

Automobile Bankruptcies, Retiree Benefits, and the Futility of Springing Priorities in Chapter 11 Reorganizations

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ABSTRACT: Both Chrysler and GM used asset sales under section 363 of the Bankruptcy Code as a way to avoid the more cumbersome chapter 11 plan process. The strategic use of section 363 asset sales in reorganization cases is becoming so common that some courts and commentators predict that the asset-sale route to a chapter 11 plan confirmation may soon supplant the traditional chapter 11 plan process. While some have decried section 363 sales as contrary to the voting system and other procedural safeguards inherent in a standard chapter 11 confirmation, this Essay argues that the section 363 asset-sale development is a natural consequence of the Bankruptcy Code being weighed down by a “springing” (or bankruptcy-only) priority of retiree medical benefits. Not only are springing priorities counterproductive to a company’s reorganization process, but they are also not even particularly effective for the priority’s recipients in the end, as both the Chrysler and GM cases demonstrated with retiree medical benefits.

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I. INTRODUCTION

When two of the three largest American automakers emerged from streamlined chapter 11 reorganization proceedings last summer, the popular press had many reasons to cover these cases much more than they typically cover the garden-variety corporate bankruptcy case. First, there was the widely held perception that these two companies, Chrysler and GM, were simply too big to fail without bringing down with them an already staggering national economy.¹ Second, both the U.S. and Canadian governments played a financing role in these two cases that was unprecedented in a chapter 11 reorganization.² Finally, the speed with which these two companies emerged from the reorganization process was itself newsworthy in an era when large chapter 11 cases often languish for years in bankruptcy court without resolution.³

As is often the case, however, the most significant aspects of these two corporate reorganizations did not receive nearly the attention that they deserved. In particular, these cases highlighted two emerging megatrends in the areas of chapter 11 bankruptcy and retiree medical benefits: increased use of both Voluntary Employees' Beneficiary Association ("VEBA") trusts and asset sales under section 363 of the Bankruptcy Code. Even more importantly, these two auto bankruptcies serve as a broader cautionary tale about the uses and abuses of special-interest priorities in the Bankruptcy Code, which Congress added with no real thought as to their effectiveness and practical utility for the priority recipients, much less their negative effect on the overall reorganization process.

The first megatrend highlighted by the Chrysler and GM chapter 11 cases is the increasing use of VEBA trusts as a way for companies with retiree-medical-benefit liabilities to simultaneously cap that financial exposure and strip it from their balance sheets. Ironically, it is often the retirees themselves—or, at least, the unions that represent them—who initiate this transition with their employer. Essentially, the transition to a VEBA trust involves moving from the employer's open-ended responsibility for retiree

1. See *In re GM Corp.*, 407 B.R. 463, 480 (Bankr. S.D.N.Y. 2009) (observing that the U.S. and Canadian governments' willingness to help fund the reorganization was not because of the deal's merits for them but rather to preserve automobile manufacturing jobs for the sake of their respective national economies).

2. The U.S. Treasury contributed \$49.5 billion to fund the reorganizations of these two companies, and the governments of Canada and Ontario contributed an additional \$9.5 billion between them. *Ramifications of Auto Industry Bankruptcies (Part II): Hearing Before the Subcomm. on Commercial and Admin. Law of the H. Comm. on the Judiciary*, 111th Cong. 16 (2009) [hereinafter *Ramifications of Auto Industry Bankruptcies*] (testimony of Ron Bloom, Senior Advisor, U.S. Department of the Treasury).

3. See Marc Swanson, *Commentary: Chrysler Bankruptcy Showed Section 363 a Worthy Solution*, MICH. LAW. WKLY., Aug. 24, 2009, WLNR 16691246 (noting that GM and Chrysler were able to emerge from chapter 11 in fewer than forty-five days each).

medical benefits to the employer's agreement to pay a negotiated and fixed payment or series of payments to an independent, tax-favored trust. Although these independent, tax-favored VEBA trusts are fraught with uncertainty for the retirees, retirees and their representatives nevertheless view them as a type of bankruptcy insurance, a least-worst outcome in a period of increasingly bleak prospects for retirees with unfunded employer-sponsored medical benefits.

The second megatrend, largely unnoticed by the popular press, is the use of asset sales under section 363 of the Bankruptcy Code as a way to avoid the more cumbersome chapter 11 plan process.⁴ The strategic use of section 363 asset sales in corporate-reorganization cases is becoming so common that some courts and commentators predict that this asset-sale route to chapter 11 plan confirmation may soon supplant the traditional plan process.⁵ While others have decried these "*sub rosa*" ("secret") plans via section 363 as contrary to the voting system and other procedural safeguards inherent in a standard chapter 11 confirmation,⁶ this Essay argues that the section 363 asset-sale development is a natural consequence of the Bankruptcy Code being weighed down by the significant springing-priority status of retiree medical benefits.

The problem with springing priorities—priorities that arise for the first time in bankruptcy—is that they are at odds with the fundamental purpose of chapter 11 reorganization, which is to maximize the value of the business enterprise for the entire creditor group, which includes claimants from all levels of priority.⁷ Not only are springing priorities counterproductive to the reorganization process, but they are also not even particularly effective for the favored group in the end. Section 1114 of the Bankruptcy Code is a classic example of an ill-advised springing priority which is not particularly effective. The intended beneficiaries, or favored group members, in the case of section 1114 are retirees with respect to their medical benefits. Medical benefits were a very big issue in the Chrysler and GM bankruptcy cases, but

4. 11 U.S.C. § 363 (2006). The traditional and "more cumbersome" chapter 11 plan process would involve, among other requirements, securing the requisite creditor votes under Bankruptcy Code section 1126's voting rules and then meeting the sixteen separate requirements for confirmation under section 1129(a).

5. See, e.g., *In re GM*, 407 B.R. at 489 (noting the broad power of judges to allow section 363 sales); Robert G. Sable et al., *When the 363 Sale Is the Best Route*, 15 J. BANKR. L. & PRAC. 121, 123 (2006) (highlighting advantages to a section 363 sale); Swanson, *supra* note 3.

6. *In re GM*, 407 B.R. at 510 (detailing the complaints of "splinter unions"); *In re Chrysler LLC*, 405 B.R. 84, 110 (Bankr. S.D.N.Y. 2009) (noting objections of certain affected retirees).

7. See H.R. REP. NO. 95-595, at 220 (1977) (stating that the premise of business reorganization is that a company's assets are worth more as a going concern than they are if they were sold for scrap); see also CHARLES JORDAN TABB, *THE LAW OF BANKRUPTCY* 7 (2d ed. 2009) ("In short, under the traditional view, chapter 11 rests on the notion 'that a business is worth more alive than dead—i.e., it is worth more as a going concern than in a forced sale liquidation.'" (quoting Charles J. Tabb, *The Future of Chapter 11*, 44 S.C. L. REV. 791, 804 (1993))).

section 1114 did not end up helping retirees very much. Instead, in those two chapter 11 cases, it was the nonbankruptcy leverage of the retirees rather than the bankruptcy-specific priority of section 1114 that ended up giving the retirees medical benefits. And what medical benefits the retirees did receive were still much less than what the two auto companies originally promised them.

The best evidence that nonbankruptcy leverage mattered most for retirees in the Chrysler and GM bankruptcies is the difference in treatment accorded to the medical benefits of the United Autoworker (“UAW”) union’s retirees compared to the treatment accorded to the medical benefits of retirees whose unions no longer provided active workers for those two auto companies. UAW retirees ended up as the beneficiaries of a VEBA trust that, in the case of Chrysler, owned more than half of the stock of the new company.⁸ Nonunion retirees, by contrast, received no special treatment for their benefits and instead had to make their claims for future benefits from a pot of cash that was largely consumed by secured creditors’ claims.⁹

The balance of this paper proceeds in four parts. Part II discusses the emergence of VEBAs as a means for employers and unions to manage the increasingly uncertain, open-ended, and massive liability represented by retiree medical benefits. Part III describes the growing use of section 363 asset sales in chapter 11 cases as a way for companies to short-circuit some of the springing priorities, such as retiree medical benefits, that the typical chapter 11 plan would otherwise present to them. Part IV explores the Chrysler and GM bankruptcy reorganizations as case studies of two megatrends: the use of VEBAs to handle retiree medical benefits, and section 363 asset sales in bankruptcy to circumvent the special protections retiree benefits receive in section 1114. Finally, Part V discusses in greater depth how the retiree-medical-benefit priority in bankruptcy first developed, why such priority was doomed to failure from its outset, and why it proved to be the “perfect storm” among bankruptcy springing priorities: massive in cost to companies, restricted only to chapter 11 cases, and failing to reflect any nonbankruptcy leverage enjoyed by the favored class of retirees.

II. THE VEBA SOLUTION FOR RETIREE MEDICAL BENEFITS

A. *THE TREND AWAY FROM EMPLOYER-SPONSORED RETIREE MEDICAL BENEFITS*

The best way to think about the role of VEBAs in the realm of retiree medical benefits is probably as an evolutionary step away from companies offering retiree medical benefits. Make no mistake about it: private companies are currently transitioning away from offering unlimited retiree

8. *In re Chrysler*, 405 B.R. at 92 (noting that New Chrysler and the UAW agreed to restructure the class-action settlement for a pre-petition retiree-benefit VEBA by funding it with 55% of the equity of New Chrysler plus a new \$4.587 billion note).

9. *In re GM*, 407 B.R. at 510; *In re Chrysler*, 405 B.R. at 110.

medical benefits, if they offered any retiree health benefits at all. This should come as no surprise to anyone, given that healthcare costs have doubled in the last seven years, while overall inflation increased only 25% over the same time period.¹⁰ During the last ten years, the percentage of private-sector employers that offered retiree medical benefits dropped from 21.6% to 12.7%.¹¹ Even among large private companies, which traditionally were much more likely than small companies to offer retiree benefits, the percentage has been cut in half over the last twenty years, from 66% to 33%.¹²

Among the employers that do continue to offer a form of retiree medical benefits, the decided trend is to change such benefits to a defined-contribution model, rather than stay with a defined-benefit model.¹³ This is understandable since with a defined-benefit model, the employer promises a certain level of coverage for retirees and then takes all of the financial risks to ensure that it can provide the promised level of coverage. In contrast to the defined-benefit approach, employers that are shifting to the defined-contribution model now set up individual retiree healthcare accounts for their employees into which the employer contributes a fixed sum. When employees retire, the employees can use the funds in these individual accounts to help pay for any health-related needs not covered by Medicare. The good news for the employee in these arrangements is that they still receive some type of benefit from their employer. The bad news is that all the risks traditionally borne by the employer—uncertainties surrounding future healthcare costs, rate of investment return on assets in the healthcare trust, and mortality rates—are now assumed by the employee.

