SUCCESSOR LIABILITY IN 363(f) SALES

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Hon. Erithe A. Smith
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Among the many tools available to debtors and trustees in bankruptcy cases is the ability to sell property of the bankruptcy estate free and clear of interests pursuant to § 363(f) of the Bankruptcy Code.[1] A sale "free and clear" typically provides a "win-win" opportunity for both the estate and the purchaser. Property free of liens, encumbrances, and interests is attractive to potential purchasers and, at least in theory, permits the maximum recovery to the estate through an increased sale price. Simply stated, prospective purchasers are more likely to bid on "clean" assets than assets that are subject to claims or interests, and will pay a higher price for the former.

While a buyer generally does not become liable to the seller's creditors by purchasing its assets, there are certain circumstances under which a buyer, as successor to the assets, may be held liable for the claims of the seller under state or federal nonbankruptcy law. Consequently, one important objective in obtaining a "free and clear" bankruptcy sale order is to cut off, or at least limit, such successor liability. Whether this goal is actually attainable under § 363(f) is a matter of continuing debate among courts and commentators and is the focus of the discussion herein.

I. OVERVIEW OF THE DOCTRINE OF SUCCESSOR LIABILITY

Under ordinary principals of state corporate law, a corporation that purchases assets from another corporation is generally not responsible for the liabilities of the seller, even if the transaction includes the acquisition of all the seller's assets.[2] This is the general rule. The judicially created doctrine of successor liability is the exception to the rule.[3] Although exception theories vary among the various jurisdictions, both state and federal, the most commonly stated grounds for imposing successor liability are:

- there is an express or implied agreement of assumption;
- there is effectively a consolidation or merger of the two corporations;
- the purchasing corporation is a mere continuance of the seller; or
- the transfer of assets is for the fraudulent purpose of escaping liability for the selling corporation's debts.[4]

Express or Implied Assumption of Liabilities

Obviously, if the purchaser expressly assumes certain liabilities of the seller, the

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[1] 11 U.S.C. § 363(f).

[2] *See Conway v. White Trucks (In re Conway)*, 885 F.2d 90, 93 (3rd Cir. 1989) (citing *Polius v. Clark Equipment Co.,* 802 F.2d 75, 77 (3rd Cir. 1986); *Ray v. Alad Corporation*, 19 Cal. 3d 22, 28, 560 P.2d 3, 136 Cal. Rptr. 574 (1977).

[3] *Id.*

[4] *See* Marie T. Reilly, "Making Sense of Successor Liability," 31 Hofstra L.Rev.745, 746 (2003); 15 William Meade Fletcher, Fletcher Cyclopedia of the Law of Private Corporations, § 7122 at 218 (perm.ed., rev. vol. 1999).

purchaser is responsible for such obligations. Less obvious, of course, is the implicit assumption of liability. In determining whether a purchaser has assumed certain liabilities, courts will generally review the purchase agreement for ambiguous language, as well as the post-acquisition conduct of the purchasing corporation.[5]

Consolidation or Merger (*De Facto Merger)*

An asset transfer may be deemed the equivalent of a statutory merger where the purchasing corporation is substantively indistinguishable from the selling corporation following the transfer. The "badges" of a *de facto* merger include 1) continuity of the business enterprise of the selling corporation, e.g., same management, personnel, assets and physical location; 2) continuity of shareholders, i.e., the shareholders of the seller become shareholders of the purchaser; 3) the dissolution of the seller; and 4) the buyer's assumption of those liabilities of the seller that are necessary for the continued operation of the seller's business operations.[6]

Mere Continuation

The mere continuation exception is conceptually similar to the *de facto* merger exception in that continuity of ownership and business operations are critical factors. However, the test for mere continuation may vary significantly among courts. For example, some courts invoke the exception where the seller corporation is dissolved and the purchaser's officers, directors and shareholders are identical to the seller's officers, directors and shareholders,[7] while others require a showing that either no adequate consideration was given for the seller's assets that could be made available for payment of the claims of unsecured creditors or one or more persons were officers, directors or stockholders of both corporations.[8] Still others employ a much broader "continuity of enterprise" test which encompasses a wide variety of factors, including whether the seller corporation is dissolved, there is common identity of officers, directors and shareholders, there is continuation of the business at the same location, there is common identity of supervisory personnel, there is continuity of assets and business operations, the business name is retained, and the acquiring entity holds itself out as a continuation of the previous

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[5] *See* Solow and Israel, "Buying Assets in Bankruptcy: A Guide to Purchasers," 10 J. Bankr. L. & Prac. 87, 94.

