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Notice Requirement Clarified for Successor Liability Protection in Chapter 11 Asset Sale Orders

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A bankruptcy court's asset sale order limiting specific pre-bankruptcy product liability claims required prior "actual or direct mail notice" to claimants when the debtor "knew or reasonably should have known about the claims," held the U.S. Court of Appeals for the Second Circuit on July 13, 2016. *In re Motors Liquidation Co.*, 2016 U.S. App. LEXIS 12848, *46-47 (2d Cir. July 13, 2016).

"[M]ere publication notice" to known or knowable claimants, explained the court, was insufficient when the debtor sought to enforce a "free and clear" provision in a "Sale Order" insulating the asset buyer from successor liability based on tort claims "that … could have been brought against" the debtor-seller. *Id.* at *26-27. Had the requisite notice been given, though, the Sale Order (and the buyer's protection against successor liability) would probably have been enforceable. *See* Bankruptcy Code (Code) § 363(f)(1) (sale may be made "free and clear of any interest in such property"); *In re Chrysler LLC*, 576 F. 3d 108, 126 (2d Cir. 2009) (successor liability claims are interests), vacated as moot, 558 U.S. 1087 (2009).

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The bankruptcy court properly found that the debtor "should have provided direct mail notice to … [known] owners" of defective vehicles, said the Second Circuit, but erred in holding that "plaintiffs were not prejudiced … because [it] would have approved the Sale Order even if plaintiffs [had been] provided adequate notice." According to the bankruptcy court, these plaintiffs would not have "succeeded on [their] successor liability argument" and their "other arguments were 'too speculative.'" *Id.* at *58. But the Second Circuit disagreed, holding that "enforcing the Sale Order [so as to insulate the asset buyer from liability] would violate procedural due process" because, with adequate notice, the "plaintiffs could have had some negotiating leverage [regarding the terms of any sale order] … and [a meaningful] opportunity to participate in the proceedings." *Id.* at *61.

The court declined to "decide whether prejudice is an element" when there is inadequate notice of a proposed § 363 sale, but agreed "[plaintiffs] have [shown prejudice] here." *Id.* at *57. Although some courts require a showing of prejudice when a party asserts a due process violation, other "courts have held … that 'a due process violation cannot constitute harmless error.'" *Id.* at *53, citing *In re New Concept Hous., Inc.*, 951 F.2d 932, 937 n.7 (8th Cir. 1991); *McNabb v. Comm'r Ala. Dep't of Corr.*, 727 F.3d 1334, 1347 (11th Cir. 2013 (" … the flatout denial of the right to be heard on a material issue can never be harmless"); *In re Boomgarden*, 780 F.2d 657, 661 (7th Cir. 1985) ("In bankruptcy proceedings, both debtors and creditors have a constitutional right to be heard on

their claims, and the denial of that right to them is the denial of due process which is never harmless error").

Relevance

The common-law "Successor Liability" doctrine protects creditors from a debtor's manipulation of corporate forms to insulate assets that would otherwise be available to them. An asset buyer ordinarily does not assume the seller's liabilities. *See, e.g., Golden State Bottling Co. Inc. v. N.L.R.B.*, 414 U.S. 168, 182 n.5 (1973) ("We recognize that … the general rule of corporate liability is that, when a corporation sells all of its assets to another, the latter is not responsible for the seller's debts or liabilities. … "). Because a fixed rule of non-assumption could be manipulated to evade valid creditor claims, most states have established exceptions to the general rule to protect the rights of the seller's creditors. *Ed Peters Jewelry Co. v. C&J Jewelry Co. Inc.*, 124 F.3d, 252, 266 (1st Cir. 1997) ("Under the common law ..., a corporation normally may acquire another corporation's assets without becoming liable for the divesting corporation's debts."). State law governs in successor liability cases. *Cargo Partner AG v. Albatrans, Inc.*, 352 F.3d 41, 44 (2d Cir. 2003) (" … New York law applies to this case [concerning successor liability]").

State law on successor liability may differ slightly from state to state, but a buyer may generally be held liable for the seller's liabilities, in four possible scenarios:

1. the buyer expressly or impliedly agreed to assume the seller's debts;
2. the buyer and seller either merged or consolidated;
3. the buyer is a "mere continuation" of the seller; or
4. the parties consummated the transaction fraudulently for the purpose of evading the seller's liabilities.

See generally, Call Center Technologies, Inc. v. Grand Adventures Tour & Travel Pub. Corp., 635 F.3d 48, 52 (2d Cir. 2011).

