEL, *supra* note 12, at 58.

30. *Id.*

31. *Id.* at 60.

ensure that a fair price was established, were usually set at well below market value.[32] The result was that they helped force holdouts to agree to the prices established in negotiations because the alternative to the upset price was so unattractive.[33]

The true beneficiaries of the railroad insolvencies are revealed by analyzing the disposition of the estate, where stockholders (management) and secured mortgage bondholders (banks) were either given equity in the new company or the right to purchase equity in the new company, while the holders of unsecured debt were given nothing.[34] This practice was eventually eliminated when the United States Supreme Court ruled it unconstitutional for stockholders to participate in the restructured company when unsecured debt was excluded.[35] However, the banks and managers were able to turn this apparent setback into a positive development by allowing the unsecured creditors to participate, but only if they contributed cash to the corporation.[36]

Finally, equity receiverships worked the way they did because the interests of the managers and investment banks that controlled the creditor's committees were precisely the same—both wanted the railroad to continue to function. Managers wanted to remain in control of the railroads, and investment banks wanted the railroads to continue to function so that their clients could profit from their investment. These two groups were able to work together to ensure that the equity receivership benefited their own interests. However, this was often done at the expense of less organized creditors.

B. *The Chandler Act and Chapter X*

Equity receiverships were eventually extended into a formal process of restructuring for all corporations in 1933 with the addition of section 77B to the Bankruptcy Act.[37] This statute extended much of the preferential treatment for manage-

32. *Id.*
33. *Id.*
34. *Id.* at 67.
35. *See* N. Pac. Ry. v. Boyd, 228 U.S. 482, 506-07 (1913) (holding that a reorganization that excluded general unsecured creditors did not eliminate the debt).
36. SKEEL, *supra* note 12, at 67.
37. Act of July 1, 1898, ch. 541, 30 Stat. 544 (superceded 1938).

ment and secured creditors that had plagued the equity receiverships by codifying practices that had given significant control over the disposition of the estate to financiers and managers.[38] Significantly, it was this very extension of power that planted the seeds of change in the restructuring industry. In particular, as part of the New Deal, the newly created Securities and Exchange Commission (SEC) began an investigation into the practices of Wall Street banks and law firms involved in corporate reorganizations. The subsequent SEC report harshly criticized the reorganization process under section 77B and the control that management and bankers exerted.[39]

As a result of this report, Congress enacted the Chandler Act[40] in 1938, which was intended to ensure that management and banks would have no role in the reorganization process of large corporations.[41] Instead, the Act created a system based on government stewardship over restructuring in order to protect the interests of public investors.[42] In keeping with this goal, Congress created Chapter X, which was designed as the sole method of restructuring large corporations. Under this Chapter, once a corporation filed for bankruptcy, a trustee would immediately replace the management of the insolvent corporation.[43] Moreover, the trustee and its advisors could have no affiliation with the corporation's major financiers or their representatives.[44] The trustee was also the only party that was able to introduce a plan of reorganization, and while creditors were allowed to give suggestions, they were given no active role in the process.[45]

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38. *See* SKEEL, *supra* note 12, at 107 (describing the powers it created to bind dissenters to a plan of reorganization and the elimination of ancillary state court proceedings, which were necessary prior to 1933).

39. *Id.* at 111.

40. Chandler Act of 1938, Pub L. No. 75-696, 52 Stat. 840 (hereinafter "Chandler Act") (repealed 1978) .

41. *See id.* §§ 157-58.

42. *See* J. Ronald Trost, *Corporate Bankruptcy Reorganizations: For the Benefit of Creditors or Stockholders?*, 21 UCLA L. REV. 540, 542-43 (1973) (discussing Justice Douglas's goal of using the independent trustee and the Securities & Exchange Commission to limit bankers' roles in the reorganization process).

43. Chandler Act § 189.

44. SKEEL, *supra* note 12, at 110-11.

45. Harvey R. Miller, *Chapter 11 Reorganization Cases and the Delaware Myth*, 55 VAND. L. REV. 1987, 2006-09 (2002).

The Chandler Act, by taking so much power away from debtors and creditors, sowed the seeds of its own destruction. First, the process created in Chapter X was simply untenable. By forcing managers to resign if the company filed for bankruptcy, it created incentives for managers to try to avoid bankruptcy at all costs.[46] Second, Chapter X proceedings were incredibly time-consuming due to the many protections that were built into the process. Particularly problematic was the strict application of the absolute priority rule, which mandated an elaborate valuation of the firm.[47] Unless there was no alternative, companies were unlikely to file for Chapter X, and as a result, the number of Chapter X cases dropped from 500 in 1938 to 68 in 1944.[48]

The Chandler Act was also destined to fail because of a drafting mistake in the legislation.[49] The Chandler Act created two chapters relating to corporate bankruptcies: Chapter X for large, publicly traded corporations and Chapter XI for "mom-and-pop firms and small corporate debtors."[50] Chapter XI did not have all of the complex rules that existed in Chapter X, and therefore, was a more attractive form of restructuring for debtors. More importantly, while there were rules governing who exactly could file for Chapter X, there were no rules regarding eligibility for Chapter XI. "By restricting access to Chapter X, but not Chapter XI, the SEC had accidentally posted a guard at the wrong door."[51]

The SEC, realizing this mistake, tried but failed to have legislation passed that would fix this loophole.[52] Following this defeat, the SEC began going to court to challenge firms' decisions to file Chapter XI rather than Chapter X, and had some success in doing-so.[53] However, in one of those successful

46. Harvey R. Miller & Shai Y. Waisman, *Is Chapter 11 Bankrupt?*, 47 B.C. L. REV. 129, 140 (2005).

47. *Id.* at 138-39.

48. *Id.* at 140.

49. SKEEL, *supra* note 12, at 162.

50. *Id.*

51. *Id.* at 163.

