Written Testimony of David A. Skeel, Jr.

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Thank you for the opportunity to testify about "Investor Protection: How to Protect Investors from the Government." My name is David Skeel, and I am the S. Samuel Arsht Professor of Corporate Law at the University of Pennsylvania Law School. It is a great honor to appear before you today.

Introduction

The past few years have been extraordinary time, and government has taken a variety of extraordinary actions. Like many Americans. I believe that some of these actions have been essential, while others have been deeply mistaken. Although I would be happy to share my views on these issues, in the remarks that follow I will not focus primarily on the correctness or incorrectness of particular decisions; I will focus instead on what I believe is a very dangerous pattern that has emerged during the crisis: the undermining of basic rule of law principles in ways that have injected enormous uncertainty into the markets.

This pattern did not begin with the current administration. When Bush administration officials and the Federal Reserve bailed out the investment bank Bear Stearns in early 2008 by midwifing its sale to JPMorgan Chase, they "locked up" the transaction with provisions that were clearly illegal under Delaware corporate law, which was the law that governed the transaction. The bailout of AIG later that year also included provisions that violated ordinary corporate law.

In the past several years, the assumption that ordinary legal requirements—and more generally, the rule of law principle that we are governed by laws, not the whims of our leaders--

can simply be ignored increasingly has become the norm. This ends-justifies-the-means mentality sometimes seems to produce desirable results in the short-run. But even the short-run benefits are often illusory. And in the longer run, ignoring the rule of law has devastating consequences for investors, the markets, and the economy as a whole.

I believe that the enormous uncertainty in the markets is one of the major reasons the economy is still struggling so mightily. Repeated departures from the rule of law are not the only reason for the uncertainty, but they are an important contributing factor, especially in industries that are likely to be subject to governmental intervention.

In the remarks that follow, I would like to comment in some detail on two of the most troubling examples of this pattern: the carmaker bailouts, and the recent nationwide mortgage settlement.

The Chrysler and General Motors Bailouts

As everyone here will remember, Chrysler and General Motors were put through so-called "quick rinse" bankruptcies in the spring of 2009. In late 2008, the U.S. government loaned more than $4 billion to Chrysler and more than $19 billion to General Motors. As a condition of additional loans, President Obama required, at the recommendation of the Auto Task Force the administration set up in early 2009, both carmakers to restructure under the U.S. bankruptcy laws.

Although the carmaker bankruptcies made use of Chapter 11, the laws governing corporate reorganization, the two cases were highly irregular.[1] In effect, the administration commandeered the bankruptcy process for the purposes bailing out the carmakers. Rather than using the ordinary Chapter 11 process, which gives creditors a variety of protections, including the right to vote on the terms of a proposed reorganization, the administration circumvented

[1] Mark Roe and I discuss the irregularities of the Chrysler transaction in detail in Mark J. Roe & David A. Skeel, Jr., *Assessing the Chrysler Bankruptcy*, 108 MICH. L. REV. 727 (2010). The discussion below draws on this analysis.

these provisions by structuring both bankruptcies as sales. Chrysler ostensibly sold all of its assets to a newly created shell corporation on June 10, 2009, and General Motors sold its assets to a new shell corporation on July 10, 2009.

The sales were not real sales at all, and they appear to have punished investors while rewarding favored constituencies. In the Chrysler bankruptcy, Chrysler sold its assets to the shell corporation (often referred to as New Chrysler) in return for $2 billion. Old Chrysler paid the $2 billion to Chrysler's senior lenders, which amounted to only 29% of the $6.9 billion that the senior investors were owed. Yet the administration arranged for New Chrysler to make enormous payments to two groups of lower priority creditors, United Auto Worker retirees and Chrysler's trade creditors. The UAW retirees received $1.5 billion in cash, a $4.6 billion promissory note, and 55% percent of New Chrysler's stock; $5.3 billion of Chrysler's trade creditors were paid in full.

