Indiana State Police Pension Trust v. Chrysler: A missed opportunity to improve collateral valuation doctrine

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INTRODUCTION

On June 1, 2009, Indiana state pension funds\textsuperscript{1} appealed to the Second Circuit the May 31 decision of Judge Arthur Gonzalez of the bankruptcy court for the Southern District of New York.\textsuperscript{2} The decision was to approve the sale of substantially all of the ailing Chrysler’s assets,\textsuperscript{3} free of all liens, to a newly organized entity known as “New Chrysler” for $2b in cash. The creditors who had liens on those assets would divide the $2b consideration, and New Chrysler would be 55% owned by the United Auto Workers (UAW) union, 20% Italian automaker Fiat, and 10% by the U.S. and Canadian governments.\textsuperscript{4} Among the questions presented in the appellant brief was “[w]hether the bankruptcy court erred in relying on a purported liquidation valuation where the assets are being sold on a going concern basis and therefore, had to be valued on such basis under Section 506(a)(1)\textsuperscript{5} of the Bankruptcy Code?”\textsuperscript{6} This paper discusses that question.

On June 5, the Second Circuit upheld the sale.\textsuperscript{7} On June 8, Justice Ruth Ginsburg of the U.S. Supreme Court granted the appellant’s request for a stay of the sale.\textsuperscript{8} On June 9, the Court vacated the stay, clearing the way for the sale to close on June 10.\textsuperscript{9} On December 14, the Court vacated the Second Circuit’s decision and remanded the case “with instructions to dismiss the appeal as moot,”\textsuperscript{10} since the sale had already closed. The Supreme Court cited United States v.

\textsuperscript{1} The Indiana State Police Pension Trust, Indiana State Teachers Retirement Fund, and the Indiana Major Moves Construction Fund are hereinafter referred to as Indiana.
\textsuperscript{2} In re Chrysler LLC, 576 F.3d 108, 108 (2nd Cir. 2009) [hereinafter Chrysler].
\textsuperscript{3} Id. at 12 (“including manufacturing plants, brand names, certain dealer and supplier relationships, and much else”).
\textsuperscript{4} Id.
\textsuperscript{5} Infra, n. 17.
\textsuperscript{6} Brief for Appellants Indiana State Police Pension Trust, et al. at 13, In re Chrysler LLC, 576 F.3d 108 (2nd Cir. 2009) (09-2311-bk) [hereinafter Appellant Brief].
\textsuperscript{7} 576 F.3d 108 at 108.
\textsuperscript{8} Indiana State Police Pension Trust v. Chrysler LLC, 129 S.Ct. 2275, 2275 (2009).
\textsuperscript{10} Indiana State Police Pension Trust v. Chrysler LLC, 130 S. Ct. 1015, 1015 (2009).
Munsingwear, which states the vacatur “clears the path for future relitigation of the issues between the parties and eliminates a judgment….”

Given the Supreme Court’s vacatur, Judge Gonzalez’s treatment of the use of liquidation as opposed to going concern valuation in Chrysler’s Chapter 11 reorganization remains an open legal issue. This paper consists of five parts. Part 1 discusses the impact of going concern versus liquidation valuation on Chapter 11 reorganizations. Part 2 examines current doctrine and identifies a point of economic inefficiency. Part 3 refines current doctrine to address the inefficiency. Part 4 applies the refined doctrine to Chrysler. Part 5 considers the potential harm of the unchanged current doctrine on capital formation.

I. WHY LIQUIDATION VERSUS GOING CONCERN VALUATION MATTERS

The value of a business is measured by its capacity to generate profits. There are two ways to realize this value, by liquidating the business or operating it as a going concern. The value of selling a business versus retaining its income stream can differ for three reasons. 1) If the liquidation is piecemeal and assets are individually sold to different buyers, synergies are lost. 2) Intangibles like good will and brand name might have value only as part of a going concern and not in a liquidation. 3) In a liquidation the sale of assets is forced, which may result in fire sale prices depending on market conditions.

Chapter 11 provides an orderly process for stakeholders to work out a plan for restructuring a distressed business. Chapter 11 seeks to preserve the business as a going concern, although there remains the risk that the reorganization could fail and the business

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12 Eugene Wedoff, Outline, The Valuation of Secured Claims in Bankruptcy: A Framework 12 (2003) (“One of the main purposes of bankruptcy reorganization, as opposed to liquidation, is to preserve going concern value of the debtor’s assets.”).
liquidate. Under section 363(b), “the trustee, after notice and hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate….”\textsuperscript{13} Section 363(b) creates a mechanism to quickly sell assets that are declining in value, known as the “melting ice cube” theory,\textsuperscript{14} to lock in their value instead of waiting on the lengthy process of confirming a reorganization plan under Chapter 11. Otherwise selling assets outside the ordinary course of business\textsuperscript{15} must be done under a plan of reorganization that has been approved by all classes of creditors.\textsuperscript{16} The distinction is that section 363(b) allows an asset sale after creditors have received notice and there is judicial approval, while confirming a plan is a lengthier process where creditors can vote down the asset sale.

