

These are unprecedented times. The catastrophic failure of prevailing credit flow has forced Federal intervention to an extent and in a fashion that creates uncertainty in traditional equity and debt relationships. We will be publishing a series of essays on this subject, beginning with the following article that explores the limits of impairment of secured creditors in a possible bailout of the US auto industry.

Hitting The Brakes On Legislative Interference With The Property Rights Of Automakers' Secured Creditors

Authors: Alan Gover and Andrew Zatz

White & Case LLP, New York

The recent financial crisis has resulted in events that once seemed impossible. Recently, in the federal government's attempts to bail out the auto industry, an event unprecedented in American history almost occurred: the forced subordination of existing secured debt to new loans issued by the federal government. If the government were to revive this concept in future bailouts and attempt to subordinate the liens of secured creditors, a suit challenging the constitutionality of such action would have a good chance of success.

The Potential For Forced Subordination

In December, 2008, as American automakers spiraled towards insolvency, the federal government scrambled to assemble a workable program to provide liquidity. One proposed solution was contained in a bill introduced in the House of Representatives, the Auto Industry Financing and Restructuring Act (AIFRA), which would have provided a loan from the federal government to the American automakers.¹ The original text of the bill

provided that the loans would be "senior and prior to all obligations, liabilities, and debts of any such holding company or company that controls a majority stake in the eligible automobile manufacturer."²

This provision resulted in a great deal of controversy, which prompted the altering of the text so that the federal government would receive a senior security interest "to the extent permitted by the terms of any obligation, liability, or debt of the eligible automobile manufacturer in effect as of December 2, 2008."³ AIFRA was passed in the House but was quashed in the Senate because of disputes over the wages to be paid to workers.⁴ President Bush and Secretary Paulson subsequently authorized the use of Troubled Assets Relief Program (TARP) funds to keep the automakers afloat, and the terms of the TARP loans contain similar language: "To the extent legally and contractually permissible, the applicable Loan Parties shall grant to Lender first-priority liens on all unencumbered assets, and junior liens on all encumbered assets."⁵ The TARP bailout may only be the beginning of Federal assistance for American automakers.⁶ The next stage of lending



Alan Gover
Partner



Andrew Zatz
Associate

Hitting The Brakes On Legislative Interference With The Property Rights Of Automakers' Secured Creditors

could arise under legislation with language resembling the original language of AIFRA, which would potentially subordinate existing secured debt to new federal government loans.

Another section of AIFRA that could possibly lead to a forced subordination of secured debt is Section 16(a), which states: "At any time as the President's designee determines that action is necessary to avoid disruption to the economy or to achieve a negotiated plan, the President's designee shall submit to Congress a report outlining any additional powers and authorities necessary to facilitate the completion of a negotiated plan . . ." This section is fairly vague, and leaves open the possibility that the President's designee or some other party could attempt to introduce new legislation that would entail broader powers and authorities for the federal government in its bailout efforts, including, for example, modifying what kind of adequate protection would be sufficient to permit the priming of the liens of automakers' secured creditors both in and outside of bankruptcy.

Further, President Bush's spokeswoman has stated that a "managed bankruptcy" is being considered as an option for the American automakers.⁸ No elaboration has been given as to what a managed bankruptcy entails, whether it involves a pre-packaged plan or another type of procedure resembling a bankruptcy filing. A managed bankruptcy could potentially involve a forced impairment of the claims or liens of the automakers' secured creditors.

Whether the federal government acts under AIFRA, a "managed bankruptcy," or some other method for providing federal loans to American automakers, the possibility of a forced impairment of secured debt remains. This could be in the form of the subordination of the existing secured debt of the automakers to loans made by the federal government.

The Effect of Subordination on Different Constituencies

In order to stay solvent in today's environment, the only options for the auto manufacturers going forward are either to file for bankruptcy or to receive

further bailouts from the federal government. If an automaker files for bankruptcy, the federal government will likely need to provide debtor-in-possession (DIP) financing to a bankrupt auto manufacturer, which, if certain qualifications are met, would prime existing debt. This financing would help prevent immediate liquidation of the bankrupt automaker. If an automaker files for bankruptcy, its secured creditors may receive equity and, in draconian scenarios, may need to put up a rights offering to prevent dilution by any debtor-in-possession financing. Unsecured creditors and equity would likely recover close to nothing. The auto unions would need to negotiate new contracts from a weaker negotiating position as prior agreements between the unions and the auto manufacturers could potentially be altered without the unions' consent in bankruptcy. Suppliers to the automakers would also likely file for bankruptcy as they are extremely dependent on the auto manufacturers. In bankruptcy, it will be easier for auto manufacturers to close dealers without providing material compensation.

