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Ability to Avoid Successor Liability Pursuant to a §363 Sale In Bankruptcy

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Cite as: *Ability to Avoid Successor Liability Pursuant to a §363 Sale In Bankruptcy*, 9 ST. JOHN'S BANKR. RESEARCH LIBR. NO. 15 (2017).

Introduction

In a case filed under chapter 11 of title 11 of the United States Code (“the Bankruptcy Code”), the company entering bankruptcy, the debtor, usually files a reorganization plan that articulates how the debtor’s assets will be addressed and creditors will be treated.¹ Once a plan is confirmed and becomes effective, the debtor “emerges from bankruptcy with its liabilities restructured along certain parameters.”² This process, however, can take years.³ Conversely, a sale of substantially all of the debtor’s assets, pursuant to 11 U.S.C. § 363, will often “occur on a very expedited basis.”⁴ In the case of the GM bankruptcy, the § 363 sale closed in a matter of weeks.⁵ The § 363 sale procedure is expeditious because the debtor “does not truly reorganize” but rather, after obtaining the bankruptcy court’s approval, “sells its primary assets to a successor corporation,” which can immediately begin operating the business.⁶ Meanwhile, the debtor is left

¹ See *In re Motors Liquidation Co.*, 829 F.3d 135, 145 (2d. Cir. 2016) (hereinafter “*Motors Liquidation*”).

² *Id.*

³ See *id.*

⁴ *In re Family Snacks Inc.*, 257 B.R. 884, 897 (B.A.P. 8th Cir. 2001).

⁵ See *Motors Liquidation*, 829 F.3d at 145.

⁶ *Id.*

with any residual assets and liabilities and, as seen in *Motors Liquidation*, will often proceed to arrange a plan for liquidation.⁷

An additional benefit of § 363 is that the sale can be “free and clear of any interest in such property.”⁸ After the Second Circuit’s recent decision in *Motors Liquidation*, however, there is concern about the efficacy of § 363(f)’s “free and clear” provision.⁹ Specifically, this holding raises the issue of whether or not § 363(f) can validly prevent third parties from asserting successor liability claims against those who purchase businesses out of bankruptcy.

This article explains how, going forward, courts will likely address the successor liability of purchasers of assets pursuant to § 363 sales. In essence, the outcome will be largely dependent on how a particular court interprets the meaning and scope of the term “interest” in § 363(f). Section I explains both the broad and narrow definitions that are currently in use, with an emphasis on the more widely used broad definition and the Second Circuit’s reasoning for applying it in *Motors Liquidation*. Section II discusses the implications of each definition, respectively, in terms of the strength of the § 363 liability shield. Section III addresses the Due Process Clause concerns raised by the prevailing broad definition, and the impact of *Motors Liquidation*’s outcome in relation to due diligence standards. The article concludes with an assessment of the extent to which successor liability can be avoided using a § 363 sale.

⁷ See *id.* at 146.

⁸ 11 U.S.C. § 363(f).

⁹ See 829 F.3d 135 (holding that the free and clear provision in the Sale Order, which governed transfer of Old GM’s assets to New GM, could not absolve new GM of liability arising out of economic loss from ignition-switch defects); see also Trevor B. Swett III, “Free and Clear” Bankruptcy Sale Orders and State-Law Successor Liability Claims: The Overlooked Question of Preemption (2017) at 3 (stating that the *Motors Liquidation* ruling “will predictably stimulate challenges” to free and clear sale orders entered into “when undisclosed or after-arising liabilities of the debtors emerge.”)

I. Free and Clear of What?

Under § 363(f), a sale of property can be “free and clear of any interest in such property” if: (1) applicable nonbankruptcy law permits such sale; (2) the party asserting the interest consents; (3) “such interest is a lien and the price at which such property is sold is greater than the aggregate value of all liens on such property; (4) such interest is in bona fide dispute; or” (5) the interest holder “could be compelled in a legal or equitable proceeding, to accept a money satisfaction of such interest.”¹⁰ There is a considerable amount of ambiguity surrounding the meaning and scope of this provision because “interest” is not defined in the Code.¹¹ Accordingly, bankruptcy courts around the country disagree about whether it should have a broad or narrow definition.¹² Some courts have limited “interest” to “*in rem* interests or interests that run with the property.”¹³ Nevertheless, courts “seem[s] to be in favor of a broader definition that encompasses other obligations that may flow from ownership of the property.”¹⁴

¹⁰ 11 U.S.C. § 363(f).

¹¹ See 3 *Collier on Bankruptcy* 363.06 [1].

¹² See *In re Chrysler LLC*, 576 F.3d 108, 124 (2d Cir. 2009).