Under Chapter 11 creditors can vote in their best interests, and they are incentivized to permit asset sales only for fair value to maximize the value of the debtor’s estate. Given section 363(b)’s bypass of creditor approval and reliance on judicial power, determining whether assets are sold for fair value becomes an exercise of judicial discretion. One bound on judicial discretion is section 506(a)(1), which says “an allowed claim of a creditor secured by a lien on property…is a secured claim to the extent of the value of such creditor’s interest…. Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor’s interest.”\textsuperscript{17}

\textsuperscript{13} 11 U.S.C. § 363(b).
\textsuperscript{14} 576 F.3d 108 at 114.
\textsuperscript{15} 11 U.S.C. §1123(a)(5)(D) (“Notwithstanding any otherwise applicable nonbankruptcy law, a plan shall— provide adequate means for the plan’s implementation, such as— sale of all or any parts of the property of the estate, either subject to or free of any lien, or the distribution of all or any part of the estate among those having an interest in such property of the estate”).
\textsuperscript{16} 11 U.S.C. §1126(a) (“The holder of a claim or interest…may accept or reject a plan.”).
\textsuperscript{17} 11 U.S.C. §506(a)(1).
Section 506(a)(1) addresses how to value collateral. Valuation of collateral is one of the most commonly litigated issues in Chapter 11.\textsuperscript{18} A claim secured by collateral is secured only up to the value of the collateral. When the collateral is disposed of under a section 363(b) sale, the creditor satisfies its secured claim from the proceeds. The section 363(b) sale of assets to New Chrysler was impacted in three ways by the use of liquidation as opposed to going concern valuation of the collateral.

A) Section 363(b) sale is not a \textit{sub rosa} plan of organization

A section 363(b) sale is not a substitute for a Chapter 11 plan, but is intended only to address melting ice cube situations.\textsuperscript{19} Otherwise section 363(b) sales could serve as “a loophole to the otherwise tightly arranged and efficient Chapter 11.”\textsuperscript{20}

The Second Circuit rejected Indiana’s argument that the section 363(b) sale in effect was a \textit{sub rosa} plan of reorganization that should have gone through Chapter 11 confirmation “because it gives value to unsecured creditors (i.e., in the form of ownership interest in New Chrysler provided to the union benefit funds) without paying off secured debt in full….”\textsuperscript{21} Assumed in this argument was that the $2b cash consideration was inadequate, and unsecured creditors like the UAW were getting value in the form of equity in New Chrysler while secured creditors whose claims had priority had not been made whole.\textsuperscript{22}

There is a split between the Second and Fifth Circuits on when a section 363(b) sale is a \textit{sub rosa} reorganization plan. The Fifth Circuit’s test is that the sale “would change the

\textsuperscript{18} Wedoff at 5 (“The resolution of these conflicts, of course, is determined within the framework of the Bankruptcy Code (Title 11, U.S.C.), but within that framework, the ultimate result usually depends on how the collateral securing a creditor’s claim is valued, and so most of the litigated issues involving secured claims involve valuation.”).

\textsuperscript{19} Petition for Writ of Certiorari at 18, \textit{In re} Chrysler LLC, 576 F.3d 108 (2\textsuperscript{nd} Cir. 2009) (“The chapter 11 confirmation process is the sole means of restructuring debts, whereas section 363 exists to maximize asset value.”).


\textsuperscript{21} 576 F.3d 108 at 118.

\textsuperscript{22} 11 U.S.C. §1129(b)(2)(B)(ii) (Known as the absolute priority rule, this section states “No one with a claim or interest that is junior to the claims of the dissenting creditor will get or retain anything under the plan.”).
composition of the debtor’s assets and have the practical effect of dictating the terms of a future reorganization plan.” It directly addresses the concern that section 363(b) sales “short circuit the requirements of Chapter 11 for confirmation of a reorganization plan….”

The Second Circuit employs a very broad test that requires the sale to have a “good business reason.” In a note in the Emory Bankruptcy Developments Journal, Fred David points out that there are two tests for a section 363(b) sale, one for business purpose and another for *sub rosa* reorganization, and the Second Circuit collapsed the two-prong inquiry into a single one that uses the business purpose test to examine whether the sale is a *sub rosa* reorganization.

The collapsed inquiry creates an opportunity where a debtor uses liquidation valuation to impose a haircut on a claim secured by collateral.

The opportunity is exploited as follows. A creditor has a claim secured by collateral. The debtor wants to transfer the collateral to a party it has a special relationship with. A court sympathetic to the debtor applies liquidation value to the collateral. This manufactures a business reason for a 363(b) sale as long as consideration offered is greater than liquidation value, thus qualifying the sale as not a *sub rosa* plan. The buyer pays slightly more than liquidation value, but receives a going concern. On the other hand the creditors received only liquidation value. If the collateral was subject to Chapter 11 protections, its sale would require approval by the secured creditor, who could hold out and negotiate for a value above liquidation value.

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24 *Id.*
25 576 F.3d 108 at 114.
26 David at 48.
27 576 F.3d 108 at 116 (“One class of creditors may strong-arm the debtor-in-possession, and bypass the requirements of Chapter 11 to cash out quickly at the expense of other stakeholders, in a proceeding that amounts to a reorganization in all but name….”).
This scenario played out in Chrysler. Chrysler faced enormous pressure from the Obama Administration to favor unsecured creditor the UAW. The Second Circuit, sympathetic to the Obama Administration, compared the $2b consideration to the $800m liquidation value of the collateral. Since “the only possible alternative to the Sale was an immediate liquidation that would yield far less for the estate,” the Second Circuit concluded there was “good business reasons for the Sale,” and thus the sale was not a sub rosa plan of reorganization.