If the federal government goes forward with bailouts similar to the recent TARP bailout, secured creditors will be better off because automakers will receive funds on a junior basis. Unsecured creditors would be forced into a partial or complete debt-for-equity conversion but would be in a better position than they would be in bankruptcy because they may retain some material value. Equity may also fare better under bailouts as its value may only be diluted due to debt-for-equity swaps instead of being wiped out completely in a bankruptcy. Unions would have stronger bargaining power and be able to rely on past agreements without the threat of forced modifications. Suppliers have not yet received material bailouts but may require them in the future if auto sales do not recover. Under further bailouts, dealers would likely receive to-be-determined payments from the automakers.

If the government goes forward with bailouts that force subordination of the secured creditors' liens, existing secured creditors would lose the value of having top priority. Secured creditors may be able to opt for a debt-for-equity swap but this would

Hitting The Brakes On Legislative Interference With The Property Rights Of Automakers' Secured Creditors

be complicated given the need to negotiate with unsecured creditors who may also be equitized. By priming its loans, the federal government would be in a similar position as it would likely be in if it provided DIP financing in bankruptcy. However, the federal government would have greater power to dictate the terms of a bailout with forced subordination than it would in a bankruptcy court. As a result, the federal government could potentially dilute the value of all creditors and equity and alter the position of the auto unions. If the government provides a bailout with forced subordination, suppliers may receive similarly structured bailouts. If secured creditors are subordinated, they may demand that dealers receive less than they would otherwise outside of court. However, dealers may still receive a certain amount due to existing state franchise laws. The federal government would be much better protected if it subordinates the secured creditors of the auto manufacturers, but would potentially be exceeding its constitutional powers. The secured creditors, as the party most closely and negatively affected by forced subordination would be in the best position to bring suit.

How Secured Creditors Could Respond

In the event of a forced impairment of their liens, secured creditors may not be without recourse for any damages they incur. The Supreme Court has a history of prohibiting government actions that exceed constitutional bounds. In the classic case of *Dartmouth College v. Woodward*, the Court held a law forcing a private college to become a public institution to be unconstitutional.⁹ The Supreme Court has found federal government overreaching to be unconstitutional even in times of emergency. In the cases of *Schechter Poultry Corp. v. United States*¹⁰ and *United States v. Butler*¹¹, the Supreme Court famously struck down legislation passed as part of the New Deal. Despite the extreme circumstances of the Great Depression that existed when the legislation was passed, the Court found that the federal government had exceeded its constitutional powers under the laws. Similarly, the Supreme Court

held that President Truman's attempt to seize steel mills to strengthen the American steel supply in support of the Korean War was an unconstitutional exercise of the federal government's power.¹²

The Supreme Court has, over the years, moved towards giving the government more deference in the exercise of its powers. The cases of *NLRB v. Jones & Laughlin Steel Corp.*¹³, *U.S. v. Darby*¹⁴ and *Wickard v. Filburn*¹⁵ explicitly moved away from the holdings in *Schechter Poultry* and *Butler*. In the case of *Lochner v. New York*, the Supreme Court declared unconstitutional a law that imposed a limit on the number of hours bakers could work.¹⁶ *Lochner* has been widely criticized as an example of the Supreme Court's over-stepping its authority to limit legislative action and the Supreme Court has since disowned the holding in *Lochner*¹⁷. While the Supreme Court has been prone to give deference to government action, the subordination of the liens of automakers' secured creditors is such an unprecedented and drastic action that it may well rise to the level where the Supreme Court is compelled to say that the government has gone too far.

If the federal government were to alter the rights of secured creditors of American automakers by subordinating their liens, secured creditors may be protected by the takings clause of the Fifth Amendment, which states: "nor shall private property be taken for public use without just compensation."¹⁸ The government has committed a taking if it has "destroyed, physically occupied, or regulated" someone's property.¹⁹ If the federal government were to alter the rights of secured creditors of the American automakers, the secured creditors could argue that their property right in their collateral was destroyed or regulated.²⁰

The Supreme Court has acknowledged that it "has been unable to develop any 'set formula' for determining when 'justice and fairness' require that economic injuries caused by public action be compensated by the government."²¹ Rather, the Court has engaged in "ad hoc, factual inquiries" that turn "upon the particular circumstances in that case."²²

Hitting The Brakes On Legislative Interference With The Property Rights Of Automakers' Secured Creditors

The case-by-case approach to the takings clause has resulted in a variety of outcomes in American case law, which makes it difficult to predict whether a takings clause argument would be accepted by a court.

