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

WHEN TWO OF THE THREE largest American automakers recently emerged from streamlined Chapter 11 reorganization proceedings, 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. Second, both the U.S. and Canadian governments played a financing role in these two cases that was unprecedented in a Chapter 11 reorganization. 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.

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 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. 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. 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, 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. 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 that 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 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. 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.

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 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.

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CHEAP FIXES are cheap for a reason. When Congress responded more than 20 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.

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