52. *Id.*

53. *See, e.g.*, SEC v. Canandaigua Enterprises, 339 F.2d 14 (2d Cir. 1964). In this case, the lower court had rejected the SEC's attempts to convert the case to a Chapter XI case, however the Second Circuit reluctantly agreed with the SEC that it should be converted to a Chapter XI case.

cases, *General Stores Corp. v. Shlensky*, the Supreme Court agreed with the SEC that the debtor in the case should be in Chapter X, but also held that the decision whether Chapter X or XI is appropriate should be based on "the needs to be served," rather than based on hard and fast rules.[54] Armed with this ruling, attorneys were able to shape cases such that the "needs" of the corporation would be better served through a Chapter XI proceeding.[55]

Debtors, however, were not able to escape the constraints of Chapter X completely on their own. Instead, in avoiding this section, they were aided by creditors, who were reluctant to be subjected to the loss of control that occurred with Chapter X proceedings, where they were kept out of the bargaining process.[56] Large creditors were often able to use Chapter XI to work out a consensual plan with the debtor that better protected their interests than the long, drawn-out process of Chapter X.[57] Creditors, in fact, were so opposed to the process that the pressure they exerted on Congress contributed to the decision not to bring the Chapter X trustees into the new Chapter 11 that was promulgated under the Bankruptcy Code of 1978.[58] Another sign of creditor acquiescence to Chapter XI filings was the fact that when cases moved from Chapter XI to Chapter X, it was often at the insistence of the SEC rather than creditors, and was often accompanied by the reluctance of courts to "insist on a course which scarcely a creditor or stockholder has sought and which might lead to disaster."[59]

Firm capital structures during this period also encouraged collective action by the major creditors and debtors because corporations were financed mainly through a combination of retained earnings and unsecured bank debt.[60] Since this bank debt was unsecured, most creditors did not have any assets

54. Gen. Stores Corp. v. Shlensky, 350 U.S. 462, 466 (1956).
55. Miller & Waisman, *supra* note 46, at 141.
56. Eric Posner, *The Political Economy of the Bankruptcy Reform Act of 1978*, 96 MICH. L. REV. 47, 109-11 (1997) (describing why large creditors would prefer Chapter XI to Chapter X).
57. *Id.* at 111.
58. SKEEL, *supra* note 12, at 178.
59. *SEC v. Canandaigua Enterprises*, 339 F.2d 14, 21 (2d Cir. 1964).
60. Mark Gertler & R. Glenn Hubbard, *Taxation, Corporate Capital Structure, and Financial Distress* 3 (Nat'l Bureau of Econ. Research, Working Paper No. 3202, 1989).

upon which they could foreclose. In addition, most of this bank debt was more "intimate," and involved banks that had long-term relationships with the debtor.[61] Therefore, it was in these creditors' economic interest to attempt to restructure the corporation.

C. *The Bankruptcy Act of 1978*

The Bankruptcy Code of 1978[62] was designed to resolve the problems created by the Chandler Act. Therefore, a large part of the reforms centered on changing the relationship between the debtor's management, creditors, the SEC, and trustees.[63] The mandatory trustee was eliminated, and much of its power was transferred to the debtor-in-possession.[64] In addition, the SEC, while still allowed to appear in cases, was given a very limited role.[65] Finally, in order to allow debtors and creditors to successfully come to an agreement, the role of the judge was also diminished, leaving judges with very little oversight in Chapter 11 cases.[66]

Yet, despite these changes, the purpose of Chapter 11 remained the same: to rehabilitate fundamentally viable companies that faced a liquidity crisis.[67] In light of this purpose and of the powers given to the debtor, the Bankruptcy Code of 1978 as it was originally conceived was perceived as incredibly debtor-friendly.[68] Critics of the Code focused on the Eastern Airlines bankruptcy[69] as emblematic of the problems of Chap-

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61. *Id.* at 5.

62. 11 U.S.C. §101 -1532 (2009) contains the United States Bankruptcy Code.

63. *See* Posner, *supra* note 56, at 109-111. (describing how both large creditors and management preferred Chpater XI reorganization over Chapter X, and preferred to avoid the involvement of mandatory trustees and the SEC, as a result these groups successfully lobbied to eliminate Chapter X).

64. Miller & Waisman, *supra* note 46, at 143.

65. *Id.* at 118.

66. Melissa B. Jacoby, *Fast, Cheap and Creditor Controlled: Is Corporate Reorganization Failing?*, 54 BUFF. L. REV. 401, 428 (2006).

67. Michelle J. White, *Corporate Bankruptcy as a Filtering Device: Chapter 11 Reorganizations and Out-of-Court Debt Restructuring*, 10 J.L. ECON. & ORG. 268, 269 (1994).

68. Harvey R. Miller, *Chapter 11 in Transition: From Boom to Bust and into the Future*, 81 AM. BANKR. L.J. 375, 387 (2007).

69. The Eastern Airlines bankruptcy occurred in 1988, and despite widespread opinion that the company could not be reorganized, management

ter 11 and the ability of debtor-friendly courts and debtors to destroy value through their actions.[70] This and similar cases led early critics of the Bankruptcy Code of 1978 to suggest that the motto of the court should be "reorganization über alles."[71]

Creditors, however, have been able to co-opt what is, or at least appears to be, a fairly debtor-friendly system.[72] Two factors in particular have contributed to transforming this debtor-friendly system. The first was the jurisprudence that developed regarding section 363(b)[73] of the Bankruptcy Code. The case law interpreted section 363(b) as providing debtors with the ability to sell assets outside of the ordinary course of business, free of any interest in the assets.[74] Section 363(b) is especially powerful because it allows for the sales to occur without a confirmation hearing, and instead only requires notice and hearing procedures.[75] Therefore, within a few years of the passage of the Bankruptcy Code of 1978, creditors began attempting to circumvent the reorganization provisions of the Code by using section 363(b) sales to dispose of the debtors' assets.

The first major test of the usefulness of this section came in the Lionel bankruptcy in 1983.[76] Lionel manufactured toy

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refused to sell the company, and as a result the company was liquidated and the going concern value of the Airline was completely destroyed. David A. Skeel, *Creditor's Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917, 920-21 (2003).

70. *Id.*

71. Miller, *supra* note 68, at 387. The phrase "reorganization über alles" means reorganization above all else.

72. The actual degree of debtor control, even during the 1980s, is subject to some debate. *See* Jacoby, *supra* note 66, at 429-30 (discussing empirical studies, which suggest that creditors had significant control during this period).

73. 11 U.S.C. § 363(b) (2009).

74. Immediately following the implementation of the Bankruptcy Code the case law regarding section 363 sales was inconsistent. *See, e.g., In re* White Motor Credit Corp., 14 B.R. 584 (Bankr. N.D. Ohio 1981) (rejecting a debtor's request to sell all of its property. *But see In re* WHET, Inc., 12 B.R. 743, 750-51 (Bankr. D. Mass. 1981) (allowing a company to use a section 363 sale to sell all of its assets). However, the *Lionel* decision, as discussed below both ended this controversy and ushered in a fundamental change in how courts examined section 363 sales.

75. 11 U.S.C. § 363(b)(1)(a) (2009).

