



# FIRST IN TIME, YET LAST IN LINE: THE DETERIORATION OF BANKRUPTCY'S ABSOLUTE PRIORITY RULE

by  
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Saying that Bankruptcy laws are complicated is an understatement. Among the various regulations in the Bankruptcy Code, there was once a simple rule: senior creditors have priority over junior creditors. But with the government's intervention in the Chrysler bankruptcy, the absolute priority rule has lost meaning. Without guarantees for senior creditor priority under 11 U.S.C. § 1129(b), fair and equitable relief for secured creditors is now in danger. This LEGAL OPINION LETTER briefly examines the absolute priority rule, creditor's committee conflicts, and the effects the Chrysler bankruptcy will have on future investors and businesses.

**The Absolute Priority Rule.** Codified at 11 U.S.C. § 1129(b)(1), the absolute priority rule states that a court shall confirm a bankruptcy plan:

...notwithstanding the requirements of such paragraph if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.

Under the absolute priority rule, a court should not approve a plan unless it provides "fair and equitable" relief to all classes. All classes include both senior and junior creditors. Courts interpret the absolute priority rule in a simple way: first in time, first in line. Or put otherwise, the meaning of fair and equitable has been read as "senior interests are entitled to full priority over junior ones." See *SEC v. American Trailer Rentals Co.*, 379 U.S. 594 (1965). But after the recent government intervention in the Chrysler bankruptcy, the absolute priority rule may lose favor.

Chrysler secured creditors were forced to take a backseat to the automobile workers union members, who were junior creditors. Secured creditors were given only thirty cents on the dollar for their shares, whereas unsecured creditors were given fifty cents on the dollar. See Todd Zywicki, *Chrysler and the Rule of Law*, available at <http://online.wsj.com/article/SB124217356836613091.html>. The government's rationale for intervention was that the junior union creditors had to be given this priority in order to preserve jobs.

The U.S. Court of Appeals for the Second Circuit addressed the creditors' concerns in *In Re Chrysler*, 2009 U.S. App. LEXIS 17441 (2nd Cir. Aug. 5, 2009). The court found that the Chrysler sale was within bankruptcy guidelines and that senior creditors had not been forced into accepting the terms of the sale. The Second Circuit's acceptance of this sort of sale opens up a dangerous loophole to the Chapter 11 process. See *id.* at 19. The court recognized the dangers of debtors "strong arming" the creditor in possession into a sale, but it did not find that the Chrysler creditors were placed under such pressure. *Id.* The Second Circuit's opinion is instructive in that it recognizes the dangers of asset sales. Without Chapter

11 compliance, asset sales can circumvent reasonable deliberation over a reorganization plan and senior creditors may ultimately be disadvantaged as a result.

Those who believe the Chrysler sale remained within the parameters of the absolute priority rule have failed to see the long-term effects of what asset sales may do to senior creditors. If courts continue to allow asset sales, they may become the norm and the Chapter 11 priority rules may become more lax as a result of this “back door” advantage creditors can utilize. Additionally, the priority given to junior creditors in the Chrysler case may create a great deal of fear and doubt for future investors, which may mean less economic growth and stability for the nation.

**Creditors’ Committees.** In addition to the current problems with enforcement of the absolute priority rule, the Chrysler situation raises further problems for creditors committees which propose reorganization plans. As a result of the current state of the economy and the increasing number of large corporations filing for bankruptcy, more and more creditors’ committees are being created. Although these committees are charged with maximizing the amount of payment and number of creditors who are paid, there are inherent conflicts in the creation of such committees and the advantages given to certain unsecured creditors. After the recent events surrounding Chrysler, the problems that arise between creditors committees may be more frequent.

Section 1102(a) of the Bankruptcy Code requires the trustee of a bankruptcy estate to appoint a committee of unsecured creditors in large and complex bankruptcy cases. The trustee is also authorized to create additional committees as it deems necessary to ensure the proper representation of all creditors involved. If an interested party so requests, the court may order the creation of additional committees to adequately represent the interests of any creditors. *See* 11 U.S.C. § 1102(a).

There is an inherent conflict between the interests of the various unsecured parties appointed to the committee, but this has been recognized by courts and allowed to an extent. But the more problematic conflict exists between secured creditors and unsecured creditors. Under the absolute priority rule, senior creditors should have priority over junior creditors. However, the unsecured creditor committee provisions of §§ 1102 and 1103 are in direct conflict with senior creditor’s rights.

A corporate reorganization plan is supposed to work much like a class action. Often in large corporate reorganizations, there are too many creditors for each to settle individually, so a committee is formed. The creditors’ committee is to represent the entire class of creditors and ensure that the maximum amount of debt is paid. However, a class action must involve similarly situated persons whose interests can be adequately represented by the class representative (or in this case the creditor’s committee).

Although creditors’ committees have functioned despite the conflicts between senior and junior creditors, this may all change. With the events that took place during the Chrysler bankruptcy, it is feasible that senior creditors could be forced to take a backseat to unsecured creditors based on the weakened role of the absolute priority rule and the continual conflicts between creditors’ committees.

**Conclusion.** Although the government attempted to save jobs and the economy by involving itself in the Chrysler bankruptcy, the long term effects may prove more harmful than helpful. The absolute priority rule, formerly clear in its statement that senior creditors have priority over junior creditors, has now lost meaning. Additionally, the continued approval of asset sales may also lead to less enforcement and use of the Chapter 11 bankruptcy procedures, thus allowing junior creditors to gain priority over senior creditors. The loss of clarity in the meaning of this rule may deter future investors and result in further economic distress.