[6] Id. *See also, Ray v. Alad Corporation*, 19 Cal. 3d at 28 ("This [consolidation or merger] exception has been invoked where one corporation takes all of another's assets without providing any consideration that could be made available to meet claims of the other's creditors (*Malone v. Red Top Cap Co.* (1936) 16 Cal.App.2d 268, 272-274 [60 P2d 543]) or where the consideration consists wholly of shares of the purchaser's stock which are promptly distributed to the seller's shareholders in conjunction with the seller's liquidation [citation omitted]")

[7] *Gallenberg Equipment, Inc. v. Agromac Intern., Inc.*, 10 F. Supp. 2d 1050, 36 U.C.C. Rep. Serv. 2d 596 (E.D. Wis. 1998), decision aff'd, 191 F.3d 456 (7th Cir. 1999); *Travis v. Harris Corp*., 565 F.2d 443, 446 (7th Cir. 1977).

[8] *Ray v. Alad Corporation*, 19 Cal.3d at 29.

business enterprise.[9]

Fraudulent Transfer

This exception is applied less frequently than the others and typically arises when a corporation purchases all or substantially all of the assets of the seller for insufficient consideration. The transaction may be deemed fraudulent as to the creditors of the selling corporation, whether or not the parties actually had the intent to defraud.[10]

Product Line

In addition to the foregoing exceptions, a handful of states have recognized the so-called product line exception as a means to imposing liability on the successor corporation. This exception is premised on the notion that liability follows the product line, i.e., if the buyer continues to manufacture or distribute the same product line under the same name as the seller, the buyer may be liable for damages arising from the product line, even if the event giving rise to liability occurred prior to the sale.[11] States recognizing this exception include California, Michigan, New Jersey, Pennsylvania, Washington, Connecticut and Massachusetts.[12]

II. THE AUTHORITY OF BANKRUPTCY COURTS TO APPROVE THE SALE OF ASSETS FREE AND CLEAR OF SUCCESSOR LIABILITY CLAIMS UNDER § 363(f)

Bankruptcy estate assets may be sold free and clear of claims or interests either by motion pursuant to § 363 or through the confirmation of a Chapter 11 plan.[13] Under §

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[9] *U.S. v. Mexico Feed and Seed Co., Inc.*, 980 F.2d 478, 35 Env't. Rep. Cas. (BNA) 1761, 24 Fed. R. Serv. 3d 1032, 23 Envtl. L. Rep. 20461 (8th Cir. 1992); *Kleen Laundry and Dry Cleaning Services, Inc. v. Total Waste Management Corp.*, 817 F. Supp. 225, 39 Fed. R. Evid. Serv. 138, 24 Envtl. L. Rep. 21411 (D.N.H. 1993).

[10] 15 Fletcher Cyclopedia of Private Corp. § 7122.40, citing, among others, *Ed Peters Jewelry Co., Inc. v. C & J Jewelry Co., Inc.*, 215 F.3d 182 (1st Cir.2000) (applying Rhode Island law) and *Fiamingo Moving & Storage Co., Inc. v. Detroit Diesel Allison, Division of General Motors Corp.*, 750 F. Supp 171 (Dist. M.D. ¶. 1990)

[11] 15 Fletcher Cyclopedia of Private Corp. § 7122.40

[12] *Id.*; *See e.g., Ray v. Alad Corporation*, 19 Cal. 3d at 34 (By taking over and continuing the established business of producing and distributing products, a purchasing corporation becomes an integral part of the overall producing and marketing enterprise that should bear the cost of injuries resulting from defective products previously manufactured and distributed by the selling corporation); *Dawejko v. Jorgensen Steel Co.*, 434 A.2d 106, 290 Pa.Super. 15, (Pa.Super.Ct.1981) (a purchaser of corporate assets who undertakes essentially the same manufacturing operation as the seller is strictly liable for injuries caused by units manufactured and distributed by its predecessor.