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

trains, and while most of its assets were unprofitable, it controlled one profitable asset, ownership of 82% of Dale, a profitable electronics manufacturer.[77] In the course of negotiations with its creditors, the creditor's committee insisted that Lionel sell the Dale stock in a section 363(b) sale in order to monetize the assets.[78] When Lionel sought approval from the bankruptcy court, the only justification given for the sale was creditor insistence.[79] Nonetheless, both the bankruptcy and district courts approved the sales.[80] The Second Circuit overturned the decision to allow the instant sale, but in doing so established that sales would be allowed outside the ordinary course of business if there a business justification for the section 363 sale.[81]

The *In re Lionel* decision was likely not the sole cause of the rapid expansion in the use of section 363. Instead, changes in the way that firms financed both their operations and their restructuring also helped strengthen creditor control. Firm financing practices changed shortly after the passage of the Bankruptcy Code of 1978, and many firms moved away from financing through retained earnings and instead began to take on significant amounts of debt.[82] In addition to increasing leverage, firms also increased their use of arms-length debt financing and moved away from bank debt financing, which had been based on long-term relationships.[83] Finally, firms also changed the type of debt that they issued, replacing the unsecured trade debt that had been frequently used in the immediate post-World War II era with new secured debt.

This change from unsecured to secured debt in turn changed the type of control that creditors could exercise over bankrupt companies, both before and after the companies filed for bankruptcy. Prior to filing, but following the beginning of financial distress, secured creditors will begin to take

77. *Id.* at 1065.
78. *Id.*
79. *Id.*
80. *Id.* at 1064-66.
81. *Id.* at 1071.
82. *See* Gertler & Hubbard, *supra* note 60, at 3-5 (discussing changes in corporate finance in the 1980s as companies began to rely more significantly on debt rather then earnings to finance operations).
83. *Id.* at 5.

control by making the company's continued financing revolving, and mandating that the company hire a chief restructuring officer.[84] Once a company with secured debt has filed for bankruptcy, section 363 gives creditors control over their "cash collateral,"[85] which includes both the property securing the loan and the proceeds from its use.[86] Debtors, in order to use this property, must receive consent from the lenders, which is generally only given when the debtor agrees to certain additional conditions.[87]

The facts from *In re Gulf Coast Oil Corp.*[88] help to show how creditors are able to exert this control. In that case, Gulf Coast Oil, prior to bankruptcy, received funding from the Laurus Master Fund, and in exchange gave Laurus a lien on all of the company's assets.[89] Therefore, once Gulf Coast Oil filed for bankruptcy, it needed Laurus's permission to continue to use any of its property. In exchange for that permission, Gulf Coast agreed to a number of stringent conditions, including a specific time period during which Gulf Coast would have to file a restructuring plan, and the requirement that the case had to be confirmed within one year.[90] Moreover, Gulf Coast also gave Laurus relief from the automatic stay if Gulf Coast violated any of these conditions.[91] In essence, Laurus was able to gain control over the entire course of the restructuring by virtue of its pre-petition loans.

The second change that has increased creditor control has been the nature of DIP financing that is offered to corporations in Chapter 11. Section 364 gives debtors the ability to receive financing while in Chapter 11.[92] This provision allows debtors to receive unsecured financing without a court order, but unfortunately for debtors, unsecured debt is almost never

84. David A. Skeel, Jr., *The Past, Present and Future of Debtor-in-Possession Financing*, 25 CARDOZO L. REV. 1905, 1917-18 (2004).

85. *See* 11 U.S.C § 363(c)(2) (2009) (stating that the estate cannot use, sell, or lease cash collateral without creditor consent or court authorization).

86. 11 U.S.C. § 363(a).

87. Baird & Rasmussen, *supra* note 3, at 784-85.

88. *In re* Gulf Coast Oil Corp., 404 B.R. 407 (Bankr. S.D. Tex. 2009).

89. *Id.* at 411.

90. *Id.* at 412.

91. *Id.*

92. 11 U.S.C. § 364 (2009).

available for DIP loans.[93] Instead, DIP financing agreements will often require not only an extremely high interest rate, but also a super-priority secured claim on many if not all of the company's assets, as well as restrictive covenants that make continued financing contingent on certain events such as cutting costs or selling the company.[94] U.S. Airways' 2002 DIP agreement evidences some of the constraints that are placed on the debtor through this form of financing: U.S. Airways was required to give the post-petition lender five of the twelve seats on the board, and was required to guarantee the post-petition lender 37.5% of the reorganized company's stock.[95]

III.
THE CHRYSLER AND GM SALES AS CASE STUDIES OF COLLECTIVE ACTION AND GOVERNANCE PROBLEMS

Before moving on to a discussion of the GM and Chrysler bankruptcies, and how they represent the "typical" structure of a section 363 sale, it is important to explain the trends that have led to the shift from debtor to creditor control that are present in both equity receiverships and Chapter XI of the Chandler Act. The first is a collective action problem that is

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93. Creditor reluctance to provide unsecured debt to the bankrupt estate is probably driven both by awareness that better terms are available with court approval as well as the perceived risk of lending to a bankrupt company. As a result, one study found that of firms that received DIP financing, 95% of loans gave lenders a superpriority administrative expense treatment and 92% gave lenders a security interest in all of the debtor's property. Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, at 15 (Columbia Univ. Ctr. for Law & Econ. Working Paper No. 321, 2008) (Northwestern Univ. Law Sch. Law & Econ. Research Paper Series, Working Paper No. 08-16, 2008), *available at* http://ssrn.com/abstract=1081661. *See also* Douglas G. Baird & Robert Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1238-39 (2006) (discussing some of the standard requirements of DIP financing agreements).

94. *See* Ayotte & Morrison, *supra* note 93, at 6.

95. *See* Micheline Maynard, *U.S. Air's Chief Lender Threatens the Ultimate*, N.Y. TIMES, Dec. 7, 2002, at C1 (describing the terms of the DIP loan that U.S. Air accepted). The U.S. Air case is sadly the rule rather then the exception, and very frequently DIP lenders will exert significant control through provisions in the DIP loans. *See* Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Fire Sales*, 106 MICH. L. REV. 1, 36-37 (2007) (discussing the harsh terms often extracted, and describing the terms of the Budget Group DIP agreement, where the company was given 50 days to sell itself).

present for smaller claimants in bankruptcies. In most bankruptcies there are a significant number of small claimants who do not have enough at stake to have an incentive to participate in the bankruptcy.[96] As a result, the potential exists that larger creditors will be able to control the process of restructuring at the expense of these small holders because they do not have an incentive to participate. Equity receiverships were able to solve this collective action problem for many claimants because of the role played by investment banks. Investment banks solved this collection problem through their ability to collect and vote debt and stock instruments and were able to centralize bargaining power.[97] The interests of the debtor and major creditors were also aligned in equity receiverships, making the collective action problem less severe because everyone was working towards the same goal.[98] The negotiations, in essence, turned on the distribution of assets of the future corporation, not on whether the corporation should continue to exist. However, despite solving the collective action problem for securities holders, there was still a collective action problem for unsecured creditors, who did not have an incentive to participate, and therefore without an effective voice were cut-out of the distributions.[99]

The Chandler Act, on the other hand, resolved the problem of inaction by smaller claimants by giving the SEC control over the course of the restructuring;[100] however it also magnified the collective action problem as there was no incentive to work towards a cooperative agreement in Chapter X proceed-

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96. Lynn LoPucki & William Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 680 (1993).