In the case of *Armstrong v. United States*, the Supreme Court held that the federal government violated the takings clause by foreclosing on collateral under a contract that was subject to liens of a third party.²³ *Armstrong* was a case of the federal government's infringing the property rights of third parties to enforce its own security interest, which would be closely analogous to the case if the federal government were to subordinate the liens of secured creditors of automakers to the liens of the government with respect to its own loans. In *Armstrong*, the Court stated that the principal purpose of the takings clause is "to bar the federal government from forcing some people alone to bear public burdens which, in all fairness and justice, should be borne by the public as a whole."²⁴ Secured creditors of the automakers could argue that they should not be forced to sacrifice the property rights they bargained for with the automakers when the public as a whole, represented by the federal government, should bear the burden of rescuing the automakers.

Courts are particularly wary of the government's taking property for its own benefit.²⁵ In *Webb's Fabulous Pharmacies, Inc. v. Beckwith*, the Supreme Court held that the federal government's collection of interest on an interpleader account was a violation of the takings clause.²⁶ The court stated that the "exaction is a forced contribution to general governmental revenues."²⁷ Similarly, if Congress were to subordinate secured creditors' liens in order to enhance the value of the government's loans, it would be forcing the secured creditors to transfer their property rights to the federal government.

A taking will be held to be unconstitutional if it is not for a valid public use. For a taking of property to be for the public use, it need not actually be "put in use for the general public" but, instead, must simply be for a "public purpose."²⁸ The Court, in *Kelo v. City of New London, Connecticut*, stated: "For more than a century, our public use jurisprudence has wisely

eschewed rigid formulas and intrusive scrutiny in favor of affording legislatures broad latitude in determining what public needs justify the use of the takings power."²⁹ There, the Court gave deference to the city of New London's public purpose of "economic rejuvenation" in condemning certain property.³⁰ Courts have found economic legislation to be particularly deserving of deference.³¹ If the purpose of legislation that results in a taking is "legitimate and its means are not irrational," a court will not question the legislature's explanation of what constitutes a public use.³²

By subordinating the secured creditors' liens, the federal government could claim that its taking satisfies the public use of keeping the automakers in business and, in so doing, saving hundreds of thousands of jobs and protecting the American taxpayers from potential default by the automakers. As such an infraction of contractual rights is unprecedented in American history, it is unclear how a court would view such a rationale. As courts generally give deference to a legislative explanation of public use, particularly in the economic sphere, it is likely a court would find such a rationale to be persuasive. However, it is possible that a court would find that such a purpose is not legitimate and its means irrational, as subordination of secured creditors' liens is an extraordinary action by the federal government. Further, it is not necessary for Congress to alter the contractual rights of secured creditors. Instead, the federal government could take a security interest junior to that of the secured creditors, as was the case in the version of AIFRA that passed in the House of Representatives and the recent TARP bailout.

Just Compensation

If a court determines that the government's taking of the secured creditors' property by impairing their liens is a constitutional taking and is for a legitimate public use, the secured creditors must receive "just compensation" for the deprivation of property.³³ Justice Oliver Wendell Holmes stated that just compensation is measured as "what has the owner lost, not what has the taker gained."³⁴

Hitting The Brakes On Legislative Interference With The Property Rights Of Automakers' Secured Creditors

Just compensation seeks to put the owner of condemned property "in as good a position pecuniarily as if his property had not been taken."³⁵ In the case of *United States v. Commodities Trading Corp.*, the Supreme Court stated: "Whatever the circumstances under which such constitutional questions arise, the dominant consideration always remains the same: What compensation is 'just' both to an owner whose property is taken and to the public that must pay the bill?"³⁶

Determining what just compensation would be if the federal government were to alter the priority of secured debt is difficult. Arguably the reduction in the value of the secured creditors' liens is the magnitude of the property right in the collateral that the secured creditors would be deprived of. However, compensating the secured creditors in such amount makes sense only if the automakers default on their loans and the secured creditors recover less than on their secured claims than they would have if the subordination had not occurred. Furthermore, the federal government might argue that the secured creditors received at least partial compensation for the subordination of their liens to the extent of any enhancement of the value of their unsecured claims created by the federal government's loans to the automakers. Such an argument has never been attempted by the federal government but could be persuasive, as the secured creditors' secured and unsecured claims collectively may be more valuable if the automakers survive the current economic turmoil than if they fail.