¹³ Larry Schnapf, *363 Sales Continue to Play Important Role in Corporate Transactions*, ABA Business Law Section (2010); See *In re Wolverine Radio Corp.*, 930 F.2d 1132 (6th Cir. 1991) (holding that an experience rating, used to gauge an employer’s rate of contribution, is not an interest within the meaning of § 363(f) because it is a “general unsecured interest” that does not “attach to property ownership so as to cloud its title”); see also *In re Fairchild Aircraft Corp.*, 184 B.R. 910 (Bankr. W.D. Tex. 1995) (asserting that § 363(f) does not authorize sales free and clear of *any interest*, but rather of “any interest *in such property*,” the latter three words limiting the interests impacted to *in rem* interests that have attached to the property, not *in personam* liabilities).

¹⁴ 3 *Collier on Bankruptcy* 363.06 [1]; see *In re Leckie Smokeless Coal Co.*, 99 F.3d 53 (4th Cir. 1996) (holding Coal Act premium payment obligations were “interests” because “while the plain meaning of the phrase ‘interest in such property’ suggests that not all general rights to payment are encompassed by the statute, Congress did not expressly indicate, by employing such language, it intended to limit the scope...to *in rem* interests, strictly defined”); see also *In re Trans World Airlines, Inc.*, 322 F.3d 283 (3d Cir. 2003) (holding that Plaintiff’s interests in travel vouchers that were issued to settle employment discrimination claims are not *in rem* interests but nevertheless are interests under §363(f) “in the sense that they arise from the property being sold.”); see also *In re PBBPC, Inc.*, 484 B.R. 860, (B.A.P. 1st Cir. 2013) (“We conclude that the more expansive reading of the term ‘any interest’ advanced by the Seventh, Fourth, Third, and Second Circuits...is more consistent with the language of the Bankruptcy Code and the policy expressed in § 363”). Given this interpretation’s pervasiveness, the trend seems unlikely to reverse itself. See Kuny, George, *Misinterpreting Bankruptcy Code Section §363(f) and Undermining the Chapter 11 Process*, 76 AM. BANKR. L.J. 235, 243 (2002) (“Even though § 363’s language does not support the breadth of interpretation that courts have imposed, this trend appears unlikely to reverse itself.”).

In *Motors Liquidation*, the court adopted this broader interpretation of “interest” holding that successor liability claims are interests under § 363 if they qualify as “claims” under the Bankruptcy Code.¹⁵ The court recognized that §363(f) does not “expressly invoke the Chapter 11 definition of claims,” nonetheless, given the expanded role of §363 in bankruptcy proceedings, it makes sense to ‘harmonize’ Chapter 11 reorganizations and §363 sales ‘to the extent permitted by the statutory language.’”¹⁶ Citing the relevant case law defining “claims,” the court summarized:

“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 (1) a 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.”¹⁷

The view that “claims” qualify under § 363(f) as “interests” is pervasive and loudly defended.¹⁸

II. Implication of Defining “Interests” to Include “Claims” in Terms of Successor Liability

The prevailing broad definition of “interest” that encompasses “claims,” allows § 363(f) to “cut off successor liability that, under applicable nonbankruptcy law, could lie against the purchaser” after a § 363 sale.¹⁹ Generally, a purchaser of assets does not assume the liabilities of the seller absent an express agreement to do so or an exception to the rule.²⁰ “Successor liability

¹⁵ See 829 F.3d 135, 155 (2d Cir. 2016).

¹⁶ *Id.* (quoting *In re Chrysler LLC*, 576 F.3d 108 (2d Cir. 2009)); see also 11 U.S.C. § 101(5) (defining “claim” as “any right to payment, whether or not such right is reduced to judgment, liquidation, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured).

¹⁷ 829 F.3d at 156.

¹⁸ See Kuny, George, *Misinterpreting Bankruptcy Code Section §363(f) and Undermining the Chapter 11 Process*, 76 Am. Bankr. L.J. 235, 258 (2002) (“State and federal decisions holding a bankruptcy purchaser liable as a successor of the debtor are directly at odds with Congressional intent to allow a debtor to sell its assets free and clear of all claims and interests therein...Absent evidence of collusion or strong public policy concerns enunciated by Congress, a bankruptcy purchaser should not be held liable for a debtor's obligations”).

¹⁹ See *id.* at 259.