One creditor, the politically influential UAW, through the Obama Administration as proxy, was able to evade Chapter 11 protections and dictate the terms of the reorganization plan. The result was that the secured debt took a haircut, while the UAW got equity in New Chrysler. If the Second Circuit employed going concern valuation for the collateral, which Indiana argued was $20-30b, then selling the collateral for $2b would not have been defensible as a valid business decision.

B) Indiana lacks standing to object to section 363(b) sale

Indiana sought to “challenge the constitutionality of the use of [federal government] funds to finance the Sale….” The merit of the claim is outside the scope of this paper, but the way the Second Circuit addressed it highlights the importance of valuation on creditors’ ability to assert claims.

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28 Brief of Washington Legal Foundation at 10, Indiana State Police Pension Trust v. Chrysler LLC, 129 S.Ct. 2275 (2009) (09-285) (“Given the undue pressure exerted on the debtors and other creditors in this case and the federal government’s own vested interest in the outcome, it is incumbent upon this Court to fully examine the disturbing specter of governmental self-dealing that is raised here.”).
29 Id. 576 F.3d 108 at 118.
30 Id.
31 Todd J. Zywicki, Chrysler and the Rule of Law, WALL ST. J., May 13, 2009 (“In other words, Mr. Obama may have helped save the jobs of thousands of union workers whose dues, in part, engineered his election.”).
32 Application for Immediate Stay of Sale Orders Issued by the Bankruptcy Court at 9, Indiana State Police Pension Trust v. Chrysler LLC, 129 S.Ct. 2275 (2009) [hereinafter Application for Stay].
33 576 F.3d 108 at 112.
Standing is a requirement that a petitioner must meet for a court to adjudicate his claim.\footnote{Whitmore v Arkansas, 495 U.S. 149, 155 (1990) (“[T]he doctrine of standing serves to identify those disputes which are appropriately resolved through the judicial process.”); Valley Forge Christian College v. Americans United for Separation of Church and State, Inc., 454 U.S. 464, 475 (1982) (“Were the federal courts merely publicly funded forums for the ventilation of public grievances or the refinement of jurisprudential understanding, the concept of ‘standing’ would be quite unnecessary. But the ‘cases and controversies’ language of Art. III forecloses the conversion of courts of the United States into judicial versions of college debating forums.”).} One element of standing is that the petitioner “suffers[s] an injury in fact,” which is “an invasion of a legally protected interest….\footnote{Lujan v. Defenders of Wildlife, 504 U.S. 555, 560 (1992).} The Second Circuit relied on the liquidation valuation to show Indiana did not suffer an injury, since “[t]he release of collateral for fair (but less-than-hoped-for) value is not injury in fact sufficient to support standing.”\footnote{576 F.3d 108 at 123.} The determination that liquidation value represented the fair value of Indiana’s collateral prevented Indiana from pursuing claims where the alleged injury was insufficient consideration. This tactic creates opportunities for a court friendly to debtors to use liquidation valuation to remove standing for what may be legitimate claims.

C) Judicial valuation validates auction process used in 363(b) sale

Judge Gonzalez correctly stated that “the true test of value is the sale process itself.”\footnote{In re Chrysler LLC, 405 B.R. 84, 98 (S.D.N.Y. 2009).} A judicial valuation approximates a hypothetical market transaction. As an approximation, a judicial valuation is less capable than a market auction, where bidders internalize the benefit of accurate valuations by being able to identify underpriced assets, of assessing value.\footnote{Stuart Gilson, Valuation of Bankrupt Firms, 13 REV. FIN. STUDIES 43, 43 (2000) (“But bankruptcy is an administrative process. The factors that lead to a reliable estimate of value in a market process are absent in bankruptcy….This absence of market forces makes valuation more complex and less precise.”).}

The auction process for the section 363(b) sale of Chrysler’s assets was heavily criticized by Indiana\footnote{Appellant Brief at 14.} and in academia\footnote{Mark Roe, Assessing the Chrysler Bankruptcy, 108 MICH. L. REV. 727, 746 (2010).} as rigged to favor Fiat, which provided the $2b cash consideration. Two checks to a flawed auction process are 1) judicial valuation of the

\footnote{576 F.3d 108 at 123.}
consideration and 2) the consent of creditors.\textsuperscript{41} As occurred in \textit{Chrysler}, the use of the very low bar of liquidation value removed a meaningful check on the flawed auction process, which left consent as the only avenue for protecting creditors’ secured interests.

II. CURRENT DOCTRINE

In crafting the Bankruptcy Reform Act of 1978, Congress understood the inherent subjectivity of valuations and did not intend for section 506(a)(1) a clean distinction between liquidation versus going concern valuation,\textsuperscript{42}instead preferring judicial discretion on a case by case basis.\textsuperscript{43} Congress did want such ad hoc analysis to be bounded by a literal interpretation of the language of section 506(a)(1).\textsuperscript{44} From this legislative history, courts have embraced a doctrine that looks at the “(1) the purpose of the valuation and (2) the proposed disposition or use of the property.”\textsuperscript{45} The second metric’s focus on the collateral’s intended use contrasts with an approach of hypothesizing what the creditor would get if negotiations failed and the debtor liquidated.

