[By-Lined Article]

High Court Greenlights Chrysler Sale Over Objection of Absolute Priority Rule

By Rudolph J. Di Massa Jr. and Sommer L. Ross

June 19, 2009

The Legal Intelligencer

On June 9, in *Indiana State Police Pension Trust v. Chrysler LLC*, the U.S. Supreme Court cleared the way for Chrysler LLC and its affiliates to sell substantially all of their assets to Italian carmaker Fiat SpA, lifting a temporary block on the sale transaction and paving the way for the troubled car company to emerge from bankruptcy. The issue before the court was narrow: whether to stay certain orders entered by the U.S. Bankruptcy Court for the Southern District of New York, one of which authorized the sale of substantially all of Chrysler's assets to Fiat free and clear of all liens, claims, interests and other encumbrances under Section 363 of the Bankruptcy Code. In its two-page opinion, the court held that the petitioners (a group of creditors know as the Indiana Funds) did not meet their burden in showing that the circumstances justified imposition of a stay.

Factual Background

On April 30, Chrysler and 24 of its domestic subsidiaries (the debtors) filed for bankruptcy protection under Chapter 11 of the Bankruptcy Code. As of the petition date, the debtors owed about $6.9 billion to their prepetition first lien lenders and $2 billion to their prepetition second lien lenders. The debtors' obligations to the first lien lenders are reportedly secured by a first lien on substantially all of the debtors' assets, while the debtors' obligations to the second lien lenders are reportedly secured by a second lien on the same assets. As of the petition date, Chrysler Holding LLC, the debtors' parent company, owed the U.S. Treasury Department $4 billion (the TARP loan). As security for the TARP loan and a related promissory note in the amount of $267 million, the Treasury was granted a first-priority lien on all unencumbered assets of Chrysler's MOPAR and a third-priority lien on those assets in which the first lien lenders and second lien lenders already hold an interest.

Before filing for bankruptcy, the debtors began a search for potential partners and strategic alliances that would affect their cost structure and allow them to expand into new products, market segments and geographic locations. Specifically, the debtors sought a strategic partner with expertise in smaller, more fuel efficient vehicles.

On Jan. 16, after renewed discussions with Fiat regarding a strategic alliance, the debtors and Fiat entered into a term sheet, which provided that Fiat would acquire 35 percent of the equity of Chrysler and would provide access to competitive fuel-efficient vehicle platforms, distribution capabilities in key growth markets and substantial cost-saving opportunities. The alliance with Fiat would also provide the debtors with a distribution network outside of North America.

On Feb. 17, as required under the terms of the TARP loan, the debtors submitted a "viability plan" to the Treasury. The viability plan set forth three options: a stand-alone restructuring of the debtors' operations with concessions from all key constituents, some of which had already been agreed upon and some of which remained subject to ongoing negotiations; a scenario showing positive synergies from the alliance with Fiat; and an orderly wind-down plan for the debtors' operations if neither of the debtors' other options could be achieved.

On Feb. 20, the president's auto task force was put in place to evaluate the debtors' viability plan. On March 30, the task force announced the results of its evaluation: Chrysler could successfully emerge as a viable entity with an appropriate strategic partner, such as Fiat. In conjunction with this announcement, the Treasury indicated that it would provide additional capital to fund the viability plan if, inter alia, Chrysler's alliance with Fiat was modified to address certain concerns and goals of the U.S. government and all outstanding issues were resolved within 30 days. Consistent with this message, a revised term sheet outlining the Fiat alliance was signed March 29. Subsequently, in order to satisfy the requirements of the Fiat alliance and the concerns of the U.S. government, Fiat formed New CarCo Acquisition LLC, a Delaware corporation, which began negotiations with key constituencies in anticipation of purchasing substantially all of the debtors' assets. One of its first actions was to negotiate a new collective bargaining agreement with the United Auto Workers. It also negotiated a settlement with the UAW that provides for the creation and funding of a voluntary employees' beneficiary association, or VEBA. Pursuant to the settlement agreement, VEBA is to be funded by a 55 percent equity interest in New Chrysler and a $4.587 billion promissory note.

