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Cover Feature

A Proposal for Chapter 10: Reorganization for "Too Big to Fail" Companies

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The Bankruptcy Code provides tools that are well-suited to address and resolve the financial problems faced by the "Big Three" automakers (Chrysler, General Motors and Ford) and other "too big to fail" (TBTF) companies. But chapter 11 as it presently exists would inevitably impose great harm on vendors and other interrelated businesses, resulting in a ripple effect, causing cascading business failures and layoffs. With comparatively minor changes to the Bankruptcy Code, enacted in the form of a streamlined new chapter 10, however, TBTF companies could use the powerful tools of the bankruptcy process to remedy their core financial problems without imposing on society unnecessary and harmful cascading business failures.

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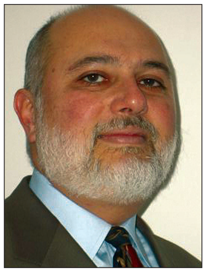
The Problem

At the root of the ripple effect is the principle that *all* unsecured debt must be subjected to the chapter 11 process and unsecured debt administered in the chapter 11 process cannot be paid until a plan of reorganization is confirmed, and then only as contemplated by the plan of reorganization. Thus, unsecured debts that have not been paid prebankruptcy are necessarily and inevitably "put on hold" for months or years once the bankruptcy case has been filed. TBTF companies, like the Big Three automakers, have extensive webs of vendors dependent on the current payment of the Big Three's accounts payable for their own survival. If the TBTF company puts all of its accounts payable on hold for months or years, its vendors and counterparties, unable to carry a large bad debt, are also likely to fail, failing to pay their own suppliers (due to their business failure or their own chapter 11 filings), potentially causing their vendors to fail as well. This ripple effect of cascading business failures, it is claimed, will inevitably result from the mandatory freezing of all accounts payable at the commencement of the bankruptcy case. The prospect of cascading business failures is generally cited as the leading reason that TBTF companies cannot or will not file for bankruptcy protection.

This ripple effect of cascading business failures need not be so, however. Very few changes would be required to create a new chapter 10 for TBTF companies to eliminate the prospect of cascading business failures.

Solving the "Cascading Business Failures" Problem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Specifically, a new chapter 10 should be enacted that would exclude from its scope ordinary-course-of-business trade debts. The parts supplier who ships on 30-day terms and collects, in the present environment, on 90-day terms, would essentially be unaffected by the bankruptcy case and would be paid for prebankruptcy shipments the same as for postbankruptcy shipments. Current employee payables would likewise be unaffected by a chapter 10 filing and would be paid in the ordinary course as they came due. This one change—paying what we refer to as "ordinary course of business prepetition trade vendors and employees" without regard to the bankruptcy filing—would avoid the otherwise inevitable cascading business failures and would shift the reorganization process to its appropriate focus: the modification of long-term contracts and the restructuring of the TBTF company's business and financial structure.

This one modification will free the bankruptcy process for a TBTF company from administering multitudes of granular claims that are unrelated to its core financial problems. It would also avoid the exogenous need for debtor-in-possession financing to fund the reclamation claims and the shift to cash-on-delivery credit terms that are often the inevitable consequence of automatically putting all trade payables on hold at the commencement of the bankruptcy case. Day-to-day operations for the TBTF company and its vendors would proceed on a "business as usual" basis, without the involvement of the bankruptcy process. Since payables would not be disrupted by the bankruptcy filing, the bankruptcy of the TBTF company would not inevitably and automatically lead to cascading business failures.

Reorganizing Vendor Relations in Chapter 10

This is not to say that relations with ordinary-course vendors could never be affected by chapter 10 reorganization; undoubtedly they will be affected. As the TBTF company reorganizes to become more efficient and profitable, it might seek different terms from some suppliers or even terminate relationships altogether, replacing the supplier or rendering the supplier unnecessary. The important point is that restructuring vendor relations to accommodate changes in business operations will not be advanced by an automatic and arbitrary suspension of the account payable otherwise due at the time the bankruptcy case is filed. Rather than imposing destructive disruption on all vendor relations at the commencement of a case, those ”ordinary course” relations should be left on a "business as usual" basis *until* restructuring those relationships advances the reorganization process.

If it becomes appropriate to restructure a vendor relationship that has been established as an open account (*i.e.,* not as a binding long-term contract), modifications or even a termination of the relationship can be accomplished in the ordinary course without the need for any bankruptcy intervention. If there is an ongoing long-term contractual relationship, it can be addressed or terminated through the provisions and procedures governing executory contracts in the bankruptcy proceeding. If rejected, reclamation rights could be addressed at that juncture and the balance of the damages claim for contract termination could be handled in the bankruptcy process. Thus, exempting ordinary-course vendor claims (as opposed to contract termination claims) from the bankruptcy process only eliminates the destructive ripple effect caused by automatically putting all outstanding trade payables on hold at the commencement of every bankruptcy case; it does not prevent the bankruptcy process from addressing, restructuring or if necessary terminating the underlying relationship with the trade vendors.

Chapter 10

In all other respects, chapter 10 would make use of the existing tools available in chapter 11 reorganizations. There are a handful of aspects of existing bankruptcy law that will prove critical in TBTF bankruptcy cases, and none of those aspects are affected by the exemption for ordinary-course vendors and employees.

