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Unsuccessful Successors? Limits on Bankruptcy Sales "Free and Clear" of Successor Liability

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Overview

While many bankruptcy sale orders contain provisions purporting to absolve the purchaser of "successor liability" claims related to the purchased assets or business, a recent case from the U.S. Bankruptcy Court for the Southern District of New York is a reminder of the limits on the enforceability of these provisions—especially against claimants who did not receive notice of the sale order. In *In re Grumman Olson Industries, Inc.*, the bankruptcy court permitted a tort claimant, injured by a product manufactured and sold by the debtor pre-sale, to assert a successor liability claim against the purchaser of the debtor's assets in a Section 363 sale, despite language in the court's own sale order purporting to exonerate the purchaser from such claims.[1] The court also engaged in a discussion regarding the nature of the successor liability claim at issue that draws into question the level of comfort that buyers may generally take from bankruptcy sale orders purporting to protect them against successor liability claims.

Successor Liability Claims

As a general proposition, the buyer of assets does not take on liability for claims running against the seller. The state law doctrine of successor liability, however, is an exception to this general rule. Under the doctrine of successor liability, a plaintiff may be permitted to assert against an asset purchaser a claim based on the seller's pre-sale actions. To sustain the claim against the purchaser, a plaintiff is typically required to satisfy three components of the claim: it must prove the merits of the claim as if the claim were asserted against the seller, it must demonstrate that the defendant/purchaser bought the seller's assets related to the claim, *plus* it must prove one or more additional elements rendering the purchaser's liability appropriate.[2] For example, successor liability may in certain states be imposed on a purchaser "for injuries caused by defective products manufactured by a predecessor *if the successor continues to manufacture the product*."[3] Due in part to the requirement of this additional element, which often consists of a conduct requirement on the part of the purchaser, some courts and commentators have characterized successor liability claims as *in personam* claims against the defendant/purchaser, rather than *in rem* interests in the

transferred property.[4]

Bankruptcy Code Section 363 Sales "Free and Clear" of *In Personam* Claims

In bankruptcy sales of assets outside of a plan of reorganization, purchasers rely on Bankruptcy Code Section 363(f), which permits bankruptcy estate property to be sold "free and clear of any interest in such property."[5] In the absence of a Bankruptcy Code definition of an "interest in property," many courts have interpreted this statutory language to include certain types of successor liability claims, protecting asset purchasers against such claims where bankruptcy sale orders so provide.

The characterization of successor liability claims as *in personam* claims that follow the asset owner, and not as *in rem* claims that follow the asset, does not itself defeat an argument that a Section 363 sale may be "free and clear" of successor liability claims. Indeed, there are many courts, particularly those in the Second and Third Circuits, that have placed *in personam* claims into the category of "interests in property" that can be extinguished in sales under Section 363, so long as such claims are "connected to, or arise from" the assets sold.[6] The general view of these courts is that "in personam claims, including any potential state successor or transferee liability claims . . . as well as in rem interests, are encompassed by section 363(f)."[7]

In the Third Circuit's seminal decision in *In re Trans World Airlines* ("*TWA*"), the court ruled that certain discrimination claims of TWA's employees, as well as claims related to a travel voucher program awarded to TWA's flight attendants in settlement of a sex discrimination class action, could be excluded in a Section 363 sale of TWA's airline assets to American Airlines and instead left in the bankruptcy estate of the debtor/seller because those claims would not have arisen but for TWA's investment in airline assets and commercial aviation.[8] In other words, because the *in personam* claims had a relationship to the use to which the transferred TWA assets were put, they were "interests in property," within the meaning of Section 363(f).

This logic tends to blur the line between *in personam* claims and *in rem* claims for the purposes of "free and clear" sales. And, indeed, there are bankruptcy policies that support an expansion of the definition of "interests in property" to include some *in personam* claims. Courts that use the "free and clear" power of Section 363(f) to exclude successor liability claims may believe that barring such claims helps to maintain Bankruptcy Code priorities by preventing unsecured claimants from proceeding against a successor entity while leaving secured creditors with recourse only to the limited assets of the estate.[9] Additionally, a broader "free and clear" power has been justified as maximizing the value of estate assets, and the return to all creditors, by encouraging purchasers who otherwise may be deterred by the risk of being held liable for claims against the debtor.[10]

***In re Grumman Olson Industries*: Purchaser Remains Subject to Successor Liability Claims**

Even against the background of decisions in the Second and Third Circuits permitting sales "free and clear" of *in personam* claims that have a connection to or arise from the transferred assets, the bankruptcy court in *Grumman* declined to bar a successor liability claim against a purchaser for an

injury related to a truck manufactured by the debtor prior to the sale. In doing so, the *Grumman* decision highlights one significant limitation to the "free and clear" power of Section 363(f) and suggests another. First, *Grumman* illustrates that successor liability claims of plaintiffs injured post-Section 363 sale by the debtor's products manufactured or sold pre-Section 363 sale—future claims that are virtually unknowable at the time of the sale—likely cannot be extinguished by a sale order. Second, *Grumman* suggests a nuanced logic for considering successor liability claims after a "free and clear" bankruptcy sale. Because successor liability claims can be thought of as arising from the post-sale conduct of the buyer, rather than from the transferred assets, such claims may be outside the reach of "free and clear" sale orders altogether.