[13] *See*, 11 U.S.C. §§ 1123(a)(5)(D) and 1123(b)(4) (recognizing the sale of property of the estate), as well as §§ 1141(b) and (c) (providing for postconfirmation vesting of property of the estate in the debtor free and clear of claims and interests).

363(b), the trustee or debtor in possession may, after notice and hearing, sell property of the estate outside the ordinary course of business. 11 U.S.C. § 363(b). Section 363(f) authorizes the property to be sold "free and clear of any interest in such property of an entity other than the estate" if any one of the following five conditions is met:

1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;
2) such entity consents;
3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;
4) such interest is in bona fide dispute; or
5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.[14]

For purposes of this discussion, the critical inquiry is whether an entity purchasing property from a bankruptcy estate may eliminate, or at least limit, its exposure to successor liability claims by acquiring the property "free and clear" pursuant to § 363(f). Put another way, can a purchaser insulate itself and the purchased assets from the claims of third parties (i.e., creditors of the debtor/seller) by "cleansing" the assets with a 363(f) sale order? Do the "magical powers" of such an order extend to successor liability claims which have not yet arisen or to claimants who are unknown at the time of the sale? Assuming the answers to all of the above is "yes," can the purchaser look to the bankruptcy court to enforce the order after the bankruptcy case has been fully administered?

B. When Does a Claim Arise?

It stands to reason that in order for a claim to be extinguished through a 363(f) sale, it must "exist" in the first instance. So, when exactly does a claim arise for bankruptcy purposes? The answer to this question may be critical in assessing the level of protection available to a purchaser concerned about successor liability. Unfortunately, there is no single universal test employed by courts to make this important determination. Over the years, four general standards have evolved: the accrued state law test, the debtor's conduct test, the pre-petition relationship test, and the fair contemplation test.

1. The Accrued State Law Test

Under this test adopted by the Third Circuit in *In re Frenville, Co.*[15], a claim arises at the time the cause of action accrues under applicable state law. This standard has been widely rejected by courts as imposing too narrow an interpretation of the term.[16]

2. The Debtor's Conduct Test

[14] 11 U.S.C. § 363(f)

[15] *In re Frenville Co.*, 744 F.2d 332 (3d Cir. 1984), *cert. denied*, 469 U.S. 1160 (1985)

[16] *See, e.g., In re Parks*, 281 B.R. 899 (Bankr. E.D. Mich. 2002); *In re Black*, 70 B.R. 645 (Bankr. D. Utah 1986).

Under this approach, the claim arises at the moment the pre-petition conduct of the debtor necessary to give rise to the alleged liability was performed, even if the actual injury is not suffered until later.[17] This theory has been adopted by a number of mass tort cases and is decidedly unfavorable to the injured plaintiff who may not suffer the injury until well after the debtor has received a discharge and the asset purchaser has been absolved of successor liability.

3. The Pre-petition Relationship Test

The pre-petition relationship test is a slight variation of the debtor's conduct test. Under this standard, a claim arises if the pre-petition conduct of the debtor necessary to give rise to the alleged liability has occurred ,*and* there is a pre-petition relationship between the debtor and the claimant (e.g., by contact, exposure, impact, privity, etc.).[18]

4. The Fair Contemplation Test

Under this approach, the existence of a pre-petition relationship alone is insufficient to give rise to a claim, even if the relevant conduct of the debtor occurred pre-petition. The claim must have also been within the fair contemplation of the parties prior to the bankruptcy.[19]

B. Does A Sale Free and Clear of "An Interest in Property" Pursuant § 363(f) Include Successor Liability Claims?

As previously noted, § 363(f) permits the sale of property of the estate "free and clear of an *interest* " in the property. "Interest," however, is not defined in the Bankruptcy Code. In order for § 363(f) to have any application to the extinguishment of successor liability claims, the term must necessarily be read to include pre-petition unsecured claims of the debtor. Courts and commentators alike have struggled with the scope of the term "interest in property" in the context of § 363(f).[20] While some courts have narrowly construed "interest in property" to mean *in rem* interests, such as liens[21], the trend seems

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[17] *See, e.g., Watson v. Parker* (*In re Parker)*, 264 B.R. 685 (10th Cir. BAP 2001); *In re Johns-Manville Corp.,* 57 B.R. 680 (Bankr.S.D.N.Y. 1986); *In re A.H. Robins Co., Inc.,* 63 B.R. 986 (Bankr. E.D. Va. 1986).