On April 30, the debtors, New Chrysler and Fiat entered into a "master transaction agreement," which provides, inter alia, that: the debtors will transfer substantially all of their operating assets to New Chrysler; and, in exchange, New Chrysler will assume certain liabilities of the debtors and pay the debtors $2 billion in cash. The master transaction agreement also provides that, before closing, Fiat will provide New Chrysler with access to competitive fuel-efficient vehicle platforms, certain technology, distribution capabilities in key growth markets and substantial cost saving opportunities; and New Chrysler will issue membership interests in New Chrysler as follows: 55 percent to VEBA; 8 percent to the Treasury; and 2 percent to Export Development Canada. After the transaction is complete, a subsidiary of Fiat will own 20 percent of New Chrysler's equity, with the right to acquire up to an additional 31 percent of New Chrysler's equity over seven years; however, Fiat will not be permitted to take majority control of New Chrysler until New Chrysler's debts to the Treasury are repaid. Further, pursuant to the master transaction agreement, the Treasury and Export Development Canada (together, the governmental entities) have agreed to provide debtor-in-possession financing for 60 days in the amount of $4.96 billion, together with a $6 billion senior secured financing facility in order to support New Chrysler's operations after the sale.

Procedural Background

On May 1, the debtors moved the bankruptcy court for an expedited hearing on various motions, including a motion to approve bidding procedures and a motion to approve the sale of substantially all of the debtors' assets to Fiat. On May 5, the bankruptcy court approved the bidding procedures motion and scheduled a hearing on the sale motion for May 27.

On May 19, the Indiana State Teachers Retirement Fund, the Indiana State Police Pension Trust and the Indiana Major Move Construction, which oversee the investment of retirement assets for certain civil servants in the state of Indiana, filed an objection to the sale motion. The Indiana Funds hold about $42.5 million of the $6.9 billion in first priority secured claims, which represents less than 1 percent of the first lien debt.

In their objection, the Indiana Funds argued that if the sale motion were approved, the first lien lenders' collateral would be stripped and those lenders would be paid only 29 percent of their debt. The collateral would then be transferred to New Chrysler, where, according to the Indiana Funds, it would be worth significantly more than the money paid to the first lien lenders. The Indiana Funds further argued that their unsecured deficiency claims would not be paid while the debtors' unsecured trade debt would be paid in full. Finally, the Indiana Funds contended that their senior claims would be impaired while the governmental entities (as junior lien holders) and VEBA and the UAW (as unsecured creditors) would receive value (i.e., equity in New Chrysler).

After a three-day evidentiary hearing, the bankruptcy court approved the sale motion. The Indiana Funds appealed directly to the 2nd U.S. Circuit Court of Appeals and, on June 2, the 2nd Circuit entered an order temporarily staying the sale to New Chrysler.

Three days later, in a three-sentence decision, the appellate court affirmed the bankruptcy court's opinion, but kept the stay in place until June 8 or the Supreme Court's denial of the stay.

On June 8, Justice Ruth Bader Ginsburg extended the stay until the court could consider the matter in greater depth. On June 9, the court issued a two-page per curiam opinion denying a stay of the bankruptcy court's order, thereby allowing the sale to proceed.

The Bankruptcy Court's Analysis

The bankruptcy court concluded that the sale of substantially all of the debtors' assets to Fiat outside of any plan of reorganization was permissible under Section 363(b) of the Bankruptcy Code and applicable 2nd Circuit authority, and that the assets should be sold free and clear of any liens and interests pursuant to Section 363(f) of the Bankruptcy Code.

Within the 2nd Circuit, in order to authorize a sale of substantially all of a debtor's assets prior to acceptance and outside of any plan of reorganization, a court must expressly find that the evidence presented demonstrated that there is good business justification for the sale, as noted in *Comm. Of Equity Sec. Holders v. Lionel Corp.* When making such a determination, "a court should consider all of the 'salient factors pertaining to the proceeding' and 'act to further the diverse interests of the debtor, creditor and equity holders.'" Factors to be considered by the court include, but are not limited to, the following: whether the asset is increasing or decreasing in value; the likelihood that a plan of reorganization will be proposed and confirmed in the near future; the effect of the proposed disposition on future plans of reorganization; the proportionate value of the asset to the estate as a whole; the amount of time elapsed since the filing; and the proceeds to be obtained from the disposition vis-a-vis any appraisals of the property. In addition, a court must consider whether those opposing the sale produced some evidence that the sale is not justified.

