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Buyer Beware: 363 Sale May Not Absolve Successor Liability

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It has long been understood by buyers of assets of distressed companies that once a sale is authorized pursuant to Section 363 of the Bankruptcy Code, the buyer is absolved of any liabilities which may have encumbered the assets of the previous owner, including causes of actions against them. However, a recent decision from the influential United States District Court for the Southern District of New York saddles buyers with the burden of unknown potential future claims.

In *Morgan Olson LLC v. Frederico (In re Grumman Olson Industries, Inc.)*, --- B.R. ----, 2012 WL 1038672 (S.D.N.Y. March 29, 2012), the Court addressed a question never before analyzed by courts in the Second Circuit, and touched upon by few other jurisdictions: "Whether a bankruptcy sale order, pursuant to Section 363 of the Bankruptcy Code … can extinguish the state law claims of third parties based on conduct by the debtor before the bankruptcy, where no injury was caused until after the bankruptcy closed." *Id.* at 1. This adversary proceeding stemmed from a suit brought by a FedEx truck driver ("Frederico") who, having been injured allegedly due to defects in the truck after the debtor's assets were sold in a 363 sale, brought suit against Morgan Olson ("Morgan"), a purchaser of certain assets of the truck manufacturer.

The 363 sale to Morgan was ordered "free and clear of all … claims … and other interests … and all debts arising in any way in connection with any acts of the Debtor." *Id.* at 2. Further, the sale order provided that Morgan would not be subject to "any liability for claims against the debtor or the [purchased assets], including, but not limited to, claims for successor or vicarious liability…" *Id.* Accordingly, Morgan sought declaratory and injunctive relief barring Frederico from suing it on the theory of successor liability.

Despite the clear and unambiguous language in the sale order, the Court, affirming the Bankruptcy Court's reading of its own order, held that Frederico could proceed against Morgan on the theory of successor liability. The Court explained that the "free and clear" language of a 363 sale does not reach far enough to extinguish a claim based on harm which did not become identifiable until after the bankruptcy closed. In fact, explained the Court, future claims, which do not mature into harm to an identifiable claimant until after the bankruptcy closed, do not fall under the category of "claims" discharged in the bankruptcy.

The main concern that underlies the Court's decision was the "enormous practical and perhaps constitutional problems [that] would arise from treating future claims like claims in a bankruptcy." *Id.* at 8 (internal quotation marks omitted). Since "notice is the cornerstone underpinning Bankruptcy Code procedure," and "inadequate notice is a defect which precludes discharge of a claim in bankruptcy," a future claimant, who does not become identifiable until after the bankruptcy has closed, cannot possibly be given proper notice, and therefore is denied due process.

Dismissing Morgan's argument that this holding will lower bids by potential buyers, who will be weary of unexpected liabilities popping up post-sale, the Court held that "to whatever extent maximizing the value of the estate is an important policy of the Bankruptcy Code, it 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 13.

Importantly, the Court did not find liability or even comment on whether a successor liability theory would be appropriate. The only issue the Court resolved was whether the plaintiff would get her day in court.

While this decision is a District Court decision and clearly not binding on most jurisdictions, the persuasiveness of the Court and the fact that many bankruptcy cases file in the Southern District of New York make this decision a significant one, which warrants close attention. Any party considering purchasing the assets of a debtor should consult with knowledgeable bankruptcy counsel to better understand these risks and help work through issues for a successful sale.

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If you have any questions about this decision or its implications, please call your principal Mintz Levin attorney or one of the attorneys noted on this advisory.

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