[18] *See, e.g., United States v. LTV Corp. (In re Chateaugay Corp)*, 944 F.2d 997 (2d Cir. 1991); *Epstein v. Official Committee of Unsecured Creditors (In re Piper Aircraft Corp.)*, 58 F.2d 1573 (11th Cir. 1995).

[19] *In re Jensen*, 995 F.2d 925 (9th Cir. 1993)

[20] For thorough and thoughtful analysis of this issue, see George W. Kuney, "Misinterpreting Bankruptcy Code Section 363(f) and Undermining the Chapter 11 Process," 76 Am. Bankr. L.J. 235, 261 (2002) ("Successor liability arises out of the *actions* of the purchaser, *not* the property itself" and, therefore, a successor liability claim is not an *in rem* interest in property that can be stripped under § 363(f))

[21] *See, e.g., In re Fairchild Aircraft Corp.*, 184 B.R. 910, 917-919 (Bankr. W.D. Tex. 1995) (363(f) applies only to *in rem* interests which have attached to the property either "by debtor's consent to a security interest or the creditor's attachment of the property resulting in a lien." The products liability claimants did not

to be toward a more expansive interpretation of the term which "encompasses other obligations that may flow from ownership of the property", including unsecured claims."[22]

In *In re WBQ Partnership*,[23] the debtor, a nursing home operator, moved to sell all of its assets free and clear of the state's statutory right to recover depreciation overpayments from either the debtor or the purchaser. Overruling the state's objections, the bankruptcy court held that the state's right to recover the overpayments was an extinguishable "interest" within the meaning of § 363(f) since "interest" extends beyond "mere liens."[24] More specifically, the court reasoned that since "lien" is a defined term under the Bankruptcy Code, Congress could have used the term "lien" instead of "interest" had it intended to restrict the scope of 363(f) to liens.[25] While on the one hand recognizing the nature of the state's right to payment as unsecured, the court noted that the government's statutory right under state law to seek payment from the buyer upon the sale of the assets was something "more than a mere claim."[26]

In the frequently cited *Leckie Smokeless Coal* case,[27] the debtor sought a declaration from the bankruptcy court that the purchaser of its assets, as successor in interest, would not be liable for the debtor's future premium obligations to certain retirement benefit plans required under the Coal Act.[28] Stated otherwise, the assets could be sold free and clear of the claims of the plans pursuant to § 363(f). The plan representatives argued that since the Coal Act obligations to pay premiums were not an encumbrance on the assets, were not enforceable through an *in rem* action, and did not arise from an ownership interest in the assets, the obligations were not "interests in property" within the meaning of 363(f). The Fourth Circuit rejected the arguments, observing that while the phrase "interest in property" could not be read so broadly as to include any and all general

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have an *in rem* interest in the purchased assets that could be extinguished under 363(f))*; In re White Motor Credit Corp.*, 75 B.R. 944, 948 (Bankr. N.D. Ohio 1987) ("General unsecured claimants including tort claimants, have no specific interest in a debtor's property. Therefore, section 363 is inapplicable for sales free and clear of such claims."); and *In re New England Fish Co.*, 19 B.R. 323, 326 (Bankr. W.D. Wash. 1982) (Civil rights claimants of the debtor do not have an "interest" in property within the meaning of 363(f)).

[22]*See In re Trans World Airlines, Inc.,* 322 F.3d 283, 289 (3rd Cir. 2003), citing 3 Collier on Bankruptcy ¶ 363.06[1]; *In re Leckie Smokeless Coal Co.,* 99 F.3d 573 (4th Cir. 1996); *In re Medical Software* Solutions, 286 B.R. 431, 446-447 (Bankr. D. Utah 2002); In *re WBQ Partnership*, 189 B.R. 97, 105 (Bankr. E.D. Va. 1995); *In re All American of Ashburn, Inc.*, 56 B.R. 186, 190 (Bankr. N.D. Ga. 1986).