In *Grumman*, the bankruptcy court was required to determine the effect of its own prior order approving a sale of assets under Section 363(f) on parties to a tort action. In July 2003, the court approved a Section 363 sale to Morgan Olson LLC ("Morgan") of certain "Lot 2" assets of bankruptcy debtor Grumman Olson Industries, Inc., a manufacturer and seller of products used in the truck body industry ("Grumman"). The sale order granted *in rem* relief with respect to the Lot 2 assets, stating that the sale of assets to Morgan was to be "free and clear of all . . . claims . . . and other interests" and enjoined claimholders from asserting their claims against the purchased assets.[11] The sale order also granted *in personam* relief, purportedly freeing Morgan from liability for claims against Grumman "arising under or related to" the transferred assets, including claims for successor liability under non-bankruptcy law.[12]

In October 2009, several years after the sale order was entered, John and Denise Frederico commenced a personal injury action against Morgan and others in the Superior Court of New Jersey, alleging that Ms. Frederico, a FedEx employee, was seriously injured in an October 2008 accident involving a FedEx truck that Grumman manufactured, designed, and/or sold in 1994, nine years prior to the Section 363 sale, and 14 years prior to the accident. Their complaint alleged that Morgan was liable as a successor under New Jersey law because it "continued the product line [of Grumman trucks] since the purchase" and held itself out to the public as such.[13] A few months later, Morgan commenced an adversary proceeding in the bankruptcy court, seeking a declaration that the sale order exonerated it from any successor liability for Ms. Frederico's injury.

On cross-motions for summary judgment, the bankruptcy court held that the sale order did not extinguish the Fredericos' successor liability claims against Morgan, reasoning that the Fredericos' rights against Morgan were not "claims" that could be extinguished in the sale order. The court noted that while the Bankruptcy Code contains the broadest possible definition of "claim" to ensure that all obligations of the debtor can be dealt with in the bankruptcy case,[14] there are some limits to the term. In this instance, the court found that the Fredericos did not hold a "claim" against the Grumman bankruptcy estate at the time of the Section 363 sale because, pursuant to the test laid out by the Eleventh Circuit in *In re Piper Aircraft Corp.*,[15] they had no relationship or contact with Grumman prior to the Section 363 sale. This was the case even though the basis for liability was Grumman's pre-sale conduct in manufacturing and selling the truck. Moreover, the Fredericos' rights could not be affected by the sale because of lack of due process. The court noted that "[a] sale order

under [Section] 363(f) that purports to free a purchaser from the debtor's liabilities does not bind parties in interest that did not receive appropriate notice of the sale."[16] The Fredericos, as unidentifiable potential future creditors at the time of the sale, did not—and, indeed, could not have—received adequate notice of the sale. Accordingly, the sale order did not bar the Fredericos' suit against Morgan.[17]

Before considering the issue of when the Fredericos' claims arose—which was ultimately dispositive—the court raised the more general issue of whether the sale order could have extinguished the successor liability claim, even if it had arisen pre-Section 363 sale, given the particular nature of the claim. The court acknowledged the precedent interpreting the "free and clear" power of Section 363(f) to encompass *in rem* interests, as well as certain *in personam* claims. But the court found that the Fredericos' *in personam* claims failed the standard set out in those cases—the claims did not arise from or relate to the transferred assets. Instead, the court observed that the Fredericos' claims against Morgan were based on the post-sale conduct of Morgan in "continu[ing] the product line [of Grumman trucks] since the purchase," "trad[ing] upon and benefit[ting] from the goodwill of the product line," and "[holding] itself out to potential customers as continuing to manufacture the same product line."[18]Concluding, the court stated: "The Sale Order did not give Morgan a free pass on future conduct, and the suggestion that it could is doubtful."[19]

Analysis

In *Grumman*, the bankruptcy court protected the successor liability claims of tort victims whose injury from the debtor's defective product occurred only post-Section 363 sale and who therefore could not have adequately asserted and protected their rights at the time of the sale. The court did so at the expense of an asset purchaser who likely expected, based on the clear language of a sale order, to have a measure of protection against successor liability claims and who could not have known at the time of the sale that this particular liability would eventually arise.