97. SKEEL, *supra* note 12, at 58. The successful solution to the collective action problem was also due to the fact that bondholders collateral was discrete areas of tracks rather then the entire railroad. *Id.* at 62. As a result, these bondholders were forced to work together because their collateral was worthless unless the railroad remained a functioning economic unit. *Id.*

98. *Id.*

99. *See id.* at 67 (discussing the standard practice in equity receiverships of giving nothing to unsecured creditors).

100. *See id.* at 122 (discussing the requirement that the SEC review any plan of reorganization submitted in Chapter X prior to plan approval or plan voting).

ings.[101] Even if creditors and debtors were able to come to a consensual agreement, their power was limited by the unwavering application of the absolute priority rule, which was zealously guarded by the SEC.[102] The result of this governance failure was that Chapter X proceedings became long, drawn out affairs that almost always failed. Indeed, there was only one successful reorganization under Chapter X prior to 1971.[103]

The second phenomenon is the problem of maintaining proper governance over the firm in bankruptcy. In equity receiverships, there was strong governance throughout the process because of the role that investment banks and the debtor's management played in the proceedings. Despite the disapproval of New Deal reformers, equity receiverships were able to successfully reform companies because the restructuring plan was negotiated in a small group in which everyone had a stake in the outcome. In the case of the Chandler Act, on the other hand, the governance issue in bankruptcy was magnified by the loss of control, which created a disincentive for managers of troubled companies to file for bankruptcy. The Trustee and the SEC, who by taking ownership of the estate successfully discouraged other stakeholders from attempting to restructure the company, made this problem worse.

The emergence of section 363 sales can be seen as a direct result of the Bankruptcy Code's failure to solve these two problems. In the case of the collective action problem, the Bankruptcy Code of 1978 is designed to achieve the goal of reorganizing companies; therefore, it is based on the concept of using negotiations to achieve a consensual solution, which can be a very time-consuming process. In addition, while the Bankruptcy Code allows for deviation from absolute priority, it still sets a high threshold for plan approval. Confirmation requires favorable votes from two-thirds of the value in a class

101. *See* Posner, *supra* note 56, at 109-111 (discussing the limited power that creditors had in the Chapter X reorganizations).

102. *See* Trost, *supra* note 42, at 544 (describing the damage that had been done to public investors as a result of the SEC's single-minded focus on applying the absolute priority rule).

103. *See* SKEEL, *supra* note 12, at 164 (describing a study that found there was only one successful Chapter X reorganization during the period from its inception to 1971).

and one-half of the holders of a class of security.[104] Moreover, even in the event of a cram-down,[105] the plan must still be approved by at least one impaired class. As a result, the debtor needs to either find a way to satisfy all of the claims or find at least one class that is willing to approve a plan with impairment.[106] These safeguards create a lengthy, time-consuming process that can be subject to capture by holdouts who are unwilling to approve a plan unless their interests are accommodated.

The time-consuming process that is created by the collective action problem is also made more complex by the power that Chapter 11 debtors are given over the estate. In particular, the Code gives managers 120 days to file a plan of reorganization,[107] and extensions are routinely granted for large debtors who face "the concomitant difficulty in formulating a plan of reorganization."[108] In cases where a company will be successfully reorganized, this ability to receive extensions is necessary, since the debtor needs time to balance the interests of a number of competing groups and formulate a plan that works.[109] However, this practice of giving out extensions is a thorn in the side of creditors who, lacking a strong interest in the success of the debtor, are primarily concerned with retrieving their money quickly.[110]

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104. 11 U.S.C. § 1126(c) (2009).

105. A cram-down is a situation where not all of the classes of creditors have approved the plan of reorganization. *Id.* § 1129.

106. *Id.* § 1129(a)(10).

107. *Id.* § 1121(b).

108. *In re* Express One Int'l, Inc., 194 B.R. 98, 100 (Bankr. E.D. Tex. 1996).

109. *See* Harvey R. Miller, *Chapter 11 Reorganization Cases and the Delaware Myth*, 55 VAND. L. REV. 1987, 2013 (2002) (explaining that the initial 120 day period does not allow enough time for a company to successfully reorganize because the first few months are devoted to dealing with the initial "trauma" of the Chapter 11 filing).

110. The problem of creditor detachment may also be magnified by the presence of hedge funds and other investors who purchase the debt claims of Chapter 11 debtors. *See id.* at 2015 (arguing that vulture investors do not care about what happens to the reorganized debtor, but instead are more concerned about receiving the profits from their investment in a relatively short-time frame). *But see* Paul M. Goldschmid, Note, *More Phoenix than Vulture: The Case for Distressed Investor Presence in Bankruptcy Reorganization Process,* 2005 COLUM. BUS. L. REV. 191, 264-65 (2005) (arguing that vulture investors increase firm value because they are interested in long-term returns); Edith

As these two problems lingered, changes in the corporate capital structure began to take shape replacing banks and unsecured debt with secured creditors who prefer to get out of bankruptcy as fast as possible. As a result, these creditors no longer have an incentive to work with the debtor, and would rather sell the company so as to make a profit or at least cut their losses. Moreover, in some cases these secured creditors have been able to co-opt management through "golden parachutes" and over-incentives, which reward management in the event of a sale.[111] The secured creditors are able to create a system where, like the equity receiverships, the benefits to secured creditors and management are aligned.

A. *GM, Chrysler and the "Typical" Section 363(b) Framework*

The facts of the GM and Chrysler bankruptcies help to demonstrate how the typical change in control of bankrupt companies occurs. Prior to filing for bankruptcy, GM and Chrysler were two of the "big three" auto makers in the United States. Both companies had roots dating back to the beginning of the twentieth century and were part of the massive industrial growth that propelled the United States throughout much of the post-World War II period. Statistics regarding GM bear out this point, as it once controlled 54% of the United States automobile market[112] and employed 390,000 union employees in 180 plants across the United States.[113] The company was so large that it was the number one corporation in the Fortune 500 for thirty-seven of the first fifty years that the list was maintained.[114] Moreover, despite a decreasing

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S. Hotchkiss & Robert M. Mooradian, *Vulture Investors and the Market for Control of Distressed Firms*, 43 J. FIN. ECON. 401, 429 (1997) (discussing an econometric study that showed the presence of vulture investors in distressed firms had a positive impact on the firm's market performance).