[23]189 B.R. 97.

[24]189 B.R. at 105.

[25]*Id.*

[26]*Id.*

[27]*United Mine Workers of America 1992 Benefit Plan v. Leckie Smokeless Coal Company (In re Leckie Smokeless Coal)*, 99 F.3d 573 (4th Cir. 1996) cert. denied, 117 S.Ct. 1251 (1997).

[28]Coal Industry Retiree Health Benefit Act of 1992, 26 U.S.C. §§ 9701-9722.

rights to payment, neither could it be interpreted so strictly as to include only *in rem* interests.[29] The court concluded that because there was a relationship between the right to demand payment of the premiums and the use to which debtor put the assets (coal-mining industry), the plan had "interests" in the assets within the meaning of 363(f).

In *In re Medical Software Solutions*, a recent case involving an all asset sale to a corporate insider, the bankruptcy court approved the sale free and clear of successor liability claims over the objection of the creditor asserting such claims.[30] Relying on *White Motor Credit Corp and WBQ Partnership*, the court summarily held that bankruptcy courts have the authority to order the sale of assets free and clear of successor liability claims to good faith purchasers in order to maximize the value of the assets for the estate.[31]

Most recently, the Third Circuit in *In re Trans World Airlines, Inc.*[32] affirmed the debtor's sale of its ongoing business free and clear of successor liability and joined the Fourth Circuit in holding that, for purposes of 363(f), "interest in property" could be read broadly enough to include an interest that could otherwise "travel with the property," even if that interest is a general unsecured claim.[33]

Prior to the bankruptcy filing (its third), TWA had entered into a court approved class action settlement of more than two thousand sex discrimination claims. The settlement required TWA to provide travel vouchers to class members and their families over the life of the class members. In addition, twenty-nine charges alleging various other violations of several federal employment discrimination statutes had been filed with the EEOC, although no litigation had been commenced as of the filing.

The bankruptcy court approved the sale of substantially all of TWA's assets to American Airlines free and clear of any successor liability of American for TWA's obligations under the travel voucher program and for the contingent EEOC claims. Further, the bankruptcy court's sale order expressly enjoined enforcement of any successor liability claims against American.

The Third Circuit affirmed the sale order on a number of grounds. First, the court adopted the reasoning in *Leckie* that under 363(f), "interest in property" is not limited to *in rem* interests but, rather, includes obligations that are "connected to, or arise from, the property being sold".[34] Further, the court noted that the plain language of 363(f)

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[29] 99 F.3d at 581-582.

[30] 286 B.R. 431, 446-447 (Bankr. D. Utah 2002)

[31] *Id.*

[32] *United States v. Knox-Schillinger (In re Trans World Airlines, Inc.)*, 322 F.3d 283 (3d Cir. 2003)

[33] *Id.* at 289.

[34] *Id.* at 289-290, citing its prior analysis of 363(f) and *Leckie* in *Folger Adam Sec., Inc. v. DeMatteis/MacGregor, JV*, 209 F.3d 252, 259 (3d Cir. 2000).

contemplates that a lien is but one type of interest.[35] Second, the court found that both the travel voucher claims and the EEOC claims could be reduced to a money judgment. Third, the court concluded that even if the claims were not interests in property, the transfer of assets free and clear of the claims was supported by the priority scheme provided in § 507(a) of the Bankruptcy Code.[36] To allow the low priority travel voucher and EEOC claimants to seek payment from American while limiting other similarly low priority creditors to the proceeds of the asset sale would be inconsistent with that priority scheme.[37] Finally, the court accepted the reasoning of the bankruptcy court that, absent the extinguishment of the successor liability claims, the sale bid would likely have been discounted substantially and that approving the sale free and clear of such claims was necessary to preserve jobs and to provide funding for other employee-related liabilities.[38]

The bottom line is there is no real consensus among the courts as to the meaning and scope of "interest" as the term is used in 363(f), and as applied in the context of successor liability claims. Stating the obvious, the ability to obtain court approval of a sale free and clear of successor liability claims pursuant to 363(f) may vary dramatically depending on the jurisdiction in which a case is pending, the nature of the particular claims, the relation of the claims to the asset being sold and the overall impact of the sale upon the administration of the case.

