HIGH COURT ERASES PRECEDENT
IN CHRYSLER BANKRUPTCY

by
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On December 14, 2009, the Supreme Court released its last orders for the 2009 calendar year. In a surprising summary order, the Court granted the cert petition in Indiana State Police Pension Trust v. Chrysler LLC and vacated the underlying Second Circuit opinion, but remanded the case with instructions to dismiss the appeal as moot. While this is far from the ideal outcome for the Indiana pensioners who sought equitable relief from the high court, the vacatur of a flawed lower court decision is nevertheless an important development that will help preserve the integrity of bankruptcy law going forward.

The Second Circuit’s opinion marked the most egregious endorsement yet of troubled firms’ use of the “quick sale” option of Section 363 of the Bankruptcy Code to avoid Chapter 11’s creditor-protective provisions. The Indiana pensioners’ appeal had sought to prevent this end-run by forcing the United Auto Workers (and others) to return to the bankruptcy estate the $4.6 billion they received as part of the sale, whereby senior secured creditors could at last be made whole. The Supreme Court’s order ended the year-long Chrysler bankruptcy battle without squarely deciding the important issues raised—but setting aside what had been an unfortunate precedent from an important court.

In January 2009, Chrysler stood on the brink of insolvency. Purporting to act under the Emergency Economic Stabilization Act, the Treasury Department extended the car company a $4 billion loan using funds from the Troubled Asset Relief Program (TARP). Still in a precarious financial situation, Chrysler initially proposed an out-of-court reorganization plan that would fully repaid all of Chrysler’s secured debt.

The Treasury rejected this proposal and instead insisted on a plan that would completely eradicate Chrysler’s secured debt, predating billions of dollars in additional TARP funding on Chrysler’s acquiescence. When Chrysler’s first lien lenders refused to waive their secured rights without full payment, the Treasury devised a scheme by which Chrysler, instead of reorganizing under a Chapter 11 plan, would simply sell its assets free of all secured interests to a shell company, the New Chrysler.

Chrysler was thus able to avoid Chapter 11’s “absolute priority rule,” which provides that a court should not approve a bankruptcy plan unless it is “fair and equitable” to all classes of creditors. The forced reorganization amounted to the Treasury redistributing value from senior, secured creditors to junior, unsecured creditors. But the government should not have been allowed, through its own self-dealing as a junior creditor, to hand-pick certain creditors for favorable treatment at the expense of others who would otherwise enjoy first-lien priority.

Tellingly, in its order vacating the opinion of the Second Circuit, the Supreme Court cited United States v. Munsingwear, 340 U.S. 36 (1950), in which the Court announced that vacatur of an intermediate appellate opinion in a case that subsequently becomes moot “clears the path for future relitigation of the issues between the parties and eliminates a judgment, review of which was prevented through happenstance.” Id. at 40. This technique, the Munsingwear Court went on to say, “is commonly utilized in precisely this situation to prevent a judgment, unreviewable because of mootness, from spawning any legal consequences.” Id. at 42.
Although the Court’s ruling prevents the Indiana pensioners from collecting what would have otherwise been considered their rightful share of the sale proceeds, it also thus erases a terrible precedent from the federal judiciary’s books. A decision upholding the Second Circuit’s ruling—even as a summary affirmance without opinion—would have further eroded bankruptcy creditors’ expectations and introduced even more uncertainty into a still-uneasy market. Those interested in preserving the expectation rights of secured creditors can only hope that the Court’s order will clear the path for future litigation of these important issues—and that the automobile bailouts, like the TARP, were a once-in-a-lifetime epiphenomenon.

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