\textit{Assocs. Commercial Corp. v. Rash} interpreted section 506(a)(1) and articulated a valuation standard for collateral.\textsuperscript{46} The Supreme Court reversed the Fifth Circuit and held that when a “plan proposes to retain collateral for use in debtor's trade or business…value of collateral (and thus amount of the secured claim) is price willing buyer in debtor's trade, business,

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  \item \textsuperscript{41} \textit{Id}. at 764.
  \item \textsuperscript{42} Barash v. Public Finance Corp., 658 F.2d 504, 512 (7th Cir.1981) (“The legislative history of § 506(a) indicated that no fixed formula exists for establishing the value of collateral.”).
  \item \textsuperscript{43} H.R. REP. No. 595, 95th Cong., 1st Sess. 356 (1977) (“‘Value’ does not necessarily contemplate forced sale or liquidation value of the collateral; nor does it always imply a full going concern value. Courts will have to determine value on a case by case basis, taking into account the facts of each case and the competing interests in the case.”).
  \item \textsuperscript{44} S. REP. No. 989, 95th Cong., 2d Sess. 54, (1978) (“While courts will have to determine value on a case-by-case basis, the subsection makes it clear that valuation is to be determined in light of the purpose of the valuation and the proposed disposition or use of the subject property. This determination shall be made in conjunction with any hearing on such disposition or use of property or on a plan affecting the creditor’s interest.”).
  \item \textsuperscript{45} \textit{In re Frost}, 47 Bankr. 961, 963 (D. Kan. 1985).
  \item \textsuperscript{46} 520 U.S. 953 (1997).
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or situation would pay to obtain like property from willing seller” as opposed to “net foreclosure value.” It emphasized that the “proposed disposition or use” clause of section 506(a)(1) is of “paramount importance” when valuing collateral.

The context for Rash was a cram down, which is “when a debtor, over a secured creditor's objection, seeks to retain and use the creditor's collateral.” This can be analogized to facts specific to Chrysler and general to section 363(b) sales, in which the court determines the value of the collateral and forces secured creditors to accept consideration in the amount of that value in exchange for not seizing the collateral. Rash embraced the replacement value standard, which is the “cost the debtor would incur to obtain a like asset for the same proposed use” and is similar in concept to going concern value.

Rash was explicit in rejecting the argument that secured creditors should be compensated under the foreclosure value standard because foreclosure is their only other option. It pointed out that there are actually two options for the collateral: foreclosure or continued use by the debtor. Because “the debtor in this case elected to use the collateral to generate an income stream[,]...that actual use, rather than a foreclosure sale that will not take place, is the proper guide.” The intuition is that the party that uses the collateral to realize going concern value enjoys a windfall if section 506(a)(1) allowed it to compensate secured creditors with liquidation

47 Id. at 953.
48 Id. at 954.
49 Id. at 955.
50 Id. at 965.
51 Id. at 959 (“[T]he creditor's interest is in the nature of a security interest, giving the creditor the right to repossess and sell the collateral and nothing more[,] ... the valuation should start with what the creditor could realize by exercising that right.” This was the Fifth Circuit’s position, which the Supreme Court rejected.).
52 Id. at 962 (“If a secured creditor does not accept a debtor's...plan, the debtor has two options for handling allowed secured claims: surrender the collateral to the creditor, see § 1325(a)(5)(C); or, under the cram down option, keep the collateral over the creditor's objection and provide the creditor, over the life of the plan, with the equivalent of the present value of the collateral, see § 1325(a)(5)(B).”).
53 Id. at 963.
Such asymmetry incentivizes debtors to go into bankruptcy to pare down secured claims to liquidation value and profit from the differential with going concern value.\textsuperscript{55}

In dicta the Supreme Court sought to settle a Circuit split where the First and Eighth Circuits used going concern value, the Fifth Circuit used liquidation value, and the Seventh Circuit used the midpoint between liquidation and going concern value.\textsuperscript{56} The Court held that “§ 506(a) directs application of the replacement-value standard” and that “whatever the attractiveness of a standard that picks the midpoint between foreclosure and replacement values, there is no warrant for it in the Code.”\textsuperscript{57} The Court’s position on midpoint valuation is based on a verbatim interpretation of section 506(a)(1)\textsuperscript{58} and not an underlying economic intuition.

Indiana is correct that the Second Circuit’s use of liquidation valuation in a going concern context lacks precedent.\textsuperscript{59} The implication of the \textit{Rash} doctrine is that “very frequently, courts choose going concern value in reorganization cases and choose liquidation value in liquidation cases.”\textsuperscript{60} The doctrine, however, ignores the economic reality that not all Chapter 11 proceedings end up as successful reorganizations and that the secured creditor might still end up with liquidation value. One bankruptcy court estimates “the chances of a small or medium-sized business surviving a Chapter 11 are about one in ten.”\textsuperscript{61}

