AMERICAN AUTO COMPANIES, OTHER BIG COMPANIES AND CHAPTER 11
How The Legal Proceeding Might Work

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Today, it looks like the government will provide $14 billion immediately to GM, Ford, and Chrysler. Although the sum represents less that half the money the Big Three requested, and includes restrictions and cabinet-level government oversight, pundits and the public are crying foul. Their reactions, along with the reality that a mere $14 billion spread around before Christmas may not be enough to keep automakers afloat, fuels speculation that one or more U.S. car manufacturers may face a bankruptcy proceeding.

If any one of these companies needs protection under the bankruptcy law, it will petition the bankruptcy court for a Chapter 11 proceeding. A Chapter 11 proceeding is a corporate reorganization. It is thorough and drastic. That law permits, even requires, the players to negotiate a plan of reorganization while holding the creditors at bay. Given the financial crunch facing the auto industry and the larger global economic downturn that has caused businesses across virtually every industry to go under, it’s helpful to understand the structure of bankruptcy law and brush up on how Chapter 11 works.

Background

The U.S. Constitution gives Congress the exclusive right to pass laws regarding bankruptcy. Although each state has statutes that set up the means to compromise debts, those provisions are little used and certainly have no place in reorganizing a large public company,

There has been a bankruptcy law on the books since the earliest days of the republic. Prior to 1898, however, the bankruptcy laws were in effect an aggregate of only 16 years. Traditionally, the function of those laws was to permit people to start afresh. They could declare bankruptcy. That meant they could declare that they did not have sufficient assets to pay their debts, and could give up their assets and start over without going to a debtors’ prison. Exemptions permitted them to keep the homestead, the family Bible, and a few other things of limited monetary value. Until the past few decades, it was considered morally reprehensible to declare bankruptcy, and even today declaring bankruptcy may subject that unfortunate soul to social stigma. That disgrace is shouldered along with the divestiture of almost all assets, save a few exempt items (now including

Social Security-type payments). In this discussion, however, the exempt items are of no importance.

The bankruptcy laws have developed considerably from that early theory. For more than 100 years, the bankruptcy law has contained different chapters dealing with different kinds of debtors, different kinds of assets, different degrees of insolvency, and other special situations.

For instance, there were, and are, separate sections and chapters dealing with the bankruptcy of entities in special positions, such as municipalities and railroads, where the goal is to keep the assets as operating units in the economy. A municipality might not be able to pay its debts as they mature, but there still has to be police departments, fire departments and school systems – and there are few or no assets to sell off. One might "liquidate" a railroad, but the tracks and rolling stock are usually necessary sinews of the national economy. Consequently, those sections provided for the reorganization of the debtors. There will still be a municipal police department, but the time within which and the extent the debts might be paid would change. The stockholders of the railroad might be wiped out, creditors might become the new stockholders, and there might be new management, but the trains will still run over the tracks.

There is no special section of the bankruptcy law dealing with large automobile companies – and there never was. There used to be a special chapter dealing with public companies, but that was abolished in 1978 – and Chrysler is owned by a "private equity" fund anyway.

The Players

There are frequently many players in a Chapter 11 bankruptcy negotiation, including stakeholders who may not be able to vote on the final plan. Bear in mind the hierarchy of participants in a business corporation: stockholders (often the least important, as stockholders' interests are often eliminated in Chapter 11 where unsecured creditors receive less than 100% of their debt), boards of directors, management, secured creditors, and unsecured creditors (in various classes).

First, the board of directors authorizes the filing of the petition in bankruptcy. Normally this happens when the management goes to the Board to ask for such a resolution. Why would management even do this? Isn't it an admission of failure? Yes and no. It may be the last best chance to save whatever there is. Senior managers have a stake in the company, such as stock options and actual stock. Chapter 11 gives them an opportunity to save some aspect of their stock holdings and, if things go as planned, they will save their jobs. There is also the ego factor. Managers believe they need just a little time and money to turn things

around. If that turns out to be the case, they will be the heroes of the day. Even the creditors will still have their old customer to sell to.

