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Chrysler, GM: Courts Extend Law On Sales

Law360, New York (October 20, 2009) -- Earlier this year, courts from the Bankruptcy Courts for the Southern District of New York to the United States Supreme Court issued a number of rulings approving the asset sales by Chrysler and General Motors.

Although popular and industry media have been replete with stories regarding the facts of these cases, this article provides an in-depth analysis of the courts' rulings on several key issues of interest to debtors and creditors in future bankruptcies.

Summary of Key Rulings

The facts related to the GM and Chrysler bankruptcies are as unusual as they are well known. However, the law is, for the most part, an extension of well-established precedent in the Second Circuit and Southern District of New York. The courts' rulings on particular issues are likely to affect future bankruptcies in the Second Circuit and Southern District of New York, notably:

- The Second Circuit and the Bankruptcy Courts addressed the circumstances under which an asset sale is proper. Specifically, the Second Circuit held that, even though "the [Chrysler asset sale] has inevitable and enormous influence on any eventual plan of reorganization or liquidation ... it is not a 'sub rosa plan' ... because it does not specifically 'dictate' or 'arrange' ex ante, by contract, the terms of any subsequent plan."[1]

- The Second Circuit and the Bankruptcy Courts addressed a debtor's ability to sell assets free and clear of future claims, with the Second Circuit affirming the Bankruptcy Court's decision that future claims are "interests in property such that they are extinguished by a free and clear sale under section 363(f)(5) ..."

- The Bankruptcy Court did not recharacterize as equity certain prepetition bridge loans that were then credit bid for the assets of General Motors.

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- The Second Circuit and the Bankruptcy Courts addressed whether an individual bank group lender has standing to object to an agreement when the bank group's agent, acting at the direction of a majority of the bank group lenders, consented to the agreement on behalf of all the bank group lenders. The Second Circuit held that, "[t]hrough a series of agreements, the [dissenting lender] effectively ceded to an agent the power to consent to such a [sale agreement]; the agent gave consent; and the [dissenting lender is] bound."[2]

Background

After receiving a combined $17.4 billion in aid from the United States government in late December 2008, Chrysler and GM approached the government for additional assistance in early 2009. The government provided this funding conditioned upon each company submitting a proposal setting forth its plans to effectuate a restructuring enabling it to sustain long-term viability.

After the automakers submitted multiple restructuring plans throughout early 2009, President Obama announced that the government's continued assistance was contingent upon the automakers' compliance with the government's time frame for each automaker to accomplish a restructuring, or otherwise file for bankruptcy protection: May 1, 2009, for Chrysler and June 1, 2009, for GM.

Chrysler

On April 30, 2009, after failing to obtain the requisite consents from its senior lenders necessary to achieve a consensual restructuring within the government's timeframe, Chrysler and 24 of its affiliates filed for Chapter 11 protection in the Southern District of New York.

Shortly thereafter, Chrysler sought the Bankruptcy Court's approval to sell substantially all of its assets to New Chrysler, a newly created company that would be owned by Fiat, the governments of the United States and Canada, and a voluntary employees' benefit association ("VEBA") controlled by the United Auto Workers.

In exchange, the UAW agreed to enter into a new collective bargaining agreement with a reduced wage structure, and to create a new VEBA structure to fund legacy UAW retiree health care obligations; the United States Treasury and Canada agreed to lend New Chrysler $2 billion, which would be used to purchase Chrysler's assets through the proposed sale; and Fiat would provide new technology and new management for the creation of smaller, more fuel-efficient vehicles.

Judge Gonzalez conducted an evidentiary hearing on Chrysler's sale motion from May 27 through May 29. The objecting parties, most notably certain Indiana pension funds (the "Indiana Funds") holding a small amount of Chrysler's secured debt, argued, among other things, that the proposed sale constituted an illegal sub rosa plan of reorganization and violated the absolute priority rule because the sale gave value to

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unsecured creditors (e.g., the UAW through the VEBA's receipt of an ownership interest in New Chrysler) without paying off Chrysler's senior secured debt in full.

Additionally, certain tort and consumer victims objected to Chrysler's effort to sell the assets free and clear of personal injury and wrongful death claims, including claims relating to successor liability, asserting that such claims were not "interests in property" as required by section 363(f) of the Bankruptcy Code.

Late in the evening on May 31, hours before General Motors filed for bankruptcy, Judge Gonzalez entered an opinion granting Chrysler's motion to sell substantially all of its assets and dismissing virtually all of the objections to the sale motion.[3]

The Bankruptcy Court stayed the sale for several days to permit appeals. A number of parties appealed, including the Indiana Funds, and, pursuant to 28 U.S.C. § 157, the Second Circuit Court of Appeals heard the appeal on direct review rather than having the district court for the Southern District of New York hear the appeal first.

After nearly two hours of oral argument, the Second Circuit Court of Appeals ruled from the bench and upheld the Bankruptcy Court's ruling in all respects. However, the Second Circuit did not issue a written opinion until nearly two months later, on Aug. 5, 2009.