111. Kuney, *supra* note 10, at 78, 110-11.

112. Michelle Maynard, *Symbol of America in Motion and Ascendancy Now Humbled*, N.Y. TIMES, June 1, 2009, at A1.

113. Bill Vlasic & Nick Bunley, *G.M.'s Latest Plan Envisions a Much Smaller Automaker*, N.Y. TIMES, Apr. 27, 2009, http://www.nytimes.com/2009/04/28/business/28auto.html?_r=1&hp#.

114. Carol Lomis, *The Tragedy of General Motors*, FORTUNE, Feb. 20, 2006, at 59-70.

market share, it remained the number one car manufacturer in the world until 2008.[115]

Chrysler, on the other hand, while never commanding as large a market-share as GM, had a similarly long history dating back to the beginning of the twentieth century. Unlike GM, which had dominated the market since the 1930s, Chrysler's performance was defined by periods of great success, followed by periods of near failure and market difficulties.[116] Chrysler, in fact, had been near insolvency in the late 1970s and during the 1980s, but had been able to survive these setbacks and merged with Daimler-Benz in a so-called "marriage of equals" in 1998.[117] This marriage, however, proved to be a disaster. Chrysler lost significant value during the ten-year alliance and was then purchased by Cerberus in 2007, which planned on turning the company around.[118]

Prior to the Financial Crisis of 2008, both Chrysler and GM had already begun suffering financial setbacks. In the case of both companies, the setbacks were caused by the same basic problems: a lineup focused on large trucks and SUVs, and high manufacturing and legacy costs that made turning a profit more difficult.[119] The financial crisis and rising gas prices intensified these problems,[120] and as a result, GM and Chrysler were forced to turn to the government for aid in late 2008.[121] The government, in providing this aid, acted much

115. Nick Bunkley, *Toyota Ahead of G.M. in 2008 Sales*, N.Y. TIMES, Jan. 22, 2009 at B2.

116. *See generally* Ed Wallace, *Why Chrysler Failed*, BUSINESS WEEK, May 5, 2009, http://www.businessweek.com/lifestyle/content/may2009/bw2009055_922626.htm (explaining the history of Chrysler, and how it historically has gone through periods of success and near bankruptcy in the past).

117. *See* Edmund L. Andrews & Laura M. Holson, *Shaping a Global Giant: The Overview; Daimler-Benz Will Acquire Chrysler in $36 Billion Deal That Will Reshape Industry*, N.Y. TIMES, May 7, 1998, at A1, D4 (explaining that Chrysler and Mercedes were planning on pitching the merger as a marriage of equals, but in reality Daimler-Benz was expected to be the dominant party). *See also* Wallace, *supra* note 116 (explaining that the marriage between Daimler-Benz and Chrysler was never going to work).

118. Bill Vlasic, *Retooling Chrysler*, N.Y. TIMES, Aug. 20, 2008, at C1.

119. *See* Thomas H. Klier, *From Tail Fins to Hybrids: How Detroit Lost Its Dominance of the U.S. Auto Market*, 33 ECON. PERSP. 2, 13 (2009).

120. Bill Vlasic & Nick Bunkley, *Hazardous Conditions for the Auto Industry*, N.Y. TIMES, Oct. 1, 2008, at C1.

121. Stephen Labaton & David M. Herszenhorn, *White House Ready to Offer Aid to Auto Industry*, N.Y. TIMES, Dec. 13, 2008, at A1.

like a secured creditor and predicated its financial assistance on the two companies developing a viable plan for restructuring. Similarly, like a secured creditor, the government made the aid revolving, and established drop-dead dates to induce negotiation.[122]

As a result of these lender-imposed deadlines, both companies faced seemingly impossible tasks and began to develop bankruptcy strategies. In Chrysler's case, its strategy initially focused on liquidating the company, and only when Fiat announced an interest in the company in January did Chrysler begin to develop a section 363 strategy.[123] GM, on the other hand, continued to receive government support following the rejection of its February 17, 2009 restructuring plan, but was told that it needed to come up with a more aggressive restructuring plan and to begin considering bankruptcy.[124] Once the automakers filed for bankruptcy, the path of their bankruptcies were almost identical and showed strong governmental control. In both cases, the government provided DIP loans, but the loans were conditioned on successful reorganization being completed by specific dates. In the face of these creditor-imposed deadlines, both companies successfully completed sales to new companies that had been created expressly for the purpose of buying them out.[125]

The outcome of the GM and Chrysler bankruptcies exhibits the failure of collective action and the governance shift that are typical in Chapter 11 cases. With respect to the collective action problem, Chrysler tried and failed to achieve a consensual solution with its creditors.[126] The reason for this was that

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122. *See* OBAMA ADMINISTRATION NEW PATH TO VIABILITY FOR GM & CHRYSLER (2009), *available at* http://www.whitehouse.gov/assets/documents/Fact_Sheet_GM_Chrysler.pdf.

123. Vivia Chen, *Drive-Through Bankruptcy*, AM. LAW., Sept. 2009, at 78.

124. OBAMA ADMINISTRATION, *supra* note 122.

125. *See* Ind. State Police Penion Trust v. Chrysler LLC, 576 F.3d 108, 119-20 (2d Cir. 2009) (holding that despite the arbitrariness of the Fiat drop-dead date the sale was Chrysler's only option); *In re* Gen. Motors Corp., 407 B.R. 463, 480-81 (Bankr. S.D.N.Y. 2009) (holding that the inability of the debtor to access funding after July 10, 2009 justified a fast decision on the § 363 motion).

126. *See* Jim Rutenberg & Bill Vlasic, *Chrysler Files for Bankruptcy; U.A.W. and Fiat to Take Control*, N.Y. TIMES, May 1, 2009, at A1 (discussing the negotiations that had occurred prior to the filing and why the failure to come to a consensual solution led to the bankruptcy filing).

certain creditors held out and refused to compromise on their claims.[127] One example involves the United Automobile Workers Union, which initially refused to agree to any cuts to retiree employee benefits.[128] The collective action problem in these cases would have been worsened by a traditional restructuring and would likely have taken years to resolve. The government, acting like a traditional secured creditor, was not willing to make that time commitment, and instead, pushed for a resolution of the collective action problem through a section 363 sale.[129]

The governance of GM and Chrysler during this period also mirrors the governance of a "typical" section 363 sale, as the government became the major decision maker for both corporations. Two examples help to illustrate the central role played by the government in managing these companies. First, the decision to fire Rick Wagoner, the CEO of GM,[130] can be seen as akin to mandating that the company hire a Chief Restructuring Officer. Second, it was the government, rather than the debtor, that negotiated with Fiat and set the terms of the sale.[131] Therefore, much like a secured lender, the government controlled all aspects of the bankrupt companies' decision to merge.