Once the petition is filed, the debtor is represented by attorneys selected by its management. Their retention must be approved by the bankruptcy court. Under the Constitution, secured creditors cannot be divested of their interest in the assets securing their debt. They must receive "adequate protection" during the proceeding and the "indubitable equivalent" of their interest in the final plan. That means that, during the proceeding, secured creditors' assets must be protected, and they have to be paid an adequate periodic sum if their agreement calls for periodic payments. They must also have fair and equitable treatment in the plan of reorganization. In exchange for this protection, attempts they make to foreclose on their collateral during the proceeding will not be heard or will fall on deaf ears.

The unsecured creditors are typically represented by an official creditors' committee. This is composed of the largest unsecured creditors; that is, the unsecured creditors holding the biggest economic stake in the enterprise. After the stockholders (who may have already have lost everything), the unsecured creditors have the most to lose. Those represented on the official creditors' committee hope to have the votes needed to approve the final plan. There may be a hierarchy of creditors and there may be different creditors' committees representing those different classes of debt. A special provision allows renegotiation and even rejection of a labor contract. Even pension plans can be dealt with, although strict provisions apply. Underfunded pension plans can be terminated, with the assets and liabilities transferred to the Pension Benefit Guaranty Corporation. There may be a committee of stockholders, but the extent to which they have influence will be proportionate to the extent that they have any equity left in the company. That might be subjected to an early determination, and if that is the case, they will have little or no say in the ultimate outcome of the proceeding. The bottom line is the interested parties must listen to each other knowing that nothing is sacrosanct.

Chapter 11 does not in so many words deal with the public interest; in other words, it is not inherently intent on keeping the assets working in the economy or keeping the workers employed. There is no room for presumptions in the language of Chapter 11 that these corporations are icons of the economy, that we need these corporate structures to provide tanks, trucks, and other armaments, or that these assets must remain operating intact, such as is true of railroads or government units. But bankruptcy practitioners and bankruptcy judges live in this world and understand quite well that those pressures play a part in determining what course of action to take. How many workers will lose their jobs if the machinery, plant, and equipment are sold off piece by piece on the courthouse steps?

The real negotiation typically takes place between the representatives of the debtor and the official creditors committee. Their job is to come up with a viable reorganization plan that ensures the entity is preserved so that each party can obtain the largest piece of the pie as rapidly as possible. They also know that they are all going to give up something to get anything. All the economic elements you can think of come into play, but the key is that CASH IS KING.

The Debtor in Possession

In a Chapter 11 proceeding, the debtor becomes a debtor-in-possession. That neat legal handle separates the before-petition filing obligations from the post-petition filing obligations. Creditors holding debts incurred before the bankruptcy petition is filed cannot take action to collect except in bankruptcy court. That means that, with rare exception, pre-petition creditors must wait until a Plan of Reorganization is approved to receive anything on their claim. That can take anywhere from a few months (in a simple case) to many years. However, post-petition filing obligations are much better off. Except for the cash problem, the company is instantly a going concern – with the old management still in charge, and obligations paid as they mature – that is, if there is cash to pay them. If there's not adequate cash for post-petition operations, and if post-petition funding can't be obtained or operations reduced to make the entity at least break even on a going-forward basis, then the debtor will promptly be liquidated and the reorganization process short-circuited.

When management decides that it needs the protection of the Bankruptcy Code, it must figure out how it is going to pay its bills during the time it takes to negotiate and get final approval of a plan. Loans approved by a bankruptcy court to be made to a debtor-in-possession take priority over all other debts, except the cost of administration. Typically, banks are quite ready to lend to a debtor-in-possession, but that will not be the case when it comes to the U.S. automakers. That is where the government may enter this picture. Initially, the U.S. Treasury will have to lend to the debtor-in-possession. And the federal government will likely have to provide the long-term cash, and/or guarantee it, and get back some paper, debt, or stock, for its favor. The current hot topic, of course, is whether the government should fund the U.S. automakers in or out of bankruptcy. As to oversight, a bankruptcy court can appoint a Trustee, and the trustee may operate the business unless the bankruptcy court orders otherwise. That is far more than oversight.

