Bankruptcy Asset Sale Not So "Free and Clear" After All

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The ability to sell an asset in bankruptcy free and clear of liens and any other competing "interest" is a well-recognized tool available to a trustee or chapter 11 debtor in possession ("DIP"). Whether the category of "interests" encompassed by that power extends to potential successor liability claims, however, has been the subject of considerable debate in the courts. A New York bankruptcy court recently addressed this controversial issue in *Olson v. Frederico (In re Grumman Olson Indus., Inc.)*, 445 B.R. 243 (Bankr. S.D.N.Y. 2011). In *Grumman Olson*, the court ruled that a section 363 sale order cannot exonerate purchasers from successor liability claims by claimants who, at the time of the sale, had not yet been injured and had no contact or relationship with the debtor or its products.

Free and Clear Sales in Bankruptcy

Section 363(b) of the Bankruptcy Code provides that a trustee or DIP may use, sell, or lease estate property outside the ordinary course of the debtor's business with bankruptcy court approval. In addition, under section 363(f), the sale may be "free and clear of any interest in such property of an entity other than the estate," provided it satisfies any one of certain specified conditions. These include, among other things, if applicable nonbankruptcy law permits a sale free and clear, if the sale price exceeds the amount of all liens encumbering the property, and if the interest is in bona fide dispute.

A bankruptcy court's power to order sales free and clear of a competing interest without the consent of the party asserting the interest has been recognized for more than a century. It promotes the expeditious liquidation of estate assets by avoiding delay attendant upon sorting out disputes concerning the validity and extent of competing interests, which can later be resolved in a centralized forum. It also facilitates the estate's realization of the maximum value possible from an asset. A prospective buyer would discount its offer significantly if it faced the prospect of protracted litigation to obtain clear title to an asset.

Meanwhile, holders of competing interests are also provided with protections by the Bankruptcy Code. Pending the bankruptcy court's resolution of any disputes, the interest holder is entitled to "adequate protection" of its interest. This most commonly takes the form of a replacement lien on the proceeds of the sale.

"Any Interest" Broadly Construed

Section 363(f) has been applied to a wide range of "interests," but courts have sometimes struggled to grasp the scope of the term, which is defined nowhere in the Bankruptcy Code or its accompanying legislative history. For example, courts have disagreed as to whether a successor liability claim constitutes an "interest" in property that can be extinguished by means of a sale free and clear. Some courts have narrowly construed the term "interest" to include only *in rem* interests (*e.g.*, liens and security interests that attach to specific property). These courts typically have ruled that product liability claims and tort actions against the seller are unaffected by a bankruptcy sale and can be asserted against the buyer. Other courts have construed the term broadly to hold that certain liabilities (*e.g.*, certain environmental remediation costs and employment discrimination claims) do not follow assets sold free and clear under section 363(f).

Special circumstances have led to the development of case-specific rules. For example, some bankruptcy courts have expanded the scope of traditional successor liability where there is an overriding need to protect federal rights or effectuate federal policies. These courts have allowed actions against a purchaser of a debtor's business if the successor had notice of the claim before the acquisition and there is substantial continuity in the operation of the business before and after the sale.

Courts have also struggled to develop an appropriate way to deal with "future claims" (*i.e.*, claims that do not arise until after the bankruptcy proceedings have concluded). Some have adopted a blanket rule that future claims cannot be discharged in a debtor's bankruptcy case. Other courts have adopted a more practical approach in dealing with future claims. Instead of denying discharge of all future claims, these courts have examined whether the debtor notified as many potential claimants as possible of the sale, whether the debtor sought court approval to preclude successor liability, and whether the debtor made arrangements for future claimants so that they are able to look to some source for recovery.

Grumman Olson

Grumman Olson Industries, Inc. ("Grumman" or the "Debtor"), a manufacturer of truck body parts, filed a chapter 11 petition in New York in December 2002. On July 1, 2003, the bankruptcy court entered an order (the "Sale Order") approving the sale of certain of the Debtor's assets to a predecessor of Morgan Olson, LLC ("Morgan"). The Sale Order purported to exonerate Morgan from potential liability from certain tort claims, providing in pertinent part that "[t]he sale . . . of assets to be purchased . . . shall be free and clear of all . . . claims . . . and

other interests . . . whether arising prior to or subsequent to the commencement of this Chapter 11 case." The Sale Order further provided that Morgan would "have no liability or responsibility for any liability or other obligation of the Debtor arising under or related to [the asset sale] . . . including, but not limited to, claims for successor or vicarious liability."

After the sale was consummated, Denise Frederico was injured when the Grumman-manufactured truck that she was driving crashed into a telephone pole. In October 2009, Frederico and her husband (together, the "Fredericos") commenced a personal injury action against Morgan in the Superior Court of New Jersey. The complaint alleged that the truck was defective and that Morgan was liable for the injuries under New Jersey's successor liability laws. Specifically, the Fredericos asserted that Morgan continued to use Grumman's product line, thereby holding itself "out to potential customers as continuing to manufacture the same product line of Grumman trucks."

