Momentum continues to shift in favor of buyers of distressed assets, but careful due diligence is still crucial

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Entities proposing to purchase assets from bankruptcy estates typically seek to insulate themselves from the risk that a person with a claim against the debtor/seller will try to impose liability for that claim on the purchaser. Fortunately for buyers, the trend in the case law continues to favor reducing such risks. However, "free and clear" sale orders under Section 363 of the Bankruptcy Code are neither guaranties against successor liability, nor substitutes for thorough presale due diligence and negotiation of protective measures in the purchase agreement.

At common law, a purchaser of assets is not liable for the liabilities of the seller unless: 1) the purchaser contractually assumes the seller's liabilities; 2) the purchase was entered into fraudulently, specifically to avoid the seller's liabilities; 3) the purchaser merges with the seller; or 4) the purchaser is a mere continuation of the seller's enterprise. *See Ricciardello v. J.W. Gant & Company*, 717 F. Supp. 56, 57-58 (D. Conn. 1989). Many states also subject the purchaser to the claims against the seller, to the extent the purchaser continued the seller's "product line" after the sale. *See, e.g., Ray v. Alad Corp.*, 19 Cal. 3d 22 (Cal. 1977). Collectively, these exceptions to the general rule of successor nonliability have been referred to as "successor liability."

Trend favors limiting buyer risk

In order to reduce their risk of successor liability, purchasers of distressed assets have historically attempted to use the bankruptcy court's power under 11 USC §363(f) to effect a sale of the debtor's property "free and clear of any interest in such property." They have aggressively pushed for an expansive reading of the term "interest in such property" in Section 363(f) to include broad categories of "claims," (e.g., tort claims) which may be extinguished through a Section 363 sale. While some courts have suggested that Section 363(f) is limited to liens or direct encumbrances on the property being sold (s*ee e.g., Zerand-Bernal Group v. Cox*, 25 BCD 965 (7th Cir. 1994) (dicta),) the trend in more recent decisions is to adopt the more expansive view espoused by buyers (*see, e.g., In re Trans World Airlines*, 40 BCD 284 (3rd Cir. 2003) (noting trend, and holding that employment discrimination claims against seller/debtor were within scope of "interest in property" for purposes of Section 363(f), so that buyer of seller/debtor's assets could acquire assets free and clear of such claims) and to prevent parties from collaterally attacking the sale order once it has been entered.

Two recent decisions from the 6th U.S. Circuit Court of Appeals further propel this trend. One case, *Al Perry Enters., Inc. v. Appalachian Fuels, LLC*, 48 BCD 244 (6th Cir. 2007), involved a coal supplier debtor that sold substantially all of its assets and executory contracts to a purchaser under Sections 363(f) and 365 of the Bankruptcy Code. Prior to the bankruptcy, Perry had earned commissions assisting the debtor in securing coal supply contracts, but some of those commissions remained unpaid. In its successful bid, the buyer assumed one of the coal contracts Perry had helped secure, but did not explicitly assume the debtor's obligation to Perry. Perry received notice of the sale but failed to object, believing that the language of the sale agreement by which the buyer assumed the coal contract Perry had helped secure was broad enough to assume the obligation to pay Perry's commission relating to such contract. However, the Sixth Circuit read the assumption language narrowly and determined that the buyer did not assume the obligation to pay Perry's claim. Furthermore, it held that the bankruptcy court's order authorizing the sale "free and clear" of claims barred Perry's claim against the buyer insofar as Perry had received notice of the potential sale and its preclusive effect on Perry's claim, and yet failed to object.

Giving further finality to bankruptcy sales, the 6th Circuit, in *In re Parker*, 499 F.3d 616 (6th Cir. 2007), held that a bankruptcy court properly stayed a state court action brought by the debtor to recover on a legal malpractice claim that had been sold by the bankruptcy estate's Chapter 7 trustee pursuant to Section 363, but which the debtor asserted had never been part of the bankruptcy estate. The court held that the sale satisfied the good-faith test of Section 363(m) of the Bankruptcy Code and that the debtor, who had notice of the sale, did not seek a stay or appeal of the original order, and was therefore barred from attacking the order collaterally in state court or elsewhere.

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Abundance of caution still warranted

Notwithstanding the trend of courts to protect buyers from claims originally asserted against the debtor, buyers should not be lulled into a sense that the "free and clear" sale orders are as protective as they may seem. Rather, buyers should continue to take steps in their due diligence to reduce successor liability risk. For example, *TWA*, *Perry* and *Parker* all involved claimants who had notice of the bankruptcy prior to asserting their claim against the successor. However, a plaintiff's case is clearly stronger against the successor/buyer in instances where either the debtor made no effort to provide for future unknown claims at the time of the bankruptcy, or where the plaintiff had no notice of the debtor's bankruptcy, no opportunity to pursue a claim in it, or no presale relationship with the debtor. *See, e.g., White v. Chance Industries, Inc. (In re Chance Industries, Inc.)*, 367 B.R. 689 (Bankr. D. Kan. 2006) (allowing a boy who was injured on a defective amusement park ride shortly after confirmation of the ride-maker's Chapter 11 plan to proceed against the debtor's successor on a products liability claim, based on the lack of a prepetition relationship between the boy and the debtor, and the failure of the debtor to establish reserves for future unknown claims in its bankruptcy, or to appoint a future claims representative). Thus, despite the pro-buyer trend in successor liability cases, buyers and their counsel should still take action to reduce successor liability risk, including by:

- Aggressively investigating the debtor's history and litigation files to identify potential unknown claims, and requiring as a condition of the sale that the debtor send notice to such potential claimants;
- Seeking to eliminate indicia of continuity that may otherwise render the buyer a successor of the seller, such as by changing the name of the purchased business post-closing;
- Establishing post-closing price holdback escrows for potential successor liability claims (to indemnify the buyer) and, if feasible, conditioning bids on the debtor providing a reserve for future unknown claimants in its plan; and
- Negotiating, if available, an assignment of insurance policies from the debtor to the buyer covering the types of potential successor liability claims likely to arise.

In short, a broad "free and clear" sale order, while clearly necessary to help protect against successor liability claims, may not be sufficient, and is certainly no substitute for thorough pre-sale due diligence and the negotiation of protective contractual provisions. ■

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Consumer bankruptcy filings up 40% in 2007

Consumer bankruptcy filings increased nearly 40 percent in 2007 from the previous year, according to the American Bankruptcy Institute's review of data from the National Bankruptcy Research Center. Consumer filings reached 801,840 in 2007, and 573,203 in 2006.

Filings are expected to continue to rise in 2008, as the home mortgage crisis exacerbates consumer debt loads, said ABI Executive Director Samuel J. Gerdano.

The data also revealed however, that December filings were 7.5 percent lower than a month earlier. Chapter 13 filings constituted 38.32 percent of all consumer cases in December, a slight decrease from November. ■

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