First and foremost, a TBTF company must be able to restructure its ongoing contractual relationships, through negotiation if possible, but if not, by exercising the power to reject executory contracts and to have the damages resulting from that rejection administered as part of the bankruptcy process. It has been suggested, for example, that the Big Three have dealer networks that are many times larger than their Japanese competitors, and that a successful reorganization will require terminating—rejecting—many dealership agreements. Outside of bankruptcy, state laws impose a patchwork of restraints and impediments to terminating dealership relationships, impediments that stand in sharp contrast to the comparative ease and speed of the bankruptcy rejection process.

A unique subset of the executory contract issue relates to the modification or, in an appropriate case, rejection of collective-bargaining contracts. Congress has specifically legislated a regime governing this issue, representing its attempt to balance the interests of the beneficiaries of collective bargaining agreements with the imperatives of the reorganization process. Presumably, that regime and its decisional law applying it would simply be incorporated into chapter 10.

Third, the Bankruptcy Code provides powerful tools to restructure secured debt on the basis of the actual value of the collateral, rather than the (often historical) amount of the nominally "secured" debt. In a reorganization that would involve restructuring obsolete plants and outdated equipment, the ability to administer the debt secured by that collateral on the basis of the actual value of that collateral will prove significant.

Finally, at the core of the bankruptcy reorganization process is a restructuring of the rights and powers of the various financial and economic stakeholders and constituencies: existing and future shareholders, bondholders and employees, secured creditors and unsecured creditors, and creditors whose contract rights have been modified or terminated in the bankruptcy process. The chapter 11 reorganization plan process works well to accomplish that objective, and presumably would be adopted in chapter 10.

Status Quo Will Not Solve the Problem

It might be suggested that the problem can be solved through the expanded use of "critical vendor orders." The premise of such orders is extortion: The debtor cannot operate unless certain "critical vendors" continue to sell to the debtor, but they are unwilling to do so unless the debtor pays their prepetition general unsecured claim at the outset of the bankruptcy case, ordinarily in full. Critical vendor orders are of dubious legal provenance and have been rejected by a number of appeal courts, but they are routinely granted in the Delaware and Manhattan bankruptcy courts, no doubt contributing to those courts' popularity.

The fundamental problem with the "critical vendor" solution is that it is enormously unfair and arbitrary. *K-Mart* provides an instructive example: 2,330 suppliers were determined by K-Mart to be critical and were paid in full or nearly so in the first days of the case; another 2,043 vendors were determined not to be critical and ultimately received 10 cents on the dollar. There can be no assurance that any given TBTF company will decide that any given vendor is "critical," so all vendors are at risk.

First and foremost, what is needed is certainty, most of all in these uncertain financial times: If cascading insolvencies are to be avoided, all of General Motors' vendors need to be assured that their current outstanding invoices will be paid in the ordinary course even if there is a bankruptcy filing. The *probable* availability of critical-vendor orders in *some* courts does not provide sufficient certainty: Will the TBTF company file in a jurisdiction that approves critica-vendor orders? Will the judge assigned to the case approve the requested critical-vendor order? Will the TBTF company view the supplier in question as a "critical vendor?" Will the TBTF company use the critical vendor order as a lever to extort onerous concessions? If society needs certainty and stability to prevent cascading insolvencies, critica-vendor orders will not provide it.

The second, and related, issue is that the dubious legal provenance of critical-vendor orders leaves TBTF companies uncertain about whether they can obtain critical vendor-orders (unless they file in "safe" jurisdictions like Manhattan and Delaware). There are excellent reasons for a company like General Motors to file in Detroit, its "home" court, but such a decision would raise the stakes tremendously: There is no clear authority in the Sixth Circuit authorizing critical-vendor orders, and there is every reason to fear that a sensible jurist applying the law as it exists would deny a critical-vendor order. Should General Motors be required to file in Delaware? Wouldn't we be better served with a system that addresses these issues outside of the forum-shopping context?

What Is Not Solved by Chapter 10

This proposal does not attempt to address, let alone resolve, the problems associated with financial-service debtors. It is not obvious how best to address an AIG or Lehman Brothers insolvency, it is not clear how one should identify "ordinary-course vendors" in that context, and it is not clear that exempting a class of ordinary-course vendors in a financial services insolvency will accomplish anything meaningful or avoid cascading insolvencies. Without denying that a solution should be found for financial institutions, that solution is beyond the scope of this proposal and the abilities of these authors.

Conclusion

Chapter 11 for a "too big to fail" company, such as a Big Three automaker, could be disastrous for the country. By arbitrarily and unnecessarily putting all accounts payable on hold for months or years—a mandatory aspect of existing chapter 11 law—the bankruptcy filing of one large company would likely result in cascading business failures among its vendors, and the vendors of its vendors.

This disaster need not occur, however. By enacting a new chapter 10 for "too big to fail" companies that includes one simple change—allowing continued current payment of ordinary-course-of-business prepetition trade vendors and employees—the bankruptcy process could be used to reorganize large troubled companies without imposing cascading business failures on society. ■

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