ALERTS

District Court Upholds Future Claimants' Due Process Rights Against Broad Releases in Section 363 Sale Order

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The United States District Court for the Southern District of New York (the "District Court") on March 29, 2012 held that a bankruptcy court sale order issued under Section 363 of the Bankruptcy Code ("Section 363") could not extinguish state law successor liability personal injury claims brought against the purchaser by third parties injured after the close of the bankruptcy case, but whose injuries arose out of conduct of the debtor prior to its bankruptcy. *Morgan Olson LLC v. Frederico (In re Grumman Olson Industries, Inc.)*, 2012 WL 1038672 (S.D.N.Y. 2012). Although the Second Circuit Court of Appeals has not yet considered this issue, the District Court's decision is in line with those of other circuit courts that have ruled on similar issues. *SeeLemelle v. Universal Mfg. Corp.*, 18 F.3d 1268 (5th Cir. 1994); *Epstein v. Official Committee of Unsecured Creditors of the Estate of Piper Aircraft Corp. (In re Piper Aircraft Corp.)*, 58 F.3d 1573 (11th Cir. 1995). This decision has important practical implications for purchasers of assets from a debtor's estate.

Facts

Grumman Olson Industries, Inc. ("Grumman"), a manufacturer of products used in truck bodies, filed for Chapter 11 protection in late 2002. *Morgan Olson LLC v. Frederico*, 2012 WL 1038672 at *1. In July 2003, a predecessor of Morgan Olson LLC ("Morgan"), purchased certain of Grumman's assets in a Section 363 sale. *Id.* The bankruptcy court order approving the sale (the "Sale Order") provided that the sale would be "free

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and clear of all . . . claims . . . and all debts arising in any way in connection with any acts of [Grumman]" and that Morgan would not be subject to "any liability for claims against [Grumman] . . . including, but not limited to, claims for successor or vicarious liability . . ." *Id.* at *2. Almost three years after the close of Grumman's bankruptcy case, Ms. Frederico ("Frederico") was injured when the truck she was driving, which included products manufactured by Grumman prior to the bankruptcy case, struck a telephone pole. Frederico filed a complaint against Morgan for Grumman's allegedly defective products under New Jersey's successor liability law (the "New Jersey Action"). *Id.* Morgan then filed an adversary proceeding in the bankruptcy court, seeking, among other things, to bar Frederico from pursuing the New Jersey Action. *Id.*

Applicable Law

Although a purchaser of assets is not generally liable under traditional common law for the seller's liabilities, courts have crafted certain specific exceptions. One exception is New Jersey's "product line exception," under which a purchaser may be subject to successor liability if it purchases a "substantial part of [a] manufacturer's assets and continu[es] to market goods under the same product line." *Lefever v. K.P. Hovnanian Enters., Inc.*, 160 N.J. 307, 310, 734 A.2d 290 (N.J. 1999). The New Jersey Supreme Court has held that the product line exception survives even when the assets are transferred pursuant to a sale order in a bankruptcy case. *See id.* at 316-18. In the New Jersey Action, Frederico argued that Morgan is subject to successor liability under the product line exception. *Morgan Olson LLC v. Frederico*, 2012 WL 1038672 at *2.

Section 363 of the Bankruptcy Code authorizes the sale of a debtor's assets "free and clear of any interest in such property of any entity other than the estate." 11 U.S.C. § 363(b). Courts in the Second Circuit have interpreted Section 363 to allow the sale "free and clear" of any interests as well as all "claims." *See, e.g., In re Chrysler LLC*, 576 F.3d 108, 126 (2d Cir. 2009). The Bankruptcy Code broadly defines "claim" to include any "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." 11 U.S.C. § 101(5)(A).

The District Court

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Affirming the bankruptcy court, the District Court held that the Sale Order did *not* exonerate Morgan from potential liability to Frederico and dismissed Morgan's adversary complaint. *Morgan Olson LLC v. Frederico*, 2012 WL 1038672 at *14-15. Thus, despite the broad release language of the Sale Order, Frederico could continue to pursue her successor liability claims against Morgan in the New Jersey Action. *See id.* at 14.

The District Court first rejected Morgan's preemption argument, i.e., that the New Jersey Supreme Court's holding in *Lefever*, that the product line theory of successor liability survives a bankruptcy court sale order, violated the constitutional supremacy of federal bankruptcy laws over state laws.[1] *See id.* at *4-5. The District Court observed that the constitutionality of the *Lefever* decision was not the subject of the appeal before it. Rather, the only issue at hand was whether enforcement of the Sale Order would be consistent with the Bankruptcy Code and due process. *Id.* at *5.