If Chrysler's assets had truly been sold to the highest bidder, and the proceeds distributed in accordance with bankruptcy's ordinary priority rules, the case would have been unusual but arguably legitimate, even if the buyer decided to take on some of the old creditors. But this is not what happened at all. First, Chrysler signed an agreement of sale with New Chrysler that <u>required</u> New Chrysler to take care of the UAW retirees and the trade creditors as a condition of the transaction. Chrysler and the government were the ones who decided who would get paid, not the supposed "buyer," New Chrysler. Second, the supposed auction was not a real auction at all. If an outside bidder had wished to submit a bid for Chrysler, the bid would not have been recognized as a "qualified bid" unless the bidder agreed to pay off the UAW retirees and Chrysler's trade creditors, just as the government planned to do. In reality, the Chrysler reorganization was a restructuring in which the government decided which creditors would get paid and which would not.

In the General Motors bankruptcy, the government did not even pretend to conduct a real sale. Although they called the transfer of GM's assets to the shell corporation (generally referred to as New GM) a sale, no money changed hands. In GM, the senior creditors were paid in full.

The government once again arranged for UAW retirees to receive a large portion of what they were owed.[2]

Defenders of the carmaker bailouts have pointed to the car industry's recent resurgence as evidence that the bailouts were a shining example of successful government action.[3] Two assumptions underlying these claims are that Chrysler and General Motors would have been swept into the dustbin of history if the government hadn't commandeered the bankruptcy process, and that the costs of running roughshod over the rule of law are not great. Neither assumption is true.

Let me start with the likely outcome if the government had not commandeered the bankruptcy process. Chrysler and General Motors could, and surely would, have been restructured without violating basis bankruptcy law principles. It was common knowledge both that General Motors needed to file for bankruptcy and that it was precisely the kind of company for which Chapter 11 is well designed—a company with a viable business but excessive costs. Many of the terms of the restructuring could have been negotiated prior to the bankruptcy filing, and it could have been quickly reorganized in Chapter 11. Chrysler would have been either restructured or many of its assets sold to a buyer such as Fiat. This is essentially what actually happened, except that the government altered the treatment of Chrysler's creditors and it rather than Fiat footed the bill for the transfer of control to Fiat.

The principal obstacle would have been financing the bankruptcy process. Both companies were low on cash and needed to borrow funds for the restructuring process, at a time when the credit markets were very weak. General Motors might well have been able to arrange funding from private banks. Moreover, even if this proved impossible, the government could

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[2] After the bankruptcy, the administration further aided General Motors by giving it a special exemption from the rules on net operating losses. See J. Mark Ramseyer & Eric Bennett Rasmussen, *Can the Treasury Exempt its Own Companies from Tax? The $45 Billion GM NOL Carryforward*, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1873429.

[3] Some also point to the fact that bankruptcy judges (and with Chrysler, an appellate court) approved the government's transactions. But the Supreme Court seems to have been sufficiently worried about the Chrysler transaction that it voided the decision approving the transaction. Ind. State Police Pension Trust v. Chrysler LLC, 130 S. Ct. 1015 (2009).

have facilitated borrowing by offering to guarantee the financing,[4] or by lending the money itself. If the government decided to step in, it could easily have provided guaranties or lent the money without insisting that its preferred terms be locked up, and without dictating that some creditors got paid and others did not.

The government's manipulation of the process already has had adverse repercussions. After the Chrysler "sale" was announced, Warren Buffett speculated that it will "disrupt lending markets in the future" and warned, "We don't want to say to somebody who lends and gets a secured position that that secured position doesn't mean anything."[5] A recent study suggests that his fears may be well-founded. Studying investment in other politically sensitive industries, three finance scholars found that companies in these industries faced a steep increase in their cost of credit as a result of the Chrysler transaction.[6] Ironically, the violation of rule of law principles in the carmaker bailouts may put more pressure on the government to bail out companies in politically sensitive companies in the future, since these companies could find it difficult to raise money when they are in financial trouble.

The National Mortgage Settlement

Let me turn now to my second illustration, the recent National Mortgage Settlement. Here the administration has added in support of, and in concert with, litigation by state attorneys general.