This shift from defined-benefit plans to defined-contribution plans mirrors a similar pattern in the world of private-sector pensions. Very few private-sector employers offer defined-benefit pension plans for their employees anymore.¹⁴ Instead, companies have largely shifted to defined-contribution pension plans, such as 401(k) accounts, in which employers contribute a fixed amount to a separate account for each employee's pension plan.¹⁵ The shift in pension plans occurred for the very same reason

10. Steven J. Sacher, *Issueman Tackles the New VEBAs*, 35 *Pens. & Ben. Rep.* (BNA) 820 (Apr. 8, 2008).

11. *Id.*

12. Jyoti Thottam, *GM's Get-Well Plan*, *TIME*, Oct. 1, 2007, at 53.

13. *Id.*

14. Christopher E. Condeluci, *The New Single-Employer Defined Benefit Plan Funding Rules: What's in Store for Defined Benefit Plan Sponsors and Participants?*, 48 *TAX MGMT. MEMORANDUM* 59, 59 (2007) (noting that from 1974 until today, the percentage of private-sector employees covered by defined-benefit plans has decreased from 44% to 17%).

15. C. Scott Pryor, "May It Please the Court": *If I Had Been at Oral Argument in Rousey v. Jacoway Part II*, *AM. BANKR. INST. J.*, Mar. 2005, at 18, 18 ("Defined-benefit plans are the traditional sort of pension plans, but defined-contribution plans (frequently profit-sharing plans) have become more common . . .").

as the shift in retiree-benefit plans: employers simply could no longer afford to carry such a large and uncertain future liability on their books, no matter how attractive such an assumption of liability might be to the employer's workforce.

B. VEBA PRIMER

VEBAs have been around for decades in this country and employers have used them to fund employee benefits for reasons other than capping the employers' liability for retiree medical benefits.¹⁶ There are currently about 12,000 VEBAs in the United States.¹⁷ One reason that employers use VEBAs is the favorable tax treatment that is accorded a VEBA. Employers get a tax deduction for any contribution they make to a qualified VEBA. The money in the VEBA also earns tax-free interest for the employees, since VEBAs are tax-exempt entities under section 501(c)(9) of the Internal Revenue Code.¹⁸ Withdrawals from a VEBA can be made only for the purpose of paying employee benefits.¹⁹

VEBAs are not just tax-exempt vehicles. They are formal trusts that must have trustees appointed to manage the investment and distribution of the trust's assets. In Chrysler's VEBA, for example, there are eleven trustees: five appointed by the UAW and six appointed independently.²⁰ The unusual challenge for the trustees of the Chrysler VEBA is managing benefit levels, because asset funding consists largely of stock in the new Chrysler rather than cash.²¹

Although VEBAs have been around for some time, they recently gained popularity as a vehicle through which to cap an employer's liability for retiree medical benefits. But using VEBA trusts for retiree medical benefits does not make sense for every employer that is liable for retiree medical benefits. Typically, an employer will seriously consider a VEBA trust for retiree medical benefits when certain conditions are present.²² The employer must be a company that is financially precarious enough that the possibility of bankruptcy legitimately threatens its employees. Otherwise, the employer must have some other reason besides the threat of bankruptcy that compels its employees' union to cooperate with the transition of retiree

16. Kristin Gunderson Hunt, *Employers Look to VEBAs To Shift Retiree Health Liabilities*, 42 BUS. INS., Jan. 21, 2008, at 9.

17. *The Pension Protection Act, VEBAs, and Other Changes to the Provision of Retirement Benefits: Show Me the Money*, 2008 PROC. ANN. MEETING NAT'L ACAD. ARB. 197 [hereinafter *Pension Protection Act*].

18. *Id.*

19. *Id.*

20. *In re Chrysler LLC*, No. 09-50002(AJG), 2009 WL 1360869, at *38 (Bankr. S.D.N.Y. May 7, 2009).

21. *Id.* at *40.

22. Sacher, *supra* note 10.

benefits from an open-ended promise to a fixed VEBA-trust contribution. The employer's additional leverage might, for example, take the form of a contractual right reserved by the company to terminate or modify its retiree benefits unilaterally, coupled with employer-friendly common law in that state on the question of when retiree medical benefits vest.

C. *THE CLASS-ACTION ROUTE TO VEBA SETTLEMENTS*

The key point to appreciate here is that the shift of retiree medical benefits from an open-ended responsibility of the employer to a VEBA trust usually happens as a result of careful negotiations between the employer and its employees, who are usually represented by a union. Because the employer needs assurances that its transition to a retiree-benefit VEBA will be binding on all affected employees and retirees, legal recognition of the employer's new retiree-benefit promise typically occur through a class-action lawsuit.²³

Such a class-action lawsuit is arranged through employer-union negotiations. Select retirees file the lawsuit, seeking a declaratory judgment that their retiree medical benefits cannot be unilaterally terminated by their employer in light of the employer's contractual promises and state common-law vesting rules.²⁴ Once the suit is filed, both sides jointly ask the court to approve a preliminary settlement agreement to end the class-action lawsuit. Such a settlement agreement generally includes not only the terms of the VEBA that would replace the employer's previous retiree-benefit obligations, but also procedures for offering an opportunity to object and for providing notice to all affected retirees and employees.²⁵

The court will then set a period for objections, usually six months to a year, at the end of which it will give final approval to the proposed settlement. Typically, fewer than 5% of affected retirees will object to the proposed settlement. The court will often cite that fact as a reason for approving the proposed VEBA agreement. Courts that approve such settlements will also commonly note that it is simply unrealistic to expect that the company could fulfill its original retiree-medical-benefit obligations and remain in business for very long.²⁶

All Big Three American automakers, Chrysler, GM, and Ford Motor Company ("Ford"), entered into class-action VEBA settlements that more or less followed the described pattern.²⁷ Ford's settlement occurred last of the

23. See generally Diane M. Soubly, *Recent Developments in Collectively Bargained VEBAs*, 22 BENEFITS L.J., Summer 2009, at 5 (detailing the class-action route to VEBAs).

24. *Id.* at 7.

25. *Id.*

26. *Id.*

27. *Retiree VEBA Approved by Court in Ford Motor Case*, 36 TAX MGMT. COMPENSATION PLAN. J. 267 (2008).

three, in August of 2008.²⁸ A federal district court in Michigan approved Ford's proposed class-action settlement to contribute \$1.4 billion to a retiree-benefit VEBA that would relieve Ford of all of its retiree-benefit obligations to its UAW union employees and retirees.²⁹ Chrysler and GM's pre-bankruptcy class-action settlements for retiree medical benefits were both later altered significantly as part of the chapter 11 cases for those two companies, with much of the original deal's obligations for cash contributions replaced in bankruptcy by contributions of shares of stock in the post-bankruptcy entities.

As noted above, the ideal employer candidate for negotiating away from uncapped retiree-benefit liability towards a fixed-cost VEBA is a company that is experiencing great financial difficulty. Nevertheless, as the auto cases proved, it is not essential that an employer actually be in bankruptcy in order for these VEBAs to be created. Besides the Big Three automakers, AK Steel Corporation provides another recent example of a financially strapped employer that managed to get approval for a VEBA settlement without being in bankruptcy. In *Bailey v. White*, the Court of Appeals for the Sixth Circuit allowed AK Steel to contribute \$663 million to a retiree-benefit VEBA in exchange for eliminating all other retiree-medical-benefit obligations that it previously owed to the two proposed classes of claimants.³⁰ The notice sent to class members specifically highlighted the possibility that AK Steel might well need to file for bankruptcy if the settlement was not approved, in which case there could be a severe reduction or complete elimination of promised retiree medical benefits.³¹

In some cases, the VEBA trust is not created until the employer is already in bankruptcy. That happened in the case of Dana Corporation, a major auto-parts supplier that had been severely affected by the downturn in the auto industry. As part of Dana's chapter 11 settlement with two different unions, UAW and United Steelworkers ("USW"), Dana promised to contribute \$764 million to a retiree-benefits VEBA to fulfill all of its obligations to union retirees, and then separately instituted a different VEBA for its nonunion retirees.³² This was the first chapter 11 case in which a union embraced the concept of a VEBA trust as a way for its employer to fulfill its obligation to provide medical benefits for the union's retirees while still having enough resources to emerge successfully from chapter 11.³³

28. PHYLLIS C. BORZI, KAISER FAMILY FOUND., RETIREE HEALTH VEBAS: A NEW TWIST ON AN OLD PARADIGM 14 (2009), available at <http://www.kff.org/medicare/upload/7865.pdf>.

29. *UAW v. Ford Motor Co.*, No. 07-CV-14845, 2008 WL 4104329 (E.D. Mich. Aug. 29, 2008).

30. 320 F. App'x 364, 367 (6th Cir. 2009).

31. *Id.*

32. Corinne Ball, *Jones Day Charts Dana Corporation's Path to Successful Emergence from Chapter 11*, MONDAQ BUS. BRIEFING, April 18, 2008, 2008 WLNR 7261652.

33. *Id.*

D. THE MASS-TORT BANKRUPTCY ANALOGY TO VEBA TRUSTS

The emergence of VEBA trusts as a way to manage the magnitude and uncertainty of retiree medical benefits is similar to the way the law dealt with mass torts in bankruptcy during the 1980s and 1990s.³⁴ The mass-tort cases typically involved a large company that previously manufactured a product that was defective in some way. Although the company corrected the manufacturing flaw, the injuries caused by the defective product would continue to manifest themselves well into the future. Nobody knew how many injuries would occur, for how long they would occur, or what the exact extent of the damage would be.

The large companies in these mass-tort cases would finally reach a point where they simply could not operate profitably with the continuing specter of tort litigation diverting their time and resources. When these companies entered chapter 11 to get relief from the tort litigation, virtually all parties agreed that the company was worth more as a going-concern than it would be if it was liquidated. Indeed, even the tort victims themselves, as well as representatives of future tort victims, could see that liquidation would not be in their interests.