In the Courts

Courts have wrestled with successor liability in the business bankruptcy context. In *Chrysler*, the Second Circuit reviewed a bankruptcy court order barring creditors of the selling dbtor from pursuing the asset buyer "for product defects in vehicles produced by" the debtor. 576 F.3d at 123-24.

The *Chrysler* court relied on Code § 363(f), which provides in relevant part that a "trustee may sell property … free and clear of any interest in such property." The issue there was whether personal injury claims were "interests in property." *Id*. The court had "never addressed the scope of the language 'any interest in such property,'"and stressed that the Code "does not define the term." *Id*. at 124. Citing the U.S. Court of Appeals for the Third Circuit's decision in *In re Trans World Airlines, Inc*. (*TWA*), 322 F.3d 283, 288-89 (3d Cir. 2003), which advanced "a broad reading of 'interests in property,'" the court noted that "the trend … toward a more expansive reading of 'interests in property' which encompasses other obligations that may flow from ownership of the property.'" *Id*., quoting 3 Collier on Bankruptcy ¶363.06[(1)].

Other lower courts had previously taken a narrower approach. *See, e.g., In re Schwinn Bicycle Co.*, 210 B.R. 747, 761 (Bankr. N.D. Ill. 1997) (held, § 363(f) "in no way protects the buyer from current or future product liability; it only protects the purchased assets from lien claims against those assets").

In *TWA*, the Third Circuit held that employment discrimination claims and a voucher program given to flight attendants to settle a class action are "interests" in property governed by Code § 363(f). 322 F.3d at 285. It explained that "to equate interest in property with only in rem interests such as liens would be inconsistent with § 363(f) (3)[,] which contemplates that a lien is but one type of interest." *Id*. at 290. *Accord, In re Leckie Smokeless Coal Co.*, 99 F.3d 573, 582 (4th Cir. 1996) (held, Coal Act Premium Payment Obligations owed to employer-sponsored benefit plans constituted interests in property governed by § 363(f)); *Myers v. United States*, 297 B.R. 774, 781-82 (S.D. Cal. 2003) (TWA applied to tort claimants asserting personal

injury claims). According to the Third Circuit in *TWA*, "the trend [among courts] seems to be toward a more expansive reading of 'interests in property' which 'encompasses other obligations that may flow from ownership of the property.'" *TWA*, 322 F.3d at 289. To the extent it approved the substance of the sale order, *Motors Liquidation* is consistent with this trend and follows *Chrysler*.

Facts

Asset Sale: This dispute arose out of the General Motors Chapter 11 case. Immediately after filing its Chapter 11 petition in June 2009, the debtor sought to sell its core assets to a new entity "owned predominantly by [the U.S.] Treasury (over 60 percent)." *Id* . at 11. "The proposed sale order provided that [the buyer] would acquire [the debtor's] assets 'free and clear of all liens, claims, encumbrances and other interests of any kind or nature whatsoever, including rights of claims based on any successor or transferee liability.'" *Id* . Other than a few liabilities that the buyer agreed to assume, "this 'free and clear' provision would act as a liability shield to prevent individuals with claims against [the debtor] from suing [the buyer]." *Id* . The buyer could then "immediately begin operating the [debtor's] business, free of [the debtor's] debts." *Id* . at *12.

Notice: The bankruptcy court ordered the debtor to "provide notice of the proposed sale order" by "direct mail … to numerous interested parties, including 'all parties who are known to have asserted any lien, claim, encumbrance, or interest in or on [the to-be-sold assets]' and to post publication notice … in major publications," specifying a deadline for "interested parties … to submit … responses and objections to the proposed sale order." *Id*. at *13. The product liability claimants here received only "mere publication notice." *Id*. at *26.

Bankruptcy Court Hearing on Sale Order: The bankruptcy court addressed and dismissed 850 objections to the proposed sale order. "Among those objections were arguments against the imposition of a 'free and clear' provision to bar claims against [the buyer] as the successor to [the debtor] … ." *Id*. at *13.

Liabilities Assumed by Buyer: The Sale Agreement between the parties required the buyer, after meaningful negotiations with parties who had received actual notice, to assume "fifteen categories of liabilities," including post-closing accidents, warranty claims and "liability for any Lemon Law claims." *Id*. at *14-15; *59-60. But the key "'free and clear' provision [of the Sale Order] would act as a liability shield to prevent individuals [the plaintiffs here] with claims against [the debtor] from suing [the buyer]." *Id*. at *11. The sale closed in July 2009 and the bankruptcy court confirmed a liquidating Chapter 11 plan for the debtor in March 2011.

