

Treasury Recognizes GM/Chrysler Loan SNAFU

posted by Adam Levitin

It seems like Treasury now realizes that it did a terrible job structuring its loans to GM and Chrysler, as I wrote at the time. (Of course, this assumes that the government was looking to recover the loans, not just make a gift to the auto companies.) The loan agreement gives the government a second or third priority security interest. That's not the safest spot in the world, especially on collateral that is pretty worthless outside of the auto companies as going concerns (who else wants a 200,000 sq. foot plant in Flint, Michigan?), and there's a good chance that the companies would eventually liquidate in bankruptcy.

Now Bloomberg reports that the government hired Cadwalader last month to help establish its place at the front of the line for repayment. **They hired a law firm after they lent the money?!!! WTF?!!!** I mean, it was pretty apparent from the GM/Chrysler term sheets that the Paulson Treasury department either wasn't getting competent bankruptcy advice or was just ignoring it. But even within the standards of the Paulson Treasury, entering this sort of multi-billion dollar distressed deal without good bankruptcy counsel is shockingly negligent. Paulson Treasury really embodied the term SNAFU.

So what's Cadwalder going to do? Is there any way to improve the government's priority? The time to get priority was when the government had the greatest leverage--before it inked the deal. Good luck now trying to convince the senior lenders to surrender priority. I don't think the government's threat of forcing the companies into the Chapter is viable. Is President Obama really going to let GM/Chrysler fail in the first months of his presidency? Seriously? Maybe the government is thinking about putting GM and Chrysler into the Chapter with an aim of doing a roll-up on its prepetition loans as part of a DIP? That's a pretty big gamble, and I dare say raises some real questions about whether the government is acting in good faith if it calls the loans to force BK so it can do a role up. Methinks those might be grounds for equitable subordination of the government's claim.

Probably the surest course is for the government to just buy out the senior lenders' positions. If the new new TARP goal is to buy up troubled assets, this might fit the bill. (But is Cerebus a "financial institution"? If GM and Chrysler are, then surely Cerebus is, right?) The government does have some leverage at least with the banks because of its other deals with them, but we could see the strange situation in which the government goes from making a bridge loan to being the major lender to GM and Chrysler.

And we still have to ask, what good is first priority when there is very limited liquidated value from GM and Chrysler's assets? There just isn't a market for most of their specialized equipment or real estate? Is anyone looking for a huge fancy HQ building in Detroit? First priority might not be enough to protect the government in a liquidation.

The lesson to be learned here is one of the most fundamental rules of secured credit and bankruptcy: get priority *before* you lend. Duh.

February 9, 2009 at 9:59 AM in Corporate Bankruptcy

Comments

This commentary reinforces my opinion that the US needs to legislate special rules for the priority and rights to be accorded to loans and investments made by the US in automakers and other entities. Why should taxpayer money, available because there are public purpose reasons to do so, be made to stand in line behind private creditors and/or be made subject to the tactical games of the sharpies who invest in distressed debt? Indeed, given the long term objectives of increasing efficiency of automaker method and product, and maintaining employment, don't we need special reorg provisions (like the RR provisions) to insure that public policy objectives are met? The 1978 Bankruptcy Code replaced old Chapter X with new Chapter 11 to facilitate more creditor involvement and control. But Chapter 11 has become an unregulated playing field for hedge funds buying and selling debtor paper. The results, quick and dirty reorganization plans that spit out new reorganization securities so that players can flip them and hit their IRR targets, and multiple Chapter 22's. Time to give courts the power to protect the public.

Posted by: Bill | February 10, 2009 at 10:10 AM

if they are to fail the sooner the better since if they delay the bankruptcy the more likely it will impact the next elections

Posted by: zed260@gmail.com | February 10, 2009 at 10:12 PM

you overlook the possibility that they couldn't get priority before. there's just no reason for existing lenders to let the govt ahead of them, unless the collateral was truly worthless, in which case it doesn't matter anyway.

Posted by: Phineus Q. Sixpack | [February 11, 2009 at 01:56 PM](#)

Sorry to get back to this so late, Adam, but I think that I've come to understand why Treasury structured the loans to GM and Chrysler as they did. Sure, they took 2nd or 3rd security interest in properties, thereby ensuring that they probably wouldn't be able to recapture a dime if GM or Chrysler went under, but what Treasury did is ensure that the money would be sent out to GM and Chrysler quickly.

Speaking from the perspective of a banker, to fight the 1st or 2nd security interests to get behind Treasury from the outset would have meant a 60-90 day battle/negotiation in court/arbitration etc. By the time that Treasury would have been OK'd as first security interest (or second), GM and Chrysler would have had to file bankruptcy, if what they claimed in their testimony to the hill was true. This would have defeated the purpose of the loans that GM and Chrysler requested. Treasury was still interested in being first or second security interest, but not without making sure the money got out to GM and Chrysler quickly.

This is why Treasury retained a lawyer to do exactly that now, after the fact. It allowed Treasury to get the money out quickly while letting them fight for first or second security interest after the money had been sent.

Posted by: Joel Lyman | [February 12, 2009 at 10:57 AM](#)

"They hired a law firm after they lent the money?!!! WTF?!!!"

Your information is not accurate.

Treasury hired counsel, Sonnenschein, on November 7, 2008, prior to lending the money.

Please see page 48 of the GAO report, reporting the initial hiring and 3 subsequent modifications to the contract for services.

<http://www.gao.gov/new.items/do9296.pdf>

Posted by: [veryinterested](#) | [February 18, 2009 at 09:30 PM](#)

I stand corrected. I realize that Treasury had a weak hand to begin with, and lots of political constraints, and recognize that I'm carping about this without perfect information (that's the nature of blogging). Maybe Sonnenschein played the hand as well as it could, and maybe Treasury just didn't listen to counsel. But Treasury's best chance of getting a good deal (say pari passu with first lien) was when the original deal was done. It's too late now.

Joel Lyman and Mr. Sixpack rightly note the difficulties in getting priority for Treasury. Treasury's leverage then, as now, was the threat of letting GM/Chrysler end up in the Chapter, which wouldn't be good even for the first lien debt. But Treasury's threat is much weaker now that Treasury has some skin in the game. This is in for a penny, in for a pound.

Posted by: [Adam Levitin](#) | [February 18, 2009 at 09:41 PM](#)

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