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  \item \textsuperscript{54} \textit{Id.} at 954 (“Applying a foreclosure-value standard when the cram down option is invoked attributes no significance to the different consequences of the debtor’s choice to surrender the property or retain it.”).
  \item \textsuperscript{55} \textit{In re} Pine Gate Assocs., 12 C.B.C. 607, 624 (Bankr. N.D. Ga. 1977) (“Having declared itself to be a fish to be reorganized, it would be inconsistent for the court now to permit the debtor to declare itself a fowl to be liquidated for purposes of ‘cramping down’ a lower ‘appraisal’ value upon the secured creditors. Therefore, a liquidation value, i.e., a foreclosure value, is a procedure totally foreign to this matter and not a proper standard for valuation.”).
  \item \textsuperscript{56} \textit{Id.} at 959.
  \item \textsuperscript{57} \textit{Id.} at 964.
  \item \textsuperscript{58} \textit{Id.} (“Section 506(a) calls for the value the property possesses in light of the ‘disposition or use’ in fact ‘proposed,’ not the various dispositions or uses that might have been proposed.”).
  \item \textsuperscript{59} Application for Stay at 9 (“…this unprecedented shift in valuation methodologies…”).
  \item \textsuperscript{60} David Carlson, \textit{Secured Creditors and the Eely Character of Bankruptcy Valuations}, 41 AM. U. L. REV., 63, 76 (1991) (Footnote 69 supports this assertion with bankruptcy cases from Illinois, Tennessee, Montana, Delaware, and California.).
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A doctrine where collateral is always valued under a going concern standard artificially increases the bargaining strength of secured creditors and creates market distortions. This is illustrated by the following hypothetical. A creditor has a claim of $7 secured by a lien against a machine, which is the sole asset in the debtor’s business. If the creditor were to seize the asset and liquidate it, it would receive $1. If the debtor were to continue using the asset, the value of the debtor’s business would be worth $25. There is a 90% likelihood the debtor’s reorganization will be unsuccessful. The debtor would then liquidate the machine and the creditor receives $1, 1/7 of its secured claim and an 86% loss. The expected value of the creditor’s claim is $3.4, since there is a 90% probability of realizing $1 and 10% for $25.

Rash would value the creditor’s claim at $25 and ignore the information on the likelihoods of outcomes. Suppose the debtor wishes to pursue a section 363(b) sale, and a strategic buyer has offered to pay $4 for the machine. The creditor, perhaps motivated by bad faith, hopes to draw out the Chapter 11 process and is not motivated to maximize return on its secured claim. It could use going concern valuation to block the section 363(b) sale by arguing that consideration is inadequate, even though the sale would maximize the value of the debtor’s estate. If the court were to incorporate in its valuation the information available on the likelihood of a successful reorganization, the creditor’s secured claim would be properly valued at $3.4 and the creditor could no longer block a sale for $4.

III. PROPOSED FRAMEWORK

The revision to the Rash doctrine proposed by this paper is inspired by an engineering concept known as decision tree analysis. A decision tree is a tool to help the decision maker manage the uncertainty that results when a decision has several possible outcomes. The decision tree maps out all possible outcomes of the decision and assigns a likelihood to each outcome.
The expected value of the decision is calculated by weighting each outcome by its likelihood and aggregating those values.

There is precedent in the literature for applying decision tree analysis to bankruptcy theory. In a note published in the *Virginia Law Review* and cited in *Chrysler*, Jason Brege developed a framework that evaluates the economic efficiency of a section 363(b) sale to replace the *Lionel* factors as the test for approving a section 363(b) sale. It is a cost-benefit analysis weighing the proceeds from a section 363(b) sale against the transaction cost of a section 363(b) sale plus opportunity cost, which is the value of having the asset for Chapter 11 reorganization. Brege conceptualizes the opportunity cost of going through Chapter 11 as the expected value of two outcomes: 1) failed reorganization and subsequent liquidation under Chapter 7 and 2) sale or retention of the business under Chapter 11. Each outcome has a likelihood of occurrence, and these likelihoods aggregate to one.

Decision tree analysis can be applied to the doctrine governing liquidation versus going concern valuation of collateral. *Rash* interpreted section 506(a)(1) to require going concern valuation of collateral when it is to be used to realize going concern value. This interpretation, however, may mean a less accurate valuation because it does not incorporate information on the likelihood of the debtor succeeding in continuing to operate as a going concern.

One solution is to refine the *Rash* doctrine to use a weighted valuation that incorporates the likelihoods of going concern and liquidation outcomes. If there was a 10% likelihood of a successful reorganization and a 90% likelihood of a piecemeal liquidation, the collateral would be valued as the weighted sum of these distinct outcomes.

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62 *In re Lionel Corp.*, 722 F.2d 1063, 1071 (2nd Cir.1983) (Lionel listed seven factors a court should consider when deciding whether to approve a section 363(b) sale).
63 Brege at 1661 (Brege actually used three outcomes, which were simplified into two for this paper.).
64 Id. (“…finite probability summing to 1.”).
Rash explicitly rejected such a midpoint approach to collateral valuation but did not identify what problems other than complexity midpoint valuations might create. Judge Richard Posner in In re Hoskins articulates the rationale for midpoint valuation by conceptualizing a negotiation between two parties in a bilateral monopoly. Calculating expected value quantifies the relative bargaining strengths of the parties.

The creditor would not accept a valuation of collateral below the liquidation value, since it could realize the same value by seizing the collateral. The debtor profits off the differential between the value it produces using the collateral and the value of the secured interest in the collateral. The more likely a reorganization might fail, the smaller the expected value of the residual profit is available to the debtor, and the more willing the creditor would be to accept a valuation closer to the liquidation value. If the creditor insisted on a valuation too high, the debtor’s expected value of the profits would shrink to the extent it no longer is worthwhile operating as a going concern. The blending of going concern and liquidation valuations captures this dynamic.

