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Testimony of Professor Lubben before U.S. House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises regarding Argentinean Debt Default and the Automotive Bankruptcy Cases

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Chair Garrett and Distinguished Members of this Subcommittee:

I hold the Harvey Washington Wiley Chair in Corporate Governance & Business Ethics at Seton Hall University School of Law in Newark, N.J. I have been at Seton Hall since entering academia in 2002, and I teach Bankruptcy, Corporate Finance, and Financial Institutions at the Law School. I also write the *In Debt* column for the New York Times' *DealBook*, and write about corporate bankruptcy for *Credit Slips*.

Before entering academia, I was an associate for several years with the law firm of Skadden, Arps, Slate, Meagher & Flom in New York and Los Angeles, where I specialized in corporate reorganization and debt restructuring. But my comments today of course only reflect my own opinions on these matters.

I was asked by minority staff to address two of the issues covered in today's hearing: the role of the United States government in both the 2001 Argentinean debt default, especially as that issue is currently being litigated, and the bankruptcy cases of GM and Chrysler in 2009.

The topic of this afternoon's hearing is "the need to protect investors from the government." As I argue below, neither topic really implicates this issue. And I have some real concerns that investors may be using the Argentinean situation to make bad law.

The Argentine Debt Litigation

At heart, Argentina's bond debt and the interpretation thereof is a matter of New York State contract law. And as a matter of New York State law, it is pretty clear that Argentina has breached the contract.

But sovereign debt implicates other considerations, as the holdout bondholders undoubtedly knew when they bought this debt.[1] Most importantly, foreign nations have sovereign immunity. Sovereign immunity is a long recognized concept – indeed, the individual states in this nation have a form of sovereign immunity recognized by the 11th Amendment to the Constitution, which was ratified in 1795.

Knowing this, the holdout bondholders nonetheless decided to decline Argentina's proffered debt restructuring and take their chances on outside litigation. In essence the holdout bondholders opted for the option bondholders always have outside of bankruptcy: liquidation instead of reorganization.

That is an acknowledged strategy, carries obvious risks and rewards. Most notably, "liquidating" a sovereign is limited to collecting a small subset of the country's property, namely that which is not protected by sovereign immunity.

But in the process of implementing this strategy, the holdout bondholders have advanced an interpretation of the *pari passu* clause– a clause that appears in all types of bond indentures, sovereign and corporate – and a notion of sovereign immunity that is tension with existing law.

A *pari passu* clause reaffirms that debt issued under a particular indenture is not subordinated, and ranks equally with all other unsecured debt of a particular issuer. In the corporate context, this distinguishes the debt from subordinated debt, which ranks lower in payment. In the corporate setting it is quite clear that such a clause does not protect the bondholders against preferential payment of other unsecured creditors.

Indeed, the general rule is that under state law there is no prohibition against preferential payments. Protection against paying one unsecured creditor ahead of another is only granted in a federal bankruptcy proceeding.[2]

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[1] *See* Stephen J. Lubben, *Out of the Past: Railroads & Sovereign Debt Restructuring*, 35 GEO. J. INT'L L. 845 (2004).
[2] 11 U.S.C. § 547.

Obviously there is no applicable federal bankruptcy proceeding with regard to sovereign debt. The holdout bondholders nonetheless have attempted to transform the *pari passu* clause from a rule of rank into a rule against preferential payments.

This is inconsistent with the settled understanding under New York law in both the corporate and sovereign debt markets, and it seems entirely appropriate for the U.S. government to bring that to the Second Circuit's attention. If the holdout creditor's position were to be sustained on appeal, not only would it have serious consequences for the sovereign debt market, but it might have unforeseen effects on the ability of corporate debtors to engage in out of court workouts and exchange offers.

Similarly, the injunction issued by the District Court at the holdout bondholders' request seems to be in direct conflict with the notion that the Foreign Sovereign Immunities Act of 1976 largely displaced courts' equitable or common law powers in this area. Given Argentina's intransigence in this matter, the District Court's frustration is understandable. But it is not in comport with the law that Congress has enacted, and the Justice Department properly advised the Second Circuit of this fact.

Indeed, I would note that the Justice Department's current actions seem in keeping with those of prior Administrations, from both parties. If Congress disagrees with the status quo in either respect, it could enact legislative changes.

That said, it should be noted that changes on either front could seriously impede this country's position with regard to the sovereign debt markets, and have serious consequences for New York's role as one of the two leading jurisdictions for sovereign debt issuance. Moreover, attempts to impose a new reading of *pari passu* clause at the federal level would intrude on what has traditionally been a state concern, namely the common law of contract.

GM & Chrysler Bankruptcies

The GM chapter 11 case, and the Chrysler case before it, involved the quick sale of the debtor's assets under section 363 of the Bankruptcy Code.[3] The terms of that sale, and the speed of the sale, were largely dictated by the post-bankruptcy (or DIP) lender. In these cases, that was the U.S. Treasury.

Before 1995 the structure of these cases might have been a novelty, but for about fifteen years quick asset sales done at the direction of a controlling lender have become rather routine.[4]

As Judge Gonzalez noted in Chrysler, "[t]he sale transaction…is similar to that presented in other cases in which exigent circumstances warrant an expeditious sale of assets prior to confirmation of a plan. The fact that the U.S. government is the primary source of funding does not alter the analysis under bankruptcy law."[5]

Nonetheless, several commentators have continued to argue that Chrysler in particular was defective because senior creditors received partial payment, while certain employees and former employees received higher recoveries as the result of payments made after the sale. Notably, Fiat and the government agreed to provide ownership stakes to certain union retirement plans after the sale.

