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Chrysler and the Rule of Law

The Founders put the contracts clause in the Constitution for a reason.

By **TODD J. ZYWICKI**

The rule of law, not of men -- an ideal tracing back to the ancient Greeks and well-known to our Founding Fathers -- is the animating principle of the American experiment. While the rest of the world in 1787 was governed by the whims of kings and dukes, the U.S. Constitution was established to circumscribe arbitrary government power. It would do so by establishing clear rules, equally applied to the powerful and the weak.

Fleeing lenders to pay off politically powerful interests, or governmental threats to reputation and business from a failure to toe a political line? We might expect this behavior from a Hugo Chávez. But it would never happen here, right?

Until Chrysler.

The close relationship between the rule of law and the enforceability of contracts, especially credit contracts, was well understood by the Framers of the U.S. Constitution. A primary reason they wanted it was the desire to escape the economic chaos spawned by debtor-friendly state laws during the period of the Articles of Confederation. Hence the Contracts Clause of Article V of the Constitution, which prohibited states from interfering with the obligation to pay debts. Hence also the Bankruptcy Clause of Article I, Section 8, which delegated to the federal government the sole authority to enact "uniform laws on the subject of bankruptcies."

The Obama administration's behavior in the Chrysler bankruptcy is a profound challenge to the rule of law. Secured creditors -- entitled to first priority payment under the "absolute priority rule" -- have been browbeaten by an American president into accepting only 30 cents on the dollar of their claims. Meanwhile, the United Auto Workers union, holding junior creditor claims, will get about 50 cents on the dollar.

The absolute priority rule is a linchpin of bankruptcy law. By preserving the substantive property and contract rights of creditors, it ensures that bankruptcy is used primarily as a procedural mechanism for the efficient resolution of financial distress. Chapter 11 promotes economic efficiency by reorganizing viable but financially distressed firms, i.e., firms that are worth more alive than dead.

Violating absolute priority undermines this commitment by introducing questions of redistribution into the process. It enables the rights of senior creditors to be plundered in order to benefit the rights of junior creditors.

The U.S. government also wants to rush through what amounts to a sham sale of all of Chrysler's assets to Fiat. While speedy bankruptcy sales are not unheard of, they are usually reserved for situations involving a wasting or perishable asset (think of

a truck of oranges) where delay might be fatal to the asset's, or in this case the company's, value. That's hardly the case with Chrysler. But in a Chapter 11 reorganization, creditors have the right to vote to approve or reject the plan. The Obama administration's asset-sale plan implements a de facto reorganization but denies to creditors the opportunity to vote on it.

By stepping over the bright line between the rule of law and the arbitrary behavior of men, President Obama may have created a thousand new failing businesses. That is, businesses that might have received financing before but that now will not, since lenders face the potential of future government confiscation. In other words, Mr. Obama may have helped save the jobs of thousands of union workers whose dues, in part, engineered his election. But what about the untold number of job losses in the future caused by trampling the sanctity of contracts today?

The value of the rule of law is not merely a matter of economic efficiency. It also provides a bulwark against arbitrary governmental action taken at the behest of politically influential interests at the expense of the politically unpopular. The government's threats and bare-knuckle tactics set an ominous precedent for the treatment of those considered insufficiently responsive to its desires. Certainly, holdout Chrysler creditors report that they felt little confidence that the White House would stop at informal strong-arming.

Chrysler -- or more accurately, its unionized workers -- may be helped in the short run. But we need to ask how eager lenders will be to offer new credit to General Motors knowing that the value of their investment could be diminished or destroyed by government to enrich a politically favored union. We also need to ask how eager hedge funds will be to participate in the government's Public-Private Investment Program to purchase banks' troubled assets.

And what if the next time it is a politically unpopular business -- such as a pharmaceutical company -- that's on the brink? Might the government force it to surrender a patent to get the White House's agreement to get financing for the bankruptcy plan?

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