The compromise solution was to create victim trust funds and accompanying channeling injunctions that would force any future tort claimant to seek relief only from the trust fund. The trick for the bankruptcy court, then, was figuring out what portion of the company's going-concern value should be allocated to the tort victim's trust fund as opposed to other claimants of the debtor company.³⁵

Given the analogous history with the mass-tort bankruptcies and the desire of the tort victims to avoid a liquidation of their tortfeasor, perhaps it should not be surprising that it was actually the UAW, representing its retirees, that approached the automakers with the idea of establishing VEBA trusts for retiree medical benefits.³⁶ First, however, the UAW had to sell that idea to its own skeptical retirees, who were convinced up to that point that the promise made to them by their employer for lifetime health benefits was ironclad and nonnegotiable. The main pitch that the UAW made to its retirees was similar to the rationale echoed in many court opinions that later approved these VEBA settlements for retiree medical benefits: namely, that the alternative—doing nothing—was clearly worse. Or to put that argument

34. See generally Michelle J. White, *Why the Asbestos Genie Won't Stay in the Bankruptcy Bottle*, 70 U. CIN. L. REV. 1319 (2002) (offering asbestos litigation as an example of the mass-tort liability problem in bankruptcy).

35. See Kathy L. Yeatter, *Fumbling Towards Consistency: Valuation of Future Asbestos Personal Injury Claims in Bankruptcy*, AM. BANKR. INST. J., Nov. 2006, at 50, 52 (noting that the *Manville* asbestos crisis demonstrated "that historical claims data cannot be taken for granted when developing a workable estimate of future asbestos personal-injury claims").

36. *UAW Gives Big Three Chance at Reinvention*, DETROIT NEWS, Nov. 5, 2007, 2007 WLNR 27512605.

another way, the UAW convinced its retirees that agreeing to accept a VEBA trust in lieu of the company's open-ended promise on retiree benefits was tantamount to a form of bankruptcy insurance for their benefits.³⁷

When the Sixth Circuit approved the pre-bankruptcy VEBA trust that GM negotiated with the UAW for the company's retirees, it pointed out that GM's overall operations had lost \$11.4 billion in 2005 while the company spent \$3.7 billion that same year on its retiree medical benefits. One of the issues in that case was whether, under state common law, the retirees' right to lifetime health benefits had vested. In approving the negotiated settlement that admittedly gave retirees less in retiree medical benefits than their employer had originally promised, the Sixth Circuit observed:

If we decided for the sake of argument that the retirees were likely to win the debate [on vesting], any such victory would run the risk of being a Pyrrhic one because the cost of insisting on irreversible healthcare benefits might well be—and indeed almost certainly would be—the continuing downward spiral of the companies' financial position.³⁸

E. VEBA COSTS AND BENEFITS FOR EMPLOYERS AND RETIREES

If VEBAs' main benefit to retirees is getting something rather than nothing, the benefit to employers is getting a fresh balance sheet devoid of the monstrous and uncertain liability that the retiree medical benefits represented. The Financial Accounting Standards Board ("FASB") issued Standard 106 in the early 1990s, requiring for the first time that employers show their retiree-medical-benefit liability as a footnote on their balance sheet.³⁹ That development was bad enough for employers with retiree-benefit promises, since employers could no longer hide from the investing public these huge unfunded liabilities. FASB's issuance of Standard 158 in September of 2006 made it all the more vital that companies deal with retiree health-benefit problems sooner rather than later, because Standard 158 required an employer to show its retiree-medical-benefit liability not just in a footnote but also on the balance sheet itself.⁴⁰

37. Katie Merx, *Strings on Auto Loans Risky for Retirees*, DETROIT FREE PRESS, Dec. 29, 2008, 2008 WLNR 24879269.

38. *UAW v. GM Corp.*, 497 F.3d 615, 632 (6th Cir. 2007).

39. Soubly, *supra* note 23, at 6; *see also* EMPLOYERS' ACCOUNTING FOR POSTRETIREMENT BENEFITS OTHER THAN PENSIONS, Statement of Fin. Accounting Standards No. 106 (Fin. Accounting Standards Bd. 1990) (discussing accounting standards applied to postretirement benefits).

40. Soubly, *supra* note 23, at 6; *see also* EMPLOYERS' ACCOUNTING FOR POSTRETIREMENT BENEFITS OTHER THAN PENSIONS, Statement of Fin. Accounting Standards No. 158 (Fin. Accounting Standards Bd. 1996) (requiring employers "to recognize the overfunded or underfunded status of a defined postretirement plan . . . as an asset or liability in its statement of financial position").

When an employer and its employees' union sit down to bargain about moving the employer's retiree-benefit liability into a VEBA, there are two key issues to negotiate: the size of the discount off the original retiree-medical-benefit promise that the employer will get and how much of the total employer funding for the VEBA will be in cash as opposed to debt or stock. Because the retirees are bargaining in the shadow of what they would likely get in a future bankruptcy of their employer, they realize that they cannot expect to get VEBA funding that equals the present value of the employer's original retiree-medical-benefit promise. Instead, retirees expect their employer to reduce its retiree-benefit liability. GM, for example, was obligated in its pre-bankruptcy VEBA settlement to give the VEBA only \$30 billion for a retiree-benefit obligation originally worth \$50 billion.⁴¹ All told, the Big Three automakers agreed in their pre-bankruptcy retiree-benefit settlements to pay a total of \$52 billion for \$88 billion worth of obligations.⁴²

Just as significant for employers as the discount on the sticker price is how the VEBA obligation will be funded. There are at least three possibilities, and often the employer's obligation to fund the VEBA will consist of a combination of the three forms: immediate cash payment, deferred cash payment, and company stock. In the Goodyear case, for example, Goodyear agreed to contribute \$1 billion to a retiree-benefit VEBA, with \$700 million coming in the form of immediate cash and the remainder in deferred cash and stock to cover 30,000 Goodyear retirees and their spouses.⁴³ Similarly, the Dana corporation agreed to fund its VEBA with \$700 million in cash and \$80 million worth of stock.⁴⁴

In the Chrysler and GM bankruptcy cases, one of the key sticking points for the Federal Government was the rate at which each company would fund the retiree-benefit VBAs. Essentially, the U.S. and Canadian governments refused to finance these two chapter 11 cases until the unions agreed to a less aggressive payment schedule than bargained for in their pre-bankruptcy VEBA settlements with the two automakers. The new VEBA deal for the Chrysler retirees obligated New Chrysler (Chrysler's going-concern) to give the VEBA a \$4.6 billion unsecured note plus 55% of the total outstanding stock to be issued in New Chrysler.⁴⁵ The GM retirees ended up with a promise from New GM (GM's ongoing-concern) to put a \$2.5 billion note in their medical-benefit VEBA, along with 12% of New GM's stock.⁴⁶

41. Hunt, *supra* note 16, at 9.

42. Katie Merx, *Veba Gag Order Irks UAW Ranks: GM Retirees Seek Details of Health Trusts*, DETROIT FREE PRESS, Jan. 6, 2008, 2008 WLNR 311728.

43. Kimberly Peterson, *Companies Eye Trusts for Retirees*, FORT WAYNE J. GAZETTE, Sept. 7, 2007, 2007 WLNR 17540975.

44. *Id.*

45. *Ramifications of Auto Industry Bankruptcies*, *supra* note 2 (testimony of Ron Bloom).

46. *Id.*

Although the unions that represented retirees were realistic enough to cut these deals in light of the alternatives available to them, nobody should pretend that retirees are happy with the substitution of VEBA trusts in place of their employers' formerly open-ended promises of lifetime health benefits. Some experts wonder whether unions have sufficient experience to handle the management of the VEBA trusts.⁴⁷ Some union members are even angry at the VEBA solution to the retiree-benefit problem because they feel that the union's job should be *protecting* its members' benefits, not managing them.⁴⁸ As one union member put it, the only choices left for retirees are between silver and lead; the gold option is completely off the table.⁴⁹ One UAW negotiating-committee member admitted that a VEBA was not what the union wanted for its retirees, "but we really didn't have much of a choice. If we didn't get our jobs, we lose everything and it wouldn't matter. We took what they gave us."⁵⁰

When one considers all of the risks inherent in a retiree-benefit VEBA, it is no wonder that retirees are not particularly happy with this approach. At best, retirees view the VEBA route as a least-worst solution to the retiree-benefit funding problem. With the original promise of lifetime health benefits for retirees, it was the employer who bore the risk of assumptions concerning future healthcare costs, return on assets for any pre-funding the employer might have undertaken, and retiree lifespan—all of which affect the total cost of guaranteeing future retiree medical benefits. With the transition to a retiree-benefit VEBA, it is the retiree beneficiaries of the VEBA who bear the brunt of all of these uncertainties.⁵¹

Furthermore, retirees covered by a health-benefit VEBA typically must take the additional risk of counting on VEBA funding that is often not in cash or not immediately paid.⁵² If part of the VEBA funding takes the form of a note, then the company obligated on the note must be financially sound enough to pay the note when it comes due. If part of the VEBA funding is in stock, then the value of that stock will depend on how well the company is performing, a key variable over which the retirees have no control.

As if these theoretical risks were not scary enough for retirees, they also entered into these VEBA deals with full knowledge of actual retiree healthcare VEBAs that went badly for other companies' retirees. In the late 1990s, for example, Caterpillar's retiree healthcare VEBA ran out of funds after just a few years, mainly due to spiraling healthcare costs not adequately

47. Hunt, *supra* note 16, at 9, 12.

48. *Id.*

49. See Peterson, *supra* note 43.

50. K.O. Jackson, *Retirees Consider Effects of Chapter 11: Medicare Benefits Top List of Labor Concessions*, KOKOMO TRIB., May 1, 2009, 2009 WLNR 8280497.

51. *Pension Protection Act*, *supra* note 17, at 204.

52. *Id.*

accounted for in the original VEBA projections.⁵³ Detroit Diesel was another retiree-benefit VEBA that went broke in the 1990s.⁵⁴ Both Caterpillar and Detroit Diesel are still fighting class-action lawsuits from disappointed retirees following the collapse of their healthcare VBAs.⁵⁵

III. SECTION 363 SALES: THE FASTER, CHEAPER ALTERNATIVE TO PLAN CONFIRMATION

A. THE BASICS OF SECTION 363 SALES

Section 363 of the Bankruptcy Code allows a debtor-in-possession, with court approval, to sell property of the estate “free and clear of any interest in such property of an entity other than the estate,” subject to certain conditions.⁵⁶ Thanks to section 363, buyers of collateral from a bankrupt estate can purchase bankruptcy assets with confidence that their full title in the asset will not be clouded by other claims to or liens on the asset. It is not clear whether the congressional drafters of section 363 envisioned that debtors in chapter 11 cases would use that provision to sell *all* of their assets to a buyer who would then continue to operate the business in more or less the form it took prior to filing chapter 11. Nevertheless, that is what more and more chapter 11 debtors are now doing.