The District Court then considered the underlying policy for permitting sales under Section 363 to be "free and clear" of "claims" that arise from the property being sold, not only "interests" in the property, as the text of the statute may suggest. *See id.* at 5. Echoing the bankruptcy court, the District Court explained that the broad reading of "free and clear" to include tort claims serves to prevent tort claimants from directly suing purchasers and thereby jumping ahead of more senior creditors in violation of the Bankruptcy Code's priority framework. *See id.* at *6. A broad application of the "free and clear" language also maximizes the value to the debtor's estate by limiting prospective purchasers' exposure to liability and thereby encouraging higher bids for the assets. *Id.*

After embracing this expansive reading of "free and clear," the District Court was left to consider whether the Sale Order could extinguish Frederico's claims. *Id.* To determine whether a claim that first arose after the conclusion of the bankruptcy case, but as a result of a debtor's prepetition conduct (a "future claim"), can be extinguished by a Section 363 sale order, the District Court first looked to precedent that analyzed whether future claims fall within the meaning of "claims" in other bankruptcy contexts. *See id.* at *7-8. Both the Fifth and Eleventh Circuits have considered and decided this issue, holding that the definition of "claim" cannot include the claims of unidentified future claimants.[2] *See id.* Although the Second Circuit has yet to weigh in on this issue, it has previously observed the potential for practical issues, such as serving

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notice and "perhaps constitutional problems," that would result if future claims were treated as falling within the Bankruptcy Code definition of "claim." *See, e.g., In re Charteuagay Corp.*, 944 F.2d 997, 1003 (2d Cir. 1991). Citing the long-recognized importance of notice and due process in the bankruptcy context, the District Court observed that courts consistently hold that future claims cannot be discharged by bankruptcy court orders because it is not possible to provide notice to unidentified future claimants. *See Morgan Olson LLC v. Frederico*, 2012 WL 1038672 at *9-10.

The District Court then applied this reasoning to a "free and clear" sale order under Section 363, noting that the same due process concerns apply regardless of whether the debtor sells its assets under Section 363 or confirms a plan of reorganization. *Seeid.* at *10. This is consistent with the rulings of other courts that have raised notice and due process concerns when considering successor liability in a Section 363 sale order context. *See, e.g., Schwinn Cycling & Fitness Inc. v. Benonis*, 217 B.R. 790, 797 (N.D. Ill. 1997) (holding that enforcing a Section 363 sale order to enjoin a future claimant's state law action would deny the claimant's due process rights and that the impossibility of providing notice to such unidentified future claimants did not lessen the due process implications). Specifically, the District Court held that, because Frederico did not receive adequate notice in the bankruptcy case and therefore did not have an opportunity to participate in the case, enforcing the Sale Order to bar her right to seek redress in the New Jersey Action would deprive her of due process.[3] *See id.* at *11. In so ruling, the District Court made a policy pronouncement that the important policy of maximizing value to the estate does not outweigh the Bankruptcy Code's policy of affording claimants the opportunity to be heard and the constitutional right to due process. *See id.* at *13. The District Court warned that an alternative approach, one that elevated maximizing value to the estate over the due process rights of future claimants and allowed the court to extinguish all future claims without notice, would make the assets of a debtor more valuable not only to creditors but also to managers and shareholders, and could entice companies to file for bankruptcy for reasons unrelated to the purposes of bankruptcy law. *See id.* at *14.

Practical Considerations

The District Court's decision makes clear that prospective purchasers of assets from debtors in the Southern District of New York, whether

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purchased pursuant to a plan or a sale order under Section 363, must consider the potential for successor liability for future claims. The District Court, although sympathetic to the concern that the uncertainty of future claims might have a chilling effect on the market for debtors' assets, essentially instructed potential purchasers to adjust their offers to take into account the risk of future claims. *See id.* at *12. Depending on the business of the target debtor, understanding these risks could well determine the success or failure of a purchase of assets under Section 363 or a reorganization plan.

Authored by Lawrence V. Gelber and Neil S. Begley.

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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[1] U.S. Const. Art. VI, cl. 2 ("This Constitution, and the Laws of the United States . . . shall be the supreme law of the land; and the judges in every state shall be bound thereby, anything in the constitution or laws of any state to the contrary notwithstanding.").

[2] *SeeEpstein v. Official Committee of Unsecured Creditors of the Estate of Piper Aircraft Corp. (In re Piper Aircraft Corp.)*, 58 F.3d 1573, 1577 (11th Cir. 1995) ("The debtor's prepetition conduct gives rise to a claim to be administered in a case only if there is a relationship established before confirmation between an identifiable claimant or group of claimants and that prepetition conduct."); *Lemelle v. Universal Mfg. Corp.*, 18 F.3d 1268, 1277 (5th Cir. 1994) (holding that even the Bankruptcy Code's broad definition of "claim," cannot be interpreted to extend to claims of claimants who were completely unknown and unidentified at the time of the petition and "whose rights depended entirely on the fortuity of future occurrences").

[3] The District Court acknowledged that some bankruptcy cases, particularly those with debtors facing mass tort liability, have addressed the potential for future claims with a "future claim representative" who acts on behalf of the interests of future claimholders, such as negotiating a reserve fund to pay future claims as they arise. *See Morgan Olson LLC v. Frederico*, 2012 WL 1038672 at *12-13. The District Court explicitly did not express a view on whether a future claims representative would have been appropriate in this case. *Id.* at *13.

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