Dealing with future tort claims in the bankruptcy process always raises concerns regarding due process, but bankruptcy treatment of the Fredericos' type of tort claims raises unique concerns. For a different type of future tort claims—a category that commonly includes the claims of individuals who are exposed pre-bankruptcy to the debtor's asbestos products but who manifest symptoms, and become identified, only post-bankruptcy—courts have, as explained in *Grumman*, been willing to address due process concerns through "the appointment of a future claims representative to protect their interests and the creation of a trust to pay their claims."[20]

In addition, where potential plaintiffs have received adequate notice of a sale order barring their claims and the order has become final without the potential plaintiffs having opposed it, those plaintiffs may be bound by the order without regard to whether the order exceeded the boundaries of Section 363 in providing the purchaser protections from successor liability claims. In *Travelers Indem. Co. v. Bailey*, the U.S. Supreme Court, in the context of the bankruptcy reorganization of Johns Manville Corporation ("Manville"), a manufacturer and seller of asbestos products, rejected the challenge of certain claimants to the enforceability of the bankruptcy court's 1986 orders—

entered more than two decades earlier—enjoining claims against Manville's non-debtor insurers.[21] The Supreme Court, emphasizing the "need for finality," found that once the orders became final and non-appealable, they were enforceable against the parties and those in privity with them "whether or not [the orders were] proper exercises of bankruptcy court jurisdiction and power."[22] Under the logic of Travelers, a final and non-appealable Section 363 sale order that grants a purchaser releases broader than what the Bankruptcy Code actually permits—for instance, releases of non-"claims"—may be enforceable against a successor liability claimant that received adequate notice of the sale.

However, for future tort claims held by claimants like the Fredericos whose injuries have not yet occurred at the time of the bankruptcy or Section 363 sale and who did not have a claims representative in the bankruptcy process, there may be, as the *Piper Aircraft* bankruptcy court noted, "no way to identify [at the time of the bankruptcy] who the victims will be or to identify any particular prepetition contact, exposure, impact, privity or other relationship between [the debtor] and the[] claimants that will give rise to [] future damages."[23] For these unique "practical and constitutional" concerns,[24] future tort claims in the latter category fell outside the protective "free and clear" power of Section 363(f) in *Grumman*. In deciding whether to purchase and how much to pay for assets in a bankruptcy "free and clear" sale, purchasers should look past the language of the sale order and carefully consider the risk of their successor liability for this special type of future tort claims.

Though not central to its holding, the *Grumman* court's more general discussion regarding successor liability claims should also cause bankruptcy purchasers to question the comfort that they can take from sale orders. Unlike the court in *TWA*, and others in the Second and Third Circuits, the bankruptcy court in *Grumman* declined to link the successor liability claims with the transferred property in order to achieve the policy goals of permitting bankruptcy sales free and clear of such claims—*i.e.*, maintaining Bankruptcy Code priorities and maximizing the value of estate assets for the benefit of creditors. Instead, the *Grumman* court focused on the purchaser's post-sale conduct in evaluating the merits of the claims—a departure from existing precedent in the Second and Third Circuits, which focus resolutely on the transferred assets and the sale order's protective provisions. If successor liability claims are viewed, as they were in *Grumman*, as arising from the buyer's post-sale conduct rather than the assets transferred in the sale, the conclusion that these *in personam* claims are "interests in property" that can be extinguished under Section 363(f) through a sale order is much more difficult. It remains to be seen whether the *Grumman* court's view in this regard is limited to tort claims for successor liability, or is the result of the specific facts of the case or the plaintiff's artful drafting of the claim—or if the *Grumman* decision projects a broader-reaching signal that courts are re-evaluating the nature of successor liability claims in the context of bankruptcy "free and clear" sales.

The Bottom Line

Buyers in bankruptcy sales under Section 363(f) should be aware that there are limits to the protections that can be obtained from a "free and clear" sale order, especially in the area of state law successor liability and even more especially in the area of tort claims based on a successor liability

theory. As illustrated in *Grumman*, a sale order may not capture and exclude all future claims. And as *Grumman* suggests, the specific facts or careful drafting of the claim on the plaintiff's part could convince a court to distinguish favorable precedent and limit the purchaser's protections.

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[1] *Morgan Olson, LLC v. Frederico (In re Grumman Olson Indus., Inc.),* 445 B.R. 243 (Bankr. S.D.N.Y. 2011).

[2] *See* RESTATEMENT (THIRD) OF TORTS: PRODS. LIAB. § 12 (1998).

[3] *Cont'l Ins. Co. v. Schneider, Inc.*, 582 Pa. 591, 600 (Pa. 2005) (emphasis added) (discussing the "product-line" exception to the general rule against successor liability).