IV.
THE IMPLICATIONS OF THIS CHANGE IN PRACTICE

The examples of Chrysler and GM indicate that modern-day section 363 sales are inconsistent with the congressional intent expressed in the Bankruptcy Code. In neither case was

127. *Id.* at B4.

128. Bill Vlasic & Nick Bunkley, *G.M. is Pressing Union for Cuts in Health Care*, N.Y. TIMES, Feb. 17, 2009, at A1.

129. *See* Chen, *supra* note 123, at 78 (explaining that the government was not willing to make the time commitment required to engage in a complete restructuring of the company). In this respect, the government acted in a way that is very similar to many secured creditors in bankruptcy who would prefer to end the proceeding as fast as possible. *See* Kuney, *supra* note 10, at 108-09 (explaining that secured creditors often use their power to force quick sales in bankruptcy); Baird & Rasmussen, *supra* note 3, at 785 (explaining that secured creditors will often favor quick sales of assets).

130. Sheryl Gay Stolberg & Bill Vlasic, *U.S. Moving to Overhaul Ailing Auto Industry*, N.Y. TIMES, Mar. 30, 2009, at A1.

131. *See* Chen, *supra* note 123, at 78.

the reorganization accomplished through the consensual negotiated process envisioned by the Code. Instead, powerful creditors were able to exert significant control, and ensure that their desired solution occurred. The question this raises is what to do to bring the bankruptcy process back towards the Congressional intent. The easiest way to counteract this inconsistency would be for Congress to change the Code and eliminate section 363 altogether. If this were done, debtors would still be able to sell assets as part of their plan of confirmation under section 1123(b)(4).[132] However, debtors would no longer be able to sell assets at the beginning of the bankruptcy, and they could only carry out such a sale once they had proven that it benefited all of the stakeholders, since the sale would have to occur as part of a plan rather than as an independent event.

However, eliminating section 363 sales may not be politically feasible, as recent changes to the Bankruptcy Code have already made it more, rather than less creditor-friendly.[133] Moreover, despite the potential for abuse, section 363 sales may create systematic benefits. One potential systematic benefit is that section 363 sales may solve a sorting problem in bankruptcy. The sorting problem exists because there is no method of ensuring the right debtors file for Chapter 11 and the right ones file for Chapter 7. This sorting problem is created by the structure of the Bankruptcy Code, where companies need to make an *ex ante* decision to file for either Chapter 7 or Chapter 11. Theoretically, companies that can be saved will file for Chapter 11 and will restructure, while companies that cannot be saved will file for Chapter 7 and be liquidated.[134] Unfortunately, this filtering system may fail either because managers are overoptimistic about their company's viability or because managers are reluctant to admit that their company is no longer viable.[135] Therefore, we would expect

132. 11 U.S.C. § 1123(b)(4) (2009).

133. The best example of the creditor friendly nature of changes to the Bankruptcy Code is the 2005 Bankruptcy Abuse Prevention and Consumer Protection Act, which made it more difficult for consumer creditors to liquidate their debts and shortened the time period that corporations could spend in bankruptcy. *See* Miller & Weisman, *supra* note 46, at 162-66.

134. White, *supra* note 67, at 269.

135. Once a company files for Chapter 7, the management of the company is immediately replaced by a disinterested Chapter 7 Trustee who is in

Chapter 11 to be oversubscribed because mangers had made the wrong *ex ante* decision. As a result, Chapter 11 will be less efficient as debtors who cannot be restructured try and fail to come up with restructuring plans to save their companies. Section 363 sales may help to solve this problem because they leave open the possibility that the sales, which ought to be carried out as part of the liquidation, will occur early on in the Chapter 11 proceeding.[136] Additionally, in cases where the debtor is nonviable, section 363 should be used because it may make the process more efficient by avoiding the need to convert the case to Chapter 7, which further delays liquidation.[137]

The second systematic benefit of the use of section 363 sales is that they may increase the price of the liquidated assets. This price increase can occur in one of two ways. First, a section 363 sale can lead to a "going concern" sale of the company in which the company is sold whole, and thereby, will likely be able to achieve a higher price based on any synergies created based on its assets. On the other hand, in Chapter 7 there is likely to be a piecemeal liquidation of the company.[138] Second, at least one empirical study has shown that the recovery rate for creditors in Chapter 11 is usually higher than the

charge of liquidating the company. 11 U.S.C. §§ 701(a), 702(b) (2009). As a result of the disinterestedness requirement, the trustee cannot be a member of the current management. Therefore, when management makes the decision to file for Chapter 7, they are not only eliminating their own positions, but also admitting that the company is no longer viable. When faced with the choice of either accepting their own failings or attempting to use Chapter 11 to reorganize the company, we would expect that at least some managers would chose to attempt restructuring, despite the likelihood that it will fail.

136. In the event of a particularly stubborn debtor, this may be made more difficult by exclusivity; however, even in that case exclusivity is temporary, and creditors retain the right to challenge exclusivity. Moreover, § 363 may give both creditors and debtors of fundamentally nonviable corporations enough flexibility to increase the value of some of the corporation's assets.

137. *See* Arturo Bris, Ivo Welch & Ning Zhu, *The Costs of Bankruptcy: Chapter 7 Liquidation Versus Chapter 11 Reorganization*, 61 J. FIN. 1253, 1271 (2006) (finding that when other variables are controlled conversions on average take one year longer, and that one of the major causes of this extra length is the conversion process).

138. *Id.* at 1256.

recovery rate for creditors in Chapter 7.[139] Therefore, it may be useful for both creditors and debtors to use the section 363 process to maximize return in both cases of restructuring and cases of liquidation.