Following the Second Circuit's ruling from the bench, the Indiana Funds moved for a stay pending appeal from the United States Supreme Court. After granting a brief stay to consider the issues, the Supreme Court unanimously terminated the stay on June 8, and the Chrysler sale closed on June 9, 2009.

General Motors

On June 1, 2009, GM and three of its affiliates filed for Chapter 11 protection in the Southern District of New York. Shortly thereafter, GM sought the Bankruptcy Court's approval to sell substantially all of its assets to New GM, a newly created entity that would be owned by the governments of the United States and Canada, and by a VEBA controlled by the United Auto Workers.

Objectors to the sale included a group of GM bondholders holding approximately .01 percent of GM's total $27 billion bond debt; a pro-se litigant holding approximately $5 million in GM bonds; and various tort, consumer and asbestos victims. Judge Gerber conducted a three-day evidentiary hearing from June 29 through July 1.

During the hearing, the objecting parties argued, among other things, that (1) the sale constituted an impermissible sub rosa plan of reorganization, (2) the U.S. Treasury's prepetition loans to GM should be recharacterized as equity or, alternatively, subject to equitable subordination, and (3) GM could not sell the assets free and clear of personal injury and wrongful death claims, including claims relating to successor liability, as such

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claims were not “interests in property” as required by section 363(f) of the Bankruptcy Code.

On July 5, Judge Gerber issued an opinion granting GM’s motion to sell substantially all of its assets to New GM.[4] The Bankruptcy Court again stayed the effectiveness of the sale order for several days to permit appeals. Several parties requested that the District Court extend the stay. However, the District Court declined to extend the stay, and on July 10, 2009, the GM sale closed.

Analysis

The Sale Did Not Constitute an Impermissible Sub Rosa Plan

The Second Circuit directly addressed the Indiana Funds’ argument that the Chrysler sale constituted an illegal sub rosa plan. Specifically, the court held that the Chrysler sale did not constitute an impermissible sub rosa plan “because it [did] not specifically ‘dictate’ or ‘arrange’ ex ante, by contract the terms of any subsequent plan.”[5]

Further, the court dismissed the Indiana Funds’ contention that the size of the transaction (e.g., the sale of substantially all assets) was dispositive on the sub rosa question, stating that the “size of the transaction, and the residuum of corporate assets, is, under our precedent, just one consideration for the exercise of discretion by the bankruptcy judge(s), along with an open-ended list of other salient factors.”[6]

Acknowledging that the Chrysler sale had “inevitable and enormous influence on any eventual plan of reorganization or liquidation,” the Second Circuit nonetheless found that this fact alone was insufficient reason to disapprove the sale, holding that “a 363(b) sale may well be a reorganization in effect without being [impermissible].”[7]

Finally, the court held that the Chrysler sale in no way upset the priority between creditors, and affirmed Judge Gonzalez’s findings below that “‘[n]ot one penny of value of the Debtors’ assets is going to anyone other than the [secured creditors].’”[8]

Significantly, the court made clear that the planned distribution of equity in New Chrysler was wholly irrelevant to whether the sale constituted an improper sub rosa plan, holding that “all the equity stakes in New Chrysler were entirely attributable to new value — including governmental loans, new technology, and new management — which were not assets of the debtor’s estate.”[9]

Similarly, relying heavily on Judge Gonzalez’s Chrysler decision, Judge Gerber in GM noted that “the sub rosa plan contention was squarely raised, and rejected [by the Second Circuit] in Chrysler, which is directly on point and conclusive [in GM].”[10]

Specifically, Judge Gerber found that the proposed sale did not dictate the terms of a plan of reorganization because it did not attempt to dictate or restructure the rights of GM’s creditors. Rather, in the Bankruptcy Court’s opinion, the sale “merely brings in

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value” and GM’s creditors “will thereafter share in that value pursuant to a Chapter 11 plan subject to confirmation by the Court.”[11]

Accordingly, Judge Gerber held that the GM sale did not amount to a sub rosa plan of reorganization, as none of the sub rosa factors were present under the terms of the sale.

A Debtor May Sell Its Assets, Free and Clear of Future Claims

With respect to the issue of whether Chrysler was permitted to sell its assets free and clear of future claims, the Second Circuit affirmed the decision of the Bankruptcy Court below, but declined to “delineate the scope of the Bankruptcy Court’s authority to extinguish future claims, until such time as we are presented with an actual claim for injury ... that is cognizable under state successor liability law.”[12]

The Bankruptcy Court had overruled the objections raised by the tort and consumer victims, and announced its view regarding the current circuit split concerning a debtor’s ability to sell assets free and clear of successor liability under section 363(f) of the Bankruptcy Code.

Judge Gonzalez held that the leading case on the issue, In re Trans World Airlines Inc.,[13] “makes clear that such tort claims are interests in property such that they are extinguished by a free and clear sale under section 363(f)(5) and are therefore extinguished by the [sale].”[14]

Further, Judge Gonzalez concluded that “in personam claims, including any potential state successor or transferee liability claims against New Chrysler, as well as in rem interest, are encompassed by section 363(f) and are therefore extinguished by the [sale].”[15]

Likewise, Judge Gerber overruled the objections of the various tort, consumer and asbestos victims who argued that section 363(f) of the Bankruptcy Code did not permit GM to sell the assets free and clear of their claims, including claims based on successor liability. The court began with an in-depth textual analysis of the language of section 363(f) and its use of the word “interest.”