Recently, Chrysler and GM are among the more prominent companies to use the section 363 sale route in lieu of a traditional chapter 11 plan. In neither case did the debtor even attempt a standard chapter 11 confirmation. Although these two cases may have been unusual in the size of their assets, the debtor’s choice in the auto bankruptcies of the section 363 route to reorganization is becoming increasingly common.⁵⁷

Chapter 11 debtors can reap a number of potential advantages by going with the section 363 asset sale. First, the sale is attractive to potential purchasers because they know that they can purchase the debtor’s assets “free and clear of any liens.”⁵⁸ Second, and often more important than the lien clearance, the purchaser generally takes the debtor’s assets free of successor liability claims that would make it difficult for the purchaser to restart the debtor’s business.⁵⁹ Third, because the sale takes place in the context of bankruptcy, the sale is binding on all nonconsenting constituencies.⁶⁰ Finally, the bankruptcy setting enables the purchaser to

53. Hunt, *supra* note 16, at 12.

54. Thottam, *supra* note 12.

55. Jesse J. Holland, *Will GM’s Health-Care Agreement with UAW Retirees Accelerate a Trend?*, DESERET MORNING NEWS (Salt Lake City), Oct. 22, 2007, 2007 WLNR 25841659.

56. 11 U.S.C. § 363 (2006).

57. *See supra* note 5 and accompanying text.

58. Sable, *supra* note 5, at 123.

59. *Id.*

60. *Id.*

cherry-pick which executory contracts and leases should be included as part of the asset sale.⁶¹

Section 363 sales are not for everyone, however. Most section 363 sales require the identification of a “stalking horse” bidder that bargains in advance with the debtor to make a certain bid in the assets auction required by section 363 procedures. The stalking horse will almost always negotiate for certain fees to be paid by the estate whether or not its bid is successful, including breakup fees and expense reimbursement fees that must be approved by the bankruptcy court.⁶²

There are other disadvantages to a section 363 sale beyond the stalking horse’s fees, when compared to the debtor’s other options of either a nonbankruptcy sale of assets or a traditional reorganization plan. First, compared to a nonbankruptcy sale of a company’s assets, a section 363 sale comes with the negative publicity that accompanies any indication that a debtor is in bankruptcy.⁶³ Second, despite the relative speed of a section 363 sale compared to a traditional chapter 11 plan, a nonbankruptcy sale of all of the debtor’s assets is still often faster than a section 363 sale.⁶⁴ Finally, compared to a traditional chapter 11 reorganization process, a section 363 sale of all of the debtor’s assets may offer the debtor less flexibility surrounding terms of the reorganization.⁶⁵

B. USE OF SECTION 363 TO AVOID RETIREE BENEFITS AND OTHER SUCCESSORSHIP LIABILITY

In both the Chrysler and GM bankruptcy cases, the key benefit that drove the decision to use the section 363 route for reorganization was the ability to avoid the requirements of section 1114 for retiree medical benefits and certain past tort liability. By using section 363, the new Chrysler and the new GM could take the assets free and clear of those requirements. In *In re GM Corp.*, Judge Gerber noted that the new GM was voluntarily assuming liability for warranty and product-liability claims that could be asserted by anyone injured *following* the section 363 sale even if the cars in question were made prior to the section 363 sale;⁶⁶ however, New GM was not assuming any old GM liabilities for injuries or illnesses that arose prior to the section 363 sale.⁶⁷ In other words, New GM was not subject to successor liability for such claims and any such claimants would be enjoined from recovering against New GM.⁶⁸

61. *Id.*

62. *Id.*

63. *Id.*

64. *Id.*

65. *Id.* at 124.

66. *In re GM Corp.*, 407 B.R. 463, 500 (Bankr. S.D.N.Y. 2009).

67. *Id.*

68. *Id.*

Judge Gerber went further than in *In re Trans World Airlines, Inc.* (“TWA”),⁶⁹ a key case developing the use of section 363 asset sales in bankruptcy, and also addressed whether the purchaser of a debtor’s assets under section 363 is subject to the retiree-medical-benefit duties imposed upon a trustee or debtor-in-possession under section 1114. In *GM*, the court noted that section 363 is silent about any duty by the debtor to first comply with section 1114 before engaging in a section 363 sale of all the debtor’s assets.⁷⁰ In the face of such silence, the court was unwilling to impose such a duty on the debtor or on the purchaser. In a section 363 sale of the entire business, any section 1114 rights of retirees to the debtor’s estate would be limited to the purchase price of the debtor’s assets that were sold. That pot of cash in essence becomes the chapter 11 estate in these section 363 sales.

TWA was one key case in the evolution of the use of section 363 asset sales in lieu of traditional plans.⁷¹ In *TWA*, the Third Circuit held that airline workers’ employment-discrimination claims against the debtor, as well as claims to a travel-voucher program that TWA established to settle a sex-discrimination suit, were both “interests in property” that were extinguished in the debtor’s section 363 sale of all TWA assets.⁷² By interpreting broadly the phrase “interest in property” that appears in section 363(f), the Third Circuit reinforced the buyer’s immunity from successor-liability claims as a legitimate enticement for debtors to use to attract purchasers in a section 363 route to a chapter 11 bankruptcy reorganization plan.⁷³

In 2007, Congress introduced a bill that would have reversed certain case law establishing successorship-liability benefits for the purchaser in a section 363 asset sale.⁷⁴ This bill provided, among other provisions, that in determining the successful bid in a section 363 auction in bankruptcy, the bankruptcy court must consider the extent to which each bidder will preserve jobs and preserve health benefits for retirees.⁷⁵ Furthermore, the bill provided that where there are competing chapter 11 plans, the bankruptcy court must consider how each plan maintains existing jobs and minimizes losses to current employees and retirees before the court decides which plan to approve.⁷⁶ The proposed bill failed to make it out of

69. 322 F.3d 283 (3d Cir. 2003).

70. *In re GM*, 407 B.R. at 511.

71. *In re Trans World Airlines*, 322 F.3d at 283.

72. *Id.* at 288–90.

73. *Id.*

74. *Protecting Employees and Retirees in Business Bankruptcies Act of 2007: Hearing on H.R. 3652 Before the Subcomm. on Commercial and Admin. Law of the Comm. on the Judiciary*, 110th Cong. 11 (2008) [hereinafter *Protecting Employees and Retirees*] (statement of Babette Ceccotti, of Cohen, Weiss and Simon LLP, on behalf of the AFL-CIO), available at <http://judiciary.house.gov/hearings/pdf/Ceccottio8o6o5.pdf>.

75. *Id.*

76. *Id.*

committee. The failure of this bill only furthered the momentum of those who were determined to expand the use of section 363 as an alternative to traditional chapter 11 plan confirmations.

Besides expanding successorship-liability immunity, developing case law on section 363 sales recently provided another key ruling that will help promote the further use of these asset sales in lieu of traditional chapter 11 plans. In *In re Delphi Corp.*,⁷⁷ the issue was whether section 363(k), which allows a secured creditor to credit bid in an auction involving an asset on which the secured creditor has a lien, applies in a sale of all of the debtor's assets as opposed to sales of individual assets of the debtor. The bankruptcy court in *Delphi* held that section 363(k) indeed allows such credit-bids by secured creditors.⁷⁸ Credit bidding is a powerful tool for a secured creditor in section 363 auctions, since the amount of debt that the debtor owes to the secured creditor can be used by the secured creditor as the equivalent of cash for purposes of bidding in the auction. Since the secured creditor is often owed more than its collateral is worth, the ability of the secured creditor to credit bid its entire secured debt means that no outside cash bidder is likely to outbid the secured creditor in the auction.

The *Delphi* court also held that it would follow the provision in the debtor-in-possession's loan documents which empowered a simple majority of the secured-lender group to credit bid the entire amount of the debtor-in-possession loan in the section 363 auction. Put another way, the *Delphi* court held that a minority of dissenting lenders could not block the attempt by the majority of lenders to credit bid the entire amount of the loan.⁷⁹ This is a significant ruling for promoting section 363 sales since it means that no single holdout creditor or minority of creditors in a lending group can prevent the group from credit bidding the entire amount of the loan.

IV. THE CHRYSLER AND GM CASES

A. THE UNPRECEDENTED ROLE OF GOVERNMENT FINANCING

It is impossible to analyze the Chrysler and GM chapter 11 cases without first mentioning the role that the governments of the United States and Canada played in those two cases. All told, the U.S. Government contributed \$49.5 billion to these two companies, and the governments of Canada and Ontario contributed another \$9.5 billion.⁸⁰ These contributions included over \$8 billion from the United States in debtor-in-possession and exit financing, along with more than \$2 billion from Canada and Ontario for the

77. No 05-44481 (RDD), 2009 WL 2482146 (Bankr. S.D.N.Y. July 30, 2009).

78. *Id.* at *6-8.

79. *Id.*

80. *See supra* note 2 and accompanying text.

same purposes.⁸¹ While both governments received significant stock in the two post-bankruptcy companies as a result of their contributions, these governmental contributions were motivated less by a desire to own auto-company stock and more by a hope to avert a national economic crisis that a liquidation of these automakers likely would have triggered.

No private lender would have lent as much or on the same favorable terms as the U.S. and Canadian governments did. In both the Chrysler and GM cases, the bankruptcy courts were quick to point out that the governments' offer to finance was contingent on a fast emergence from chapter 11, and that absent the government financing, a liquidation of the automakers seemed to be the only other option.⁸² The court in *GM* specifically noted that the U.S. and Canadian governments' willingness to lend in this case was not because of the merits of the deal for them but simply to preserve auto jobs in their countries.⁸³

In assessing the objections of the First-Lien Lenders who were complaining about Chrysler's section 363 sale, the *Chrysler* court compared the \$2 billion purchase price for the proposed asset sale under section 363 with the \$800 million high-end estimate of a liquidation of Chrysler.⁸⁴ Further, the *Chrysler* court noted that the First-Lien Lenders should have exercised their option to credit bid if they thought the asset-sale offer price was not a good one.⁸⁵

B. KEY POINTS IN BOTH CASES

The *Chrysler* and *GM* cases offered strikingly similar sale procedures and raised essentially the same chapter 11 bankruptcy issues. The main difference between the two cases was that in the *Chrysler* case, the international automaker Fiat formed the purchasing entity that successfully bid for all of Chrysler's assets. In the *GM* case, the purchasing entity was a corporation that the U.S. Government formed for the sole purpose of creating a post-bankruptcy GM.

The key issues in both cases were whether a bankruptcy court could allow a section 363 sale of substantially all of a debtor's assets in lieu of a traditional chapter 11 confirmation process, and to what extent the purchaser of the assets was free of various liabilities (including section 1114) that were owed by the assets' debtor-seller. The main objection in both cases was that the proposed asset sales amounted to impermissible "*sub rosa*" plans that contradicted the Bankruptcy Code's overall framework.