The looming possibility that a company filing for bankruptcy will undergo a section 363 sale may also give management additional leverage in its attempts to consensually resolve financial distress prior to filing for bankruptcy because creditors want to avoid the messy process of bankruptcy.[140] Chapter 11 is not the only method that companies can use to successfully reorganize their debt. Instead, companies can restructure their balance sheets through either public or private workouts.[141] Public and private workouts change the capital structure of the company, transforming part of the company's debt into equity. In the alternative, workouts may change the interest rates and repayment terms characterizing the company's debt.[142] Workouts operate through negotiations with unsecured creditors, and it is in these negotiations where debtors are able to use the threat of a section 363 sale to pressure creditors to cooperate in a consensual restructuring. This threat may help resolve the holdout problem in a way very similar to the "upset price" that was enforced in equity receiverships of the nineteenth century. Empirically, there has been a surge in both the number of private debt workouts in 2008 and 2009 and in the amount of debt that is dealt with in these workouts.[143] This trend reflects not only the increasing unwillingness of management to file for bankruptcy, which is

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139. *See id.* at 1290 (discussing the fact that the Chapter 11 recovery rate for creditors appears to be consistently higher than the Chapter 7 recovery rate).

140. *See* Alan Schwartz, *Bankruptcy Workouts and Debt Contracts*, 36 J.L. ECON. 595, 596 (1993) (arguing that creditors have the same incentive to engage in debt workouts and avoid restructuring as litigants do in settling to avoid litigation costs, but that despite these incentives they often will not agree to the workout).

141. Sris Chatterjee, Upinder S. Dhillon & Gabriel G. Ramirez, *Resolution of Financial Distress: Debt Restructurings via Chapter 11, Prepackaged Bankruptcies, and Workouts*, 25 FIN. MGMT., no. 1, 1996 at 1 (1996).

142. *Id.* at 6.

143. Edward I. Altman & Brenda Karlin, *The Re-Emergence of Distressed Exchanges in Corporate Restructurings* 5 (N.Y. Univ. Working Paper No. FIN. 09-012, 2009), *available at* http://ssrn.com/abstract=1469130.

costly[144] and results in reducing management's control,[145] but also the increasing realization among bondholders that a "haircut" is better then the risk of losing all of their value.[146] Assuming that creditors will remain willing to engage in this cooperative behavior, workouts may allow debtors to retain control for longer periods of time, and to potentially avoid bankruptcy entirely.

However, despite these benefits, there are also significant harms that may arise from section 363 sales. In particular, "futures" claimants, unsecured creditors, and stockholders are often harmed by these sales. Futures claimants are parties who are unaware that the debtors conduct has harmed them at the time of the bankruptcy, but who were harmed by the action of the debtor.[147] One example of a futures claimant is a worker who has been exposed to asbestos by a company and will eventually develop asbestosis.[148] In that case, the debtor's action has already caused the harm, but because the disease takes years to develop, the worker does not know that she has been harmed by the debtor's actions.[149] The interests of these futures claimants are impaired because section 363 sales extinguish any right they have to sue the firm. For example, in the Chrysler bankruptcy, the initial sale order would have extinguished future products liability claims for defective vehicles that had already been sold by Chrysler.[150] These claims are

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144. *See* Ben Branch, *The Costs of Bankruptcy: A Review*, 11 INT'L REV. FIN. ANALYSIS 39, 53-54 (2002) (summarizing the costs of bankruptcy and estimating it reduces creditor recovery by approximately 35%).

145. *See, e.g.*, Kuney, *supra* note 10, at 52-56 (discussing how DIP lenders are able to take control of the restructuring process); Miller, *supra* note 68, at 385 (arguing that creditor power has increased significantly since the Code was adopted). In addition to the control that managers will lose to creditors during the process, it is also extremely likely that the management will be replaced during the course of the reorganization. *See* Ayotte & Morrison, *supra* note 93, at 9-10 (reporting the high turnover of Chapter 11 management).

146. Christopher Palmeri, *Take a Haircut Now, Avoid Bankruptcy*, BUS. WK., May 4, 2009, at 27.

147. Yair Listokin & Kenneth Ayotte, *Protecting Future Claimants in Mass Tort Bankruptcies*, 98 NW U. L. REV. 1435, 1435 (2004).

148. *Id.*

149. *Id.*

150. Marcia Coyle, *Plaintiff Suits Against Automakers Stall Out: Chrysler Sale, GM Bankruptcy Leave Personal Injury Plaintiffs in the Dust*, Nat'l L.J., June 15, 2009, at Col. 1. Chrysler, however, later reversed this position, and allowed

extinguished because some courts have read the "free and clear of any interest" language in section 363(f)[151] to mean that the court has the power to extinguish all claims against the company.[152] This view is often based on a constitutional argument that allowing these claims would violate the takings clause, since the court is requiring the purchaser to bear a burden that ought to be borne by the estate.[153] This problem is also unique to section 363 sales because other provisions like 11 U.S.C. § 524(g)(4)(B)(i) allow for the court to appoint a futures claim representative, who would have a voice in the plan confirmation process, but does not have a role in the process of approving section 363 sales.[154]

Other potential losers in section 363 sales are the unsecured creditors and shareholders. The reason that unsecured creditors lose in the process is that they could in fact benefit from having a bankruptcy proceeding endure for a longer period of time. First, a longer case can create more upside for unsecured creditors and shareholders if firm value improves.[155] Equity holders face even stronger incentives to try to increase the length of time that a company spends in bankruptcy. The reason for this is that due to the absolute priority rule, they cannot be given anything until the unsecured creditors are paid in full.[156] Second, in a restructuring that results in a plan of confirmation, the valuation of the

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futures claimants to bring their claims against the new company. *See* Christopher Jensen, *Chrysler Reverses Stance on Product Liability*, WHEELS, Aug. 28, 2009, http://wheels.blogs.nytimes.com/2009/08/28/chrysler-reverses-stance-on-product-liability.

151. 11 U.S.C. § 363(f) (2009).

152. Matthew T. Gunlock, Note, *An Appeal to Equity: Why Bankruptcy Courts Should Resort to Equitable Powers for Latitude in Their Interpretation of "Interests" Under Section 363(f) of the Bankruptcy Code*, 47 WM. & MARY L. REV. 347, 359 (2005).

153. William T. Bodoh & Michelle M. Morgan, *Inequality Among Creditors: The Unconstitutional Use of Successor Liability to Create a New Class of Priority Claimant*, 4 AM. BANKR. INST. L. REV. 325, 359-360 (1996).

154. 11 U.S.C. § 524 (2009).

155. *See* Ayotte & Morrison, *supra* note 93, at 6 (discussing benefits for unsecured creditors through a longer bankruptcy proceeding).

