



WHITHER CREDITORS' RIGHTS?

by
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The turmoil in the automotive industry has many observers concerned about creditors' rights and the stability of the free-market economy. Government's role in the Chrysler bankruptcy proceedings caused many to doubt the security of private investments in public companies. Under the Chrysler bankruptcy, an unsecured creditor—United Auto Workers (UAW)—received more per dollar than the secured creditors, i.e. the Indiana State Pension Fund. The UAW also received a 55 percent stake in the reorganized Chrysler; the Pension Fund received virtually nothing. George F. Will, *More Judicial Activism, Please*, WASH. POST, June 14, 2009, A15. This result caused observers to question the soundness of the absolute priority rule, which compensates secured creditors for lending money to a company at a rate lower than it could obtain in the credit markets by ensuring that the secured creditors are paid before any unsecured creditors. See 11 U.S.C. § 1129 (2004 & Supp. 2009). The secrecy surrounding GM's bankruptcy reorganization plan is arousing the same concerns that were raised by the Chrysler bankruptcy. The secured creditor's right to be paid first or to receive adequate protection may no longer be the inviolate rule of law that it has been.

Chapter 11 bankruptcy proceedings operate on the premise that a failing business is more valuable to creditors if it is reorganized and allowed to continue operating than if the business is liquidated and the proceeds distributed to creditors. Under routine bankruptcy procedures, a stay is placed on the business's assets and any claims by creditors against the business are suspended. While the business is under the protection of Chapter 11, it will continue to operate as the debtor and creditors negotiate a reorganization plan. Unless the bankruptcy court appoints an independent trustee to manage the business while it is in bankruptcy, the existing management will continue to operate the business as the debtor-in-possession (DIP).

Because bankruptcy proceedings move slowly, the business will need to sell or lease out its property to continue operating. The business' creditors, however, have a right to the business's assets as collateral for the loans and investments they made to the company before it filed for bankruptcy. Section 363(c)(1) of the Bankruptcy Code permits the DIP to sell or lease the business' assets in the ordinary course of business, provided that the business's creditors receive adequate protection. See 11 U.S.C. §§ 361, 363(c)(1) (2004 & Supp. 2009). The concept of adequate protection is crucial to any bankruptcy proceeding because it ensures that creditors will be compensated for leaving the business's assets with the business during the bankruptcy proceedings. If creditors could not be guaranteed that they would be compensated by the bankrupt business for the use of their collateral, creditors would have no incentive to leave the collateral assets in the business. Typically, creditors will receive adequate protection in the form of either a new stake in the assets of the post-petition business or equity in the reorganized business.

The next case that will test the endurance of the bankruptcy code is a case involving Delphi, Corp. Delphi is an auto-parts supplier that used to be a subsidiary of GM before it was spun off in the 1990s. Since 2005, Delphi has been in bankruptcy. Martin Zimmerman, *Creditors Win Auction for Delphi*, L.A. TIMES, July 28, 2009. The courts and the creditors have been content to slowly work out the terms of reorganization. Delphi's secured creditors and others provided DIP financing which allowed it to operate during the pendency of its four-year bankruptcy. Peter Lattman, *Judge Backs Auction for Delphi in Rebuke to Plan*, WALL ST. J., June 11, 2009, at B1. However, as a result of economic downturn, Delphi's creditors began pushing the company toward liquidation to recover their investment. Martin Zimmerman, *Creditors Win Auction for Delphi*, *supra*. Then GM declared bankruptcy.

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Believing immediate action was needed to save GM, the government attempted to impose a bankruptcy plan on Delphi. Under the arrangement, the government would purchase for \$2.5 billion some of Delphi's assets that it considered essential for the reorganization of GM. Peter Lattman, *Judge Backs Auction for Delphi in Rebuke to Plan*, *supra*. The rest of Delphi's assets would be sold to Platinum Equity for a mere \$250 million. *Id.* Platinum would then take control of Delphi and attempt to bring it out of bankruptcy. Delphi's senior creditors, however, objected to this proposal, claiming that their rights were being ignored and noting that they would only be receiving twenty cents on the dollar. *Id.*

The proposed Platinum Equity deal constitutes a sale of virtually all of Delphi's assets to GM and Platinum Equity. This type of sale is governed by 11 U.S.C. § 363 (2004 & Supp. 2009) and is commonly referred to as a "Section 363 sale." Section 363 sales can only proceed after notice has been provided to interested parties and a hearing has been conducted to determine if the sale is in the interest of the secured creditors and the bankruptcy estate. At the hearing, the secured creditors, the creditor's committee (which represents all of the unsecured creditors), and the potential buyers present the issues and concerns to the bankruptcy judge. The bankruptcy judge considers the relevant factors, such as, the value of the assets to the bankruptcy estate, the possibility of a successful reorganization plan emerging in the near future, any alternative uses of the assets, and the expected future value of the assets. *In re the Lionel Corp.*, 722 F.3d 1063, 1071 (2nd Cir. 1983). In weighing these factors, the bankruptcy judge should "act to further the diverse interests of the debtor, creditors and equity holders, alike," rather than following the requests of one special interest group or another. *Id.*

A ruling by Federal Bankruptcy Judge Robert Drain on June 10, 2009, put a hold on the government-brokered deal to sell off substantially all of Delphi's assets to GM and private-equity firm Platinum Equity. If Delphi is to sell off its assets, the judge ruled, it must be done at a public auction. Peter Lattman, *Judge Backs Auction for Delphi in Rebuke to Plan*, *supra*. This was a major victory not only for Delphi's secured creditors, but also for creditors in general. Rather than allowing an ambiguous government-sponsored purchase of Delphi to proceed, Judge Drain forced the sale of Delphi's assets out into the free market, in accordance with basic bankruptcy jurisprudence. *See Protective Committee for Independent Stockholders of TMT Trailer Ferry, Inc. v. Anderson*, 390 U.S. 414 (1968) ("The need for expedition, however, is not a justification for abandoning proper standards."). Of course, Platinum Equity was still permitted to resubmit its bid for Delphi; the company, though, had to compete against others interested in acquiring Delphi. On July 22, 2009, Delphi's creditors overwhelmingly voted to not accept the Platinum Equity deal. Delphi's lenders cited the fact that they would only receive twenty cents on the dollar from the deal and that salaried retirees would lose up to seventy percent of their pensions as a result of the Platinum Equity deal. David McLaughlin, *Bankruptcy Judge Allows Delphi to Sell Assets to Lenders*, *GM*, WALL ST. J., July 30, 2009.

After arduous negotiation, Delphi did much better. Rather than receive a pittance for the loans they had made to Delphi, its secured creditors sought control of the company through a credit bid. David McLaughlin, *Bankruptcy Judge Allows Delphi to Sell Assets to Lenders*, *GM*, WALL ST. J., July 30, 2009. Under the terms of the credit bid, the lenders would forgive \$3.5 billion in past loans to Delphi in exchange for equity in the company. *Id.* Additionally, GM agreed to purchase Delphi's global steering division and four other factories, which GM views as essential to its own financial recovery. *Id.* The creditors and other lenders will retain ownership of the rest of Delphi's assets that are not sold to GM.

The *Delphi* case is reassuring because even in tough economic times, the free market is still able to operate in a way that produces solutions that bring added value to the table. Delphi and its creditors would have certainly been in a less advantageous position had the Platinum Equity deal been forced on them.