81. *Ramifications of Auto Industry Bankruptcies*, *supra* note 2, at 21 n.2 (testimony of Ron Bloom).

82. *In re GM Corp.*, 407 B.R. 463, 474 (Bankr. S.D.N.Y. 2009); *In re Chrysler LLC*, 405 B.R. 79, 96-97 (Bankr. S.D.N.Y. 2009).

83. *In re GM*, 407 B.R. at 480.

84. *In re Chrysler*, 405 B.R. at 97.

85. *Id.* at 98.

In the *GM* case, Judge Gerber explained that the bankruptcy court had the authority to authorize a section 363 sale in order to preserve value in the company while it was still there, rather than force the debtor to wait for the inevitable liquidation that would result from a full-plan process.⁸⁶ This is particularly true, he held, when the Government's offer to fund the section 363 sale is set to expire in a few days. Judge Gerber held that GM's proposed transaction was not a *sub rosa* plan, but simply a sale of the debtor's assets. The usual chapter 11 plan process would occur after the sale, using the purchase price received for the assets.⁸⁷ The precise distribution of the debtor's property would happen following the asset sale, and the purchase price would be collected under the normal distribution rules of the Bankruptcy Code. Implicit in this holding was the finding that the purchase price received from the bidder exceeded other possible dispositions of the assets, such as a piecemeal liquidation sale.

Judge Gerber cited *In re Lionel Corp.* for the proposition that section 363(b) gives courts great discretion to authorize non-ordinary-course sales, and that "a bankruptcy judge must not be shackled with unnecessarily rigid rules when exercising the undoubtedly broad administrative power granted him under the Code."⁸⁸ Judge Gerber declared that in the Second Circuit, "even the entirety of a debtor's business may be sold without waiting for confirmation when there is a good business reason for doing so."⁸⁹ In a case like this, Judge Gerber held, where the debtor sells all or substantially all of its assets in a section 363 sale, then the chapter 11 "plan" submitted for confirmation is not a traditional reorganization plan; instead, it is simply a liquidation plan (albeit wholesale, not piecemeal) in which the proceeds are distributed to the chapter 11 claimants.⁹⁰

Judge Gerber outlined the specific questions in *Lionel* that he considered when deciding whether to allow a section 363 sale of substantially all of the debtor's assets prior to confirmation: (1) What percentage of total assets do the assets to be sold represent; (2) How much time has elapsed since the case was filed; (3) How likely is it that a plan will be proposed and confirmed soon; (4) What is the effect of the proposed asset sale on future plans of reorganization; (5) How do the projected proceeds to be gained from the sale compare to appraisals of the assets to be sold; (6) Does the proposal envision use, sale, or lease of the assets; and (perhaps most importantly, according to *Lionel*) (7) Is the asset increasing or decreasing in value?⁹¹

86. *In re GM*, 407 B.R. at 474.

87. *Id.* at 486.

88. *Id.* at 488 (quoting *In re Lionel Corp.*, 722 F.2d 1063, 1069 (2d Cir. 1983)) (internal quotation marks omitted).

89. *Id.* at 489.

90. *Id.* at 493.

91. *Id.* at 490.

Judge Gerber added four questions of his own to *Lionel's* list of “nonexclusive” factors: (1) Is there enough cash for the estate to survive until confirmation in the absence of the proposed sale; (2) By the time of plan confirmation, will the sale opportunity have been lost; (3) If the sale opportunity is lost by confirmation, will there likely be other equally attractive sale opportunities at confirmation; and (4) “Is there a material risk that by deferring the sale, the patient will die on the operating table?”⁹²

Besides the objection that the sale amounted to an impermissible “*sub rosa*” plan, the other chief objection in the *GM* case was that certain unsecured creditors would receive value out of the transaction despite the fact that certain priority or secured creditors were not getting paid in full. Such an outcome seems at odds with the general principle in bankruptcy of “absolute priority,” where no lower class of claimants is entitled to receive any value until all senior classes, such as secured creditors, have been paid in full.⁹³ As to this objection, the *GM* court noted that what the unsecured creditors, such as the UAW and the retiree-benefit VEBAs, were getting in this instance was not due to their pre-petition claims on the company before the section 363 sale. Rather, Judge Gerber emphasized, this value was in consideration of new commitments that they made to or modifications they agreed to with the purchaser of the assets—the new GM.⁹⁴

In a similar vein, the *Chrysler* court stressed that any distributions of equity received by the UAW, Chrysler’s VEBA, or the U.S. Treasury were not for pre-petition claims, but rather for consideration that was provided under separately negotiated agreements with New Chrysler:

As discussed previously, New Chrysler views the skilled workforce as essential to its future operations and, as a natural consequence, has engaged in negotiations with their representative. . . . The UAW further states that its leadership would not have recommended that its members ratify the amended collective bargaining agreement unless New Chrysler agreed to fund the VEBA.⁹⁵

V. THE FUTILITY OF SPRINGING PRIORITIES

A. THE IRONY OF THE GOVERNMENT’S ROLE IN THE AUTO BANKRUPTCIES

There are a number of ironies surrounding the treatment of retiree medical benefits in the *Chrysler* and *GM* cases, but all of them reinforce the point that when Congress creates a large special-interest priority that arises only in bankruptcy, it usually ends up doing more harm than good. Perhaps

92. *Id.*

93. The “cramdown” provisions for confirmation in section 1129(b)(2) of the Bankruptcy Code articulates the absolute-priority rule.

94. *In re GM*, 407 B.R. at 498.

95. *In re Chrysler LLC*, 405 B.R. 79, 99–100 (Bankr. S.D.N.Y. 2009).

the biggest irony with the treatment of retiree medical benefits in these cases is the U.S. Government's shifting approach to the issue.

When Congress added section 1114 to the Bankruptcy Code in 1988, the idea was to make sure that retirees were paid their promised medical benefits, even though such benefits would otherwise be a relatively low priority in bankruptcy, as a pre-petition unsecured claim.⁹⁶ The beauty of the section 1114 solution for Congress was that it gained political points for members who voted for the bill,⁹⁷ but cost the U.S. Treasury nothing. Section 1114 did not commit tax dollars to bail out retiree benefits but simply reallocated resources within chapter 11 bankruptcies from one set of claimants to another. It was a politically popular piece of legislation at the time since the winners in this reallocation were a discrete and identifiable group: unions and retirees. Of course, the fact that it cost the U.S. Treasury nothing did not mean that this new springing priority would be costless to everyone. The parties who would be feeling the pain of section 1114 were nameless, faceless creditors (banks, hopefully) that could not effectively organize as a group to successfully oppose this amendment.

More than twenty years later, the U.S. Government's own money was on the line in a couple of chapter 11 cases that could have been severely skewed by a strict application of section 1114. Suddenly, the Government was not nearly as charitable as it once was concerning the plight of retirees. For starters, the U.S. Treasury in *GM* insisted that GM pay at least half of the \$20 billion dollars that GM was obligated to pay to the retiree-benefit VEBA under the pre-bankruptcy settlement in common stock, rather than in cash, as was originally promised to retirees.⁹⁸

The Chrysler bankruptcy involved a similar pattern. In the 2007 UAW-Chrysler pre-bankruptcy agreement surrounding retiree benefits, Chrysler's payments to the retiree-benefit VEBA were supposed to start on January 1, 2010.⁹⁹ However, the U.S. Government told Chrysler even before it filed chapter 11 that in order for Chrysler to get a \$6 billion pre-bankruptcy bailout loan, there had to be changes to the retiree-benefit VEBA agreements that were decidedly less generous to retirees.¹⁰⁰ The U.S. Government insisted that New Chrysler and UAW restructure the pre-bankruptcy class-action settlement with retirees so that at least 50% of the

96. See Retiree Benefits Bankruptcy Protection Act of 1988, Pub. L. No. 100-334, 102 Stat. 610 (codified as amended at 11 U.S.C. § 1114 (2006)) (detailing new protections for retiree medical benefits in chapter 11 reorganization cases).

97. See, e.g., 134 CONG. REC. S6826-27 (daily ed. May 26, 1988) (statement of Sen. Howell T. Heflin) ("I am proud to have been part of an effort that will provide my fellow Alabamians and other retirees across this Nation with a greater sense of security—that our Nation's tremendous health care resources will be available to them in times of need.").

98. *In re GM*, 407 B.R. at 478.

99. *In re Chrysler LLC*, No. 09-50002 (AJG), 2009 WL 1360869, at *37 (Bankr. S.D.N.Y. May 7, 2009).

100. *Id.*

funding for the retiree-benefit VEBA would come from New Chrysler's equity.¹⁰¹ The retiree-benefit VEBA for Chrysler retirees ended up being funded by 55% of the equity of New Chrysler plus a new \$4.587 billion note.¹⁰² The \$4.587 billion note owed to the VEBA will be paid starting in 2010 and continuing through 2023. The largest payments (worth \$823 million) are back-loaded and will occur in the last five years of the payment period.¹⁰³

B. ANOTHER ENRON?

The structure of this VEBA funding, triggered by the same government that created a special Bankruptcy Code priority for retirees in the first place, leads to a second irony. The main benefit to retirees covered by retiree-medical-benefit VEBAs is the insurance against future misfortunes from the employer who made the original unfunded promise to provide such benefits. However, due to the changes that the U.S. Government required in the funding structure of the retiree-benefit VEBAs in *Chrysler* and *GM*, the strength of the retirees' health-benefit prospects is tied directly to the success of New Chrysler and New GM. Since each VEBA trust's funding consists almost entirely of either company stock or promises by the company to pay cash in the distant future, retirees find themselves facing the same risks that caused them to seek VEBA trusts in the first place.

One commentator analogized the health-benefit problem that Chrysler and GM retirees face to what Enron's retirees encountered with their pensions: the danger of having all of your eggs in one proverbial basket.¹⁰⁴ The difference between the auto cases and Enron is that the Enron retirees were taken by surprise with the sudden collapse of their employer. In the auto cases, retirees face the Enron lack-of-diversification risk with their eyes wide open, which may or may not be a more preferable fate.

C. SECTION 1114 VERSUS NONBANKRUPTCY LEVERAGE

The third noteworthy irony with the treatment of retiree medical benefits in *Chrysler* and *GM* is how little protection section 1114 ended up giving retirees compared to the protection that nonbankruptcy leverage afforded certain groups of retirees. In both auto cases, there were small groups of retirees whose unions would no longer provide any active employees to work for New Chrysler or New GM. As shaky as the funding for the UAW retiree-benefit VEBAs ended up being, at least the UAW retirees

101. *In re Chrysler LLC*, 405 B.R. 84, 92 (Bankr. S.D.N.Y. 2009).

