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Does a Bankruptcy Sale Order Cut Off Successor Liability Claims? Courts in the Second Circuit Speak Out

It is a common observation that, in an increasing number of Chapter 11 cases, the end game is a sale of the debtor's assets pursuant to section 363 of the Bankruptcy Code. So-called "363 Sales" offer a number of advantages to buyers and sellers alike. The sale process is relatively quick. The bankruptcy court order confirming the sale will protect the transaction from "second-guessing" by other parties in interest. Provided that the purchaser is proceeding in "good faith," any appeal from the sale confirmation order will be dismissed as moot unless the objecting party can obtain a stay of the order – a practical impossibility in most cases. And perhaps most importantly, if one or more statutory conditions are satisfied, the sale will be "free and clear" of liens and other third-party interests.¹

However, the Bankruptcy Code does not define the universe of third-party "interests" that can be washed away by a bankruptcy sale order. It has been left to the courts to mark the outer limits of this concept. Several courts have debated whether a 363 Sale will vest ownership of the debtor's assets in a buyer free and clear of successor liability claims. A number of recent decisions from the United States Court of Appeals for the Second Circuit (which includes the United States District Court for the Southern District of New York where many large Chapter 11 cases are filed) shed useful light on this issue.

Assessing the risk of successor liability should be on every asset purchaser's due diligence checklist. As a general rule, a purchaser can buy assets without taking on any of the seller's liabilities. However, there are four widely recognized exceptions: The seller's liabilities may follow the assets into the hands of the buyer if (1) the buyer expressly or implicitly assumes the liabilities, (2) the transaction amounts to a de facto merger or consolidation, (3) the purchaser is merely a continuation of the seller, or (4) the parties entered into the transaction with the fraudulent intent of escaping liability for the seller's debts. Traditionally, the "mere continuity" exception applies only where buyer and seller are owned and operated by the same persons. In the product liability area, some courts have embraced an expanded exception known as the "product line" exception.

In the 363 Sale context, buyers who are concerned about successor liability typically ask for a judicial declaration that the buyer will not be liable for any of the liabilities of the seller, a finding that the buyer would not proceed with the purchase in the absence of protections against successor liability claims, and an injunction against the assertion of such claims. A number of courts have been receptive to such provisions, which they view as furthering the bankruptcy policy goals of maximizing the value of the debtor's assets and treating creditors equally. Several recent decisions from courts in the Second Circuit have embraced this view.

The recent General Motors and Chrysler bankruptcies are cases in point. In each case, the bankruptcy court approved a sale of the debtor's assets on terms that protected the buyer against successor liability claims.

In the *Chrysler* case, the sale order was temporarily stayed while the objecting parties pursued an expedited appeal to the United States Court of Appeals for the Second Circuit. Agreeing with decisions from the Third and Fourth Circuits, the Second Circuit held that “the term ‘any interest in property’ encompasses those claims that ‘arise from the property being sold,’” including existing successor liability claims.² The court went on to note that the protections in the sale order against successor liability claims were a critical inducement to the sale, and were justified as a matter both of policy and of practical necessity:

With its revenues sinking, its factories dark, and its massive debts growing, Chrysler fit the paradigm of the melting ice cube. ... “To allow the claimants to assert successor liability claims against [the purchaser] while limiting other creditors’ recourse to the proceeds of the asset sale would be inconsistent with the Bankruptcy Code’s priority scheme.” Appellants ignore this overarching principle and assume that tort claimants faced a choice between the Sale and an alternative arrangement that would have assured funding for their claims. But had appellants successfully blocked the Sale, they would have been unsecured creditors fighting for a share of extremely limited liquidation proceeds. Given the billions of dollars of outstanding secured claims against Old Chrysler, appellants would have fared no better had they prevailed.³

However, the court was more tentative in dealing with the arguments advanced on behalf of future product liability claimants. Noting that the sale order purported to extinguish all successor liability claims, present and future, the court remarked:

We affirm this aspect of the bankruptcy court’s decision insofar as it constituted a valid exercise of authority under the

Bankruptcy Code. However, we decline 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 an injury that is caused by Old Chrysler, that occurs after the Sale, and that is cognizable under state successor liability law.⁴

One of the objectors petitioned the United States Supreme Court for review of the Second Circuit’s opinion. While the petition was pending, the sale closed. Subsequently, the Supreme Court remanded the case to the Second Circuit with instructions to dismiss the appeal as moot.⁵ Accordingly, the Second Circuit’s opinion no longer has the weight of binding precedent, although it continues to be cited by other courts, and its ultimate effect (cutting off the rights of various claimants, including product liability claimants) remains undisturbed.