Pre-Packaged Plans

In the typical case, debtors try to set up pre-packaged plans of reorganization before they file. These are delicate secretive negotiations with major creditors

and funders. These negotiations require the company and the major creditors to recognize that the debtor cannot pay its debts as they mature and continue in business as it is currently operating. That is a scary proposition. Even so, in normal cases the negotiation may fail because somebody decides that his obligations to continue have been completed and a bankruptcy petition may get filed, voluntarily by the debtor or involuntarily by disgruntled creditors. Normally these negotiations take place behind closed doors. In U.S. auto company cases, that will be very difficult. And whatever anybody does will result in plenty of second-guessing.

A successful pre-packaged plan will also need a commitment from a lender to provide working capital to the debtor-in-possession and ultimately to participate in the reorganized enterprise. In the case of the U.S. auto companies, the U.S. Treasury will be the giant elephant in the room when the creditors, the management (technically representing the company), and others negotiate. The supplicants will certainly need its blessing.

In the course of the negotiations, management will have to agree to drastic cuts in compensation, labor will have to renegotiate its contracts or risk having them rejected by the bankruptcy court, and agreement may be necessary that subsidiaries and divisions of the company may have to be sold off or liquidated. Only then might a plan pass the ultimate test that it is fair and reasonable – and that it has reasonable expectation of economic feasibility. It seems likely that only with substantial management and labor concessions might the U.S. Treasury find the political support to fund any reorganization.

The Bankruptcy Proceeding

If a pre-packaged plan were to be agreed upon, there would still have to be a bankruptcy proceeding. In that proceeding, there would be some formal discovery, and a disclosure statement would have to be submitted outlining the causes of the bankruptcy and explaining the financial ramifications of the proposed reorganization plan. In addition, more than two-thirds in dollar amount and one-half in number of various voting classes would have to be convinced to support the plan. After the statutorily required ritual has been completed, the bankruptcy court would then have to confirm the proposed plan. That means it would have to find that the plan complied with all the statutory requirements, one of which is that it appears economically viable. All of that takes time.

The Passage of Time

During the time that the bankruptcy proceeding was being used to develop and confirm a plan, the company would be operating as the debtor-in-possession. By the time a final plan is voted upon, at least 12 months will have passed and the

economy will have changed. The company may have succeeded, stayed in the doldrums, or simply sucked up more and more cash.

In the best-case scenario, the company would be able to stand on its own feet and the proceedings could be dismissed. The very passage of time would make difficult any attempt to provide repeated interim financings to the debtor-in-possession while the statutory requirements for plan approval were carried out. More than one dip in the well would be very problematic. In the worst-case scenario, the proceedings could have been deemed a failure and converted to a liquidation.

A few weeks ago, a spokesman for GM claimed that GM was only facing a "short-term liquidity crisis that needs a bridge loan." That's an old tune. Most companies that file a Chapter 11 proceeding claim that they need just a little more time and just a little cash to resume their ever onward upward climb to some wonderful golden Nirvana. Twenty-twenty hindsight shows it was true of Chrysler, because it survived as an independent for another 20 years.

Chapter 11 is a drastic remedy. Lack of immediate cash may be a symptom, but it is rarely the reason a Chapter 11 proceeding is necessary. The U.S. auto companies may have been taking steps to repair their business models, but the appearance is that they are not nimble enough to compete with foreign automakers. Economics may no longer be a dismal science, but the variables make the outcome of the application of Chapter 11 supported by the U.S. Treasury one of high risk.

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