Rash recognized that there was a likelihood that under Chapter 11 the secured creditor would receive liquidation value. Reorganization is risky for creditors since they would

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65 520 U.S. 953 at 964 (“The Seventh Circuit rested on the ‘economics of the situation’….We agree with the Seventh Circuit that ‘a simple rule of valuation is needed’ to serve the interests of predictability and uniformity. We conclude, however that § 506(a) supplies a governing instruction less complex than the Seventh Circuit’s ‘make two valuations, then split the difference’ formulation.”).
66 102 F.3d 311 (7th Cir.1996).
67 Id. at 315 (“…the relation between secured creditor and defaulting debtor would be as good an example of bilateral monopoly as the settlement of a lawsuit is….There is no way to predict where in the bargaining range the bargain would be struck. But to economize on bargaining costs, people who find themselves in a bilateral monopoly situation will often agree simply to split the difference.”).
68 Id. at 316 (“So the midpoint of the bargaining range, which is the point that the bankruptcy court chose in this case, is a reasonable approximation of the likely average valuation of the debtor's automobile that the secured creditor and defaulting debtor would agree upon….Since the midpoint rule is superior from the standpoint of the underlying economics of the situation to either of the alternative rules-wholesale value or retail value-we hold…the value of the secured interest is the average of the retail and the wholesale value of the collateral.”).
participate in the downside of a failed reorganization. The Supreme Court argued that the creditor should be compensated for the risk with a premium, which going concern rather than liquidation valuation better provides. The result is although there is a likelihood of the reorganization failing and the creditor receiving liquidation value, that likelihood should always be set to zero when valuing collateral.

One justification might be because the likelihood is hard to estimate, rounding down to zero ensures the collateral is never undervalued. However such a position is as arbitrary as always assuming the likelihood is 100% and thus using liquidation value. Under the Court’s logic, even if there was information that the likelihood of the reorganization failing was 99.99%, that likelihood should still be rounded down to zero. As long as the proposed use of the collateral is to realize going concern value, collateral should be valued as a going concern regardless of how unlikely such an outcome might be.

Judge Posner proposes applying equal weights to going concern and liquidation valuations. This paper proposes a framework where courts estimate the probabilities of success and failure and use those as weights. Such an inquiry is at best speculative and imprecise, but making the inquiry explicit forces a court to contemplate such variables and apply its best judgment, as happens in all other aspects of valuation analysis. Bankruptcy courts already make similar assessments under section 1129(a)(11), where a proposed plan is evaluated for its chance of success. One compromise might be to add a qualification to section 506(a)(1) that

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69 520 U.S. 953 at 953 (“If a debtor keeps the property and continues to use it, the creditor obtains at once neither the property nor its value, and is exposed to double risks against which the Code affords incomplete protection: The debtor may again default and the property may deteriorate from extended use.”).


71 11 U.S.C. §1129(a)(11) (For a plan to be confirmed, a requirement is that the “[c]onfirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan, unless such liquidation or reorganization is proposed in the plan.”).
requires a court to consider the likelihood of a reorganization succeeding without having to quantify it. If the court believes the reorganization is more likely than not to succeed then it applies going concern valuation.

The intuition behind the weighted average valuation standard is that using more information when available increases the accuracy of a valuation. Before Rash, many courts used only the liquidation valuation standard, while other courts used going concern valuation. Rash created a more flexible framework where courts would consider information on the proposed use of the collateral in deciding which valuation standard to apply. The weighted average valuation framework builds on Rash to include additional information relevant to collateral valuation, the likelihoods of the possible outcomes of the reorganization.

IV. APPLICATION TO CHRYSLER

Indiana believed the assets sold to New Chrysler had a going concern value of $25b, far exceeding the $6.9b claim of first-lien lenders. It had a strong argument for using going concern valuation. Chrysler was not being liquidated but in effect was being reorganized through shell company New Chrysler. Statements regarding the asset sale, like saving jobs and stabilizing the auto sector, indicated the intent was to preserve Chrysler as a going concern. Applying Rash, going concern was more appropriate than liquidation valuation given the purpose of the sale and use of the assets, because “upon consummation, New Chrysler will be Old Chrysler in essentially every respect.”

72 Appellant Brief at 5.
73 Id. at 43.
74 Application for Stay at 7.
75 Id. at 24.
The result from using liquidation value runs counter to Chapter 11’s role as a forum where all claimholders have opportunity to advocate their best interests. Claimholders like the UAW, Fiat, and Treasury got to participate in the going concern value while first-lien lenders received liquidation value.\footnote{\textit{Id}. ("The company is effectively the same, only the secured creditors have been eliminated from the capital structure, and the unsecured creditors have been elevated.").} Such a result demonstrates the danger of giving too much discretion to courts in valuing collateral, which creates opportunity to afford special treatment to preferred creditors.\footnote{Carlson at 86 ("A change of standards to serve pro-debtor or pro-creditor politics belies the objectivity that valuations are supposed to represent. It would be better if a single valuation standard was adopted for an entire bankruptcy proceeding.").}

Neither Chrysler, Judge Gonzalez, nor the Second Circuit addressed the merit of using going concern as an alternative to liquidation valuation of collateral, and none mentioned the holding in \textit{Rash}. Chrysler, in its appellee brief to the Second Circuit, acknowledged “the Debtors commenced these cases to implement a prompt sale of most of their operating assets that will preserve Chrysler's business as a going concern under new ownership….\textsuperscript{78}”\footnote{Brief for Debtors-Appellees Chrysler LLC, \textit{et al.} at 2, \textit{In re} Chrysler LLC, 576 F.3d 108 (2nd Cir. 2009) (09-2311-bk) [hereinafter Appellee Brief].} Judge Gonzalez compared the $2b consideration to “the value that the First-Lien Lenders could recover in an immediate liquidation”\footnote{405 B.R. 84 at 97.} to justify the sum as adequate, which is logic \textit{Rash} was explicit in rejecting.