102. *Id.*

103. *Id.*

104. Merx, *supra* note 37 (quoting labor expert Harley Shaiken that "[i]t's as if we, as a nation, learned nothing from Enron, essentially risking the health care of retired and active workers in such a cavalier fashion").

will be made nearly whole by their companies' benefit promises if the post-bankruptcy companies end up flourishing. In contrast, the bankruptcy court in *Chrysler* held that non-UAW retirees could look only to the debtor's estate—the debtor's estate in *Chrysler* was represented by the cash from the asset purchase price—to recover unsecured claims from any reductions in their promised medical benefits.¹⁰⁵ Non-UAW retirees could not, however, require New Chrysler to honor benefit promises, since “the purchased assets are sold free and clear of those potential unsecured claims.”¹⁰⁶ In overruling those objections from the non-UAW retirees, the *Chrysler* court noted that “if the Sale Motion were not approved, which would likely result in the Debtors' liquidation, there would likely be no value to distribute to any retirees, all of whom would be unsecured creditors.”¹⁰⁷

Similarly, in the *GM* case there were three “Splinter Unions”: unions whose retirees were not covered by the UAW VEBAs and who relied solely on the protections of section 1114 for any health-benefit relief. Those retirees complained that New GM would violate section 1114 if the company did not agree to assume the obligation to fund their retirees' medical benefits, or at the very least, comply with the rules of section 1114 regarding termination or modification procedures.¹⁰⁸ The court in *GM*, however, said that a section 363 purchaser of assets does not have to assume any retiree-medical-benefit liability that it does not wish to, nor does it need to comply with section 1114.¹⁰⁹

Old GM, the debtor, had said that it would comply with section 1114. However, the old GM knew that it would be liquidating soon, and so the debtor's promise to the retirees ended up not being worth very much.¹¹⁰ The bankruptcy court in *GM* used the fact that the Splinter Unions had very few active employees working for GM to explain why the new GM offered those unions' employees very little in continued retiree benefits:

The obligations [to the Splinter Union retirees] in question are very sizeable—more than \$3 billion in retiree health care and hundreds of millions more for retirement life insurance. Those large figures show why the Splinter Unions care about the issue, and why New GM feels that it cannot assume those obligations when such a small number of Splinter Union members will be working for New GM.¹¹¹

105. *In re Chrysler*, 405 B.R. at 110.

106. *Id.*

107. *Id.*

108. *In re GM Corp.*, 407 B.R. 463, 509 (Bankr. S.D.N.Y. 2009).

109. *Id.*

110. *Id.*

111. *Id.* at 510 n.120.

In other words, the court held, it all comes down to “what have you done for me lately?” Or more accurately, “What can you do for me going forward?” Nor was the U.S. Government reticent about admitting, through its business decisions in this case, that what mattered here was not the priority scheme of the Bankruptcy Code that it had created, but rather the nonbankruptcy leverage that is currently enjoyed by certain classes.

The *GM* court addressed the Splinter Unions’ complaint that there was a “conspiracy” among GM, the U.S. Treasury, and UAW preventing the Splinter Unions’ retirees from being treated as well as the UAW retirees:

The U.S. Treasury, in making hard decisions about where to spend its money and make New GM as viable as possible, made business decisions that it was entitled to make, and the fact that there were so few Splinter Union employees still working for GM was an understandable factor in that decision.¹¹²

The Chrysler and GM bankruptcy cases were not the first time that a bankruptcy court specifically allowed certain groups of retirees to receive better health benefits than other groups of retirees. In *In re McLouth Steel Corp.*,¹¹³ a case that pre-dated the passage of section 1114, the bankruptcy court let the debtor-in-possession pay retiree benefits to union retirees according to the union contract, even though the company in bankruptcy was not paying those same vested retiree benefits to salaried retirees.

In some chapter 11 cases, unlike the two auto bankruptcies, there is no group of retirees without nonbankruptcy leverage. In such a case, the debtor-in-possession does not need to worry about treating any group of retirees well. Instead, the debtor can use section 363 to sell all of its assets to a new purchaser, who will operate the business, but who will not have to honor any retiree-medical-benefit promises made by the debtor-seller. In *In re Horizon Natural Resources Co.*,¹¹⁴ ten unionized coal companies filed jointly for chapter 11, and each union had a successorship clause in its collective-bargaining agreement. Under these clauses, the employer promised not to sell its operation without the buyer’s agreement to assume the employer’s obligation under the collective-bargaining agreement.¹¹⁵ The hope with these clauses was that the employer’s obligations to union workers and retirees would “run with the company,” and presumably would also run with the assets of the company if they were sold as a unit.

The debtors hoped to use chapter 11 as a means to reorganize the companies, but soon realized that their only feasible option in chapter 11 would be to liquidate their assets.¹¹⁶ The debtors filed two chapter 11 plans

112. *Id.* at 512.

113. 23 B.R. 167 (Bankr. E.D. Mich. 1982).

114. 316 B.R. 268 (Bankr. E.D. Ky. 2004).

115. *Id.* at 271.

116. *Id.*

to sell the assets as a unit under section 363 to a buyer who they hoped would reclaim the mine sites and continue the business in some form. The union argued that benefits under the Coal Act, such as retiree benefits, could not be modified under section 1114.¹¹⁷ The debtors' financial consultant testified that retiree medical benefits were costing the company \$16 million per year, and that without the free-and-clear sale under section 363, he believed that the chapter 11 plan would not be confirmable and that the mines would not be reclaimed and operated by any buyer.¹¹⁸

The bankruptcy court in *Horizon* observed that if this section 363 free-and-clear sale was not authorized, the assets would be liquidated piecemeal, thereby yielding less money for all claimants.¹¹⁹ The court then held that the legacy costs of the retiree benefits made it impossible to sell the business as a going-concern with those costs attached to it.¹²⁰ The court concluded that the debtors had met their section 1114 burden of showing that absent the proposed section 1114 modifications, conversion of the case to chapter 7 and piecemeal liquidation would result.¹²¹ Therefore, the court allowed the section 363 sale to take place without the buyer's responsibility to assume the retiree medical benefits, despite the successorship clauses in the collective-bargaining agreements.

D. SECTION 1114 AS THE PARADIGMATIC SPRINGING PRIORITY

In the world of springing priorities in bankruptcy, section 1114 has a number of features that qualify it as perhaps the most harmful example of that phenomenon. First, Congress chose to insert this special priority only in chapter 11 cases rather than in any bankruptcy case of an employer.¹²² Although members of Congress apparently did not think through all the implications of that decision, one could understand why they made this choice. One reason is that Congress drafted the provision in reaction to a particular chapter 11 case, involving LTV Steel,¹²³ in which the debtor ceased making retiree-benefits payments as soon as it filed for chapter 11.¹²⁴ An additional reason why section 1114 ended up where it did in the Bankruptcy Code is that this retiree-benefit-protection amendment

117. *Id.* at 273.

118. *Id.*

119. *Id.* at 279.

120. *Id.* at 282.

121. *Id.*

122. Had Congress placed the retiree-benefit priority in chapter 5 of the Bankruptcy Code rather than chapter 11, the retiree priority would have applied in both chapter 7 and chapter 11 bankruptcy cases. 11 U.S.C. § 103(a) (2006).

123. *In re Chateaugay Corp.*, 64 B.R. 990 (S.D.N.Y. 1986).

124. See *LTV Bankruptcy: Hearing on Oversight on the LTV Corporation Filing for Bankruptcy Under Chapter 11 of the Federal Bankruptcy Code Before the S. Comm. on the Judiciary*, 99th Cong. 44-51 (1986) (noting the *In re Chateaugay Corp.* impetus for the new bill).

immediately followed and was intended to mirror section 1113, the collective-bargaining-agreement section from which Congress borrowed most of section 1114's language.¹²⁵

Put aside for the moment the obvious difference between a collective-bargaining agreement and a company's promise to pay retiree benefits: the former represents a form of executory contract (since both the debtor and non-debtor have obligations owed to each other), whereas the promise to pay retiree medical benefits is nothing more than a general unsecured claim owed by the debtor to the retirees, a "one-way street" as it were. The most important negative consequence of section 1114 being a chapter 11-only priority for retirees is that this placement in the Bankruptcy Code ignores the many struggling companies that end up either converting their chapter 11 case to chapter 7 liquidation, or simply filing chapter 7 from the start. In other words, the protection in bankruptcy given to retirees by section 1114 is very limited because so many employers end up in a chapter 7 bankruptcy that gives retirees no special protection.

There is still another more subtle problem with only placing the retiree-benefits-protection amendment in the Code's chapter 11: even when an employer files chapter 11 and does not convert to a chapter 7 case, the "best interests of creditors" requirement for chapter 11 confirmation means that retirees might be required to forfeit some of the priority that section 1114 otherwise attempts to give them. Essentially, section 1129(a)(7), the "best interests" test, says that unsecured creditors cannot be forced to accept a chapter 11 plan that does not treat their claims at least as well as they would have been treated in a chapter 7 liquidation of the same debtor.¹²⁶

Imagine a situation where the proposed chapter 11 plan allows retirees to keep their medical benefits in whole or in large part, but limits other prepetition unsecured creditors (as is often the case) who receive mere cents on the dollar for their claims. If the discounted present value of the retiree-medical-benefit claims is large enough, the other unsecured creditors could threaten to block confirmation of the proposed plan. These creditors' theory would be that the chapter 11 plan does not pay them as much as they would receive in a chapter 7 liquidation of the debtor, and thus violates the "best interests" requirement for confirmation. The creditors might well be correct because in chapter 7, the retirees' special rights would disappear and they would share equally with other unsecured creditors, thus boosting the relative priority of the claims of the non-retiree unsecured creditors.

Whether the non-retiree unsecured creditors would ultimately prevail on this argument would depend not only on the size of the retiree claim for benefits, but also on the size of the debtor's "going-concern surplus." The

125. See Daniel Keating, *Bankruptcy Code § 1114: Congress' Empty Response to the Retiree Plight*, 67 AM. BANKR. L.J. 17, 39 (1993) (explaining the history behind the new section).

126. 11 U.S.C. § 1129(a)(7).

going-concern surplus is the difference between the value of the debtor as a going-concern and its liquidated value under chapter 7. If that difference is large enough and the total value of the retiree-benefit claim is small enough, then it is possible for retirees to enjoy their special priority in a chapter 11 plan without making non-retiree creditors worse off than they would be in a chapter 7 liquidation of the debtor that lacks retiree priority. In other words, the going-concern surplus in a given case might be large enough that the non-retiree creditors are still better off in a chapter 11 case that subordinates their claims to those of the retirees.