In the instant case, the bankruptcy court found that the debtors had established a good business justification for the sale of their assets. In support of its conclusion, the court determined that the master transaction agreement was the only viable option available to the debtors. The court also found that if the sale were not approved, the debtors' assets would be liquidated, and the liquidation would not produce as large a payout to the first lien creditors. In addition, the court found that the sale was necessary to preserve some portion of the going concern value of the debtors' business and to maximize the value of the debtors' estates. The court noted that the financing for the sale was contingent upon a sale closing quickly, and any delay could result in a withdrawal of Fiat's offer. The court also found that the sale negotiations had been conducted in good faith, at arm's length, and were in the best interests of the debtors' estates.

Although the Indiana Funds argued that the sale violated the absolute priority rule contained in Section 1129(b)(ii) of the Bankruptcy Code (because of the fact the governmental entities and VEBA are receiving an ownership interest in New Chrysler, while first-priority creditors are only receiving 29 cents on the dollar), the court disagreed. The court found that the sale motion did not allocate any sale proceeds away from the first lien lenders. Rather, in accordance with the applicable provisions of the Bankruptcy Code, the security interest of the first lien lenders is to attach to the $2 billion sale proceeds, and there will be an immediate and indefeasible distribution of all of the sale proceeds to the first lien lenders. The court was satisfied by the evidence presented at the sale hearing that the $2 billion sale price exceeded the liquidation value of the debtors' assets, which was estimated at $800 million.

In further support of its ruling, the court pointed out that under Section 365 of the Bankruptcy Code, a debtor-in-possession may assume and assign executory contracts or unexpired leases. As the debtors' assumed contracts were to be assigned to New

Chrysler, the court responded that New Chrysler, as purchaser, had the right to negotiate deals with other non-debtor parties. A potential consequence of this series of transactions is that certain creditors would receive more favorable treatment than other creditors in a higher priority class. However, the court did not deem such treatment to be a violation of the absolute priority rule, because the agreements among non-debtor parties did not divert value from the debtors' assets or affect the allocation of the sale proceeds.

The Court's Analysis

The only issue before the court was whether to stay certain orders entered by the bankruptcy court, including the order that approved the Fiat sale transaction. The court denied the stay, stating that the Indiana Funds had not satisfied their burden of demonstrating that there is: a reasonable probability that four justices consider the issue sufficiently meritorious to grant certiorari or to note probable jurisdiction; a fair chance that a majority of the court will determine that the decision below is erroneous; and a likelihood that there will be irreparable harm if the stay is denied. The court also noted that a denial of a stay is not an adjudication on the merits of the underlying legal issues and that its determination to deny the stay is based on the record and proceedings of this case alone.

Conclusion

A view of some bankruptcy practitioners is that the Chrysler bankruptcy litigation signals the beginning stage of the demise of the absolute priority rule: As bankruptcy courts look for pragmatic solutions, they may be more inclined to allow debtors and other interested parties to work around the absolute priority rule. We may all get a clearer picture of the trend as the Chapter 11 case of General Motors develops.

Rudolph J. Di Massa, Jr., a partner at Duane Morris, is a member of the business reorganization and financial restructuring practice group. He concentrates his practice in the areas of commercial litigation and creditors' rights. He is a member of the American Bankruptcy Institute, the American Bar Association and its business law section, the Commercial Law League of America, the Pennsylvania Bar Association and the business law section of the Philadelphia Bar Association.

Sommer L. Ross practices in the area of business reorganization and financial restructuring. Admitted to practice in Delaware, Pennsylvania and New Jersey, Ross is a 2004 graduate of Rutgers University School of Law, where she was a member of the Rutgers Law Journal, and a graduate of the University of Delaware.

This article originally appeared in The Legal Intelligencer and is republished here with permission from law.com.