In February 2010, in a product liability case in which K&L Gates LLP represented the defendant buyer, the Second Circuit had occasion to revisit the question whether a 363 Sale can cut off successor liability claims. The case, *Douglas v. Stamco*, is of particular interest because it involved an issue that the Court of Appeals had skirted in the *Chrysler* case: the impact of a 363 Sale on a “future” product liability claim.⁶ The 363 Sale took place in 2001. In 2005 – long after the 363 Sale, but before the seller’s bankruptcy case had closed – the plaintiff was injured in an accident involving a machine manufactured by the seller prior to the 363 Sale. The plaintiff brought suit against the buyer in 2008. On an appeal from the dismissal of the plaintiff’s complaint, the Second Circuit affirmed, holding that the undisputed facts simply did not support any theory of successor liability. Addressing the significance of the 363 Sale, the court stated:

The underlying public policy concerns implicated by this case also weigh in appellee’s favor. Allowing the plaintiff to proceed with his tort claim directly against Genesis II would be inconsistent with the Bankruptcy Code’s priority scheme because plaintiff’s claim is otherwise a low-priority, unsecured claim. See 11 U.S.C. § 507(a); see also *In re Trans World Airlines, Inc.*, 322 F.3d

283, 292 (3d Cir. 2003) (“To allow the [plaintiff] to assert successor liability claims against [the purchaser] while limiting other creditors’ recourse to the proceeds of the asset sale would be inconsistent with the Bankruptcy Code’s priority scheme.”).

Moreover, to the extent that the “free and clear” nature of the sale (as provided for in the Asset Purchase Agreement (“APA”) and § 363(f)) was a crucial inducement in the sale’s successful transaction, it is evident that the potential chilling effect of allowing a tort claim subsequent to the sale would run counter to a core aim of the Bankruptcy Code, which is to maximize the value of the assets and thereby maximize the potential recovery to the creditors. See *Toibb v. Radloff*, 501 U.S. 157, 163 (1991) (recognizing that the Bankruptcy Code’s general policy is “maximizing the value of the bankruptcy estate”); see also *Licensing by Paolo, Inc. v. Sinatra (In re Gucci)*, 126 F.3d 380, 387 (2d Cir. 1997) (stating that a sale pursuant to § 363 of the Bankruptcy Code “maximizes the purchase price of assets because without this assurance of finality, purchasers could demand a large discount for investing in a property that is laden with the risk of endless litigation as to who has rights to estate property”). In light of the foregoing, we conclude that the district court did not err in granting the defendants’ Rule 12(b)(6) motion.⁷

The ruling of the Court of Appeals is embodied in a summary order, which does not have precedential effect. Nonetheless, the court’s summary order has been cited with approval by two lower courts, including the United States District Court for the Southern District of New York in the *General Motors* case.⁸ That court’s memorandum and order, which was filed on April 13, 2010, is the most recent pronouncement by any federal court in the Second Circuit on the 363 Sale/successor liability issue.

In the *General Motors* case, the bankruptcy court followed in the footsteps of its sister court in the

Chrysler case, and confirmed a sale of the debtor’s assets on terms that protected the buyer against successor liability for existing product liability claims. Five product liability claimants appealed to the district court, which dismissed the appeal as moot under section 363(m) of the Bankruptcy Code, since the sale order had not been stayed and the sale had closed. To circumvent the mootness issue, the appellants argued that their objection to the extinguishment of their successor liability claims was really an objection to the jurisdiction of the bankruptcy court, and could not be mooted. The district court rejected this argument, and also rejected the appellants’ suggestion that the provisions regarding successor liability be stripped from the sale order. In its lengthy and thoughtful opinion, the court reviewed the policy underpinnings of section 363, and discussed both the *Chrysler* and *Stamco* decisions. The court concluded its opinion by invoking the same considerations of practicality that underlay the *Chrysler* decision:

Although, like the Bankruptcy Court, this Court is not unsympathetic to the plight of the accident victims here ... we note that their position in the bankruptcy appears to be neither better nor worse than that of any other unsecured contingent creditor. Moreover, the relief Appellants sought in the Bankruptcy Court and now seek from this Court would unravel the 363 Transaction, the only alternative to which is a liquidation in which they and other unsecured creditors would have received nothing.⁹

The decisions discussed in this Alert articulate the important bankruptcy policy reasons why 363 Sales have been held to cut off successor liability claims. Buyers who contemplate purchasing (or who have purchased) assets from a bankruptcy estate and who are concerned about the risk of successor liability should consult with counsel to ensure they are taking full advantage of section 363.

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¹ See 11 U.S.C. §§ 363(f) and (m).

² *In re Chrysler LLC*, 576 F.3d 108, 126 (2d Cir. 2009), vacated as moot sub nom. *Ind. State Police Pension Trust v. Chrysler LLC*, 129 S. Ct. 2275 (2009), appeal dismissed as moot, *In re Chrysler LLC*, 592 F.3d 370 (2d Cir. 2010).

³ *Chrysler*, 576 F.3d at 119, 126 (quoting *In re Trans World Airlines, Inc.*, 322 F.3d 283, 292 (3d Cir. 2003)).

⁴ *Id.* at 127.

⁵ *Ind. State Police Pension Trust v. Chrysler LLC*, 129 S. Ct. 2275 (2009).

⁶ *Douglas v. Stamco*, No. 09-1390-cv, 2010 WL 337043 (2d Cir. Feb. 1, 2010).

⁷ *Id.* at *2 (emphasis added) (footnote omitted).

⁸ *In re Motors Liquidation Co.*, No. 09 Civ. 6818 (NRB), 2010 WL 1524763 (S.D.N.Y. Apr. 13, 2010); *In re Remember Enters., Inc.*, No. 09-12179, 2010 WL 481248 (Bankr. M.D. N.C. Feb. 5, 2010).

⁹ *Motors Liquidation Co.*, 2010 WL 1524763, at *15.