These concerns about the chapter 11-only nature of the retiree-benefit priority are not just theoretical. Consider how they played out in a case involving a chapter 11 liquidation of an employer. In *In re North American Royalties, Inc.*,¹²⁷ the court had to decide whether its approval was required for an agreement between the debtor and the debtor's unions to terminate retiree medical benefits included in the collective-bargaining agreement. The court held that section 1114 would not require such approval, but that section 363(b) would require approval of the termination as a transaction outside the ordinary course of business.¹²⁸

This holding forced the debtor to show that it had a sound business purpose for terminating the retiree medical benefits for hourly employees, since they were covered by the collective-bargaining agreement. At this point, however, since the chapter 11 estate consisted of nothing more than a pot of cash, the attorney for the lenders' group said that if the court found that the retiree medical benefits must be continued, he would move to convert the case to a chapter 7 liquidation so that section 1114 would not apply at all.¹²⁹ This case demonstrates the limited protection that section 1114 affords to retiree medical benefits, particularly in the common case where a debtor ultimately chooses whether it liquidates in chapter 7 or chapter 11.

E. DEFINING THE SCOPE OF THE SECTION 1114 PRIORITY

Beyond the chapter 11-only nature of the retiree-benefit priority, a second vexing feature of section 1114's springing priority is discerning the nature of the priority that Congress intended to give retirees in chapter 11 cases. Section 1114 is not a priority that fits neatly within the Bankruptcy Code's normal priority scheme of section 507.¹³⁰ Section 507 neatly lays out an order of priority for the favored claims in both chapter 7 and chapter 11.¹³¹ By contrast, section 1114's key priority provision is 1114(e)(1), which

127. 276 B.R. 860 (Bankr. E.D. Tenn. 2002).

128. *Id.* at 863.

129. *Id.* at 865.

130. 11 U.S.C. § 507.

131. *Id.*

states that the debtor “shall timely pay and shall not modify any retiree benefits,” and then gives exceptions that essentially allow modifications that enable the reorganization of the debtor.¹³² The problem with the command, “shall timely pay,” is that it fails to answer the question, “ahead of what?”

Soon after the passage of section 1114, one bankruptcy court struggling with the “shall timely pay” language faced the issue of whether the debtor in chapter 11 should continue to pay retiree benefits even when the only cash it had on hand was encumbered by the liens of secured creditors.¹³³ Although the court in that case ultimately concluded that section 1114’s language could not have intended for retiree-benefit claims to trump the claims of perfectly secured creditors, the court had to contend with a letter sent to the court from section 1114’s sponsoring senator urging the court to keep paying retiree benefits.¹³⁴

Besides section 1114’s core “shall timely pay” language, there is a kind of “back-up priority” contained in section 1114(e)(2), which provides that any retiree-medical-benefit payment that is required to be made before plan confirmation gets administrative-expense priority status.¹³⁵ This is an interesting provision on a number of levels. First, it seems to assume that despite the “shall timely pay” command of section 1114(e)(1), not all debtors will necessarily “timely pay” retiree benefits as required during the pendency of the chapter 11 process. In other words, if all debtors actually complied with the “shall timely pay” command, then there would be no need for a back-up priority such as section 1114(e)(2). Second, it is somewhat ambiguous as to which unpaid retiree-benefit claims this back-up priority of section 1114(e)(2) covers: the ones that the debtor never paid without good reason, or also the benefits that the debtor failed to pay because the court allowed the debtor to modify the benefits it originally owed. Congress probably meant section 1114(e)(2) to cover the former, since it would not make much sense to create a safe harbor for debtors who could not afford to pay originally promised retiree benefits, and then tell those same debtors that the allowed benefit reductions would themselves become priority claims.

132. 11 U.S.C. § 1114(e)(1).

133. *In re GF Corp.*, 115 B.R. 579 (Bankr. N.D. Ohio 1990), *vacated in part*, 120 B.R. 421 (Bankr. N.D. Ohio 1990).

134. The written statement the court received came from Senator Howard Metzenbaum, the sponsoring senator of the retiree legislation, who urged the court to allow the retirees to continue to receive payments as consistent with “the intent of Congress.” *Id.* at 583. The court responded that section 1114’s failure to reconcile the rights of secured creditors with the special retiree priority was just one example of section 1114’s misfit within the context of the larger Bankruptcy Code: “Unfortunately, § 1114 addresses a specific concern alone, and it is inattentive to the overall objectives of the Bankruptcy Code. . . . [S]hort of printing money, there is no way to see that all claims are paid in full.” *Id.* at 585.

135. 11 U.S.C. § 1114(e)(2).

On the other hand, it probably does not make sense for any retiree-benefit claims to take on the character of an administrative-expense claim. Administrative-expense claims, which are second priority in section 507 behind domestic support obligations,¹³⁶ are defined in section 503 as expenses that the estate incurs in order to survive. As section 503(b)(1)(A) puts it, administrative expenses include “the actual, necessary costs and expenses of preserving the estate.”¹³⁷ Classic examples of administrative-expense claims include wages for the debtor’s workers, attorney fees for the debtor’s attorneys, or money lent to the debtor post-petition. The theory behind the administrative-expense priority is that absent such a priority, nobody would want to lend money to the debtor, or provide goods or services on credit.¹³⁸ After all, absent the special priority, there is a high likelihood that the debtor, already in bankruptcy, will not be able to repay its post-petition lenders. Yet if one considers the nature of the retiree-benefit claim—arising as it does from the pre-petition labors of retirees—the retiree claim just does not seem to fit neatly into the administrative-expense paradigm.

F. SPRINGING PRIORITIES OR SPRINGING CLAIMS?

A third and recurring puzzle to the section 1114 springing priority is whether Congress intended this admitted springing priority to be a “springing claim” as well. In other words, vested retiree-benefit claims would clearly receive a priority in chapter 11 cases; less clear is whether Congress also intended to create retiree-benefit claims that automatically vested after entering a chapter 11 bankruptcy. When employers promise their employees retiree medical benefits (or, rather, when they *used to*), employers often hedge such promises with unilateral rights to terminate or modify the benefits. Rich case law has developed around the vestation of retiree medical benefits,¹³⁹ but the point here is simply that employers sometimes actually do succeed in reserving for themselves the right to terminate or modify retiree medical benefits. The question that many courts faced since the enactment of section 1114 is whether that section intended to create a claim for retiree benefits in chapter 11 where none would otherwise exist outside of chapter 11. This issue arises in cases where nonbankruptcy law held that the retirees’ right to benefits was not vested and therefore was not otherwise a claim in bankruptcy.

136. *Id.* § 507(a)(2).

137. *Id.* § 503(b)(1)(A).

138. TABB, *supra* note 7, at 676 (noting that the administrative priority makes sense, since otherwise “it would be difficult to induce people to participate in the administration of the bankruptcy case, and the whole system might grind to a halt”).

139. *See generally* Keating, *supra* note 125, at 24–28 (summarizing relevant case law).

Congress had its chance to clarify this issue for the courts,¹⁴⁰ but instead Congress has only obfuscated it. Most of the cases on this issue have held that section 1114 only applies to retiree benefits that are already vested under nonbankruptcy law.¹⁴¹ In other words, most courts have been unwilling to assume that the “springing priority” status of retiree benefits were also intended to be a “springing claim” where a claim did not actually exist before going into chapter 11.¹⁴²

Congress confused matters on this issue by adding section 1114(l) as part of the 2005 Bankruptcy Code amendments. Section 1114(l) provides that if a debtor modifies retiree benefits within 180 days before the debtor files chapter 11 and while the debtor is insolvent, then the bankruptcy court shall undo the modifications at a party’s request, “unless . . . the balance of the equities clearly favors such modification.”¹⁴³ This new section does not speak directly to the question of whether a debtor can exercise nonbankruptcy termination rights of retiree medical benefits while in chapter 11, but it does say that a debtor cannot do so in the six months before bankruptcy. One pair of commentators have argued that section 1114(l) must imply that a debtor already in chapter 11 should also not be allowed to modify or terminate retiree benefits outside of the strict procedures of section 1114, even if the retiree benefits in question were not vested under nonbankruptcy law.¹⁴⁴ The argument is that if Congress would not allow an employer to exercise a retiree-benefits termination right on the eve of bankruptcy, then it certainly could not have intended that the same employer be allowed to simply exercise the termination right post-bankruptcy.

Courts similarly were not persuaded that section 1114(l) settled the “springing claims” issue in favor of retirees. In *In re Delphi Corp.*,¹⁴⁵ the court disagreed that section 1114(l) changed the majority view that section 1114 only applies to vested retiree medical benefits. The court speculated that

140. See *Protecting Employees and Retirees*, *supra* note 74, at 13 (noting that the proposed bill provided that section 1114 requirements and procedures would apply regardless of whether a debtor could make unilateral changes to retiree health benefits).

141. See 7 COLLIER ON BANKRUPTCY § 1114.03[1]–[2] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2010) (citing applicable case law and concluding that section 1114 “applies only to benefits that have been previously promised by the debtor; it does not create any new obligations on the trustee or debtor in possession”).

142. For a very recent example of a court that went the other way, see *In re Visteon Corp.*, 612 F.3d 210 (3d Cir. 2010), which held that section 1114’s restrictions on termination apply even where the contractual language creating the benefits specifically allows unilateral termination outside of bankruptcy.

143. 11 U.S.C. § 1114(l) (2006).

144. Richard Levin & Alesia Ranney-Marinelli, *The Creeping Repeal of Chapter 11: The Significant Business Provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, 79 AM. BANKR. L.J. 603, 610–11 (2005).

145. No. 05-44481 (RDD), 2009 WL 637315 (Bankr. S.D.N.Y. March 10, 2009).

perhaps Congress meant for section 1114(l) to only apply to pre-petition terminations of vested, rather than nonvested, retiree medical benefits.¹⁴⁶ The *Delphi* court noted that there are no statements in the legislative history of either section 1114(l) or the general 2005 Bankruptcy Code amendments that suggest Congress intended section 1114(l) to overrule cases that limited section 1114 to vested retiree benefits.¹⁴⁷ Finally, the court noted that there was a specific bill introduced in the House of Representatives in 2007 that would have overruled the majority line of cases on the question, but that bill was never enacted.¹⁴⁸

G. SPRINGING PRIORITIES AND THE BIG PICTURE OF CHAPTER 11

In order to fully appreciate the futility of springing priorities such as section 1114, one needs to step back and remember the supposed purpose of chapter 11 in business bankruptcy. Congress intended chapter 11 to maximize value for all claimants by enabling companies that might have otherwise faced an unnecessary liquidation outside of bankruptcy to reorganize.¹⁴⁹ Chapter 11 responds to a collective-action problem that persists outside of bankruptcy: namely that, under nonbankruptcy law, it is in each individual creditor's interests to race to dismantle the debtor's assets when the debtor is insolvent, even where the debtor is clearly worth more as a going-concern than broken up and liquidated piecemeal.