The Second Circuit echoed the bankruptcy court’s position and also argued that “the Indiana Pensioners exaggerate the extent to which New Chrysler will emerge from the Sale as the twin of Old Chrysler."\footnote{576 F.3d 108 at 119.} It pointed out that New Chrysler will make “newer, smaller vehicles using Fiat technology that will become available as a result of the Sale - moreover, at the time of

\footnotesize{\bibliography{references}}
the proceedings, Old Chrysler was manufacturing no cars at all.” It also focused on the “election of a new management team, new union contracts, and new access to Fiat dealerships in the European market.”

The factual inquiry of whether New Chrysler is a truly distinct entity or simply a reformed Chrysler is a separate issue tangential to the one addressed in this paper. The relevance is that if New Chrysler is indeed an unrelated entity that transacts at arms-length with Old Chrysler, then Old Chrysler has no incentive to sell assets to New Chrysler for less than fair value consideration. The section 363(b) sale of substantially all of Old Chrysler’s assets means liquidation of Old Chrysler and its cessation as a going concern. Under Rash, collateral should be valued with a liquidation standard since Old Chrysler’s proposed use of the assets is liquidation. If New Chrysler instead, however, is deemed a continuation of Old Chrysler, then the proposed use of Old Chrysler’s assets by New Chrysler would in substance be Old Chrysler operating as a going concern. Under Rash, proposed use of the collateral as a going concern requires going concern valuation to be applied.

A) Applying Rash doctrine to Chrysler

Indulging Indiana and taking the position that New Chrysler is merely Old Chrysler wearing new clothes, Rash would consider the $6.9b claim of first-lien creditors to be secured by $25b in collateral. A $2b cash offer for $25b in collateral would be grossly deficient. Given that Old Chrysler was losing $100m a month in going concern value and unassisted would implode in weeks, this paper assumes a 10% probability of realizing the $25b going concern value, whether from turning around the business or a white knight topping Fiat’s $2b offer. The

81 Id.
82 Id.
83 Id.
84 Roe at 741.
probability of first-lien lenders receiving the $800m liquidation value was 90%. Thus the $6.9b first-lien claim was secured by collateral with an expected value of $3.22b. The first-lien lenders would be better off accepting an offer from Fiat for Chrysler’s assets above $3.22b and lifting their lien rather than holding out for a better deal.

The Obama administration accused Republican Indiana Treasurer Richard Mourdock of being politically motivated in seeking to block the section 363(b) sale to Fiat.\footnote{Chrysler Slams Indiana State Treasurer’s Demands, N. Y. TIMES, May 26, 2009.} Indiana’s investment in Chrysler amounted to less than 1% of its portfolio.\footnote{Id.} Hungry for a national profile upon which to build a career,\footnote{Mourdock later became the 2012 Republican nominee for Indiana’s U.S. Senate seat.} Mourdock’s objective was to pick a fight, as the $2m legal fees\footnote{Brian Baxter, \textit{White & Case Chrysler Litigation Bills a Hot Topic in Indiana}, AM. L. DAILY, Sept. 10, 2010.} litigating 	extit{Chrysler} equaled the $2m monetary reward of winning.\footnote{Chrysler Slams Indiana State Treasurer’s Demands.}

Assume Fiat will realize $5b in synergies from buying Chrysler’s assets. An economic inefficiency results if \textit{Rash} is applied, the collateral is valued at $25b, and there is a creditor like Indiana with ulterior motives. Fiat offers $4b for Chrysler’s assets. Indiana, eager to argue against the constitutionality of using federal government funds to finance the sale, uses the $25b valuation of the assets to block the sale. An economic cost of $1.78b results, $1b of which accrues to Fiat in missed synergies and $.78b to first-lien creditors in pursuing an option with a $3.2b expected payoff instead of one with $4b.

\textbf{B) Applying proposed framework to Chrysler}

Using the framework proposed by this paper, the court would value collateral using information on the likelihoods of a turnaround of Old Chrysler succeeding (10%) or failing (90%), the payoff of success ($25b), and the payoff of failure ($800m). Calculating an expected value of $3.22b, the court would consider first-lien lenders adequately compensated by Fiat’s
offer of $4b. Given that Chrysler is decreasing in going concern value as its employees and suppliers lose confidence, it fits the melting ice cube situation, and the section 363(b) sale to Fiat would be approved.

The first-lien lenders would take a 53% loss on their original $6.9b investment. The section 363(b) sale would not constitute a sub rosa plan under the Second Circuit’s collapsed inquiry, since selling $3.22b in assets for $4b in cash is a valid business decision. Indiana would not have standing to litigate its constitutional claim since it did not suffer an injury in receiving $4b in cash for $3.22 in assets. There would be some validation for the criticized auction process employed in the section 363(b) sale to Fiat, since $4b in cash was received for $3.22 in assets. This paper does not endorse these outcomes as optimal but mentions them to demonstrate the impact of a weighted valuation approach on the section 363(b) sale. The divergence between these outcomes and what actually happened in Chrysler illustrates why a consistent approach to valuation is needed.