156. 11 U.S.C. § 1129(b)(2)(B) states that a plan cannot be confirmed that gives any interest in the debtor's property to a more junior creditor unless the creditors in more senior classes are paid in full. Equity interest is the most junior creditor class in a bankruptcy, and as a result cannot receive any interest in the property unless all of the creditors are paid in full.

company is determined through a process of negotiations, and in these negotiations they may seek to increase their recovery.[157] The reason for this potential unsecured recovery is that in the face of an uncertain valuation by the court, secured creditors may be willing to compromise with the unsecured creditors in order to control the outcome of the restructuring, rather then risk being forced to accept an unfavorable valuation decided by a judge.[158]

V.
AN AGENDA FOR REFORM

Ultimately, section 363 sales are popular because they represent a market-based solution to the major collective action and governance problems that exist in any bankruptcy. Much like equity receiverships, they provide a method for influential creditors and management to control the process of restructuring and guarantee a favorable outcome or one that benefits them at the expense of other creditors. Additionally, despite the fact that this may cause harm to some stakeholders, there may also be benefits to the estate as a whole in some cases. It is therefore unclear how to proceed in regulating these sales. If we assume that the major problem created by section 363 sales is the harm caused to futures claimants, unsecured creditors, and stockholders, then these problems can be resolved through judicial action, rather than through congressional intervention.[159] The reason for this is that the rules governing section 363 sales are all judicial creations. In the case of futures claimants, the statutory text specifies that "interests" are extinguished, but the definitional section of the Bankruptcy Code does not define the term "interests."[160] Therefore, it is

157. Stuart C. Gilson, Edith S. Hotchkiss & Richard S. Ruback, *Valuation of Bankrupt Firms*, 13 REV. FIN. STUD. 43, 44-45 (2000).

158. Douglas G. Baird & Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty & the Reorganization Bargain*, 115 YALE L.J. 1930, 1966-68 (2006).

159. There may also be the problem that fundamentally viable corporations are destroyed as a result of § 363 sales. However, this problem is more speculative, because it is impossible to determine whether or not they would have been viable had the process continued. Moreover, it is also possible that § 363 sales allow for viable companies to be saved through a going concern sale. Therefore, possible reforms based on this harm will not be discussed.

160. *See* 11 U.S.C. § 101 (2009).

possible that courts could define "interests" in such a way that future claimants would be excluded. On the other hand, courts could use their "equitable power" under 11 U.S.C. § 105(a)[161] in order to ensure that the futures claimants are protected in a section 363 sale.[162] It is also likely that if courts showed an increased willingness to consider the interest of futures claimants, this alone might enforce some market discipline and cause debt agreements to include express protection for futures claimants.

The case for judicial power to protect unsecured creditors and stockholders in the section 363 process, however, is even stronger. Section 363 sales of all of a company's assets exist only because of judge-made law. In fact, up until the *Lionel* decision, courts often rejected attempts to use section 363(b) to sell all of the corporation's assets outside of an "emergency" situation.[163] It was only with the *Lionel* decision, and the creation of the business justification rule, that section 363(b) sales became common practice.[164] However, the *Lionel* decision may also provide a partial justification for beginning a pushback against the secured creditors. The reason that the decision might help accomplish this goal is that the *Lionel* court made clear that section 363 sales cannot occur purely because of creditor demand, and that instead there must be an *business justification* for the sale.[165] Therefore, it is possible that judges could begin to play a larger role in the process of deciding whether or not to approve a sale, rather than serving as "a figurehead without any meaningful discretion" who "might as well leave his or her signature stamp with the debtor's counsel and go on vacation."[166]

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161. 11 U.S.C § 105(a).

162. *See* Gunlock, *supra* note 152, at 367 (arguing that § 363 was initially an equitable remedy, and therefore courts should use their equitable powers to determine whether to treat a "claim" against a debtor's property as an "interest").

163. *See, e.g., In re* White Motor Credit Corp., 14 B.R. 584, 590 (Bankr. N.D. Ohio 1981).

164. *See* Ind. State Police Pension Trust v. Chrysler LLC, 576 F.3d 108, 114 (discussing the history of § 363 sales after *Lionel*).

165. *In re* Committee of Equity Security Holders v. Lionel Corp., 722 F.2d 1063 (2d Cir. 1983).

166. *In re* Humboldt Creamery, LLC, No. 09-11078, 2009 Bankr. LEXIS 2470, at *5 (Bankr. N.D. Cal. Aug. 14, 2009).

In taking on this oversight role, bankruptcy judges should learn from the concepts employed by the Delaware Court of Chancery, which has developed an extensive jurisprudence in examining the fairness of takeovers of Delaware corporations. In particular, the Delaware courts have adopted the "entire fairness" standard of review in cases where a corporation's sale involves a controlling shareholder.[167] Delaware adopted this standard out of concern that in cases where the controlling shareholder received a unique benefit, there was the potential for abuse, and that in light of that potential these cases should receive more judicial scrutiny.[168] The same justifications apply to cases of controlling creditors because it is very possible they may be able to force the sale on the other parties. Moreover, it is likely that in the event courts start to play this oversight role, the market will be forced to exercise some self-discipline, and parties will begin to more carefully examine the impact of the sales.

The other potential advantage of using a judicial rather than legislative solution is that it creates additional flexibility in responding to changes in the parties' behavior and plans. Indeed, the history of the Chandler Act and the Bankruptcy Act of 1978 show that controlling shareholders will often contract their way around formal rules. This ability to contract around the rules is a result of the inherent governance and collective action problems that exist in bankruptcy law. Therefore, creating a system that focuses on judicial enforcement creates flexibility, which will allow courts to more effectively thwart creditor attempts to bypass the system. This would also be a fitting change, demonstrating that history is repeating itself, as the courts attempt to play a role similar to the one they played during the hay day of the equity receiverships.[169]

However, no matter what courts decide to do, ultimately the likely result of any bankruptcy system is that certain creditors and management will play a significant role in determining the outcome of the restructuring. This result is bound to

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167. *See In re* Cysive, Inc. Shareholders Litigation, 836 A.2d 531, 547-48 (Del. Ch. 2003) (discussing the mandatory nature of the entire fairness review in controlling shareholder litigation).

168. *See* Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1116-17 (Del. 1994) (discussing the ability of controlling shareholders to influence the decision in ways that non-controlling shareholders cannot).

169. Tabb, *supra* note 22, at 20.

happen because not only do these parties' interests often align, but these parties also have the most to lose in the restructuring process. Neither the motivation of the government in the GM and Chrysler bankruptcies, nor the methods used in these modern day proceedings are all that different from the equity receiverships of the past. Instead, the modern and historical bankruptcy cases are remarkably similar—the creditors with the most to lose in the case cooperated with one another to find a distribution that worked, and then sold the corporation to a new company in name only. The cases, therefore, are not examples of a drastic change in how bankruptcy works, but instead show how little the system has really changed over time.