

Asset Sales in Bankruptcy: An Important Decision

U.S. bankruptcy law permits debtors-in-possession and trustees to sell assets free and clear of claims, liens and other interests. But a federal judge in New York ruled recently that a purchaser does not necessarily buy free and clear when a product manufactured pre-bankruptcy causes injury after a sale closes. *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). In this situation, the purchaser can remain liable for injuries caused by the asset purchased from the debtor.

In *Morgan*, the debtor, Grumman Olson Industries Inc. (Grumman), manufactured parts for trucks. In 2002, Grumman filed Chapter 11 in the Southern District of New York and sold its assets to Morgan Olson L.L.C. (Morgan) pursuant to Bankruptcy Code sections 363 and 365. The Bankruptcy Court's order approving the sale (Sale Order) provided that the sale 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." *Morgan Olson*, at *4 (quoting Sale Order ¶¶ 4, 14). The Sale Order also provided that the Bankruptcy Court would retain jurisdiction "to interpret, implement and enforce the provisions of the Sale Order." *Id.*, at *7 (quoting Sale Order ¶ 20).

In 2005, the Bankruptcy Court confirmed a liquidating plan for Grumman and closed the bankruptcy case. Then, in 2008, the driver of a truck manufactured with Grumman parts was injured when the truck struck a telephone pole. The driver, Denise Frederico (Frederico), sued Morgan in New Jersey state court, asserting that the truck "was manufactured, designed and/or sold by Grumman in 1994 and was defective for several reasons." *Morgan Olson*, at *8. The complaint alleged that Morgan was liable for Frederico's personal injuries as a successor-in-interest to Grumman based on New Jersey successor liability law.

In 2010, Morgan sued Frederico in Bankruptcy Court to enjoin the state court action. Bankruptcy Judge Stuart M. Bernstein ruled against Morgan and dismissed Morgan's complaint. On appeal, U.S. District Judge J. Paul Oetken affirmed Judge Bernstein's decision, holding that section 363 sales orders cannot bar otherwise viable state law claims that arise after a sale when injuries stem from an asset's pre-bankruptcy defects.

Bankruptcy Code section 363 authorizes sales of debtors' property free and clear of claims for two overriding reasons. First, a suit against a buyer would permit a claimant to receive a better recovery — from the buyer — than other unsecured creditors would receive on their claims against a debtor. Second, asset sales free and clear of liabilities are believed to "induce a higher sale price for the assets, thereby maximizing the value of the estate and maximizing potential recoveries to creditors." *Morgan Olson*, at *22.

Significantly, section 363 sales can take place only after "notice and a hearing." This requirement affords parties "due process" that comports with the U.S. Constitution and is "the cornerstone underpinning Bankruptcy Code procedure." *Id.*, at *29 (quoting *Western Auto Supply Co. v. Savage Arms, Inc. (In re Savage Indus., Inc.)*, 43 F.3d 714, 720 (1st Cir. 1994)). But notice of an asset sale cannot be given to unknown, future claimants — those who are injured after a sale closes. Judge Oetken observed that the "Fredericos did not receive adequate notice of their potential claim in the Grumman bankruptcy proceedings because, at the time of the bankruptcy, there was no way for anyone to know that the Fredericos ever would have a claim. Enforcing the Sale Order against the Fredericos to take away their right to seek

redress under a state law theory of successor liability when they did not have notice or an opportunity to participate in the proceedings that resulted in that order would deprive them of due process." *Id.*, at *38.

The Court acknowledged that its ruling could hinder debtors' and trustees' ability to obtain the maximum purchase price in section 363 sales. Purchasers of businesses that previously sold products that could later cause injuries would bid less by factoring into their bids the cost of potential liabilities. But, the Court further observed, seeking maximum value "is no more fundamental than giving claimants proper notice and opportunity to be heard before their rights are affected, to say nothing of constitutional requirements of due process." *Id.*, at *44. ♦

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