Weighted valuation should be the only approach in determining secured interests under section 506(a)(1). It weights the payoffs guiding the creditor in its position regarding a section 363(b) sale and assigns the creditor bargaining strength reflective of this position. If there is a high likelihood of the collateral realizing going concern value without a section 363(b) sale, the weighted approach would calculate a high expected value to reflect that. This increases the power of the creditor to block a section 363(b) sale by constraining the ability of a court to find a valid business reason to justify the sale.

While under Rash, Judge Gonzalez’s use of liquidation valuation is incorrect, the $2b result is not necessarily incorrect. If weighted valuation was used to arrive at $2b, with a going concern valuation of $25b and liquidation valuation of $800m, embedded in the calculation is an
assumption of a 5% probability of realizing going concern value and 95% for liquidation value. Determining the 5% and 95% probabilities would result from a battle of expert testimonies as is done for the $25b and $800m valuations. By recognizing the probabilities as inputs, the proposed framework forces a bankruptcy court to justify them, which Judge Gonzalez did not for the $2b valuation. This could decrease the ability of judges to exploit the subjectivity of valuations to circumvent the law and arrive at a preferred result.

V. IMPACT OF UNRESOLVED LEGAL ISSUE ON CAPITAL FORMATION

Many in the finance community predicted Chrysler would deter the efficient flow of capital. If liquidation value is the floor for guaranteeing a creditor’s secured interest, then borrowing costs will increase since creditors anticipate recovering less in the event of bankruptcy. The alternative is to up the amount of collateral to protect against the possibility that a bankruptcy court applies liquidation valuation. Start-ups that have little collateral to put up may pay exorbitant interest rates or be shut out from financing.

The Supreme Court’s vacatur of Chrysler may increase uncertainty in capital markets. It is unclear what the Court thinks about Judge Gonzalez’s use of liquidation valuation and whether Rash should be updated. Without a settled doctrine for collateral valuation, lenders will react to developments in bankruptcy and Circuit courts, injecting volatility into the lending industry. Many courts continue to use midpoint valuation, since the position of Rash against midpoint valuation is merely dicta, which is authoritative but not binding.

90 95% * $800m + 5% * $25b = $2b.
91 Appellee Brief at 2 (“[T]he Debtors presented testimony from 12 witnesses (either live or through depositions) and introduced 48 exhibits into evidence.”).
93 Wedoff at 15.
If *Rash* remains good law, the benefit is that it clarifies that valuation should relate to the collateral’s proposed use and that the likelihood of the proposed use occurring is irrelevant. The drawback is that such a standard lacks nuance and is arbitrary. The standard lacks nuance because it excludes a dimension in the analysis, which is the likelihood of the proposed use occurring. The pro-creditor result of always using going concern valuation in Chapter 11 is as arbitrary as always using liquidation valuation. Unsupported by economic reasoning, *Rash* inhibits capital formation in two ways.

A) Increases the ability of vulture investors to shake down distressed businesses

Vulture investors buy claims and then threaten to make the Chapter 11 process as unconstructive as possible unless they are paid off. Unlike other distressed debt investors, vulture investors are unconcerned with maximizing the value of the debtor’s estate and instead focus on how to extort the debtor. Given that *Rash* strengthens the bargaining hand of secured creditors, the ability of vulture investors to be a nuisance increases. If a vulture investor is sufficiently aggressive, other creditors might buy out its claim at a premium just to remove the vulture investor from the Chapter 11 process.

B) Decreases demand for secured credit as a form of financing

Given the increased ability of vulture investors to shake down debtors, *Rash* could discourage businesses from taking on secured debt. This could particularly impact asset intensive industries that can put up a lot of collateral. The diminishment of secured debt as a form of cheap financing could inhibit the pursuit of value creating initiatives.
CONCLUSION

Bankruptcy courts are courts of equity where judges are afforded substantial discretion to determine the result. Participation by judges not formally trained in the art of valuation is an unavoidable facet of bankruptcy cases. This paper seeks to partly mitigate the arbitrariness in valuation of collateral by proposing a weighted valuation framework to replace the Rash doctrine, which has created opportunities for abuse and waste.

All parties in Chrysler framed the choice between going concern and liquidation valuation as a binary one. Such oversimplification excludes variables relevant to valuation analysis, the likelihoods of outcomes in a reorganization, and reduces the rigor of the valuation. While likelihoods of outcomes are difficult to estimate, the goal is for the court to think about them and consider how they might impact the analysis. Valuation is an educated guess about an asset’s value, and attempting to estimate a relevant variable fits closer to that spirit than ignoring the variable.

Unfortunately, the Supreme Court’s decision not to revisit Chrysler represents a missed opportunity to settle the issue of going concern versus liquidation valuation of collateral and to revise the Rash doctrine. The result is an unnecessary source of economic sub-optimality in Chapter 11 reorganizations and section 363(b) sales. “Two potential stories can be told regarding Section 363(b) sales…. [T]he divergence between the two views rests on a razor's edge dependent upon the level and quality of court intervention in both confirmation of reorganization plans and in valuation of Section 363(b) sales.”

94 In the early English legal system, there were courts of equity and courts of law. Courts of law were bound by the law in their decisions, while judges in courts of equity were allowed more leniency to substitute their own common sense in place of the law.
95 Brege at 1644.