²⁰ See 3 *Collier on Bankruptcy* 363.06 [7].

is an equitable exception to this rule.”²¹ Though the doctrine is a creature of state law and thus varies from state to state, generally, successor liability does not attach unless: “(1) the purchaser expressly or impliedly assumed the liability; (2) the transaction amounted to a merger or consolidation of the businesses; (3) the purchaser was merely a continuation of the seller; or (4) the transaction was entered into fraudulently in order to avoid liability for the obligations.”²² In sum, “successor liability [claims] arises out of the *actions* of the purchaser, *not* the property itself” and therefore, “are not properly viewed as *in rem* claims.”²³ Thus, jurisdictions that strictly define “interest” as *in rem*, would not use §363(f)’s liability shield to block successor liability claims that would otherwise exist under applicable nonbankruptcy statutory and common law.²⁴

In contrast, within jurisdictions that have concluded that claims are a subset of “interest” under §363(f), “the dominant interpretation is that § 363(f) can be used to sell property free and clear of claims that could otherwise be assertable against the buyer of the assets under the common law doctrine of successor liability.”²⁵ Similarly, courts have also used § 363(f) to bar statutory successor liability claims.²⁶

²¹ *Id.*

²² *Id.*

²³ Kuny, 76 AM. BANKR. L.J. at 260-61; *See also In re Fairchild Aircraft Corp.*, 184 B.R. at 920-21 (“[W]hile successor liability may give a party an alternative entity from whom to recover, the doctrine does not convert the claim to an *in rem* action”).

²⁴ *See* Kuny, 76 AM. BANKR. L.J. at 263; *see also* Nathan F. Coco, Note, *An Examination of Successor Liability in the Post-Bankruptcy Context*, 22 J. Corp. L. 345, 356 (1997) (“Because successor liability is by its nature an in personam claim, it is not extinguished by the mere transfer of assets achieved by §363(f)”).

²⁵ Kuny, 76 AM. BANKR. L.J. at 267; *See Forde v. Kee-Lox Mfg. Co.*, 437 F. Supp. 631 (W.D.N.Y. 1977) (holding that sale free and clear bars civil rights suit based upon pre-sale conduct of businesses, *aff’d*, 584 F.2d 4 (2d Cir. 1978); *see also In re. All. Am. of Ashburn, Inc.*, 56 B.R. 186 (Bankr. N.D. Ga. 1986) (holding that assets had been sold free and clear of interests, including successor liability claims based on cases concluding that claims are a subset of interest), *aff’d*, 805 F.2d 1515 (11th Cir. 1986).

²⁶ *See* Kuny, 76 AM. BANKR. L.J. at 268.

III. Due Process Concerns

Allowing §363(f) sales to be free and clear of successor liability claims gives rise to due process issues.²⁷ This is because, “[g]enerally, legal claims are sufficient to constitute property such that a deprivation would trigger due process scrutiny.”²⁸ Moreover, “an elementary and fundamental requirement of due process...is notice reasonably calculated, under all the circumstances, to appraise interested parties of the pendency of the action and afford them an opportunity to present their objections.”²⁹ Due process was squarely at issue in *Motors Liquidation*, and ultimately dictated the outcome because absent a finding that the ignition switch plaintiffs’ due process rights were violated, the free and clear provision of the sale order would have barred their claims.³⁰ The court reasoned that because of ample evidence that Old GM knew, or at the very least, should have known of the ignition-switch defects at the time of the § 363 sale, the plaintiffs were entitled to actual notice, not merely the notice by publication that they received.³¹ Going forward, this outcome will serve to set a higher due diligence standard for purchasers.³²

Conclusion

The extent to which a buyer can avoid successor liability by purchasing a debtor’s assets free and clear under § 363(f) of the Code, depends on whether the adjudicating court limits the

²⁷ See *id.* at FN 107.

²⁸ *Motors Liquidation*, 829 F.3d at 158 (citing *N.Y. State Nat’l Org. for Women v. Pataki*, 261 F.3d 156, 169-70 (2d Cir. 2001)).

²⁹ *Id.* (citing *Mullane v. Cent. Hanover Bank & Tr. Co.*, 339 U.S. 306, 314 (1950)).

³⁰ See *Motors Liquidation*, at 158, 166.

³¹ See *id.* at 159-60.

³² Randles, Jonathan, *2nd Circ. Says ‘Buyer Beware in GM Ruling on Ch. 11 Sale*, Law 360, July 15, 2016, https://www.law360.com/articles/817545/2nd-circ-says-buyer-beware-in-gm-ruling-on-ch-11-sale?article_related_content=1 (suggesting that before entering a § 363 sale agreement, a potential purchaser should “scrutinize a debtor’s business” to ensure debtors are forthright about any underlying issues and to be sure all known and potential claimants are notified of the potential sale”).

definition of “interests” to *in rem* interests. If so, the § 363(f) liability shield will not prevent third parties from bringing successor liability claims. However, to date, the notion that a buyer *can* avoid successor liability by purchasing a debtor’s assets free and clear under §363, “has largely prevailed in the courts.”³³ That is because courts more frequently define “interests” to include all interests that arise from the property being sold, thus encompassing successor liability claims. However, as demonstrated by *Motors Liquidation*, even if a court adopts the broader definition, successor liability can still be imposed, notwithstanding a valid liability shield, if any third parties with “claims” that the debtor is aware of are not provided notice that complies with due process.

³³ Swett III at 3.