The court concluded that “interest” “means more than a lien, but [the textual analysis] does not tell us how much more.” The Court stated that “[n]either the Code nor interpretive aids tells us how broadly or narrowly — in the particular context of section 363(f) — “interest in property” should be deemed to be defined.”[16]

Judge Gerber considered the applicable caselaw on successor liability, and noted that, while national caselaw was split in this area, the caselaw in the Second Circuit and the Southern District of New York was not split.

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Judge Gerber stated that, in Chrysler, Judge Gonzalez expressly considered and rejected the efforts to impose successor liability, and noted “a hugely important additional fact:” the Second Circuit, after hearing extensive argument on the issue, affirmed Judge Gonzalez’s Chrysler order “substantially for the reasons stated in the opinion below.”[17]

Citing to principles of stare decisis and the fact that the “claims sought to be preserved here are identical to those in Chrysler,” Judge Gerber held that GM could sell its assets free and clear of successor liability claims.[18]

The GM Court Rejected an Effort to Recharacterize Treasury’s Prepetition Loans

The Bankruptcy Court also rejected the argument that some or all of the U.S. Treasury’s prepetition loans to GM should be recharacterized as equity on the basis that the lenders never intended to be repaid and sought instead to convert those loans to equity in New GM.

Judge Gerber applied the standard he set forth in Adelphia Communications Corp. v. Bank of America (In re Adelphia Communications Corp.),[19] which enumerated an eleven-factor test to determine whether debt should be recharacterized.

Applying the Adelphia test to the facts presented, the Bankruptcy Court found, inter alia, that GM was inadequately capitalized at the time the U.S. Treasury extended the loans to GM, that GM could not obtain financing from outside lending institutions, and that the record did not show the presence of a sinking fund to provide for repayment of the loans in question — three of the 11 factors arguing in favor of recharacterization.

However, the court determined that, “[o]f the remainder, every single factor supports finding that this was genuine debt.”[20]

In particular, the court found that the transaction was (1) fully documented as a loan, (2) constituted secured debt, (3) included intercreditor agreements to address priority issues with other secured lenders, (4) had interest and maturity terms and, significantly, (5) had separate equity features which provided for warrants to accompany the debt instruments.

Judge Gerber concluded that recharacterization was inappropriate and held that, as a matter of law, the U.S. Treasury’s prepetition loans to GM constituted debt.

Additionally, Judge Gerber rejected the contentions that the U.S. Treasury’s prepetition loans to GM should be equitably subordinated because Treasury had acted inequitably by extending billions of dollars in prepetition loans to GM.

The court found that the U.S. Treasury had not acted inequitably in any way, that no harm had been done to GM’s creditors, and that treating the U.S. Treasury as a lender was consistent with the Bankruptcy Code.

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Further, Judge Gerber noted that the U.S. Treasury's "efforts to ensure that [GM creditors and employees] were not throwing their money away in a useless exercise, and were expecting GM to slim down so it could survive without governmental assistance, are hardly inequitable; they were common sense."[21]

A Dissenting Individual Lender May Not Have Standing to Object to a Sale Supported by the Agent

The Indiana Funds, members of a bank group that provided prepetition secured financing to Chrysler, challenged the release of their liens pursuant to § 363(f)(2), on the basis that the Indiana Funds did not consent to the release of their liens. Under § 363(f)(2), assets sold in a section 363(b) sale may be sold free and clear of any interest, including liens, when the entity holding such interest consents to the sale.

The Second Circuit agreed with the Bankruptcy Court's ruling below that, although the Indiana Funds did not themselves consent to the release, consent was validly provided by the collateral trustee, who had authority to act on behalf of all lenders to Chrysler's syndicated loan.

Specifically, the Second Circuit found that, upon Chrysler's entering bankruptcy, the collateral trustee had "the power to take any action necessary to realize upon the collateral — including giving consent to the sale of the collateral free and clear of all interests under § 363" and, further, that the collateral trustee "could take such action only at the direction of the lenders' agent, and the agent could only direct the trustee at the request of the lenders holding a majority of Chrysler's debt."[22]

Finding that each of these conditions had been met, the Second Circuit held that, "under the terms of the various agreements, the minority lenders [e.g., dissenting lenders such as the Indiana Funds] could not object to the trustee's actions ... " as such lenders, including the Indiana Funds, "effectively ceded to an agent the power to consent to such a sale; the agent gave consent; and the [lenders, including the Indiana Funds,] are bound."[23]

Conclusion

Although the facts of the Chrysler and GM bankruptcies were remarkable, the courts' respective analyses of Chrysler and GM's assets sales were rooted firmly in the well-established precedent of the Second Circuit and Southern District of New York.

We expect the two Bankruptcy Court opinions, and particularly the Second Circuit opinion in Chrysler, to serve as the standard by which all assets sales in the Second Circuit (and possibly throughout the United States) are measured.

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