Note that these payments to current and former employees were paid outside the bankruptcy process. There is no real connection between creditor recoveries in the bankruptcy cases, and union recoveries outside the bankruptcy case.

We can debate whether it is wise for the government to bail out the UAW, but it does not implicate the bankruptcy process *unless* this bail out is being funded by value that should have gone into the debtors' estates. And it is not even clear that it was a

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[3] Stephanie Ben-Ishai & Stephen J. Lubben, *Sales or Plans: A Comparative Account of the "New" Corporate Reorganization*, 56 McGill L.J. 591 (2011).
[4] Stephen J. Lubben, *No Big Deal: The GM and Chrysler Cases in Context*, 83 Am. Bankr. L. J. 531 (2009).
[5] *In re Chrysler LLC*, 405 B.R. 84, 87 (Bankr. S.D.N.Y. 2009), *aff'd,* 576 F.3d 108 (2nd Cir. 2009). The Second Circuit's judgment affirming, but not the bankruptcy court ruling approving the sale, was subsequently vacated as moot by Indiana State Police Pension Trust v. Chrysler LLC, 130 S. Ct. 1015, 175 L. Ed. 2d 614 (2009).

bail out: the government-backed buyer may have simply wanted to make the UAW happy, so that it did not destroy the value of the automakers post-bankruptcy.[6]

In short, Fiat and the U.S. and Canadian governments needed the UAW in a way that they did not need the former lenders. Anybody who has every negotiated a restructuring understands that power comes in many forms. [7]

In the absence of any other bidder interested in buying either of the automotive companies, the argument that the funds going to the unions should have instead gone into the estates amounts to little more than a claim that government should have overpaid for the debtors' assets. Or, alternatively, that the creditors should have received a bailout too – a policy question, and not one that demonstrates a violation of the Bankruptcy Code or the "rule of law."

Indeed, if the creditors had been bailed out we can be sure that would have been the subject of much criticism too. The U.S. and Canadian governments negotiated hard, just a private DIP lender would. I think we should expect nothing less.[8]

We should also note that 90% of the Chrysler creditors agreed to take the sale proceeds offered to them. At heart, chapter 11 is always a process where a majority can bind a holdout minority to a deal.

A few holders of a minority stake in Chrysler's syndicated loan did object to the sale process – most notably the Indiana pension funds. But the terms of every syndicated loan agreement I've ever seen provides the lead banks with the power to settle a default, often subject to approval by a majority of the debt holders.

Chrysler's loan was no different: the vast majority of the holders approved the settlement that involved them receiving all of the sale proceeds. That's precisely what they were entitled to.[9]

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[6] Douglas Baird makes this point well here: http://jla.oxfordjournals.org/content/early/2012/02/28/jla.las001.full#xref-fn-36-1

[7] http://epicureandealmaker.blogspot.com/2009/05/more-of-kickin-sitcheyation.html

[8] http://epicureandealmaker.blogspot.com/2009/05/you-realithe-of-courth-thith-meanth-war.html

[9] As Baird, *supra*, neatly summarizes:

And I'm quite sure that any distressed debt investor – like the Indian pension funds, who bought the Chrysler debt at pennies on the dollar – would understand that this is how floating rate debt works. The dissenting creditors were outvoted. They agreed to majority rule in their contract, and there does not seem to be any reason why they should not be bound by their contract.

Finally, it is often argued that the bidding procedures used in these cases somehow "stacked the deck" in favor of government as buyer of the automotive companies. Some have argued that the bidding procedures may have deterred an unknown bidder, thus undermining the process.

This again shows a lack of understanding of modern chapter 11 practice and presumes that the procedures have more "stickiness" than they actually do. The caselaw is abundant and clear that bankruptcy courts have an obligation to consider the highest bid presented, even if it does not conform with previously approved bidding procedures. Any investor who contemplates buying a multi-billion dollar distressed corporation will know this – the contrary presumption is just not credible. If there was another bidder out there, it would have shown up with its bid and asked the court to consider it.

The reality is that both automakers failed at a point where the government was the only possible source of financing. Lehman had failed just months before – there was no possible way these companies could have received private DIP financing, especially GM, which required a DIP loan several times larger than any other. The government stepped in to provide the needed financing. As a result, it was in a position to negotiate the best possible deal it could – just as any other lender would have done.

In an idea world the automotive companies would have gotten their houses in order before the financial crisis struck. But they didn't, and the government had to act as DIP lender or face the chaos of these companies liquidating at a time of economic stress. That would have imposed severe costs on U.S. taxpayers as a result of management's failures. Hopefully the U.S. government will never have to do that

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> Chrysler, the debtor that filed the bankruptcy petition, gave everything it had to its secured creditors. It did not pay its general creditors anything. It sold its assets to New CarCo for $2 billion in cash. The absolute priority rule required that all of this cash go to the secured creditors and it did.

again, but again there is little to the notion that the government perverted the Code or otherwise overplayed its hand.

I appreciate the opportunity to appear before the Committee today to share my views and look forward to any questions.