Although beyond the scope of this discussion, it is worth noting that selling property through a confirmed plan carries a greater level of certainty since, under § 1141, property may be sold free and clear of *claims* and interests. As a practical matter, however, many debtors do not have the financial ability to maintain their business operations (thereby preserving maximum value as a going concern) throughout what could be a long and expensive plan confirmation process. For such debtors, a quick preconfirmation 363(f) sale may be the only viable option.

C. What about Future Claims and Unknown Claimants?

The problem of unknown or unknowable claimants typically arises in product defect or mass tort cases where the injury occurs prior to the sale, but is unknown to the claimant until after the sale, or where the act giving rise to the injury occurs preconveyance but the injury does not actually occur until after the conveyance of assets. The due process

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[35]Section 363(f)(3) provides:

> The trustee may sell property . . . free and clear of any interest in such property of an entity other than the estate, only if –
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> (3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property.

[36]Section 507(a) sets forth the various categories of claims that are entitled to payment ahead of general nonpriority, unsecured claims.

[37]322 F.3d at 292.

[38]*Id.* at 293.

challenge of providing sufficient notice to such claimants is difficult and may be impossible.

While some courts allow notice by publication, publication in every news outlet in the country is wholly ineffective as to claimants who have not yet been injured or are otherwise not aware that they are at risk of injury in the future. Absent notice of the bankruptcy case and the opportunity to participate in the proceedings, a 363(f) sale will not effectively abrogate successor liability.[39] Although procedures for dealing with the claims of unknown and unknowable claimants may be devised through a chapter 11 plan (e.g., by the appointment of a future claims representative and the establishment of a channeling trust), such protections are not available in the context of a 363(f) sale. Accordingly, a purchaser may not rely solely on a 363(f) sale order for insulation for successor liability claims by unknown claimants.

D. Does The Bankruptcy Court Have Jurisdiction to Enjoin Successor Liability Claims Against the Purchaser After the Bankruptcy Case Has Been Fully Administered?

Even if the debtor and the purchaser are able to obtain a bankruptcy court order approving an asset sale free and clear, whether the purchaser will later be able to seek injunctive relief in the bankruptcy court against successor liability claims after the administration of the bankruptcy case remains uncertain. The purchaser's best bet is being in the right court at the right time. For example, in *Paris Indus. Corp*, the district court affirmed the bankruptcy court's permanent injunction order enforcing its 363(f) sale order against products liability claimants and enjoining the claimants from suing the purchaser on successor liability grounds, even though the claimants had not received notice of the sale.[40]

The court based its decision, in part, on the authority of bankruptcy courts to enforce their orders against collateral attack.[41] By contrast, the First Circuit in *Savage Industries* found the bankruptcy court's injunction improper where the affected claimants had not been afforded notice of either the 363(f) sale or the confirmation hearing, and where the successor liability action did not present a threat to the administration of the bankruptcy case.[42]

CONCLUSION

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[39] *See In re Savage Industries*, 43 F.3d at 721 (In the interest of fundamental due process, creditors who were not afforded "appropriate" notice of the chapter 11 bankruptcy case, chapter 11 plan, or the privately negotiated terms of the asset transfer agreement were entitled to maintain their successor liability claims against the purchaser); *but see In re Trump Taj Mahal Associates*, 156 B.R. 928, 939-940 (Bankr. N.D. NJ 1993) (Due process requires notice that is reasonably calculated under the circumstances to apprise an interested party of the pendency of an action. Constructive notice is all that is required for unknown creditors in order to provide adequate due process).

[40] *Paris Mfg. Corp. v. Ace Hardware Corp. (In re Paris Indus. Corp.)*, 132 B.R. 504, 509-512 (D. Me. 1991).

[41] *Id.* at 508.

[42] *Savage Industries, Inc.*, 43 F.3d at 723; *see also Zerand-Bernal Group, Inc. v. Cox*, 23 F.3d 159 (7th Cir. 1994).

Given the current environment, the purchaser seeking to acquire assets from a bankruptcy estate free and clear of successor liability pursuant to §363(f) faces significant risks, among them the possibility that the court will decline to approve an order extinguishing such liability, as well as the possibility that the court may lack jurisdiction to enforce the sale order, even if granted.