# RECENT DECISIONS LIMIT SCOPE OF PROTECTION FROM SUCCESSOR LIABILITY IN BANKRUPTCY SALE ORDERS

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Decisions in two recent cases raise concerns for those interested in buying assets out of bankruptcy.

The bankruptcy sale process is frequently used by parties interested in purchasing assets, which may be encumbered by various liens, claims, or interests. The bankruptcy code, under certain circumstances, authorizes the sale of a debtor's assets free and clear of liens, claims, and interests. This is meant to allow a buyer to acquire assets without the risk of future claims being asserted with respect to the purchased assets, as well as to maximize the value of a debtor's assets, thereby maximizing creditors' recovery.

Despite this long-held doctrine, recent court rulings have begun to call into question the effectiveness of sale orders purportedly releasing asset purchasers from liability. In *Nationwide Mutual Insurance Co. v. Eagle Windows & Doors Inc.*, the South Carolina Supreme Court held that in order for an asset purchaser to be released from liability, the injured party and the debtor need to have had a relationship prior to the asset sale. In *Morgan Olson, LLC. v. Frederico*, the U.S. District Court for the Southern District of New York similarly held that a § 363 sale order does not extinguish the future claims of those who are not harmed until after the close of the bankruptcy if the future claimant has no notice or opportunity to be heard in the bankruptcy—a violation of the future claimant's due process rights. The district court noted that the U.S. Court of Appeals for the Second Circuit's rulings have been consistent with the "pre-confirmation relationship test" of the U.S. Court of Appeals for the Eleventh Circuit, which the South Carolina Supreme Court followed. Thus, both the South Carolina Supreme Court and the district court held that if the future claimant did not have notice of the bankruptcy, the claim is not barred by the sale order authorizing the sale of assets free and clear, and the purchaser may be held liable.

## Attorneys

James Thoman

## Practices & Industries

Bankruptcy, Restructuring & Commercial Litigation

Financial Services

## *Nationwide Mutual Insurance Co. v. Eagle Windows & Doors Inc.*

The South Carolina Supreme Court case began with homeowners suing a contractor, Gilliam, for installing defective windows. Shortly thereafter, the window manufacturer, Eagle & Taylor Company (Eagle), went out of business, and its assets were purchased by Eagle Windows and Doors (EWD) through a bankruptcy court order providing that the sale of Eagle's assets was "free and clear of all liens, claims, encumbrances, and interests." The sale order further stated that EWD was not a successor in interest to Eagle, and that the sale of assets to EWD would not subject EWD to any liability based on Eagle's prior business. Gilliam settled with the homeowners and filed a contribution suit against EWD as the successor in interest to Eagle. To determine whether Eagle's liability survived the bankruptcy court's sale order, the state court addressed which liabilities EWD was immunized from through its purchase of Eagle's assets "free and clear" of all claims.

Bankruptcy Code § 101(5)(A) defines the term "claim" broadly to ensure that all obligations of a debtor are addressed in bankruptcy, including contingent claims. However, in determining whether the homeowners had a claim against Eagle arising before the sale of Eagle's assets, the South Carolina Supreme Court used a narrower test promulgated by the *Eleventh Circuit in Epstein v. Official Comm. of Unsecured Creditors (In re Piper Aircraft Corp.)*.

In *Piper*, the bankruptcy court appointed a legal representative to set aside monies from the sale of Piper's assets to pay off future product liability claims. When the representative set aside 100 million dollars for future claimants, the Official Committee of Unsecured Creditors and Piper objected on the ground that future claimants did not have "claims," as defined in § 101(5) of the bankruptcy code, against Piper under a pre-petition relationship test. However, in determining the scope of the term "claim," the Eleventh Circuit expanded the pre-petition relationship test. The court expanded the term "claim" to include claims occurring post-petition but prior to confirmation of a plan of reorganization because of the potential for identification of victims during the bankruptcy process. Thus, under the "Piper test," there is a § 101(5) claim, where the events occurring before the bankruptcy confirmation create a relationship, such as contract, exposure, impact, or privity, between the claimant and the debtor.

Adopting the Eleventh Circuit's Piper test, the South Carolina Supreme Court found that Gilliam, standing in for the homeowners as the claimant, did not have a "claim" under Bankruptcy Code § 363(f) because there was no pre-existing relationship between the homeowners and Eagle giving rise to a claim within the meaning of the sale order; the homeowners had only dealt with the contractor before the asset sale. As such, the South Carolina Supreme Court held that Gilliam's contribution claim against EWD was not barred by either the bankruptcy court's sale order or the application of bankruptcy law.

## *Morgan Olson, LLC. v. Frederico*

The case on appeal before the U.S. District Court for the Southern District of New York in *Frederico* involved a personal injury claim against Morgan Olson, the successor company to MS Truck Body Corp.—the purchaser of Grumman Olson Industries' assets. Grumman Olson Industries, a manufacturer of truck bodies, sold a truck to the employer of the injured person prior to filing for bankruptcy in 2003. Pursuant to Bankruptcy Code § 363(f), the bankruptcy court approved the sale of a portion of Grumman's assets to Morgan. According to the sale order, Morgan purchased the assets free and clear of liens

and interests, and the sale order released Morgan from successor liability for claims arising before or as a result of the asset purchase. After the bankruptcy, the employee was injured in the truck made by Grumman, and the employee sued Morgan as Grumman's successor in interest.

The district court's analysis was similar to that of the South Carolina Supreme Court, in that both courts required that future claimants be guaranteed due process, including notice and an opportunity to be heard. The court found that the claimants did not receive adequate notice of their potential claim during the bankruptcy proceedings because during the bankruptcy there was no way to know that the specific claimant would ever have a claim. To take away the claimants' right to seek redress when they did not have notice or opportunity to participate in the proceeding would result in a deprivation of claimants' due process rights. As such, the court held that the claim against Morgan as successor in interest was not barred by the sale order or Bankruptcy Code § 363(f).

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Although the purchasers in the South Carolina case and the district court case took care to eliminate their liability for existing or future claims associated with the asset purchase, and the bankruptcy courts explicitly limited such liability in the sale orders, when later challenged, the courts did not uphold sales free and clear.

These cases serve as a reminder of the limitations of a sale order to protect from successor liability when assets are purchased through a bankruptcy sale. Accordingly, when considering purchasing assets in the bankruptcy context, purchasers should pay particular attention to the nature of the business and include potential successor liability risk when formulating the purchase price.

## For more information, please contact:

James C. Thoman
716.848.1361
jthoman@hodgsonruss.com