In the event of forced subordination, the federal government could argue that secured creditors are not entitled to just compensation because the alteration of their liens took place during an emergency. In the case of *In the Matter of Property Located at 14255 53rd Ave S.*, Washington's Department of Agriculture destroyed trees that were potentially hosting beetles that could have destroyed many more trees.³⁷ The Court of Appeals of Washington stated: "When immediate action is necessary in order to avert a great public calamity, private property may be controlled, damaged or even destroyed without compensation."³⁸ In the case

of *United States v. Caltex (Philippines)*, companies owning terminal facilities in the Philippine Islands filed suit after their facilities were destroyed by the United States army to prevent enemy forces from utilizing the facilities as a logistic weapon.³⁹ The Supreme Court held that this was not a compensable taking under the takings clause because "the common law had long recognized that in times of imminent peril – such as when fire threatened a whole community – the sovereign could, with immunity, destroy the property of a few that the property of many and the lives of many more could be saved."⁴⁰

However, other courts have held that just compensation must be paid even if a taking occurred during an emergency. In the case of *United States v. Pewee Coal Co.*, the President issued an executive order directing the Secretary of Interior to take possession of all coal mines where a strike was threatened or had occurred and to operate such mines.⁴¹ The Supreme Court stated that, because of the taking of the mine, "the United States became liable under the Constitution to pay just compensation."⁴²

If the federal government alters the secured creditors' liens, it could argue that it did so under emergency circumstances. American automakers are on the brink of insolvency and hundreds of thousands of jobs are at stake. Furthermore, casualties of the credit crunch are mounting and the federal government is attempting to do whatever it can to stop the downturn. Nevertheless, it is questionable whether a court would accept such an argument given varying decisions on whether an emergency excuses the payment of just compensation.

Hitting The Brakes On Legislative Interference With The Property Rights Of Automakers' Secured Creditors

Conclusion

While the federal government might argue that just compensation has been paid or that just compensation need not be paid because of emergency circumstances, the automakers' secured creditors need not take the forced subordination of their liens lying down. There are strong arguments that such action would require actual compensation under the Fifth Amendment and, given the Supreme Court precedent, secured creditors would have a good chance of success in a suit for their damages.

Alan Gover is a partner in the New York office, where he serves as an advisor to boards of directors and managements and financial and strategic investors, including sovereign wealth funds and other global financial and business institutions.

Alan writes and speaks on strategic planning and reorganization and bankruptcy. He has been acknowledged in many professional rankings, including for the past fifteen years in "Best Lawyers in America".

+ 1 212 819 8595
agover@whitecase.com

Andrew Zatz is an associate in the New York office. He specializes in financial restructuring and insolvency law. Andrew graduated magna cum laude from Fordham University School of Law in 2007.

+ 1 212 819 8504
azatz@whitecase.com

The information in this article is for educational purposes only; it should not be construed as legal advice.