Corporate bankruptcy law responds to the collective-action problem by providing a single forum to collect the debtor's assets and an automatic stay to prevent further dismantling of the debtor.¹⁵⁰ Furthermore, bankruptcy law provides a reach-back period during which creditors who engaged in strategic collection behavior on the eve of bankruptcy are required to disgorge their gains in favor of the collective process.¹⁵¹ In other words, bankruptcy reorganization law is primarily procedural rather than substantive.¹⁵² As a general proposition, chapter 11 takes nonbankruptcy rights as it finds them.¹⁵³ The main goal of the bankruptcy process is to increase the size of the total pie. The relative size of the pieces has already

146. *Id.* at *6.

147. *Id.*

148. *Id.*

149. *See supra* note 7 and accompanying text.

150. *See* 11 U.S.C. § 362 (2006) (discharging automatic stay). This is the primary section of the Bankruptcy Code that prevents creditors from collecting pre-petition debts once the debtor files a bankruptcy petition. *See id.*

151. *See id.* § 547 (preference-avoidance powers).

152. *See* TABB, *supra* note 7, at 81 (stating that “[b]ankruptcy is primarily a remedial device designed to deal with the problem of multiple defaults, to provide a forum to sort out efficiently the rights of numerous creditors and other parties in interest in a collective proceeding”).

153. *See* *Butner v. United States*, 440 U.S. 48, 54-55 (1979) (stating that “Congress has generally left the determination of property rights in the assets of a bankrupt’s estate to state law,” and that “[p]roperty interests are created and defined by state law”).

been determined by pre-bankruptcy contractual arrangements and by nonbankruptcy legal rules.

To this view of corporate bankruptcy law, a doubter might interject, “But what about all the special priorities in the Bankruptcy Code—don’t they prove that bankruptcy is also meant to affect substantive priorities?” Although that objection to the procedural view of bankruptcy has surface appeal, a closer look at the various bankruptcy priorities reveals that the retiree-medical-benefit priority is different both in kind and scope than most of the other priorities that the Bankruptcy Code provides to certain creditors.

For starters, a majority of the most important creditor priorities in bankruptcy simply reflect the nonbankruptcy leverage of the favored creditor group, in which case such priorities are not really “springing” priorities at all. The single most important priority in bankruptcy is the priority accorded to secured creditors, whose pre-bankruptcy leverage comes from the bargained right to foreclose on, and sell, specific property of the debtor if the debtor defaults on their loan. Section 507 of the Bankruptcy Code does not list that priority. The priority that perfectly secured creditors enjoy is not even listed as one of the section 507(a) priorities, yet it goes without saying in the Bankruptcy Code that a perfectly secured claim is higher in priority than the highest priority unsecured claim.¹⁵⁴ There is nothing “springing” about that priority—it merely reflects the secured creditor’s nonbankruptcy leverage, which in this case is a constitutionally protected property interest.

Consider a second important category of creditor priorities in bankruptcy: the administrative-expense priority. As noted earlier, this priority in bankruptcy is a springing priority only because the claim itself represents something that arises in bankruptcy. This priority too is all about leverage—not nonbankruptcy leverage per se, but the leverage of a lender or provider to withhold funds, goods, or services from the debtor unless there is a special assurance of repayment. That is where the administrative priority comes into play—it serves as a kind of statutory repayment insurance to enable the debtor to secure important funds, goods, or services during the pendency of a bankruptcy case.

Another priority that arises in bankruptcy for the first time is the statutory priority for wages and benefits found in section 507(a)(4) and in section 507(a)(5).¹⁵⁵ These seem like classic springing priorities. Nevertheless, workers possess significant leverage not enjoyed by most other unsecured creditors, even without a formal priority outside of bankruptcy. Indeed, it is for this reason that so many first-day orders include requests to

154. TABB, *supra* note 7, at 735.

155. 11 U.S.C. § 507(a)(4)–(5).

pay current wages without even waiting until section 507 priority claims are paid.¹⁵⁶

Regarding first-day orders, another apparent springing priority that cannot be found in section 507 of the Bankruptcy Code is the court-created necessity doctrine that allows a chapter 11 debtor-in-possession to pay certain critical vendors with pre-petition unsecured claims for past deliveries.¹⁵⁷ When the court grants such payments, often as part of a first-day order, it gives these vendors a priority they do not formally own outside of bankruptcy. Yet, just like current workers, these vendors have a strong, albeit informal, priority outside of bankruptcy due to their leverage with the debtor as a supplier of critical goods and services. Once again, then, this apparent springing priority is merely a priority that reflects the already-existing nonbankruptcy leverage of that claimant.

Yet another significant priority for chapter 11 cases found in section 507 is the tax-claim priority of section 507(a)(8).¹⁵⁸ Just like the other major priorities mentioned above, this one reflects the reality that this creditor, the government-taxing entity, has at its disposal various forms of nonbankruptcy leverage that are simply not available for a typical pre-petition unsecured creditor.

The size of springing priorities matters, too, since only a fairly large springing priority makes it worthwhile for the debtor to forego the benefits of the usual chapter 11 confirmation process in favor of shortcuts such as section 363 sales. There are at least a few priorities in section 507 that do not reflect nonbankruptcy leverage—fish- and grain-storage operators, and consumer deposits—but all of these are capped at a level that ensures that they will not skew the case away from a standard chapter 11 confirmation.¹⁵⁹ Although the first priority listed in section 507(a), for domestic-support obligations, is both springing and uncapped, that is a priority claim that is not likely to play a role in most chapter 11 business reorganization cases, since those cases involve businesses rather than individuals.¹⁶⁰

Circling back then to the retiree-medical-benefit priority of section 1114, it becomes easy to see that this priority is different from most other bankruptcy priorities in the way it skews the chapter 11 reorganization process as no other priority does. When a huge class of claimants is suddenly given a priority in chapter 11 that they do not have outside of chapter 11, then those parties, with control over the reorganization process, will do everything they can to keep a company out of chapter 11. Now that section 363 is becoming a commonly accepted alternative to a standard section

156. TABB, *supra* note 7, at 1086–87.

157. *Id.*

158. 11 U.S.C. § 507(a)(8).

159. *Id.* § 507(a)(6)–(7) (regarding fish- and grain-storage operators and consumer deposits, respectively).

160. *Id.* § 507(a)(1).

1129 confirmation process, parties who wish to avoid the effects of section 1114 can get the best of both worlds: block the retiree-benefit priority and still preserve the going-concern value of the firm in a chapter 11 bankruptcy.

In effect, what we are seeing now is the final chapter of the retiree-medical-benefit bubble, just as we have watched the winding down and aftermath of the housing bubble. And just as with the mortgage crisis, there is no quick fix for those already in the game. The only hope is to reform the system going forward, but such reform will be cold comfort for the hundreds of thousands of retirees who planned their retirements with the sincere belief that their health benefits were guaranteed for life.

A detailed plan for the future reform of retiree medical benefits is beyond the scope of this Essay, but a couple of observations are in order. The first point is that an employer should not promise (or perhaps more accurately, a union should not accept an employer's promise) of retiree medical benefits unless they are pre-funded. This outcome was effectively legislated in the pension arena, where employers can now either pay as they go with individual retirement accounts for their employees, or pre-fund any defined-benefit pension promises made to their employees. Such a requirement in the retiree-benefit realm would clearly make retiree-benefit promises much more modest than those in the past, but at least current employees would not suffer from the painful effects of detrimental reliance that so many retirees now feel, especially in the automobile and steel industries.

Second, formal legislative reform in this realm may not be necessary to avoid similar disasters going forward. Employers are all too cognizant today of the crippling, long-term effects of legacy costs on their ability to compete. Today, the folly of creating new legacy costs is nothing short of obvious to employers as they watch both the defined-benefit pension crisis and the retiree-medical-benefit crisis play themselves out on Wall Street and on Main Street. Furthermore, the new FASB rules that require the present cost of future promises to be reflected directly on balance sheets are a short-term consequence to any company foolish enough to ignore the long-term costs of making unfunded retiree-medical-benefit promises.¹⁶¹

The trend in both pensions and retiree medical benefits is for employers to pre-fund those benefits, but to cap their exposure by putting the funds in a separate account that places all future risks on the individual employee.¹⁶² While this approach is not nearly as attractive to the employee in the short-term, it does avoid the old system's sense of false security to which so many current retirees once fell prey.

161. See *supra* text accompanying notes 39–40.

162. See generally Daniel Keating, *Harsh Realities and Silver Linings for Retirees*, 15 AM. BANKR. INST. L. REV. 437 (2007) (noting movement away from defined-benefit pension plans).

VI. CONCLUSION

Cheap fixes are cheap for a reason. When Congress responded more than twenty years ago to the retiree-medical-benefit crisis in the LTV Steel bankruptcy case, it enacted an amendment to the Bankruptcy Code, section 1114, that did not cost the U.S. Treasury a dime. While the bill-signing photo opportunities gave a short-term boost to the political fortunes of the bill's sponsors, the long-term benefits to the bill's intended beneficiaries, the retirees, were destined to be far less glamorous.

Chapter 11 of the Bankruptcy Code should neither be the place to fix nonbankruptcy problems, nor the place to reorder relative priorities that exist under nonbankruptcy law. Most priorities that appear in the Bankruptcy Code merely reflect leverage that the favored claimants already enjoy outside of bankruptcy. Creating a priority in chapter 11 for a claim that ends up being very large will drive the debtor and other creditors to look for ways to avoid the effects of the springing priority. That is precisely what happened in the two major automobile bankruptcies of 2009 with the springing priority of retiree medical benefits. It was no accident that both companies, under pressure from the U.S. and Canadian governments, chose the section 363 fast-track sale of substantially all the debtors' assets—conveniently also avoiding any application of section 1114.

The next time Congress wants to use chapter 11 of the Bankruptcy Code as a quick-fix for a larger economic problem, it should consider the Chrysler and GM chapter 11 bankruptcies. These bankruptcies are case studies of what happens when Congress insists on weighing down the Bankruptcy Code with special-interest amendments that ignore the value-preservation core of the chapter 11 process. As even Congress should know by now, those who fail to study history are doomed to repeat it.