In March 2010, Morgan commenced an adversary proceeding in the bankruptcy court seeking declaratory and injunctive relief to preclude the Fredericos from bringing their successor liability action. Morgan contended that the Sale Order and the accompanying asset purchase agreement exonerated it from any liability, including liabilities under state successor liability laws, arising from defective products manufactured by the Debtors and sold prior to the consummation of the Sale Order. Both Morgan and the Fredericos moved for summary judgment.

The Bankruptcy Court's Ruling

At the outset, the bankruptcy court concluded that it had subject matter jurisdiction over the dispute despite confirmation of the Debtor's chapter 11 plan. Among other bases for this

conclusion, the court explained that "[i]t is well-settled that a bankruptcy court retains jurisdiction to interpret and enforce its prior orders, especially where, as here, the bankruptcy court expressly retains jurisdiction to do so."

Addressing the merits, the court held that a sale under section 363(f) does not exonerate a buyer from successor liability claims by parties who, at the time of the sale, had not yet been injured and had no identifiable connection as potential creditors to the debtor or its products. Because the Fredericos did not hold a claim at the time the Sale Order was entered, the court ruled that the order did not preclude the Fredericos from suing Morgan in state court. The court expressed no view as to whether Morgan was actually liable under New Jersey successor liability law for the underlying injury.

Future Tort Claims

The Sale Order expressly exonerated Morgan from any "claims," including those for successor liability. Section 101(5)(A) of the Bankruptcy Code defines "claim" in the broadest possible fashion to mean "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured." Even so, the court acknowledged that, at least with respect to future tort claims, the term "claim" has an outer boundary. The court distinguished between two types of future tort claims. In the first, the tort claimant had prepetition exposure to the debtor's product but had not yet manifested symptoms or discovered an injury. In the second, the tort claimant was injured after consummation of an asset sale or confirmation of a plan as a result of a defective product manufactured and sold by the debtor prepetition. The court placed the Fredericos in the latter group.

Fair-Contemplation Test

The Second Circuit, the bankruptcy court explained, has adopted a "fair contemplation" test to differentiate between contingent or unmatured claims, which qualify as "claims" under section 101(5), and potential future tort claims, which do not. Under this test, set forth in *United States v. LTV Corp. (In re Chateaugay Corp.)*, 944 F.2d 997 (2d Cir. 1991), "a contingent or unmatured claim is a 'claim' if the occurrence of the contingency or future event that would trigger liability" may have conceivably been considered by the parties at the inception of the original relationship between the parties. *Chateaugay* involved environmental claims, not tort claims. Nevertheless, the court in *Grumman Olson* found the hypothetical posited in *Chateaugay* to be instructive:

> Consider, for example, a company that builds bridges around the world. It can estimate that of 10,000 bridges it builds, one will fail, causing 10 deaths. Having built 10,000 bridges, it becomes insolvent and files a petition in bankruptcy. Is there a "claim" on behalf of the 10 people who will be killed when they drive across the one bridge that will fail someday in the future? If the only test is whether the ultimate right to payment will arise out of the debtor's pre-petition conduct, the future victims have a "claim." Yet it must be obvious that enormous practical and perhaps constitutional problems would arise from recognition of such a claim. The potential victims are not only unidentified, but there is no way to identify them. . . . What notice is to be given to these potential "claimants"? Or would it suffice to designate a representative for future victims and authorize the representative to negotiate terms of a binding reorganization plan?

The bankruptcy court also considered a "modified version" of the "fair contemplation" test articulated by the Eleventh Circuit in *Epstein v. Official Committee of Unsecured Creditors (In re Piper Aircraft Corp.)*, 58 F.3d 1573 (11th Cir. 1995). In *Piper*, the court applied a two-part test to determine when a person holds a "claim" against a debtor manufacturer and thus may be barred from pursuing a successor buyer: (i) the events occurring prepetition must have created a relationship; and (ii) the basis for liability must be the debtor's prepetition conduct in designing, manufacturing, and selling the allegedly defective or dangerous product.

In *Grumman Olson*, the court concluded that the Fredericos' claim failed the *Piper* test and fell "squarely within the *Chateaugay* hypothetical." The Fredericos, the court explained, had no prepetition relationship with Grumman. In fact, the only connection the Fredericos had with Grumman was through Denise Frederico's employer, who purchased the truck that she drove. As such, the court ruled that the Fredericos did not hold a "claim" against the Debtor's estate at the time of the section 363 sale.

The court also noted due-process concerns with respect to a sale order under section 363(f) that purports to cleanse assets sold to a purchaser "free and clear of any interest in such property." A sale order, the court emphasized, does not bind parties that have not received adequate notice. Because the Fredericos could not have been identified as potential claimants prior to the sale or received adequate notice of the bankruptcy case, the sale, confirmation of Grumman's plan, or the deadline for filing a proof of claim, the Fredericos did not receive adequate notice to satisfy due-process concerns.

Outlook

Grumman Olson should alert bankruptcy practitioners that purchasers of assets in a section 363 sale may face future liability from potential tort claimants. *Grumman Olson* suggests that sweeping "free and clear" language in a sale order purporting to extinguish a purchaser's liability for potential future tort claims may not necessarily achieve that objective in all cases. Purchasers would be well advised to consider such risks.