Copyright © 2009 White & Case LLP

1. H.R. 7321, 110th Cong. (2008).
2. Jeffrey McCracken & Elizabeth Williamson, *Bailout Bill Vexes Banks as U.S. Stakes Auto Claims*, Wall St. J., Dec. 11, 2008.
3. H.R. 7321, 110th Cong. § 12(d)(1) (2008).
4. Greg Hitt, Jeffrey McCracken & John D. Stoll, *Rescue Big for Detroit Collapses in Senate*, Wall St. J., Dec. 12, 2008.
5. *Indicative Summary of Terms for Secured Term Loan Facility*, December 19, 2008, Appendix A to Secured Bridge Loan Facility, Chrysler, available at <http://www.treas.gov/press/releases/reports/chryslerfinaltermappendix.pdf>; *Indicative Summary of Terms for Secured Term Loan Facility*, December 19, 2008, Appendix A to Secured Bridge Loan Facility, GM, available at <http://www.treas.gov/press/releases/reports/gmfinalterm&appendix.pdf>
6. John D. McKinnon & John D. Stoll, *U.S. Throws Lifeline to Detroit*, Wall St. J., Dec. 2, 2008.
7. H.R. 7321, 110th Cong. § 16(a) (2008).
8. David E. Sanger, Bill Vlasic & Micheline Maynard, *Car Bankruptcy Cited as Option by White House*, NY Times, Dec. 18, 2008.
9. 17 U.S. (4 Wheat.) 518 (1819).
10. 295 U.S. 495 (1935).
11. 297 U.S. 1 (1936).
12. *Youngstown Sheet & Tube Co. v. Sawyer*, 343 U.S. 579 (1952).
13. 301 U.S. 1 (1937).
14. 312 U.S. 100 (1941).
15. 317 U.S. 111 (1942).
16. 198 U.S. 45 (1905).
17. See *West Coast Hotel v. Parrish*, 300 U.S. 379 (1937); *Lincoln Federal Labor Union v. Northwestern Iron & Metal Co.*, 335 U.S. 525 (1949); *Williamson v. Lee Optical*, 348 U.S. 483 (1955).
18. U.S. Const. amend. V. If the federal government were to attempt to alter secured creditors' rights in bankruptcy, the takings clause would still apply. *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555, 589-602 (1935) ("The bankruptcy power, like the other great substantive powers of Congress, is subject to the Fifth Amendment.") (holding that an amendment to federal bankruptcy law that extinguished mortgage liens without the full repayment of the loans that they secured violated the takings clause).
19. *Boyle v. United States*, 200 F.3d 1369, 1374 (Fed Cir. 2000).
20. This argument would require secured creditors to show that their contractual rights under Credit Agreements to which they and an automaker were party, including liens granted therein, are a property right in collateral. "Property interests . . . are not created by the Constitution. Rather, they are created and their dimensions are defined by existing rules or understandings that stem from an independent source such as state law . . ." *Board of Regents v. Roth*, 408 U.S. 564, 577 (1972).
21. *Penn Central Tramp. Co. v. City of New York*, 438 U.S. 104, 124 (1978).
22. *Id.* at 124.
23. 364 U.S. 40, 41-49 (1960).
24. *Id.* at 49.
25. *Connolly v. Pension Benefit Guaranty Corp.*, 475 U.S. 211, 224 (1986) ("But here, the United States has taken nothing for its own use, and only has nullified a contractual provision limiting liability by imposing an additional obligation that is otherwise within the power of Congress to impose").
26. 449 U.S. 155 (1980).
27. *Id.* at 163.
28. *Kelo v. City of New London, Connecticut*, 545 U.S. 459, 479-80 (2005) (citations omitted). See also *Hawaii Housing Authority v. Midkiff*, 467 U.S. 229, 241 (1984) ("[W]here the exercise of the eminent domain power is rationally related to a conceivable public purpose, the Court has never held a compensated taking to be proscribed by the Public Use Clause").

Hitting The Brakes On Legislative Interference With The Property Rights Of Automakers' Secured Creditors

29. *Id.* at 483.
30. *Id.* at 483-84.
31. *Eastern Enterprises v. Apfel*, 524 U.S. 498, 528 (1998) (“Congress has considerable leeway to fashion economic legislation, including the power to affect contractual commitments between private parties”); *Usery v. Turner Elkhorn Mining Co.*, 428 U.S. 1, 15 (1976) (“[L]egislative acts adjusting the burdens and benefits of economic life come to the Court with a presumption of constitutionality, and . . . the burden is on one complaining of a due process violation to establish that the legislature has acted in an arbitrary and irrational way”).
32. *Hawaii Housing Authority v. Midkiff*, 467 U.S. 229, 242-433 (1984); *See also United States v. Gettysburg Electric R. Co.*, 160 U.S. 668, 680 (1896) (courts will not question the legislature’s judgment as to what qualifies as public use “unless the use be palpably without reasonable foundation”).
33. U.S. Const. amend. V.
34. *Boston Chamber of Commerce v. Boston*, 217 U.S. 189, 195 (1910).
35. *Olsen v. United States*, 292 U.S. 246, 255 (1934); Just compensation is defined as “placing the property owner in the same position monetarily as he would have been if his property had not been taken.” *Pottinger v. City of Miami*, 810 F.Supp. 1551, 1570 (FN 30) (1992) (citing *United States v. Reynolds*, 397 U.S. 14, 16 (1970)).
36. 339 U.S. 121, 123 (1950).
37. 86 P.2d 222, 223-24 (Wash. Ct. App. 2004).
38. *Id.* at 226.
39. 344 U.S. 149, 150-51 (1952).
40. *Id.* At 154.
41. 341 U.S. 114, 115-16 (1951).
42. *Id.* at 117.