Proceedings Below: Individual plaintiffs sued the buyer in April, 2014 in the bankruptcy court, asserting tort damages. The buyer then moved to enforce the Sale Order to enjoin these claims being asserted by the plaintiffs. *Id*. at *25. As noted, "the bankruptcy court held that [the Buyer] could not be sued — in bankruptcy court or elsewhere — for [tort] claims that otherwise could have been brought against [the debtor], unless those claims arose from [the buyer's] own wrongful conduct." *Id*. at *27.

The Second Circuit

The court took a direct appeal from the bankruptcy court's ruling. Its opinion dealt primarily with "the extent to which the bankruptcy court may absolve [the buyer], as a successor corporation, of [the debtor's] liabilities." *Id*. at *28-29. According to the court, if "the Sale Order covers certain claims, then [it] would have to consider whether plaintiffs' due process rights are violated by applying the 'free and clear' clause to those claims." *Id*. at *34. But if the order "did not cover certain claims, ... then those claims could not be enjoined by enforcing the Sale Order and due process concerns would not be implicated." *Id*. at *35.

Ability to Sell Assets Free and Clear

Recognizing that the Code does not define the type of "interest" of which property may be sold free and clear, the court relied on its

earlier *Chrysler* decision for guidance in holding that "successor liability claims are interests." *In re Chrysler LLC,* 576 F. 3d 108, 126 (2d Cir. 2009). *Id*. Although *Chrysler* was vacated by the Supreme Court on mootness grounds, the Second Circuit still found the decision to "have persuasive authority." *Id* . at *38.

Because "successor liability claims are interests," the court reasoned that certain claims "may be barred under Chapter 11 generally." *Id*. at *48. According to the Second Circuit, "a bankruptcy court may approve a 363 sale 'free and clear' of successor liability claims if those claims flow from the debtor's ownership of the sold assets. Such a claim must arise from a (1) right to payment (2) that arose before the filing of the petition or resulted from pre-petition conduct fairly giving rise to the claim. Further, there must be some contact or relationship between the debtor and the claimant such that the claimant is identifiable." *Id*. at *39-40.

Applying this test, the court found that "(1) pre-closing accident claims, [and] (2) economic loss claims arising from the [debtor's defective products] ... are covered by the Sale Order ... ." *Id*. at *40. To the contrary, "independent claims relating only to [the buyer's] conduct and ... Used Car purchasers' claims" were not covered by the Sale Order. *Id* .

Required Notice

Having determined which claims were covered by the Sale Order, the court then addressed the type of notice the claimants "were entitled to as a matter of procedural due process and, ... if they were provided inadequate notice, whether the bankruptcy court erred in denying relief on the basis that most plaintiffs were not 'prejudiced.'" The bankruptcy court, explained the Second Circuit, properly held that the debtor should have provided direct mail notice to vehicle owners because the record showed that it "knew or reasonably should have known about the [defective products] prior to bankruptcy." *Id*. at *47. As the court stated, "[individuals with claims arising out of the defective products] were entitled to notice by direct mail or some equivalent as required by procedural due process." *Id*. at *52.

The court also rejected the bankruptcy court's finding that the claimants had not been prejudiced. The claimants had been deprived of the opportunity, given their possible "negotiating leverage, ... to participate in the proceedings" and negotiate a possible preservation of their claims against the buyer. *Id*. at *61. In the court's view, "there was a reasonable possibility that plaintiffs could have negotiated some relief from the Sale Order." *Id*. at *65.

Finally, the Second Circuit dismissed the bankruptcy court's fear that the debtor faced liquidation if the sale were not approved. In its view, the major participants in the case, including the U.S. Treasury Department, "would have endeavored to address the [defective product] claims in the Sale Order if doing so was good for the [buyer's] business," and that "accommodations could have been made." *Id*. at *66.

Comment

Motors Liquidation does not bar "free and clear" provisions in asset sale orders that are designed to protect buyers against successor liability. Instead, it merely requires adequate notice. As the Second Circuit previously held, Code "§ 363(f) permitted the bankruptcy court to authorize the sale free and clear of [tort claimants'] interest in the property." *Chrysler*, 576 F. 3d at 126. "Both [the Second] and the Third Circuit have continued to cite *Chrysler* favorably." *Id* ., citing *In re N. New England Tel. Operations LLC*, 795 F. 3d 346 (2d Cir. 2015); and *In re Jevic Holding Corp.*, 787 F. 3d 173, 188-89 (3d Cir. 2015) cert. granted, ____ U.S. ______ (June 28, 2016).

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