[4] *See, e.g., In re Trans World Airlines, Inc.*, 322 F.3d 283, 290 (3d Cir. 2003); *Grumman*, 445 B.R. at 249; *In re Chrysler LLC*, 405 B.R. 84, 111 (Bankr. S.D.N.Y. 2009); *see also George W. Kuney, Misinterpreting Bankruptcy Code Section 363(f) and Undermining the Chapter 11 Process*, 76 AM. BANKR. L.J. 235, 257-62 (2002). The remedy for successor liability claims may also support this characterization. Liability resulting from a successful successor liability claim is not capped at the value of the assets sold. *See* Kuney, *supra* note 4, at 261.

[5] 11 U.S.C. § 363(f).

[6] *TWA*, 322 F.3d at 289-90 (citing *Folger Adam Sec., Inc. v. DeMatteis/MacGregor, JV,* 209 F.3d 252, 259 (3d Cir. 2000)); see *Ind. State Police Pension Trust v. Chrysler LLC (In re Chrysler LLC)*, 576 F.3d 108, 126 (2d Cir. 2009), *judgment vacated*, 129 S.Ct. 2275 (2009); *United Mine Workers of Am. 1992 v. Leckie Smokeless Coal Co. (In re Leckie Smokeless Coal Co.)*, 99 F.3d 573, 582-83 (4th Cir. 1996); *see also In re General Motors Corp*., 407 B.R. 463, 499-506 (Bankr. S.D.N.Y. 2009) (following Second Circuit's analysis in Chrysler, which had not yet been vacated), *aff'd sub nom. Campbell v. Motors Liquidation Co.(In re Motors Liquidation Co.)*, 428 B.R. 43 (S.D.N.Y. 2010); *Douglas v. Stamco*, 363 Fed. Appx. 100, 102-03 (2d Cir. 2010) (relying entirely on policy considerations, rather than analysis of the term "interests in property," in concluding that asset sale under Section 363(f) extinguished successor liability claims).

[7] *Chrysler*, 405 B.R. at 111. As a point regarding process, the guidelines for the conduct of asset sales in effect in the U.S. Bankruptcy Court for the Southern District of New York state that a proposed sale order generally "should not contain voluminous findings with respect to successor

liability, or injunctive provisions" and that a sale motion seeking findings limiting the purchaser's successor liability must "disclose the adequacy of the debtor's proposed notice of such requested relief and the basis for such relief." *Adoption of Amended Guidelines for the Conduct of Asset Sales*, General Order M-383 at 10-11 (Bankr. S.D.N.Y. Nov. 18, 2009).

[8] *TWA*, 322 F.3d at 288-90.

[9] *See, e.g., Stamco*, 363 Fed. Appx. at 102-03; TWA, 322 F.3d at 291-93.

[10] *See, e.g., Stamco*, 363 Fed. Appx. at 102-03; TWA, 322 F.3d at 291-93.

[11] *Grumman*, 445 B.R. at 246.

[12] *Id.*

[13] *Id.* at 250.

[14] *See* 11 U.S.C. § 101(5).

[15] *Epstein v. Official Comm. of Unsecured Creditors (In re Piper Aircraft Corp.)*, 58 F.3d 1573 (11th Cir. 1995) (in context of debtor's sale of assets under chapter 11 plan, holding that future tort victims did not have "claims" within the meaning of 11 U.S.C. § 101(5) such that their rights could be administered in the bankruptcy).

[16] *Grumman*, 445 B.R. at 254.

[17] The *Grumman* court rejected Morgan's argument based on analogy to the sale order entered by the bankruptcy court in *Chrysler*, which purported to extinguish the purchaser's liability for potential future tort claims, noting that the Second Circuit had subsequently questioned the reach of the bankruptcy court's authority to extinguish future claims. *Id.* at 255-56; *see Chrysler*, 576 F.3d at 127.

[18] *Grumman*, 445 B.R. at 250.

[19] *Id.*

[20] *Id.* at 251. This type of arrangement is typically facilitated by a channeling injunction issued by the court, which, in general, directs plaintiffs' claims to a funded trust and bars claims against the debtor and/or related entities. *See, e.g., In re Johns Manville Corp.,* 68 B.R. 618, 626 (Bankr. S.D.N.Y. 1986); *see also* 11 U.S.C. § 524(g) (codifying authority of bankruptcy court to issue channeling injunctions in asbestos-related bankruptcy cases).

[21] 129 S. Ct. 2195, 2205-07 (2009). The basis of the challenge was that the bankruptcy court exceeded its subject matter jurisdiction in enjoining claims against the non-debtor insurers that were not derivative of the debtor's wrongdoing.

[22] *Id.* at 2205, 2206.

[23] *In re Piper Aircraft Corp.*, 162 B.R. 619, 627 (Bankr. S.D. Fla. 1994).

[24] *Grumman*, 445 B.R. at 251.

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