The litigation that led to the settlement alleged that five of the nation's largest banks, each of which was a major mortgage lender and servicer during the real estate bubble, use "rob-signers"—law firms that filed large numbers of foreclosure documents without bothering to check the details—and added unnecessary fees such as overpriced insurance. The practices in

[4] The FDIC used a somewhat similar strategy with banks during the crisis.
[5] Lou Whitman, *Buffett warns of Chrysler cramdown ramifications*, TheDeal.com, May 5, 2009.
[6] Bradley Blaylock, Alexander Edwards & Jared Stanfield, *The Market-Wide Consequences of Governmental Intervention*, available at www.ssrn.com/papers=1685618. Another study finds that the cost of issuing bonds in favored industries went down, due to the prospect that these firms may benefit from a bailout. Deniz Anginer & A. Joseph Warburton, *The Chrysler Effect: The Impact of the Chrysler Bailout on Borrowing Costs*, available at www.ssrn.com/paper=1833731.

question are disturbing and, to the extent the allegations are true, deserve to be punished. But the litigation focused only incidentally on the actual misbehavior. It appears to have been designed to take money from the largest banks to use for other purposes.

Under the settlement, the banks agreed to provide for $20 billion in loan modifications and loan relief, together with $5 million in cash to the state and federal governments. Almost none of this money is linked to the abuses that gave rise to the litigation. Nearly all of the homeowners whose foreclosure documents were robo-signed appear to have been in default, and do not appear to have been capable of repaying their obligations. They are not the principal beneficiaries of the $25 billion. While a small amount of the settlement funds may go to preventing robo-signing and related practices in the future, the vast majority will go to mortgage relief for homeowners who were not affected by these practices, or to give budget relief for states.

The states' actions since the settlement was formally approved in April have dramatically underscored the disconnect between the ostensible basis for the litigation and the actual use of its proceeds. According to recent reports, the states have allocated nearly $1 billion of their settlement funds to general budgets and non-housing programs. To give three examples, Georgia intends to use its funds "to attract new businesses to the state in order to create more jobs," Missouri is using its funds for higher education, and Virginia "funneled almost all of its payout to the state's general fund."[7]

It is perhaps worth noting that I am no fan of the big banks or of the foreclosure practices that ostensibly gave rise to the litigation. I believe that the dominance of a small handful of giant banks is a major problem in our financial services industry.[8]

But the litigation that led to the mortgage settlement had almost nothing in common with genuine litigation. "In a real lawsuit," as I put it elsewhere, "lawyers investigate the grievance in

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[7] Meg Handley, *Should States be Chided for How They Use Their Mortgage Settlement Money?*, U.S. NEWS & WORLD REP., May 24, 2012, available at www.usnews.com/news/blogs/home-front/2012/05/24/ (relying on data from ProPublica).

[8] I discuss these concerns in great detail in DAVID SKEEL, THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD-FRANK ACT AND ITS (UNINTENDED) CONSEQUENCES (2011).

question, and if they persuade the court that their client has been harmed, the court or jury awards relief that is designed to remedy the harm, and perhaps to deter violations in the future. The chief objectives of the judicial process are fact finding and redress."[9] The mortgage settlement doesn't have any of these qualities. The attorneys general who pursued the litigation do not seem to have done any meaningful investigation at all. Rather than interviewing witnesses, reviewing the relevant documents, and seeking redress based related to their findings, they and the administration seem to have viewed the litigation as a way to provide additional legislative stimulus without actually going to Congress. This is a dangerous misuse of the judicial process.

Conclusion

The examples I have focused on in these remarks unfortunately are not the only illustrations of eroding respect for the rule of law. This pattern is becoming the norm. To mention just one more major illustration, the recently enacted Dodd-Frank Act explicitly requires that bank regulators liquidate any large financial institution that that they take over under the new Title II resolution rules. Almost no one thinks a giant financial institution would actually be liquidated if it fell into financial distress, however, and regulators already are signaling that they would use the resolution rules to preserve, not to liquidate, a troubled financial institution.

In the past, terms like "political risk" and "moral hazard plays" were most often used in connection with investment in the volatile markets of the developing world. Since the onset of the economic crises, the repeated circumvention of basic rule of law principles has made these concerns increasingly relevant to U.S. markets. Investors' inability to assume that their legal priorities will be honored, that laws will be applied as written, and that litigation will not be used to extract money for unrelated purposes has injected enormous uncertainty into the markets. I believe that recommitting to honor rule of law principles would make an important contribution to economic recovery, and to ensuring that our markets once again live up to their reputation as the fairest and most robust in the world.

[9] David Skeel, *Mortgage Settlement or Mortgage Shakedown?*, WALL ST. J., Feb. 21, 2012, at A19.