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Section 363(f) Sales May Not Be So Free and Clear After All

Purchasers of assets, whether such assets are to be purchased in or out of bankruptcy, are generally concerned about potential successor liability claims. The Bankruptcy Code provides some reassurance to purchasers by allowing property of a debtor to be sold free and clear of claims, liens and other interests.[1] In March 2012, however, the Southern District reiterated that section 363(f) of the Bankruptcy Code may not eliminate all potential personal injury successor liability claims. In its ruling, the Court held that section 363(f) may not be used to extinguish state law claims that arise from a debtor's prepetition conduct where such conduct does not result in injury until after the completion of the debtor's bankruptcy case.

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In *In re Grumman Olson Indus., Inc.*, a manufacturer of truck parts, filed for Chapter 11 bankruptcy protection on December 9, 2002 in the Southern District of New York (the "Bankruptcy Court").[2] On July 1, 2003, the Bankruptcy Court entered a sale order pursuant to section 363(f) of the Bankruptcy Code authorizing the sale of certain of the Debtor's assets to MS Truck Body Corp., a predecessor to Morgan Olson L.L.C. ("Morgan").

The Sale Order sought to limit Morgan's potential exposure to successor liability claims in various ways, including by providing that the sale of the assets was "free and clear of all … claims … and other interests … and all debts arising in any way in connection with any acts of the Debtor." The Sale Order further provided that the sale of the assets would not subject Morgan to "any liability for any claims against the Debtor … including, but not limited to, claims for successor or vicarious liability …" The Bankruptcy Court thereafter entered an order confirming the Debtor's liquidating plan on October 31, 2005 and entered an order closing the Debtor's bankruptcy case on December 29, 2006.

In 2008 a truck driven by Denise Frederico was involved in a collision causing injury to Frederico. The truck had been manufactured, designed and/or sold by Grumman in 1994. Frederico commenced a personal injury action in New Jersey Superior Court against Morgan alleging that the truck was defective and that Morgan should be held liable to Frederico under a theory of successor liability.[3] In response, Morgan brought an adversary proceeding against Frederico in the Bankruptcy Court seeking declaratory and injunctive relief barring Frederico from bringing her claims against Morgan. Morgan argued that the Sale Order insulated it from successor liability claims, including claims like the ones being brought by Frederico. The Bankruptcy Court disagreed with Morgan and determined that the Sale Order did not exonerate Morgan from liability to Frederico.[4] Morgan then brought an appeal before the Court.

One of the issues before the Court on appeal was whether the Sale Order could be used to extinguish claims of third parties where the injury occurred after the close of the bankruptcy case and where such parties, as future claimants, did not receive any notice of or opportunity to participate in the bankruptcy case. The Court held that because Frederico did not receive any notice or opportunity to participate in the bankruptcy case, Frederico's due process rights would be violated if she were barred from bringing her claims against Morgan.

Section 363(f) of the Bankruptcy Code provides, in relevant part, that a debtor's property may be sold "free and clear of any interest in such property of an entity other than the estate" if certain conditions are met, as specified in section 363(f).[5]

As a preliminary matter, the Court stated that although section 363 refers only to interests of property itself, the statute does allow for the extinguishment of claims that arise from the property being sold. The dilemma before the Court, however, was to determine the interplay between section 363(f) and the occurrence of future claims for injuries that had not yet occurred at the time that the Sale Order was entered.

In reaching its decision, the Court first reviewed the definition of the term "claims" under section 101(5) of the Bankruptcy Code.[6] The Court acknowl-

edged that the Second Circuit has generally interpreted the term "claims" broadly.[7] Despite such a broad interpretation, however, the Second Circuit has generally been in agreement with other courts that future claims may not always be discharged in a debtor's bankruptcy case.

In addressing whether future claims can be discharged in a bankruptcy case, the Court looked to the reasoning and analysis presented in *In re Chateaugay Corp*.[8] In that case, the court found that future tort claims should be subdivided into two categories. The first category relates to contingent, unmatured claims which often arise in cases where the claimants were exposed to the debtor's products prepetition but such claimants had not yet discovered their injuries, such as in asbestos cases. Such claimants do hold a "claim" against the debtor at the time of the sale as such term is defined in the Bankruptcy Code and a sale order can therefore protect a debtor against this type of future tort claim.

The second category of future tort claims comprises those where the claimants are injured after the completion of the sale as a result of a defective product manufactured or sold by the debtor prior to the commencement of its bankruptcy case. This is the category in which the Court classified Frederico's claim.

In the *Chateaugay* case, the court adopted the fair contemplation test pursuant to which "a contingent or unmatured obligation is a 'claim' if the occurrence of the contingency or future event that would trigger liability was within the actual or presumed contemplation of the parties at the time the original relationship between the parties was created."[9] Applying the *Chateaugay* test, the Court found that Frederico's claim was not a claim within section 101(5) of the Bankruptcy Code because Frederico did not have any prepetition relationship with Grumman. As a result, Frederico did not hold a "claim" against the estate at the time that the Sale Order was entered and Frederico's claim could therefore not be discharged by the Sale Order.

The Court further found that section 363(f) of the Bankruptcy Code requires notice and a hearing prior to the sale of a debtor's property free and clear. In this case, Federico, as a future claimant, had not received notice because "at the time of the bankruptcy, there was no way for anyone to know that the Fredericos ever would have a claim."[10] As a result, the Court found that Frederico's right to due process would be violated if she were prevented from seeking redress of her claims under successor liability laws.

The *Grumman* case provides a useful reminder that the "free and clear" language of section 363(f) is not an automatic means of avoiding all potential successor liability claims. Rather, purchasers should undertake a meaningful due diligence process prior to the purchase of any assets to ensure that they are not unknowingly taking on potential liabilities. The *Grumman* case likewise should prompt purchasers to fully review the terms of the proposed sale order and understand the risks that may arise under such order.

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1. 11 U.S.C. § 363(f).
2. *Morgan Olson L.L.C. v. Frederico (In re Grumman Olson Indus., Inc.)*, No. 11 Civ. 2291, 2012 U.S. Dist. LEXIS 44314 (S.D.N.Y. Mar. 29, 2012) (JPO).
3. Frederico based her argument upon New Jersey's product-line exemption to the general rule against successor liability which states that "by purchasing a substantial part of [a] manufacturer's assets and continuing to market goods in the same product line," the purchasing company can be held liable as a successor for defects in the predecessor's products. *Lefever v. K.P. Hovnanian Enters., Inc.*, 160 N.J. 307, 310 (N.J. 1999).
4. *Morgan Olson L.L.C. v. Frederico (In re Grumman Olson Indus., Inc.)*, 445 B.R. 243 (Bankr. S.D.N.Y. 2011).
5. 11 U.S.C. § 363(f).
6. The Bankruptcy Code defines the term "claim" as a (A) 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; or (B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured. 11 U.S.C. §101(5).
7. *See, e.g., In re Motors Liquidation*, 428 B.R. 43, 57-58 (S.D.N.Y. 2010).
8. *United States v. LTV Corp. (In re Chateaugay Corp.)*, 944 F.2d 997 (2d. Cir. 1991).
9. *Id.* at 1004 (internal citations omitted). *See also Epstein v. Official Committee of Unsecured Creditors (In re Piper Aircraft, Corp.)*, 58 F.3d 1573 (11th Cir. 1995) (adopting and applying a modified version of the fair contemplation test).
10. *Id.* at 708.

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