SECOND CIRCUIT OPINION IN CHRYSLER BANKRUPTCY: GOOD NEWS FOR LOAN-TO-OWN INVESTORS

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To Our Clients and Friends:

Last week, the Second Circuit panel that heard the Chrysler bankruptcy appeal issued its opinion in support of its June 5 approval of the sale of Chrysler under section 363 of the Bankruptcy Code.

The Second Circuit's opinion is interesting for its explicit recognition of prevailing economic conditions and their implications for the bankruptcy process. With remarkable frankness, the opinion observes that in the current economic crisis section 363 sales have become "even more useful and customary" and suggests that the "'side door' of § 363(b) may well 'replace the main route of Chapter 11 reorganization plans.'" In so doing, the Second Circuit's opinion is likely to reinforce recent trends in the loan-to-own market in which a section 363 sale is increasingly the preferred strategy.

VALUE MAXIMIZATION JUSTIFIES SECTION 363 SALES

The principal issue before the Second Circuit was the objectors' contention that the Chrysler section 363 sale constituted an impermissible *sub rosa* plan of reorganization. Chief Judge Jacobs, in delivering the *Chrysler* opinion for the unanimous appellate panel, surveyed the Second Circuit's section 363 jurisprudence, which has long recognized that section 363 of the Bankruptcy Code permits sales, including sales of an entire enterprise, that bypass the usual safeguards of a chapter 11 reorganization. The Court emphasized that the practical considerations justifying such sales might apply even absent an emergency. Consequently, a section 363 sale is permissible so long as there is a "good business reason" for the transaction. A sufficient business reason, the Court suggested, might be based on as little as concern that a transaction which would "increase (or maintain) the value of an asset to the estate" might soon disappear in the absence of quick action. In fact, the Court suggested that concern about the loss of such a transaction might be a sufficient justification for a sale even where it was the product of a "seemingly arbitrary" deadline set by an investor if the debtor lacked the leverage necessary to force an extension.

The Second Circuit conceded that there are limits to what is permissible under section 363, noting that while debtors need flexibility and speed, proponents of a sale "should not be able to nullify Chapter 11's requirements." However, the limits identified by the Court were few

and insubstantial. In particular, the Second Circuit's *Chrysler* opinion rejected the contention that the Chrysler sale was improper because it had an "inevitable" and "enormous" impact on any eventual plan of reorganization or liquidation. The Court stated that a sale of all or substantially all of a debtor's assets "may well be a reorganization in effect" without violating section 363. Only where a sale goes so far as to "specifically dictate" the terms of a plan "by contract" does it violate section 363 according to the Second Circuit.

CREDITORS DISSENTING FROM SECTION 363 SALES ARE BOUND BY THE TERMS OF THEIR AGREEMENTS

Assets may be sold under section 363 free and clear of liens only under certain conditions enumerated in section 363(f) of the Bankruptcy Code. In a previous update, we described the Bankruptcy Court's conclusion that the Chrysler sale met one of these conditions because the $2 billion purchase price paid for Chrysler exceeded the economic value of Chrysler's secured creditors' claims. The Second Circuit focused on another prong of section 363(f): assets may be sold free of liens if the secured lender consents.

The Second Circuit concluded that the objectors had, in fact, consented to the sale by the terms of the agreements through which they obtained their liens. The dissenting creditors had vigorously argued, particularly on appeal, that the Fiat transaction was not an exercise of remedies under their agreement, which the agent was authorized to approve on their behalf with the approval of a majority of lenders, but rather an amendment of the agreement itself requiring the dissenters' approval. The Second Circuit rejected that interpretation, concluding that the section 363 sale was an exercise of remedies under the syndicated loan documents, such that "Chrysler was not required to seek, let alone receive" each lender's consent.

Although differences in syndicated secured lending documents may produce different results, the conclusion of the Court in *Chrysler* is consistent with that of other courts considering consent to section 363 sales by lenders in recent bankruptcies: section 363 sales are likely to be considered an exercise of remedies and not amendments under secured lending agreements, notwithstanding the profound effects such dispositions may have on the lenders' expectations.

Please feel free to contact us with any questions.

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